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COMMENT ON THE IMPACT OF *ELLINGTON* V. *EMI MUSIC* ON DRAFTING AND INTERPRETING NEW YORK CONTRACTS

CORPORATION LAW COMMITTEE

In 2014, the Court of Appeals held in *Ellington* v. *EMI Music, Inc.*, 24 N.Y.3d 239 (2014) that, absent a clear intent to bind future affiliates, a contractual provision referring to "affiliates" pertains only to then-existing affiliates and does not include future affiliates. Two recent trial court opinions illustrate the differing outcomes courts may reach when applying this rule. Drafters of contracts governed by New York law should be aware of *Ellington*'s potential implications for the use of "affiliates" in contracts, and draft precisely so as to avoid unintended results.

I. *Ellington*

In *Ellington*, Duke Ellington's grandson sued EMI for, among other things, breach of contract. At issue was an agreement Duke Ellington signed with EMI's predecessor and certain related entities that provided for payment to Ellington (and his successors in interest) of "a sum equal to fifty (50%) percent of the net revenue actually received by [EMI and its affiliates] from . . . foreign publication" of the subject musical compositions. *Id.* at 242. This was known as a "net receipts" arrangement. In the decades that followed, the music licensing industry underwent significant structural changes. As the Court of Appeals explained, "At the time the Agreement was executed, foreign subpublishers were typically unaffiliated with domestic music publishers. Recently, however, many domestic publishers, including EMI, have affiliated with foreign subpublishers." *Id.* at 243. In particular, EMI became affiliated with certain preexisting foreign subpublishers, who retained 50% of the royalties generated from foreign sales; the remaining 50% was then split between EMI and Ellington's heirs as provided for in the contract. *Id.*

Ellington's grandson claimed that "the amount retained by the affiliated foreign subpublishers prior to remittal of the remainder to EMI is an amount received by EMI, and therefore, when using affiliated foreign subpublishers, EMI should remit to [Ellington's heirs] half of the entire amount generated from the foreign sale of the relevant musical compositions." *Id.* In a divided opinion, the Court of Appeals rejected the grandson's argument on the basis that there was no "explicit language demonstrating the parties' intent to bind future affiliates of the contracting parties." *Id.* at 248. It held that "absent explicit language demonstrating the parties' intent, the term affiliates only refers to those in existence when the contract was executed." *Id.* In reaching this conclusion, the majority noted that "the parties did not include any forward looking language," *id.*, and that "the use of present tense language in the Agreement also demonstrates that the parties intended that the Agreement would bind only affiliates in existence at the time of the Agreement." *Id.* at 247.

In reaching its decision, the Court recognized that the globalization of the music industry made the "net receipts" arrangement more favorable to music publishers than to artists. Regardless, the Court refused to consider EMI's subsequent affiliation with foreign subpublishers to be a distortion of the parties' intent, and instead concluded that the parties simply did not account for the possibility of such affiliation.

The concurring and dissenting opinions in *Ellington* addressed the possibility that the decision might be read as permitting parties to circumvent contractual obligations simply by creating a new affiliate. *See Ellington*, 24 N.Y.3d at 248 ("As a general proposition, it seems wrong to me that, when a contract is written to bind 'any . . . affiliate' of a party, its effect should be limited to affiliates in existence at the time of contracting. That invites parties to create new affiliates, and to have them do what the old affiliates are prohibited by the contract from doing.") (Smith, J., concurring); *id.* at 253 ("[T]here is something troubling about interpreting 'affiliate' in the context of this Agreement, as the majority does, to include only those affiliates in existence at the formation of the contract. This interpretation sets the stage for the type of abuse alleged here, namely corporate reconfigurations that avoid the understanding of the parties.") (Rivera, J., dissenting).

The possibility that *Ellington* might allow some parties to sidestep contractual obligations gained the attention of *Law360*, which noted the "warning" in Judge Smith's concurrence "that the ruling on 'affiliates' could lead to foul play by music publishers." Bill Donahue, "Top NY Court Backs EMI in Duke Ellington Royalty Suit," *Law360*, Oct. 23, 2014. It also prompted a number of law firms to publish client notices on the decision's potential implications. Jeffrey Osterman, of Weil, Gotshal & Manges LLP observed that a default interpretation of "affiliates" to exclude future entities would necessitate a change in customary drafting practice: "The holding may surprise practitioners because many agreements do not define 'affiliates' with forward looking language to expressly capture future affiliates and the potential for gamesmanship, given such a default interpretation seems dangerous." Jeffrey D. Osterman, "Contract Drafting and Interpretation of 'Affiliate,'" Feb. 11, 2015. Osterman also noted the potentially broad scope of agreements affected by the decision: "The case impacts all contracts that use the term 'affiliate,' including provisions related to releases, license grants, non-competes, and assignment/change of control." *Id.* As Anthony Lupo and Kelli Scheid of Arent Fox LLP explained, there is now risk that general reference to affiliates "may not capture the entire universe of entities that the parties intend to bind." Anthony V. Lupo & Kelli A. Scheid, Arent Fox LLP, "When the music stops: NY Court of Appeals limits meaning of 'affiliate,'" Mar. 24, 2015.

II. Recent Cases Applying *Ellington*

Two recent trial court opinions applying *Ellington* illustrate the issues posed by the Court of Appeals' decision. The courts reached divergent conclusions as to whether affiliates created after the date of the parties' contracts were covered by the contracts' terms. These cases underscore the need for specificity when using the term "affiliates" in contracts governed by New York law.

First, in *Korff* v. *Corbett*, Justice Eileen Bransten of the Supreme Court Commercial Division in Manhattan found that revenue received by an entity that was not an affiliate at the time of execution of the agreement was not within the scope of amounts due to plaintiff from defendants and their "affiliates." 2016 WL 3357260, No. 601425/2003, at *1-2 (Sup. Ct. N.Y. Cnty. June 15, 2016).

Defendants Richard Corbett and certain related companies (collectively, "Corbett") hired plaintiff Joseph Korff to serve as their attorney in developing a vacant lot adjacent to Tampa International Airport. *Id.*, at *1. In July 1990, they entered into a letter agreement setting forth Korff's compensation (the "Letter Agreement"). The Letter Agreement provided in relevant part that Corbett would "pay upon receipt by International Plaza, its partners *or affiliates*, 5% of gross receipts (excluding gross receipts from the current golf course operation) until $26,250,000 is paid when the percentage will be 10%." *Id.* (emphasis added). Corbett signed the agreement "on behalf of himself and all entities in which he has an interest," and separately signed on behalf of International Plaza. *Id.*

Thereafter, in December 1993, Corbett created CSAT, L.P. ("CSAT") to hold certain partnership interests. Corbett claimed that, because CSAT was not in existence at the time of the signing of the Letter Agreement, its revenues were not within the scope of the gross receipts of affiliates that Corbett pledged to remit to Korff. *Id.* at *12; *see* Aff. of David J. Eiseman in Support of Defs.' Mot. for Summ. J. ("Eiseman Aff.") ¶¶ 10, 56. . As CSAT was the recipient of a significant amount of the gross receipts from the project, this interpretation would have the effect of substantially reducing the funds subject to the plaintiff's claim.

The Supreme Court agreed with the defendants, holding that CSAT's gross profits did not fall within the scope of the agreement because "CSAT was not, at the time the Agreement was executed, an International Plaza partner or affiliate." *Korff*, 2016 WL 3357260, at *12. Therefore, its profits were not within Corbett's pledge to pay 5% of International Plaza, its partners or affiliates' gross receipts. *Id.*

More recently, Justice Charles Ramos, also of the Commercial Division in Manhattan, held in *Ciment* v. *Spantran, Inc.* that *Ellington* did <u>not</u> apply so as to exclude unnamed future entities from the parties' contract. 2017 WL 87177, No. 655680/2016, at *3 (Sup. Ct. N.Y. Cnty. Jan. 6, 2017). In that case, the Shareholders Agreement between Morningside Translations, Inc.'s ("Translations") founders provided that it would "apply to [Translations] and all business entities owned by [Translations]." *Id.* at *1. While no other entities had been acquired at the time, "the parties contemplated that Translations would grow significantly throughout the years." *Id.*

Ten years later, one of the company's divisions (Evaluations) spun off into its own independent entity. *Id* at *2. The plaintiff alleged that the Shareholders Agreement applied to Evaluations so as to give him minority rights in that entity, including a seat on the board. The defendants responded, citing *Ellington*, that the Shareholders Agreement did not apply to future entities because it lacked specific language to that effect. *Id.* at *3.

The court found *Ellington* to be "inapposite" because it was "undisputed that Translations did not own any entities when the Shareholders Agreement was executed but both Plaintiff and [his co-founder] had contemplated for future growth. Instead, the phrase 'all other entities owned' was included in Section I of the Shareholders Agreement to demonstrate an intent by the parties to include future entities." *Id.* at *3.

III. Caution to Drafters

To a contracting party, there are few things more troubling than a failure to bind the correct parties, whether by virtue of over- or under-inclusiveness. Thus, in light of *Ellington*, drafters of contracts to be governed by New York law must be mindful of the possibility that courts will interpret the absence of specific language covering future affiliates as evidence that such affiliates are not bound by the contract's provisions. Practitioners should pay close attention to use of the term "affiliates" in contracts to be sure that entities intended to be included or excluded in the future are identified with precision.

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