

By Mark Litwak

## Minimizing the Risk for Motion Picture Investors

**Indie films are rarely smash hits, but due diligence can protect starry-eyed investors**

**M**otion picture investments have a notoriously bad reputation. Not only is the film business inherently risky—because no one can predict what will appeal to audiences—but the industry also has attracted more than its fair share of unsavory characters who prey on unsophisticated investors drawn by the glamour of show biz.

Notwithstanding the many horror stories of movie investors being fleeced, an increasing number of motion pictures are being produced with private equity financing. In many instances there is just no alternative. Bank financing based on presale contracts has become difficult to arrange. Why should buyers take a chance on buying a project before it is produced when there are so many completed films available for sale? While insurance-backed schemes flourished for a short time, this source has largely dried up in the wake of French insurance giant AXA's lawsuit against Chase Manhattan Bank<sup>1</sup>

and the generally disappointing performance of many movies backed with insurance guarantees. For most fledgling filmmakers, the only way to finance a film is to raise funds from family, friends, and acquaintances. Only first-timers with the stature of Robert Redford or Barbra Streisand will find an open door at the studios.

Meanwhile the publicized success of a few "indie" films (defined as films not financed either directly or indirectly by a distributor or one of its subsidiaries<sup>2</sup>) and a booming economy have encouraged investors to take a chance on this risky business. *The Blair Witch Project* was produced for a paltry \$40,000, yet it grossed \$142 million at the domestic box office. Moreover, a hit film can generate significant additional revenue from television, home video, merchandising, music publishing,

soundtrack albums, sequels, and remakes. While a success like *The Blair Witch Project* is extremely rare, such hits continue to motivate aspiring filmmakers and encourage investors to dream of riches.

The latest digital technology has made movie making more accessible than ever. Until recently a fledgling filmmaker needed to raise \$100,000 or more to pay for cameras, film stock, and processing. Now features can be shot with inexpensive digital cameras and edited on desktop computers. As a result, we are

likely to see a significant rise in the number of indie films and a corresponding increase in the number of movie investors.

In deciding whether to fund an indie picture, most investors pay scant attention to the economic realities of the film business. Approximately 95 percent of the domestic box office is garnered by the major studios, with the remainder split among independent and foreign films. Of the estimated 1,000 U.S. indie films made each year, about two-thirds will never be distributed. Only a few dozen indie films receive

more than a token U.S. theatrical release. Approximately one-third of each year's crop will be released on home video or television or licensed in foreign territories. But many of these films will never generate enough revenues for their backers to recoup their investment. A first-time filmmaker has a particularly difficult time attracting name actors and securing distribution.

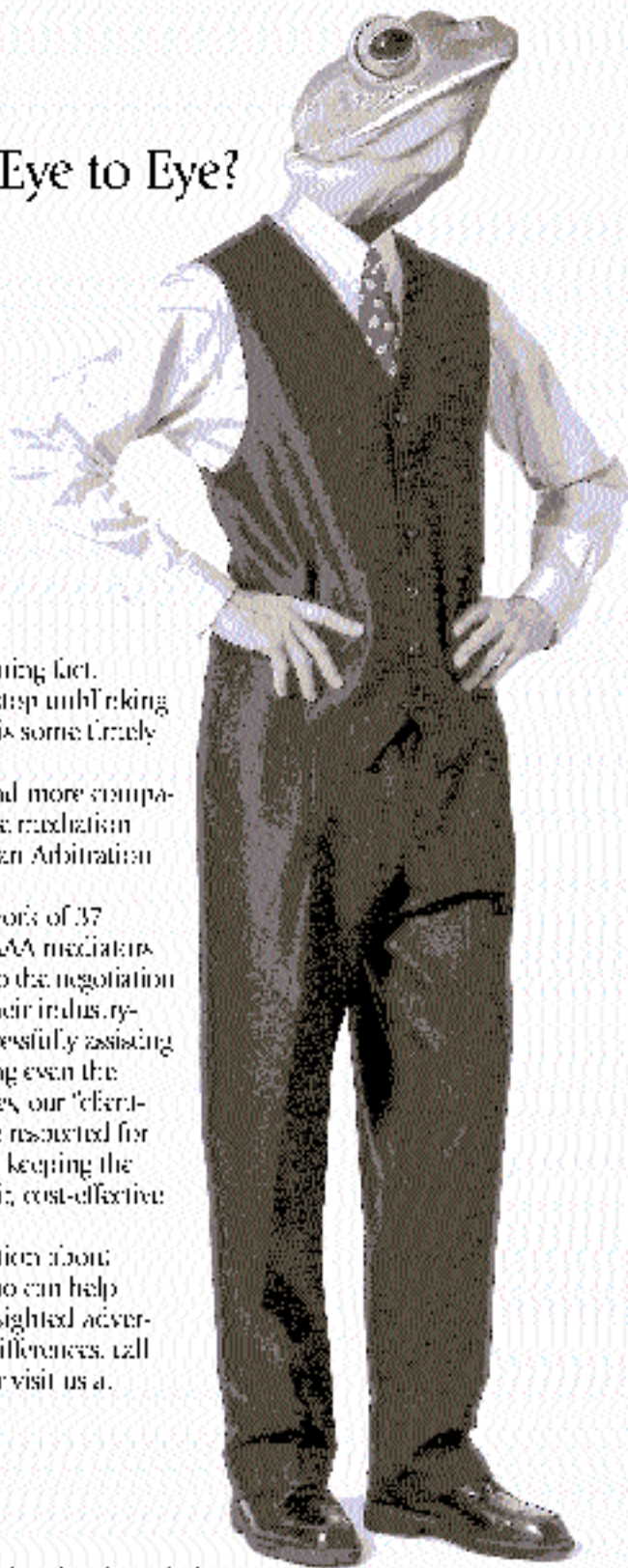
Attorneys and financial advisers often try to discourage their clients from making movie investments. They rarely succeed. For many people, an investment in a

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film is much more exciting than buying stocks or real estate. For those clients who insist on investing in movies, attorneys can take steps to minimize the risk.

✓ **Practice due diligence.** The most important task to undertake before investing in a film is a thorough investigation of all the participants involved in the deal. Just as an experienced investor conducts research about a corporation before purchasing a share of its stock, the client or attorney should check into the reputation and track record of any filmmaker or distributor with whom the client contemplates doing business.<sup>3</sup> Background checks may involve such actions as speaking to filmmakers and investors who have done business with a participant, reviewing a participant's previous work, and even obtaining court records to see if the participant or the participant's company has been sued. Research will greatly increase the odds of choosing a business partner who has integrity and brings to the table the skills, expertise, and resources needed to succeed in any endeavor.

One of the easiest ways to determine the professionalism of a potential partner is by looking at his or her track record. The importance of the track record of a film producer or distributor cannot be overstated. A prudent film investor should never back a filmmaker or production team that does not possess the proven skill needed to make a movie that looks professional. While the rewards of investing in a first-time filmmaker are potentially high, the risk involved in such a venture is great. It is much safer to back filmmakers who have completed at least one feature film or who possess impressive credits in music videos, short films, or documentaries. Filmmaking involves such a tremendous learning curve<sup>4</sup> that a filmmaker with substantial credits will be measurably more professional and prepared for the exigencies of production.

✓ **Obtain full disclosure.** Federal and state securities laws are designed to protect investors. Offerings to the public generally require prior registration with the Securities and Exchange Commission and/or a state agency. So-called private placements are limited to persons with whom the offeror has a preexisting relationship. Even if registration is not required, the antifraud provisions of the securities laws require that the offeror make full disclosure of all facts that a reasonably prudent investor would consider important in deciding whether to invest. The information disclosed should include a detailed recitation of all the risks involved in developing, producing, and marketing a movie. Attorneys should advise their investor clients to avoid offerings that provide anything less than full

and truthful disclosure. Attorneys should also carefully review any Private Placement Memorandum (PPM) that may be involved in the prospective deal and make sure their clients are aware of its contents.

✓ **Identify the film's potential market.** As a moneymaking investment, a film is only as good as its potential market. As self-evident as this statement may seem, investors may be tempted to allow personal feelings about a project's message or a director's vision to influence their financial decision to invest. An attorney must strive to remind the client that a film investment must be viewed as a business venture like any other. Toward that end, the attorney should review all the factors affecting the marketability of a film.

Certain types of film are inherently more marketable than others. There is a very limited market for short films, documentaries, black-and-white films, and foreign language films. The choice of film stock (or videotape) also plays an important part in the marketability of a film. Distributors and exhibitors, including the top festivals, traditionally have looked unfavorably upon motion pictures that were not shot with 35-millimeter film. The acceptance of movies produced digitally is a growing trend, however. For example, the Sundance Film Festival recently began exhibiting movies on the latest digital projectors, which have a resolution comparable to 35-millimeter film projectors.

The subject matter of a film also has an impact on its marketability. Certain themes, topics, and genres can be difficult, if not impossible, to sell. Movies with a religious theme, for example, can easily offend audiences and scare away distributors. The 1999 film *Dogma*, a comedy with an explicitly Catholic focus, perfectly illustrates how a seemingly bankable hit (young, hot director and stars plus big Hollywood money) can have serious problems finding a distributor simply because of its religious theme. Further examples of hard-to-sell films include cerebral comedies that can be difficult to export because their humor may not translate well, films with a great deal of violence that may be shunned by European television (which is a prime market for independents), and films with explicit sex that may not survive the censorship boards in certain countries.

Absent winning a major film festival, films without name actors are difficult to sell. Of course, name recognition varies around the world. The star of an American television series may be a big name in the United States but unknown abroad. On the other hand, some U.S. actors have large followings abroad (such as David Hasselhoff, the star of the U.S. television series *Baywatch*, who is extremely popular in Germany) but are less

of a draw in the United States. There are several publications that can be consulted to determine the commercial appeal of actors.<sup>5</sup>

The sensibilities of the director often determine the marketability of the final product. A filmmaker who shows no concern about entertaining an audience may leave an investor with an expensive home movie. This is not to say that the only films one should invest in are lowbrow commercial fare like *Dumb and Dumber*. A well-made art film like *Elizabeth* can win awards and make a handsome return on investment. Filmmakers with no clear idea of their intended audience are another problem for investors. If a filmmaker is envisioning a *Lassie*-type family film spiced with four-letter words, the filmmaker probably does not realize that his or her film cannot be sold as a family film because of the vulgar language, yet the story will probably not appeal to teenagers and adults either.

✓ **Ensure a congruence of interests.** Basic business tenets provide that it is best to invest in an endeavor in which all participants share the risks and rewards. An attorney should be wary of clients investing in a project in which other parties will benefit while their clients take a loss. For example, a filmmaker who receives a large fee from a production may wind up prospering financially from a film that returns nothing to the investors. To avoid this result, an investor should look for a filmmaker who is willing to work for a modest wage and share in the success of a project through a deferment or profit participation. Not only does this type of arrangement equalize the risk and reward, it helps focus the filmmaker on the ultimate goal of producing a profitable movie.

A beginning filmmaker might receive a minimal salary during the time it takes to produce a film. The filmmaker might also receive a deferred payment, which is an additional amount usually payable after the investors recoup their capital investment. In addition, most filmmakers receive a significant share (from 5 percent to 50 percent) of the "back end," or profits, derived from the motion picture, if there are any. In a similar vein, an investor can take comfort investing in a motion picture on the same terms as a distributor when both parties recoup at the same time.

✓ **Understand the parameters of a fair deal.** Investors usually are entitled to recoup all of their investment from first gross revenues before payment of deferments or profits. Frequently investors are allowed to recoup 110 percent to 125 percent or more of their investment in order to compensate them for loss of interest and inflation. A film's profit is declared after the payment of all debts, investor recoupment, and payment of defer-

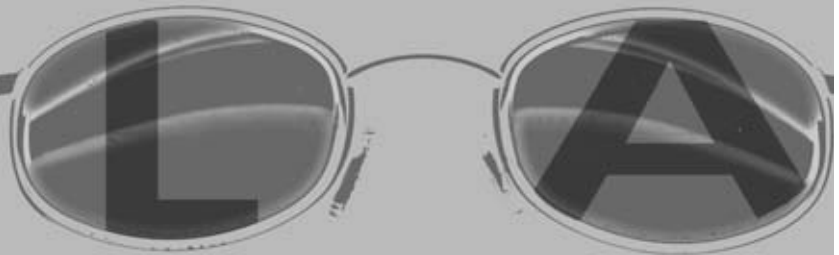
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ments. Once those payments are made, the profit is generally split 50/50 between the producer and the investors. Thus investors who provide 100 percent of the financing are usually entitled to 50 percent of the profits. The 50 percent share of profits due the producer may be reduced by whatever profits are granted to third-party profit participants such as the film's writer, director, and stars.

✓ **Obtain all promises in writing.** Any first-year law student can explain the importance of reducing all promises and agreements to writing. In the fast-paced business of filmmaking, the written agreement is not just important—it is essential.<sup>6</sup> A film investor should never accept oral assurances from a producer or distributor.<sup>7</sup> If a producer or distributor promises to spend \$50,000 on advertising, make sure the promise is in writing; if there is not enough time to draft a long-form contract, demand a letter reiterating the promise. Retain copies of all correspondence, contracts, and any promotional literature. If a filmmaker makes fraudulent statements in order to induce your client to invest, you will have a much stronger case if the statements are in writing.

Requiring all agreements to be in writing not only protects the interests of investors but can also reveal the poor business practices of potential partners. Filmmakers who make handshake deals may handle other business dealings in a sloppy manner, such as neglecting to obtain the necessary contracts needed to fully secure ownership of a motion picture. In order to have a complete chain of title to a film, a filmmaker needs to secure written contracts with many parties, including actors, writers and composers. Filmmakers must obtain:

- Depiction releases from all actors who are identifiable in the film. (This release may be part of an actor's employment agreement.)
- Written employment agreements with everyone who makes a creative contribution to the film (such as the writer, the cinematographer, and the composer). These agreements must be fully executed before the parties begin working. Also, the agreements must state that the party's services are being provided on a work-for-hire basis and the copyright to the party's work product vests in the production company or producer.
- License agreements to incorporate any copyrighted work, such as music, still photos, and stock footage, in the movie.

Filmmakers who fail to pay attention to such legal niceties lack the professionalism needed to succeed.

✓ **Secure an arbitration clause.** An investor should consider making all contractual disputes subject to binding arbitration rather than litigation, with the prevailing party enti-

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tled to the reimbursement of legal fees and costs. An arbitration clause may provide that the arbitration award is final, binding, and not appealable. Without these requirements, an investor could avoid trial costs but still incur large legal bills on appeal. The parties should also specify the venue for any arbitration as well as the number of arbitrators and their qualifications.<sup>8</sup>

Investors may also want their filmmakers to demand an arbitration clause when contracting with distributors. Although the investor is not a direct party to those contracts, filmmaker disputes with a distributor can affect the investor's bottom line. The filmmaker is invariably the financially weaker party in an agreement with a distributor and may not be able to afford to retain an attorney and pay court costs in order to bring suit. If the filmmaker does not have a viable means of protecting his or her interests, the filmmaker and the investors may be forced to watch from the sidelines as a distributor ignores the terms of a distribution agreement and runs off with all the revenue from the film.

Most entertainment industry arbitrations are conducted under the auspices of either the American Arbitration Association or AFMA (formerly known as the American Film

Marketing Association but now simply known as AFMA), a trade organization representing the interests of international distributors. The AAA has a well-defined system of procedural rules and maintains numerous offices across the United States and in many foreign countries. AFMA is the entity that organizes the American Film Market (AFM), which is held each February in Los Angeles. AFMA arbitrations usually occur in Los Angeles, but they can also be held during an international film market or in a foreign city. All AFMA arbitrators are experienced entertainment attorneys.

Under AFMA rules, if a filmmaker wins an arbitration award against a distributor and the distributor refuses to comply with the award's terms, the filmmaker can have that distributor barred from participation in future AFMs. Since the AFM is one of three major international film markets, the inability to participate may damage the business prospects of a company. This remedy is particularly useful if the distributor's assets are located outside the United States and thus difficult to reach under the authority of U.S. law. The threat of being barred from the AFM may convince a distributor to obey an arbitration award.

Some disreputable individuals, however,

have sought to avoid awards against them by abandoning their distribution company, which is often a shell, and then incorporating a new company. Conducting their business under a new name, they exploit another wave of filmmakers, fully expecting to abandon their new company when the law catches up with them. To preclude such behavior, AFMA has created a personal binder enforceable against executives. If an executive signs this binder, and the executive's company fails to comply with an arbitration award, the executive can be personally barred from participating in future AFMs.

✓ **Provide for interest on late payments.**

In addition to nailing down remedial measures for contract disputes, an investor should remove any incentive for a producer or distributor to hold onto the investor's money. In some states, courts make no award of prejudgment interest to a prevailing party unless there is a provision in the contract for it. If an investor becomes embroiled in a dispute with a distributor who is unlawfully holding onto \$100,000, and the investor wins the case after four years of litigation, the court may award only \$100,000 if the contract does not provide for prejudgment interest. Therefore, attorneys should insist that a provision for prejudgment interest be written into their



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✓ **Secure a completion bond.** A completion bond guarantees that if a film goes over budget, the investor will not confront the dilemma of either putting up more money or owning an incomplete film. A completion guarantor—an insurance company that insures the production against budget overruns—will issue a bond only after thorough investigation. Companies such as the Motion Picture Bond Company and Worldwide Film Completion have special production expertise. Their investigation includes closely reviewing the production personnel, script, and budget in order to assess whether they think the production team can film the script within the shooting schedule and budget proposed. The completion bond company usually is quite diligent in its review because if the film goes over budget, the bond company is financially responsible. Having a completion bond provides both financial and psychological peace of mind to an investor.

✓ **Take an active role.** As a shareholder in a corporation, or a limited partner in a partnership, an investor has very limited control over the management of the enterprise. In the past, investors who wanted limited liability had to be willing to pay the price of accepting limited control. With the creation of the limited

liability company, however, an investor can be one of the managers of the enterprise while still maintaining limited liability. With an LLC, an investor can have a vote on critical decisions such as script, cast, and budget approval as well as the acceptance of distribution agreements. By being actively involved in the production, an investor will be better able to monitor the performance of the filmmaker and discover problems while there is still time to remedy them. An LLC allows investors with more financial savvy than the filmmaker the opportunity to oversee important business decisions.

✓ **Make sure funds are spent on production.** During fund-raising for a movie, filmmakers commonly set up an escrow account to hold investor funds. The money stays in the escrow account until the filmmaker raises the minimum amount necessary to produce the film. If the filmmaker cannot raise enough money, the funds in escrow are returned to the investors. By depositing money in an escrow account, investors are protected because they know none of their capital will be spent unless and until all the money needed to produce the film has been raised.

A budget and cash flow schedule should be approved before funds are disbursed.

When funds are available for production of the film, there should be a system of checks and balances in place to ensure that all monies are properly spent and accounted for. Production funds should be placed in a separate segregated account and not commingled with the filmmaker's personal funds. All checks against funds from the account should be signed by two individuals. An investor may want one of the signatories to be a trusted person selected to represent the investor.

✓ **Make sure the filmmaker retains control of all master materials.** Original film negatives, video masters, sound masters, artwork, still photos, and slides should not be delivered directly to a distributor. Instead, the filmmaker should store the masters at a secure film laboratory designated by the filmmaker, and the distributor should be given a lab access letter that enables the distributor to order copies of the film so that the distributor can fulfill orders. Master materials should be kept in the filmmaker's control at a laboratory for a number of reasons:

- Masters that are lost or damaged may be irreplaceable. Even if they are replaceable, the filmmaker will incur a substantial expense to do so.
- In the event of a dispute, the filmmaker may be in the best position to seek a remedy.

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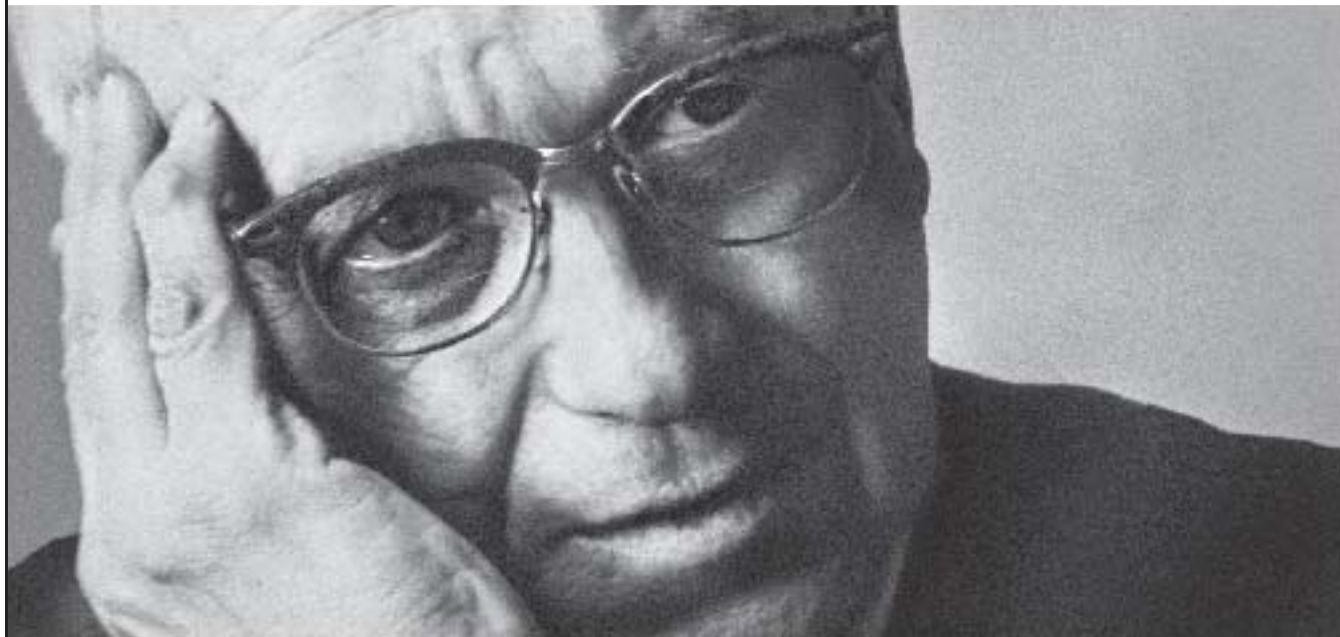
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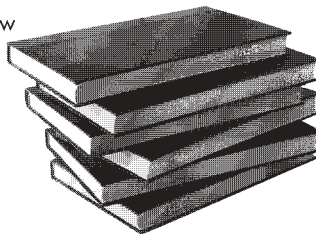
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If the distributor has defaulted, for instance, the filmmaker may have a right to terminate the agreement and seek a new distributor. The filmmaker will need access to his or her materials, however, in order to deliver the film to a new distributor.

- If the initial distributor goes bankrupt, extricating the masters from the distributor may only be possible through costly and lengthy proceedings in bankruptcy court.

- The filmmaker may need to give several distributors access to the masters. Typically, independent filmmakers enter into multiple distribution deals. One deal is often with an international distributor (also known as a foreign sales agent) for licenses abroad, while one or more deals may also be made with domestic companies for distribution in the United States and Canada. The best solution when dealing with multiple distributors is to place the masters in a professional laboratory. Each distributor is then granted a lab access letter enabling it to order copies.

- Cheating can be discouraged by having the laboratory report to the filmmaker how many copies have been duplicated. Suppose that at the end of one year, the laboratory reports that 10 film prints have been made, but the reports from the producer reveal only eight sales. This is a red flag alerting the filmmaker that sales may have been made that were not reported. Most filmmakers would not know if their film had been licensed in, for example, Malaysia.<sup>9</sup> Distributors do not order copies of films without a sales contract in hand. Typically, they receive full payment for the sale before they manufacture a duplicate and ship it.

In selecting a laboratory to deposit film-making materials, the filmmaker should choose one that charges competitive rates and has experience duplicating films for international distribution. Buyers in certain countries, such as Germany, are notoriously finicky and often reject films on the grounds of poor technical quality. It is also a good idea to select a laboratory that is not the laboratory ordinarily used by the distributor. A laboratory in the habit of fulfilling orders for a distributor who is a regular customer may not bother checking to see if that distributor has the authority to order copies. Moreover, the laboratory might inadvertently release the master to the distributor. Similarly, the filmmaker should always deliver the master directly to the laboratory—and only after the laboratory and the distributor have signed a lab access letter. If the filmmaker delivers materials to the distributor, and the distributor places them with a laboratory, the laboratory may treat the distributor as the owner of the film. Also, materials should be deposited in the laboratory under the filmmak-

er's name, not the distributor's name, so it is always clear who is the owner.

The lab access letter should include language permitting the filmmaker to receive copies of all invoices or periodic reports disclosing the nature and amount of duplication performed by the laboratory. Some filmmakers insist that the laboratory ship all copies directly to the territory buyers. The distributor will probably insist that the lab access letter be irrevocable for the term of the distribution deal. The distributor will want to retain access to the materials in order to fulfill any orders arising from its licenses.

✓ **Make sure the filmmaker obtains and registers a security interest.** Generally, a security interest gives the secured party rights in designated collateral. In the movie and television industry, film lenders may want to secure their financial interests by obtaining a security interest in the film negative and master materials. Likewise, investors may want their filmmakers to protect themselves by having distributors grant a security interest—with the proceeds derived from exploitation of the film as the collateral. By obtaining a security interest, the filmmaker will have rights superior to those held by unsecured creditors. This can be a tremendous benefit if the distributor goes bankrupt. If that hap-

pens, the proceeds derived from the sale of the filmmaker's movie will be paid to the filmmaker first.

It is important not only to have a written security agreement but to record it properly. The provision for a security interest agreement should be included in the distribution agreement. Separate long form and short form security agreements should be signed by the parties, as well as a UCC-1 form, which is recorded with the secretary of state in the state where the collateral or distributor is located. The security interest should also be recorded with the U.S. Copyright Office in Washington, D.C.

✓ **Do not invest more than you can afford to lose.** Finally, notwithstanding the various strategies that investors can use to protect themselves, investing in a film remains a high-risk undertaking. While visions of Oscars and box office bonanzas may dance in their heads, potential investors should ask themselves whether the complete loss of their prospective investment would appreciably affect their standard of living. ■

<sup>1</sup> AXA Reassurance S.A. v. Chase Manhattan Bank, No. 121290 (N.Y. Sup. Ct. 1999). AXA agreed to underwrite two films but later sought to extricate itself from its obligations.

<sup>2</sup> Under this definition, films financed by Miramax, a

subsidiary of Disney, are not indie films.

<sup>3</sup> See the Filmmaker's Clearinghouse at <http://www.marklitwak.com/results.htm>—sponsored by Mark Litwak, the Film Arts Foundation, the Association of Independent Video and Filmmakers, and MOVIE MAKER MAGAZINE—for information on film distributors.

<sup>4</sup> Recently a novice filmmaker completed production only to discover that his movie was shot with a defective lens. Fixing the problem will require tens of thousands of dollars in additional expenditures.

<sup>5</sup> THE ULMER GUIDE surveys financiers, sales agents, and other industry insiders. The *Star Power* guide published in the HOLLYWOOD REPORTER is another valuable resource. THE ULMER GUIDE can be reached at [julmer@primenet.com](mailto:julmer@primenet.com) and the HOLLYWOOD REPORTER at (213) 525-2087.

<sup>6</sup> See Edward A. Klein, *Doing Lunch*, LOS ANGELES LAWYER, Apr. 1998, at 37.

<sup>7</sup> See Harrison J. Dossick, *Resolving Disputes over Oral and Unsigned Film Agreements*, LOS ANGELES LAWYER, Apr. 1999, at 18.

<sup>8</sup> It is common for parties to have disputes resolved by a single arbitrator who is an entertainment attorney.

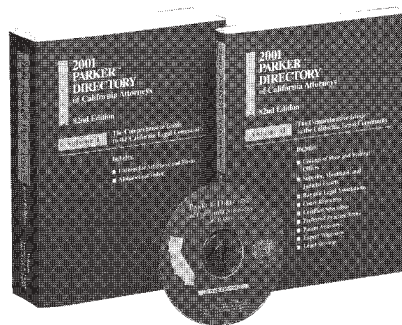
<sup>9</sup> One way to monitor which countries have licensed a film is to place the music on the soundtrack with a music publisher—perhaps a publishing company that the producer establishes—and make sure the publisher has entered into an agreement with ASCAP, BMI, or one of the other music collection agencies. These agencies collect public performance royalties when the film is exhibited on television in the United States and in theaters and television abroad. If the music is registered with one of these agencies, and royalties from, say, Thailand are remitted, the investor is alerted to the fact that the film is being exhibited in Thailand.

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