Lommen Abdo Cole King Stageberg, P.A.

ENTERTAINMENT & SPORTS LAW SYMPOSIUM

THURSDAY, NOVEMBER 12, 2009

Financing Independent Film and Television Properties in a Recession

Daniel M. Satorius
Sherri Ulland

There is a crisis in the film and television industry. A glut of product seeks distribution. Distributors of that product pay very little to acquire the product and the distributors have shrunken budgets with which to distribute that product.

The 'glut of product' problem and the weak economy make it very difficult to finance the production of new product. Securing funding from traditional sources is particularly difficult if not impossible. The independent part of the industry has been hit hard. Yet, savvy producers are still able to fund their projects, albeit at reduced numbers.

This article focuses on financing independent productions including financing trends and options and legal issues related thereto.

1. The current situation. The revenues from the old distribution channels (broadcast, theatrical, television, home video) are flat or declining. Financing of film/TV in the future will depend on what happens to revenues from new media. Presently, new media revenues are a small fraction of revenues from the old distribution channels – although new media revenues are trending up in a promising fashion. Nevertheless, it will be years before revenues from new media replace revenues from old media.

   Production companies seeking financing are met with more demanding requirements from financiers. In particular, financiers require greater demonstration of potential revenues, especially presales.

   It appears the levels of production financing available to production companies will continue to shrink. As a result budgets for independent works will get smaller. What will that mean for production values? Will star level talent still be drawn to independent projects? How long before the monetization models in the new media are sufficiently significant to create a viable business for independent productions?

2. Financing Trends. Over the years funding sources have come and gone (Japanese money, German money, insurance money, etc.) while other sources rise and fall in importance in the mix of financing options. It is important to keep in mind that financing independent productions requires the use of multiple financing methods to complete funding.

   a. *On the rise*: state incentives and tax credits, sponsorships and product placement (it's not just for the big corporations anymore), mix of non-profit and for-profit, crowd sourcing.

b. *On the decline*: negative pick-ups, foreign and domestic pre-sales, broadcast, debt.

c. *Suspended during the economic downturn*: equity, credit.

d. *Evergreen*: deferrals.

3. Overview of financing sources for companies producing independently.

a. *Equity*. Equity financing occurs when individuals or firms (not actively involved in the operation and control of the company, that is, they are passive) invest in a production company in exchange for the right to receive a share of the proceeds from the exploitation of the company's output. Usually the ultimate source of equity funding is wealthy people, sometimes sophisticated and sometimes not, who are drawn to the art and commerce of films and television programs. Each year thousands of films are made using equity financing as the principal source of financing.

b. *Pre-sales*. These agreements are entered into between production companies and distributors or television companies prior to the completion of the production. Presales attract financiers because they reduce the risk that the completed work will not get distributed. The production company should be careful about splitting distribution rights among distributors in different media (e.g. theatrical, DVD, broadcasting, international) because there is a risk that the production company will not be able to attract a one distributor (for example, a domestic theatrical distributor) if certain rights (such as DVD) are not available because they were pre-sold to another distributor.

c. *Negative Pick-up*. These agreements are entered into between a production company and a distributor wherein a production company licenses or sells some or all rights in the work to the distributor. In exchange, the distributor promises to pay a specified sum of money at the time the negative of the completed film is delivered. Hence, "negative" pickup. The distributor's promise to pay funds at the time of delivery is not cash in hand with which to pay production costs. So the production company must finance the negative pick-up agreement, usually by borrowing (i.e. debt) against the agreement.

d. *Debt: Production*. An option for financing production costs are loans from banks or other lenders. Lenders do not make unsecured loans to production companies and so production companies must provide collateral in the form of presale agreements, negative pickup agreements, letters of credit, or tax credits/rebates. When negotiating agreements that will become collateral for loans, the production company must satisfy the lender's requirements and requirements of other parties such as unions, other financiers, and bond companies. The production company must coordinate the negotiations all agreements so the agreements will be

acceptable to the lender. Lenders will scrutinize those companies providing the collateral (the distributors and the state governments) to determine their ability to fulfill the terms of the agreement and to make payments under that agreement. Lenders will also require payments under the agreements be payable directly to the lender to pay off the loan. Lenders also require completion bonds, and may require further guarantees and other security. Most banks are not familiar with loans for the film and television industry and therefore will not consider such loans. There are a few banks, mostly in California and Europe that make these types of loans.

e. *Debt: Gap/Super Gap*. These are loans differ from the above loans in several ways. First, gap/super gap loans are mezzanine financing and are subordinated to senior debt, such as bank financing. Second, these lenders may accept higher risk collateral for example against unsold (usually foreign) territories. The lenders who made such loans require sales estimates from reputable foreign sales agents. These estimates are based on the foreign sales agent's evaluation of the cast, director, producer and script as indicators of the success of the work in the international markets.

f. *Co-Productions – Domestic.* Independent co-productions generally happen when a small production company with limited resources, but some experience in the industry, develops a package (discussed below) that is attractive to a larger well-financed production company. The well-financed company contributes financing, the ability to attach A-list talent, distribution and other resources and contacts. The company that developed the package contributes rights, its talents and resources and usually some financing.

g. *Co-Productions - Foreign* - Foreign companies are another possible source of funding to US independent production companies. Foreign companies' financing often comes in large part from government tax and financial incentives available from the foreign companies' governments. The US is often left out of international co-productions because the US has no film/TV production treaties with other countries. But some foreign co-production opportunities are available to US companies. Canada has provided many opportunities for co-productions, as has Germany recently.

   i. To interest international companies in co-productions, US producers must think through those elements in a package that will attract international partners, such as, story, director and other production personnel, stars, and financing. US productions with A-list actors and stories in the action, sci-fi, horror genres have found acceptance with foreign audiences. Non-physical comedy generally does not do well in foreign territories.

   ii. Treaties, taxation systems and financial incentive programs are complex, constantly changing and require the assistance of experienced advisors. Often municipalities, provinces and states have incentive programs in addition to the

federal/central governments. Many countries have point systems that require minimum participation and percentage of contribution from their nationals including for example director, writer, director of photography, principal lead actors, etc. Usually a certain significant amount of production must take place in that country that results in a minimum spend in that country and the story must have a strong connection to that country or its culture. Foreign partners generally acquire rights in foreign territories and a portion of the ownership of the film in exchange for the foreign partner's investment.

iii. Other good reasons to co-produce a film in a foreign country include, for example, more favorable exchange rates, lower labor costs, non-unionized labor, new and exotic settings and locals.

iv. Potential foreign co-production partners can be approached at markets or festivals such as: Cannes, Berlin, Amsterdam, American Film Market, and the IFP Market.

h. *Soft Money: Government incentives: State Incentive programs.* Many states have programs to encourage companies to produce film and television productions in their states.

i. Tax Credits and Tax Rebates. Tax credits apply to a taxpayer’s state’s income tax or corporate tax liability. Credits must be taken by taxpayers of the state issuing the credit. Unless the production company is able to use the tax credit itself, transferability of the tax credit is essential. States often have annual caps on the amount of funds set aside for tax credits/rebates. So when creating a financing plan that included tax credits/rebates, it is important to analyze the risks that the funds the state has earmarked for tax credits/rebates may be exhausted before the production company can take advantage of the program.

ii. Other programs include use of state-owned property free or at reduced fees, lodging and hotel occupancy tax waivers or rebates.

i. *Soft Money: Government incentives: Federal incentive programs.*

i. Section 181: Taxpayers can treat 100% of the production costs of a qualified film or TV production as an expense. They can deduct the full amount of the production costs in the year the costs are first incurred. The guidelines include: production cost must not exceed $15,000,000 ($20,000,000 if produced in a defined low-income location) including all direct and indirect costs. One should assume that deferments, participation and residuals are included in those costs. 75% of compensation must be in the US. No porn. The film must be completed by December 31, 2009 (likely to be extended.)

ii. Section 199: Qualifying films, videotape productions, renting and licensing activities can receive a 9% tax deduction in 2010 and thereafter. This

deduction results in the equivalent of a reduction of a taxpayer's federal income tax from qualified U.S.-based production activities. The deduction may not exceed 50% of the W-2 wages paid by the production company for the tax year in question. Also not less than 50% of the total compensation must be for services performed by U.S. persons (actors, production personnel, producers, etc.), including residuals and participations (which can be estimated and forecast).

iii. These tax benefits can pass through to shareholders, partners, and members.

j. *Deferrals*. Deferral agreements are entered into between production companies and companies supplying services or goods during the production. These agreements provide for reduced or no payment to the supplier at the time the production is shot. In exchange, the production company agrees to pay the supplier from a pool of money set aside out of revenues from the exploitation of the work. Suppliers who enter into deferral agreements include, for example: "above the line" personnel: producers, directors, writers, talent; "below the line" personnel: technicians, film/sound lab companies, equipment rental companies and sound studio rental facilities.

k. *Crowd sourcing*. Crowd sourcing is any process that uses a community of internet users to take on tasks that one would ordinarily hire someone to do. Crowd sourcing has been used to do market research (Netflix, Amazon), marketing (viral networking, Fancorp), political action (Moveon.org), information network building (Wikipedia), user generated content (YouTube), and financing (the WorkBook Project). Thanks to the internet it is possible to target individuals (read "customers" and "fans") and personalize the approach to these people like never before. Content providers can tailor their marketing messages (including fund raising messages) to identifiable groups and individuals. When using crowd sourcing to raise funds, agreements must be carefully crafted to avoid infringement of state and federal securities laws and charitable fund-raising laws.

l. *Other.* Independent producers have a myriad of other options for funding including for example: grants, non-profit funds and the use of fiscal agents, product placement and sponsorship, and the evergreen - self financing.

4. What independent producers must do to finance their works:

a. *Start with the 'butts in the seats.'* Imagine the audience as they are experiencing your work. Start from that point and work backwards to the beginning of the creative process. At each of the following steps ask yourself if the script and your approach to production support the answer to that step's questions.

i. Who is the audience? Why are they interested in your work? What is it about your work that drew them in and caused them to 'buy' your work?

ii. How will they consume it – i.e., what medium/screen (theatrical, television, internet, DVD)?

iii. How will they pay and how much (if at all) will they pay to view it?

iv. How will they find out about the work? How will you market your work to them?

v. How much revenue will be generated from the various ways the audience will consume your work? How much of that revenue will find its way back to you and the financier? Your budget should not exceed that amount.

vi. Who are the distributors/broadcasters/cablecasters? Make a realistic list of these companies. They will be your "partners."

vii. What similar works have been distributed? Who distributed them? How were those works marketed?

b. *Put together better packages*.

i. Presentation packages are presented to potential financiers, talent agents/managers, distributors, collaborators and others. What elements constitute a presentation package?

1) Rights and source material: A synopsis of the story, screenplay, article or book.

2) The production entity. The package should demonstrate that the production company and the people behind it have the capacity and experience to deliver the completed project.

3) Talent. Successful distribution usually depends on casting well-known talent and/or stars in the project. Financiers and distributors will require certain rolls to be occupied by approved talent – those who are perceived to attract audiences.

4) Budget. The budget should be sufficient to successfully produce desired film or television program.

c. *Reduce production budgets*. Distributors are paying MUCH LESS to acquire films and television programs. Revenues from distribution in the internet world do not come close to replacing the shrinking revenues from traditional distribution windows (as NBC Universal CEO Jeff Zucker has said we are trading 'analog dollars for digital dimes'). So production companies must reduce their budgets drastically.

d. *Make split rights distribution deals*. This used to be a no-no (see paragraph 3.b. above) but now that distributors buy works for almost nothing, production companies must re-think the split rights prohibition. Consider giving theatrical rights (assuming theatrical is appropriate) to one distributor, DVD to another, and television to yet another. And even split DVD rights – keeping the right to self-distribute from your website and other self-distribution efforts.

e. *Have your marketing plan designed before you start shooting and make sure your budget included marketing*.

The means of production and distribution used to be controlled by big companies. Not any more. Prosumer cameras and editing is available everyone. Internet distribution avenues are readily accessible to independents. The future of the independent media business will be shaped by how content providers adapt themselves to marketing, promotion, advertising, and publicity via the internet and other new technologies. Those content providers who cannot capture an audience through new marketing approaches will not survive despite cheap production equipment and technologies available in recent years, and virtually free internet distribution.

The new technologies must be used not only to supplement the old methods of marketing, such as television and print, but to replace them. Because the new technologies allow targeted even personalized marketing on a whole new level, content providers no longer have to be louder than all others to get the attention of their potential audience.

f. *Make better works*.

5. Protecting clients in troubled times (or anytime for that matter).

a. *Chain of title issues*. Make sure the chain of title for all property, including especially intellectual property, is properly registered and documented and filed with the proper authorities. If you are a financier or other party who has a claim such as a security interest against property, including intellectual property, make sure the liens and mortgages are filed properly. If you are the production company and the work is based on or incorporates the property rights (copyright, trademarks) of others, or could infringe other rights of third parties (defamation, right of privacy, right of publicity), clear those rights by getting agreements or licenses, or qualifying them with a legal excuse (fair use, first amendment.)

b. UCC filings and liens. If you are an owner of a company that owns equipment or other assets, consider using and filing financing statements and UCC documentation of your claims against those assets to secure your interests in the company and give you priority in the event of claims by creditors.

c. If you are a vendor supplying services, products or equipment to an independent production company, consider the following:

   i. Conduct due diligence of parties with whom you are doing business.

   ii. If you are contracting with a production company and any part of your fee comes out of revenues from the exploitation of the production, such as back-end, find out if distribution has already been secured for the production.

   iii. If you are owed fees for services from a production company, consider getting guarantees from individual owners of the company.

   iv. Make sure your agreement with the production company contains bankruptcy provisions adequately protecting you.

   v. Escrows are another good way to assure payment. But if the production company files for bankruptcy, the escrow agreement can be rejected by the trustee.

   vi. Irrevocable letter of credit may be better than an escrow in the event of the production company's bankruptcy.

d. Clients who are union members. In these difficult times with fewer employment opportunities, union members often find it hard to turn down work that is non-union. Confirm that the production company is in fact a signatory to the collective bargaining agreement. Most independent production companies are single purpose entities formed to produce a single film. The production company must arrange for, qualify for and sign the collective bargaining agreements. Many independent production companies use non-union workers for some or all of the positions. Also keep in mind union members who work for non-union companies can be fined or turned out of the union.

6. Securities law issues.

Any time that a business attempts to raise funds (other than borrowing from a bank or other financial institution), it is likely that its activities will involve federal and state securities laws. Under the securities laws, a "security" includes, but is not limited to, stock, bonds, notes, debentures, options, etc.

Failure to comply with federal and state securities laws can result in both criminal and civil penalties for the business entity, as well as for the entity's officers, directors and other controlling persons. These potential penalties are in addition to the possibility that non-compliance will result in the entity being required to return to the investors (with interest and attorney's fees), the investor's entire investment. Non-compliance may also result in the entity's officers, directors and other controlling persons becoming personally liable to return the investor's money (with interest and attorney's fees).

While complying with the securities laws may seem to be an obstacle or nuisance when a business is engaging in fund raising activities, it is important to remember that the securities laws protect the interests of both the investors and the business itself. A business which complies with the securities laws is greatly protected against lawsuits and other claims by disgruntled investors.

The sale of any security must either be registered or exempt from registration. Registering the transaction pursuant to which the security is being issued or sold requires that a registration statement be filed with the appropriate authority. Registration is a lengthy and expensive process in most cases.

Under exemptions from registration, certain sales of securities are deemed not to need the protection of registration. Some possible exemptions include: the private placement exemption (including Regulation D and 4(2) exemptions), the Section 4(6) exemption, the Regulation A exemption and the Regulation S exemption which exempts certain offers and sales of securities outside the United States.

Regulation D has three different exemptions. The use of Rule 506 is often recommended. Under Rule 506, no limitation is placed on the amount of securities which may be offered and sold. Prescribed disclosure is required in Rule 506 offerings only if sales are to be made to non-accredited investors.

The securities laws require full and fair disclosure prior to the sale of the security so that the investor understands the risk of investment. These "anti-fraud" rules basically require a business which is raising capital to disclose information to the prospective investor such that all the information disclosed does not mistake a material fact, or omit to state a material fact that could impact the investor's decision to invest. Therefore, even in cases where no specific disclosure is required, it is important that a business engaged in fundraising provide full and complete disclosure of material information to potential investors in order to insulate itself from potential anti-fraud liability.

Resources

IndieWire http://www.indiewire.com/

IMDb http://www.imdb.com/

Flixster http://www.flixster.com/

Creative Commons http://creativecommons.org/

Electronic Frontier Foundation http://www.eff.org/

Cinematech http://cinematech.blogspot.com/

Wired Magazine http://www.wired.com/

Workbook Project http://workbookproject.com/

© Copyright 2009 Daniel M. Satorius
© Copyright 2009 Sherri Ulland

DANIEL M. SATORIUS – Satorius Law Firm. PC. Dan's practice focuses on transactions, intellectual property, financing, and the representation of business and individuals. His clients include Academy Award, Emmy Award, and Peabody Award winning independent producers, directors, writers, and television stations in the film and television industry; Grammy award winning songwriters, recording and performing artists, producers, publishers, record companies, and studios in the music industry; and authors and publishers in the literary and electronic publishing industry. Contact Dan at IDS Center, Suite 2000, 80 South Eighth Street, Minneapolis, MN 55402. Phone: (612) 336-9332. Email: dan@satoriuslawfirm.com.

The information contained in this article is not intended as legal advice or as an opinion on specific facts. For more information about issues raised in this article, please contact Daniel M. Satorius. The invitation to contact us is not to be construed as a solicitation for legal work, does not create an attorney /client relationship, and is not to be construed as an offer of representation in any jurisdiction in which the attorneys are not admitted to practice. Any attorney/client relationship will be confirmed in writing. You can also contact us through our Website at www.satoriuslawfirm.com.

Copyright laws and treaties protect this article. You may make a single copy of materials on this site for personal use. You may make copies for others, but not for commercial purposes. If you give a copy to anyone else, it must be in its original, unmodified form, and must include all attributions of authorship, copyright notices, republication notices and disclaimers. Except as described above, it is unlawful to copy, republish, redistribute and/or alter this article without prior written consent of the copyright owner. For reprint and redistribution requests, please email info@satoriuslawfirm.com.