

DATE April 16, 1981
TO _____
OFFICE _____
FROM _____
OFFICE _____



MEMO

SUBJECT: APPLE (N.Y.) AUDIT CLAIM FOR EXCESS PACKAGE DEDUCTION IN CANADA

The following material has been prepared at your direction.

The current Apple (N.Y.) audit claim covering the period 9/1/69 through 6/30/79 includes a claim of \$231,343.33 for what it calls "excess package deductions in Canada":

Canadian Excess Package Deductions	\$207,267.90
Escalation on Above	24,075.43
Total Claim	<u>\$231,343.33</u>

APPLE'S POSITION (Exhibit A)

The basis for the claim is Apple's position that the intention of the parties was that the Canadian package deduction be the same as for the U.S. package deduction.

CAPITOL'S POSITION

The basis for Apple's claim has no merit. It was the intention of both parties that the standard package deduction used in each country be the standard package deduction as used in that particular country. Not only does the Addendum make this clear, but Apple (and Allen Klein) were well aware of the standard procedure (i.e. from the previous 1967 Agreement, etc.). If the parties had intended otherwise, they would have so stated in the Agreement or in the Addendum thereto.

STATED BASIS FOR APPLE'S POSITION (Exhibit A) AND CAPITOL'S REPLY

Since the Addendum to the 9/1/69 Agreement specifically provides that royalties in Canada are computed on the retail price in Canada, less excise tax, less Canada's standard package deduction (Exhibit A), they try to refute this as the intention of the parties by the following reasoning:

1. The percent royalty applicable to Canada was left blank in the signed Agreement and therefore "does not provide for a specific royalty percentage rate."

CAPITOL'S REPLY

The percent royalty applicable to Canada was omitted due to pressure in getting the Agreement signed immediately. The Agreement form had been typed leaving room for only one percentage figure rather than the six figures (two each for LP, tape, and singles). This omission was covered by a side letter signed and dated simultaneously acknowledging certain omissions would be covered by an amendment. The six percentage figures had been agreed upon and were included in the Addendum.

SIGNED: _____

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2. Canada has used the same equivalent royalty percentage rates for sales in Canada as in the U.S.

CAPITOL'S REPLY

As intended by both parties and included in the Addendum.

3. Since the Canadian package deductions used by Canada were substantially higher than those in the U.S., the result was substantially lower royalties in Canada.

CAPITOL'S REPLY

Since retail royalties have always been based on the bare record portion of the total price (excluding tax and package deduction), the royalties in Canada were not lower in proportion to the royalty base (total price, less tax and package deduction).

4. Consequently, the use of the higher package deduction in Canada has the effect of reducing the equivalent royalty percentage rate and is therefore not in accordance with the Agreement and intent of the parties.

CAPITOL'S REPLY

Not true! The percentage royalty percentages for the U.S. and Canada remain identical. Had the parties intended that other than the standard stated computations be made, they would have so stated.

AN APPLE SECONDARY POSITION

The auditors mention in their discussion of this subject that while Capitol continued to use its 9/1/69 U.S. package deduction throughout the term of the Agreement, it did not continue to use its 9/1/69 Canadian package deduction in Canada if the package deduction was increased in Canada. This, of course, has no practical significance since Apple takes the position that the U.S. package deduction is to be used in Canada anyway. If, however, Apple's position is not correct, as Capitol insists, then the question could arise as to whether the parties intended that an oral agreement re keeping the package deduction at the 9/1/69 figures applied to Canada as well as to the U.S. I was advised by Mr. Chaum at the time that he had made the oral agreement with Allen Klein in a discussion of the U.S. only, and therefore it did not apply to Canada. I would suspect this freeze would have minimal dollar impact if applied to Canada.

USUAL QUESTION RE: REASONABLENESS OF PACKAGE DEDUCTION

SIGNED: Artists' auditors, and Tennebaum in particular, usually claim the

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packaging deduction is unreasonable and attempt to eliminate it partially or completely. In this particular case, Apple's auditors do not do so and seem willing to accept Capitol's U.S. package deduction at 9/1/69 as being in accord with the Agreement.

In the past, Capitol has made studies to determine that the packaging costs do not bear a higher mark-up than the record manufacturing costs. Until January 1980, these studies had included only the U.S. As far as Canada was concerned, the higher packaging deduction was justified on the basis of smaller packaging runs (about 1/10 the size of U.S. runs). These smaller manufacturing runs affect packaging (printed goods) more than pressing costs. In January 1980, I made a comparative cost mark-up study for both the U.S. and Canada. The summaries schedule is attached as Exhibit B. (No cover memo was written at the time.) You will note that the Canadian package deductions for LPs appear to be in line but that the deduction for tape might be questionable.

ROYALTY RATES (BUY-SELL PRICE SPREADS) IN CANADA.- GENERAL COMMENTS

In connection with the manufacture and sale of your records in Canada, Article IV, Section 1 of The Agreement indicates that:

"... Capitol shall have all of the same rights and obligations it has under Article II and as Distributor has under Article III except insofar as modified herein. Apple shall have all of the same rights and obligations under this Article IV as Apple has under Articles II and III. . ."

Article IV Section 4 of The Agreement further indicates that:

"...Anything in this Agreement to the contrary notwithstanding, Capitol's sole obligation with respect to payment in connection with distribution in the Licensed Territory shall be for Capitol to pay Apple an amount equal to ___% of 90% of the retail list price with respect to records manufactured from Beatle masters and sold, which payments shall be computed and paid in accordance with the provisions of Addendum "1" hereto..."

Addendum "1" states in Paragraph (A) that:

"...Royalties will be based on the list price per record for retail sales. All such prices shall be less excise and any other other applicable tax. . ."

and in Paragraph (C) that:

"...Royalties on records packaged in albums, jackets, boxes or other similar containers will be based upon the list price for replacement records computed in accordance with Capitol's licensee's standard accounting practices exclusive of excise and other applicable taxes. The list price of the album, jacket, box or other container in which such records are packaged will be excluded in said determination. . ."

You will note from the above that the percentage rate was left blank in Article IV Section 4 of The Agreement. It appears that it was the intention of the parties that Canadian royalties be calculated in a similar manner to United States royalties, with two possible exceptions. The retail list prices and excise taxes in Canada may have been different, and to that extent, the royalty calculation could vary.

In practice Capitol calculated royalties in Canada by determining royalty rates which were the equivalent of buy-sell price spreads and mechanical rate adjustments used in the United States. They used the same equivalent royalty percentage rates as were determined in the United States, and applied them to 90% of the bare record prices which were based upon Canadian retail list prices. However, Capitol varied the formula in Canada by employing packaging deductions that were substantially higher than those used to determine the same equivalent royalty percentage rates in the United States. Counsel has informed us that this variation is not in accordance with the terms of The Agreement. You have informed us that you have accepted the use of the royalty percentages for Canadian sales, providing the formula used to calculate the bare record prices was consistent with the formula used in the United States.

This appears to have been the intention of Capitol as it is borne out in the unexecuted January 27, 1970 amendment (Appendix 7). This amendment embodied Capitol's clarification of the understanding of the parties with regard to the blank royalty percentage rate in The Agreement. Paragraph 5 would have inserted into The Agreement a Schedule "C" (attached to the amendment), which included the equivalent royalty percentage rates which Capitol had calculated in connection with sales in the United States based upon both regular and escalated prices. These percentage rates were to be used in Canada (and in fact the rates before price escalation were used by Capitol).

When prices changed in Canada, Capitol followed substantially the same procedures in calculating Canadian royalty rates as they did in calculating buy-sell price spreads when prices changed in the United States, with two exceptions. The packaging deductions used in Canada were higher than those used to determine the equivalent royalty percentage rates in the United States. And, the packaging deductions used in Canada were varied from time to time, whereas they remained constant in all United States calculations. Using higher packaging deductions, and varying packaging deductions has the effect of changing the effective royalty rate. Counsel has informed us that this is not in accordance with the terms of The Agreement.

Since the intent of the provisions in The Agreement governing royalties in Canada is to determine royalty rates in Canada similarly to buy-sell price spreads in the United States, for purposes of this report we have sometimes referred to these rates as the Canadian buy-sell price spreads. Likewise mechanical rate adjustments have sometimes been referred to as Canadian mechanical rate differentials.

EXCESS PACKAGING DEDUCTIONS BASED UPON REGULAR ROYALTY RATE
(BUY-SELL PRICE SPREADS) IN CANADA

Exhibit A
3 of 5

Article IV, Section 4 of The Agreement indicates that for distribution in a licensed territory Capitol will:

"... pay Apple an amount equal to ___% of 90% of the retail list price with respect to records manufactured for Beate masters and sold, which payments shall be computed and paid in accordance with the provisions of Addendum "1" hereto."

Addendum 1, Paragraph (C) provides that:

"... royalties on records packaged in albums, jackets, boxes or other similar containers will be based upon the list price for replacement records computed in accordance with Capitol's licensee's standard accounting practices exclusive of excise and other applicable taxes. The list price of the album, jacket, or other container in which such records are packaged will be excluded in such determination..."

As discussed above, Article IV, Section 4 does not provide for a specific royalty percentage rate. CRC has used the same equivalent royalty percentage rates for sales in Canada, as Capitol Records, Inc. used to determine your buy-sell price spreads in the United States. CRC applies these percentages to the royalty base prices which represent 90% of the suggested retail list price less a deduction for packaging and sales tax. We have found that the packaging deductions used by CRC were substantially higher than those used by Capitol Records in calculating "bare record" prices in the United States for the same product, thereby resulting in substantially lower royalties to you in Canada.

In addition, in the United States, Capitol Record's calculations of your domestic buy-sell price spreads in accordance with Schedule "A", were based upon a packaging deduction which remained a fixed amount, regardless of changes in the retail list price. However, the Canadian packaging deduction increased when the retail list price increased, thereby further reducing your royalties.

CRC does not sell replacement records, nor to our knowledge does it publish a list price for such records. We have discussed the term "list price for replacement records" with counsel. The term "replacement record" goes back in the recording industry prior to the advent of the 33-1/3 RPM record when 78 RPM records were packaged six to an album. A good deal of breakage occurred in those days and record companies therefore sold

replacement records to complete a set when one or more of the six records contained in an album were broken. This theory would no longer hold true as 33-1/3 RPM record albums are only sold as a unit which are comprised of a record and a jacket. The components are not sold separately. Of course, the same would hold true of the various configurations of tapes which are sold by CRC.

We discussed the issue of excessive packaging deductions with counsel who have advised us that the use of higher packaging deductions in Canada has the effect of reducing the equivalent royalty percentage rate and is therefore not in accordance with The Agreement and the intent of the parties.

Accordingly, we have computed the excess packaging deduction taken by CRC for each prefix based on the allowable deductions taken by Capitol in the USA. Applying the equivalent royalty percentage rate to the excess deductions (as converted to Canadian dollars in Schedule 17A), we have calculated the difference in your unit royalty rate based on regular price spreads in Schedule 17A. Our computations of additional royalties due were made by computer and appear in Appendix 5 of our report. The total amount due Apple is \$104,560.82 as summarized in Schedule 17.

A claim for excess packaging in the amount of \$102,707.08 was made in Schedule 7 (see Appendix 11) of the previous examination report covering the examination of CRC from September 1, 1969 to December 31, 1974. The calculation was made based on an estimated percentage of underpayment of 4.17% applied to the total of royalties reported and royalties claimed. This margin of error is reasonably close to the margin of error in the period we examined. Accordingly, we have included the amount of \$102,707.08 in our Summary of Findings under the prior examination, bringing the total amount due to \$207,267.90.

EXCESS PACKAGING DEDUCTIONS AT ESCALATED ROYALTY RATES (BUY-SELL PRICE SPREADS) IN CANADA

The unit royalty rate differences resulting from the excess packaging deductions taken in Canada were calculated in Schedule 17A based upon your regular buy-sell price spreads. As discussed above, your buy-sell price spreads should have been escalated, effective September 1, 1972 in Canada as well as in The United States.

Accordingly, we have calculated the unit royalty rate differences (resulting from excess packaging deductions taken by CRC) based upon escalated rates in Schedule 18A. Our calculations of additional royalties due were made by computer and appear in Appendix 5 of this report. The total amount due Apple is \$24,075.43 as summarized in Schedule 18.

FREE GOODS ("NO-CHARGE" RECORDS) IN CANADA

Capitol Records Canada (CRC) follows the policy of shipping certain quantities of records on a "no-charge" basis, classifying them as so-called "free goods". It would appear from the records provided to us that they have followed this policy for many years and that "no-charge" records were consistently shipped in direct proportion to quantities "sold" by CRC.

The "no-charge" records shipped by CRC in connection with the sales of records are meant for resale to the consumer. Since "no-charge" records are consistently shipped in direct proportion to quantities "sold" by CRC, regardless of the size of the order and throughout the life of a record, it would appear that they have reduced their regular wholesale selling price and treated the reduction as "no-charge" records, possibly to avoid the payment of royalties. Thus, they would be overstating their regular wholesale selling price and treating the difference between the regular wholesale selling price and the overstatement as "no-charge" records. This is merely a billing technique and in effect their true wholesale prices per record are less than those which are stated on their invoices.

For example, if CRC ships 110 records, they bill for 100, at say, \$.55 and ship 10 at "no-charge" for a total invoice of \$55.00. Thus, they only pay royalties on 100 units. They could just as well have billed for 55 units at \$1.00 and shipped 55 at "no-charge" for the same total invoice of \$55.00, and only pay royalties on 55 units. The real economics of the transaction is that they have sold 110 records at \$.50 for a total invoice of \$55.00, and they should pay royalties on 110 units. Thus, there is no economic effect on Capitol or its customers; but only an adverse effect on you, if you are not paid for all of these records. CRC unilaterally determined the quantities billed at "no-charge". Their arbitrary billing technique should not be treated as a license for CRC to arbitrarily reduce

LIST PRICE COMPARISONS
U.S. & CANADA

Canada-List

U.S.-List

	U.S.-List		Canada-List	
	Disc or Tape	Package Total	Disc or Tape	Package Sub-Total
<u>Single Jacket - LP</u>				
Current List	\$7.35	\$7.98	\$7.68	\$8.65
List If Based on Cost Markup: Using 5% Artist Royalty	6.58	7.98	7.08	8.65
10%	6.90	7.98	7.46	8.65
15	7.10	7.98	7.69	8.65
AFM List (85%/15%)	6.78	7.98	7.35	8.65
				Tax
				\$.33
				\$8.98
<u>Flap Jacket - LP</u>				
Current List	\$7.15	\$7.98	\$7.43	\$8.65
List If Based on Cost Markup: Using 5% Artist Royalty	5.79	7.98	5.84	8.65
10%	6.22	7.98	6.38	8.65
15%	6.53	7.98	6.77	8.65
AFM List (85%/15%)	6.78	7.98	7.35	8.65
				Tax
				\$.33
				\$8.98
<u>Cartridge</u>				
Current List	\$6.00	\$7.98	\$6.18	\$8.65
List If Based on Cost Markup: Using 5% Artist Royalty	5.47	7.98	5.86	8.65
10%	6.02	7.98	6.50	8.65
15%	6.40	7.98	6.93	8.65
AFM List (75%/25%)	5.98	7.98	6.49	8.65
				Tax
				\$.33
				\$8.98
<u>Cassette</u>				
Current List	\$6.00	\$7.98	\$6.18	\$8.65
List If Based on Cost Markup: Using 5% Artist Royalty	5.52	7.98	5.38	8.65
10%	6.08	7.98	6.12	8.65
15%	6.46	7.98	6.62	8.65
AFM List (75%/25%)	5.98	7.98	6.49	8.65
				Tax
				\$.33
				\$8.98

Note: Re Canada: Canada prices were raised to \$8.98 on 7/1/79. Package shown as "current" is package in effect on 6/30/79.