Risky Business

IN PRIVATE EQUITY FINANCING, IT PAYS TO PLAY BY THE RULES

"We are commodities brokers, William. Now, what are commodities? Commodities are agricultural products, like coffee that you had for breakfast, wheat, which is used to make bread, pork bellies, which are used to make bacon, which you might find in a bacon and lettuce and tomato sandwich."

—RANDOLPH DUKE, *Trading Places*

MOST OF MY FRIENDS obtained their first understanding of high finance from Ralph Bellamy and Don Ameche in John Landis' 1983 comedy classic, *Trading Places*. The film provides the viewer with an overview of some of the more sophisticated forms of equity and commodities fundraising—and if belly laughs traded as easily as pork bellies, Eddie Murphy would be a very wealthy man. ("But he *is* a wealthy man," you're saying to yourself. My point exactly!)

For independent moviemakers, features like *Trading Places*, Oliver Stone's *Wall Street*, Mel Brooks' *The Producers* and Ben Younger's *Boiler Room* are really all that's required to understand investments and raising money though securities offerings. A securities offering occurs when you raise money from "passive investors," who hand over their cash in exchange for the hope that you will make a movie that generates a profit. Because the investors are deemed "passive" rather than "active," they have little (or no) say in how the film is made. The producer merely truthfully tells the dentist—I mean, investor—what will be done, and then does it without the investor leaning over his or her shoulder.

Regardless of how it's labeled, any type of investment contract where a profit is intended to be earned is a "security." Upon viewing the aforementioned films, most moviemakers will come away with an understanding that this method of fundraising involves a lot of laws—and failure to comply with those laws can lead to big problems. Once you grasp that concept—and the notion that attorneys can help you comply with said laws—your lesson in equity financing is pretty much done.

Securities laws are those regulations, statutes and cases that govern the offer and sale of investments to passive investors, such as those that traditionally provide money to moviemakers. Unless there is an exemption from registration, securities offered or sold in the United States must be registered with the Securities and Exchange Commission (SEC) and the appropriate state authorities. Remember, the SEC is the same entity that brought down Martha Stewart. If they can topple her empire, bringing you down would be a snap.

What do securities laws require?

To paraphrase Lieutenant Daniel Kaffee (Tom Cruise) cross-examining Colonel Nathan Jessup (Jack Nicholson) in *A Few Good Men*: "They want the truth!"

The foundation of U.S. securities laws is the Securities Act of 1933 (a.k.a. the "truth in securities" law), which has two basic objectives: one, to require that investors receive financial and other significant information concerning securities being offered for public sale; and two, to prohibit deceit, misrepresentations and other fraud in the sale of securities. A primary means of accomplishing these goals is the disclosure of important financial information through the registration of securities.

Is there an exemption from registration for the independent movie producer?

Most independent film productions are on a scale where an exemption from registration must be identified in order for the company to solicit investors for the film. The burdens associated with registration would otherwise make such a requirement prohibitive to obtaining investment financing. Fortunately, there are numerous statutory and regulatory exemptions from federal and state registrations. Which exemption applies will depend on a variety of circumstances, including how much money is sought. All of the various exemptions place constraints on the number and type of investors that are allowed.

Many exemptions limit the number of investors any one production can have (usually no more than 35 investors in any one state). More often than not, there is also a strict prohibition of general solicitation and advertising. This means that the Website you are running to solicit potential film fans to invest in your project is subjecting you to serious liability. The entire site is deemed a general advertisement and that's against the rules! Usually, state exemptions roughly correspond to the federal exemptions for which a company may be eligible. How the state laws interact with federal laws will depend on which federal exemptions apply.

How does an independent producer comply with these exemptions and the law?

Still believe the myth that you can simply pirate a friend's business plan to raise financing for your own movie? In order to comply with federal and state laws, a moviemaker seeking to raise money through passive equity fundraising should consult with a qualified entertainment attorney, well-versed in securities regulations. A typical film production that seeks to raise thousands—or millions—of dollars from private investors must jump through some hoops to ensure compliance with securities laws. First, the company has to identify which federal and state exemptions are applicable. Next, the company must appropriately structure itself and the marketing of its securities.

A motion picture production company that is set up for the purpose of receiving investment funds is usually created as a limited liability company (LLC). The limited liability company will have an operating agreement that defines how the company is run, who runs it, how money will be spent, etc. The limited liability company will also issue subscription documents to all investors, to be completed and returned to the company. Additional disclosure documents will provide details of the company's business plan, officers, activities, financial history and structure, revenue distribution and information on the film the company intends to produce. All of these documents need to clearly state to the investors that there is no guarantee of a return and that investment in a motion picture is a high-risk investment.

Remember, what the government demands you tell your potential investors is the truth! Comparisons of your "character study" movie to a major studio's tent-pole, 3,000-theater release are deceptive. Likewise, not all independent films yield profits the size of *My Big Fat Greek Wedding* or *The Blair Witch Project*. Even if you think they already know this, investors need to have it in writing that high returns are the exception, not the rule.

"Chances are these investors are investing in **YOU**, not just your film."

The SEC and many states also require that you file notice of your fundraising activities with the state. At the state level, these filings are called "blue sky" filings, as they were enacted to identify con men who promised riches but were selling little more than the clear blue sky above them. For the most part, both the federal and state filings are usually formalities that are submitted after investment money starts coming in.

What if I just ignore the securities laws?

As with any law, there are penalties for non-compliance. The government can levy fines, issue stop-orders and attach a "scarlet letter" to your name in the event you ever seek to raise funds in the future. When it comes to securities laws, though, more important than government penalties is the fact that the company has its own financial incentive for complying, and it's separate from any desire to avoid government sanction.

Adhering to these regulations allows the production company to protect itself. It eliminates the opportunity that investors might have to recover their investment funds before a financial return is realized by the company by "blowing the whistle" on the corporation. Your next door neighbor may be chummy with you today, but he might not have the same attitude when your picture bombs. The fact is, having passive investors and not complying with the securities laws is the equivalent of handing each investor a "Get Out of Jail Free" card. If the film makes money, they reap the rewards; if it doesn't, they can, under certain circumstances, invoke the assistance of securities laws to force you to pay their initial investment back.

The following true story illustrates this point: An investor shows up on the set on the first day of principal photography, requesting his $10,000 back from the producer so that he can use it as a down payment on a new house. The producer had no documentation, no investment contract and no filings with the SEC or the state authorities and, thus, nothing to support his argument that the $10,000 was an "investment" and would only be returned to the investor if and when the film had earned adequate revenue.

After learning of the legal consequences of his sloppy actions with regard to how he accepted money, the producer is required to beg and borrow to come up with enough money to pay off this investor (plus the return that the investor was expecting) in order to avoid having a lawsuit on his hands or the SEC knocking on his door. Proper documentation and filings could have prevented this situation and would not have permitted the investor to strong-arm the producer into generating an inappropriate return on his investment. The additional sum of money the producer would have spent to consult an attorney about the proper manner to collect passive equity would have been far less than the money the producer actually doled out (not to mention the time and expense associated with having the entire principal production jeopardized).

Compliance with the law is not that difficult when you enlist qualified counsel. And investors are rarely scared off by a private placement offering that informs them of the "risky" nature of moviemaking. Most investors respect candor, and if the film does not yield a profit, unfounded expectations are not crushed. Chances are these investors are investing in *you* and who you are, not just your film. Compliance with the law tells your investors: I care about your money and I take the business of making movies seriously. **MM**

Want David Pierce to answer your legal question? E-mail counselor@moviemaker.com. Next issue we'll answer reader questions.