OTHER PEOPLE'S MONEY:

Financing the Low Budget Independent Feature Films With Private Equity Securities Offerings

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Thousands of low budget independent feature films are made each year with financing from outside of the studio system. Some production companies who make these films simply do not have access to financing within the industry. Others choose to avoid industry financing because of the controls and other restrictions accompanying such financing. For an increasing number of independent filmmakers, the studio system is, simply stated, not relevant whether because of the subject matter of the film, the approach to the material, the intended audience, the geographic remoteness to the traditional centers of production, or other reasons.

These production companies often turn to private investors for financing. And when the do they enter the enigmatic world of securities law[ii].

STATE AND FEDERAL LAWS APPLY

Let's begin with stating the obvious: structuring equity financing and complying with state and federal securities law is complex and the penalties for failure to comply are severe. Therefore, the assistance of knowledgeable and experienced securities lawyer is essential. Whether the production company is selling stock in a corporation, membership interests in a limited liability company, or partnership interests in a limited partnership, ownership interests are likely to be deemed "securities" under state and federal law. [iii] Any arrangement under which one invests money in a common enterprise with the expectation of deriving a return primarily through the efforts of others can be considered a security. Even promissory notes and investment contracts can be considered securities. [iv]

Simply put, any arrangement to finance your film involving a passive investor[v] is probably subject to securities laws.

***Failure to comply with securities laws is illegal.* It is illegal to**

offer or sell securities unless a registration statement has been filed with the Security and Exchange Commission and appropriate state authorities or unless the securities or the transactions qualify for an exemption from registration. Failure to comply with securities laws can result in severe penalties, not only for the offeror but in some cases also for lawyers, accountants, and others who have control over or knowledge concerning the securities.

What are the penalties? **Offering or selling securities in violation of the Securities Act of 1933 (the "Securities Act") is a felony punishable by up to 5 years imprisonment and a $10,000 fine[vi] for each violation. It is common for criminal indictments to also include counts of violation of federal mail fraud, wire fraud and conspiracy statutes. In addition, the Commissioner of Securities is empowered to enjoin actions such as the sale of securities that violate the Securities Act[vii] and to suspend or revoke the rights of attorneys and accountants to practice before the Securities Commission. The Commissioner may also seek civil penalties up to $500,000 per violation.[viii]**

The Securities Act also permits injured parties (e.g. the unhappy investor) to bring civil actions against issuers for violations[ix] and against brokers, attorneys, accountants, and others who control the person liable under Sections 11 or 12[x]. Many civil actions involve claims seeking rescission of the transaction and the return of the investment. But damages, penalties, and other remedies are also available to plaintiffs in such actions.

State statutes provide for similar administrative sanctions, civil and criminal penalties, injunctive remedies, and civil causes of action.

The exemption. **Registered public offerings are impractical for the single independent feature film or even a small film fund. It can easily cost more than $100,000 in legal fees and costs to register an offering, not to mention technical requirements such as operating**

history, audited financials and the like. Greater financial reporting requirements for public offerings also make them less suitable for the financing of a single film.

Fortunately, there are a number of exemptions from registration that are suitable and commonly used for independent film private offerings. Selecting the right exemption(s) (the statute(s) or regulation(s) that will be relied on to exempt the offering from registration offering) is a key step in helping a production company structure its offering.

Although other options are available, Rule 504 for films under $1 million, Rule 505 and/or § 4(6) for films between $1 and $5 million, and Rule 506, § 4(2), and/or §3(a)(11) for budgets over $5 million are the likely exemptions from registration to be relied upon for independent feature film projects.

The Regulation D ("Reg. D") exemptions (Rules 504, 505, and 506) are a 'safe harbor' for those who comply with the exemptions to avoid registration. But no statute exempts the offeror from fraud claims as discussed below. The Reg. D exemptions are non-exclusive and can be utilized along with other exemptions such as §4(2).

The §4(2) or "private offering" exemption requires a subjective determination as to whether an offering qualifies as a "private placement". The relevant factors include: the degree to which the dollar size of the offering and the number of units offered is limited, the degree to which number of offerees is limited, the degree of sophistication of the offerees (whether they have sufficient experience and knowledge in finance and business), whether the offerees can bear the risk (for example, whether the investors are accredited), the extent to which information is available to the offerees, the extent to which the offering is private in nature, and the whether the purchasers agree to not resell their securities. Section 4(2) does not allow general solicitation or advertising. Because

evaluating these factors requires subjective analysis under §4(2), whereas the factors are more objectively specified in Reg. D exemptions, it is generally advisable not to rely strictly on §4(2).

However, in limited circumstances reliance solely on §4(2) may be appropriate. For example, where there is a small number of accredited and sophisticated investors (e.g. five or less), particularly where the offeror is well known to the investors such as family members, and where the investors are given complete access to all relevant information about the offeror and the offer, in these situations it may be reasonable to save the expense of an offering memorandum in favor of abbreviated documentation.

The §4(6) exemption may be useful if financing can be raised solely from accredited investors and the amount raised is less than $5 million.

The definition of an accredited investor is an institutions such as banks and insurance companies or natural persons whose net worth (with spouse) is greater than $1 million or whose net income exceeds $200,000 per year ($300,000 per year with spouse) for the past two years[xi].

The §3(a)(11), the "Intrastate Offering" exempts "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."[xii] To qualify for this exemption, the offering must be strictly within a single state, including, for example, the offeror, all offerees and purchasers, and the business -- all of which must come to rest in a single state. There are no specific disclosure requirements under this exemption or the SEC's Rule 147, but, as discussed below, anti-fraud rules and the state securities laws apply.

The selection of federal regulation or statute must be made in conjunction with the state securities laws (the Blue Sky Laws) of each state in which the offering is offered and/or sold.

Counting Offers and Sales.

Jumpstart Our Business Startups (JOBS) Act[xiii]

The JOBS Act, signed into law on April 5, 2012, expands certain exemptions from registration making it easier in some circumstances for independent production companies to finance their companies through the sale of equity offerings. The next part of this article focuses on two sections of the JOBS Act. The first, Title II allows general solicitation of certain private placement offerings to accredited investors via the internet and can be used now. The second, Title III, allows equity crowdfunding, but it is not yet available because the process for the approval of the SEC's rules governing equity crowdfunding has not been completed. The best guess is that the earliest date equity crowdfunding under the JOBS Act will be available will be early in 2016.

Title II: General solicitation under the JOBS Act.

Title II modifies Rule 506 of Regulation D. Rule 506 is a frequently used exemption that provides a safe harbor from registration. It allows companies to sell unregistered securities to an unlimited number of accredited investors and a limited number of non-accredited investors. Now, with modifications under Title II of the JOBS Act, Rule 502 issuers can engage in the general solicitation and advertisement regarding the sale of their securities to accredited investors. Prior to Title II, issuers had to have a preexisting relationship with potential investors in order to offer the sale of their securities. Under Title II, issuers using 506 can promote the sale of their securities to accredited investors using the internet. It is

important when relying on this exemption that the issuer take reasonable steps to verify that the investor is in fact accredited.

Title III: Crowdfunding under the JOBS Act

Prior to the passage of the JOBS Act, startups and entrepreneurs could only use the internet to raise financing through donations. Crowdfunding could not be used for investing in business ventures. That meant the 'crowd' of funders who gave money to a project could not share in the upside of a commercially successful project.

Crowdfunding[xiv] under the JOBS Act will allow production companies to raise financing by selling securities in a mini-public offering without registration. It will make it easier for non-accredited investors (people who are not wealthy) to invest in startup businesses. This opens up a huge market of potential investors not formerly (for practical purposes) available to independent production companies.

How does it work?

• Non-Accredited Investors: The exemption makes it easier for independent producers to raise financing from non-accredited investors which is the vast majority of the Americas (those who are not millionaires.)

• Total Amounts Raised; Time Period in which to raise it: The exemption allows independent producers to offer and sell securities in a total amount of up to $1 million in 12 months.

• Amounts that Investors can Invest: Amounts sold to any one investor cannot exceed the greater of $2000 or

- **5% of the investor's annual income or net worth if annual income or net worth is less than $100,000.**

- **10% of the investor's annual income or net worth if annual income or net worth is greater than $100,000.**

• Must Use an Intermediary: The securities can be sold over the internet but offers must be conducted through a broker or funding portal and cannot be made directly by the company selling the securities.

• Minimums - You Can't Use the Funds Until You Raise the Target Amount: The independent producer is required to set a target offering amount (up to $1 Million) and a deadline to reach that target (up to 1 year.) The independent producer's intermediary (the broker or portal) cannot release funds to the independent producer until the target is reached. If the target amount is not raised, the funds go back to the investors.

• Notices of the Offering: The independent producer cannot advertise its offering.

• Issuer Disclosure Requirements: The independent producer must make certain disclosures to the SEC, to investors, and to the brokers or funding portals. The information to be filed with the SEC includes, for example, financial statements that are certified by the independent producer's CEO, reviewed by an independent CPA, or audited depending on the target amount of the offering to be raised. After the Crowdfunding offering, the independent producer must report annually to the SEC and give investors reports and financial statements.

• Finders: Finders and promoters cannot be compensated under the Crowdfunding exemption unless SEC rules are satisfied to ensure the finder clearly discloses all past and prospective compensation.

• Easing of State Law Requirements: The new law provides

that sales of securities under the Crowdfunding exemption will not be subject to state law registration, documentation or offering requirements but states will still have jurisdiction with respect to claims for fraud, deceit or unlawful conduct.

The JOBS Act will make it easier for independent producers to sell securities to the general public including non-accredited investors. If the donor version of Crowdfunding (e.g. Kickstarter, Indiegogo, and Rocket Hub) is any indication, the investor version of Crowdfunding will be very successful. In the donor version of Crowdfunding, people who have never supported media projects before are making donations in surprising numbers. Some projects have raised millions of dollars. Now these same supporters can get involved in media projects as investors.

But Crowdfunding is still in its nascent stages, and there are numerous legal pitfalls to navigate. As Crowdfunding becomes more widely used, it will most certainly draw increased scrutiny from the SEC and others. Nevertheless, it is the view of many that the JOBS Act may prove to be the most significant change to the securities laws since the Acts of 1933 and 1934.

***A note about state equity crowdfunding laws*. There are over a dozen states who have enacted interstate versions of the Crowdfunding section of the JOBS act. But these state rules only apply only to *intrastate* offerings, for example the sale of the securities of a Wisconsin company to Wisconsin residents.**

ANTI-FRAUD.

As mentioned above, exemptions from registration, such as the provisions of Re. D, do not avoid claims of fraud. S.E.C. Rule 10b-5[xv], other anti-fraud provisions[xvi], and state "mini-10b-5" laws offer disgruntled investors causes of action for misrepresentation or failure to disclose risks associated with the investment. *Simply stated, 10b-5*

says it is unlawful for anyone to make a false statement about a material fact, to omit a material fact, or mislead someone in connection of the sale of, or the offer to sell, securities.

Although some securities laws such as Rule 504 do not require the offeror to provide an offering document to the offeree, in most situations it is advisable to provide a thorough written document (sometimes referred to as an 'offering memorandum' or a 'private placement memorandum' or 'PPM' for short) for several reasons. First, the offering document is a written record the terms of the offering and the representations and disclosures given to the offeree. Second, a properly drafted offering memorandum can provide a defense to claims of fraud and misrepresentation.

Not every offering demands an offering memorandum. In situations involving highly negotiated transactions with a small number of sophisticated accredited investors who have extensive access to the offeror's books and records, an offering memorandum may not be necessary and the costs of preparing it may be avoided. Nevertheless, in most situations the prudent course is to present the potential investor with a carefully written memorandum fully describing all relevant material risks and terms.

THE OFFERING MEMORANDUM

Disclosing risks. **Investments in the production of independent films are highly risky. Securities laws do not prohibit investors from taking such risks, but they do require the offeror to give the investor a complete disclosure of the material risks.**

The lawyers who drafted the Securities Act 80 years ago believed disclosing of risks was the best way to regulate securities. They subscribed to Louis Brandeis' admonition that "sunshine is said to be the best of disinfectants"[xvii].

In the spirit of disclosure of material risks, the offering memorandum must be drafted to carefully spell out all material factors that contribute to increased risk. In preparing the offering memorandum, careful thought must be given to the risk factors section. The following risk factors are common in independent film offerings and deserve special mention.

The highly speculative feature film industry. **The motion picture industry is a highly speculative and competitive industry. It is impossible to predict the market appeal and profitability of any particular motion picture with any degree of certainty. The revenues of each film depend on a number of factors, such as the popularity of other films being distributed at the time, competition for exhibition time at theaters, critic's reviews, how the distributor perceives the commercial value of the film word of mouth, and the often fickle and unpredictable public taste. The offering memorandum should describe these risks that the production company has limited or no control over and upon which the success of the film is in large part dependent.**

Competition. **The offering memorandum should include a discussion of the marketplace competition that the film will face. Many other films will compete with the offeror's film for theater and shelf space. Most such films will be better funded. These competitors include the so-called "major" studios, who have a successful history of attracting talent, obtaining properties, hiring key employees for the production of films, and distributing the completed film to choice exhibition outlets. The combination of these and other factors means a small number of films, usually from the majors, account for very large percentages of total box office receipts. Consequently, many independent films never return their investment.**

The experience of the principals**. An inexperienced filmmaker at the helm increases the investor's risk. The production company is responsibility for developing the film, securing financing, hiring cast,**

directors and other personnel, overseeing the production of the film, and arranging for its distribution. The effective completion of all these tasks is critical to the successful completion and distribution of the film. If the film will be the first theatrical feature-length motion picture developed and produced by the production company, this fact must be disclosed.

***Distribution*. The offering memorandum should disclose the risks involved in the distribution of the film. In particular, it should discuss whether any distribution agreements have been entered into and whether those agreements are with major or independent distributors.**

In most cases the funds raised via an offering are only sufficient to produce the film and market it to distributors. Often funds are not raised to distribute the film because it is the intent of the production company to secure an agreement with a distributor. Until the film is distributed or an agreement is made for distribution, there will be no revenue and, consequently, no return to the investor. Therefore, the existence or lack of a distribution agreement is an important risk factor to be discussed in the memorandum.

Independent distribution may be more risky for the investor than distribution by a "major". In the motion picture industry, "independent distributor" refers to a distributor unaffiliated with the so-called "majors" such as The Walt Disney Company (Buena Vista, Walt Disney Studios), Viacom (Paramount Pictures), Sony (Sony Pictures and MGM), News Corp (Twentieth Century Fox), Time Warner (Warner Bros and New Line Cinema), NBC Universal, and their affiliates. Majors often have greater bargaining power than independent distributors, which gives them a competitive advantage when booking films into theaters and negotiating distribution agreements in other media. Majors usually devote more resources to the marketing of a film, resulting in greater prerelease exposure[xviii].

Modification to the film. **It is common in the motion picture industry for a screenplay to undergo significant revisions prior to production. In addition, after production, the film may be further revised during the editing process. These changes are made by the production company or third parties involved in the production or distribution of the film. The production company is given the discretion to make these changes, a fact which should be disclosed in the offering memorandum to alert investors that the story represented in the screenplay which is synopsized in the offering memorandum and often made available to investors may and probably will change.**

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In addition to a discussion of the risk factors, the offering memorandum should spell out the material terms and factors impacting the deal such as how the company is going to use the funds raised under the offering, how will the company distribute the company's revenues, who and how will the company be managed, what conflicts of interest may exist, how will the company be governed and controlled including the terms of the operating agreement or member control agreement. The following discusses some of those material terms that are specific to independent film offering memorandums.

Rights in underlying properties. **The germ of a feature film may come from a variety of sources: original screenplays, books, articles, short stories, life stories, songs, etc. Screenplays may be owned by one or more of the principals of the production company/offeror. The production company must enter into written agreements to acquire motion picture and television rights (and other rights) in underlying works/rights if owned by other parties. The offering memorandum should include a discussion of the production company's ownership and/or control of such rights, including the copyright status, and a discussion of the material terms of those agreements.**

Agreements with third parties. **It may be necessary or advantageous for the production company/offeror to associate with other companies such as other production companies, financiers, or distributors, to obtain financing for the production and/or distribution of the film. These associations may take the form of co-productions, agreements for the pre-sale of distribution rights in certain territories, agreements for the distribution or broadcast of the film, loans, or other arrangements. The offering memorandum should discuss the company's rights to make such agreements and include a discussion of the material terms of any agreements existing at the time of the offering.**

Distribution of proceeds. **The offering memorandum describes the order of distribution of the proceeds from the exploitation of the picture (and any other revenues). The production company must carefully structure the distribution of proceeds to strike the appropriate balance between the rewards to the investors and the rewards to those who make creative contributions.**

A common distribution of proceeds arrangement in an independent feature film offering memorandum is as follows: The first receipts are disbursed to the company's unpaid expenses (such as over-budget costs), operating costs, loans, and reserve for future expenses. Second, if the distribution of proceeds provides for deferrals, the next proceeds are distributed in the form of deferrals (described below) to creative contributors, such as major talent, whose contributions will have a substantial impact on attracting financing and/or distribution. Third, to the investors until the investors are paid back 100% of their investment plus, oftentimes, a return on their investment, for example, an additional 10% to 20% of their investment. Fourth, the balance of the proceeds is divided on a 50::50 or similar basis between the investors and the producer/owners, for example, the producer members in a limited liability company.

Deferrals. **A deferral is a delayed payment made to key parties involved in the production of the film. Deferral payments are almost always pre-negotiated fixes amounts and not percentages. Usually, deferral payment arrangements are made with those creatives, such as major talent, whose contributions will have a substantial impact on attracting financing and/or distribution. Sometimes in micro budget films, deferrals are used to pay creative contributors or other vendors who were paid a lesser cash payment from the production budget than their customary payment. To investors who are accustomed to evaluating offering memorandums for investment opportunities in fields such as real estate, medical technology, or computer technology, the concept of "deferrals" may be new. In independent film financing, the use of deferrals is common.**

An example of a creative participant for whom a deferral arrangement may be advantageous to the production company is an actor or actress with name recognition value who is likely to help "open" a film, that is, help to sell tickets in the first days and weeks of the film's theatrical run and help distribution in other markets. The use of such actors can have considerable financial benefits to the theatrical run of the film and to the film's performance in other markets. Consequently, distributors are more likely to enter into a distribution agreement for a film in which those actors appear. It follows that financiers are more incline to finance/invest in such films.

Actors with television or studio credits have what is called a "quote". A quote is what an actor was (theoretically) paid on his/her last picture. Producers of small budget independent films may not be able to afford to pay the actor's full quote, but may be able to make a deal to pay union scale or a multiple thereof. The balance of the actor's quote is paid on a deferral basis (plus, in many cases, a percentage of production company's or the partnership's profits).

The justification for such arrangements is apparent. Talent who, by virtue of their notoriety, sell tickets (and therefore make

distribution agreements with distributors feasible) deserve substantial compensation. That compensation may be beyond the means of the production company's cash budget, but the production company can offer to make up the difference out of amounts advanced by the distributor for the right to distribute the film.

All of this may be to the benefit of the investor because without marquee-value actors, there may be no distribution agreement, and without distribution, the investor's investment is worthless. Furthermore, under this arrangement investors part with less money up front for the actor's fee, although they may have to wait behind the level one actor to recoup their investment.

Deferral arrangements are a material factor affecting an investor's investment, and therefore must be disclosed in the offering memorandum. The following factors must be treated in that disclosure: (1) the priority in which the deferral payments will be paid from the distribution of the company's revenues; (2) the amount of money to be put in the deferral pool; (3) the production company's discretion in committing funds from the deferral pool; and (4) the production company's discretion to determine the value of the goods and services subject to the deferred payment.

Striking a balance. **As stated above, a balance must be struck between rewards to the investors and rewards to the 'creatives' involved in the production of the film. The investors must feel they are being treated fairly or it will be difficult to sell the securities. The talent must feel that they are being treated fairly or they may not participate in the project.**

Participation in "profits." **Some members of the creative team such as actors, writers, directors, and producers often receive a percentage of the production company's profits in addition to payments from the budget. This percentage, commonly called "profit participation" or "points". Points paid to 'creatives' are often the**

producer's responsibility and paid from the producer's share rather than the investor's share of the profits. In other situations, the producers and the investors share those points. The arrangement regarding profit participation should be disclosed in the offering memorandum.

CHOICE OF ENTITY.

Separating the production company from the financing company. **The business of producing a film (hiring and firing crew and talent, operating vehicles and equipment, renting locations, entering into contracts with suppliers, and the like) can create substantial liability. Claims can be brought by injured third party for breach of contract or personal injury. To better manage the risks associated with such liabilities, a separate entity can be formed to undertake the business activities and transactions associated with the production of the film.**

A corporation is often used as the business structure for the production of the film. The assets of that corporation are usually limited to cash on hand and the expectation of payments under the agreement with the company financing the production. Creating such a corporation insulates the liabilities that can be created during production from the assets of the financing company such as the screenplay, film footage, and revenues from the distribution of the film and derivative works. The agreement between the corporation and the financing company is a work-for-hire agreement by which the financing company owns the copyright in the film and corporation acquires no copyrights.

The financing company. **When choosing an entity for the financing company, the selection is generally between a limited partnership, limited liability company, or, to a lesser extent, as we shall see, a corporation. General partnerships comprised of individuals and sole proprietorships should be avoided because they**

do not limit owners' exposure to liabilities. Investors find such exposure unacceptable. Limited partnerships, limited liability companies and corporations are more effective in limiting liabilities. Note that when production companies come together to make a film, they form entities such as joint ventures, general partnerships consisting of corporations, or LLCs.

Control is very important to a production team making a film. Filmmakers want control of creative and management decisions affecting the production and exploitation of the film. Arguably, they are the best parties to make those decisions in normal circumstances. At any rate, investors must closely scrutinize the filmmakers' creative and management skills as part of the investor's decision to invest. An investor who invests in a limited partnership cannot participate in the management of the partnership (and therefore the creative and production decisions) without losing limited liability status. Limited liability companies can be similarly structured to separate the managerial rights from the ownership rights.

Another factor to consider in the selection of the type of entity for the financing company is how much flexibility the type of entity allows in structuring the return of capital and losses to the investors. Investors generally expect most of the film's income and losses to be distributed to them before the production team participates to any significant extent. After the investors are paid back their investment and perhaps a return, the division of proceeds may switch to favor the production team. This variable manner of distributing proceeds does not necessarily correspond to the parties' ownership interests in the financing company. This flexibility in distribution of profits and losses is useful and is relatively easy to achieve in limited partnerships and limited liability companies. It is difficult to achieve in Subchapter S-corporations where profits must be distributed prorata on a per share bases annually. Subchapter C-corporations can achieve some of that flexibility through the use of classes of shares but the resulting structure may be complex and cumbersome.

Tax considerations. **A discussion of tax aspects of an equity offering is beyond the scope of this article. It is very important that a knowledgeable tax attorney or accountant with experience in film production be consulted to analyze the tax law issues involved in the creation and structuring of the financing and production entities. Put simply, Subchapter C-corporations are subject to double taxation**

FREQUENTLY ASKED QUESTIONS

Filmmakers raising money for the first time for their feature films commonly ask the following questions.

"Must the offering memorandum use such negative language?"

This is a frequently expressed lament of clients who are unaccustomed to securities offerings. As creators of an artistic project, filmmakers react strongly to what they perceive as negative and disparaging descriptions of their business.

The response to this complaint is two-fold. First, for the reasons expressed elsewhere in this article, companies offering to sell securities are required by law to fully and factually describe all material aspects and risks of an offering, without misrepresentation or omission of relevant factors. This duty is imposed not only on the offeror but also on the lawyer preparing the document. The properly drafted offering memorandum serves to protect the offeror and others from disgruntled investors who seek to bring actions against the offeror for fraud or breach of contract.

Second, a thoughtful and thorough offering memorandum expressed in the customary language of securities offerings is actually a better sales tool. Sophisticated investors, typically those with disposable income to invest in projects such as feature film, are accustomed to lengthy offering documents that emphasize the extreme

risk of the investment. In fact, if offered a non-standard offering memorandum, they may question the professionalism of the company and those associated with the project. Which would likely lead them to not invest in the company.

"Why do investors invest in independent feature films?"

At some point in the review of the offering memorandum, usually in the 'Risk Factors' section, clients will pause and in frustration ask, "Why would anyone in their right mind ever want to invest in an independent film?"

In our experience investors who buy units in an independent feature film offering are motivated by both the potential for profit and for personal reasons. The independent film investment represents a more personal investment than the typical investment. The investment may express the investor's desire to help the filmmaker, patronize the arts, support a particular cause or promote a particular topic, or get close to the making of a film for other personal reasons. Many potential investors with an interest in a film project have family members who are pursuing a career in film or television.

Although risky, investments in independent features have the potential for significant profits and may therefore appeal to investors who seek to balance their portfolio with high-risk/high-return potential investments. A profit motive may not be the principal reason for the investor's investment, but everyone, especially those who are sophisticated business people with the discretionary funds to invest in films, wants to be treated fairly when it comes time to be paid back. No one wants to be the chump.

Also many investors are attracted to film because as an investment, it is not "correlated" to the stock market. That is, the box office does not go up and down with the stock market. This gives

investors a counterbalance and portfolio diversification.

"How do I set the minimum and maximum amount of the offering?"

The use of the minimum/maximum arrangement are often used in independent film offerings. The minimum is the least amount of dollars it will take for the production company to make its film and the maximum is a larger, more ideal sum that would produce a better, perhaps more marketable film with higher production values.[xix]

The minimum/maximum arrangement restricts the offeror (the production company) from using any funds unless at least the minimum is raised. Thus if the minimum is not raised within the offering period, all funds must be returned to the investors. If the minimum is raised, the offeror is given the option to move directly into production and/or continue in its attempts to raise additional money up to the maximum. The use of the minimum/maximum arrangement protects the early investors by giving them the assurance the investors' funds will not be used and be returned to the investor if the offeror fails to raise sufficient funds to cover at least the minimum.

"How long do I have in which to sell the offering?

Realistically it may take the production company years to develop and raise financing for his/her film. What happens if the production company fails to raise the minimum before the offering period specified in the offering memorandum closes? If the offering is made on a minimum/maximum basis and the minimum is not raised, the investors' funds must be returned at the end of the offering period.

To qualify for most exemptions under securities laws, the offering period cannot exceed 12 months. But it may be advantageous to set a shorter period. If the offering period is too long (for example

the full 12 months), it may be difficult for the production company to get investors to commit to the purchase of units. Investors do not want their capital sitting idly for long periods of time in an offeror's bank account or an escrow account while the offeror attempts to raise other funds to make the film. So investors tend to put off writing checks until the last minute. The longer the sales period, the longer the investors will put off buying the securities offered in the offering and the greater the opportunity for other investments to come along and draw the investors' funds away from the production company's offering. The production company must strike a balance between the benefits of a short sales period and the reality of the market that may make it difficult to raise the minimum in a short period of time.

One option is to set the sales period at a relatively short period, say 90 to 120 days, and give the production company the option to extend the offering period. This strategy may strike the right balance between creating a sense of urgency while at the same time giving the production company the flexibility to extend the offering period for the additional time needed to raise the minimum set in the offering memorandum.

"Can I use brokers and finders?" "Can I pay finder's fees?"

Generally, the officers of the offeror and the principals involved in managing the day-to-day operations of the company can offer to sell investments in the company. Broker/dealers[xx] are permitted to sell securities in most types of offerings although the extent of their solicitation may be limited, as for example, in those types of offerings where general solicitation is prohibited. However, in reality, most independent film offerings are not brokered.

Finders are persons or businesses who receive a fee for soliciting and directing potential investors to the offeror. Finders who are not registered broker/dealers can be used in limited circumstances but neither the offeror nor the finder should do so without the advice

of counsel. Extreme caution is required when finders are used. Certainly finders must not undertake activities, such as general solicitation, that the offeror is prohibited from undertaking. Generally, risk is created for both the finder and the offeror when finders do more than merely introduce potential investors to the offeror. Potential liability may occur when the finder discusses the terms of the offering, negotiates the sale of the securities, is paid based on the outcome of the offering, or has acted as a finder or broker in prior transactions. Many states have regulations restricting the ability of offerors to use finders.

"Can my attorney help me sell units?"

The short answer is, "No." The sale of securities creates significant liability for lawyers and their firms. Attorneys are probably not licensed as broker/dealers and participation in the sale could violate state and federal licensing regulations. Also the attorney's participation in the securities transaction creates a potential conflict of interest between the client and the attorney.

"Can I give potential investors projections and comparables?"

The decision to make oral or written projections of the future value of an investment in an offering must be made cautiously. The statutory safe harbor for projections (so-called "forward-looking statements") is not available for offerings of a partnership or a limited liability company.[xxi] Without a safe harbor it is difficult to predict the extent to which an offeror will be liable for his/her projections.

However, the reality is that projections are common. In fact it is difficult to discuss the proposed sale of securities in an independent film offering without making projections. Offerors may feel it is necessary to provide projections to attract investors. Those choosing to make projections should be careful to put them in writing, identify them as forward-looking statements, include meaningful cautionary

statements and disclaimers, and identify the assumptions and important factors that could cause actual results to differ materially from those in the forward-looking statements. Obviously, such statements must not be made if the offeror or the person making the projections knows them to be false or misleading.

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 4900, 80 South Eighth Street, Minneapolis, MN 55402. Phone: (612) 356-4100. Email: dan@satoriuslawfirm.com.**

ENDNOTES

[i] **Daniel Satorius' firm is Satorius Law Firm, PC in Minneapolis, Minnesota. Mr. Satorius represents clientele in the entertainment industry.**

ii. **Securities offerings for independent film projects are a special sub-category within the big world of securities law. This article focuses on some of the unique characteristics of independent feature film offering that distinguish them from the offerings of other types of ventures. As a result, some issues typically covered in discussions of securities law are not covered in this article. For example, public offerings, for the reasons discussed herein, are generally not used for independent film offerings. Since most independent film offerings are for one film, have a limited duration, are not publicly traded and have no market, resale and the restrictions thereon are not discussed here.**

iii. **Private debt financing is not discussed in this article but it is a viable alternative to private equity financing. It is also possible to blend the two. In private debt financing arrangements the filmmaker does not give up to the financier any management rights, the financier can get a priority in a bankruptcy or distressed business scenario, the interest on the loan is deductible by the filmmaker, and it is possible to give the investor some participation in the upside. But creditors in private debt generally require priority treatment when it comes time for the pay out of the film's revenues and so are generally paid prior to the equity owners including the producers.**

iv. **SEC v. W.J. Howey Co., 328 U.S. 293, 299-300 (1946).**

[v] **A passive investor is a person or entity who provides financing but who is not actively involved in the business, and expects to share in the profits of the film.**

vi. **The Securities Act of 1933 (the "Securities Act") §24, 15 USC §77x.**

vii. **Securities Act §20 (b), 15 USC §77t(b).**

viii. **Securities Act §20 (d), 15 U.S.C. §77t(d).**

ix. **Securities Act §§ 11, 12, and 17(a), 15 U.S.C. §77k. 77l, and 77q(a).**

x. **Securities Act §§ 10 and 15, 15 U.S.C. §77o and 77t.**

[xi] **See Rule 501(a) of Regulation D.**

xii. **The Securities Act §3(a)(11), 15 USC §77c(a)(11).**

[xiii] **Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. (Apr. 5, 2012).**

[xiv] **Title III of the JOBS Act.**

xv. **The Securities and Exchange Act of 1934 § 10(b), 15 USC § 78j(b), 17 CFR § 240.10b-5, (SEC Rule 10b-5), which states as follows:**

"Employment of Manipulative and Deceptive Devices:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

xvi. ***See e.g.*** **The Securities Act §§ 11, 12, and 17(a), 15 USC §§ 77k, 77l, and 77q(a).** ***See also*** **The Securities and Exchange Act of 1934 §§ 9(e) and 18(a), 15 USC §§ 78i(e) and 78r.**

xvii. **Louis Brandeis, Other Peoples Money p. 92 (1914).**

xviii. **Most films do not recover their distribution and production costs from theatrical distribution alone and must rely on other markets such as television, cable, video/DVD/VOD, and foreign distribution. Many films never show a profit, even after release in other markets. Risks associated with foreign distribution include fluctuations in currency and foreign exchange control laws that delay or prevent receipt of payment in United States dollars. In all distribution arrangements there is a risk of non-payment or incorrect payment.**

Distribution agreements grant the distributor broad latitude and discretion in the distribution and exploitation of the film. Distribution contracts typically include terms that relieve the distributor from distribution in any particular media or market. A distributor will also probably not be restricted from giving preferences to or otherwise favoring any film over any other films which the distributor may distribute including the distributor's own films. Because a distributor may have a lesser financial stake in the filmmaker's independent film than it has in films it owns and distributes, it may tend to prefer its own films in making distribution decisions. Similar risks are also present with regard to any sub-distributor utilized by a distributor. Therefore, conflicts between the filmmaker's independent film and other films distributed by a distributor may arise.

[25]**The production company should be advised to include in the budget appropriate amounts for marketing and distribution which should include at a minimum costs of entering and attending film festivals, presentations to distributors – but may also include the very substantial costs of marketing and distributing the film into the various distribution markets. The budget should also cover administration costs, *e.g.* legal, accounting, office overhead, reporting to the investors, and the ongoing operations of the production company.**

xx. **Where an offering is offered for sale by brokers, the filmmaker/offeror must carefully negotiate the agreement with the broker/dealer, especially with respect to the issue of whether the broker is undertaking the offering on a "firm commitment underwriting" basis where the broker is underwriting the offering and must buy the unsold balance of the offering for their own account or a "best efforts" basis where the broker is not so obligated.**

xxi. **The Securities Act § 27A(b)(2), 15 U.S.C. §77z-2(b)(2); The Securities and Exchange Act of 1934 § 21E(b)(2), 15 U.S.C. §78u-5(b)(2).**