Honorable Patricia L. Collins
Los Angeles Superior Court Judge, retired
1900 Avenue of the Stars, Suite 250
Los Angeles, California 90067-4303
(310) 201-0010 PH
(310) 201-0016 FAX
Email: judgecollins@adrservices.org

Referee

SUPERIOR COURT FOR THE STATE OF CALIFORNIA

FOR THE COUNTY OF LOS ANGELES- WEST DISTRICT

NAPOLEON PICTURES LIMITED, a California corporation, Plaintiff, v. FOX SEARCHLIGHT PICTURES, INC., a Delaware corporation; and DOES 1 through 10, inclusive, Defendants.	CASE NO. SC 113978 [Hon. Bobbi Tillman, Department M] **Proposed STATEMENT OF DECISION** **Complaint filed: August 30, 2011**

I.

PRELIMINARY MATTERS

On August 30, 2011, Plaintiff NAPOLEON PICTURES LIMITED ("Napoleon") filed a Complaint against defendant FOX SEARCHLIGHT PICTURES, INC. ("Searchlight") asserting causes of action for Breach of Contract, Negligent Misrepresentation, Promissory Estoppel, Reformation and Accounting. Napoleon's claims related to Searchlight's participation obligations to Napoleon upon Searchlight's 2004 acquisition of Napoleon's film, Napoleon Dynamite ("the Picture"). Napoleon initiated the lawsuit following a two-year audit of Searchlight's participation statements. As a result of the audit, Napoleon concluded that Searchlight had underreported revenues, miscalculated participation percentages and breached its contract obligations.

On October 4, 2011, Plaintiff Napoleon and defendant Searchlight filed a Stipulation For Order Appointing the Honorable Patricia Collins (retired) as Referee pursuant to Code of Civil procedure § 638 on grounds that the parties had entered into a written contract providing that any controversy arising from that agreement be heard by a Referee. On October 4, 2011, Los Angeles Superior Court Judge Hon. Linda Lefkowitz entered an Order appointing the Honorable Patricia Collins (retired) pursuant to Code of Civil procedure § 638 to hear and determine any and all of the issues in this action, whether of fact or law, and to report a statement of decision to the Court. Subsequently, the Honorable Patricia Collins (retired) presided over a trial by reference of this matter, held June 4-8, 11, 18, 25, 2012, July 2-3,18-19, 2012 and August 20-21, 2012.

On June 25, 2012, Napoleon moved to amend its Complaint to add claims based on evidence adduced during the trial relating to an MTV profit participation, and to fees charged against merchandising revenue. Searchlight did not object to the amendment, provided it was given time to conduct additional discovery and present additional witnesses to defend the new claims. The Referee granted the Motion and on July 9, 2012, Napoleon submitted an Amended Complaint for Breach of Contract, Promissory Estoppel, Fraud, Negligent Misrepresentation, Reformation and Accounting. Napoleon withdrew its Fraud Cause of Action by email dated July 12, 2012, representing that it would pursue its new claims as part of its cause of action for breach of contract. Searchlight did not oppose this Amended Complaint, as subsequently modified, reserving its defenses based on Statute of Limitations and the Incontestability provision of the Agreement.

Over the fourteen trial days, numerous witnesses were called and gave testimony, videotaped deposition testimony was played, and physical evidence introduced and received. Following oral arguments on August 21, 2012, and the subsequent submission of proposed rulings on objections to certain deposition testimony, this matter was submitted. The Referee herein submits her Proposed Statement of Decision.

//

//

//

II.

FACTS

On November 23, 2003 Napoleon retained Cinetic to represent it in the licensing of the Picture and all related rights in all media for exploitation of the Picture worldwide. Napoleon had produced the Picture for a budget of approximately $404,000 (before obtaining music rights and miscellaneous deliverables that eventually brought the total to approximately $1.1million). Cinetic agreed that it would assist Napoleon with the "negotiation, and together with Sloss Law Office, LLP, documentation of distribution and licensing agreements for the Picture and with overseeing the legal aspects of delivery". [Exhibit ("Exh.") 3]. In consideration for the services of Cinetic and Sloss Law Office LLP, Napoleon agreed to pay Cinetic 10% of all license and related revenue.

John Sloss was an experienced entertainment attorney who had a reputation as an aggressive negotiator. A principal at Cinetic and the Sloss Law Firm, he had a very close relationship with Joseph DeMarco of Searchlight, and to date has negotiated at least ten other films with Searchlight and DeMarco, who died in June 2008. The first film Searchlight acquired through Sloss was *The Brothers McMullen* in 1995. That film was a large success for Searchlight. Sloss negotiated a 30% home video royalty rate with no distribution fee for *The Brothers McMullen*. This negotiated 30% home video rate, according to the Term Sheet [Exh. 195], applied to "Home Video Royalty". All payments for this film acquisition, unless otherwise addressed in the Term Sheet, were to be in accordance with a Participation Definition, which was incorporated by reference as Exhibit A. The Participation Definition [Exh. 196], entitled and referenced also in the Term Sheet as "Definition of Gross Receipts & Distribution Expenses/Acquisition", did not specifically define "Home Video Royalty", as referenced in the Term Sheet, but did address in subsection (ii) "Home Video Receipts". Under subparts (A) and (B) in the Participation Definition, captioned "Sales" and "Rentals", respectively, the boilerplate reference to "20%" was inter-delineated to read "30%". Subpart (D) "Economy Line Sale", was not inter-delineated and maintained the original preprinted royalty rate formula (providing for a reduction from 20% depending on the discounted sale price). As the subparts defining "Sales" and "Rentals" were inter-delineated, Searchlight apparently agreed to a 30% royalty rate for both, but did not alter the royalty for "Economy Line" video sold at a discount.

Shortly after the sale of *The Brothers McMullen*, Sloss negotiated the acquisition of *She's the One* where Sloss obtained a 40% video royalty rate for, what is described in the Term Sheet as, "High Price Product", again with no distribution fee. [Exh. 197]. The Term Sheet incorporated by reference a Participation Definition described as "Definitions of Gross Receipts/ Expenses Acquisition". The relevant Participation Definition was in fact entitled "Definitions of Gross Receipts & Distribution Expenses/Acquisition." [Exh. 198]. That Definitions did not define the term "High Price Product", but did include defined categories of Home Video Receipts entitled "Sales" (which were wholesale sales), "Rentals" (which were revenues based on rentals) and "Economy Line Sales." The definition for "Economy Line Sales", included a subpart entitled "High Price." *High Price was defined as the highest wholesale list price for sale of cassettes to wholesale dealers effective on the first date of release of a Picture.* Economy Line Sales were essentially sales at least 20% *below* the "High Price." By deduction and inference, the reference in the Term Sheet to "High Price Product" necessarily excluded Economy Line. It is not clear if the reference includes both "Sales" and "Rental".

The next film that Sloss sold to Searchlight was *Super Troopers,* in which Sloss negotiated a home video rate of 31.66% royalty *less* a 25% distribution fee. The effective royalty rate was thus 23.75%. DeMarco refused to give Sloss the royalty rate previously given for *She's The One,* and Searchlight also insisted on a distribution fee.

Generally, actors, directors and producers involved in films that are in production receive a 20% royalty. Sloss contended that Searchlight should pay a higher royalty for the films he was selling, as Searchlight was acquiring a completed film as opposed to producing a movie where the finished product remained to be seen. With a finished product where the filmmakers had covered the production costs, a completed film was far less speculative, according to Sloss. However, because of the "quality of the company and considering the magnitude of the advances [Searchlight] paid and considering Joey's representations to me that this was all he could ever do and would never do better," the 23.75% effective rate offered for *Super Troopers* was acceptable to Sloss. The Term Sheet [Exh. 32] refers to a royalty of 31.66% for "High Price Product Royalty" and incorporates the Definition of Net Profits/Acquisition. But when Sloss received the Definition, he noticed High Price included only rental and the "Sell-through" royalty rate was only 10%. [Exh. 173]. When he confronted DeMarco, DeMarco responded that this 10% boilerplate provision did not reflect their deal and would not materially affect the overall effective royalty negotiated, that the structure of the rate was something "particular to the bureaucracy within Fox" and "not worth the fight." According to Sloss, DeMarco assured him it would be negligible, as it would apply only to marked down video. As Sloss trusted DeMarco, he did not insist the language be changed.

Thereafter, Sloss negotiated three additional movies with DeMarco prior to their negotiating the acquisition of the Picture --i.e., *Waking Life, The Deep End, and Kissing Jessica Stein.* Sloss maintained that he obtained the same effective royalty rate on all three films, with the 10% rate allegedly limited only to cost plus or bargain bin sales. The Term Sheets for both *The Deep End* and *Kissing Jessica Stein* referenced a 31.66% rate for "High Price Product Royalty" and incorporated a Definitions of Net Profits. In documenting *Kissing Jessica Stein,* Sloss agreed to adopt the pre-negotiated Definition of Net Profits, which Definition does not contain a definition captioned High Price Product Royalty. It does define "High Price Royalty" and "High Price Sales." The former provides for a 20% royalty for "High Price Sales." High Price Sales is defined as sales generally intended for rental to the public. The Definition provides for a 10% royalty for "Sell-Through", defined as sales intended for purchase by the public. [Exh. 17]. In each acquisition, according to Sloss, "there was always the 10% in the boilerplate" and a representation by DeMarco that it would be negligible as it would apply to cost plus sales only.

In January 2004, Cinetic arranged for the Picture to show at the Sundance Film Festival. Immediately after it first screened on January 17, 2004, the Picture generated huge interest, including from David Gale of MTV. Sloss however quickly arranged to meet with Searchlight as he not only had a close relationship with DeMarco, but he believed that Nancy Utley was an "inspired" marketer at Searchlight who would know how to market the film, and that Searchlight would be the best distributor. Sloss was particularly interested in obtaining a large advance, as well as a favorable home video royalty rate for the Picture, as video at the time was a much larger source of revenue than theatrical. Sloss negotiated privately with DeMarco who confirmed that nothing had changed at Searchlight relative to the effective distribution rate Sloss could obtain for home video. Sloss reached a deal with DeMarco on January 18th at Sundance, with Searchlight paying an acquisition price of $4.75 million, and targeting a June 2004 release date, which was very unusual. Napoleon also received contingent compensation of 50% of "Remaining Gross Receipts", less distribution expenses, the acquisition price, and a 30% distribution fee on all media except home video, the distribution fee for the latter being 25%.

According to Sloss, and undisputed by Searchlight, Searchlight would only agree to a royalty deal on home video and it also insisted on taking a distribution fee against the royalty. Knowing that the minimum or standard royalty rate for home video was 20%, Sloss intended to obtain a greater than minimum rate for his client Napoleon. Sloss understood that home video at the time was the most significant back end revenue and was a critical term as far as Sloss was concerned. Hence, he purportedly again negotiated the 31.66% royalty rate, less the 25% distribution fee, resulting in a 23.75% effective royalty rate, and achieving Sloss' goal of obtaining a better than average rate. This was the same rate Sloss had obtained for *Super Troopers,* and according to Sloss, the best rate DeMarco could allow on behalf of Searchlight.

In negotiating the home video royalty rate, Sloss purportedly asked DeMarco if anything had changed at Fox that would "make this different than the other deals in terms of the effective negotiated rate for home entertainment being the 31.66 percent with a 25 percent distribution fee for the great, great majority of revenue, and he confirmed that nothing had changed and that would be the case." Sloss testified that he and DeMarco specifically discussed bargain bin sales: "that was part of the confirming conversation as to whether the 10% that would *invariably* show up eventually or apply to sell through would be for cost-plus drastically marked down."

Sloss and DeMarco memorialized their agreement in a Term Sheet. [Exh. 25]. The negotiated royalty for home video is referenced in the Term Sheet in subparagraph 6(f) entitled "<u>Participation Terminology</u>", which reads as follows:

"Payment of any amounts provided for hereunder and all other terms and conditions related to such amounts shall be in accordance with the terms and conditions set forth herein or,

if not addressed herein, in Searchlight's Definitions of Net Profits (High Price Product Royalty shall be 31.66%, with Schedule '1' - Glossary attached thereto ('Participation Definition'). [Exh. 25]. The Term Sheet did not attach the Definition.

The Participation Definition is essentially a comprehensive document describing in meticulous detail how participation payments are to be calculated and rendered. It defines all of the applicable terms, states all applicable rates and defines the treatment and interplay of all revenue and expenses. According to Sills, the purpose of a definition is "to assist in defining certain terms that would be used in the preparation of profit participation statements on behalf of the participant." The A-level Definition is a "pre-negotiated" document with preferential terms, typically included as an "Exhibit A" to the various documents comprising an acquisition and participation agreement. Searchlight offers an A-Level" participation Definition in its acquisitions on a "take it or leave it basis", contending it has been "pre-negotiated" and offers the best terms.

Sloss contends that he understood, based on his conversations with DeMarco, that the reference to "High Price" in the Term Sheet included all home video sales, as distinguished only from video sales that were sold at a discounted price. Sloss purportedly did not distinguish between *rental* and *sell through* in negotiating with DeMarco, as the price for rental and sell-through was beginning to equalize, with rental no longer being a higher priced item. Moreover, Sloss understood that sell-through was beginning to exceed rental in terms of market share. According to Sloss, DeMarco and Sloss had discussed the concept of high price product in previous deals (*Super Troopers, Kissing Jessica Stein, Waking Life)* where Sloss contends DeMarco had confirmed that high price meant almost all home video, except bargain bin. DeMarco had previously represented that only bargain bin sales would generate the lesser 10% royalty rate and would encompass a de minimus level of sales. Sloss testified that he reconfirmed with DeMarco their prior understanding that despite the boilerplate in the definition, the 10% royalty would only apply to bargain bin sales.

Subparagraph 6(e), entitled "Third-Party Participants" provided that Napoleon was "solely responsible for all payments to third-party participants in the proceeds of the Picture (excluding SAG residuals)." The Term Sheet also directed Searchlight to pay 10% of any payments due under Paragraph 6 directly to Cinetic Media.

Sloss had so much trust in DeMarco that he allowed Searchlight two days to sign the Term Sheet at Sundance, operating in the interim on a handshake.[1] The Term Sheet was finally signed on January 20, 2004. Paragraph 21 provided: "*More formal documentation memorializing the parties agreement will be prepared, and will contain the balance of the terms governing this agreement, which other terms shall be in accordance with Searchlight's standard agreements of this type subject to good faith negotiations within Searchlight's usual parameters; in any event, however, this shall represent the valid and binding obligations of Searchlight and Licensor with respect to the subject matter hereof. matter hereof.*" (sic)

Paul Brennan, a transactional entertainment lawyer at the Sloss firm, was responsible for ensuring, on behalf of Napoleon, that the documentation reflected the terms of the agreement that Sloss had negotiated. After Sloss and DeMarco negotiated the material terms memorialized in the Term Sheet, Brennan negotiated the long form paperwork with Jamie Taylor, in house legal counsel at Searchlight. At the time of the Napoleon Dynamite transaction, 25% of Brennan's practice was independent film acquisition transactions. On February 20, 2004, Searchlight provided Brennan with a draft of the Standard Terms and Conditions, which supplemented the Term Sheet. [Exh. 28]. This letter enclosed 19 various Exhibits and Schedules that the Standard Terms referenced. Taylor did not enclose a copy of the Participation Definition.

When after four weeks Brennan did not reply to Taylor's February letter, Taylor began sending weekly reminders to Brennan. [Exh. 45-6]. Brennan finally responded with his comments on April 7, 2004. [Exh. 39]. On April 16, 2004, Taylor sent another draft of the Standard Terms to Brennan, and again did not enclose the Participation Definition. [Exh. 40]. On May 7, 2004, Taylor again wrote to Brennan sending a further revised Standard Terms with seven Exhibits, all of which Exhibits needed to be signed by Napoleon or its principals and returned to Taylor. This letter advised Brennan that upon counter signature, Taylor intended to

---

[1] Had Searchlight backed out of the acquisition prior to signing, the impact on Sloss' ability to negotiate a deal with another distributor would have been disastrous, according to Sloss.

return "additional copies of all Exhibits and Schedules, and the 'A-Level' Definition of Defined Net Proceeds/Acquisition with Glossary for your files." [the 'A-Level' Definition of Defined Net Proceeds/Acquisition with Glossary hereinafter referenced as "the Definition"]. Brennan did not inquire or request a copy of the referenced Definition.

On May 10, 2004, Taylor wrote to Brennan that upon review of his files, he could not determine whether he had sent Brennan a copy of the "A-Level" Rider, the Definition of Defined Net Proceeds/Acquisition. Taylor also advised that the Term Sheet referred to "our obsolete Definition of Net Profits." Taylor represented that Brennan "should find the Definition of Defined Net proceeds/Acquisition tracking the Definition of Defined Net Proceeds which was used on 'CLUB DREAD', with the exception of the term 'acquisition price' being substituted for the term 'production charges' (in the 'CLUB DREAD' document) and there is no 'Agreed Over-budget Deduction.'" [Exh. 44]. The Definition used in CLUB DREAD provided for a single 20% royalty rate.

Taylor dictated the May 10, 2004 letter and asked his assistant Sheila Jane Moore to prepare and send this letter. It was Taylor's practice to place the dictated tape on Moore's desk and include on the tape instructions regarding what enclosures were to accompany the dictated letter. Although Moore did not have a specific recollection of this particular letter, according to her usual practice, Moore would have typed the letter and at the bottom of the letter typed the abbreviation: "Encl.", indicating that she was enclosing a document with the cover letter. The "Encl." notation on the bottom of Exhibit 44 thus indicates that she enclosed the referenced Definition when mailing this cover letter. Moore believed she then faxed the letter to Brennan, as evidenced by the fax cover sheet contained in Exhibit 44, but did not fax the Definition. She instead noted on the fax cover sheet, that the "Attachment to above cover letter sent via U.S. mail." The attachment to which she was referring was Exhibit A, Definition of Defined Net Proceeds. As her general practice, Moore did not fax the Definitions, as the document was approximately fifty pages long and contained shaded portions that became illegible when faxed.

Instead, consistent with her practice, Moore would have faxed the May 10 cover letter and prepared the A-Level Definition of Defined Net Proceeds/Acquisition as an enclosure to accompany the original May 10 cover letter for mailing to Brennan. The first page of the

Definition would be personalized with reference to the particular film, here, Napoleon Dynamite. Moore could tell that Taylor had prepared the first page of the Definition here as it is dated Saturday May 8, 2004. Taylor would have accomplished this by inputting into a computer the information pertinent to the particular transaction, here the film Napoleon Dynamite. After this information is inputted, the page is printed. Whether prepared by Moore or Taylor, this first page would print on a printer in Moore's cubicle. Moore would retrieve the balance of the Definition from a bin in the copy room where several sets of the Definition, clearly marked as the A-Level Definition for acquisitions, were typically available. She would have prepared copies for Searchlight Central Files [Exh 172] and also copies for Taylor's personal file, and would have placed the envelope containing the Definition and May 10 cover letter in the basket where outgoing mail was regularly collected. The copies that were maintained for Central Files and Taylor's file would differ from the original sent to Brennan, as the latter would not contain the "bcc" distribution list. Moore would have also maintained the fax confirmation sheet in Taylor's file, but not the fax cover sheet.

When Taylor signed Declarations in support of Searchlight's Motion for summary adjudication, and in reply to an opposition to that motion, he asserted incorrectly that he had mailed and faxed the Definition. In fact, he did neither. He merely instructed Moore to send the letter and the Definition to Brennan. While Moore did not directly place the envelope in the U.S. Mail, she had no reason to believe that after following her usual procedure and placing the Definition in the outgoing mail bin, it was not stamped and sent through the mail system.

The Sloss firm received the faxed cover sheet and faxed May 10 cover letter as they were subsequently found in the Sloss files and produced in discovery. The Sloss firm was never able to locate a copy of the Definition during discovery. Neither Brennan nor Sloss can recall if he ever received the May 10, 2004 letter or the Definition. Neither claims to have relied at all on the representation that the Definition tracks the Club Dread Definition. Brennan testified that he would not have been "particularly concerned" about obtaining a copy of the Definition as there were "something like a dozen exhibits" and the executed Term Sheet contained the material terms. When the Sills firm was retained to audit the Participation Statements, it was provided various documents by either Jeremy Coon or the Sloss firm. In discovery, the Sills firm produced the following documents in this order: Standard Terms and Conditions - Distribution Rights Acquisition Agreement dated as of January 18, 2004, with Exhibit A, Glossary, Exhibits E-1, E-2, G, H-1, H-2, K-1 and K-2.

On May 12, 2004, Taylor again wrote to Brennan, enclosing another version of the Standard Terms for signature, along with the various Exhibits that required signatures. [Exh. 90]. Again, Taylor ended the letter with the representation that upon counter signature, Taylor intended to return "additional copies of all Exhibits and Schedules, and the 'A-Level' Definition of Defined Net Proceeds/Acquisition with Glossary for your files." On May 20, 2004, Brennan sent Taylor partially executed Standard Terms and Exhibits.

The Definition was in fact sent to Napoleon at some point in time, as Jeremy Coon, President of Napoleon, had a copy. Neither Brennan nor Sloss ever requested a copy of the Definition at any point before the Term Sheet was signed or prior to advising their client to execute the Standard Terms and Conditions. Purportedly, Napoleon, as distinguished from its agents, did not receive a copy before Coon signed the Standard Terms.

On June 11, 2004, the Picture was theatrically released.

Meanwhile, shortly after execution of the Term Sheet, Searchlight and MTV began discussions relative to MTV marketing and branding the Picture. As MTV had an exclusive arrangement with Paramount, Paramount needed to consent to the arrangement. To obtain Paramount's consent, Searchlight had to agree to a Co-Financing Agreement with Paramount, wherein Searchlight and Paramount shared the costs of distributing the Picture equally, as well as shared 50% in all revenues due Searchlight under its Agreement with Napoleon. Searchlight was to distribute the film domestically and in certain limited foreign countries, while Paramount had the option to distribute the Picture in all other foreign territories. In the initial draft of the Co-Financing Agreement, the enumerated contracting Parties included MTV, and MTV was required to provide marketing, branding and promotional services. In consideration, MTV was to receive a 5% Participation. The final Co-Financing Agreement was ultimately executed only as between Searchlight and Paramount. [Exh.42]. MTV executed a separate Marketing and Branding Agreement with Searchlight, wherein it was required to provide "*marketing/branding, advertising, publicity and promotional support*" for the Picture, including on-air support at a level outlined pursuant to a predetermined On-Air Plan. [Exh. 441]. MTV was entitled to contingent compensation in an amount equal to 5% of 100% of "Defined Gross Proceeds," with permutations apparently not relevant here. The applicable Contingent Compensation was to be computed in accordance with Fox's Definition of Defined Net Proceeds/Acquisition.

Exhibit "P" to the Co-Financing Agreement between Searchlight and Paramount is captioned Schedule of Third Party Percentage Participations. This exhibit recites Napoleon's Participation and tracks Paragraph 6 of the Term Sheet [Exh. 25] in almost identical verbiage, although Exhibit P omits subparagraph (a) in the Term Sheet, captioned Acquisition Price. In reciting the Napoleon Participation Terminology, Exhibit P reads:

> "Payment of any amounts provided for hereunder and all other terms and conditions related to such amounts shall be in accordance with the terms and conditions set forth herein or, if not addressed herein, in Twentieth Century Fox Film Corporation's Definitions of Net Proceeds/Acquisition (<u>provided however, the</u> High Price Product Royalty shall be 31.66%, <u>in lieu of the 20% provided therein</u>), with Schedule '1' - Glossary attached thereto ('Participation Definition')." *(underscore added.)*

In comparison, the Term Sheet reads as follows:

> "Payment of any amounts provided for hereunder and all other terms and conditions related to such amounts shall be in accordance with the terms and conditions set forth herein or, if not addressed herein, in Searchlight's Definitions of Net Profits (High Price Product Royalty shall be 31.66%, with Schedule '1' - Glossary attached thereto ('Participation Definition').

Exhibit P specifically calls attention to the fact that the 31.66% royalty rate is replacing a 20% royalty rate, while the Term Sheet does not.

Napoleon did not know that Searchlight had given MTV a 5% Participation. Nor did Napoleon know that Searchlight would deduct this MTV Participation from Gross Receipts as an advertising expense. The amount of the MTV Participation was ultimately included in Searchlight's Distribution Expenses in the Participation Statements, but was not called out separately as a payment to MTV or a profit participation. The Definition allowed Searchlight to deduct as a distribution expense all costs incurred that "Fox may determine in good faith" are directly related to or allocable to "the advertising, publicizing and promoting of the Picture in any way, including ... "Costs of purchasing advertising time on ... television ... ." [Exh. 68, page 22-23]. Pursuant to the Marketing and Branding Agreement, MTV created Interstitials that consisted of new footage with the actors, as well as footage from the film, that were shown on MTV between June 7, 2004 and August 6, 2004 to promote the Picture. MTV and Searchlight valued this airtime at over $4 million. The airtime that MTV allocated to these Interstitials was not taken from its inventory of commercial time, but from inventory allocated for promotion of MTV programming. Since the inception of the Agreement, Searchlight has expensed against gross receipts approximately $2.75 million as MTV advertising expenses paid as the 5% participation.

The Agreement between Searchlight and Napoleon required Searchlight to make payments according to a schedule defined in the Definition and to provide Participation Statements in summary form according to a defined schedule. Napoleon had detailed audit rights under the Agreement. Additionally, the Definition contained an "Incontestability" provision that renders any transaction correct if an objection is not filed within 42 months from the date of mailing of the Participation Statement. If the objections are not resolved, the objection is deemed waived unless Napoleon institutes an action within 6 months after the expiration of the 42-month period.

On July 22, 2004, Searchlight sent fully executed copies of the Standard Terms, Exhibits, Schedules and the Definition to Brennan. [Exh.31]. Paragraph 1 of the Standard Terms, entitled "Definitions," reads as follows: "*All terms initially capitalized are specifically defined terms and shall be defined as set forth in the documents in which they appear within quotation marks in the Main Agreement and any of the documents referenced in Paragraph 20, thereof, including these Standard Terms and Conditions (collectively, 'Agreement').*" [Exh.20]. The "Main Agreement" is defined as the Term Sheet dated January 18, 2004. Paragraph 20 in the Term Sheet does not refer to documents, but to "Assignment of Payments." Instead, Paragraph 21 in the Term Sheet does provide in pertinent part: "More formal documentation memorializing the parties agreement will be prepared, and will contain the balance of the terms governing this agreement, which other terms shall be in accordance with Searchlight's standard agreements of this type subject to good faith negotiations within Searchlight's usual parameters; … ." Despite the back and forth drafts, both Taylor and Brennan missed this error in referencing Paragraph 20 instead of 21.

On July 11, 2006, Napoleon notified Searchlight of its intent to exercise its audit rights and appointing Steven Sills as its auditor. Searchlight consequently put this audit notice in its "audit queue", as Searchlight can only accommodate a limited number of audits at any given time. Sills had other audit requests on behalf of other clients in the Searchlight queue as well. Not until August 2008, did Searchlight notify Sills that he could begin the audit in August 2008. The parties agreed to delay, however, so that they could include the September 2008 participation statement in the audit. That Statement was prepared in November and consequently Sills began the audit on behalf of Napoleon in December 2008. The time between Napoleon's notice of intent to audit and the beginning of the audit was not atypical and can be longer for other studios.

Once the audit fieldwork began, Searchlight provided Sills' team with a workspace on the Searchlight premises, along with the work papers for the Napoleon Participation Statements. The work papers remained at the workspace assigned to Sills' team throughout their fieldwork, although they were free to make copies to take with them. As the audit proceeded, Sills' team would identify certain transactions and request the underlying detail. For example, they requested a printout of every distribution expense. Thereafter, they identified certain of those expenses and requested the back up documentation. The fieldwork proceeded until completed in approximately October 2010.

On December 10, 2010, Sills, who had since merged his practice with Green Hasson James (hereinafter referenced as the Sills Firm for simplicity), submitted a draft audit report to Napoleon, with a copy to Sloss. On December 21, 2010, Sills submitted a revised draft report to Napoleon. [Exh. 151]. Both of these reports assumed a 10% "sell-through" home video royalty rate. The latter also added a claim that Searchlight had misclassified certain high price sales as "sell-through." Neither of these draft audit reports included a claim that "sell-through" should have earned a 31.66% royalty, rather than 10%. On January 24, 2011, the Sills Firm again revised their draft audit report. [Exh. 153]. This report assumed that Sloss had negotiated with

DeMarco an overall 25% home video rate for both high price and "sell-through" and applied this 25% royalty across all home video.

On February 10, 2011, Sills met with Steve Kaplan and Jose Garza to review a draft of the final audit report. Sloss subsequently submitted a final audit report to Sloss on February 14, 2011, requesting that Sloss forward the final report to Steve Kaplan at Fox. [Exh. 155]. This report contained a claim #5 for underreported Paramount home video, adopting the 31.66% and 10% rates, applied to high price and sell-though respectively, and describing Paramount as a "sub-licensee". Claim No. 6 read as follows:

"Claim No. 6. Understatement of Home Video Royalties:

The Agreement provides for a 31.66% royalty on 'High Price' receipts and a 10% royalty on 'Sell Through' receipts. You have informed us that during the negotiation of the Agreement, Fox's representatives informed you that they anticipated a net overall royalty rate of 25%."

Due to the change in the home video marketplace, from a rental market to a sell through market, 87% of the Picture's video sales were at the lower rate, resulting in an overall video royalty rate of 12.88%. It should be noted that this rate is approximately one-half of the industry standard minimum rate of 20%.

Had Fox reported to you based on the 25% overall rate provided to you during the contract negotiations, home video royalties would have been increased by $16,894,429. "

On February 16, 2011, Sloss submitted to Searchlight a final audit report, modified slightly from the February 14th version. The February 16th version contained the identical Claim No.6 for Understatement of Home Video Royalties asserting the 25% overall rate, but renumbered the claim as Claim No.5. [Exh.12]. This version of the final report contained fifteen claims seeking adjustments from Searchlight, but omits the above referenced original Claim #5 regarding the Paramount understated home video. Prior to submission of this February 16th report, Searchlight had conceded certain claims and the report notes that, as to those conceded claims, Searchlight agreed to correct the errors.

Throughout the fieldwork of the audit, the Sills audit team assumed the Definition Exhibit A was the applicable Definition. In approximately November-December 2010, Sills noticed that the home video gross appeared low and consequently made inquiry of his audit team and subsequently of his client. Based on information subsequently obtained from Sloss regarding his version of his agreement with DeMarco, and after Sills reviewed deposition testimony, Sills concluded that the Definition Exhibit A did not apply to the Napoleon agreement. On May 12, 2012, Sills submitted to Searchlight a modified supplemental audit report. This report incorporates Sills' conclusion that the Definition Exhibit A did not apply to the Napoleon contract with Searchlight. [Exh. 146]. This report applied a 31.66% royalty rate to all home video, without differentiating between "sell-through" and high price. Sills did not segregate any sales as "bargain bin" and apply a 10% rate, as there was no delineation in the Searchlight records of sales categorized as "bargain bin." Various of the 15 Claims made in this report, as well as the February 2011 report, were subsequently conceded by Searchlight just prior to the trial of these claims and were paid.

As of the date the trial commenced, the following Napoleon Claims remain disputed:

<u>Claim No. 4:</u> Electronic Sell Through (EST) is equivalent to "Pay Television" as the video is merely transferred electronically with no distribution costs, and should consequently be paid as "Pay Television", not Home Video. The only difference between EST and Video on Demand (VOD) is the delivery mode. If there is no Definition that applies, both EST and VOD should be paid 100% on the gross, not based on a royalty, resulting in a Claim of $121,095. The net claim, after deducting the 30% distribution fee, is $84,767. Napoleon's share is 50% of this amount. If the Definition applies, there is a specific provision that allows Searchlight to pay VOD based on 20% of gross receipts.

<u>Claim No. 5</u>: Searchlight incorrectly applied a 10% royalty rate to sell-through video. As 87% of home video sales constituted "sell-through," the effective royalty rate paid for both high price and sell-through, after deducting the 25% distribution fee, was 9.66%. The agreement negotiated between Sloss and DeMarco provided for a 31.66% royalty on all sales except bargain bin, less the distribution fee of 25%, which should have resulted an effective rate of 23.75%. Searchlight reported $139,371,500 in home video sales through September 2008. Applying the

31.66% rate to all sales yields a $44,125,017 royalty owed Napoleon, rather than the roughly $17.9 million Searchlight had previously calculated. Applying the 25% distribution fee to the difference between the amounts previously reported and that actually owed –i.e., $26,176571, results in a sum of $19,632,428. Napoleon's claim is fifty percent of this amount because of its 50% profit participation, $9,816,214.

Claim No. 6: Residuals on Home Video are improperly deducted. As a royalty recipient, Napoleon does not participate in expenses. This claim amounts to $805,667. Napoleon's share is 50% of this amount.

Claim No. 7: Foreign version costs are not deductible. These are costs attributable to dubbing and are not solely allocable to the theatrical release of a film. The dub tracks are also used for home video distribution and the costs should be allocated, based on total gross revenue amounts, as between theatrical expenses in which Napoleon participates and Home Video expenses in which Napoleon does not participate as it is only receiving a royalty. Of the gross revenue from the foreign market, 45% was derived from home video. Sills therefore allocated 45% of the dubbing costs to Home video. This claim is for 45% of $149,700, equaling $66,710. Napoleon's share is 50% of this amount.

Claim No. 8: Price protection reserves, which amount to a reserve in anticipation of giving customer credits for price reductions, are not properly deducted regardless of whether the Definition applies and constitutes a claim of $6,584. After deducting a distribution fee of 25%, the net amount is $4938. Napoleon's share is 50% of this amount.

Claim No. 9: Prime Time Media charges totaling $10,667 in commission paid to a Fox-owned company for placing advertising are not proper advertising expenses chargeable against Napoleon. Napoleon's share is 50% of this amount.

Claim No. 11: Foreign Tax credits should inure to the benefit of Napoleon. Searchlight charged the Picture with $206,811 in foreign taxes paid. If Searchlight subsequently obtains a credit in this amount against their U.S. taxes, Searchlight does not actually incur this tax and should not be charging Napoleon for the amount of the tax. Napoleon's share is 50% of this amount. As Napoleon did not have access to the tax returns that Searchlight or its parent company files, it was unable to determine if they received the credit, but maintain a right to a share of the benefit of any credit taken.

Claim No. 12: Inadequately supported advertising expenses were charged in the amount of $250,714. Napoleon's share is 50% of this amount.

Claim No. 13: EchoStar is a pay-per-view television provider that has underpaid Searchlight by approximately $90,000. After Sills brought this error to the attention of Searchlight, Searchlight asked EchoStar for additional payments. Searchlight has agreed that to the extent Searchlight obtains the underpayment from EchoStar, Napoleon should obtain the benefit. Napoleon's share is 50% of this amount.

In the midst of trial, Napoleon amended its Complaint and added the following claims:

A. That Searchlight is inappropriately deducting as an advertising expense a 5% participation that Searchlight granted to MTV without Napoleon's knowledge or consent ($2,424,531). Napoleon's share is 50% of this amount;

B. That Searchlight has inappropriately deducted duplicative fees –i.e., a 30% distribution fee and a 40% administrative fee ($2,746486), from the merchandising revenue owed to Napoleon. Napoleon's share is 50% of this amount.

Searchlight disputes the above Claims, and as to the latter two Claims, it contends that the statute of limitations and Incontestability clause of the Definition constitute a bar to any recovery.

II.

ANALYSIS

1. Burden of proof.

Napoleon contends that Searchlight bears the burden of proof in this matter and must prove that it satisfied its payment obligations to Napoleon, citing *Wolf v. Superior Court* (2003) 106 Cal.App.4th 625, 635. *Wolf* stands generally for the proposition that a party that pays contingent compensation, as Searchlight here, does not owe a fiduciary duty to the participant. In dicta, the *Wolf* court also found that under the circumstances of that case, the burden was on the studio, not the plaintiff, to prove its accountings were correct. *Wolf* was decided on demurrer and the court was bound to accept Wolf's allegations that the studio had failed to comply with audit requests and failed to disclose information necessary for *Wolf* to determine how the accountings were prepared. Both courts that have since applied *Wolf* in contingent compensation cases have rejected its burden-shifting dicta. See e.g., *Cusano v. Klein*, 280 F. Supp. 2d 1035, (Wolf's burden-shifting language was not only dicta, but did not apply where the plaintiff has both an audit right and the right to conduct discovery). In *Sander/Moses v. NBC* (2006) 142 Cal. App. 4th 1086, the Court of Appeal found that *Wolf* did not apply at trial, and that the burden of proof was on the participant, where the participant had the right to audit and conduct discovery. The Referee finds there is no authority that provides here for a shifting in the traditional burden of proof, and thus the burden remains with the Plaintiff.

2. Whether the Definition of Defined Net Proceeds/Acquisition is part of the Agreement.

In the main, the parties dispute the terms of the Agreement that Searchlight has been applying to account to Napoleon for its participation. The parties agree that the Term Sheet [Exh 25] and the Standard Terms [Ex. 20] set forth the material terms of their agreement, but dispute the meaning of certain terms used in the Term Sheet and dispute whether the Term Sheet incorporates by reference the Participation Definition otherwise known as the A Level Definition of Defined Net proceeds/Acquisition. ["the Definition"] [Exh 68]. Searchlight contends that the Term Sheet incorporates the Definition by reference, rendering this Definition a binding part of the agreement between the parties, governing payment of the participation. Napoleon maintains the Term Sheet referenced an obsolete version of the Definition that was never provided to Napoleon, and that no Definition is incorporated into the Term Sheet. Both sides agree that the Term Sheet controls to the extent it states any payment terms. The Term Sheet states that the royalty rate for *High Price Product Royalty* shall be 31.66% and the parties dispute the meaning of *High Price Product.*

According to Searchlight's interpretation of the Term Sheet and applying the Definition, *High Price Product* refers only to home video *rental* revenue. Searchlight contends that as the Term Sheet states the royalty rate only for home video *rental* revenue, the royalty rate for *sell-through* home video is dictated by the Definition. The Definition provides for a 10% royalty rate for home video *sell-through*. Based on this interpretation of the Agreement, Searchlight has been accounting to Napoleon.

Napoleon contends that Searchlight is in breach of the Agreement as the Definition is not an agreed upon or negotiated participation Definition and does not govern the agreement between Napoleon and Searchlight. It consequently contends, among other things, that the 31.66% royalty rate applies to all home video, except bargain bin. Napoleon bases this argument primarily on the following contentions:

1. Sloss' testimony that he and DeMarco struck a deal at Sundance for an overall royalty rate of 31.66% for all home video, except bargain bin sales;

2. The Term Sheet corroborates the purported Sloss-DeMarco deal where it states that there shall be a 31.66% royalty rate for *high price product;*

3. In 2004, there was no price difference between sell-through and rental, and both were considered high price product;

4. The Term Sheet references an obsolete document -- i.e., "Definitions of Net Profits;"

5. Searchlight has been rendering participation payments based on a 10% royalty rate for *sell through* home video according to the Definition, a document not referenced in any of the documents comprising the agreement between the parties;

6. Jamie Taylor represented in his letter of May 10, 2004, that the Definition that was applicable to the agreement between Napoleon and Searchlight tracked the Definition used in Club Dread, which Definition consisted of a single royalty rate;

7. Searchlight did not provide a copy of the applicable Definition to Napoleon or its lawyers until after the Standard Terms were executed.

In determining whether the Definition is inapplicable to the agreement between the parties here, the Referee must decide whether under applicable law Searchlight has met the necessary requirements to incorporate the Definition by reference into the Term Sheet. It is undisputed that "a contract may validly incorporate by reference the provisions of a document not physically a part of the basic contract." *Chan v. Drexel Burnham Lambert, Inc.*, 178 Cal.App.3d 632, 641 (1986). However, "[f]or the terms of another document to be incorporated into the document executed by the parties the reference must be clear and unequivocal, the reference must be called to the attention of the other party and he must consent thereto, and the terms of the incorporated document must be known or easily available to the contracting parties." *Williams Constr. Co. v. Standard-Pacific Corp.* (1967) 254 Cal.App.2d 442, 454 (emphasis added); see also, *Adajar v. RWR Homes, Inc.* (2008)160 Cal.App.4th 563, 571; *Kleveland v. Chicago Title Insurance Co.* (2006)141 Cal.App.4th 761, 765; *Shaw v. Regents of the University of California* (1997) 58 Cal.App.4th 44.

Addressing first whether the Definition was called to the attention of Napoleon, the Referee notes that the Term Sheet refers to *a* participation definition as follows: "Participation Terminology: Payment of any amounts provided for hereunder and all other terms and conditions related to such amounts shall be in accordance with the terms and conditions set forth herein or, if not addressed herein, in Searchlight's Definitions of Net Profits (High Price Product Royalty shall be 31.66%, with Schedule "1" – Glossary attached thereto ('Participation Definition')."

The reference to the *Definitions of Net Profits* in the Term Sheet was a misnomer, identifying an obsolete version of a Participation Definition. No one advocates that the obsolete *Definition of Net Profits* is applicable to the agreement here. Napoleon certainly does not proffer evidence that either Sloss or Coons signed the Term Sheet under the impression that the terms of the obsolete *Definition of Net Profits* applied to the agreement. Sloss reviewed the Term Sheet and Coons signed it, apparently without questioning the term that provided "Payment of any amounts provided for hereunder and all other terms and conditions related to such amounts shall be in accordance … with Searchlight's Definitions of Net Profits (High Price Product Royalty shall be 31.66%, with Schedule "1" – Glossary attached thereto ('Participation Definition')," unless otherwise set forth in the Term Sheet. The fact that *a* Participation Definition was incorporated by reference into the Term Sheet was called to the attention of Napoleon and its attorneys.

After Coons executed the Term Sheet, Taylor forwarded to Brennan the first draft of the Standard Terms on February 20, 2004, enclosing eight exhibits and nine related

Schedules. He did not enclose the Definition. [Exh. 28]. Six weeks later, on April 7, 2004, Napoleon's attorney, Brennan, responded with his comments. On April 16, 2004, Taylor responded to Brennan's comments. On May 7, 2004, Taylor sends further revised Standard Terms, along with additional copies of various exhibits, but not the Definition identified as Exhibit A. In this correspondence to Brennan, Taylor does reference the Definition and uses the correct caption stating "upon counter signature, I'll return 2 fully-signed copies of the Standard Terms and Conditions and Lab Access Letter, as well as additional copies of all Exhibits and Schedules, and the A Level Definition of Defined Net Proceeds/Acquisition with Glossary for your files." [Exh 29]. This is apparently the first reference to the Definition in correspondence with Napoleon's lawyers, albeit not the first reference to a Participation Definition applying to the contract.

Searchlight finally identified the misnomer in the Term Sheet in Taylor's letter of May 10, 2004. [Exh.44]. The letter advises both that the referenced Definition was not the operative Definition and clarifies which Participation Definition Searchlight intended to reference. Taylor states that the Term Sheet referred to an "obsolete Definition of Net Profits (which has not been used since the days of 'SUPERTROOPERS')" and identifies the intended Definition as the "'A-Level' Rider, the Definition of Defined Net Proceeds/Acquisition." The letter references an enclosure, which Moore testified was the Definition, which she would have enclosed with the original cover letter via mail. Again in a letter sent May 12th, Taylor references the Definition.

The Referee finds that the fact of the incorporation of the Definition was sufficiently called to the attention of Brennan and Sloss both in the Term Sheet and later in the various letters from Taylor that repeatedly correctly identified the Definition. The contract need not recite that it "incorporates" another document, so long as it "'guide[s] the reader to the incorporated document.'" *Shaw v. Regents of Univ. of California*, 58 Cal.App.4th 44, 54 (1997) (internal citation omitted); *see also Wolschlager v. Fid. Nat. Title Ins. Co.*, 111 Cal.App.4th 784, 791 (2003) (finding that the plaintiff was bound to an arbitration clause contained in an insurance policy referenced in an agreement, where the agreement identified the policy by name and the plaintiff could "easily locate the incorporated document"). Certainly the Term Sheet, along with Taylor's May 10th letter, and letters of May 7 & 12, "guided" Brennan to the Definition and its applicability to the agreement.

Significantly, both Brennan *and* Sloss were also not novices relative to film acquisition agreements, and specifically insofar as acquisition agreements with Searchlight, both were well aware that a Participation Definition was customarily incorporated into the Agreement. Napoleon is consequently charged as the principal "with knowledge *which [its] agent acquires before the commencement of the relationship* when that knowledge can reasonably be said to be present in the mind of the agent while acting for the principal." *Columbia Pictures Corp. v. De Toth*, 87 Cal.App.2d 620, 629-31 (1948) (emphasis added); *cited with approval in O'Riordan v. Fed. Kemper Life Assur.*, 36 Cal.4th 281, 288-89 (2005). By referencing a Definition in the Term Sheet, and in Taylor's various letters of May 7, 10 and 12, Searchlight notified Napoleon that a Participation Definition would apply to the Agreement.

As the reference in the Term Sheet misidentified the Definition, it raises the issue whether the reference to the correct Definition was "clear and unequivocal." While Napoleon contends it never received the applicable Definition before it signed the Standard Terms, it is undisputed that Taylor did identify the Definition in his May 10, 2004 letter to Brennan. The evidence establishes that on May 10th Searchlight faxed Taylor's letter to Brennan. There is no dispute the Sloss firm received this fax copy of the May 10th letter. The Referee presumes the addressee, Paul Brennan, received it on or about May 10, 2004, although he could not specifically recall the letter. The May 10th letter communicated: 1) that the Definition referenced in the Term Sheet was erroneously named, 2) that Searchlight instead intended to incorporate the Definition, and 3) that the correct version of the Definition was being delivered via mail with the original of the May 10th cover letter. The letter is short and makes a point of clarifying which Definition applied. Which Definition would apply to the agreement between Napoleon and Searchlight was thus made clear and unequivocal by May 10, 2004, given that Taylor in his letter of this date accurately identified the Definition.

Napoleon and Searchlight dispute whether the Definition was actually sent with the May 10, 2004 letter and, if not, Napoleon argues the Definition terms were not known or made available to Napoleon. The Referee determines that the weight of the evidence supports Searchlight mailed the Definition to Brennan on May 10, 2004. The fax cover states that the Definition would be mailed with the original cover letter. If the Definition did not arrive as promised, reason dictates that Brennan would have inquired further by contacting Taylor. There is no evidence that Brennan contacted Taylor about a missing Definition. Brennan himself cannot say that he did not receive the Definition; he simply does not recall seeing it. The only evidence that the Definition was not sent is the testimony of Sloss that in 2008 when he searched the Sloss files, he could not locate a copy.

The testimony of Taylor and Moore further support that the Definition was mailed on May 10th. First, Moore identified the letter and enclosed Definition in the Searchlight central files as a letter she prepared. [Exh.172]. Moore testified credibly to her general practice relative to preparing cover letters and sending the Definition pertaining to a particular deal. Her practice was to prepare the Definition for delivery via mail, deposit the envelope in the mail pick up drop and send a complete copy to Central Files. She testified that she would have followed this procedure relative to the May 10th letter. There is no persuasive evidence to impeach Moore on this point. In fact, the persuasive evidence is to the contrary. The copy of the letter and Definition that went to Central Files was located. The Sloss firm received the fax cover sheet informing Brennan that the Definition was being sent via mail, as the cover sheet and the cover letter were found in the Sloss firm files. Both the faxed and mailed versions referenced an enclosure by the footer "Encl." at the bottom of the letter, and by inference in the body of the letter. Moore would have no reason to prepare the letter, send it by fax, advise the recipient that the enclosure was coming via mail, send a complete copy with enclosure to central files, but not actually follow through and mail the enclosure.

Brennan tried to explain how he might have received the May 10 letter and yet failed to inquire further or obtain a copy of the Definition. His suggestion that he was not "particularly concerned" about receiving the Definition, or any of the dozen or more Exhibits, is not credible. That an experienced transactional lawyer would not familiarize himself with *all* of the exhibits that comprise the deal flies in the face of reason and good practice. The Term Sheet expressly incorporates a Participation Definition. Brennan's task here was to document the deal described by the Term Sheet. While the Term Sheet purportedly contained all of the material terms, Brennan nonetheless negotiated the long form paperwork over the course of several months. Drafts went back and forth. Obviously, he and Taylor were concerned about more than the material terms in the Term Sheet; the details were not unimportant. Moreover, Brennan had to concede that his practice was to review the documentation before his client signed the long form paperwork. His caveat that he assured himself that all of the appropriate exhibits were provided and reviewed, but *only to the extent he had been provided with such documentation*, is illogical and implausible. While Brennan claimed he might not know if a document were missing if he weren't provided with it, the Term Sheet expressly incorporated a Participation Definition. The May 7, 10 and 12th letters all reference the Definition. Brennan would have known that the Definition was missing, if it were in fact missing. He did not ask Taylor for a copy of the Definition, referenced in the Term Sheet and the three letters from Taylor, most likely because Brennan had received the Definition that Taylor sent on May 10th.

Having handled a number of transactions for film acquisitions, Brennan would also have been aware of the significance of a Participation Definition. For example, in documenting the deal for *Waking Life* in June 2001, Searchlight sent Brennan a "Negotiated Participation Definition", explaining that it "reflects a composite of modifications to Fox' Standard Definition which are favorable to the participant." [Exh. 45]. In July 2001, Searchlight again sent Brennan the "Negotiated Participation Definition" relative to the acquisition of *Kissing Jessica Stein*. [Exh. 194.]. No lawyer would ignore missing, and expressly referenced, exhibits and allow Searchlight to decide which of the referenced exhibits he could review before advising his client to execute paperwork. Brennan's testimony was internally inconsistent to say the least and simply not believable.

That the Sloss firm could not locate the Definition in their files years later does not carry sufficient weight to persuade the Referee that the letter and the enclosed Definition did not arrive. The May 10 letter was addressed to Brennan and faxed to Brennan, and he undoubtedly received that letter, as the fax cover sheet was located in the Sloss firm files. Brennan does not deny receiving it, but only that he does not specifically recall the letter. Either Brennan was careless and truly was not concerned with obtaining a copy of the Definition, or he carefully documented the deal and made certain he had reviewed all documents, including the applicable Exhibits and Schedules. If he was sloppy, one might question what care Brennan might have taken respecting the Definition when it arrived with the May 10 letter via mail. If he were instead careful, he noted the various references to the Definition, knew the significance of the Definition, read the letter enclosing the Definition, reviewed the Definition when it arrived and satisfied himself that he had reviewed all applicable documents.

Assuming arguendo, that the Definition was not delivered to the Sloss firm, had Brennan wanted to review the Definition and discovered that he did not have a copy in his files, all he had to do was request another copy. Even if he did not receive or ask for the Definition, the Referee finds he had the ability to obtain and review the Definition before advising his client to sign the agreement. *See Wolschlager v. Fid. Nat. Title Ins. Co.*, 111 Cal.App.4th 784, 791. (Plaintiff bound by arbitration clause, even if unknown to him, where he had received and signed a preliminary title report that referenced an insurance policy and attached portions, even if not an entire policy, as the policy with the clause was easily available to him.) The Definition, and its terms, was thus known or knowable to Brennan. As Napoleon's agent, Brennan's knowledge as to the applicable Participation Definition is attributable to Napoleon. To the extent counsel for Napoleon might have been remiss in not obtaining or reviewing a copy of the Definition, Napoleon is nonetheless subject to its provisions. See *Hummel v Hummel* (1958) 161 Cal. App.2d 272, 277.

Napoleon cites to *Adajar v. RWR Homes, Inc*. (2008) 160 Cal.App.4th 563 holding that a reference in a home purchase application to a Sample Warranty booklet did not incorporate by this reference certain "2001 and 2002 Warranty" booklets, as the latter were not provided to the buyers prior to the close of escrow. *Adajar* is distinguishable in several respects. First, the *Adajar* court did not disavow the general rule that "a party is bound by the provisions of an agreement which he signs, even though he does not read them and signs unaware of their existence." Id at 571. Rather, in *Adajar*, the court could not determine which arbitration provisions would be binding on the signing party. There, the party seeking to compel arbitration, despite having the burden of proving the terms of the arbitration agreement, did not produce the Sample Warranty booklets. This failure of proof deprived the court of any ability to review the allegedly agreed upon arbitration provisions in the Sample Warranty booklets. Likewise, it could not compare the agreed upon, but missing, Sample Warranty booklet arbitration terms with those in the 2001 and 2002 Warranty Booklets to determine if they were the same. The moving party sought to compel the arbitration terms of the 2001 and 2002 booklets, but could not establish that the referenced Sample Warranty terms in the booklet actually delivered to the purchasers tracked the terms it sought to enforce.

While both in *Adajar* and here, the parties executed documents incorporating a version of a document referenced in the initial documentation, a key distinction is established here. In *Adajar*, the moving party could not prove that the arbitration terms it sought to enforce were the same terms contained in the warranty booklets it had provided to the buyers before the close of escrow. The warranty booklet allegedly provided to the buyers *before* escrow closed was *never* produced to the court. Here, in contrast, *before* Napoleon had signed the final documentation (i.e., the Standard Terms), Searchlight had advised Brennan and Sloss that the referenced Participation Definition was misidentified in the Term Sheet, *and* correctly identified the applicable Definition. Searchlight also *delivered* the applicable Participation Definition with the letter of May 10th and has produced it in this trial. Even if Brennan, never received the Definition, despite having been mailed, the existence and applicability of the Definition was called to the attention of both Brennan and Sloss and was available to them had they asked. Thus, as the Definition was clearly called to the attention of Brennan, and available to him, Searchlight adequately incorporated it into the agreement as the Participation Definition.

Moreover, there is little if any credible evidence to support Napoleon's theory that Searchlight purposely "slipped " the Definition in so that Napoleon would not realize that it was to receive only a 10% royalty on sell-through. The Definition was not hidden from Brennan. If Searchlight wanted to conceal the Definition from Brennan or Sloss, Taylor would not have referenced it in his May 7, 10 and 12 letters, and Moore would not have faxed a letter advising that the Definition was coming in the mailed copy of the letter. The Definition was certainly available to Brennan for the asking, even if the Definition sent by mail never arrived.

Napoleon also contends it did not *consent* to the Definition terms because it was not only not given a copy to which it might consent, but the parties did not negotiate the terms of the Definition and did not sign it. See Shaw v. Regents, supra at 54 (to effectively incorporate another document by reference, other party must consent). The claim of non-delivery has not been proven. In fact, the evidence supports the contrary. The fact that the parties did not sign the Definition is also not dispositive. It is sufficient if the documents that the parties do sign validly incorporate the referenced document. Cf. Id.(parties signed patent agreement that validly referenced the patent policy). As to the failure to negotiate this term, the evidence again establishes the contrary. While the parties here did not negotiate the particular terms of the Definition, the Term Sheet establishes their agreement that *a* Participation Definition would govern the agreement relative to payment terms, unless otherwise addressed in the Term Sheet itself. Sloss, an experienced transactional lawyer who had transacted numerous deals with Searchlight, was not a stranger to the general parameters of the Participation Definitions used by Searchlight over the years. He had negotiated many deals with Searchlight in which a pre-negotiated Participation Definition was routinely incorporated. Significantly, he acknowledged that in documenting *Super Troopers, Waking Life*, *The Deep End,* and *Kissing Jessica Stein,* he *knew* that the Definition in each agreement included a 10% sell-through royalty rate in conflict with the terms he had purportedly negotiated with DeMarco. While Napoleon argues that the Definition here is one that Sloss had never seen before, the significant term –i.e., high price sales, had been defined in each of the prior Definitions with which Sloss was familiar and consistently defined high price sales in terms of rental revenue only. To the extent Taylor later represented that the Definition of Net Profits (used in these prior agreements) was *obsolete,* neither Sloss nor Coons relied on this statement. Taylor made this statement months after Sloss advised Coos to sign the Term Sheet in January 2004. In January, when Sloss negotiated the deal, Sloss not only expected a participation definition to apply, but also anticipated "that the 10 percent [for sell-through] would be there in the boilerplate."

There is nothing to suggest here that Sloss would have done anything differently had he read the Definition applicable to Napoleon. Moreover, Sloss knew that the A level Definition was a pre-negotiated Definition, the terms of which were not subject to negotiation, except as negotiated in the Term Sheet. Napoleon is chargeable with this knowledge, as well. *See Columbia Pictures v DeToth* (1948) 87 Cal. App. 2d 620, 629-30 (Principal charged with the knowledge of experienced motion picture agent who was familiar with the standard form of director's contract). That the Definition used by Searchlight would change periodically over the years only reinforces the Referee's conclusion that Brennan and/or Sloss would have reviewed the applicable Definition here, before advising their client to execute the agreement.

Napoleon contends that in the same letter of May 10th, Taylor misrepresented that the Definition tracked the Definition used in CLUB DREAD. The definition for CLUB DREAD involved a single royalty rate. Napoleon argues that this misrepresentation created further confusion. However, because neither Brennan nor Sloss recalled the letter, let alone the comparison with Club Dread, Taylor's statement comparing the Definitions to Club Dread could not have created any actual confusion. While the representation was potentially misleading, it did not actually mislead anyone.

Thus, the provision that a Participation Definition would govern all payment terms, not otherwise addressed in the Term Sheet, is clearly stated in the Term Sheet and was intended by all parties. Sloss apparently counseled his client to sign the Term Sheet, despite not having been provided a copy of the referenced Participation Definition, but understanding that a Participation Definition would apply to all payments not otherwise specified in the Term Sheet. Significantly, Jeremy Coon elected to sign the Term Sheet with its obvious reference to a Participation Definition, apparently without requesting a copy of the referenced Participation Definition. Napoleon thus agreed to the terms stated in this Term Sheet, including that a Participation Definition governed all payment terms that were not addressed in the Term Sheet. Consequently, the Referee finds that Napoleon and Searchlight both intended, and consented, to the use of a Participation Definition governing all payment terms not otherwise stated in the Term Sheet. See *Williams Construction v Standard-Pacific Corp.* (1967) 254 Cal. App.2d 442, 454 ("utterly unrealistic to accept the proposition that a failure to know what is in the [referenced document] was anyone's responsibility and fault but [the signing party], and most certainly the [referenced document] was readily available to her.")

After Searchlight informed Napoleon's agents which version of the Participation Definition applied to the Term Sheet, Napoleon thereafter executed the Standard Terms and Conditions. [Exh 20]. This document references the Term Sheet as the "Main Agreement," and that Main Agreement incorporates a Participation Definition, which was specifically identified, at least by May 10, 2004 in correspondence from Searchlight to Brennan, as the "'A-Level' Rider, the Definition of Defined Net proceeds/Acquisition." While Napoleon argues that Taylor's effort to clarify which Definition was to apply came within days prior to execution of the contract by Napoleon, the fact is that Napoleon did not execute the Standard Terms until May 20, 2004. At least a week prior to its execution of the Standard Terms, Napoleon's counsel and agent, had been informed that the Definition applied. Napoleon is deemed to have consented to the applicability of the Definition. Whether Brennan, Sloss or Napoleon read the Definition is immaterial to a determination as to its applicability. The Definition was known or knowable. A party is bound by an agreement, regardless of whether it has read all of its terms. Chan v. Drexel

Burnham Lambert (1986) 178 Cal. App.3d 632, 641; King v Larsen Realty, Inc. (1981) 121 Cal. App.3d 349, 358.

Napoleon does not contest that it subsequently received a copy of the Definition of Defined Net Proceeds/Acquisition in July 2004 following counter signature. [Exh.31]. When Coons asked Brennan in October 2004 about the 49 page Definition he had just received, Brennan did not express surprise or make inquiry of Searchlight. As strong corroboration of the fact that the parties agreed that a Searchlight Participation Definition would govern the agreement, Napoleon and Sloss relied upon the Searchlight Definition of Defined Net Proceeds/Acquisition in asserting Napoleon's audit rights and originally contesting Searchlight's accounting. Both the Sloss firm and Napoleon conducted themselves consistent with the premise that a Participation Definition, and specifically the A-Level Definition of defined Net Proceeds/Acquisition, governed the agreement. For almost seven years, neither Napoleon nor its agents ever professed surprise that payments were being made according to the terms of the Definition, or that the Definition terms were part of the contract. As late as February 2011, Napoleon, Sloss and Sills acknowledged that the Definition was a part of the agreement. That final audit report dated February 14, 2011 addressed to Napoleon and delivered to Sloss states:

"Claim No. 6. <u>Understatement of Home Video Royalties</u>:

The Agreement provides for a 31.66% royalty on 'High Price' receipts and a 10% royalty on 'Sell Through' receipts. You have informed us that during the negotiation of the Agreement, Fox's representatives informed you that they anticipated a net overall royalty rate of 25%."

Due to the change in the home video marketplace, from a rental market to a sell through market, 87% of the Picture's video sales were at the lower rate, resulting in an overall video royalty rate of 12.88%. It should be noted that this rate is approximately one-half of the industry standard minimum rate of 20%.

Had Fox reported to you based on the 25% overall rate provided to you during the contract negotiations, home video royalties would have been increased by $16,894,429. " (emphasis added.)

Sloss not only read the above quoted Claim No. 6, he also concurred in the deletion of a different claim regarding Paramount underreported home video, and approved the above referenced Claim *as worded* for Understatement of Home Video Royalties (renumbered as Claim No.5). Sloss then forwarded this audit report to Searchlight on February 16, 2011. Not until the eve of trial fifteen months later, with the third version of the final audit report, dated May 12, 2012, does Napoleon first claim the Definition is inapplicable. Napoleon's conduct demonstrates that it intended to be governed by the Definition. See Crestview Cemetery Assn. v. Dieden (1960) 54 Cal.2d 744, 754; Oceanside 84, Ltd. v. Fidelity Fed. Bank (1997) 56 Cal.App.4th 1441, 1449-50. Not until after Napoleon calculated that the royalty rate in the Definition applied to 87% of video revenue, did it ultimately repudiate the Definition.

In short, Napoleon signed a Term Sheet governing its licensing agreement with Searchlight relative to the Picture, which Term Sheet incorporates by reference a Participation Definition that applies to all payments not otherwise addressed in the Term Sheet. By May 10, 2004, Napoleon was advised both of the error in labeling the Definition in the Term Sheet and of the accurate title of the applicable Definition intended by Searchlight. Napoleon's lawyers thereafter were sent a copy of the Definition well before Napoleon executed the Standard Terms. After executing the Standard Terms, Napoleon and Sloss thereafter conducted themselves for almost seven years consistent with the understanding that the Definition governed the agreement. Given the facts established in this trial, as enumerated above, the Referee finds that the Definition of Defined Net Proceeds/Acquisition governs all payments not otherwise addressed in the Term Sheet.

3. Home Video Royalty Claim.

A. Whether the Term Sheet when read in conjunction with the Definition provides for an overall royalty rate of 31.66%, excluding bargain bin.

The parties also contest whether the royalty rate in the Term Sheet governs both rental and sell-through home video royalty, or only rental video royalty. The Term Sheet refers to a

31.66% rate for *High Price Product Royalty.* If the reference to *High Price Product Royalty* in the Term Sheet only addresses *rental* video royalty, by its terms the Term Sheet dictates that the Definition royalty rate controls as to all other home video revenue. If, as Napoleon contends, the Term Sheet reference to *High Price Product Royalty* includes both rental and sell through, the 31.66% royalty rate would apply to all home video revenue, except for bargain bin sales. Searchlight has accounted to Napoleon on the basis of its contrary position that the Term Sheet references only home video *rental* royalty when it states that "High Price Product Royalty" shall be 31.66%, subjecting all sell-through home video revenue to the 10% royalty rate dictated by the Definition.

Napoleon maintains that the agreement purportedly reached between Sloss and DeMarco dictates the meaning of *High Price Product* and denies that the Definition is even applicable for the reasons articulated above. The Referee has rejected that argument as explained, *supra.* Napoleon alternatively argues that even if the Definition were applicable, the term *High Price Product* is not found in the Definition and again is defined according to the understanding between Sloss and DeMarco to include all video revenue except bargain bin.

According to Searchlight, the Term Sheet is an unambiguous agreement that must be read with the Definition and the Standard Terms, and specifically paragraph 23(c), which subparagraph renders it an integrated agreement. As such, Searchlight argues, the parol evidence rule precludes extrinsic evidence, such as Sloss' purported discussions with DeMarco, to contradict the meaning of any wording contained in the Term Sheet. See *Alling v. Universal Manufacturing Corp.*, 5 Cal.App.4th 1412, 1436 (1992) (rejecting parol evidence where it was inconsistent with the terms of the parties' integrated written contract). Searchlight contends that the definition of "High Price Product," which is initially capitalized in the Term Sheet, is a defined term and expressly found in the Definition and not subject to further explanation via extrinsic evidence.

To resolve this dispute, the Referee first considers whether the written documents define, or reveal any ambiguity in the reference to, *High Price Product.* The Referee may consider parol evidence if the meaning of the term is ambiguous as written, or to determine whether the extrinsic evidence reveals a latent ambiguity. In permitting the parties to introduce extrinsic evidence relevant to construing the meaning of the reference to "High Price Product Royalty" in the Term Sheet, the Referee recognizes that as a general rule, no oral representation can alter the terms of an integrated agreement. *Alling v. Universal Manufacturing Corp.*, 5 Cal.App.4th at 1436. Parol evidence may be considered, however, if it is offered to construe an ambiguous written agreement, and then only when the language of the agreement is "reasonably susceptible" to the interpretation offered by the party. *Winet v. Price*, 4 Cal.App.4th 1159, 1165 (1992); *see also EPA Real Estate P'ship v. Kang*, 12 Cal.App.4th 171, 177 (1992) (rejecting parol evidence that evidenced "a new, additional and completely different agreement" than the parties' written agreement). Further, even if a contract appears unambiguous on its face, extrinsic evidence may be considered to expose a latent ambiguity where the extrinsic evidence reveals more than one possible meaning to which the language of the contract is yet reasonably susceptible. [Citations.]" (*Wolf v. Superior Court* (2004) 114 Cal.App.4th 1343, 1350-1351.) "[I]f extrinsic evidence reveals that apparently clear language in the contract is, in fact, 'susceptible to more than one reasonable interpretation,' then extrinsic evidence may be used to determine the contracting parties' objective intent." Id. "The court generally may not consider extrinsic evidence of any prior agreement or contemporaneous oral agreement to vary or contradict the clear and unambiguous terms of a written, integrated contract." Id. "[E]vidence may not be used to create a contract the parties did not intend to make or to insert language one or both parties now wish had been included. However, extrinsic evidence is admissible to demonstrate that a material term of an integrated agreement is ambiguous and to interpret that term." Id. Hence the Referee has permitted introduction of certain extrinsic evidence to aid in ascertaining the meaning of "High Price Product".

The starting point in this analysis is the written documents constituting the agreement – i.e., the Term Sheet, the Standard Terms and Conditions, and the Definition. The Term Sheet itself does not define High Price Product. However, the Standard Terms provide that "all terms initially capitalized are specifically defined terms and *shall* be defined as set forth in the documents in which they appear within quotation marks in the Main Agreement and any of the documents referenced in paragraph 20." (emphasis added). [Exh. 147]. High Price Product Royalty is initially capitalized in the Term Sheet and thus is a defined term, presumably defined elsewhere in the documents referenced in Paragraph 20. While paragraph 20 does not reference documents, but rather the payment to Cinetic, but paragraph 21 does reference additional documentation, the Referee concludes the reference is a scrivener's error and that the parties intended to reference paragraph 21. Consequently, to ascertain the meaning of High Price Product Royalty, the Referee must look to the balance of the written documents.

The Definition does not define as a single term the phrase "High Price Product Royalty", but the term "High Price" captures an enumerated royalty category under "Product Royalty Amounts." Under the category of "Product Royalty Amounts," are three royalty categories:

a) High Price Sales/Rental Royalty

b) Sell-Through Royalty

c) Direct Marketing Sales

[Exh. 68-7].

The Product Royalty Amounts for **High Price Sales/Rental Royalty** are stated as 20% of 100% of "High Price Sales of Cassettes" and to the extent "monies are received from wholesale dealers … based on rentals of Cassettes." **High Price Sales** is thereafter defined in the Definition under Home Video Definitions as Cassettes sold "which are generally intended for rental by members of the public for Home Video Exhibition (**the so-called 'rental' market**)." (emphasis added) [Exh. 68-8]. While the phrase "High Price Product Royalty" is not a single defined term, it is obviously the combination of two defined terms –i.e., "Product Royalty Amounts", consisting of three categories, and "High Price Sales/Rental", one of the Product Royalty categories. Although the royalty for High Price is stated in the alternative as "High Price *Sales/Rental* Royalty", the reference, upon a careful reading, is to a single category –i.e., "the so-called rental market."

Likewise, *High Price Product* as defined cannot include the Sell-Through category, as Sell-Through is a market category separate and distinct from *High Price Sales/Rental Royalty.* According to the Definition, the Product Royalty Amounts for Sell-Through Royalty is stated as 10% of 100% of "the monies derived … from Sell-Through Sales of Cassettes" and Sell-Through Sales is defined under Home Video Definitions as Cassettes sold "intended for purchase by members of the public for Home Video Exhibition. (**the so-called 'sell-through market**)" (emphasis added). Thus, the Definition clearly distinguishes the two categories as capturing two distinct markets—the sell-through market and the rental market. Significantly too, Sell-Through is also not defined in any manner similar to High Price, nor is it defined in any way based on price. Rather, the definition of Sell-Through is tied to the manner in which the public will ultimately use the Cassette. Notwithstanding the choice of wording, the phrase High Price is also defined on the basis of how the video is ultimately used, not according to a price point.

The Referee is urged by Napoleon to construe the written documents against the drafter, Searchlight and find that the term is not defined therein. While Searchlight drafted the Term Sheet, the principle requiring construction against the drafter does not apply, as here, where the contract is the product of negotiation, especially where both parties are sophisticated and represented by counsel. *Boston Properties v. Pirelli Tire Corp.*, 134 Cal.App.3d 985, 994-95 (1982) ("The master lease was prepared by counsel for C. C. & F. Los Angeles Properties, Inc., however, *counsel for Pirelli* made comments and *modifications with respect thereto*.' (Emphasis added.) We are, therefore, not required to construe its provisions in favor of or against either party."); *Dunne & Gaston v. Keltner*, 50 Cal.App.3d 560, 563 n.3 (1975) ("when an agreement is arrived at by negotiating, the 'preparer' principle should not be applied against either party." (citing *Indenco, Inc. v. Evans*, 201 Cal.App.2d 369, 375).) Sloss represented Napoleon in the negotiation of the Term Sheet and is undeniably an experienced and able advocate who had negotiated many deals prior to this one. Napoleon's advocates were not only experienced and skilled, but Sloss aggressively negotiated for changes to the Term Sheet, as is evident from the email chains between Sloss and DeMarco dated January 18, 2004. [Exh. 4] Sloss also pushed hard for additional terms in the Standard Terms. [Exh. 402]. To the extent Brennan assisted Sloss in documenting the agreement, he too, was highly experienced. Napoleon also had significant bargaining power, as there was a high level of interest in the film and the evidence suggested that there were a number of other potential bidders for the Picture.

Taking into consideration all of the above, the Arbitrator concludes that because *High Price Product* is written in initial caps, the parties intended it as a defined term within the written agreement. Reference to the Definition discloses an obvious meaning. The Definition includes a category entitled *Product Royalty Amounts* and references a subcategory, High Price

Sales/Rental Royalty. "High Price Sales/Rental Royalty" sets forth the royalty rate *for sales of* Cassettes in the "rental market." Referencing only the documents constituting the agreement, the most reasonable interpretation of "High Price Product" is the meaning to which *High Price* is *consistently* accorded in the Definition –i.e., that it applies solely to rental. If High Price Product Royalty as referenced in the Term Sheet is limited to rental, then "Sell-Through Sales" are consequently not addressed in the Term Sheet. If, as the Term Sheet provides, the Definition governs all payments not addressed in the Term Sheet, the Definition should determine the sell-through royalty rate –i.e., 10%.

Notwithstanding the wording in the Term Sheet and the Definition, Napoleon maintains that the written documents need to be considered in the context of the purported agreement between Sloss and DeMarco, which provided that there would be an overall royalty rate of 31.66% that applied to all but bargain bin home video sales, and in the context of the actual market conditions relative to rental and sell-through. Napoleon contends that DeMarco's representations to Sloss shed light on a different alternative meaning intended by the parties in their reference to *High Price Product Royalty* –*i.e.*, that the term refers to all product, sales and rental, except bargain bin.

"High Price," according to Napoleon, is a literal term, recognizing that cassettes for both video rental and sales in 2004 typically sold at the same price. The only video that garnered a significantly different price was video priced for bargain bin. Napoleon claims "high price" is DeMarco's shorthand to distinguish between the bargain bin sales and everything else, which was priced higher. According to Napoleon, the Term Sheet, in stating a royalty rate for "High Price Product Royalty" of 31.66%, included both forms of higher priced video—rental and sell-through. Applying Napoleon's analysis, only bargain bin is not governed by the Term Sheet. As the Definition only applies to terms not covered by the Term Sheet, Napoleon maintains the Definition would govern only bargain bin home video sales. The 10% royalty rate derived from the Definition (subpart VI(1)(c)(ii)(B)(1)(b)) thus would apply only to bargain bin, as all other home video sales fall within the literal definition of "high price" and the purported intention of the parties that all other home video sales would garner a 31.66% royalty rate.

The extrinsic evidence Napoleon offers consists largely of the testimony of John Sloss relative to his negotiations with DeMarco, who is now deceased, along with evidence of the absence of a price difference between rental and sell-through in 2004, and the trend in the home video market in 2004 relative to the proportionate share of rental versus sell-through. Sloss contends that on January 18, 2004, he and DeMarco negotiated a single home video royalty rate that DeMarco labeled: "High Price Product Royalty" in the Term Sheet. He and DeMarco purportedly did not negotiate and differentiate between rental versus sell-through, but agreed upon a single royalty for all home video revenue, except the marginal sales from bargain bin, consistent with the prior agreements between Sloss and DeMarco in their previous deals, including *The Brothers McMullen, She's the One* and *Super Troopers.*

Napoleon explains that the purported agreement between Sloss and DeMarco must be considered in the context of the relative market share of rental home video and sell-through home video. Home video originally consisted almost entirely of VHS cassettes sold to dealers for rental to the general public. Sales directly to the general public were initially minimal and often at a bargain bin price. Cassettes for rental were traditionally sold to dealers at a significantly higher price than those intended for sale directly to the public. Demonstrative of this is Searchlight's applicable Definition in 1993 used in *An Awfully Big Adventure,* in which it differentiated simply between rental, known as High Price, and sales to the public, known as Economy Line. [Exh. 134-42]. Later, Searchlight made attempts to distinguish between video revenue based on a price point, with bargain bin or economy line distinguished from all other home video revenue, the latter being primarily rental. In January and April 1995, the Definition used in the *Brothers McMullen* and *She's the One,* respectively, separately referenced the royalty rate for "rentals" and "sales," but provided for the same rate. The Definition for both *Brothers McMullen* and *She's the One* defines High Price Sales as sales of "cassettes" that are "generally intended for rental by the public". The Definition also included a lower rate for "economy line." The latter was defined in terms of a price point –i.e., sold at a wholesale list price at least 20% less than the "high price." *High Price* was not used as a royalty category, but merely defined a reference point to further define economy line –i.e., the highest wholesale list price as of the date of release. As the use of an Economy Line category became difficult to track, Searchlight eliminated this category eventually.

By 2001, largely due to the introduction of DVDs, any high price distinction between cassettes sold for rental versus sales was diminishing. Moreover, by 2003, sell-through comprised about 66% of the market, with rental about 33%. Rental was now largely sold on a revenue sharing basis, using a different compensation model. This point was corroborated by testimony from Sloss, Daniel Mackechnie, Thomas Arnold, and Richard Marks. Two bargain markets eventually emerged. Dealers were heavily discounting VHS to clear them out with the advent of DVD. Plus, as DVDs were so inexpensive to manufacture relative to VHS, secondary markets, such as grocery stores were selling DVDs for as little as a dollar. As DVDs became more readily available, the price of DVDs generally fell. The evidence supports that any price distinction between rental and sales was gradually evaporating in 2004. Nonetheless, Searchlight did initially make the Picture available in VHS for rental at a high price.

Despite the evolution of the relative market shares of rental and sell-through, in 2001, when Sloss negotiated *Super Troopers*, the Definition no longer referenced categories by a price point and no longer included a separate royalty for "economy line." "High Price" was no longer defined relative to any price point. Instead, the applicable Definition defined "High Price" in terms of the ultimate use by the general public. [Exh. 173]. Rental was categorized as high price in the Definition, even though rental was no longer actually distinguished by a higher price. In 2004, Searchlight continued to categorize home video revenues in its Definition according to the cassette's ultimate use by the general public, omitting any reference to a true price point. Regardless of the actual similarity in pricing of home video whether intended for sales or rental, Searchlight had maintained in its Definition the use of the term *high price* as a reference to sales intended for rental to the general public. The term "High Price" in 2004 was not used as a reference to any price point, as is apparent from all uses of the term in the Definition. Each reference to "High Price" in the Definition includes only rental, and is not defined by any true price point.

Sloss contends that by January 2001, sell-through constituted a large portion of home video revenue. According to Sloss, home video was "the most significant negotiated point financially in terms of the back end of the movie." Given that sell-through accounted for such a large share of the market, Sloss claims that he never would have agreed to a rate lower than 20% for sell-through, as 20% was the industry minimum.

Richard Marks, a transactional entertainment attorney and proffered expert in the customs and practices in the industry, corroborated Sloss. Marks opined that the minimum home video royalty in the entertainment industry was 20%, except for bargain bin revenues, which produced a 10% royalty. He further testified that it would be unusual to *negotiate* a 31.66% home video royalty, but allow a 10% boilerplate royalty to apply to 80-90% of the home video revenue.

As rebuttal to Sloss' testimony, Searchlight has introduced evidence of the deal Sloss struck with United Artists in 2003 for the Acquisition of *Pieces of April*. United Artists acquired that movie for $3 million and Sloss agreed to a royalty rate of 25% for rental and 15% for sell through. Sloss obviously agreed to limit the higher royalty rate of 25% to the rental market, while accepting a significantly lower than average rate for the purportedly larger sell-through market (although notably United Artists did not charge a distribution fee). [Exh. 435]. Also, in selling *Enduring Love* in February 2004, Sloss agreed to a 20% royalty for both rental and sell through with a 22.5% distribution fee, resulting in an effective rate well below 20% for both sell through and video.

Comparing deals between films is nonetheless fraught with peril, as each deal stands on its own, subject to all of the varying components of the deal. Searchlight has argued throughout, that each deal is a distinct mosaic precluding comparison between particular terms. Bargaining power differs from film to film, as do the various deal points within each agreement. A favorable acquisition price in one deal, such as the $4.75 million price for Napoleon, may justify a lower royalty rate in that same deal. All three of Sloss' films sold prior to the Picture paid a much smaller contingent compensation and nowhere near the advance Napoleon commanded. As for the acquisition price here, the evidence supported that it was one of the highest prices ever paid for an acquisition at Sundance. As Searchlight points out, once the acquisition price was paid, Napoleon had covered all of its investment, had made a profit well beyond that investment, and shifted all of the risk to Searchlight.

As of 2008, Sell-Through revenue for the Picture constituted approximately 87% of its home-video sales. In pressing its claims, Napoleon argues that Sloss would not have negotiated a 31.66% royalty rate that would apply to a mere 13% of home-video sales. The negotiated higher rate of 31.66% was a material deal point called out in the Term Sheet, which term, according to Napoleon, would be rendered immaterial if it applied only to the 13% of home video sales categorized as rental. While the fact that sell-through constituted 87% of home video revenues for the Picture was not known until after the audit, Sloss contends he understood in 2004 that sell-through was a significant share of the home video market. Taking Sloss' claim at face value --i.e., that sell-through constituted a significant share of revenue in 2004, then Sloss knew that sell-through would not be de minimus. Yet, Sloss claims that DeMarco assured him the 10% sell-through royalty would only apply to bargain bin sales. This testimony then begs the question -- why Sloss did not negotiate the parameters of bargain bin if he believed Sell-Through revenue was as considerable as rental revenue. If the 10% royalty, which on its face applied to *all* sell-through, was truly intended to apply only to bargain bin, logic dictates that Sloss would have documented such a significant term in the agreement. Not only did he not document this understanding, he admits that he and DeMarco never actually agreed upon any price point or mechanism for identifying bargain bin. According to Sloss, DeMarco warranted that the 10% would be de minimus, while at the same time explaining that the 10% royalty language in the Definition was an internal Searchlight position and a "battle not worth fighting." DeMarco gave Sloss no explanation regarding how Searchlight accounting would understand that the 10% only applied to bargain bin, nor did Sloss press him on the point. Sloss contends an agreement was reached upon an overall home-video sales royalty rate, except for bargain bin, but he implicitly admits that essential terms necessary to implement the agreement were not discussed. Sloss' version of the agreement in the face of express written language to the contrary defies reason.

Napoleon also points to the testimony of Jamie Taylor to support its claim that High Price Product Royalty refers to all sales, rental and sell-through. It points to the following exchange at the reference hearing:

Q: I said, you don't know if it was Mr. DeMarco's intent when he drafted the language in Exhibit 25 that he meant that the high price product terminology should apply to all sales, high price sales and all high price rentals, correct?

A: No, I don't know. But I interpreted it that way.

Napoleon, however, takes this response out of context. In context, it appears Taylor was speaking of high price sales *as defined in the Definition*, which included only rental. Immediately preceding the above referenced question and answer, Taylor opined that it was a mistake for DeMarco to have used "high price product" in the Term Sheet. Instead, DeMarco "should have used defined terms in the participation definition." Taylor believed DeMarco had been taking a shortcut in preparing the Term Sheet by using the Term Sheet from *Super Troopers*. Taylor opined that in the Super Troopers Term Sheet he had understood that DeMarco used "high price product royalty" intending to capture two 20% royalty categories in the Definition. Those two 20% categories in the *Super Troopers* Definition of Defined Net Profits/Acquisition were called "High Price Royalty" and "Rental Royalty." But both consist of exclusively rental revenue, despite their titles. [Exh. 134-80.]. Taylor explained: "In other words, there were two royalties of 20%. One was a high price sales, and there was a separate paragraph dealing with a rental royalty. My understanding in reviewing the SUPER TROOPERS deal was that the 31.66 percent override those two 20 percent royalties, there was also a 10 percent sell-through, so when Mr. DeMarco called it high price product royalty, he was capturing the 20 percent high price sales and the 20 percent rental royalty. At least that is my interpretation." Following this explanation of Super Troopers, he was asked:

> Q: "Right. You don't know if he made a mistake? In fact, you have no knowledge if it was Mr. DeMarco's intent to make it clear that the word "high price product" was to refer to high price sales and high price rentals; correct?
>
> A: Do I know?

Q: I said, you don't know if it was Mr. DeMarco's intent when he drafted the language in Exhibit 25 that he meant that the high price product terminology should apply to all sales, high price sales and all high price rentals, correct?

A: No, I don't know. But I interpreted it that way.

The exchange that Napoleon highlights immediately follows Taylor's explanation that there were two 20% categories. As those two 20% categories in *Super Troopers,* to which Taylor had just been referring, "high price sales" and "high price rentals," are both exclusively rental revenues, it is unclear how Taylor understood the question. In any event, Taylor's opinion is undermined by the fact that he never discussed this term with DeMarco. He was specifically asked:

> Q: Is it correct you never discussed with Mr. DeMarco what he meant by the term "high price product royalty"?
>
> THE WITNESS: I don't recall, and I don't even recall focusing on the words "high price product royalty" when I was negotiating this definition.

Notwithstanding his lack of recall, Taylor apparently did have an understanding that the 31.66% high price product royalty applied only to rental. When he prepared the Marketing and Branding Agreement with MTV, he recited the Napoleon home video royalty participation, in part, as follows: "provided however, the High Price Product Royalty shall be 31.66%, in lieu of the 20% provided therein." The reference to "in lieu of the 20% provided therein" is necessarily to the rental royalty in the Definition, as the sell-through royalty was stated in the Definition as 10%. The royalty of 31.66% was thus not in lieu of the 10% sell-through rate.

Sloss, himself, implicitly confirms that the language in the documents, including the "boilerplate" in the Definition, is clear. With *Super Troopers*, Sloss negotiated a Term Sheet that referenced the 31.66% royalty as High Price Product Royalty –exactly as was done here with Napoleon. When Sloss thereafter read the applicable Definition, he immediately recognized that the Definition language called for a 10% royalty for sell-through, contrary to the terms he believed he had just negotiated with DeMarco. And he called this conflict to DeMarco's attention. Sloss testified:

> "[T]here was a reference to a 10 percent sell-through together with the 150 pages of all the other terms. I called Joey and went through a number of terms with him, among them the 10 percent sell-through, and I said what is this, we negotiated a 31.66 royalty with a 25 percent distribution fee. And he said -- he said, 'There are battles that I have to fight within Fox, for instance, the reason we are doing a distribution fee and a royalty is something particular to the bureaucracy within the corporation of Fox.' I didn't know

whether it was because there was a video division and there was a distribution division and the distribution division would get the fee and the video division would get the royalty. And he said, 'In situations -- With regard to this sell-through, it is not worth the fight. It is going to be negligible, it will apply only to things marked down, in essence, to cost plus, and it will not apply to the great, great majority of video.'"

The Definition here and the one applicable to *Super Troopers,* contain virtually identical provisions regarding the 10% sell-through royalty. Moreover, in every agreement between Super Troopers and the Picture (*Waking Life*, *The Deep End, Kissing Jessica Stein)*, Sloss knew exactly what the "boilerplate" contained relative to the 10% royalty for sell-through, and felt obligated to confirm with DeMarco each time that, notwithstanding the written boilerplate, Searchlight would administer the participation statements to the contrary. If Sloss believed the Term Sheet's reference to High Price Product Royalty expressly included all sales and clearly overrode the 10% sell-through provision in the Definition, he would not have needed to have these conversations with DeMarco.

In documenting the deal regarding Searchlight's acquisition of *Little Miss Sunshine* in 2006, the parties intended that all home video would pay the same royalty and clearly stated as much. The term sheet does not simply refer to *High Price Product Royalty.* The *Little Miss Sunshine* Term Sheet expressly provided for a 31.66% royalty rate for "*High Price Sales/Rental Royalty* ***and Sell Thru."*** *[Exh. 13].* While Napoleon highlights that in that instance, unlike with *Napoleon Dynamite*, Searchlight provided the Sloss firm with the Definition *prior* to execution of the Term Sheet, the Referee finds this fact insignificant in light of Sloss' testimony regarding *Waking Life*, *The Deep End, and Kissing Jessica Stein.* Sloss knew and expected the Definition in each case would contain the "boilerplate" 10% sell-through royalty rate, and nonetheless agreed to a Term Sheet identifying the 31.66% rate as applying only to High Price Product Royalty.

Finally, as corroboration that the written documents are unambiguous, Steven Sills, a highly experienced auditor of studio participation agreements, easily construed their meaning. In his first final audit report, prepared after a two year audit, he concludes that the 10% royalty applies to sell-through, while the 31.66% rate applies to rental. He did not question the meaning of the term "High Price Product Royalty" as used in the Term Sheet. He readily interpreted the phrase High Price Product to mean only rental revenue. He also apparently understood that the Term Sheet did not address a royalty for "sell-through" and consequently applied the Definition royalty rate of 10% for sell-through revenue.

The Referee may only interpret terms provided by parol evidence when the language of the agreement is "reasonably susceptible" to the interpretation offered by the plaintiff. *Winet v. Price*, 4 Cal.App.4th 1159, 1165 (1992); *see also EPA Real Estate P'ship v. Kang*, 12 Cal.App.4th 171, 177 (1992). Napoleon wishes to interpret the written terms of the Agreement as follows: 1) to disregard the meaning assigned to High Price in the Definition and expand the Term Sheet reference to High Price Product Royalty to include all sell-through, except bargain bin, and 2) to redefine the sell-through language in the Definition to mean solely "marked down, cost plus" video sales. The Referee concludes that the written terms of the agreement are not reasonably susceptible to the modifications that Napoleon proposes. High Price cannot be construed as meaning all home video sales, except bargain bin. Such a modification is *inconsistent* with the written terms, considering both the Term Sheet and the Definition. This meaning contradicts the meaning consistently applied to *High Price* in the Definition. Most importantly, the proposed meaning is also unworkable, given that the Term Sheet is fatally silent on identifying the price point, as is the Definition. Napoleon's proposed meaning would require the Referee to add terms on which the written documents are silent and which terms were never negotiated. Parol evidence principles prohibit the Referee from adding terms not negotiated. See Rivers v Beadle (1960) 183 Cal.App.2d 691, 697-98, 700 (evidence did not violate parol evidence rule, as it did not vary the terms of the writing or supply any terms). Civil Code Section 1636 is also instructive: "A contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of the contracting, *so far as the same is ascertainable* and lawful." (emphasis added)

To interpret the Agreement as Napoleon advocates, the Referee would have to define bargain bin sales. The terms cost-plus and bargain bin are certainly not self-explanatory from an accounting application. Napoleon offers no solution as to how Searchlight would account for bargain bin in the absence of some delineation. Napoleon suggests that as bargain bin revenue was so de minimus, it was a term not worth negotiating. Yet, a definition of bargain bin concomitantly and necessarily defines the scope of all other sales. Purportedly, "all other sales" was a significant universe; a universe this significant mandated some definition. This is particularly true where Sloss knew that the Definition that Searchlight had been using in his four prior deals (*SuperTroopers, Kissing Jessica Stein, Waking Life, The Deep End)* provided for a 10% royalty for *all* sell-through. The applicable Definitions in each of these deals no longer defined a price point for bargain bin as they once did in his earlier deals. [Exh 17; 134-89;173; compare with Exh. 198].

There is no evidence that Sloss and DeMarco ever negotiated a definition for bargain bin sales or even discussed possible price points. While Sloss contends that DeMarco agreed that sell-through would be limited to "cost-plus" or "bargain bin," they failed to address even the broadest parameters of these terms. When asked to explain how he understood this 10% rate for cost-plus would operate, Sloss had no idea. He never had any specific understanding and simply could not explain how Searchlight might identify bargain bin revenue to limit application of the 10% royalty rate provision in the Definition. He only knew that DeMarco could not change this provision, as it was an intractable internal Searchlight position and a "battle not worth fighting." He allegedly relied on DeMarco's purported uncorroborated oral representation that Searchlight would only apply this rate to a de minimus amount of the home video revenue.

The Referee is both constrained by the principle articulated in *Wolf, supra,* that evidence "may not be used to create a contract the parties did not intend to make or to insert language one or both parties now wish had been included," and by the absence of any evidence that would allow the Referee to insert a definition of "bargain bin." Consequently, the parol evidence offered by Napoleon cannot provide a basis for altering the written agreement.

In sum, the Referee finds High Price Product Royalty is not ambiguous. The term is in initial caps, meaning it is a defined term in the written documents, and the Definition consistently refers to High Price as exclusively *rental* revenue. The sell-through language is equally unambiguous and is not limited in any fashion by a price point. Although the Referee concludes that the term "High Price Product Royalty" is not ambiguous when read in the context of the Definition, she has considered Napoleon's extrinsic evidence both to allow Napoleon potentially to demonstrate that there may be a latent ambiguity and to explain what the parties intended by the phrase in question. However, the Referee concludes that the evidence presented does not reveal a latent ambiguity, that the explanation is contrary to the express terms of the writing, and the explanation would require the Referee to add terms not negotiated by the parties. *Alling v. Universal Manufacturing Corp.*, 5 Cal.App.4th at 1436. As written, the agreement provides that the 31.66% royalty applies to High Price Product, which is defined by the Definition only as *rental* revenue, and provides for a 10% royalty rate for all sell-through revenue. Given these terms, Searchlight has not breached the agreement by accounting to Napoleon according to these terms.

B. **Whether the Doctrine of Mistake Requires Reformation of the Agreement.**

Napoleon argues that at a minimum, there was a mistake and the Agreement should be reformed to reflect the mutual intent of the parties. Civil Code §1640 provides:

"When through fraud, mistake or accident, a written contract fails to express the real intention of the parties, such intention is to be regarded, and the erroneous parts of the writing disregarded."

Section 3399 provides:

"When through fraud or a mutual mistake of one party, which the other at the time knew or suspected, a written contract does not truly express the intention of the parties, it may be revised on the application of a party aggrieved, so as to express that intention."

To establish fraud as a ground for reformation, Napoleon must prove that DeMarco falsely represented either that the agreement (the Term Sheet and Standard Terms with incorporated Exhibits and Schedules, including the Definition) was in conformity with the intended agreement, or he misrepresented that the written agreement will be in conformity with the intended agreement. See California Civil Practice, Business Litigation §28:11, citing Lane v. Davis 172 Cal.App.2d 302, 342; 5 Witkin, California Proc. (4th ed.), Pleading § 768. Alternatively, to prove a mistake is mutual, Napoleon must establish the failure of the written contract to express the intention of the parties due to the inadvertence of both of the parties.

"Reformation on the ground of mutual mistake presupposes actual agreement between the contracting parties as to what they intend, but further presupposes that all parties mistakenly believe that the written contract expresses their intention." California Civil Practice, Business Litigation §28:7, *citing*, *Jones v. First American Title* (2003) 107 Cal.App.4th 381, as modified on denial of reh'g, (Apr. 23, 2003); *Treadway v. Camelia Convalescent Hospitals, Inc.* (1974) 43 Cal.App.3d 189.

In determining whether a mutual mistake has occurred, a court may consider parol evidence, even if the agreement is integrated. *Hess v. Ford* (2002) 27 Cal.4th 516, 524. However, the Referee is also constrained from revising the agreement to make a new agreement for the parties and "may only reform the writing to conform with the mutual understanding of the parties at the time they entered into it, if such an understanding exists." Id.

To obtain the remedy of reformation, Napoleon must prove such fraud or mutual mistake by clear and convincing evidence. "[W]here one seeks to reform a written instrument by the introduction of extrinsic evidence, the courts have generally required clear and convincing proof or something more than a preponderance of the evidence, as the basis for such an invasion of the parol evidence rule." Moore v Vandermast (1941) 19 Cal.2d 94, 97.

The Referee has concluded for the reasons explained previously herein that the reference in the Term Sheet to the obsolete Definition, while a "mistake," was corrected *prior* to execution of the Standard Terms. Consequently, the correct version of the Definition was incorporated by reference into the Agreement. Moreover, the evidence does not support that Sloss was under any misunderstanding that the Definition was to be incorporated into the final agreement. As to each of the prior four films that Searchlight acquired through Sloss, a similar, albeit not identical, Definition applied, and Sloss expected and understood in each instance that the Definition would contain the "boilerplate" 10% royalty for sell-through. The weight of the evidence supports that Sloss similarly expected the Definition here would include the same boilerplate, as he clarified with DeMarco that despite the boilerplate, their agreement would be otherwise. Napoleon has thus not established a mistake or fraud as to the incorporation of the Definition.

Napoleon argues as well that if the "High Price Product Royalty" reference in the term Sheet is construed to include only rental home video revenue, the parties made a mistake in using that terminology. Napoleon seeks to reform the Term Sheet to reflect that the 31.66% royalty rate also applies to home video sell-through, except for bargain bin. Napoleon contends that either 1) Searchlight defrauded Napoleon when DeMarco advised that the 10% sell through royalty rate would only apply to bargain bin, and the agreement should be reformed to reflect his representations, or 2) DeMarco and Sloss erred when using the term High Price Product Royalty to document their purported intent to capture all home video, except bargain bin.

Sloss is the only witness to the purported oral agreement reached in conversations between Sloss and DeMarco and the scope of the 31.66% royalty rate they discussed. By the time Napoleon and Sloss asserted the contention that the 31.66% royalty rate applied to all home video, except bargain bin, DeMarco was deceased. Sloss, himself, dismisses any claim of fraud. He testified:

> A: It is my assertion that if Joseph DeMarco were alive today, he would be echoing my position.
>
> Q: If he weren't echoing your position, he would have lied to you?
>
> A: That's not even clear. He might have misunderstood at the time. I mean, there is a lot of reasons, I guess, you could argue he wouldn't echo my position. Maybe he would be told by the company to get in line. I mean, I don't know the answer to that. That is complete speculation. I don't believe -- I honestly do not believe he lied to me.
>
> On the second day of his testimony, he reiterated:
>
> A: "I do not believe Joe Demarco lied to me."

Sloss never claims that DeMarco intentionally misrepresented to him that the Term Sheet or Standard Terms reflected an agreement that the 31.66% royalty would apply to all home video except bargain bin, knowing that the written agreement did not so provide. Instead, Sloss concedes that DeMarco acknowledged the 10% royalty rate for sell-through in the Definition, but represented that that rate, despite the language of that provision, would be applied only to bargain bin sales. Sloss asserts that the deal he struck was not memorialized, but orally acknowledged.

In determining whether Napoleon has established by clear and convincing evidence that there was a mutual mistake, the Referee finds from the evidence that in 2004, Sloss was an experienced transactional lawyer with a reputation for being an aggressive and effective negotiator. Sloss contends that he reached an agreement that is not only contrary to the terms of an expressly integrated agreement, but is not memorialized or confirmed in a single piece of paper. Sloss' testimony strains reason; he did not document any of the several identical conversations he purports to have had repeatedly with DeMarco, reaching the same understanding over and over again, beginning with *Super Troopers,* then *Waking Life*, *The Deep End, Kissing Jessica Stein,* as well as the Picture here. Despite communications with DeMarco on other deal points via email, not a single email confirms this purported agreement with DeMarco. Even when Sloss notes that the home video revenues for Napoleon are low, he does not follow up by confirming with DeMarco that the royalty is being properly applied, or even inquiring how it is being applied.

DeMarco, too, did not make a single note, write a single email or letter or send a memo either to Sloss, Brennan, Taylor, Kaplan or Searchlight's accounting department to memorialize the deal regarding the limitation of the 10% royalty to bargain bin only. If, the purported agreement were true, DeMarco would have needed to advise Searchlight's accounting department to disregard the 10% sell-through for all but bargain bin sales and instruct them regarding application of this modified royalty term. It is difficult to conclude that this was a mere oversight on DeMarco's behalf, given the repeated instances in which he purportedly made this agreement. Despite that this agreement applied to five movies, DeMarco never once wrote a single word to confirm or implement the agreement.

Also probative, are the facts that Sloss was sent all of the versions of the final audit reports, and the iterations of the purported DeMarco oral agreement. Just before issuing his first draft, on December 10, 2010, Sills discusses whether Sloss wants to "go with the … 25% overall royalty claim." [Exh. 225]. In the subsequent first draft of the final report dated December 24, 2010, Sills does not include this "25% overall royalty claim," but assumes the terms as stated in the Term Sheet and Definition, applying a 31.66% royalty to rental and 10% royalty to all sell-through, and makes no claim for underreported sell-through video. [Exh. 151]. This report is forwarded to Sloss for his review in December 2010.

Between December and January 24, 2011, Sills does modify the report and adds the Claim at issue here for underreported home video, reciting the following version of the purported agreement:

> "The Agreement provides for a 31.66% royalty on High Price receipts and a 10% royalty on Sell-Through receipts, you have informed us that during the negotiation of the Agreement, Fox' representatives informed you that they anticipated a net overall royalty of 25%.
>
> Due to the change in the video marketplace from a rental market to a sell-through market, 87% of the Picture's video sales were at the lower rate, resulting in an overall video royalty rate of 12.88%. It should be noted that this rate is approximately one-half of the industry standard minimum rate of 20%.
>
> Had Fox reported to you based on the 25% overall rate, provided to you during contract negotiations, home video royalties would have increased by $16,894,429." [Exh. 153].

According to Sills, either Jessica Lustgarten of Cinetic or Sloss relayed this version of the DeMarco agreement. Sloss believes Sills misunderstood the explanation. However, if the agreement was simply that a 31.66% royalty applied to all home video except bargain bin, there appears to be nothing so complicated as to result in the version Sills relates in his February final report.

Significantly, Sills forwarded this report to Sloss for his approval on January 24, 2011 [Exh.153] and Sloss subsequently forwarded this claim as recited above in a final audit report to Searchlight on February 16, 2011. [Exh. 12]. Sloss testified that there was a great likelihood that he did not read this report because in late January he was busy at Sundance and at the Berlin Film Festival on February 14th. However, the cover email in the January transmittal to Sloss not only highlights this new claim, but specifically asked Sloss whether he was comfortable with the language of the claim and whether he wanted to discuss further. Fourteen days pass before another version of the report, containing the same claim was again sent to Sloss. Two days later, Sloss sent this report to Searchlight without changing the Claim asserting the overall 25%

royalty rate. Not until Sills prepares a third version of the audit report over a year later in May 2012, does the report include Sloss' present version of his purported agreement with DeMarco. And even now, Sloss cannot fill out the necessary details to the purported agreement.

Given the above, the Referee concludes that Napoleon has not established by clear and convincing evidence either that there was a mutual mistake, or a unilateral mistake, on Napoleon's part, known by Searchlight. Sloss' testimony is impeached by the various audit reports and is not corroborated by any witness or document. His version of the agreement is also inherently incredible, given that it lacks key terms, necessary to its implementation.

Sloss admittedly does not reach any understanding with DeMarco as to the details or mechanics of the agreement. DeMarco purportedly represents that Searchlight will apply the 10% royalty to only deeply discounted, cost plus and bargain bin sales, but does not define any of these terms or provide any enforceable parameters. Sloss does not request any clarification as to how their understanding would be practically applied, and how internal Searchlight accounting would know how to implement an undocumented and undefined agreement. The Referee is constrained in reforming an agreement only by the terms actually agreed upon. As Sloss admittedly never reached agreement with DeMarco as to how to define bargain bin, the Referee cannot create her own terms here. Given that material terms of the purported agreement were never defined, Napoleon has not established that it is entitled to a reformation of the Agreement.

C. Whether Searchlight is liable under a theory of negligent misrepresentation.

Napoleon's Complaint alleges that DeMarco negligently misrepresented that there would be an effective overall royalty rate of 25%, and that High Price receipts represented the overwhelming majority of Searchlight's home video receipts, with all other receipts nominal and insignificant by comparison, and that it was unnecessary to negotiate a royalty rate for other home video receipts. Searchlight counters that these statements were necessarily predictions and that negligent misrepresentation cannot be based on a negligent false promise, such as this. Searchlight also maintains that the alleged misrepresentations are at variance with the express written terms of the agreement and are barred by the parol evidence rule. Finally, Searchlight insists that Napoleon did not justifiably rely on the representations because Sloss wanted

Searchlight to acquire the film and actively avoided other interested buyers, despite the high interest, and because Sloss, an experienced and shrewd negotiator, knew that the Definition "boilerplate" included a 10% royalty for all sell-through.

Fatal to Napoleon's claim for negligent misrepresentation is the fact that the written agreement is inconsistent with the oral representations that Sloss attributes to DeMarco. To the extent DeMarco represented that the 31.66% royalty would apply to all home video except bargain bin, the written agreement provides otherwise. It provides that a 31.66% royalty applies only to rental and that the 10% rate applies to all sell through. Parol evidence cannot establish a misrepresentation where the written terms are to the contrary. See *Duncan v. McCaffrey Group, Inc.* (2011) 200 Cal.App.4th 346; *Alling v. Universal Manufacturing Corp.* (1992) 5 Cal.App.4th 1432, 1437. As far as the alleged representation that the 10% royalty would only apply to a de minimus amount of revenue, limited to bargain basement, the language in the Definition similarly contradicts that statement.

If the representation is a reassurance that sell-through would constitute a small percentage of home video, it is likewise a prediction that is not actionable. See *Tarmann v. State Farm* (1991) 2 Cal.App.4th 153. Nor could Sloss have reasonably relied on this prediction. As an experienced transactional attorney himself familiar with the evolving nature of home video revenue, Sloss would have no reason to believe that DeMarco possessed superior information as to the trend in home video revenue. See *Guido v Koopman* (1991) 1 Cal.App.4th 837, 843-44 (knowledge, experience and education of person claiming reliance must be considered); *Kolodge v. Boyd* (2001) 88 Cal.App.4th 349, 373. Sloss also admits that he honed in on Searchlight to the exclusion of other interested buyers because he knew that Searchlight would be the best distributor and believed that Nancy Utley was an "inspired" marketer at Searchlight who would know how to market the film.

Having failed to prove either a misrepresentation or reasonable reliance, Napoleon has not established that Searchlight is liable under a theory of negligent misrepresentation.

<u>D. Promissory Estoppel.</u>

Napoleon's claims for damages relative to sell-through home video revenue based on a theory of promissory estoppel fail for similar reasons. First, the promise alleged is not sufficiently delineated. Laks v. Coast Fed'l Sav. & Loan Ass'n (1976) 60 Cal.App.3d 885, 890-892. Sloss concedes that he and DeMarco did not define the parameters of "all sell-through, bargain bin." Second, promissory estoppel is generally a substitute for consideration. No one denies that the parties executed a written agreement that provides for consideration. The parties simply dispute the manner in which the consideration is to be calculated as to one term in the agreement. See Raedeke v. Gibraltar Sav. & Loan Ass'n (1974) 10 Cal.3d 665, 672. Finally, the evidence does not support that Sloss, a seasoned transactional attorney with a reputation as an aggressive negotiator reasonably relied on DeMarco's representations that sell-through would be de minimus.

5. **<u>Remaining Contract Claims</u>**

A. Claim for Breach based on Underreported Electronic Sell-through (EST) and Video on Demand (VOD).

Napoleon argues that EST and VOD should be reported at 100%, not, as Searchlight reports, at 10% and 20%, respectively. Napoleon claims Searchlight underreported EST and VOD by $84,767. Napoleon's share of this unreported revenue is $42,383.50.

As for VOD, Sills conceded that if the Definition is an operative part of the agreement, it expressly provides that VOD is to be reported on a 20% royalty basis. [Ex. 68-9, ¶ (C); 68-46, ¶ AX]. As the Referee has found that the Definition has been incorporated into the agreement, the VOD revenue has been properly reported on a 20% royalty basis.

As for EST, Napoleon contends both that the Definition does not apply, and that even if it did, EST should be reported at 100%. The Definition contains no express reference to *EST.* Considering the various categories defined therein, EST fits within Television Exhibition, not Home Video Exhibition. Napoleon also asserts that as a matter of fairness and logic, Searchlight incurs no costs such as in the manufacture of a DVD, and thus EST should not be treated like a DVD, but rather like Television Exhibition.

According to the testimony, EST is made available to the intermediary dealers either through physical master tapes or via some sort of electronic file. The intermediary then sends an electronic file to the ultimate purchaser's iPod, television or computer, which allows the purchaser to maintain a permanent copy of the movie on their iPod, television or computer.

Searchlight defends its treatment of EST as Home Video Sell-Through revenue paid as a royalty by arguing that it cannot be Television Exhibition, because Television Exhibition is defined as "other than Home Video Exhibition," and EST necessarily falls within Home Video Exhibition. Searchlight tries to prove the latter by referring first to the definition of "**Cassettes.**" The Definition defines Cassettes as:

> "Motion Picture Copies stored in a cassette, cartridge, videogram … or 'storage/retrieval device' … designed to be used with a reproduction apparatus which causes a Motion Picture to be visible on the screen of a television receiver, television monitor … or any comparable device no known or hereafter devised."

A Motion Picture Copy is a "copy, whether temporary or permanent, in any form or made by any process now known or hereafter devised of a Motion Picture." Searchlight then refers to the definition of Sell-Through as:

> "Cassettes of a Motion Picture sold to wholesale, retail or other dealers … which are generally intended for purchase by members of the public for Home Video Exhibition …." (emphasis added)

Home Video Exhibition is the "non-public exhibition of a Motion Picture, whether by means of a pre-recorded Cassette or by means of a 'downloading' such Motion Picture to a Cassette." (emphasis added).

Undeniably EST involves a non-public exhibition of a Motion Picture. But to fall within the definition of Home Video Exhibition, EST must also be accomplished by means of "a pre-recorded Cassette or by means of 'downloading such Motion Picture **to a Cassette.**'" Addressing the first alternative –i.e. by means of a "pre-recorded Cassette," the reference to "*pre-recorded*" can only be intended to modify cassettes that fall within the categories of "cassette, cartridge, or videogram" and not "storage/retrieval device." (A pre-recorded storage/retrieval device is either redundant or an oxymoron.) There is no evidence to support that EST is accomplished by the sale of "pre-recorded cassettes" to the ultimate users of EST -- "members of the public." Clearly, the ultimate users are not purchasing and exhibiting the movie by means of a pre-recorded Cassette. Consequently, EST does not qualify as Home Video Exhibition under the first prong –i.e., accomplished by means of a pre-recorded Cassette.

Home Video Exhibition might also be accomplished by means of 'downloading' such Motion Picture to a Cassette. Searchlight endorses this interpretation in defending its accounting of EST as home video, arguing that the definition of a Cassette includes a storage/retrieval device. According to Searchlight, EST is accomplished by means of downloading the electronic file to the ultimate user's iPod, television or computer, all of which might qualify as a storage/retrieval device. But a close reading of the governing definition of "Cassette" precludes a television or computer as storage/retrieval devices. The definition of "cassette" necessarily assumes the storage/retrieval device is something other than a television or computer, as the definition stipulates that the storage/retrieval device is "designed *to be used with* a reproduction apparatus which causes a Motion Picture to be visible on the screen of a television receiver, television monitor … or any comparable device now known or hereafter devised." The storage/retrieval device is thus a device that is used in conjunction with a computer or television. EST therefore does not fall within this second prong of Home Video Exhibition.

The conclusion that EST is not included within Home Video Exhibition becomes even more apparent when the definitions of "Cassette" and "Sell-Through Sales" are juxtaposed. As EST is the sale of a copy of the Picture for permanent use, EST cannot qualify as rental. Thus, it must fit within the only other category of home video sales –i.e., "Sell-Through Sales." "Sell-Through Sales" are sales of Cassettes to dealers, which Cassettes are then sold by the dealers to the public. As defined, a Cassette is either a physical cassette (DVD, videotape etc.) or a "storage/retrieval device." The evidence established that EST involves the electronic or physical transmission of a copy of a movie to the dealer, and then transmission of a digital file for download to the ultimate buyer's television, computer screen or other electronic device.

Clearly, EST transmission between the dealer and the ultimate user does not involve a physical cassette, cartridge or videogram. However, Searchlight's witnesses suggested that the electronic transmission of the Motion Picture used in EST involves a *storage/retrieval device*, and thus falls within that prong of the definition of "Cassette". There are two problems with this analysis. First, it is clear from the definition of "Sell-through", that the subject of the sale is a

Cassette travelling through the hands of an intermediary dealer into the hands of the ultimate purchaser. Sell-Through Sales are "Cassettes … sold to … dealers … which are generally intended for purchase by members of the public". As defined, the cassette that the dealer is purchasing from Searchlight is the *same* Cassette that the dealer is selling to the ultimate buyer. If the storage/retrieval device is the ultimate purchaser's iPod, television or computer, the iPod, television or computer is neither the object of the sale from Searchlight nor the object of the sale to the ultimate user. Even if the iPod, television or computer is a "storage/retrieval device", Searchlight is not selling this "Cassette" to the dealer, nor is the dealer selling it to the ultimate purchaser. Rather, Searchlight is selling either a physical Cassette or an electronic file to the dealer. The dealer is then selling a copy of the movie to the ultimate user via a digital media file for download on a hard drive that the purchaser already owns. The purchaser is not buying a physical cassette or a storage/retrieval device. EST does not therefore fall within the definition of Home Video, either under the definition for Home Video Exhibition, Cassettes or for Sell-Through.

EST is more reasonably characterized as Television Exhibition under the Definition. "Television Exhibition" is defined as:

> "The exhibition of a Motion Picture using any form of Motion Picture Copy for transmission by any means now known or hereafter devised (including over the air, cable, wire, fiber, master antennae, satellite, microwave, closed circuit, laser, multi-point distribution services or direct broadcast systems) which transmission is received, directly or indirectly by retransmission or otherwise, impaired or unimpaired, for viewing the Motion Picture on the screen of a television receiver or comparable device now known or hereafter devised (including high definition television), other than Home Video Exhibition or Theatrical Exhibition."

Searchlight should be reporting EST based on 100% of revenues, rather than on a royalty basis, as EST does not fall within the definition of Home Video, nor does it fall within VOD, as VOD is a temporary download. Napoleon shall prevail on this claim and should recover 50% of the difference between the amounts paid through September 2008 and that which Searchlight should have paid if reported at 100%. Sills calculates this amount as $26,737, less the distribution fee of 30%. [Exh. 146-6, 37].

B. Merchandising Fees.

Napoleon argues that Searchlight cannot deduct both a 30% distribution fee and a 40% (15% for foreign markets) administration fee on merchandising revenues. Searchlight contends that the Term Sheet expressly allows for the deduction of a 30% Distribution Fee on all media, except home video. This would include merchandising. Searchlight further points to the Definition at Paragraph 8 [Exh.68 -14], which provides that Searchlight may take a 40% administration fee. The parties dispute whether these fees are prohibited as duplicative.

Napoleon counters that if the Term Sheet provides for a 30% distribution fee for all media, including merchandising, then this 30% fee should trump and override any administrative fee. The express terms of the Term Sheet provide that all payments and all other "terms and conditions related to such amounts" shall be in accordance with the terms set forth in the Term Sheet, and if *not addressed* in the Term Sheet, only then does the Definition apply. The administration fee is identical to the distribution fee, according to Napoleon, with the only real distinction one of semantics. Alternatively, Napoleon argues that merchandising is not "media" and is not subject to the 30% distribution fee. "Media" is a form through which the Picture is exhibited, and does not include merchandise.

Searchlight also argues that this claim is untimely, as it was not asserted until June 25, 2012 over a year after the audit was completed and the first final audit report submitted. According to Searchlight, because it first reported the administrative fee deduction to Napoleon in its December 2004 Distribution Statement [Exh. 174-1], the incontestability period of 42 months began to run and expired on September 14, 2008. [Exh. 68 ¶H]. While the delayed audit may have tolled this period pursuant to the mutual understanding of the parties until February 16, 2011, when Napoleon submitted the first final audit report, this claim was not asserted within six months thereafter or in the Complaint filed August 30, 2011. Instead Napoleon first brought this claim on June 25, 2012. If operative, the incontestability clause bars Napoleon from bringing this claim.

Napoleon contends that Searchlight wrongfully concealed this duplicative charge and Searchlight's fraudulent non-disclosure tolls the incontestability clause. The Participation Statements only reference the 30% distribution fee, not the additional administrative fee. Napoleon has the burden of establishing any fraudulent concealment. *Baker v. Beech Aircraft Corp.* (1974) 39 Cal.App.3d 315, 322.

The Agreement permits Searchlight to provide Participation Statements in summary form. Those statements expressly reflected the 30% distribution fee and also contained figures including the administrative fees, albeit not called out as administrative fees. The September 2008 Statement discloses a 30% distribution fee with a cumulative deduction of $3,525,566. Upon audit, the 40% administrative fee was obvious in the work papers, which were made available to the auditors. [Exhs. 436-5; 439F-209]. Even if the auditors limited themselves to the most recent work papers for the September 2008 Statement, those work papers expressly identified a cumulative deduction of $2,746,486, referenced as a 40% and 15% administrative fee. [Exh. 436-5]. The work papers, in fact, show check marks next to each of these entries, suggesting that the auditors tabulated these numbers in their audit. [Exh. 436-4]. Higa and Sills both concede that the auditors simply overlooked this purported duplication. Napoleon has failed to carry its burden of demonstrating wrongful concealment such to toll the incontestability clause. Napoleon did not timely raise this claim. The Incontestability provision bars this claim.

C. Residuals

Napoleon contends that Searchlight should not be permitted to deduct residuals that it is required to pay from home video as a distribution expense. Paragraph 2(a) on page 28 of the Definition expressly allows as a distribution expense from Home Video any Guild Payments. Paragraph D(1)(f) on page 22 of the Definition describes Guild Payments as including amounts due under applicable Collective Bargaining agreements, as well as the Participant's Residuals. The Definition thus expressly allows for this deduction as a distribution expense and Napoleon's claim here fails.

D. Foreign Version Costs.

Napoleon contends that the foreign version costs of $149,744 should be allocated to home video in proportion to home video revenues, and not deducted entirely from theatrical revenues.

It argues that these costs are dubbing costs that benefit the home video versions of the Picture distributed in foreign markets. It reasons that it is inequitable to deduct the entire expense against the theatrical revenues. Napoleon bears 50% of the costs for theatrical, while Searchlight bears 100% of costs allocated to home video. As home video receipts account for 45% of total revenue generated in foreign markets, Napoleon believes Searchlight should allocate 45% of dubbing costs ($66,710) to home video and eliminate this expense from the Statement.

Searchlight responds that the Definition expressly provides that dubbing costs be deducted from the "first medium of exploitation of such foreign language version." [Exh. 68-25, ¶h]. The first medium of exploitation of the Picture in the foreign market was theatrical. Under the express terms of the Definition, the dubbing costs are properly attributed to theatrical. Not only is Napoleon's suggestion that costs be allocated proportionately in conflict with the Definition, it is unworkable, as the proportion of home video revenue to theatrical constantly changes. Given the unambiguous language in the Definition, this claim fails.

E. Price Protection Reserves.

Napoleon contends that Searchlight improperly reduced home video revenue by $6584 in price protection reserves. According to Napoleon, there is no provision in the agreement that allows such a deduction.

Searchlight points to the Definition at page 9 ¶4, wherein it permits Searchlight to deduct "trade rebates [and] returns" and "for all of which reasonable reserves may be established and maintained in accordance with Distributor's customary practices." When Searchlight reduces the wholesale price of a video, it provides a credit to a distributer who is holding inventory purchased at a higher price. This credit is given in lieu of taking a return of the product and reshipping the product at the lower price. According to Searchlight, this is effectively a credit for a return, without actually having the product returned and reshipped. This is a reasonable practice that obviates unnecessary shipping costs and is properly characterized as a "return," given the practical effect of the policy.

Napoleon has not presented any persuasive evidence that the reserves that Searchlight has maintained are not reasonable and in accordance with its customary practices. This claim fails.

F. Prime Time Media Charges.

Napoleon contends it should not have been charged for $10,667 in commissions paid to Prime Time Media, a Fox-owned in house advertising agency, as it is not an actual out-of-pocket advertising expense as Fox retained a portion of the commission. Searchlight claims that the Definition expressly allows for the deduction of advertising expenses, "including the fees of a Fox subsidiary or division engaged in placing certain advertising" as long as the fees are not "greater than those customarily charged by third party vendors for comparable services." [Exh. 68-23, ¶F]. Steve Kaplan testified that the commission was 3.15%, a rate that he believed was appropriate. Napoleon does not contend that the fee paid was out of line with that customarily charged, but only that it is not an actual out-of-pocket expense that can be charged. The evidence supports that the payment is allowed by the Definition. This claim fails.

G. Foreign tax Credit.

Napoleon contends that to the extent Searchlight received tax credits for foreign taxes paid, it should pass this credit on to Napoleon, as the tax was not actually an expense it incurred. As Searchlight refused to provide its tax records to Napoleon, Napoleon could not determine whether the credit was actually taken. Searchlight contends that the Definition allows it to charge the tax payments as an expense regardless of whether it ultimately receives a credit. Searchlight defends this provision on the basis that its parent, News Corp., does not track tax credits on a film-by-film basis.

The Definition provides at page 20, ¶(b) that the Participant is not entitled to "claim, share or participate in any credits … with respect to any Taxes, nor shall the deductible amount of any Taxes … be decreased … because of the manner in which Taxes and tax credits are treated by" Searchlight. Given the express terms of the Definition, this claim is properly denied.

H. Inadequately Supported Advertising Expenses.

Napoleon asserts that Searchlight deducted advertising expenses totaling $250,714 that it could not support with adequate documentation. Searchlight disagrees that its documentation is inadequate. The Definition is instructive on this issue at page 22, ¶(g)(i) where it provides in pertinent part that such expenses may be deducted "as Fox may reasonably determine in good faith" are directly related to or allocable to the Picture. Where expenses are paid for a group of movies, and the specific amount allocable to a particular picture cannot be determined, Searchlight is allowed to deduct "such sums as may be consistent with [its] usual practice in such matters." [Exh. 68-31, ¶3].

The evidence supporting Searchlight's allocation of the disputed expenses consists of four invoices for internet advertising as follows: Microsoft $72,857 for period June 14-30, 2004; Microsoft $132,857 for period July 1-31, 2004; IncFusion $25,000 for period July 2004; and $20,000 Yahoo for period beginning July 2, 2004. None of these invoices identify Napoleon Dynamite. In defending its allocation of these expenses entirely to the Picture, Searchlight considered the fact that four films opened in the same time frame: The Clearing July 2, 2004, The Dreamers February 6, 2004, Garden State July 28, 2004 and Napoleon Dynamite June 11, 2004. It reviewed the relative box office performance of each film and the relative percentage of the Internet advertising expenditures. For example, Searchlight spent $1,987,146.31 on four films; $601,409.34 on Garden State advertising, relative to $1,074,385 on Napoleon Dynamite. These figures equate to 30.3% of the advertising for Garden State and 54% for Napoleon. In terms of box office, Napoleon had 55.9% of the box office while Garden State's receipts constituted 33.6%.

Kaplan then reviewed the media plan for the Picture to see what was budgeted for Internet spending. As the budget was consistent with these expenditures, he concluded that Searchlight reasonably determined in good faith that these expenditures could be allocated to the Picture. In essence, because Napoleon did better at the box office than the other four films, Searchlight has justified charging the Picture with the advertising expenses, without any direct evidence corroborating that the advertising was actually for the Picture.

Napoleon argues that there was a limited release of the Picture on June 11, 2004 and a wide release of the Picture on August 27th. The advertising at issue, extending from mid June to the end of July could have been targeted for The Clearing, which opened July 2nd or Garden State, which opened July 28th. Napoleon notes further that Searchlight produced no documentation that advertising for the Picture appeared on the sites that are the subject of the invoices during the time frame referenced.

Significantly, Searchlight has not established that the amounts expended on the advertising at issue were actually spent on advertising for the Picture. Rather, Searchlight has worked in reverse. As the Picture did well, more advertising expenses are allocated to it after the fact. Using this logic allows Searchlight to direct expenses to the more successful film, regardless of whether the expense was actually incurred to advertize that film. Searchlight has failed to establish that its decision to allocate 100% of the disputed advertising expenses to the Picture was reasonable. The evidence does not support that these advertising expenses are directly related or reasonably allocable to the Picture and should not have been deducted. Napoleon should recover its 50% share, i.e., $125,357.

I. **Unreported EchoStar.**

Napoleon seeks to recover its share of a payment owing to Searchlight from EchoStar. There is no apparent dispute that once Searchlight receives the sum due, it will pay Napoleon its share, i.e., $31,471.50. According to the Definition, such amount is due to Napoleon only once it is "received and earned." If payment has been received by Searchlight, it is owing to Napoleon.

J. **Interest on Claims.**

Napoleon asserts that it should recover interest on its claims. Searchlight contends that as the claims were not liquidated, no prejudgment interest can be awarded. However, certain of the claims were liquidated, and specifically those awarded here. The EST values were known and calculable, as were the advertising expenses.

Searchlight also contends that the Definition does not provide for interest. [Exh.68-40; ¶E]. However, the clause to which Searchlight cites provides simply that its obligation to pay Napoleon under the terms of the Definition shall not bear interest. Paragraph E merely relieves Searchlight of any obligation to pay interest on amounts tendered to Napoleon as they become due or at such time as Searchlight tenders payments owing. It does not preclude an award of prejudgment interest with a judgment determining that Searchlight did not pay Napoleon according to the terms of the agreement. Interest at the legal rate should apply to the amounts awarded for EST and unsupported advertising costs, running from the date the complaint was filed.

K. **MTV Participation.**

Napoleon charges that Searchlight breached the contract by secretly deducting as a distribution expense under the category of advertising, the participation fee Searchlight owed to MTV pursuant to the Branding and Marketing Agreement. Searchlight defends this claim on two grounds. First, the incontestability clause bars the claim, as it is untimely, having been brought in the middle of the trial. Second, Searchlight contends the participation is an advertising cost that is directly allocable to the Picture and permitted by the Agreement.

Addressing the incontestability defense, Napoleon argues that Searchlight fraudulently concealed this payment, preventing Napoleon from discovering this claim. The delayed discovery rule, according to Napoleon provides that Napoleon's claim does not accrue until it actually discovered the injury or could have discovered the injury. Napoleon sites to *Weatherly v. Universal Music Publishing Group* (2004) 125 Cal.App.4th 913, 920 for the proposition that Searchlight cannot profit from Napoleon's ignorance of its claim where Searchlight prevented the discovery.

It is undisputed that Searchlight never disclosed to Napoleon the terms of its Marketing and Branding Agreement with MTV. The Participation Statements to Napoleon did not call out the MTV participation payment under any category entitled "Participations," contrary to the usual custom and practice in the industry in preparing participation statements. The amount deducted for this participation was instead folded into advertising expenses and was not itemized in the Statements. While Napoleon was aware of the existence of the Co-Financing Agreement between Paramount and Searchlight, it was unaware of the terms, as Searchlight refused to produce to Napoleon the Co-Financing Agreement. Ilan Haimoff, with the Sills' firm, requested a copy of this agreement during the audit on October 28, 2010. [Exh 237]. Searchlight admittedly refused to provide it. Had Searchlight produced the latter, Napoleon would have learned of the separate agreement with MTV, including the 5% profit participation.

Searchlight argues that the participation was evident from a review of the work papers and Napoleon's auditors should have taken note of it. Searchlight notes that it provides the auditors with all of its work papers for each statement under audit at the beginning of the audit and that these papers remain available to the auditors throughout the audit. Had the Sills Firm accounted for all of the monies categorized as advertising expense, it would have discovered the MTV participation payments within that category. According to Sills, the auditors work from the most recent statement covered under audit, here the September 2008 Statement, as that statement contains cumulative numbers for all preceding statements. These cumulative numbers, subsumed in the September 2008 statement are audited, rather than auditing each particular proceeding statement. Admittedly, the Sills Firm did not account for all of the advertising expenses and erroneously assumed that the differential in the advertising accounting was attributable to Paramount.

The work papers and the subsequently requested back up documentation included a printout captioned "Domestic Distribution Expenses" containing cumulative balances for what appears to be all distribution expenses domestically. This printout did not call out the MTV participation payment. [Exh.233]. Searchlight argues that while the participation was not included in the pages identified as Exhibit 233 of the work papers, the work papers as a whole, to which Napoleon's auditors had complete unfettered access, nonetheless include the Participation Statement to MTV. While there are references to a participation in the work papers, the MTV participation is not connected in any obvious way with the advertising expenses. Significantly, the work papers do not flag that the MTV participation is being deducted from Napoleon's proceeds.

Moreover, the auditors were misled by the information Searchlight provided in response to their requests. Early in the audit process, Myles Higa requested a detailed listing "by invoice/journal of distribution expenses". [Exh. 504]. In response, Searchlight provided Higa with a computer printout, listing what appear to be all distribution expenses. [Exh.235A]. The MTV participation was not identified in what appears to be the universe of all advertising expenses in the listing provided. Nor is this a typical advertising expense that would have been anticipated by the auditors. The evidence was undisputed that this participation was treated and reported differently than was the usual custom and practice, and that utilizing a profit participation as consideration for advertising is also uncommon, if not unique to this deal. Hence, the reference to an MTV participation, albeit contained in the volume of work papers, was not readily or easily recognized as an advertising or distribution cost.

The Referee concludes that Searchlight did not disclose this profit participation and misled the auditors when it failed to produce the MTV Marketing and Branding Agreement or identify the payments to MTV as an advertising expense in response to the auditor's request for an itemization of distribution expenses. Consequently, it would be inequitable to allow Searchlight to assert the Incontestability provision as a bar to Napoleon's claim regarding the MTV Participation.

Not until it was examining witnesses during the reference trial, did Napoleon discover that Searchlight had been deducting participation payments made to MTV as an advertising expense against the Picture. As the participation payments to MTV were deducted from Gross Receipts, the participation was effectively borne 50% by Napoleon, and 50% by Searchlight and Paramount jointly. Napoleon contends that this was a breach of the contract between Napoleon and Searchlight. While Napoleon may have appreciated the value of MTV branding the Picture, Searchlight never advised Napoleon that there would be a cost to Napoleon in the form of a 5% participation, nor did Searchlight obtain Napoleon's consent to deduct the payment from gross receipts. Napoleon argues that the provision of MTV branding and marketing was the consideration Paramount and MTV provided for the Co-Financing Agreement, and was not a cost to be subsequently borne by Napoleon without its consent. Moreover, Napoleon contends that the MTV airtime never cost MTV a cent, as it was taken from their promotional airtime, as opposed to its commercial airtime allotment.

The history behind the agreement between Searchlight and MTV is relevant. Almost immediately at Sundance, Searchlight decided that the Picture would benefit from MTV branding, and MTV was similarly interested in marketing the Picture. In order to obtain MTV's involvement, which had an exclusive arrangement with Paramount, Searchlight needed to obtain the consent of Paramount, who demanded a Co-Financing Agreement. While the Co-Financing Agreement provides that Paramount shares in the profits with Searchlight, it also requires Paramount to bear 50% of the costs incurred in acquiring and distributing the Picture. In negotiating the terms of this Co-Financing Agreement, the parties apparently also agreed to a 5% participation for MTV.

The original drafts of the Co-Financing Agreement included MTV as a party to the Agreement and provided in part as follows *"(c) MTV Support: "MTV shall provide a level of marketing, advertising, publicity and promotional support (including "on-air" support on MTV Networks) commensurate with other so-called MTV "franchise" pictures … at no charge to either Fox or Paramount."* The draft Agreements also provided for MTV's 5% profit participation. By the final draft of the Co-Financing Agreement, MTV had been eliminated as a party, as was subparagraph (c) addressing MTV Support, but the reference to the 5% participation to MTV remained. For reasons not disclosed, Searchlight ultimately entered into a separate agreement with MTV –i.e., the Marketing and Branding Agreement. Napoleon suggests the separate agreement was created in anticipation of an objection by Napoleon and to create a subterfuge for expensing the MTV payments as advertising expenses, rather than having Searchlight and Paramount absorb the costs.

Under the MTV Marketing and Branding Agreement, Searchlight engaged "*MTV to render marketing/branding and other services on the terms and conditions outlined herein in connection with the exploitation of the Picture … .*" This agreement incorporated the provision for MTV Support with more specific requirements, as follows: "*MTV shall provide a level of marketing/branding, advertising, publicity and promotional support, including causing 'on-air' support on at least 1 MTV Network in the Fox Territory … on the level outlined in the MTV On-Air Plan attached hereto … at no charge to either Fox or Paramount for either airtime in connection with the implementation of the US Plan … or MTV Overhead, provided further, that notwithstanding the foregoing, MTV shall be entitled to charge its direct, out-of-pocket third party costs incurred in connection with the implementation of the MTV On-Air Plans for the Fox Territory … .*" [Exh.441].

Napoleon argues that Searchlight deducts a 30% distribution fee from payments to Napoleon and that Searchlight's agreement with MTV effectively delegates a portion of its distribution obligations to MTV. Napoleon maintains that the Marketing and Branding agreement requires MTV to provide marketing and branding services, which do not qualify as "advertising" expenses. MTV was required to provide its marketing and branding services at no cost to the Picture as the consideration provided by Paramount and MTV for the Co-Financing

Agreement. The participation Searchlight pays to MTV is in consideration for distribution services that MTV provides and for which Searchlight already charges Napoleon in its 30% distribution fee. According to Napoleon, Searchlight therefore cannot charge Napoleon the participation payment to Napoleon. Nor can Searchlight claim the participation as an advertising expense.

Napoleon's attempt to characterize the MTV airtime for interstitials as a distribution service that should be provided without extra cost to the Picture, is unsupported by the evidence. Paragraph C of the Definition on page 17 expressly provides that the imposition of a distribution fee does not diminish the charges that may be expensed under the enumerated distribution expenses. One of those enumerated categories is "Advertising Costs." [Exh. 68, page 22, ¶(g). If the services provided by MTV generate reimbursable advertising costs to Searchlight, Searchlight is not precluded from expensing the costs merely because MTV's services might fall within the broader parameters of distribution services.

In arguing that the services of MTV are not valid advertising costs, Napoleon contends that MTV incurred no costs in broadcasting the interstitials in its promo airtime. Napoleon relies on the testimony of Tina Exharos, Executive Vice President for Marketing and Creative at MTV, who explained that MTV allocates airtime between commercial airtime and promotional airtime. The former is sold to third parties for traditional commercial use, while the latter is used by MTV to promote its own programming. Napoleon argues that because only promotional time was used for the Napoleon interstitials, MTV lost no commercial revenue time. Napoleon reasons that, if MTV lost no paid commercial time, it incurred no cost, and Searchlight cannot account for its participation payment to MTV as a reimbursement to MTV, who used its own promo time for advertising.

Searchlight's evidence, however, establishes that the MTV airtime, whether allotted from commercial or promotional airtime, has value to MTV. As promoting its own programming has "commercial" value to MTV, the re-allocation of its promo time to broadcast interstitials for the Picture, provided value to the Picture and resulted in a cost to MTV in the consumption of MTV's promo airtime. If MTV is using the airtime to advertise the Picture, it is foregoing the promotion of its own programming in that time slot. To the extent Napoleon claims the expensing of the participation is not permissible as there was really no cost to MTV, this argument finds no support in the evidence, as the promo airtime was valuable time that MTV would have otherwise allocated to promoting its own shows. The Referee cannot conclude that this airtime was worthless vis-à-vis MTV.

Napoleon also argues this participation cannot be an advertising cost as it is not a sum that Searchlight pays for a particular advertisement, nor is it a customary and usual method of paying for advertising. Rather, Napoleon insists, MTV was required to provide the airtime as consideration for the Co-Financing Agreement between Searchlight and Paramount. Napoleon contends that the payments to MTV are an unadulterated profit participation in the Picture's proceeds, paid as consideration for the overall Co-Financing Agreement with Paramount and MTV, and unconnected to any expense actually incurred by Searchlight as an advertising cost. As a profit participation given by Searchlight without Napoleon's approval, Napoleon maintains the payment necessarily had to be properly identified and paid solely from Searchlight's share of its 50%.

Searchlight counters that regardless of the manner in which the payment is calculated, it qualifies as a cost of advertising under the Definition, and Napoleon's consent to this compensation formula is not required. The Definition provides that Distribution expenses shall include Advertising Costs. It describes permissible Advertising Costs under Section VI, subparagraph D.1(g):

"(i) 'General Advertising Costs': All costs incurred, which are directly related to or allocable to (as Fox may reasonably determine in good faith) the advertising, publicizing and promoting of the Picture in any way, including the following:

...

(B) *Radio and Television: Costs of purchasing advertising time on radio and television ...* .Exh. 68]

Subsection (i) allows Searchlight to include as an advertising expense, costs incurred that are directly related to the purchase of advertising for the Picture, *and* costs allocable to the Picture "as Fox may reasonably determine in good faith." Broadcasting the interstitials on MTV's network undeniably constituted advertising directly related to the Picture. In fact, no one disputes that the advertising was cleverly conceived and likely contributed to the success of the Picture. But Napoleon insists that Searchlight did not pay a penny for these interstitials that it can properly deduct as advertising expenses because MTV was obligated to provide this service under the Marketing and Branding Agreement. However, simply because MTV and Searchlight did not contract for advertising based on a fixed price for a specified airtime, does not preclude Searchlight from allocating the participation as an advertising cost.

Under the Definition, Searchlight may include an expense if it determines in good faith that the cost incurred is allocable to the Picture. Searchlight's conduct prior to finalizing its agreement with MTV is probative of whether it allocated the participation expense as an advertising cost in good faith. In early June 2004, Searchlight analyzed the value of the proposed MTV advertising schedule to determine if the advertising warranted the 5% participation. The schedule was very specific as to the amount of air time and the time frame during which the interstitials would be aired. Daniel Pittman, from Searchlight, consulted with a third party advertising agency to value the proposed MTV advertising plan, which plan constituted a minimum MTV obligation under the proposed Marketing and Branding Agreement. After consulting with this third party, Pittman valued the MTV advertising plan as providing \$4.6 million worth of advertising time. This value did not take into consideration the overall value of MTV branding or appearances on MTV's network by the Picture's characters. After Searchlight performed this valuation, it executed the Marketing and Branding Agreement with MTV. Searchlight's efforts in valuing the advertising time demonstrate its good faith in formulating a fair compensation structure for MTV's advertising services in an arms length transaction.

Exharos' testimony corroborated the value that Searchlight had originally placed on the MTV advertising schedule in 2004 when it negotiated the Marketing and Branding Agreement. Her testimony supports that MTV provided airtime valued at over \$4million to broadcast effective advertising that benefited the Picture. As of September 2008, the value of the MTV airtime allocated to the Picture far exceeded the \$2,424,531 paid to MTV for this advertising. To date, the participation to MTV has paid just over \$2.7 million. The evidence indisputably supports that Searchlight would have paid over $4 million had it purchased similar MTV airtime, absent the Marketing and Branding Agreement with MTV.

Other than the argument that providing promotional airtime is cost free to *MTV*, Napoleon did not present any evidence to challenge the testimony of the value of the airtime *to the Picture*. While the consideration to MTV will increase over time as it continues to receive participation payments, there was no evidence to suggest what this amount might be and that such payments over the life of the Marketing and Branding Agreement would exceed the value of the advertising obtained for the Picture from MTV.

Also corroborating the reasonable value of the MTV advertising is the fact that after auditing the advertising expenses, Napoleon did not make any audit claim that the reported total amount of $26 million in advertising costs was excessive or unwarranted. Not until Napoleon learned that the advertising was paid according to a formula based on a profit participation related to the Co-Financing Agreement did it register any objection to any portion of the dollars spent for advertising. Napoleon did not present any evidence to challenge that the total advertising amount was excessive. Nor did Napoleon present evidence refuting that the services provided by MTV were directly for the benefit of, or allocable to, the Picture. The overwhelming weight of the evidence establishes that the airtime that MTV provided was used to air the Napoleon Dynamite interstitials.

Napoleon challenges that it should not be required to pay an undisclosed participation that it characterizes as consideration for the MTV branding and marketing services, services that were in turn the consideration for the Co-Financing Agreement. Napoleon contends that this payment is owed solely by Searchlight and Paramount to MTV. Napoleon highlights that in the original drafts of the Co-Financing Agreement between Searchlight and Paramount, MTV was a party to the agreement and was to provide "for the express benefit of Fox" marketing, advertising and publicity services for the Picture "at no charge to Fox or Paramount." [Exh. 238]. The original drafts of the Agreement, however, also expressly provided for the 5% participation.

Napoleon also relies on Paragraph 4(a) of the Fox-Paramount Agreement, arguing that Searchlight and Paramount agreed that they would split the entire cost of the MTV participation 50/50. Paragraph 4(a) of that agreement provides:

> "Division of Gross Receipts: 'Gross Receipts' (as defined in Exhibit 'GR') derived from the distribution of the Picture throughout the universe shall be shared between Fox and Paramount after first deducting all 'Distribution Costs' (as defined in Exhibit 'GR') (subject to the reimbursement procedures set forth below), and third party participations, including without limitation, residuals, royalties, deferments and participations in the net proceeds or gross proceeds of the Picture, which participations are limited to those participations payable to NPL and MTV as set out in Exhibit 'P', as follows: 50% thereof to Fox, 50% thereof to Paramount.

Napoleon reads the last phrase to mean that Fox and Paramount agreed to absorb the 5% participation to MTV 50% each. However, Napoleon strains the meaning of this paragraph in that the last phrase --i.e., "*as follows: 50% thereof to Fox, 50% thereof to Paramount*", does not modify the enumerated deductible expenses. Rather, it logically modifies the phrase "*Gross Receipts ... derived from the distribution of the Picture throughout the universe shall be shared between Fox and Paramount.*" This interpretation makes sense for several reasons. First, the paragraph directs that the Gross receipts are shared *after first deducting* all of the enumerated costs including "residuals, royalties, deferments and participations". In order to *first deduct* anything from a single pot –i.e., the Gross Receipts, the deduction cannot be apportioned. If a cost is to be deducted from Gross receipts, as here, one cannot allocate a proportionate share of the deduction as to Fox and Paramount *before deducting* from Gross Receipts.

If the 50/50 percentage were instead a different ratio (for example, Fox bears 70% of the costs, and Paramount 30%), Napoleon's interpretation is more obviously unworkable. Consider: how could Gross Receipts be reduced by participations "70% thereof to Fox, 30% thereof to Paramount"? The enumerated categories of deductible costs and participations can be *first deducted* in their entirety from the Gross Receipts, but cannot be apportioned in any way and then deducted from gross receipts. Instead, the paragraph must be read to provide that all enumerated costs are deducted in total from Gross receipts. Once all of these deductions are taken against gross receipts, Paramount and Fox share the net 50% each. The final phrase, "*50% thereof to Fox, 50% thereof to Paramount,*" can only modify the Gross Receipts payable **to** each party –i.e., "Gross Receipts … shall be shared between Fox and Paramount … as follows: 50% thereof to Fox, 50% thereof to Paramount."

Also telling is that the phrase that Napoleon believes dictates that Fox and Paramount alone must bear the cost of the MTV participation, reads "*50% thereof **to** Fox, 50% thereof **to** Paramount,*" meaning the Gross Receipts are distributed "to" them 50/50, rather than referencing a deduction "from" their share of Gross Receipts. Otherwise, the latter phrase should read "50% thereof <u>from</u> Fox, 50% thereof <u>from</u> Paramount." This interpretation is reinforced when read in conjunction with the following Paragraph (b) "Application/Allocation of Gross Receipts," wherein it states in subparagraph (i) *"Fox and Paramount shall make payments to each other so that after such payments have been made, **Gross Receipts shall have been allocated as provided in Paragraph 4(a)** above."*(emphasis added.) Paragraph 4(a) instructs the allocation of the gross receipts is 50% each.

The written agreement between Napoleon and Searchlight limits Searchlight's ability to allocate advertising expenses only to the extent the cost must be directly related to the Picture or allocable to it in the judgment of Searchlight, exercised in good faith. The agreement does not limit such chargeable costs to any particular formula by which compensation is paid. The agreement does not authorize Napoleon to second-guess Searchlight contracts for the provision of services for the Picture. The agreement likewise does not limit Searchlight's discretion to negotiate payment terms for advertising. Its decision to purchase advertising services from MTV in exchange for a participation, while unusual, did not generate an unreasonable expense for the MTV airtime valued at $4.5million. Napoleon has not offered evidence disputing the value or quality of the MTV advertising. To date, Searchlight has paid out in participations to MTV an amount of $2,424,531, rendering the advertising obtained to date a good value benefitting the Picture. Napoleon would obtain a windfall if it recovered the amount paid to MTV for advertising that actually aired, without criticism from Napoleon, and presumably benefitted the Picture, contributing to its success.

Napoleon has not established that Searchlight has breached the agreement by paying for MTV advertising through a participation. The Agreement allows Searchlight to deduct reasonable advertising expenses. As the Agreement between Napoleon and Searchlight does not preclude paying for advertising with a profit participation, and does not require Searchlight to obtain any approval from Napoleon for the formula Searchlight negotiates for the purchase of advertising, Searchlight has not breached the agreement.

L. Searchlight's Affirmative Defenses for a Setoff.

In its Answer, Searchlight seeks to setoff any recovery by Napoleon by amounts it overpaid on VOD at 100% through October 31, 2005, rather than on a royalty basis of 20%. The claimed overpayment totals $590,639. Searchlight contends it may take this setoff, regardless of whether the statute may have run on an affirmative claim. See Code Civ. Proc. §431.70; Davis & Cox v. Summa Corp.(9th Cir. 1985) 751 F.2d 1507, 1521-22. Under Section 431.70, the relief granted by a setoff may not exceed the amount awarded to Napoleon.

Searchlight explained in testimony given by Steve Kaplan and Hector Garza that VOD was a new media transaction and it took a while for Searchlight to verify which revenue streams fell within the category of VOD. In the meantime, it paid VOD at 100%, until it was able to differentiate and verify the VOD income stream.

Searchlight has however failed to prove the amount overpaid. The evidence at best is an assertion by Steve Kaplan as to an amount overpaid and a cursory notation, without any documentary support. [Exh 131-2]. While he testified that he could go back to 2005 and distinguish between VOD and other televsion income, he did not testify that he actually did perform this task, or how he calculated the numbers that he scribbled on Exhibit 131. This affirmative defense is thus not established.

M. Accounting.

Napoleon has conducted an audit of Searchlight's records for the period June 2004 through September 30, 2008, the period that is the subject of this lawsuit. From December 2008 through the end of 2010, Naploeon's auditors had access to Searchlight's books and records. Following this audit, Napoleon's auditors preapred an audit report that was the genisis of the claims asserted here. Napoleon has not established that there is any ground to support an order for an accounting, given that it has already audited the relevant records. Such relief is denied.

III

CONCLUSION

Pursuant to California Rule of Court 3.1590 (c)(1), this shall constitute the Referee's proposed Statement of Decision. This proposed Statement of Decision shall become the Statement of Decision unless, any party within 15 days after this proposed Statement of Decision has been served, serves and files objections to the proposed Statement of Decision.

DATE: November 28, 2012

Hon. Patricia Collins, retired
Referee

PROOF OF SERVICE

State of California
County of Los Angeles

I certify that I am employed in the County of Los Angeles, State of California. I am over the age of 18 and not a party to the within action; my business address is 1900 Avenue of the Stars, Suite 250, Los Angeles, California 90067.

On November 29, 2012, I served the foregoing documents described as the **PROPOSED STATEMENT OF DECISION** on the interested parties in this action by placing a true copy thereof enclosed in a sealed envelope addressed as follows:

Martin D. Singer, Esq.
Allison S. Hart, Esq.
LAVELY & SINGER
2049 Century Park East, Suite 2400
Los Angeles, California 90067

Linda M. Burrow, Esq.
Tina Wong, Esq.
CALDWELL LESLIE & PROCTOR
1000 Wilshire Boulevard, Suite 600
Los Angeles, California 90017

Hon. Bobbi Tillmon
SUPERIOR COURT OF CALIFORNIA
COUNTY OF LOS ANGELES
9355 Burton Way, Department M
Beverly Hills, CA 90210

___X___ **BY U.S. MAIL,** I caused such envelope with postage thereon to be placed in the United States mail at Los Angeles, California.

_______ **BY FACSIMILE,** I caused such to be faxed to the attorneys on November 29, 2012

_______ **BY E-MAIL OR ELECTRONIC TRANSMISSION:** I caused a copy of the document(s) to be sent from e-mail address _______________ to the persons at the e-mail addresses listed in the Service List. I did not receive, within a reasonable time after the transmission, any electronic message or other indication that the transmission was unsuccessful.

_______ **BY PERSONAL SERVICE,** I caused such envelope to be delivered by hand to the attorneys on _______________.

___X___ **STATE** I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

___X___ **FEDERAL** I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made.

Executed on November 29, 2012 at Los Angeles, California

____
Michael Tousey