

THE BIG PICTURE[®]

MV-Link Productions (MV-Link) is a producer and distributor of motion picture films. It specializes in action adventure films popular with males, mostly in the teen and young adult market. While it has only been in business for 7 years, it has produced several moneymaking hits as well as many more minor "B" films that are shown on cable networks and through video rental stores.

MV-Link has recently completed the production of five new films. This set of five films contains one film ("Kombat Rex") that marketing research indicates will be a top box office hit. The other four (KR II, KR III, KR IV, KR V) are "filler" films that will be bundled with the hit and licensed to theatres for exhibition. To receive access to the hit, theatres must agree to show all films a minimum number of times.

In July 2006, MV-Link entered into an exclusive contract with PACE Theatres, Inc. (PACE), a large theatre chain with approximately 475 theatres across the United States. This contract provided in part as follows:

Agreement: PACE is granted the right, license, and permission to display the five films listed herein during the contract period. In consideration of this contract, MV-Link will receive:

1. \$5,000,000, payable \$2,500,000 upon contract signature and \$2,500,000 on September 1, 2006.
2. \$500 for each film showing in each location.

Contract period: The contract period shall be the six months commencing on September 1, 2006.

Limitation on screenings: PACE agrees to show Kombat Rex no more than 42 times per theater and the four accompanying films (KR II, KR III, KR IV and KR V) no fewer than 18 times each per theater.

Exclusivity: PACE shall have exclusive screening rights during the contract period. MV-Link acknowledges that an integral inducement in consideration of the contract is PACE's interest in being the sole source, without competition from other theaters in the market, during the contract period.

At the signing of the contract, PACE paid \$2,500,000 of the \$5,000,000.

PACE sent checks to MV-Link for \$2,500,000 on September 1, 2006, and \$5,462,500 on January 20, 2007, along with an audited statement detailing the number of showings as of December 31, 2006. The following is a summary of that information:

Film	Number of Showings	Amount Due
Kombat Rex	8,550	\$4,275,000
KR II-V	2,375	1,187,500
	10,925	\$5,462,500

In March 2007, MV-Link received a demand notice from PACE that all monies previously paid were to be returned or they would file a lawsuit. In their letter, they enclosed a newspaper clipping from a movie theatre in Toronto, Canada that was advertising the set of five films for showing the second week of February 2007.

Required

Write a report using the report writing guide from the course website.

In preparing your report remember to review LDC financial accounting concept 5 (cash flow vs. GAAP income), financial accounting concept 8 (understanding the timing of revenue recognition), management accounting concept 5 (understanding how to budget revenue), and business law concept 1 (offer and acceptance of contracts; enforcement of contracts: interpreting the parties' intent).

Note: To the extent that you may recognize any antitrust issues (which we would not expect) please ignore them for purposes of this analysis.

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Statement of Financial Accounting Concepts

Statement 5. Recognition and Measurement in Financial Statements of Business Enterprises Financial Accounting Standards Board

GUIDANCE IN APPLYING CRITERIA TO COMPONENTS OF EARNINGS

CON5, Par. 78

78. This section discusses the need for and provides further guidance in applying the fundamental criteria in recognizing components of earnings. Changes in net assets are recognized as components of earnings if they qualify under the guidance in paragraphs 83-87. Certain changes in net assets (discussed in paragraphs 42-44 and 49-51) that meet the four fundamental recognition criteria just described may qualify for recognition in comprehensive income even though they do not qualify for recognition as components of earnings based on that guidance.

CON5, Par. 79

79. Further guidance in applying the recognition criteria to components of earnings is necessary because of the widely acknowledged importance of information about earnings and its components as a primary measure of performance for a period. The performance measured is that of the entity, not necessarily that of its management, and includes the recognized effects upon the entity of events and circumstances both within and beyond the control of the entity and its management.⁴⁸ The widely acknowledged importance of earnings information leads to guidance intended in part to provide more stringent requirements for recognizing components of earnings than for recognizing other changes in assets or liabilities.

CON5, Par. 80

80. As noted in paragraph 36, earnings measures the extent to which asset inflows (revenues and gains) associated with substantially completed cash-to-cash cycles exceed asset outflows (expenses and losses) associated, directly or indirectly, with the same cycles. Guidance for recognizing components of earnings is concerned with identifying which cycles are substantially complete and with associating particular revenues, gains, expenses, and losses with those cycles.

CON5, Par. 81

81. In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted. Moreover, as a reaction to uncertainty, more stringent requirements historically have been imposed for recognizing revenues and gains than for recognizing expenses and losses, and those conservative reactions influence the guidance for applying the recognition criteria to components of earnings.

CON5, Par. 82

82. The guidance stated here is intended to summarize key considerations in a form useful for guidance for future standard setting—guidance which also is consistent with the vast bulk of current practice. The following paragraphs provide guidance separately for recognition of revenues and gains and for expenses and losses as components of earnings.

Revenues and Gains
CON5, Par. 83

83. Further guidance for recognition of revenues and gains is intended to provide an acceptable level of assurance of the existence and amounts of revenues and gains before they are recognized. Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

a. Realized or realizable. Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

b. Earned. Revenues are not recognized until earned. An entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. Gains commonly result from transactions and other events that involve no "earning process," and for recognizing gains, being earned is generally less significant than being realized or realizable.

Business Law concepts

Interpretation of contracts

General rules of construction

Courts look to contracts to determine the parties' obligations. Most of this is based on the language of the agreement, however sometimes there are issues not mentioned or ambiguously addressed in a contract. What to do if there is a dispute about a topic not addressed (or ambiguously addressed) in the contract? Courts follow general rules in construing contracts called "rules of construction." Some of these rules are articulated in cases, some are intuitive but few are codified in statute. It makes it difficult, sometimes, for business people to make business decisions. The more you understand how courts tend to approach contractual disputes, the more effective you will be at managing resources. Here are a few rules of construction that may apply to Adventure Films. Think about how they affect your analysis of the case. Use them (cite to specific sources) in your analysis of the case.

Courts seek to preserve, not invalidate agreements

Courts in general try to preserve contracts, even if there is a flaw in the agreement. There are important reasons for this: courts want parties to a contract to rely on the contract. Business would be harmed if everyone who entered a contract thought that with a sharp enough lawyer they could find some defect that would get the contract invalidated. Commerce relies on the premise that parties will do what they have agreed to do, and that if not, there will be some remedy at law. If you need an illustration of this point, think of any country in which political power, wealth or corruption mean that getting legal rights enforced depends on your political clout rather than on the law. Look at how much foreign investment gets made in such countries. Look at the overall wealth of the citizens of such countries. It is not hard to conclude that the American legal system, despite its flaws, helps the economy by ensuring that the judicial system enforces legal rights.

This brings up an important point with students studying business law: there is a tendency to seize on any contractual defect and conclude that entire agreements are not binding. This is a serious error. For one thing, it's sloppy; sometimes students are concluding that contracts are not binding in order to avoid completing their analysis (e.g. "They didn't mention xxx! That's wrong! There's no contract!"). Some of it is naïve: there are few contracts that do not have some ambiguities; invalidating all of them would mean that there were virtually no legally binding agreements. Some of it is well-intentioned but overzealous: when you first learn about business law even good students often want to apply it literally. Avoid this tendency and recognize that only in cases where courts conclude that the parties never, truly, agreed will they invalidate a contract based on missing or ambiguous contractual terms. Courts are not "contract police" rather "contract enforcers."

Here are some references that should aid your analysis:

In *DeSantis v. Wackenhut Corp.*, 793 S.W.2d at p. 677, the court observed that "the most basic policy of contract law . . . is the protection of the justified expectations of the parties. The parties' understanding of their respective contractual rights and obligations depends in part upon the certainty with which they may predict how the law will interpret and enforce their agreement."

"The law does not favor but leans against destruction of contracts because of uncertainty; it will, if feasible, so construe agreements as to carry into effect (the) reasonable intention of parties if that can be ascertained." *Bohman v Berg* (1960) 54 Cal 2d 787.

Courts construe a contract's meaning to be consistent with the parties' intention

The central rule of contractual analysis is to interpret based upon the parties' intent on entering the agreement. It is central to legal analysis to recognize that courts do not enforce agreements based upon what the judge thinks is fairest, "right" or best. The judge was not a party to the agreement and his or her opinion is irrelevant on this issue. Instead, interpret contracts to most consistently enforce the parties' reasonable expectations. The judge's job (and your job in this assignment) is to figure out what the parties intended and to interpret the contract consistent with that intent.

Here is some authority for this proposition:

The contractual meaning "is determined by objective manifestations of the parties' intent, including the words used in the agreement, as well as extrinsic evidence of such objective matters as the surrounding circumstances under which the parties negotiated or entered into the contract, the object, nature and subject matter of the contract, and the subsequent conduct of the parties." *Morey v. Vannucci* (1998) 64 Cal.App.4th 904, 912.)

"The fundamental goal of contractual interpretation is to give effect to the mutual intention of the parties. The mutual intention to which the courts give effect is determined by objective manifestations of the parties' intent, including the words used in the agreement, as well as extrinsic evidence of such objective matters as the surrounding circumstances under which the parties negotiated or entered into the contract; the object, nature and subject matter of the contract; and the subsequent acts and conduct of the parties." 1 Witkin Summary of Cal. Law, Contracts (9th ed. 1987) § 684, pp. 617-618.

"A contract must be so interpreted as to give effect to the mutual intention of the parties as it existed at the time of contracting, so far as the same is ascertainable and lawful." Cal. Civ. Code § 1636.

Missing or ambiguous terms

Contracts are interpreted as they were apparently intended by the parties at the time the contract was created. If the parties' intent can be determined, courts will supply missing terms or clarify ambiguities. They will not, however, insert terms to create an agreement where none, really, exists.

Here are some relevant references:

"A contract extends only to those things concerning which it appears the parties intended to contract. Our function is to determine what, in terms and substance, is contained in the contract, not to insert what has been omitted. We do not have the power to create for the parties a contract which they did not make and cannot insert language which one party now wishes were there." *Levi Strauss & Co. v. Aetna Casualty & Surety Co.* (1986) 184 Cal. App. 3d 1479, 1485-1486.

"However broad may be the terms of a contract, it extends only to those things concerning which it appears that the parties intended to contract." Cal. Civ. Code § 1648.

"If parties had concluded (a) transaction in which it appears they intend to make contract, (the) court should not frustrate their intention, if it is possible to reach fair and just result, though this requires choice among conflicting meanings and filling of some gaps left by parties." *Rivers v Beadle* (1960) 183 Cal App 2d 691.

Plain meaning

This is not a trick. It is just common sense. Interpret contractual language consistent with commonly-understood definitions and interpretations of its language.

Here is a source for this statement:

"The paramount consideration is the intention of the contracting parties' . . . as it existed at the time of contracting, so far as the same is ascertainable and lawful.' This intention must be ascertained from the words used, after taking into consideration the entire contract and the circumstances under which it was made. The words used in a contract must be given their ordinary meaning, unless there is evidence that the parties intended to use them in a unique sense or to give the words some different meaning." *Moss Development*, 41 Cal.App.3d at p. 9.