NEWS ANALYSIS

Is Hollywood Failing to See the Big Picture?

As piracy spreads from music to films, studios may be in danger of acting too slowly to meet changes in technology.

By Patrick Goldstein
Times Staff Writer

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On a Monday morning in late September, just weeks after the music industry hit hundreds of file-sharing consumers with lawsuits, News Corp. Chairman Peter Chernin held an anti-piracy summit meeting in his executive conference room on the studio lot.

On hand was an impressive array of top Hollywood studio brass, including Viacom Entertainment Group Chairman Jonathan Dolgen, Time Warner Entertainment Group Chairman Jeff Bewkes, Warner Bros. Chairman Barry Meyer, MGM Chairman Alex Yemenidjian and Sony Entertainment Vice Chairman Yair Landau.

The studio chiefs, along with Motion Picture Assn. of America President Jack Valenti, listened intently as Universal Music President Zach Horowitz, a chief architect of the record industry's anti-piracy strategy, gave a report from the battlefront. Horowitz said a stream of TV reports and front-page stories about the lawsuits, in addition to various educational efforts, seemed to have slowed the pace of illegal downloading.

But Horowitz offered a blunt prediction: In a year, the outlaw file-sharing services that have helped send record company profits spiraling down would be crowded with movies and TV shows. If you're going to file lawsuits, he advised, do it right away before millions of people online are sharing movies and TV shows for free.

Not everyone thought it was time to sue. Valenti launched into one of his signature orations, lobbying the moguls to continue exploring more advanced technological copy protection. When Valenti concluded, according to several people in the room, Chernin told the MPAA chief, "Jack, I totally disagree with you." Chernin urged the studio chiefs to follow the lead of the music companies and move ahead with lawsuits.

When the Fox chief called for a raised-hand vote, it was unanimous. While no one will confirm a specific timetable, the studios have instructed Valenti to begin preparations for lawsuits aimed at avid file sharers, be they junior high schoolers, computer-savvy techno geeks or grandmothers.

If there was any doubt how seriously these entertainment behemoths view the threat of piracy, it came into focus near the end of the meeting. According to several parties in the room, Dolgen, exasperated by the lengthy debate, spoke up, saying, "It sounds like all we're doing here is arguing over the size of the coffin."
The music industry's dramatic profit slide, which began with the arrival of Napster and other illegal downloading services, has given Hollywood such a bad case of the heebie-jeebies that when movie executives get on the subject of piracy, they begin to sound like county sheriffs.

"People have been stealing music and now they are out there stealing our movies," says 20th Century Fox Film Co-Chairman Jim Gianopulos. "There is a massive looting going on that's only going to get worse when these [digital video recording] storage devices become commonplace."

The argument over digital entertainment rages from the halls of Congress to college dorms to family living rooms. Ravaged by illegal downloading, record companies have been forced to fire thousands of employees and trim their rosters of low-selling performers.

A group of media companies has sued Replay TV — a system that allows TV viewers to watch programs when they want — to prevent the company's digital video recorders from automatically skipping commercials or allowing viewers to transmit TV programs or movies to other Replay users on the Internet.

And in Hollywood, piracy fears prompted the recent MPAA ban on awards season "screeners" — DVD copies of the year's top films sent to critics and talent guild members. That's set off an uproar that continues despite efforts at a compromise allowing screeners for Academy Awards voters only.

The piracy battle lines are clear. On one side are technology fans and entrepreneurs, such as rock manager Jim Guerinot, who believe media conglomerates are fighting a losing battle trying to rein in the digital revolution.

"You can't protect content — kids live to hack every new anti-piracy gimmick like they're playing a video game," says Guerinot, who manages the bands No Doubt and the Offspring. "These companies can't be in the entertainment business if they're in the arm-wrestling-litigation business. It's not a game they can win."

In the other corner are media conglomerates such as News Corp. and Time Warner, which have been lobbying for more aggressive legal enforcement, legislative protection and education offensives to protect their content from digital pirates. Warner's Barry Meyer, who instigated the Oscar-screener ban, sees piracy as "a life-or-death issue for our business." In fact, Meyer believes that the word "pirate" doesn't do justice to the crime. "To young people, 'piracy' means something swashbuckling and cool," he says. "A better word would be 'theft.' "

Emotions have been running high because the piracy debate heralds a reordering, if not a reinvention, of the way entertainment is consumed. The travails of the record industry are just the first nasty shock in what will eventually be a technological earthquake. Schwinn went bankrupt when it was slow to adjust to the arrival of carbon-fiber and aluminum-frame mountain bikes. Kodak has never recovered from ignoring the new technology of digital cameras and camcorders.

"As an industry, we are going to have to adjust. The tide is coming in whether we want it to or not," says Sony America Chairman Howard Stringer. "We've got to redefine our relationship with our customers and recognize that it's a two-way dialogue. We can't sit back and close our eyes for five years the way the record business did before they began to deal with new technology."

The entertainment business prides itself on absorbing and exploiting virtually every youth culture trend. But when it comes to revamping its business model, Hollywood can be as resistant to change as Detroit automakers or the steel industry. When TV sets appeared in living rooms in the late 1940s, movie studios panicked, treating the new medium with the same disdain and distrust that executives today have for baby-faced Internet downloaders. How could we possibly survive, the old moguls moaned, trying to compete with something that is free?

Hollywood survived and flourished in the new medium. But today's corporate CEOs by and large have a similarly dyspeptic view of the future. Feeling the drumbeat of quarterly earnings reports, they are not paid to be bold
visionaries. They are rewarded by maximizing profits, not risking them pursuing new technology. It's especially
telling that the first genuine success with a legal downloading music service, Apple's iTunes, was devised by a
technology company with no stake in the old CD business model.

Entertainment companies, especially in profitable times, remain wedded to the past. Years after video became the
preferred method of filmmaking for everyone from George Lucas to parents, movies are still shown in theaters on
film projectors, a century-old technology.

It took the music business four years — from fall 1999, when Napster swept through college campuses, to this last
month, when Apple's iTunes Music Store became available for personal computers — to develop a legal file-sharing
service that had both a diverse selection of music and few onerous restrictions on use.

During that time, consumer technology has exploded with consumer-friendly inventions, from cellphone cameras
and plasma HDTVs to Blackberries, iPods and Nokia's new N-Gage, a cellphone, MP3 player and game system
combined in one device.

Music executives admit they were slow to react to the sudden appearance of Napster, but contend they hit a variety
of speed bumps, especially in getting artists and music publishers to give permission to sell their music on the
Internet. "There definitely was a cautiousness born out of a concern that we were dealing with things we didn't fully
understand," Horowitz says.

"We didn't have anyone who understood technology," says Universal Music Group Chairman Doug Morris. "We
had lawyers involved [in the creation of legal downloading services] who'd only read about technology in books.
Look at Steve Jobs — he changed the world. It required a technology company guy to bridge the gap, because
having run a company like Pixar, he understood both creativity issues and technology."

Despite having seen the consequences of the record industry's failure to act quickly and provide a compelling legal
downloading alternative, the movie business is in danger of repeating the same mistakes. Sony first tested the
technology for its Movielink online movie store in 2000. But according to Stringer, it took two years of laborious
negotiations to get four other studios to sign on as partners. Even today, Fox and DreamWorks don't license their
movies to the service. Movielink still only has 450 movies available to download; and once viewers begin watching,
their access to the movie expires in 24 hours.

"We believe those constraints are too restrictive," says Sony's Landau. "But this is a partnership, and some of our
partners believe in restricting our service."

Why are media companies so resistant to change, especially when compared to their technology brethren? One
obvious answer: Tech companies are entrepreneurial. They live and die by the success of new inventions.
Hollywood's main concern is content and, in recent years, it has pursued a deeply conservative content-creation
strategy, churning out movie franchises largely based on comic books, remakes and sequels.

When it comes to new technology, change can be an especially scary proposition because no one can safely predict
whether a new product will save or destroy a business. The Internet nearly wrecked the music industry. But home
video recorders, which the studios fought tooth and nail when they first appeared in the 1970s, turned out to be a
huge boon, creating a new profit stream for the movie business.

"The battle that the studios lost actually created the business mechanism that can help them deal with the Internet,"
says William Morris agent Marc Geiger, a cofounder of Artist Direct, an entertainment company that serves as a
one-stop commerce outlet for music fans. "They have seven or eight different ways for a consumer to watch a
movie, depending on their habits and the price they're willing to pay, from theaters and DVDs to HBO and pay-per-
view. And it's all because movies are essentially already distributed digitally. I go home at night, call up a movie
and store it in a hard drive — it's called TiVo — and I'm doing exactly what the music business is screaming about,
except I'm doing it legally and paying for it."

The studios have other advantages besides flexible ways to sell and price their product. The same consumers who feel gouged by record company CD prices have fewer complaints about the value of movies and DVDs.

"The music business was charging their best customers higher prices for CDs, even though it was something that cost less to manufacture [than the vinyl LP that preceded it]," says Warner's Meyer. "There was also no way for a customer to get what they wanted — one or two songs — without paying full price for it. We've gone the other direction, putting more value into our DVDs while charging less for them."

Both Valenti and Chernin cite research findings that in the U.S. alone, anywhere from 350,000 to 750,000 copies of movies are illegally downloaded every day. Those numbers sound jaw-dropping, but it raises the question that if all that downloading is going on, how is it possible that DVD sales are rocketing through the roof? Put simply: If consumers are buying movies after seeing them on the Web for free, is that piracy or free promotion?

"It's not our imagination," says Fox's Gianopulos. "To ignore the illegal downloading because DVDs are so popular is like saying your store is doing good in the front showroom, but people are backing up the truck in the back and looting the warehouse."

In the promotion-versus-piracy wars, it's the media giants trying to protect their blockbuster entertainment battling small media entrepreneurs eager to expose a promising band or low-budget art movie. While music conglomerates saw Internet downloading as a huge loss in revenue, independent record labels were happy to put their band's live tracks and outtakes on the Web, viewing it as great exposure.

In 2000, Offspring decided to give away its new album on its Web site, offering fans who left their e-mail addresses an opportunity to win a $1-million MTV giveaway. According to Guerinot, the band's manager, the group believed the Web site traffic would not only boost record sales but provide an invaluable e-mail database. But the group's record company, Sony Music, a Big Media company, saw the giveaway as an invitation to piracy. Sony threatened to sue, forcing the band to scale back and offer one song, not the entire record.

"Of course, by the next day, the entire album was available everywhere but offspring.com," Guerinot says. "It shows how different our goal — which was to build a long-term online business — was from their goal, which was to control their manufacturing and distribution machine and show a profit to Wall Street and their stockholders."

This piracy-versus-promotion divide was a key ingredient in the recent Oscar-screener showdown, which found studio art-house divisions arguing that academy members should have unlimited access to DVDs, while their parent companies fought against any widespread distribution.

And no wonder: The Oscars have almost zero box-office impact on a Big Media blockbuster such as "The Lord of the Rings," which is a prime piracy target. But the Oscars mean everything to art-house films such as "American Splendor" or "In America," which are largely ignored by pirates but depend on Oscar nominations to reach a broader audience.

Even within the same studio, there are often conflicting strategies.

Fox was a big proponent of the Oscar-screener ban, worried that DVDs of its big holiday release, "Master and Commander," would fall into the hands of pirates. But when Fox TV's new teen drama "The O.C." needed to make a splash with young viewers, the network sent out 15,000 DVDs of an early cut of the show's first episode to readers of Teen People and Teen Vogue. No one worried about piracy because the promotional value of seeing a new show outweighed the loss of control in how the program was passed around by fans.

Soon it will be the movie business' turn to cope with wrenching change.
"We're always thinking about how to deal with the pace of technological development," Gianopulos says. "One day there was Napster, the next day it was everywhere. You need to change your established ways of thinking, but you have to consider its impact on your established business."

In part because of piracy concerns, Warner Bros. last week released "The Matrix Revolutions" on the same day, even at the same hour, in every major global market.

Warner's chief, Meyer, predicts that "there is a day coming when, to properly protect movies from piracy, we'll leverage off the original theatrical marketing campaign and release movies any way the consumer wants it — on his computer, on his TV or at Wal-Mart — all at the same time."

Even in this era of sweeping technological change, one immutable law remains: The customer is always right. The record industry has been staggered because it was two steps behind its audience, which is bad enough when you're promoting a new song, even worse when you're trying to build a new business. The movie industry realizes that it can't afford to be slow off the mark.

As Chernin put it in a recent speech: "How do you create a new economic model faster than the old ones are being destroyed?"

If history is any judge, Hollywood will have to take some big risks to discover the answer.

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Recent Times coverage of piracy issues is available at http://www.latimes.com/piracy