ORGANIZING YOUR COMPANY

Filmmakers frequently establish a company to produce and own their movie. While there is no legal requirement to do so, there may be some benefit to operating under the auspices of a company rather than making your film as an individual or as a partner. The most common business entities used by filmmakers are corporations (S or C type), limited liability companies (LLC), and limited partnerships (LP).

One reason to form a company is the desire to protect personal assets from potential liability. If a movie is produced by a company that is a separate legal entity from the filmmaker, then the filmmaker may not be liable for the debts and obligations of the company. However, for the filmmaker to avoid personal liability, he must sign all contracts in the name of the company and not give any personal guarantees.

Filmmakers and investors may be willing to accept the complete loss of their film investment, but will hesitate to risk losing their homes and other assets. By establishing a separate business entity, investors can own the company that produces and owns the film, without being personally liable for the actions of the company. With a corporation, investors become shareholders; with an LLC they become "non-managing" members; and with a limited partnership they become limited partners.

Conducting business through a company does not insulate an individual against all liability. If you are negligent and harm another, both you and your company may be liable. In other words, while establishing a company may protect you from liability for your company's breach of its contracts, it does not preclude other people from suing you for your own negligence. So, for example, if you carelessly run over someone with your car, you are liable even though no contract exists between you and the victim. It is irrelevant whether you even know the victim. Similarly, if you are negligent on a movie set and cause injuries to others, you may be liable even if you are operating under the auspices of a company.

Before forming a company, you should consider other ways to minimize liability. You could take extra care in conducting your affairs, and you could purchase insurance. Keep in perspective that every day as you engage in routine tasks, you are exposing yourself to liability if you act carelessly and injure others. The risk increases when you hire a cast and crew, because as their employer you can be held liable for their negligence.

Another reason to establish a company is to reduce taxes. Corporations may be able to deduct certain expenses that would not be deductible, or only be partially deductible, by a sole proprietor. Some fringe benefits (*e.g.*, medical insurance, pension plans) that a company provides employees may be tax deductible for the company rather than income to the employee. Therefore, by setting up a company, paying yourself a salary, and giving yourself generous fringe benefits, you may gain certain tax advantages. On the other hand, the tax benefits may not outweigh the cost of forming the company, which includes legal fees, filing fees, and the annual cost of preparing and filing a company tax return. Moreover, some states assess a minimum annual tax on companies even if they do not earn any income.

As you consider whether to set up a company you should evaluate the relative advantages and disadvantages of different business vehicles

Sole Proprietorship

A sole proprietor is nothing more than an individual engaged in a business. The business can operate under the individual's name or a fictitious name. For example, Bob Jones could conduct his business under the name Serendipity Productions. In this case, Bob Jones is *doing business as* (ADBA") Serendipity Productions. While Bob may operate under the banner "Serendipity Productions," in the eyes of the law Bob and Serendipity are one and the same.

If you choose to operate under an assumed name, you are required to file a Fictitious Business Statement with the local or state government. You should first check to make sure that no individuals or companies are using the same or a similar name. An assumed name is any name other than your full legal name.

Fictitious Business Names (DBA)

In California you file a Fictitious Business Name Statement with the County Clerk's office. First conduct a search to ensure the name you want to use is not already being used by another person or entity in your county. This search can be done by computer in the County Clerk's Office or over the Internet. Visit the County of Los Angeles, Registrar-Recorder/County Clerk web site for an application and to conduct an Internet search for name conflicts (http://regrec.co.la.ca.us/fbn/).

In New York, there is a $5 fee for the Department of State to search for name conflicts. For information on how to file a Fictitious Business Name in New York State, visit the New York State Department of State website**:** http://www.dos.state.ny.us/. This site provides a step-by-step guide on filing a Fictitious Name. For answers to a variety of questions filing a name go to: http://www.dos.state.ny.us/corp/crpfaq.html#corpname.

California charges $10 to register the first fictitious name, and two dollars for each additional fictitious name filed on the same statement and conducting business at the same site. California requires publication of a statement within 30 days of your use of a fictitious name. Publication must be in a newspaper of general circulation in the county in which your principal place of business is located. The Registrar-Recorder/County Clerk web site lists newspapers of general circulation. In California, Fictitious Business Name Statements expire in five years. A new statement needs to be filed before the expiration date if you want to continue doing business under the assumed name. A $10 fee is charged to renew, but there is no publication requirement for renewal.

New York charges a $20 fee to register a name for a business entity and the filing can be done by mail, fax, over the phone using a credit card, and in person at the Albany Office. The necessary forms can be downloaded from the State Department's website. For more specific information on the filing process, call the New York State Division of Corporations' at (518) 473-2492. Partnerships, corporations and LLCs may operate under assumed names, but they must file

Fictitious Business Name Statements. A person or company can operate under several DBAs. Note that banks will not allow you to open an account under a fictitious name until you have filed your statement.

Merely recording a DBA statement does not preclude others from using the same or a similar name. Nor does recordation prevent others from claiming your name infringes their rights. If your DBA is similar to another's name, that entity may bring an action against you for unfair competition or trademark infringement. In order to more fully secure rights to a name, you may want to conduct a trademark search to see if anyone is using the name, and if there is no conflict, register your name as either a state or federal trademark.

The principal advantage of operating as a sole proprietor is that it is simple and inexpensive. No formalities are required, and no legal fees or expenses need be incurred (unless one operates under an assumed name, in which case there is the minor expense of filing and publishing a notice). If you are operating a business without co-owners or partners, and you do not form a separate legal entity to run the business, then by default you are functioning as a sole proprietor. A sole proprietor does not file a separate tax return for his business, but he does need to attach Schedule C to his individual income tax return. This schedule discloses business revenues and expenses. In California, there is no minimum annual tax or use tax charged to sole proprietors. As with any business, the owner may need to obtain business licenses and permits, withhold taxes for salaries paid to employees, and acquire workers' compensation insurance.

The main drawback to operating as a sole proprietorship is the owner's liability for the obligations of the business. Because the owner has unlimited liability, it is wise to purchase insurance. General liability coverage is available to cover physical injuries to third parties such as bystanders injured during a movie shoot. An errors and omissions (E&O) policy insures a filmmaker if he inadvertently infringes the rights of third parties by defaming them, invading their privacy, or infringing their copyrights. Worker's compensation insurance covers injuries suffered by employees. Other policies can insure cameras, equipment and film footage. For more information on insurance, conduct an Internet search using the keywords "entertainment" and "insurance", or visit my website for a listing of insurance and completion bond companies (www.marklitwak.com). Contact information for entertainment insurance and completion bond companies also appears in this handout.

General Partnership

A general partnership is an association of two or more persons conducting a for-profit business as co-owners. Parties who operate as partners in running a business will be treated as partners under the law even if they don't specifically intend to be partners, and even if they don't formalize their relationship with an oral or written partnership agreement. It is always a good idea, however, for partners to enter into a written agreement to clarify the nature of their relationship.

It is often said that one should choose one's partners carefully. That is because each partner is liable for the acts of other partners in carrying on the partnership business. Although Partner A may not have the permission or consent of Partner B to take certain actions, Partner B may be liable for Partner A's conduct. For example, if partner A buys a photocopier for the partnership business without the agreement or knowledge of his partners, all the partners are responsible to pay for the equipment unless the vendor knew that Partner A did not have authority to make the purchase. Likewise, if Partner A crashes a car rented for the partnership business, Partner B may be liable for damage to the car and to any persons injured.

The rights and duties of partners are usually set forth in a written partnership agreement. If there is no agreement, the law will define the partner's relationship. For example, under California law (Cal. Corp. Code ' 15018), absent an agreement otherwise, partners share management and control of a business equally, and share profits and losses equally. Furthermore, partners have the right to be repaid funds they contribute to the partnership, and a majority vote settles disagreements among the partners.

State law often requires that partners have certain rights that cannot be varied by agreement of the partners. For example, in California, partners have the right to inspect the partnership books, and have the right to a formal accounting. Each partner has an obligation to disclose to the other partners all information relating to the partnership business, and each partner has to account to the other partners for any benefits received by a partner from the partnership business.

Limited Partnership

In a limited partnership there are two types of partners: general and limited. A general partner runs the business and essentially has the same rights and obligations of a partner in a general partnership. A limited partner is a passive investor who does not have any right to manage or control the business. A limited partner has limited control and limited liability.

If the partnership business incurs debts or liabilities, a general partner may be liable, while a limited partner is not. Thus, by establishing a limited partnership one can permit an investor to risk $50,000 of capital to produce a film, but the investor's house and other assets are not vulnerable. This is an important protection because investors with substantial assets are usually the ones who can afford to invest in a risky endeavor like filmmaking.

If a limited partner actively participates in the management and control of the partnership business, the limited partner can lose his limited liability status and become liable for the debts and obligations of the partnership. Sometimes investors get so caught up in the excitement of making a movie that they become actively involved in production. This may prove to be a mistake for both parties. When your dentist-investor comes down to the set and starts to tell you how to direct your picture, it may be time to point out that his participation may result in his loss of limited liability. Merely consulting with or advising a general partner, however, will not affect a limited partner's status.

In order for a filmmaker to insulate himself from liability as a general partner, the filmmaker could form a corporation and have the corporation serve as general partner. Thus the corporation, which is usually controlled by the filmmaker, is liable as the general partner, not the filmmaker. This structure was often used in the days before limited liability companies (LLCs) were permitted. With LLCs, both the managing members and non-managing members have limited liability, so there is no need to set up a corporation to shield the filmmaker, thereby reducing formation expenses.

Although limited partners cannot take an active role in producing a film, they are not entirely without rights. In California, for example, a limited partnership is required to maintain certain financial records and income tax returns, which the limited partners have the right to inspect and copy (Cal. Corp. Code §§ 15615, 15634(b)). Limited partners representing more than 10% of the total interests of limited partners have the right to call a partnership meeting (Cal. Corp. Code § 15637(b)), and if the limited partnership has more than 35 limited partners, the partnership has to provide an annual report with financial statements (Cal. Corp. Code § 15634(c)(1)).

Partners in a limited partnership usually have a written agreement, although they can operate under an oral agreement (Cal. Corp. Code § 15611(y)). If the partnership agreement is oral, the burden of proving the terms of the agreement will be on the general partner.

No particular form of writing is required, but to the extent that the partners do not carefully define their relationship, state law will determine it for them. Thus, it is a good idea to have a written agreement so that disputes and misunderstandings can be avoided. A written agreement allows the partners to decide how they want to allocate income, gain, loss, deduction and credit for tax purposes. The partners may want to modify various provisions of state law that would otherwise apply. However, some provisions of state law, such as those concerning the withdrawal or removal of a general partner, cannot be overridden by the partnership agreement. Because a limited partnership is a separate legal entity for tax purposes, a federal employer identification number (EIN) needs to be obtained. This number will be required to open a bank account and to file tax returns. Likewise, other licenses and permits may be needed.
Since limited partners are passive investors, their interests are considered securities. Unless exempt, offers and sales of securities need to comply with federal and state security laws. See Chapter 3 for a discussion of these laws.

Corporation
A corporation is an entity created under the laws of a state. It is treated as a distinct legal entity from the individuals who own and manage it.

There are different types of corporations. This section will focus on for-profit corporations since they are typically used by filmmakers. However, non-profit corporations are sometimes formed, especially for documentaries or other projects funded by grants and donations. Donors who make a gift to a non-profit corporation with the proper tax status can deduct the amount of the gift in calculating their income taxes. Another type of corporation is known as a “close corporation,” or “statutory close corporation.” There may be advantages in setting up such a corporation if it is going to be owned by a single person or a closely-knit group of shareholders.

There are two primary reasons to incorporate. First, incorporating establishes a separate legal entity from the filmmaker and therefore serves to protect the filmmaker from personal liability arising from corporate actions. Second, there may be tax benefits derived from incorporating. There are a number of expenses that a corporation can deduct that individuals are not permitted to deduct.

While doing business as a corporation can insulate a filmmaker from personal liability, this shield will exist only if the corporation has been properly established and the required formalities have been complied with. If a court determines that a corporation is being used as an "alter-ego" of the principals, or if it is an undercapitalized "shell" company designed to unfairly insulate its owners from responsibility for their actions, the court may allow third parties to "pierce the corporate veil" and hold the principals liable. To ensure that shareholders, directors and officers of the corporation are protected, the corporation should be adequately capitalized with a reasonable amount of money to function in view of its intended business. Moreover, the corporation's assets should not be commingled with those of its principals (*i.e.*, you should set up a separate bank account), and financial records, minutes of meetings and other documentation should be maintained. Basically, if you don't treat your corporation as a separate legal entity, then you should not expect a court to see it any differently.

A corporation is formed by filing articles of incorporation with the Secretary of State (Cal. Corp. Code § 200) along with a filing fee. In addition, in California, a minimum annual tax must be paid.

After formation, the shareholders or incorporator must designate the members of a board of directors, and the directors in turn can appoint officers such as a President, Vice President and Treasurer. Bylaws need to be adopted, and shares of stock issued. All of these actions should be documented in the corporation's minutes. Minutes should also be taken at board of directors and shareholder meetings. California requires that there be an annual election of at least a portion of the board of directors (Cal. Corp. Code §§ 301, 301.5).

Stock is considered a security and its sale is subject to state and federal securities laws. Generally, unless there is an applicable statutory exemption, stock cannot be sold or offered for sale without compliance with state and federal securities laws. In addition, full disclosure to potential investors is usually required before offering to sell stock. The sanctions for securities law violations can be severe, including criminal penalties. Stock should not be sold or transferred without consulting an attorney.

Corporations formed under California law are considered "domestic" corporations in California. Corporations formed in other states or countries are called "foreign" corporations. Foreign corporations can conduct business in California, and set up offices in the state, if they qualify (register) to do so.

Corporations are subject to state and federal income taxes. Thus, the corporation has to pay a tax on its income, and amounts it pays out to shareholders as dividends are taxable to the shareholders. This potential double-taxation is the major drawback of the corporate form of business.

One way to minimize the tax bite is to have the corporation pay out its accumulated net income to its officers or directors in the form of salaries, or to the shareholders in the form of dividends. If the corporation has no net income at the end of the tax year, there is no tax due other than any minimum tax. This method of minimizing taxes is legal provided the salaries are not excessive.

Another way to avoid double-taxation is to elect to become an S corporation. An S corporation can avoid most federal and state taxes on income by passing through profits and losses to the shareholders. In other words, the S corporation is treated for tax purposes like a partnership, with profits and losses passed through to the partners and not taxed at the company (partnership or corporate) level.

Not all corporations can elect S status. An S corporation cannot have more than 75 shareholders. It can only have one class of stock, and shareholders cannot be nonresident aliens. The decision whether to request that the IRS treat a corporation as a C or S corporation is made after you set up the corporation. The corporation can change its status from C to S and back again by filing the appropriate forms with the IRS.

California law allows a great deal of discretion in selecting a corporate name. Generally, the words “corporation” or “incorporated” need not be included. Corporate names can be reserved with the Secretary of State before incorporating.

Limited Liability Company (LLC)

The limited liability company (LLC) is a relatively new form of business entity that combines some of the best aspects of partnership and corporate forms of business while avoiding some of the drawbacks of each. Members of an LLC have the same limited liability protection granted limited partners and corporate shareholders. Unlike a corporation, however, an LLC has more flexibility as to how to pay taxes, and can largely avoid the problem of double taxation.
An LLC has two classes of members: managing members and non-managing members. Like general partners, the managing members run the business. Like limited partners, the non-managing members are investors who do not operate the business. Both managing and non-managing members have limited liability.

An LLC can elect to be treated like a partnership for federal income tax purposes, and thereby avoid federal tax at the company level. LLC members report their respective shares of LLC income or losses on their individual tax returns. Although the LLC is not a tax-paying entity, the LLC must report its taxable income and file an informational return with the IRS.

In California, LLCs are subject to state income tax, but the amount of tax is modest, and no tax is assessed until there is total income of $250,000 or more per year. However, like corporations and limited partnerships, LLCs are subject to an annual tax of $800 for the privilege of doing business in California.

An LLC is established by filing Articles of Organization with the Secretary of State (Form LLC-1). The filing fee currently is $70. As of January 1, 2000, an LLC can be established with a single member.

An LLC can be managed by one or more managers (a “manager-managed” LLC) or by all the members (a “member-managed” LLC). A manager-managed LLC is like a limited partnership with two classes of members: managers that actively supervise the enterprise and non-managers who do not. Similarly, a member-managed LLC is like a general partnership where all the partners are involved in running the business.

In a manager-managed LLC, a manager need not be a member, but can be an outsider hired to manage the enterprise. Managers are considered agents of the LLC and they can bind the LLC to contracts with third parties. In a manager-managed LLC, the non-managing members are not considered agents of the LLC. The interest of a non-managing member is a security, and securities laws apply. If all the members are active in the management of the LLC (*i.e.*, all members are managers), there are no passive investors and the members' interests are not considered securities.

The LLC's name must end with the words "limited liability company" or the abbreviations "LLC" or "L.L.C." The name cannot include such words as "Trust," "Inc." or "Corporation." The name cannot be one that is likely to mislead the public and cannot be confusingly similar to the name of another LLC. To determine if a name is available, contact the Secretary of State's office.

As with other business entities, if the LLC operates under a fictitious name, the company will need to file a DBA. Since the LLC is a separate legal entity, it will need to apply for an EIN, obtain any applicable state and local business licenses, and file state and federal tax returns.

Excerpt from *Risky Business, Financing and Distributing Independent Films* by Mark Litwak, (Silman-James Press, 2004).