NET PROFIT DEALS: NOT YOUR TRADITIONAL RECORD DEAL

By Bart Day

In recent years there has been a rapidly increasing use of so-called “Net Profit Deals,” as an alternative to the traditional type of record deal. This has been the particularly true with indie label record deals.

The basic idea is that any net profits will be split between the artist and the record label, after ALL expenses connected with the artist’s records have been deducted by (and reimbursed to) the label from record sales income.

Compare this with the traditional record deal, where the artist is paid on a royalty basis, with a typical artist royalty in the range of 12 to 15% (of the retail price) but sometimes higher (especially for more established artists).

Ten years ago, out of every ten indie record deals I negotiated, only one or two were Net Profit Deals. Today it’s more like six or seven out of every ten, at least.

In this article, I will first compare the basic aspects of Net Profit Deals and traditional record deals, and the advantages and disadvantages of each, both for labels and for artists. Then I will show some sample royalty calculations for both. Finally, I will provide some detail about typical clauses in Net Profit Deal contracts, and how those clauses compare with traditional record deals.

THE BASICS OF NET PROFIT DEALS

To compute the net profits in a Net Profit Deal, the record company deducts off the top its actual out-of-pocket costs for recording, manufacturing, promotion, marketing, etc. Some labels also deduct a so-called “Overhead Fee” of 10 to 15% of the gross record sales income. After the record company deducts all of these expenses and reimburses itself, the label then pays the artist whatever percentage of the profits their contract requires (usually 50%).

Though this percentage is obviously much larger than the 12 to 15% royalty range mentioned above for traditional record deals, the artist in a Net Profit Deal is getting 50% of the income from records sold, but only what’s left after ALL expenses are paid.

In traditional record deals, on the other hand, the artist starts getting their artist royalties after the record company has recouped the recording costs (and any cash advances to the artist) from the artist’s royalties. The record company absorbs all other costs out of its own pocket – such as duplication, shipping and promotion costs – and those costs don’t factor into the calculations of what is to be paid to the artist.

A BRIEF WORD ABOUT “360 DEALS”

Net Profit Deals are also different from so-called “360 Deals,” which so much has been written about lately.
A “360 Deal” is usually with a major label and has two components: (1) The first part of the 360 Deal contract pertains to record sales and contains basically the same terms as a traditional record deal, usually with the artist being paid on a “royalty” basis as described above; (2) The second part of the 360 Deal contract gives the label a right to receive a percentage of certain other income streams which labels have not historically shared in, such as artists’ touring and merchandising income.

There is no standard 360 Deal. The terms vary substantially from deal to deal, and from label to label. A lot depends on the track record and negotiating leverage of the artist, plus how much of an advance is being paid.

A “full” 360 Deal allows the label to share in all entertainment industry income, including touring, music publishing, merchandising, product endorsements, book publishing income (if the artist writes a book), and on and on. However, there are numerous 360 Deals that are not “full” 360 Deals; instead, the label shares in only certain types of income, such as touring and merchandising.

Usually the label’s share of those non-record kinds of income is in the range of 10 to 20 percent, but for new artists it can get as high as 50 percent.

360 Deals are a bit complicated and will be dealt with in more depth in a future article.

ADVANTAGES AND DISADVANTAGES OF “NET PROFIT DEALS” FOR LABELS

Advantages (for Labels)

In most Net Profit deals, the label doesn’t have to pay the artist anything (including, under many contracts, even mechanical royalties) until the label has recouped all costs fronted by the label. This is, of course, appealing to labels.

Disadvantages (for Labels)

The main disadvantage of Net Profit Deals for labels is on the back end – that is, if the records are successful and the costs relatively small in comparison. In that scenario, the deal will be less profitable for the label than would be the case with a traditional record deal.

ADVANTAGES AND DISADVANTAGES FOR ARTISTS

Advantages (for Artists)

Net Profit deals can be attractive to artists as well, but for completely different reasons.

For one thing, if record sales are quite substantial and if the costs involved are reasonable in comparison to the income from sales, the artist may come out significantly better with a Net Profit Deal than with the traditional record deal.

Also, to many artists the idea of a 50-50 split of net profits seems inherently more fair and understandable than the voodoo economics of the traditional record deal. Plus, some artists prefer the general feel of a profit split situation, which can feel more like a partnering relationship and a more collaborative relationship with the label than is the case with the traditional artist-label relationship.

However, the appeal of a 50-50 relationship is somewhat dampened by the fact that even if the contract states that there is to be a 50-50 income split, in reality the label may be receiving more that 50% of the net income. This is because, as mentioned above, some labels deduct an “Overhead Fee” off the top, along with all other costs (such as recording, duplication, and promotion costs). Then, whatever is left is divided 50-50. And so, the label is receiving an Overhead Fee off the top, AND 50-50 of whatever the “Net Income” is determined to be. (See the sample calculations below to see exactly how those calculations are done and how the “Overhead Fee” results in the label receiving more that 50% of the net profits.)
This is just one example of some of the subtle financial issues under the surface with Net Profit Deals. As a result, it is not always easy to determine in advance whether a Net Profit Deal will be more or less advantageous than a traditional record deal. Comparing the economics of Net Profit Deals to traditional record deals can be very confusing, and to a large extent, like comparing “apples and oranges.”

The only way to really analyze the financial ramifications of a Net Profit Deal versus a traditional record deal is to “spreadsheet it,” based on a ballpark estimate of what the total expenses will be and what the sales levels will be. It is always crucial to “crunch the numbers.” That being said, those projections can be difficult and problematical for an untested new artist with no prior record releases. On the other hand, for artists with prior record releases, they can use the income and expense history of their prior records as an indicator of the likely income and expenses for their next record and do the necessary projections accordingly.

Incidentally, if you are an artist, you need to discuss a pending Net Profit Deal with your publisher (if you have been signed to a publishing deal), and with any co-writers, since these mechanical royalty provisions in Net Profit Deals may seriously affect their income. Also, you need to clear the royalty provisions with any producers whom you have hired directly (as opposed to a situation in which the record company has hired the producer and has agreed to pay the producer separately from any monies owed to you as an artist). Otherwise, the situation is fraught with potential legal and relationship problems.

Disadvantages (for Artists)

Net Profit Deals also present certain disadvantages for artists, including the following:

**Mechanical Royalty Issues**

In a traditional record deal situation, artists who write songs for their own records are entitled to receive mechanical royalties (“mechanicals”) on all record sales on a quarterly or semi-annual basis. These mechanical royalties are paid by the label in addition to the 12-15% artist royalties mentioned above and are a crucial source of cash flow for most artists.

In the case of Net Profit Deals, though, mechanical royalties are handled differently, usually in one of two ways:

1. Either the mechanical royalties will be paid similarly to how they are paid in a Traditional Record Deal context, but the amount of mechanical royalties paid to the artist will be treated as an advance to the artist and later deducted from the artist’s share of the net profits (if any); **OR**

2. No separate mechanical royalties will be paid to the artist for their original material. Instead, the artist will receive only a share of net profits, and no separate mechanical royalty payments. The contract will usually say something like; “All monies payable to Artist hereunder shall be inclusive of any mechanical royalties which would otherwise be payable to Artist.”

In this latter instance, the artist does not have the benefit of the cash flow from mechanical royalties that would be paid in the case of a traditional recording agreement.

The problems caused by this lack of cash flow are compounded by the fact that usually the label is spending money faster than it comes in. Therefore, even if there are eventually net profits from the record, it will likely take quite some time before the artist receives a share of the net profits, since in the case of a successful record the label is usually spending money faster than it is coming in. And in the worst case scenario – i.e., situations where no net profits ever materialize – the artist will receive ZERO money from the deal (i.e., no ARTIST royalties and no MECHANICAL royalties).

**Audit Issues**
Another potential disadvantage of Net Profit Deals is that it is much more difficult and cumbersome for artists to do a royalty audit with Net Profit Deals than with traditional record deals, all other things being equal. This is because, in the case of Net Profit Deals, the only way that an artist can know whether they have been paid the proper amount is by verifying ALL income and ALL expenses that the label incurred. On the other hand, in the case of the traditional record deal, the artist needs to verify only the income received and certain limited kinds of expenses (primarily just recording costs and independent marketing and promotion costs), and not all expenses. Remember too that audits can be very expensive, easily costing around $15,000 to $20,000 dollars (and often much more, particularly in the case of major label artists having substantial sales).

In any event, it is still wise for artists to make sure that their Net Profit Deal contract provides strong audit rights and provides that if the label’s accounting statements are off by a certain percentage, the label will then be obligated to reimburse the artist for any audit costs incurred.

**Merchandising**

Frequently in Net Profit Deals the label will have the right, for example, to create and sell a new T-shirt for each record released during the term of the deal. Those T-shirts are then sold from the label’s website and the other usual channels. The band then shares in the net profits from those sales.

However, the label’s sale of such T-shirts tends to reduce/cannibalize the artist’s sale of its own T-shirts. And since merchandise income is such a big part of surviving on the road, any band entering into a Net Profit Deal needs to either try to avoid giving the label the right to sell such T-shirts and similar merchandise, or at the very least, negotiate the best possible contractual rights and protections in regards to label-created merchandise.

**“Overhead Fees” (aka “Administration Fees” and “Marketing Fees”)**

From an artist’s point of view, these “Overhead Fees” are questionable, since the label is already entitled to receive 50% of any net profits. Sometimes these fees can either be removed entirely from the contract or the percentage reduced when the deal is being negotiated.

**Some Sample Calculations: (Comparing Traditional Recording Contract Royalty Calculations to “Net Profit Deal” Calculations)**

For purposes of these sample calculations I am just plugging in some sample (and admittedly somewhat random) numbers here. Certainly all of these numbers will vary substantially from one artist-label situation to the next.

Also, to try to keep things as simple as possible in the sample calculations below, I am not factoring in any numbers for such things as income from the digital distribution of single songs or income from licensing masters for films and TV shows. I am also drastically oversimplifying how royalties are calculated in the case of the traditional record deal.

Finally, this major point: I’m not taking into consideration here the fact that major labels generally spend substantially more on recording costs, marketing etc. than indie labels do. And so, I’m not trying to base these calculations on realistic numbers of what either an indie label or major label would spend. Instead, the purpose of these sample calculations is just to show the methodology of the calculations of the net profit deal versus the traditional deal, using essentially the same set of numbers for both deals.
So, now the fun begins:

### Sample Calculation of Artist Royalties (Traditional-type Recording Contract)

**ARTIST ROYALTIES (Traditional-type Recording Contract):**

- $15 – RETAIL price per record
- \( \times \) 10% net artist royalty rate
  
  \[ \text{\$1.50 artist royalty rate (for each record sold)} \]
- \( \times \) 30,000 records sold
  
  \[ \text{\$45,000 in artist royalties} \]

  (minus) $20,000 in recording costs (recouped/deducted by the record company from the artist's royalties)

  (minus) $10,000 (50% of independent marketing and promotion costs, and tour support given the band). (Normally the major label is entitled to recoup from artist royalties 100% of the amount given to the artist as tour support, and 50% of the money spent on independent (outside) marketing and promotion costs (as opposed to the cost of the label's own staff doing marketing and promotion).

  \[ \text{= \$15,000 in ARTIST royalties} \]

**MECHANICAL ROYALTIES (Traditional-type Recording Contract):**

(where there are 10 songs on the album and the artist wrote all ten songs)

- Six and 83/100 CENTS (6.83 CENTS) per song for each record sold.
  
  (Explanation: In most recording contracts, the artist/songwriter is not paid the full "statutory rate" provided for by the U.S. copyright law, but instead 75% of that amount. As of January 1, 2009, the statutory rate is nine and one/tenth (9.1) cents per song for each record sold. This 6.83 CENTS equals 75% of this so-called "statutory rate" of Nine and one/tenth cents per song for each record sold.

- \( \times \) 10 songs
  
  \[ \text{= \$68.3 in mechanical royalties per album} \]

- \( \times \) 30,000 albums
  
  \[ \text{= \$20,490 total SONGWRITING/PUBLISHING royalties} \]
COMBINED ARTIST ROYALTIES AND MECHANICAL ROYALTIES (under Traditional-type Recording Contract):

$15,000 - Artist Royalties

$20,490 - Mechanical Royalties

$35,490 TOTAL Received by Artist

Now, compare the above numbers to the following **Net Profit Deal** calculations.

Sample Calculation of Artist Royalties (Net Profit Deal) (assuming that the contract does not require the separate payment of mechanical royalties to the artist)

<table>
<thead>
<tr>
<th>ARTIST ROYALTIES:</th>
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<tr>
<td>If RETAIL price per record = $15</td>
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<tr>
<td>And if WHOLESALE price per record (the price actually received by record company from distributor) = $9</td>
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30,000 records sold @ $9 per record = $270,000 gross income from distributor

( minus) $20,000 recording costs

( minus) $40,500 “Overhead Fee” deducted by label (based on 15% of the $270,000)

( minus) $30,000 in duplication and printing costs (calculated at $1/per record) for 30,000 records

( minus) $20,000 costs incurred by label to advertise, market, promote the record

= $159,500 net received by record company from record distributor(s)

½ of this amount is payable to **Artist** = $79,750

½ to the **Label** = = $79,750 (IN ADDITION TO the $40,500 “Overhead Fee” deducted and retained by the Label)

Remember – these are only sample calculations. Any significant changes in the numbers plugged into these calculations will obviously have a large impact on the final totals in these calculations.
Also, in no way should these calculations be interpreted to mean that an artist will come out better financially with a Net Profit Deal than with a traditional-type recording contract. Every situation has its own unique numbers, and which type of contract is better will depend on the exact numbers that are used. This is one reason why it is so important for artists to do the best possible income/expense projections for their particular situation.

Finally, if a record is a big flop it won't really matter much which kind of deal was used, since in either scenario there will usually be no artist royalties owed to the artist, and no net profits for the artist to share in. The one exception to this general comment is the fact that under the traditional record deal (and some Net Profit Deals), the artist will have been receiving mechanical royalties along the way. That being said, if the record is a flop, mechanical royalties will be minimal anyway.

OTHER TYPICAL DEAL POINTS

Despite the differences between Net Profit Deals and traditional record deals, there is a certain amount of overlap between the two. This is because many of the issues that need to be addressed in a traditional record contract also need to be addressed in a Net Profit Deal – for example, how much the recording budgets will be, who will be in charge of the artist's official website, and so on.

Some other examples:

The "Term"

In recording contract parlance, both in traditional deals and Net Profit Deals, “the Term” means how long the artist will be recording for the label, and how many albums the artist will be obligated to record for the label.

In both traditional deals and Net Profit Deals, “the Term” is usually for one initial album, with the label entitled to a series of options for a certain number of follow-up albums. The contract usually contains complex provisions that essentially create a timetable for the recording and release of those albums.

Sometimes, particularly in indie deals where the artist has already recorded and self-financed an album prior to entering into a recording contract, the deal may be just for one record (aka a “one off deal”). But this rarely happens with major labels.

After the label has released all of the albums that it has optioned, the so-called “Term” ends. But even after the end of "the Term," the label is usually entitled under the contract to continue selling the albums recorded during "the Term" and to continue owning the copyrights in those albums. (See the “Ownership of Masters” section below.)

It is crucial, from an artist’s point of view, that the recording agreement contain clearly defined termination provisions in case the deal is unproductive or if the label fails to perform its obligations. The contract should specify what the artist's rights will be if the record doesn’t get released, or if it goes out of print, or if the label ceases to have bona fide national distribution, or if the label defaults on certain other obligations stated in the contract.

The “Territory”

Both traditional deals and Net Profit Deals typically allow the record company to sell records worldwide. But if the artist has significant negotiating clout, the contract might allow the label to sell only in certain territories (e.g., North America). This is most likely to happen in a one-record indie deal, where the artist had already made the record, at the artist’s expense, prior to the signing of the deal.

Ownership of Masters
In traditional record deals (major and indie), the label usually owns the masters and the copyrights in the masters. The ownership will typically continue for the full life of the copyrights of the masters, i.e., a very long time, and long after the parties are no longer actively working together.

In Net Profit Deals, the masters are either owned by the artist and label jointly, or far more commonly, by the record company alone.

If an artist has already financed a recording, then the artist has a strong argument for owning any such masters. This is based on a working assumption common in the entertainment industry that whoever is paying for the production costs should own the resulting work - i.e. the master recordings. And, if the artist will own the masters (and the copyrights in the masters), then the artist will only be licensing the masters to the label, giving the label the right to sell copies of the record for a certain specified period of time.

By the way, you should know that Section 203 of the U.S. copyright statute allows artists and writers in certain instances to terminate any post-1978 copyright transfers and licenses (and thereby get reversion of the copyrights in their masters) after 35 to 40 years. The artist must follow certain procedures in order to make such a reversion happen.

Section 203 is complicated, but something that more artists need to be aware of, especially artists who signed record deals and/or publishing deals in the late 1970’s and the 1980’s. Section 203 will start getting a lot more public attention in the next year or two, as these reversions will start happening in 2013. Even now, though, there is substantial action behind the scenes with artists and songwriters giving reversion notices and, in some instances, renegotiating their deals.

**Marketing and Promotion Issues**

In either a traditional deal or a Net Profit Deal, the artist should seek the right to approve (or at least be consulted about) major marketing and promotion decisions, and to have the contract guarantee that the label will spend at least a certain specified amount of money each year for marketing and promotion.

Sometimes the contract will provide that if the label fails to make the guaranteed “spends,” the label will not be entitled to exercise any options for follow-up records.

**Approval Rights**

Both traditional deals and Net Profit Deals usually contain other clauses relating to the artist’s approval rights – for example, whether the artist has a right of approval over the studios and producers to be used, and over the label’s issuance of licenses to third parties allowing them to use the artist’s music in film and television productions, commercials, compilation records, computer games, etc.

**Accountings**

In most cases the agreement requires the label to regularly provide (usually semi-annually) artists with an itemized accounting for record sales, along with payment of any monies (if any) then owed to the artist.

**Co-Publishing Rights**

Sometimes, a label will demand that the artist also enter into a co-publishing deal (usually a separate contract), giving the label a part-ownership interest in the artist’s songs and hence the right to share in the publishing income earned from outside sources, such as when an artist’s songs are used in a film or TV show, or when a song is “covered” by another artist.
This happens far more often with indie labels than with major labels, and I see it most often in indie deals involving country, hip hop/rap, and Christian music.

As a general rule, it is not in an artist’s best interests to give away co-publishing rights to the label, and particularly so if the artist is not receiving a substantial cash advance for giving away those rights.

CONCLUSION

Net Profit Deals have become common fairly recently, and so there are not yet any established industry standards concerning the exact terms of such deals. Instead, there is often a lot of improvising done during contract negotiations, in terms of exactly how any particular deal will be structured or exactly what terms will be included in the contract.

For an artist considering the advisability of entering into a Net Profit Deal, and particularly when comparing a Net Profit Deal offer from one label and a traditional deal offer from another label, it is crucial to “crunch the numbers” and evaluate carefully the various financial, legal and logistical issues lurking under the surface.

Editor’s Note: Bart Day is a veteran entertainment attorney and represents numerous national recording artists, publishers, labels, managers, producers, and others active in the music industry. He has a Portland, Oregon-based entertainment law practice and presently divides his time between Portland and Los Angeles.

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