Motion Picture Distribution, Film Splitting, and Antitrust Policy

Stanley I. Ornstein

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Motion Picture Distribution, Film Splitting, and Antitrust Policy

by

STANLEY I. ORNSTEIN*

"Another immutable fact is that all exhibitors hate all distributors and vice versa."—Paul N. Lazarus

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Introduction

In 1985 and 1986 the United States Department of Justice filed thirteen suits against motion picture theater owners across the country, charging them with collusive price fixing and market allocation in the licensing of films from motion picture distributors. Instead of bidding against one another for each new movie, groups of exhibitors in various cities allegedly prearranged to "split" the right to bid for forthcoming movies among themselves. Consequently, distributors found only one exhibitor negotiating for their films in each market area. Split agreements appear to be a rather blatant form of collusion. In their defense, exhibitors argued that film splitting provides efficiency gains, which lower the costs of movie distribution and increase competition, both between exhibitors and between motion pictures. Facing criminal charges, film splitting exhibitors in the midst of litigation are an admittedly biased group, but could there be merit to their claims?

Despite the widespread use of film splitting for over thirty years, it has long been a puzzling practice and the subject of much antitrust litigation. Distributors, the parties most directly harmed by such a collusive monopsony, have rarely challenged film splitting. Film splitting flourished for years with both distributor and United States government approval. Distributors' long acceptance of film splitting, when they could have curtailed the practice by lawsuits and other means, suggests that splitting agreements offered efficiency gains to distributors which outweighed their potential anticompetitive costs.

1. [1980-1988 Transfer Binder] Trade Reg. Rep. (CCH) ¶¶ 45,085-45,086. A number of private suits on film splitting, arguing that rivals were foreclosed from competition and boycotted by distributors, have also been tried. See, e.g., The Movie 1 & 2 v. United Artists Communications, Inc., 909 F.2d 1245 (9th Cir. 1990); Balmoral Cinema, Inc. v. Allied Artists Pictures Corp., 885 F.2d 313 (6th Cir. 1989); Harkins Amusement Enters., Inc. v. General Cinema Corp., 850 F.2d 477 (9th Cir. 1988); 3 Penny Theater Corp. v. Plitt Theatres, Inc., 812 F.2d 337 (7th Cir. 1987); Exhibitors' Serv. Inc. v. American Multi-Cinema, Inc., 788 F.2d 574 (9th Cir. 1986). A parallel investigation of alleged first-run movie exhibition monopolization in select cities was conducted by the Justice Department, resulting in a suit on exhibitor monopolization in Las Vegas, Nevada. United States v. Syufy Enters., 903 F.2d 659 (9th Cir. 1990).


4. The first industry-wide challenge by distributors to split agreements did not occur until the early 1980s. See, e.g., General Cinema, 532 F. Supp. at 1244. Even this action took place in the form of a countersuit by Buena Vista against General Cinema. Id.
What these gains were, however, remained a puzzle to most commentators.\(^5\)

Distribution practices, for which business reasons are unclear at times, such as tie-in sales, resale price maintenance, and product bundling, have often been viewed as anticompetitive, foreclosing markets to rivals and extending monopoly power. This Article investigates whether film splitting is a naked price conspiracy or a means to improve economic efficiency. Should it be judged a \textit{per se} offense, as the government and others hold, so plainly anticompetitive that no elaborate study is necessary, or are there sufficient potential efficiencies generated by splitting to warrant its investigation under a rule of reason?\(^6\) In short, this Article attempts to explain why both exhibitors and distributors long favored the use of film splitting. Section I describes the main forms of license agreements in film distribution. Section II provides a brief history of the legal status of split agreements. Section III summarizes the leading case on split agreements, \textit{United States v. Capitol Service}.\(^7\) Section IV surveys past explanations of split agreements. Section V describes motion picture distribution practices before the landmark \textit{Paramount} decision.\(^8\) Section VI analyzes post-\textit{Paramount} distribution practices and the purposes of splitting. Section VII assesses current legal standards in splitting cases as the basis for a rule of reason analysis.

\section{Methods of Film Licensing}

Motion picture licenses are granted in four ways: competitive bidding; competitive negotiations; noncompetitive negotiations; and film splitting.\(^9\) In competitive bidding, distributors send out bid letters


\(^6\) Rule of reason investigations of price fixing agreements are uncommon but not without precedent. Efficiency gains from price fixing agreements have, in some cases, been sufficient to make them legal. \textit{See} NCAA \textit{v. Board of Regents of the Univ. of Okla.}, 468 U.S. 85, 100-02 (1984); Broadcast Music, Inc. \textit{v. CBS, Inc.}, 441 U.S. 1, 20-23 (1979).

\(^7\) \textit{United States v. Capitol Serv., Inc.}, 756 F.2d 502 (7th Cir. 1985) [hereinafter \textit{Capitol Serv. II}].

\(^8\) \textit{United States v. Paramount Pictures, Inc.}, 344 U.S. 131 (1948).

for a specific movie, announcing minimum terms. Terms may include nonrefundable rental guarantees offered for the rights to a film, an advance payment against subsequent box office receipts, sharing box office receipts on some percentage terms, cooperative advertising percentages, provisions for geographic exclusivity relative to other showings of the same movie (known as clearances), length of movie run, and opening date. For peak season showings, during Easter, the summer months, and Christmas, competitive bids are generally solicited six months or more in advance. All bids can be rejected if found inadequate, with either a new request for bids or competitive negotiations. In competitive negotiations, a distributor negotiates with two or more exhibitors competing for the right to license a movie, rather than opening bidding to all theaters in a given market area.

In noncompetitive negotiations a distributor negotiates with only one exhibitor. This takes place by necessity in one-theater-owner or "closed" towns. In some cases, a single owner may control all or almost all first-run screens in a city. Another form of noncompetitive negotiation, known as "tracking," occurs when a distributor deals with the same exhibitor in a city on a non-explicitly contractual but long-term basis, similar to an exclusive dealing arrangement. This informal exclusive dealing arrangement is sometimes known as a "marriage."

Finally, under split agreements, exhibitors organize to allocate forthcoming movies among themselves; exhibitors decide with whom a distributor will negotiate initially for a given film. Distributors typically send bid letters to first-run exhibitors, but only the split agreement's designated exhibitor negotiates with the distributor. Other exhibitors agree not to compete with a designated exhibitor. Frequently, a distributor would make a phone call to find out which

11. Id.
12. Id.
13. Id.
14. Fellman, supra note 9, at 319-20.
16. Id. at 137.
17. Id.
18. See Fellman, supra note 9, at 318.
19. Fellman, supra note 9, at 316; Cassady, supra note 5, at 162.
20. Cassady, supra note 5, at 162.
22. Id.
23. Cassady, supra note 5, at 164-65.
exhibitor had been assigned its movie. If an agreement cannot be reached on a particular movie, the distributor may negotiate with a second, designated exhibitor or an exhibitor who remains outside the split-agreement. In a sense, a split-agreement involves noncompetitive negotiations, although alternative exhibitors are available. The process differs from tracking since multiple exhibitors take turns negotiating for movies.

A further important aspect of motion picture distribution involves financial settling-up between exhibitor and distributor. Since exhibitors' expectations of film revenues are often not fulfilled, post-screening “adjustments” have long characterized movie distribution. Adjustments change the terms of the initial license agreement, such as length of run, geographic clearances, percentage rental terms, and advertising sharing. For example, rather than have a theater play to a relatively empty house, negotiations can shorten the licensed run without penalty to the theater or allow a “move over,” which moves the film to a smaller theater. In other cases exhibitors are reimbursed directly for lost revenues. Since distributors and exhibitors must work together on a long-term cooperative basis, it behooves the distributor not to impose prohibitive losses on exhibitors. Adjustments have been part of the motion picture distribution process since at least the 1930s.

Adjustments are not used in competitive bidding. Guarantees by exhibitors are not refundable nor are license terms adjusted if a film does poorly. Adjustments would distort the bidding process, leading to grossly inflated bids, since winning exhibitors would expect adjustments to compensate for inflated bids. Adjustments after competitive bidding would also leave distributors vulnerable to price discrimination lawsuits by non-winning bidders.

25. Id. at 145-46.
26. Tracking was considered a form of splitting in the 1950s, when exhibitors were commonly tracking with one or more distributors. See Cassady, supra note 5, at 164. Splitting as generally used here refers to a rotation of exhibitors film-by-film, regardless of film distributor. Tracking refers to quasi-long-term, voluntary, noncontractual exclusive dealing arrangements. Capitol Serv. I, 568 F. Supp. at 138.
27. Michael Conant, Antitrust in the Motion Picture Industry 75 (Arno Press 1978) (1960); Fellman, supra note 9, at 321.
28. Conant, supra note 27, at 75, 135.
29. In some cases, adjustment forms were used by exhibitors to request license revisions. Id.
30. Fellman, supra note 9, at 321.
II

The Legal History of Film Splitting

Splitting and tracking dominated film licensing agreements following the Paramount decision. The Justice Department did not challenge split agreements for thirty years and periodically issued statements before congressional committees and in communications with the movie industry approving their use. The government's acceptance of split agreements likely stemmed from an attempt to follow the precedent laid down in the Paramount decision. In Paramount the Supreme Court reversed the district court's call for mandatory competitive bidding on all films, holding that competitive bidding favored exhibitors with the "longest purse." By allowing split agreements, the government may have believed it was ensuring a more equitable division of films and thus preserving small exhibitors.

Numerous private actions were brought against split agreements. In many cases exhibitors who were not members of a split agreement claimed they were illegally denied films by distributors and splitting exhibitors. In most instances the courts found little evidence of an illegal boycott. Prior to 1977, the courts judged splitting agreements under a rule of reason analysis. If distributors consented to a split agreement, it was legal. If distributors did not consent to a split agreement they could recover damages from exhibitors. Thus,

32. Cassady, supra note 5, at 161.
36. Southway, 672 F.2d at 485; Wilder, 632 F.2d at 1135; Dahl, Inc. v. Ray Cooper Co., 448 F.2d 17 (9th Cir. 1971); Viking, 320 F.2d at 287; Admiral, 437 F. Supp. at 1268.
37. Harkins, 850 F.2d at 480; Dahl, 448 F.2d at 17; Viking, 320 F.2d at 287; Admiral, 437 F. Supp. at 1268.
38. See, e.g., Dahl, 448 F.2d at 19; United States v. Loew's, Inc., 1962 Trade Cas. (CCH) ¶ 70,347.
39. Id.
precedent existed for distributors to block the use of split agreements. The courts' position made economic sense. If distributors, those potentially most harmed by splits, did not object when they had full knowledge of a split's existence and could have stopped it by various means, then why should the courts intervene? Of course, there was strong dissent from commentators, who viewed splits as naked price fixing agreements and market allocations.\(^{41}\) However, the law also held, somewhat belatedly, that if distributors participated in splits to boycott non-split member exhibitors, then splits were illegal.\(^{42}\)

On April 1, 1977, the Justice Department reversed its almost thirty-year stand, announcing that split agreements were virtually indistinguishable from bid-rigging and thus \textit{per se} illegal.\(^{43}\) Exhibitors were warned that continued use of split agreements would result in prosecution. Several exhibitors brought suit asking for a declaratory judgment as to whether split agreements were illegal \textit{per se}.\(^{44}\) The court found that the splits were not illegal \textit{per se} and were to be judged under the rule of reason.\(^{45}\) The Justice Department did not appeal. Subsequent lower court opinions were divided on the \textit{per se} status of split agreements.\(^{46}\)

Meanwhile, the Justice Department, tiring of a lack of voluntary compliance with its 1977 announcement, brought a civil action against a split agreement in Milwaukee, Wisconsin, on both rule of reason and \textit{per se} grounds.\(^{47}\) Both the district and appellate courts found in favor of the government, ruling that splits were \textit{per se} illegal.\(^{48}\) Once \textit{Capitol Service} was upheld on appeal, the Justice Department filed numerous suits against film splitting. From January 1985 through January 1987, the Justice Department filed fourteen suits across the United States, covering both large cities (e.g., Denver, Dallas, and Los Angeles) and small cities (e.g., Quincy, Illinois; Greenville, South Carolina;
and Deptford, New Jersey). In eight cases exhibitors signed consent decrees, paying fines ranging from $75,000 to $750,000. In at least two cases, exhibitors chose to contest the government's claims.

III

**United States v. Capitol Service, Inc.**

The leading case on film splitting is *Capitol Service*. The facts are fairly typical of film splitting cases and will aid in understanding why splitting is currently regarded as anticompetitive. Four exhibitor chains in Milwaukee, Wisconsin, accounting for thirty-three of thirty-seven first-run screens, met on November 30, 1977 to form a film-split agreement. Under the agreement, exhibitors took turns negotiating for films, with each having a geographic clearance. The government argued that the split included the following agreements: (1) not to bid on films; (2) not to negotiate for a film until it was split; and (3) not to compete for a film against a split-member. According to the exhibitors, the agreement simply allocated the “right of first negotiation” for a movie. If negotiations broke down, a distributor could always turn to another exhibitor.

From 1975 to the start of the split agreement in 1977, films in Milwaukee had been licensed by competitive bidding, competitive negotiations, or tracking. Anticipated high-grossing films were licensed by competitive bidding. Other films were licensed by competitive negotiations or, in some cases, by tracking. Exhibitors described the pre-1975 licensing method as tracking; the court described it as a distributor-by-distributor split agreement. In fact, even after splitting was instituted, United Artists continued tracking with two of the defendants.

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50. Id.
54. Id. at 141.
55. Id. at 143.
56. Id.
57. Id.
58. Id. at 139.
59. Id.
60. Id.
61. Id.
62. Id. at 146.
Testimony established that a major purpose in adopting splitting was to eliminate competitive bidding. Exhibitors believed that competitive bidding led to excessive guarantees, rental percentages in favor of distributors, and extended playtimes well beyond minimum license terms.63 This testimony proved determinative in the court’s decision.64

The court also relied on empirical evidence to conclude that the split was anticompetitive. First, the number of competitive bids for films dropped sharply after 1977, from seventy-four in 1977 to four in 1978 and to one in 1980.65 Second, guarantee payments dropped from $1.8 million in 1977 to $140,000 in 1980.66 Third, the number of adjustments in rental terms favoring exhibitors increased after 1977.67 Fourth, playtimes shortened after 1977.68

The evidence was interpreted as showing the monopsony power inherent in split agreements.69 The court’s arguments, however, are questionable. The court’s view that increased adjustments are necessarily an indication of monopsony leverage is incorrect. Since adjustments do not take place under competitive bidding, they would naturally increase in the absence of bidding. If monopsony rents exist, how they are divided between rental terms and adjustments is of no substantial consequence since the full amount can, in principle, be extracted in either rental terms or adjustments. Increased adjustments do not indicate an extension of monopsony power but only a different division in revenues between rental terms and adjustments. In addition, adjustments are used outside of splits, such as in tracking, and thus are not inherently anticompetitive.

The court’s view that shortened runs are an indicator of monopsony power is also questionable. Both exhibitors and distributors are interested in maximizing revenue at the box office for a given admission price. Exhibitors are interested in maximizing tickets sold since concession goods sales accrue exclusively to exhibitors and offer much

63. Id. at 139-40.
64. Distributors knew of the agreement from its inception yet did nothing to stop its use. Id. at 145. Distributors testified that they were opposed to the split agreement and they also filed an amicus curiae brief in support of the government. Id. at 136. Given that they could have taken private action long before, their protests were more than a little disingenuous.
65. Id. at 144.
66. Id. at 146.
67. Id. at 147.
68. Id.
69. Id.
higher profit margins than box office receipts.\textsuperscript{70} Because admission prices are generally constant across first-run theaters in a city, maximizing box office revenues and tickets sold are equivalent. Thus exhibitors would not want to end film runs prematurely anymore than would distributors. If runs were shorter under the split agreement, and if this were not due to other causes, such as changes in the quality of films or increased nonfilm competition, then movie runs under competitive bidding were nonoptimal. By providing playtimes for more movies, and thus a greater selection and variety of movies, splitting appears to have improved competition in at least one dimension.

The defendants introduced evidence that splitting had no adverse affect on the share of total rentals accruing to distributors.\textsuperscript{71} Distributor film rental revenues include guarantees, advances against box office, box office share, share of advertising paid by exhibitors, and any adjustments made post-screening.\textsuperscript{72} A study showing that distributor film rental revenues in Milwaukee, Minneapolis-St. Paul and many eastern cities were no different between split and non-split cities was rejected by the court.\textsuperscript{73} The court found that many factors which determine film rentals were not adequately accounted for in the defendants' study.\textsuperscript{74} Defendants also offered procompetitive rationales for split agreements, such as improved licensing efficiency and increased competition between movies, between exhibitors, and between distributors.\textsuperscript{75} The court found these arguments factually doubtful and immaterial because the court was not required to distinguish between good and poor forms of competition under the Sherman Act.\textsuperscript{76} The court found the split-agreement was \textit{per se} illegal and illegal under the rule of reason because the alleged procompetitive benefits were deemed not material.\textsuperscript{77}

\textsuperscript{71} \textit{Capitol Serv. I}, 568 F. Supp. at 134.
\textsuperscript{72} \textit{Id.} at 136-38.
\textsuperscript{73} \textit{Id.} at 148.
\textsuperscript{74} \textit{Id.} In \textit{General Cinema Corp. v. Buena Vista Distrib. Co.}, Buena Vista submitted a study comparing license terms under competitive bidding and splitting in comparable theaters and locations. 532 F. Supp. 1244, 1263 (C.D. Cal. 1982). The study found that bidding increased percentage rental terms to distributors, increased the likelihood of guarantees, and resulted in a larger number of extended runs. \textit{Id.} For further evidence, see discussion \textit{infra} part VII.A.
\textsuperscript{75} \textit{Capitol Serv. I}, 568 F. Supp. at 153.
\textsuperscript{76} \textit{Id.}
\textsuperscript{77} \textit{Id.} at 154.
IV

Alternative Explanations of Split Agreements

A. Collusion

According to the Justice Department, exhibitor price collusion explains split agreements. There are good reasons to be suspicious of this explanation. First, the retail or exhibitor level of the movie industry does not generally possess characteristics conducive to viable collusive agreements. In most cities there are no significant barriers to entry, demand is not strongly inelastic because of substitute forms of entertainment and movie viewing, costs differ across chains and between chains and independents, films and theaters are not homogeneous, and the demand for movies is not stable over time. In addition, exhibitors have no means of forcing rivals into a split agreement or preventing members from dropping out and competing against the splitting firms. Any member facing a string of poor movies, owing to bad luck of the draw under a split agreement, can bid against the split, leading to a breakdown of the agreement.

Second, exhibitor collusion is at odds with much movie industry analysis. The predominant view is that distributors have substantial monopoly power which they have wielded for decades to block entry into distribution, restrict the output of movies, and raise distributors' rental shares. Whatever the merit of this view today, there is little chance that exhibitors could successfully collude against distributors via splitting agreements. Distributors are well aware of the operation of split agreements. They can easily halt any exhibitor conspiracy by refusing to deal, bringing antitrust suits against exhibitors, or reporting the exhibitors to the Justice Department. In addition, throughout the 1950s, when the incidence of splitting was probably at its peak, there was tremendous excess capacity in theaters owing to the rapid

78. See, e.g., id. at 152 (DOJ's press release Apr. 1, 1977) (claiming that all splits are per se illegal).
79. See, e.g., id. at 139 (distributor-by-distributor split among exhibitors broke down when Capitol Service licensed the film “Lucky Lady” outside the terms of the split agreement).
81. Cassady, supra note 5, at 161.
penetration of television, giving exhibitors little bargaining power over distributors.\textsuperscript{82}

It is important to note that distributors had years of experience dealing with monopoly exhibitors. In the 1930s there were hundreds of one-theater towns.\textsuperscript{83} Prior to \textit{Paramount}, distributors often owned a partial interest in theaters in one-theater towns or dealt with pooling agreements among independent theater owners.\textsuperscript{84} In the 1980s there were even moderate sized cities, such as Las Vegas, Nevada, where one firm was alleged to control all first-run movie theaters.\textsuperscript{85} Ignoring for the moment potential entry into high concentration markets, distributors are not without recourse when bargaining with monopsony buyers. Lost distributor revenues from refusals to deal in such situations represent a tiny fraction of a distributor's worldwide sales. But for a local or regional theater owner, with many screens to fill and a fickle public demanding constant variety in movies, lost revenues by a distributor's refusal to deal can amount to a substantial portion of total firm sales, placing the exhibitor in greater financial risk.\textsuperscript{86} Similar distributor leverage, along with threatened or actual lawsuits, could be utilized if splitting resulted in monopsony rental terms. It is difficult to imagine distributors at the mercy of an exhibitor splitting cartel.

Distributors have rarely attempted to stop split agreements by legal action. They participated actively in splits with the full knowledge of such agreements for years.\textsuperscript{87} It was not until \textit{General Cinema}, some thirty years after \textit{Paramount}, and after hundreds of thousands of licenses had been signed under split agreements that distributors first joined to support a challenge to split agreements.\textsuperscript{88}


\textsuperscript{83} United States v. Griffith, 334 U.S. 100, 101 (1947) (defendant corporations owned theaters in three states, 62% of which faced no competition within each respective city in 1939).


\textsuperscript{85} United States v. Syufy Enters., 903 F.2d 659, 661-62 (9th Cir. 1990).

\textsuperscript{86} See, e.g., \textit{id.} at 662 (because more than 300 films are released every year, successful theater owners must run multiplex theaters with up to 18 screens so movie-goers may choose from a wide variety of films).


\textsuperscript{88} An amicus curiae brief filed by eight distributors stated, the Distributors are adamantly opposed to, and have not, do not and will not participate or acquiesce in any exhibitor split arrangement. The Distributors regard any and all exhibitor splits as horizontal, anticompetitive agreements among
Despite the trappings of harmful collusion in split agreements, true exhibitor welfare-reducing collusion remains doubtful. Consequently, efficiency reasons for split agreements have long been sought.

B. Efficiency Explanations

Defendants in recent film splitting cases have offered a number of explanations for splitting, few of which have convinced the courts. As noted above, the defendants in *Capitol Service* held that film splitting is more efficient than competitive bidding. Among the claimed benefits from splitting were: 1) theaters obtain better movies for longer runs, providing greater consumer satisfaction and higher levels of attendance; and 2) nonmajor distributors obtain access to first-run theaters under splitting, increasing competition between distributors.

*General Cinema* claimed a more extensive list of procompetitive benefits. Six justifications for splits were offered: 1) Splits provide greater lead time for advertising; 2) Splits provide greater flexibility in scheduling runs by allowing adjustments in license terms after a picture opens; 3) Splits reduce paperwork, time, and effort; 4) Splits reduce the risk of an empty screen or a distributor being without an exhibition outlet; 5) Splits assure outlets and playtimes of a distributor's choice; and 6) Splits provide competitive protection for small independent theaters, keeping them in business.

The court found these benefits provided convenience or financial gains to General Cinema but did not enhance competition. As a factual matter, the lead time for advertising justification was doubtful since lead times are long under bidding, which generally takes place about six months before a movie's release. The competitive protection for small theaters justification was inapplicable since antitrust is directed toward protecting competition, not less efficient competitors. No evidence was introduced to indicate that paperwork entailed substantial costs, and the issue of protection against empty screens was dismissed on the grounds that all competition entails risks.
and antitrust enforcement is not intended to reduce risks. Assuring distributors of their choice of outlets carried little weight since distributors are free to choose outlets and playtimes of their preference under competitive bidding.

The schedule flexibility and risk reduction justifications remain as arguable issues. The court found that mere flexibility in scheduling did not increase competition. This interpretation is questionable. Split agreements allow mistakes in license terms, such as run lengths, to be corrected, whereas competitive bidding locks exhibitors into fixed run lengths. If box office receipts fall below expectations, split agreements allow run lengths to be shortened, freeing screens for new and potentially more profitable movies. This flexibility increases product variety and the number of movies shown, benefiting consumers.

The court was also hasty in dismissing lower risk under splitting as not competition enhancing. For example, while all commerce entails risk and accompanying costs, competition drives costs to minimum efficient levels of operation. Lower risks reduce costs, and cost reduction comprises a large part of the gains from competition. Cost reducing practices that earn a competitive rate of return are clearly competition enhancing. Hence, to the extent that splitting reduces risk by insuring films for exhibitors and screens for distributors, it lowers the cost of distribution, thereby increasing consumer welfare.

C. Other Explanations

Based on an informal survey of lawyers involved in split agreement antitrust cases, Gordon compiled eight explanations for splits and distributor acquiescence: 1) Splits give superior play dates and market coverage; 2) Splits allow advanced scheduling and exhibitors do not object to blind bidding under splits; 3) Splits allow adjustments on film rentals in contrast to bidding; 4) Through adjustments, splits allow a sharing of risk not available under competitive bidding; 5) Distributors do not want to appear greedy; 6) Splits eliminate discrimination lawsuits by exhibitors who lose out in competitive bidding; 7) Splits preserve exhibitors and thus avoid monopsony buying conditions; and 8) Distributors fear suing exhibitors because of loss of


97. Id. at 1272-73. The dismissal of point five may be too cavalier. One of the common reasons offered for the 1985 through 1986 wave of vertical mergers by distributors into exhibition was to gain secure outlets and playtimes. See Will Tusher, Distrubs Pursue Circuit-Buyer with a Passion, DAILY VARIETY, Jan. 5, 1987, at 1. See also De Vany & Eckert, supra note 84, at 98-99.

goodwill and future business. But whether these explanations refer to splits by rotation or tracking is unclear. But if the former, the factual and economic basis for many of the explanations, such as one, two, five, seven, and eight, is doubtful.

Gordon, who championed the collusion theory of splits, offered two additional explanations, building on points six and eight. First, splitting is imposed by exhibitors on distributors as part of a monopsony cartel. Distributors acquiesce because challenging split agreements entails substantial costs beyond any benefits. To contest splits distributors would have to either refuse to deal with exhibitors or bring an antitrust action. Either approach would allegedly harm distributors. They would lower distributor goodwill and jeopardize existing outlet networks since exhibitors' incentives to cooperate would be lower. According to Gordon, the antitrust approach to halting splits would necessitate an enormous amount of litigation and costs.

Gordon's arguments are not convincing. Distributors' goodwill with exhibitors was well established by prior business and litigious behavior. Distributors and exhibitors have long been suing one another in hundreds of suits over such matters as blind bidding, under-reporting of receipts, and discrimination in licensing, so in many areas benefits were expected to exceed costs.

Gordon's view on antitrust costs is also doubtful. A few major antitrust victories by distributors, entailing substantial treble damages, would send a strong signal to exhibitors, dissuading them from collusion. A modern day example is reflected in the Justice Department's filing of cases against split agreements. Hundreds of suits would not be necessary. But even if legal costs were an issue, because of the incentive of distributors to get a free-ride on the litigation efforts of rivals, for example, distributors could have avoided such costs (and foregone the potential gains from court awarded damages) by bringing their evidence of collusion to the Justice Department.

100. Id.
101. Id. at 240.
102. Id. at 240-41.
103. Id. at 241.
104. Id.
105. Id.
106. Id.
107. Gordon reports hundreds of private cases in the 1950s. Id. at 259 n.79. Conant found 351 private cases from 1951 to 1957. Conant, supra note 27, at 178-79.
Second, under Paramount distributors were enjoined from discriminating against exhibitors in any form; all exhibitors in theory were to be offered a fair chance at licensing each movie released.¹⁰⁸ This ruling provided the basis for hundreds of lawsuits by aggrieved exhibitors who felt themselves unfairly treated or who saw an opportunity to hold up distributors. Splitting reduced the incidence of aggrieved exhibitors since only one exhibitor in an area would be designated to negotiate for a given film and exhibitors agreed not to compete against one another for individual films. Thus, film splitting could reduce the cost burden of discrimination suits. Interestingly, competitive bidding was also used by some distributors to limit discrimination lawsuits.¹⁰⁹

D. Economists' Theories

Economists have offered more sophisticated rationales for split agreements. Kenney and Klein argue that film splitting in the form of tracking was instituted by distributors following Paramount to maintain the pre-1948 quasi-franchise distribution system and all of its benefits.¹¹⁰ While certainly an applicable argument for the 1950s, splitting in the form of tracking in that era differs from splitting by film rotation across exhibitors. Splitting by rotation is not designed to produce the long-term quasi-franchise arrangements available through tracking.

Kenney and Klein conjecture that split agreements by rotation have persisted due to their ability to facilitate the optimal amount of exhibitor inputs, such as clean theaters, high quality sound, and seating.¹¹¹ As noted, renegotiation or adjustments in rental payments by a distributor, should a movie bomb at the box office, can take place under split agreements.¹¹² Kenney and Klein posit that deviations in exhibitor input services from optimal levels are better monitored and adjusted under split agreements.¹¹³

While the potential for adjustments on rental terms greatly facilitates distributors and exhibitors coming to mutually advantageous terms and promotes long-term working relationships, how important distributor input monitoring and adjustments are to maintaining optimal inputs is unclear. Since all exhibitors depend on repeat consumer

¹⁰⁹ 1953 Hearings, supra note 33, at 582 (statement of William Zimmerman).
¹¹⁰ Kenney & Klein, supra note 5, at 527-28.
¹¹¹ Id. at 529-30.
¹¹² Id.
¹¹³ Id.
sales, if they face competition or potential competition, they have a strong incentive to provide optimal inputs, such as clean theaters, fresh popcorn, high quality projection and sound systems, courteous service, and so forth. Failure in these areas leads to lower consumer sales since consumers can readily switch to other theaters, videocassettes, cable movie channels, or other forms of entertainment. Therefore, the significance of Kenney and Klein's optimal input hypothesis remains uncertain.

V

Film Distribution and Efficiencies
Prior to Paramount

A. Film Distribution

Distribution during the 1930s and 1940s was characterized by extensive vertical integration, franchising, bulk purchasing of movies, buyer pooling agreements, and price discrimination.\textsuperscript{114} During a two-month or three-month buying season exhibitors would purchase (rent) blocks of films, sight unseen, from various distributors for the following year's showing. The films had yet to be produced. Theaters contracted for different quantities of films depending on their film turnover, with first-run houses contracting for far fewer films than sub-sub-run houses. Theaters typically contracted with many distributors for their annual supply. Bulk purchasing through block booking provided distributors with outlets, provided exhibitors with movies, minimized inventory, and provided the basis for financing production.

Films were released to theaters on a sequential basis, first-run, second-run, and so on, with time clearances between first-runs and second-runs of a few to over 100 days.\textsuperscript{115} Seventy-five percent of first-run films had time clearances of more than twenty-eight days.\textsuperscript{116} Theaters were given geographic or zone clearances over rivals, with about two-thirds of first-run theaters having clearances of ten miles or more.\textsuperscript{117} Distributors designated which theaters had first-run status, and they generally reserved that status for their own theaters.\textsuperscript{118} Since thirty to seventy percent of film rentals came from first-run showings, a first-run theater designation was a highly valuable asset.\textsuperscript{119} In addi-
tion to length of run and time and zone clearances, licenses set minimum admission prices. This system of clearances and resale price maintenance was clearly designed to price discriminate.

B. Vertical Integration and Vertical Contractual Relationships

Prior to the post-war Paramount decisions, film distribution was tightly controlled by the eight Paramount defendants. The five major defendants—Paramount, Loew’s, Twentieth Century-Fox, Warner, and RKO—were integrated into production, distribution, and theater ownership. These five firms controlled most first-run theaters in both large and small cities through sole or joint ownership, leases, or franchise agreements with independent theaters. Ownership of theaters by the five majors, both individually and jointly, is shown below in Table 1. Total theaters owned represented about twenty-four percent of all theaters in the United States in 1945. Seventy percent of first-run theaters in the nation’s ninety-two largest markets (100,000 population and above), generating the bulk of rentals, were controlled by the top five distributors. These five firms also engaged in extensive cross-licensing. Each of the top five integrated firms rented extensively from the other major distributors. Approximately seventy to eighty percent of rentals from the top five firms’ theaters came from the top five distributors. The top eight distributors accounted for ninety-five percent of film rental payments to distributors from 1935 to 1944. In addition to theater ownership and film cross-licensing, franchising or exclusive dealing contracts of one year or more were common. Thus, long-term stable relationships through vertical integration and exclusive dealing contracts characterized many distributor-exhibitor relationships during this era. Licensing and distribution entailed block booking and a complex system of film releases to capture the gains from price discrimination.

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120. Id. at 58-61.
121. Id. at 43-57.
122. Id.
123. See id. at 48-50.
124. Id. at 50.
125. Id. at 61.
126. Id.
127. Id. at 62.
128. Id. at 44-46.
129. Schad v. Twentieth Century-Fox Film Corp., 136 F.2d 991 (3d Cir. 1943); Conant, supra note 27, at 64; Kenney & Klein, supra note 5, at 521 n.64.
Table 1
Theater Ownership by the Top Five Major Distributors, 1945\textsuperscript{130}

<table>
<thead>
<tr>
<th>Firm</th>
<th>Theaters Owned</th>
<th>Joint Ownership with Independent Owners</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paramount</td>
<td>1,395</td>
<td>993</td>
<td>2,388</td>
</tr>
<tr>
<td>Twentieth Century-Fox</td>
<td>636</td>
<td>66</td>
<td>702</td>
</tr>
<tr>
<td>Warner Bros.</td>
<td>501</td>
<td>20</td>
<td>521</td>
</tr>
<tr>
<td>Loew's</td>
<td>135</td>
<td>21</td>
<td>156</td>
</tr>
<tr>
<td>RKO</td>
<td>109</td>
<td>187</td>
<td>296</td>
</tr>
</tbody>
</table>

Joint Ownership with Top Five Firms: 361

Total: 3,137, 1,287, 4,424

C. Benefits from the Distribution System

Numerous benefits accrued to distributors and exhibitors from this arrangement. The elaborate system of runs, time and zone clearances, and admission price control maximized total revenues through price discrimination. Vertical integration and franchising established long-term, stable buyer-seller relationships. This reduced the administrative cost of distribution by standardizing the process of exchange. Long-term buyer-seller relationships lead to trust and cooperation, which, because of the symbiotic relationship between distributor and exhibitor, facilitate mutually beneficial gains. Under such relationships post-contract adjustments were expected to balance out in the long-run, so that both sides could avoid litigation. For example, long-term relationships should reduce cheating on license terms.

1. Reduced Cheating

Cheating on rentals was and continues to be a major problem in film distribution. Distributors’ monies come from box office receipts, which are controlled by exhibitors, providing opportunities for exhibitor fraud.\textsuperscript{131} Exhibitors have a number of tactics available to increase

\textsuperscript{130} Conant, supra note 27, at 49.

\textsuperscript{131} One estimate stated that 20% to 25% of theaters engaged in some form of cheating in 1947, costing distributors approximately $20 million. Id. at 71. For modern accounts
their share of receipts at the expense of distributors. By delaying payment of distributors’ shares, the exhibitor gains from the interest earned on the monies. Among the fraudulent practices exhibitors have engaged in are: submitting false invoices for local advertising or failing to report rebates on newspaper advertising; showing a film at an unauthorized location; screening a film for an extra, unauthorized showing; recycling untorn tickets to the box office for resale; under-reporting ticket sales from a roll of tickets; and illegally reproducing movie prints. The extent of illegal print reproduction in the 1930s and 1940s remains unknown. But in the age of videocassettes the industry estimated annual losses at $1 billion in the mid-1980s alone.

The incidence of exhibitor opportunism will vary with the organizational form of distribution. Vertical integration into exhibition by distributors reduces cheating on receipts since employee-managers, who can be fired and are not residual claimants, cannot gain to the same extent as owner-managers. Long-term franchise relationships should also reduce exhibitor cheating since the gains from long-term relationships, such as lower distribution costs and a secure, high-quality supply, are lost if an exhibitor is caught cheating and is terminated. In order to insure long-term relationships, distributors may provide an income premium to franchised theaters. Cheating would jeopardize such an income premium, further reducing the likelihood of fraud. Thus, the widespread ownership of theaters and use of franchising by major distributors reduced the cost of distribution by reducing the extent of exhibitor cheating.

2. Gains from Block Booking

Another feature of distribution during this era was block booking. Block booking was a major focus of the Justice Department’s antitrust suit against the movie industry in 1938. In 1940 the five major distributors agreed in a consent decree to limit block booking to

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of exhibitor cheating on receipts, see Daily Variety, Mar. 7, 1985, at 4; Daily Variety, May 13, 1985, at 1; Daily Variety, May 21, 1985, at 1. Specialized firms are hired to audit receipts and minimize cheating.


135. Vogel, supra note 70, at 31-32.
five films or less, which drastically limited its use. The objection to block booking was that it extended monopoly power by forcing exhibitors to lease poor quality films in order to obtain high quality films. This reasoning makes little sense since the full monopoly power of a copyright holder can be extracted from high quality films without resorting to overcharging on low quality films. Monopoly power of the copyright holder can only be extracted once. Moreover, films were booked in blocks long before production, so film quality at the time of booking was unknown.

Block booking must provide some efficiencies. In general, block booking reduces the transaction costs of distribution relative to film-by-film distribution. As stated, films were sold blind well in advance of actual production. This allowed producers to lower inventory costs and finance future production. But the eventual success of a film is indeterminate until its actual release. Theater owners have an incentive to reject low quality films (discovered after initial showings) and show only high quality, high demand films. Block booking prevented this cream-skimming. Block booking contracts specified penalty damages of 1/nth of a block's total value for rejecting a film. Hence, block booking insured the production of a wide selection of films by preventing exhibitor free-riding on a producer's efforts.

Block booking was also a more economical way to sell films. Relatively low value goods or complementary goods are often best sold in bundles rather than item by item. For example, network produced television programs are sold to affiliate stations in packages rather than program-by-program. Distributing program-by-program or film-by-film is decidedly more expensive. The administrative cost differences alone are staggering. Under block booking, studios handled about ten thousand contracts per year. Under picture-by-picture, theater-by-theater contracting in the 1950s, they handled hundreds of thousands of contracts per year. After block booking was effectively banned, exhibitors found film-by-film distribution far more expensive and returned to quasi-forms of block booking when given an opportunity.

138. De Vany & Eckert, supra note 84, at 81-83.
140. Conant reports that in 1950, 3,700 theaters booked Paramount films in groups with a right to cancel 20% of those booked. CONANT, supra note 27, at 145 n.136. Another study reports that when block booking was limited to no more than five films, under the
Block booking also reduced risk and, coupled with adjustments, provided a more efficient form of risk sharing between distributors and exhibitors. Owing to the varying quality of films, blocks of films yield portfolio gains since revenue streams are not perfectly correlated. This reduces the variance of revenues and thus risk. Risk reduction is especially important for asset holders who are non-diversified, which likely was the case for many theater owners. Since a film's value is unknown, a priori, further mutually beneficial gains were provided by ex-post adjustments in contract terms. In the case of poor movies, distributors could compensate exhibitors by direct payment or adjustments in rental terms. Exhibitors could compensate distributors for high quality films by providing better play dates for subsequent films or absorbing a higher share of advertising expenditures. Theater ownership by distributors or franchise agreements with independent theaters formalized risk sharing through block booking and adjustments.

Hence, the complex, tightly controlled movie distribution system prior to Paramount provided distinctly lower costs of distribution. Vertical integration and franchising reduced cheating, administrative costs, and risk. Block booking lowered distribution costs per film, reduced cream-skimming, and reduced risk.

VI

Post-Paramount Distribution

The Paramount decrees tore apart this complex system of film distribution. The five major distributors were forced to divest themselves of theater ownership. All distributors were prohibited from franchising with affiliated or independent theaters. Banned as well were block booking, control of admission prices, and any form of discrimination in licensing movies, such as on runs, clearances, and rental shares. Distributors were barred from favoring former affiliated theaters or particular exhibitors. The prohibitions were clearly intended to protect independent first-run theaters by providing them

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with equal access to all new movies. Paramount was like a grand Robinson-Patman Act for theaters: All forms of discrimination across like theaters were to end.

Lost in the process of these sweeping changes were the efficiency gains from vertical integration, long-term franchising, and block booking. Whatever the anticompetitive effects of these policies as decided under Paramount, they had clearly served to reduce distribution costs. The banned policies evolved over many years of competitive pressures for efficient distribution. Such efficiencies are not forsaken easily. Distributors and exhibitors would naturally seek close legal substitutes for the forbidden practices.

A. Efficiencies from Tracking and Splitting

Two forms of licensing dominated movie allocation following Paramount: tracking and splitting by rotation. It is noteworthy that when distributors and exhibitors were free to choose alternative forms of film allocation in the 1950s, competitive bidding, the method initially mandated by the court, was used for only a tiny fraction of films.

Voluntary tracking represents a substitute for two practices banned by Paramount: vertical integration and exclusive dealing through franchising. Tracking provides the efficiencies of long-term distribution relationships achieved through repetitive buying and selling, standardization of distribution, and subsequent settling-up. Tracking allows adjustments after a movie’s revenues are known, facilitating long-run survival of competitive theaters and reducing the likelihood and extent of exhibitor fraud on distributors’ rental shares. Tracking avoids the costlier, more complex, and higher risk means of allocating films by competitive bidding. Bid preparation and evaluation is time consuming and costly, and bids are difficult to compare across exhibitors because consumer demand is jointly dependent upon run length and geographic clearance. Relative to tracking, bidding


143. Examples in other areas abound. For instance, the per se illegality of resale price maintenance has led to de facto forms of resale price maintenance, so that its efficiencies are maintained. Dealers are influenced in indirect ways to maintain prices, which in turn influences manufacturers to police rival dealers’ pricing policies to prevent free riding. Similar skirting of the law to maintain distribution efficiencies occurred when exclusive territories were made per se illegal. See Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977).

144. A 1955 survey by Loew’s found that for an average picture with 15,000 bookings, competitive bidding was used in only 3.2% of situations. Universal Pictures had a similarly low incidence of competitive bidding. 1956 Hearings, supra note 139, at 372, 474.

145. De Vany & Eckert, supra note 84, at 89.
increases exhibitors' uncertainty over films to be shown and rental terms. The extent of tracking following the Paramount decision is unknown, but based on accounts of licensing practices in numerous antitrust cases it appears to have been a common practice.\textsuperscript{146} Hence, although integration through ownership or franchising was disallowed under Paramount,\textit{ de facto} integration through tracking provided a substitute means of gaining comparable efficiencies by noncontractual exclusive dealing arrangements.

Splitting by rotation offered similar distribution cost advantages over competitive bidding, but without the long-term stable buyer-seller efficiency gains of tracking. Splitting avoided the costly process of bidding and attendant exhibitor uncertainty over film acquisitions and unremunerative rental terms. Splitting allowed adjustments, with its risk sharing between distributor and exhibitor and, of primary importance, reduced exhibitor incentive to commit fraud.\textsuperscript{147} And, as noted earlier, splitting guards against discrimination lawsuits since each member of the split is given an equal opportunity to obtain good movies, with possibly a better chance of receiving a box office hit than under competitive bidding.

Splitting by rotation also offers a weak form of block booking. Implicit in distributors’ participation in splitting is that some theater will screen their movies, reducing the risk of production. In like fashion to block booking, splitting reduces the cream-skimming tendency of exhibitors since films are assigned to exhibitors on a rotating basis. Splitting is no less binding on exhibitors than block booking since penalty clauses can be activated if a theater does not fulfill its contracted run.\textsuperscript{148}

Decreases in distribution costs and flexibility in scheduling through adjustments increase output and are procompetitive. Lower distribution costs help keep down admission and concession prices, increasing consumer demand and consumer welfare. As noted, flexibility in scheduling through adjustments allows shorter runs for low grossing movies, freeing screens for potentially higher demand mov-


\textsuperscript{147} Adjustments were commonplace after Paramount, with, in some cases, actual guarantees of exhibitor profits. CONANT, supra note 27, at 135. For example, cash adjustments to exhibitors from Loew's in 1955 were $2 million, representing 3.5% of total Loew's distributor income. 1956 Hearings, supra note 139, at 363-64 (statement of Charles M. Reagan).

\textsuperscript{148} Admiral Theatre Corp., 437 F. Supp. at 1278.
ies. This increases consumer welfare by increasing both the number and variety of movies shown.

To summarize, licensing by tracking or splitting offered distinct advantages over competitive bidding and served to preserve some of the efficiencies lost due to the absence of vertical integration, exclusive dealing, and block booking following Paramount. Competitive bidding offered none of the efficiencies lost under Paramount, plus it entailed some clear cost disadvantages, such as a costly bidding process, greater exhibitor uncertainty, lack of risk sharing, and an increased incentive for exhibitor fraud. It is not surprising that the incidence of competitive bidding following Paramount was extremely low.

B. Empirical Evidence

This analysis implies that distribution costs should have risen after 1948 owing to less efficient forms of movie licensing. No detailed firm data on distribution costs are available, but some indirect evidence suggests that costs rose appreciably after 1948. With an increase in distribution costs, distributors would attempt to raise their share of box office receipts in order to maintain prior profit margins. Estimates of distributors' rental shares for this era differ across studies, but all indicate a rise after the Paramount decision. Distributors estimated their average rental share rose from 26% in 1947 to 35% in 1953. According to exhibitors, distributors' average share rose from 32.6% in 1947 to 35.9% in 1955. Using distributor receipts estimated by Crandall, distributors' shares rose from 30.4% in 1948 to 39.5% in 1954.

Whether the rise in distributors' rental shares was due solely to distribution cost increases is not clear. The industry was in great turmoil during this era due to the rise of television and reductions in total attendance. Moreover, vertically integrated distributors' rental shares prior to divestiture may have been understated to hide profits in theatrical divisions in order to avoid payouts under profit participation contracts. With divestiture, profits could be hidden less easily.

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149. Crandall, supra note 80, at 68-70.
150. Id. at 65.
151. 1956 Hearings, supra note 139, at 305.
152. Crandall, supra note 80, at 59-60. By way of comparison with the 1970s and early 1980s, average distributor shares ranged from a high of 45.3% in 1980 to a low of 34.3% in 1984. Vogel, supra note 70, at 44. For top grossing movies, shares are higher. Star Wars gained 59.3% of total domestic gross. See Peter S. Myers, The Studio as Distributor, in The Movie Business Book 275, 279 (Jason E. Squire & Englewood Cliffs eds., 1983).
153. Crandall, supra note 80, at 68-70.
Distributor rental shares could also have risen if the supply of movies fell, as exhibitors competed for a smaller supply.\textsuperscript{154} Releases over this period for the top nine distributors first rose from 249 in 1947 to 320 in 1951 then fell to 301 in 1953 and 215 in 1955.\textsuperscript{155} Hence, the initial increase in supply should have lowered distributor shares but no such effect was evident. The decline in supply after 1951 could have raised shares, but the demand for movies also fell. Paid admissions fell from 3.352 billion in 1948 to 1.956 billion in 1954.\textsuperscript{156} Thus, the rapid distributor share rise after 1948 does not appear to be due to a reduction in film supply.

Also consistent with a rise in distribution costs would be a rise in admission prices, as exhibitors attempted to recoup higher film licensing costs. Of course, demand conditions had to allow any price rises. Average admission price in real terms rose sharply, from forty-six cents in 1948 to sixty-one cents in 1950, a thirty-three percent rise, and remained near sixty cents throughout the 1950s.\textsuperscript{157} Hence, the evidence, although indirect, is consistent with a shift to less efficient and thus costlier methods of film licensing after Paramount.

In summary, the Paramount decision cost distributors many of the most efficient distribution practices of the prior period—vertical integration, exclusive dealing, and block booking. Tracking and splitting, which dominated licensing practices in the 1950s, were attempts to substitute for the distribution efficiencies lost under Paramount. The rise in distributor rental shares and admission prices after 1948 is consistent with this loss in distribution efficiency.

\section*{VII
Splitting and the Rule of Reason}

The above analysis indicates that a rule of reason approach is more consistent with splitting’s actual impact. However, recent deci-

\textsuperscript{154} Rental shares appear to fluctuate inversely to the number of movie releases. Vogel found a simple correlation between shares and number of film releases of -.4 for the period 1965 to 1983, which is significant at the .05 level. \textit{Vogel, supra} note 70, at 83.

\textsuperscript{155} \textit{Film Book Daily Yearbook} 100 (1959); \textit{Film Book Daily Yearbook} 69 (1949).


\textsuperscript{157} Average nominal admission adjusted for the entertainment tax was deflated by the \textit{CPI} to obtain real prices. \textit{See Vogel, supra} note 70, at 362-63, 369. The ban on retail price setting by distributors under Paramount may also have contributed to the price rise. However, distributors continued to use resale price maintenance after Paramount by awarding licenses to theaters who adopted their suggested admission price. The Justice Department approved this method of licensing. \textit{1956 Hearings, supra} note 139, at 738.
sions have completely dismissed efficiency rationales for splitting. This approach deserves reexamination.

The standards set forth in *General Cinema* and *Capitol Service* indicate that for defendants to prevail under a rule of reason they must demonstrate that distributor rental shares are no different between split and non-split cities, holding constant all relevant factors that influence rental shares, and that splitting provides competitive gains beyond mere financial advantages to exhibitors and distributors. Splitting must result in demonstrable improvements in competition. Presumably, equal distributor rental shares between split and non-split cities implies no loss in consumer welfare under splitting.

A. Rental Share Equality

These are difficult standards to meet and, in the case of rental share equality, set out an incorrect standard. In the absence of competitive bidding, distributors' rental shares should fall. However, distribution costs will also be lower under splitting, compensating for foregone bidding revenues. Unfortunately, quantifying cost savings has proven difficult for defendants. Nevertheless, distribution costs are reduced by eliminating the costs of competitive bidding, reducing fraud, reducing litigation expenses, and insuring outlet availability. Where splitting is accepted by distributors, cost savings must compensate for foregone revenues, since distributors can end splitting whenever its relative profitability becomes unfavorable. Only if distributors' risk-adjusted profit rates, not gross rental share, were lower under splitting could a case be made that splitting was potentially anticompetitive.

Some idea of the magnitude of rental share differences can be gained from past studies. Twentieth Century-Fox found in a comparison of split agreement and competitive bidding cities that its rental income was five percent lower in split cities.\(^\text{158}\) In a similar vein, after guarantees to distributors were banned in Pennsylvania, which dramatically reduced competitive bidding, rental shares to distributors fell by four percent.\(^\text{159}\) A four or five percent rental differential between split agreement and competitive bidding cities seems rather modest in terms of alleged exhibitor monopsony power.

If these figures are accurate, they help explain the long acceptance of splits by distributors. Competitive bidding at various times could easily have entailed five percent higher costs of distribution due, for example, to greater exhibitor fraud, litigation costs, and adminis-

\(^{158}\) Myers, *supra* note 152, at 282.

trative costs. Thus, the courts' standard of zero rental share differences between split and non-split cities would likely lead to incorrect decisions under a rule of reason approach.

B. Changes in Efficiency Across Licensing Methods

Although the efficiency advantages to splitting in general during certain eras is evident, these advantages are not immutable. The small differences in distributor rental shares between split agreement and competitive bidding cities is consistent with frequent shifts between distribution methods as relative costs change. In the 1950s splitting and tracking dominated distribution. In the 1970s competitive bidding dominated distribution. The relative costs and benefits of alternative forms of distribution change over time with, for example, the supply and demand for movies, changes in the technology of distribution and monitoring exhibitors, and new legal results in exhibitor-distributor disputes. As relative costs and benefits change, distributors will shift from splitting to tracking to bidding and back again. And at any given time, regardless of existing distribution arrangements, a unique movie can be licensed by competitive bidding.

One crucial factor in determining the profitability of alternative distribution methods is the supply and demand for movies. As the supply of films tightens, competitive bidding becomes more attractive to distributors. The average supply of new films by national distributors declined in general from the 1940s to the 1980s, decade-by-decade. The average annual supply of film releases were: 420 in the forties; 338 in the fifties; 230 in the sixties; 246 in the seventies; and 207 from 1980-1984. During one particularly sharp decline, new film releases fell from 282 in 1971 to 167 in 1977 and then rose to 232 by 1983. Concurrently, the number of screens in the United States rose from 12,825 in 1965 to 20,200 in 1984, or by fifty-eight percent. During the period of 1971 through 1977 screens increased nineteen percent while new releases fell by thirty-nine percent. It is no wonder that competitive bidding dominated distribution in the 1970s.

161. Jim Robbins, Distributors, Exhib 'Marriages' Increase as Bidding Dries Up, DAILY VARIETY, July 19, 1985, at 3. Charles M. Reagan, Vice-President of Loew's, testifying in 1956, stated, "we have indicated a willingness to eliminate competitive bidding whenever possible in situations where returns from the theaters are comparable by licensing our picture on a split basis." 1956 Hearings, supra note 139, at 373.
162. VOGEL, supra note 70, at 45; Guback, supra note 80, at 215.
163. VOGEL, supra note 70, at 45; Guback, supra note 80, at 215.
C. Competitive Effects

Before discussing potential competitive improvements in distribution and the movie industry due to splitting, the nature of that competition must be outlined. At issue in splitting cases is the wholesale market for movies. The general view is that improved competition in wholesale markets—lower costs, lower prices, greater output, better service, and so forth—redounds to the benefit of retail consumers, assuming competition at the retail level.

The main form of competition for first-run movies at the retail level is product differentiation across movies. Admission price is roughly the same across first-run theaters in a geographic market. Consumers choose movies more on word-of-mouth advertising, critics’ reviews, and performers than admission price. Price competition exists between first-run and second-run movies, between movies and videocassettes, and between movie-going and other forms of entertainment. However, once a decision is made to attend a first-run movie, then product differentiation, exhibitor location, and theater characteristics determine movie choice. Competition takes the form of the number, variety, and quality of movies, along with the quality of exhibition. Improvements in these dimensions reflect increased competition.

Competition at the wholesale level in the licensing of films takes place on price or license terms, the number of movies, movie quality, and the costs of distribution. The lower the cost of distribution, the less pressure to raise admission and concession prices in competition with alternative forms of movie-watching and other leisure-time activities. Improvements in the number and quality of movies parallel product competition at the retail level.

In contrast to these dimensions of competition, the debate on splitting agreements has focused largely on license terms. The debate has centered almost exclusively on how box office revenues are divided between distributors and exhibitors, with the difference being used as a test of exhibitor collusive monopsony power.

The emphasis on revenue division as the crux of the problem is overly narrow, missing the many other dimensions of competition at the wholesale and retail levels. How rents are divided up between buyers and sellers presents no antitrust welfare issue unless output is restricted. The effect of splitting agreements on retail competition and output has not been addressed in any antitrust case. As shown above, splitting can improve competition relative to competitive bidding by reducing distribution costs and increasing movie variety and the number of movies screened.
In the long-run, both distributors and exhibitors must earn competitive rates of return to remain in business. Pure monopsonistic pricing by exhibitors would drive distributors from the market. There is no evidence that distributors have been driven from the market by exhibitor collusion. On a national basis, the number of major distributors has remained relatively constant at six to ten distributors since the 1930s, with many minor distributors moving in and out of the market over time.\footnote{164. \textit{Conant}, supra note 27, at 107-53; \textit{Guback}, supra note 80, at 218-25.}

In summary, splitting affects far more than just how box office receipts are divided up between exhibitors and distributors. It affects key dimensions of competition: the costs of distribution; admission and concession price; and the number and variety of movies in competition. The leading cases have ignored these competition-improving gains from splitting. This has inevitably led to a per se treatment of splitting.

\textbf{VIII}

\textbf{Conclusion}

Various motion picture exhibitors have been fighting against distribution practices for decades, including block booking, blind bidding, time and zone clearances, resale price maintenance, and competitive bidding. For much of that time the Justice Department has been their ally. Having achieved major victories against certain practices, such as block booking and blind bidding, it is ironic to find the Justice Department imposing heavy fines on exhibitors for a practice that it condoned for thirty years. It is additionally ironic since distributors, those most likely harmed by anticompetitive uses of splitting, actively participated in split agreements for years.

There is clearly much more to split agreements than an alleged naked price fixing agreement. Efficiency gains can explain the use of splitting in many cases. As a system widely used by both distributors and exhibitors, in competition with other forms of distribution for over thirty years, it provided mutually beneficial gains. Without such gains it would have long since disappeared. Splitting generates cost savings in distribution over competitive bidding and can enhance competition by increasing the number and variety of movies screened. Splitting should be judged under a rule of reason, with the procompetitive efficiencies of splitting weighed against its potential anticompetitive losses.