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Independent Motion Picture Financing: Unregistered Limited Partnership Offerings

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COMMENT

Independent Motion Picture Financing: Unregistered Limited Partnership Offerings

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I. INTRODUCTION

Prior to 1976, investment capital for independent feature-length motion pictures was relatively easy to obtain. Through extravagant tax benefits to investors, the government essentially subsidized the independent film production industry. Films with little commercial value were being produced, and were happily financed by high-income taxpayers because of these providential conditions. Because of significant changes in the tax laws that first reduced, then virtually eliminated these tax incentives, investment capital has become difficult to obtain. Filmmaking projects are now financed, for the most part, based on commercial merit and sound business principles.

Independent motion picture producers are now competing on equal footing with all other business entrepreneurs for limited amounts of investment capital and must rely on sound business principles to structure and capitalize their film projects. Because film production is more an art than a business, and is generally learned through years of involvement in the motion picture industry, counsel have typically encountered difficulty in

applying traditional transactional legal principles to services requested by film producers. This article supplies the practitioner with a general working knowledge of independent motion picture preproduction, and suggests some methods of applying traditional business and legal principles to achieve the successful capitalization of such ventures.

Part II of this article discusses the relevant components of a prefinancing package. Part III explores the important role of insurance in motion picture production. The formation of a limited partnership is covered in Part IV. Raising capital to finance the film production through an unregistered securities offering is discussed in Part V. In Part VI, the tax consequences of investing in motion picture productions via limited partnerships is covered. This article concludes in Part VII that motion picture production capital can be obtained from the capital market if the project is properly packaged and commercially viable.

II. Prefinancing Package

Before a film production project can attract financing from any source it must have an intrinsic commercial appeal that can be communicated to potential investors.[1] The promotional packaging of a filmmaking project becomes a pivotal point in its genesis because investors assume that the ticket-buying public will respond to an advertisement of a motion picture in the same way they themselves respond to a summary representation of the film. Therefore, the promotional package must be carefully prepared to capture the interest and imagination of the potential investor.[2]

A. The Screenplay

The first stage of preproduction is the screenplay. The story

1. The appeal could come from a well-known personality associated with the project, such as a Hollywood film star, or a famous director, producer, or writer. Also, the commercial appeal of a project often rests on its subject matter; for example, a recent important event or one of historical significance, or the story of a celebrated personality. Typically, however, a composite of all facets of a project's makeup will create commercial interest in it.

2. It should be made as attractive as possible within the limits of the production company's resources. Although counsel is not expected to be expert in the aesthetic aspects of preproduction packaging, general legal and business sagacity, coupled with impartial common sense, should help to discern the merits of the undertaking of any particular project.

structure is the foundation upon which the entire production is built. Generally, the story exists before the decision to make the motion picture, with the possible exception of "formula" films[3] or sequels. If a completely original screenplay has been produced, it is a relatively simple undertaking to secure the rights to make it into a movie. However, if a screenplay, written or planned, is based on the work[4] of another author,[5] the rights must be obtained from the original author before it can be used.

1. *Acquiring literary property rights*

If an author has written an entirely original screenplay, three methods are available to secure the rights to use it. Counsel can help the producer (1) negotiate a contract to purchase the screenplay outright, (2) purchase an option contract to secure an exclusive right in the property for a period of time without tying up a great deal of capital, or (3) purchase the rights to exploit the work for motion picture production. The third method should include all motion picture and television sequel and series rights, merchandizing rights, and publishing rights, including novelization of the work and its sequels in order to secure potentially lucrative commercial benefits.

If a screenplay is based on an already published work, the right to exploit the work must be obtained from its owner.[6] As with a screenplay, an underlying literary property may be procured through outright purchase, an option contract, or a purchase of exploitation and development rights. To ensure that a purchaser's rights are secure in any literary property, a "mortgage of copyright" should be recorded and a copyright title search commissioned.

2. *The mortgage of copyright*

A mortgage of copyright creates a security interest in a literary property under federal law and perfects the security interest when it is recorded with the Copyright Office in Washington,

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3. Formula films are typically closely patterned after box-office successes.

4. This includes fiction and nonfiction.

5. A screenplay based on a nonfiction story must be derived from independent sources and not "secondary" sources created by other authors.

6. The owner could be the author or the publisher, depending on the terms of their publication agreement. Because publication rights of a published work are necessarily already preempted, the rights to print promotional synopses should be secured with the exploitation rights.

D.C.[7] Such a mortgage may be recorded not only for the underlying literary property, but also for the screenplay when completed, and on the motion picture upon its completion. Perfecting a security interest in a property does not necessarily secure a first position in priority. To ensure a first position, a copyright title search must be undertaken.

3. *Copyright title search*

Several law firms in Washington, D.C., specialize in copyright title searching and can ensure title priority by conducting a thorough search. Such a search establishes whether any person other than the grantor has a security interest in the property,[8] and if it is already copyrighted and registered with the Copyright Office.[9] To protect against the possibility of a property's title being changed and registered to someone else under a different title, the search is typically rigorous, and should be undertaken only by specialists.[10]

In the event of conflicting transfers of the same copyright, the new Copyright Act provides for first position of a prior transferee if he records within thirty days of the execution of the transfer of copyright.[11] Therefore, one cannot be fully assured of a clear copyright until the appropriate waiting period has run. If all of the above precautions have been taken, an Errors and Omissions insurance policy should adequately cover against unforeseen claims of infringement and misappropriation.[12]

B. The Preproduction Staff

Because the screenplay is the foundation of a motion picture production, in the event that a screenplay has not been procured or developed, the first person that will be hired by the producer or production company will generally be a screenplay

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7. 17 U.S.C. § 205(a) (1982). *See generally* Weiss & Benjamin, *Feature Film Secured Financing: A Transactional Approach*, 15 U.C.C. L.J. 195 (1983).

8. Weiss & Benjamin, *supra* note 7, at 201-02.

9. *Id.*

10. *Id.*; Note, *Transfers of Copyright for Security Under the New Copyright Act*, 88 YALE L.J. 125, 131 n.31 (1978).

11. 3 M. NIMMER, NIMMER ON COPYRIGHT § 10.05[A] (1982); Weiss & Benjamin, *supra* note 7, at 202. The grace period is 60 days for a foreign transfer.

12. *See infra* notes 33-34 and accompanying text. In addition to these enumerated precautions, performance licenses for music should be obtained, as well as releases for the filming of distinctive locations, buildings, businesses, personal property, and products.

writer. The writer supplies the blueprint for the entire production and has the responsibility of making the story not only appealing, but portrayable. The production cost of a story is largely dependent on how it is structured in the screenplay. Therefore, the writer should be fully informed of budget constraints before the screenplay is developed.[13]

The director has the meticulous responsibility of translating the screenplay into a motion picture. Bringing the director into the project at a point where he can contribute to the production of the screenplay can greatly facilitate the entire preproduction process. The more thorough knowledge the director has of the story, the better he can supervise the staffing of cast and crew, the budgeting of scarce resources, and the scheduling of film shooting. Although the director has ultimate responsibility over these areas, he has, of course, assistants to help in the daily execution of these tasks.[14]

C. The Production Budget

The budget for producing a motion picture is largely controlled by the anticipated market for the film. Every project has a minimal amount of capital necessary to produce it at a targeted level of quality. The level of quality must be maintained not only through principal photography, but throughout post-production as well. The entire chain of production is only as strong as its weakest link; if too much of the budget is expended early in the production and cut-backs must be made in

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13. *See infra* note 15 and accompanying text.

14. One of the director's principal assistants is the unit production manager. The unit production manager's duties include finalizing and implementing a detailed production budget, planning all logistics through the completion of principal photography, and streamlining the shooting schedule for greatest efficiency. Typically, a unit production manager negotiates for crew, equipment, locations, and catering on behalf of the producer. Such a person must be thoroughly acquainted with film production and have strong "people" skills.

Another indispensable member of the director's staff is the first assistant director. The duties of the first assistant director are to run the on-set production under the watchful eye of the director, to be the director's liaison with the unit production manager (who controls the purse strings) and other members of the crew and staff, and to ensure that the production remains on schedule. The duties of the unit production manager and the first assistant director are so closely related to planning and implementing the details of the production that both should be included in the preproduction preparation as soon as resources allow. *See* G. GOODELL, INDEPENDENT FEATURE FILM PRODUCTION 65-66 (1982).

the later stages, the additional quality gained earlier will be diminished by lesser post-production quality.[15]

1. *The cast*

Whether the casting of a film controls the budget, or the budget controls the casting is largely dependent on the principles of quality discussed above. If large amounts of capital are made available to attempt to ensure a successful film venture, the cost of specific principal actors with strong box office appeal can be budgeted ahead of time. If, however, the production budget is limited, and actors must be cast who will work within those financial restraints, a more vigorous casting effort will be necessary to find the most qualified actors who will work within those contract ranges. In any case, a casting director with intimate knowledge of the industry, especially regarding "going rates" and actors' abilities is best employed to cast the principal and supporting actors.[16]

2. *The crew*

The producer, with the help of the director and production manager, will typically select the key members of the production crew.[17] They will in turn select their own production staffs. Achieving a high level of technical competence in the production

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15. For these reasons, as with the unit production manager and the first assistant director, the director should be included in the planning process as early as the venture's resources will allow. They will add a wealth of experience in estimating the amount of capital necessary to produce the motion picture at the anticipated level of quality. For an in-depth analysis of motion picture production budgets, see *id.* at 68-74.

16. The casting director, as well as counsel should be thoroughly acquainted with the rules and regulations of the Screen Actors Guild and should be capable of negotiating contracts with actors' agents. The casting director acts under the direction of the producer and director, who make the ultimate casting decisions. Because no criteria exist to establish the credentials of one claiming to be a casting director, a prudent method of securing the names and addresses of qualified casting directors would be to contact Breakdown Services Ltd., 8111 Beverly Boulevard, Suite 308, Los Angeles, CA 90048 (request the C/D Directory).

17. The key members of the production crew are generally the director of photography (cameras and lighting), sound mixer (recording and balancing sound), gaffer (chief electrician), key grip (supervises assistants to gaffer), production designer (plans and supervises visual design), property master (inventory and maintenance of props), wardrobe master (inventory and maintenance of wardrobe), key makeup artist (applies and supervises makeup and hairdressing), special effects expert (plans and executes special effects), stunt coordinator (plans and executes stunts), location manager (scouts and secures production sites), still photographer (still photographs), and set construction foreman (key carpenter).

of a feature-length motion picture is important to the overall quality of the finished product. Therefore, the best-qualified crew members available within the production budget should be secured. If union personnel are to be used, such a determination must be made early in the planning stages so that budgetary and scheduling considerations might be adequately contemplated.

3. Using union personnel

Some of the advantages of using union crew members are the wide availability of qualified personnel, union certification of the members' level of expertise, and the smooth running nature of productions under the organized structure mandated by union rules. Some disadvantages of using union crew members are the inflexibility of union rules and regulations, the need to abide by state and federal laws governing labor contracts, and the high level of regular and overtime wages, including health and pension benefits. However, most of these disadvantages are outweighed by the quality of personnel that are available through unions.

The largest union governing motion picture production personnel is the International Alliance of Theatrical Stage Employees and Moving Picture Machine Operators of the United States and Canada (IA). Affiliated with the American Federation of Labor-Congress of Industrial Organizations (AFL-CIO), the IA controls technicians and others from production and post-production through distribution. Most of the premier technicians in the film production industry are members of the IA and can be secured only through labor agreements with the union. Such agreements generally require that a minimum number of IA members be employed on the project,[18] and narrowly define job categories for all crew members from which they may not deviate in the performance of their duties. This isolation of duties can lead to inefficiency because idle crew members may not help busy members regardless of the need.[19]

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18. Typically, the minimum number is 25.

19. Another example of the inefficiency of union rules is the dual location requirement. If a scene is to be photographed outside of the geographic jurisdiction of the union local, either new members of the foreign local (who are unfamiliar with the director and the production) must be hired to replace the old crew, or a "standby" crew from the new local must be hired to "watch over" the original crew which has been moved to the new location. In either case, the union ensures the employment of two crews during a single photographic session.

If any IA member, or a producer who has signed an IA contract, works on a motion picture production, then the union contract mandates that all crew members performing duties over which the IA has jurisdiction must be IA members. A producer may risk using a "mixed" crew, but does so at the peril of being delayed if the IA discovers the unauthorized personnel and orders the IA members off the production. Therefore, counsel should carefully advise producers of the burdens and benefits accompanying union contracts, and the possible risks associated with avoiding them.

4. Equipment

Although securing the proper equipment for producing a motion picture falls under the responsibilities of the producer and production manager, counsel should participate in the negotiations for equipment rental to ensure that the contracting rental house will quickly repair or replace faulty equipment.[20] Because of the great expense of delay, rental contracts should outline the responsibilities of the rental house in detail regarding the replacement and repair of such faulty equipment.[21] Services procured for the production, such as from film and sound laboratories, should be negotiated with care equal to that for on-site equipment.

III. INSURANCE

Accidents, oversights, and acts of God or man can devastate a film production budget. To ensure that costs do not skyrocket because of delay due to theft, vandalism, accident, death, injury, sickness, lawsuits, errors, etc., adequate insurance should be secured. The following types of insurance are essential and should be procured for the production of a feature film regardless of the nature of the financing vehicle used.[22]

A. Cast and Crew Insurance

The most valuable asset of any film production is the people that participate in it. Because of the highly specialized nature of

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20. Most rental agreements are standard contracts drafted by counsel for the rental houses and must be renegotiated for any special considerations.

21. This ensures that valuable portions of the production budget are not expended on idle cast and crew during related down-time.

22. This list should not be considered exhaustive.

all of the components of filmmaking, no one is dispensable. From the principal actors to the set builders, if something unfortunate should befall one of them, he or she would have to be cared for and replaced immediately. For a member of the cast, this might necessitate reshooting scenes in which that person appeared. For a member of the crew, it means having to be replaced quickly. Every hour that production is halted costs many thousands of dollars. The prohibitive costs of these contingencies can be covered with the purchase of appropriate insurance.[23]

1. *Death and disability insurance*

If a member of the cast or the director should suffer death, injury, or illness, cast insurance reimburses the production company for extra expenses incurred in completing principal photography.[24] Counsel should negotiate with the insurance company regarding coverage of other crew members, depending on the availability of replacements. Insured parties must usually be examined by the insurer's doctors who check for pre-existing conditions. Coverage begins approximately two weeks before filming,[25] and ends a reasonable time after filming is scheduled to terminate, allowing for some delays.[26] Cast insurance covers the production company's cost to replace the disabled person, but workers' compensation insurance covers the injured party's expenses during recovery.

2. *Workers' compensation*

State law mandates that employers provide workers' compensation insurance for employees to cover against the eventuality of death, disability, or disease that occurs in the course of, or arises out of employment. In most states, this applies to all temporary and permanent cast and crew members, even those claiming "independent contractor" status for income tax purposes. Failure to carry workers' compensation insurance leaves the production company vulnerable to civil liability, and violates the law of most states.

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23. The approximate cost of insurance for a feature film production is two percent of the film's budget, plus five to 6 percent for a completion guaranty bond, plus the cost of workers' compensation insurance (approaching 10 percent in some cases).

24. *See* G. GOODELL, *supra* note 14, at 76.

25. *Id.*

26. Weiss & Benjamin, *supra* note 7, at 208.

B. Theft or Destruction of Sets and Equipment

Props, sets, and wardrobe insurance covers against loss, damage, or destruction of those items during production.[27] Should circumstances necessitating a claim against the props, sets, and wardrobe insurance arise, extra expense insurance reimburses the production company for the attendant costs of delay.[28] Miscellaneous equipment insurance covers loss, damage, or destruction of cameras. It also covers sound, lighting, camera, and grip equipment.[29] Film production equipment and other associated property is costly to replace and should always be fully insured to protect the production budget.

C. Theft or Destruction of the Negative or Film

Negative, film, and videotape insurance covers loss, damage, or destruction of raw film or tape stock, exposed film, and sound tracks and tapes.[30] This coverage has limits, however, and may not insure against some types of loss due to human error.[31] Faulty stock, camera, and processing insurance covers some of the limitations mentioned above, but also fails to insure against errors in judgment.[32]

D. Tort Liability

Property damage liability insurance reimburses for damage to or destruction of the property of others while in the control, care, or custody of the production company.[33] Comprehensive liability insurance covers against bodily injury and property damage claims associated with filming and includes the use of non-owned vehicles, except air and watercraft. Errors and omissions insurance protects against tort claims arising from misappropri-

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27. G. GOODELL, *supra* note 14, at 78.

28. *Id.*

29. *Id.* This equipment is covered whether owned or rented by the production company.

30. *Id.*

31. For example, loss due to fogging, faulty equipment, developing, editing, processing, camera work, exposure to light, dampness, or extreme temperature, or errors in exposure, lighting, recording, or incorrect selection of stock are not covered. *Id.*

32. Production members should be obligated to perform their duties with extreme caution to reduce the possibility of ever needing to make claims against these types of insurance.

33. G. GOODELL, *supra* note 14, at 79. There may be limits to damage caused by certain types of vehicles.

ation, breach of contract, breach of confidence, violation of moral rights, libel, slander, defamation of character, and invasion of privacy. Although these tort actions can be insured against, an insurer will not issue a policy until rigorous copyright title searches have been completed and all pertinent written releases secured.[34] Guild/Union flight accident insurance fulfills contract requirements with guilds and unions providing blanket aircraft accidental death insurance for the cast and crew. Together, these forms of insurance shield the production company from most tort liability.

E. Completion Guaranty Bond

Because delays in production are the greatest single source of budget overrun, prudent counsel should advise procuring a completion guaranty bond[35] to insure against unforeseen delay. Sources of delay on a film production project are as numerous as the components that go into a film production. Supplying the bond will render the investment much more stable in the eyes of potential investors.

In the event the completion guarantor must step in, he may attempt to avoid his duties under the bond by claiming fraud on the part of the production company.[36] This failing, he would attempt to take complete control of the production.[37] Neither of these possibilities is attractive; thus, the producer has more than a little incentive to complete the film on time and on budget. In any event, counsel should ensure that the triggering events enumerated in the bond are based on objective criteria[38] to protect the producer's right of artistic control of the production.

IV. The Limited Partnership

The most popular and feasible vehicle for raising investment capital for producing independent feature films is the limited partnership. Limited partnerships are flexible and can be

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34. *See supra* note 6 and accompanying text.

35. The completion guaranty bond is much like a performance bond for any other interim financing project; issued by a third party guarantor for a premium after he has thoroughly evaluated the ability of the production company to complete the project on time. *See generally*, Weiss & Benjamin, *supra* note 7, at 205-06.

36. *Id.*, at 204-06 & n.20.

37. *Id.* at 206-07.

38. Typically, an agreed percentage over budget or number of days behind schedule. *See id.* at 207.

structured to allow many investors to participate, thus not requiring a large investment from any single participant. The Uniform Limited Partnership Act (1916), [hereinafter ULPA][39] defines a limited partnership as "a partnership formed by two or more persons[40] under the provisions of [state statutes], having as members one or more general partners and one or more limited partners."[41] The general partners have the responsibility of actively managing the affairs of the limited partnership and have unlimited liability for its debts. Conversely, the limited partners have a passive role in management and are liable for the debts of the partnership only to the extent of their investment. A major benefit of the limited partnership investment is that partnership profits are taxed only once—at the individual level—unlike standard corporate profits, which are taxed at both the corporate and individual levels.

A. Formation of a Limited Partnership

1. Certificate of limited partnership

To form a limited partnership the partners must sign and swear to a Certificate of Limited Partnership (certificate)[42] and record it in the governmental office designated by the statute of the state in which the limited partnership is being formed.[43] Section 2(1)(a) of the ULPA enumerates the information that must be included in the certificate.[44]

If at any time the information in the certificate no longer accurately reflects the status of the limited partnership, it must

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39. All states except Louisiana have adopted either the ULPA, or the more recent version of it, the Revised ULPA.

40. The Uniform Partnership Act (which governs limited partnerships where the ULPA is silent) defines "person" as "individuals, partnerships, corporations and other associations." U.P.A. § 6(1), (2) (1916) [hereinafter UPA].

41. ULPA § 1. It is beyond the scope of this article to guide counsel through the complicated and specialized field of forming, operating, and advising a limited partnership. For a comprehensive treatment of that subject, see, Falk, 24-2nd C.P.S. (BNA), *Limited Partnerships: Legal Aspects of Organization, Operation, and Dissolution* (1987).

42. ULPA § 2. The certificate must contain the information specified in the state statute, generally that contained in § 2(1)(a), unless the state has adopted a shortened form of the certificate.

43. ULPA § 2(1)(b).

44. This includes, among other things, the names and addresses of the general and limited partners, the past and future capital contributions of each limited partner, and each limited partner's share of the profits based on his capital contribution. ULPA § 2(1)(a).

be amended.[45] Because such changes are not recognized by law until the amendments are properly recorded, counsel should ensure timeliness in drafting and recording them. Because the certificate contains only a summary of the structure of the limited partnership, parties often draft a more comprehensive document to govern their business relationships called the Limited Partnership Agreement, or sometimes, the Articles of Limited Partnership.[46]

2. *Limited partnership agreement*

The agreement often governs such aspects of the parties' business relationship as the allocation of profits and losses and participation in the management of the business. These relationships must be carefully considered and incorporated into the agreement, not only to promote the efficiency and potential of the enterprise, but also to preserve its favored tax status.[47] Counsel drafting agreements often seek to "narrow the scope of and more sharply define the general partner's fiduciary duties to the partnership and its partners" by including very specific limiting provisions.[48]

B. Contributions

In most states contributions to the enterprise by limited partners may be in the form of cash, property, or services in ex-

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45. Events enumerated in the ULPA that trigger a need to amend are as follows: (1) changes in the members of the limited partnership; (2) a change in the name of the enterprise or in the nature of its business; (3) a change in the amount or nature of the contribution of any limited partner; (4) a change in the continuation or dissolution of the enterprise; or (5) an agreed change in relationships among the partners or limited partners. ULPA § 24(2).

46. Counsel should ensure that the certificate and agreement are consistent in every detail, or courts could give greater weight to the recorded document, invalidating the contradictory terms of the agreement.

47. If the statutes controlling the formation and operation of limited partnerships are not "substantially" complied with, the favored tax status of limited partnership could be denied. ULPA § 2(2); IRS Classification of Organizations for Tax Purposes, 26 C.F.R. § 301.7701-1(b), (c) (1988).

48. Falk, *supra* note 41, at A-38. To avoid potential conflict of interest liability, counsel should include a narrow "purpose of the partnership" provision and a statement allowing the general partners to engage in other similar enterprises. *Id.* A statement limiting the amount of time that the general partners need to devote to the enterprise and limiting their responsibility for adverse consequences of their business decisions to a "gross negligence" standard could help to avoid litigation in the event of loss of the limited partners' contributions.

change for limited partnership interests.[49] Contributions can often be required at the time of entry into the limited partnership, delayed until a later date, or made in installments over any period of time.[50] To provide added security for investors, some limited partnerships utilize a capitalization escrow account.[51]

V. THE OFFERING

Limited partnership interests are "securities" under the broad definitions of both state and federal law.[52] As such, all sales and offers to sell limited partnership interests must comply with applicable state and federal securities law. Registering a limited partnership offering with the appropriate state and federal agencies is a time consuming and costly undertaking. For this reason, it is desirable to seek to qualify an offering under one of the registration requirement exemptions available under applicable law.[53]

The following are suggestions for counsel to consider in recommending possible appropriate exemptions to clients. These exemptions are well-suited to independent motion picture production for reasons that are enumerated within each section. The positive aspects and potential hazards of each exemption are flagged within its section to assist counsel in evaluating the overall costs and benefits of each offering exemption.[54]

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49. Under ULPA § 4, the contribution of services in exchange for limited partnership interests are prohibited, but most states have recently adopted a more liberal position. Counsel must ensure that such contributions are valid in each state where the limited partnership interests are offered or warn against such contributions. No restrictions exist in any state on the form that a general partner's contribution may take.

50. This is not true of registered public offerings. 17 C.F.R. § 240.3a12-9 (1988).

51. This device ensures a full refund of investors' contributions if the business fails to raise the full amount of the offering. Whatever the method of collecting contributions, it must be properly documented in the certificate and agreement and adhered to in every detail.

52. Securities Act of 1933, as amended, § 2(1), 15 U.S.C. § 77b(1) (1982); SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946) ("certificate of interest or participation in any profit-sharing agreement . . . .").

53. It is beyond the scope of this comment to provide a detailed analysis of the methods of qualifying an offering for exemption from the requirements of state securities laws. The requirements of each state's own Blue Sky laws must be fulfilled in detail to avoid a violation of those laws. In many states, however, the Blue Sky laws exempting an offering from registration requirements complement the federal requirements.

54. Counsel not well versed in the law of securities and securities offerings should seek expert advice before proceeding with an offering; the hazards are numerous and the liability staggering.

Federal law provides four exemptions[55] from the registration requirements of section 5 of the Securities Act of 1933[56] (hereinafter Securities Act,[57]) that are particularly useful for capitalizing independent film projects. They are (1) the section 3(b) "small offering" exemption,[58] (2) the section 4(2) "private placement" exemption,[59] (3) the section 4(6) "accredited investor only" exemption,[60] and (4) the section 3(a)(11) "intrastate" exemption.[61]

To "simplify and clarify" the first two exemptions above, sections 3(b) and 4(2), and "expand their availability, and to achieve uniformity between Federal and State exemptions in order to facilitate capital formation consistent with the protection of investors,"[62] the Securities and Exchange Commission (SEC) promulgated Regulation D.[63] Regulation D comprises Rules 501 through 506. Rules 501 through 503 contain general provisions applicable to the three exemptions provided in Rules 504 through 506.[64] Rule 505, the "small offering" exemption under section 3(b), provides an exemption for offerings not exceeding $5,000,000. Rule 506, is a "safe harbor" provision under section 4(2), and provides a "private placement" exemption regardless of the dollar amount of the offering.

Another possible exemption existing under Regulation D is contained in Preliminary Note 7:

> Offers and sales of securities to foreign persons made outside the United States effected in a manner that will result in the securities coming to rest abroad[65] generally need not be registered under the Act. This interpretation may be relied on for

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55. Although other exemptions exist, these are most appropriate for the size and type of offering contemplated by this comment.

56. 15 U.S.C. § 77e (1982).

57. 15 U.S.C. §§ 77a-77bbbb (1982).

58. 15 U.S.C. § 77c(c) (1982).

59. 15 U.S.C. § 77d(2) (1982).

60. 15 U.S.C. § 77d(6) (1982).

61. 15 U.S.C. § 77c(a)(11) (1982).

62. SEC Release No. 33-6389 (Mar. 8, 1982).

63. 17 C.F.R. §§ 230.501-230.506 (1988).

64. Because Rule 504 provides an exemption for offerings not exceeding $500,000, an insufficient sum to produce a quality feature-length motion picture, Rule 504 is excluded from further consideration.

65. *See* NABU Manufacturing Corp., pub. avail. Sept. 24, 1982. *See also* Atlantic Metropolitan Corp., pub. avail. Jan. 21, 1983.

such offers and sales even if coincident offers and sales are made under Regulation D inside the United States.[66]

A. The Section 3(b) Small Offering Exemption

Section 3(b) of the Securities Act authorizes the SEC to exempt small or limited offerings from registration.[67] Such an exempted issue of securities is limited to a $5,000,000 aggregate offering ceiling.[68] It was pursuant to its goal of making such exemptions broadly available that the SEC promulgated Rule 505 of Regulation D. Rule 505 exempts offers and sales of securities by non-investment company[69] issuers.[70]

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66. Preliminary note 7 to Regulation D, *citing* SEC Release No. 33-4708 (July 9, 1964) (citation omitted). It is beyond the scope of this comment to treat this exemption in depth; however, because of the excellent source of capital available under this exemption, counsel should investigate its possible usefulness for any particular offering. *See generally* Elkins & Meeks, 51 C.P.S. (BNA), *Regulation D* (1986) [hereinafter Elkins & Meeks]. Foreign sales are also not counted against the limited number of purchasers (*see infra* notes 71-74 and accompanying text.) or the aggregate offering price (Preliminary note 7 to Regulation D).

67. The SEC is empowered to add any class of securities to the securities exempted in § 3 if it determines that enforcement under the Act regarding those securities is not necessary in the public interest and for the protection of investors because of the small amount involved or the limited nature of the offering.

68. Rule 501(c); Rule 505(b)(2)(i) ("shall not exceed $5,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering of securities under [Rule 505] . . . .").

69. The SEC staff has taken the position that "investment company" as used in Regulation D has the same meaning as in the Investment Company Act of 1940 (ICA), as amended. 15 U.S.C. § 80a-1 (1982). Section 3(a) of the ICA defines "investment company" to mean

> any issuer which— (1) is or holds itself out as being engaged primarily, in the business of investing, reinvesting, or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percentum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Section 3(c) of the Act sets forth various exceptions. *Id.* at § 80(c)(1)-(13).

70. In addition to the aggregation and investment company limitations outlined above, limitations regarding the number of purchasers, integration, information requirements, the manner of offering, resale, and filing of notice of sales must be complied with in detail to qualify for the exemption.

1. Number of purchasers

Rule 505(b)(2)(ii) provides that an issuer must "reasonably believe"[71] that no more than thirty-five purchasers will participate in the offering.[72] Accredited investors[73] are not counted against the thirty-five purchaser limit of Rule 505(b)(2)(ii).[74] Because of the large amounts of capital required to produce feature length motion pictures, the 35 purchaser limit requires large individual investments on the part of each accredited investor. For this reason it is desireable to limit the amount required of each purchaser by qualifying as many purchasers under the above definitions of accredited investor and single purchaser as possible.

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71. Rule 505(b)(2)(ii) requires that an issuer be in possession of facts sufficient to establish a belief that there are no more than 35 purchasers. An issuer should compel a purchaser to complete and sign a questionnaire qualifying the purchaser as an accredited investor and represent in the subscription agreement that he is purchasing the securities for his own account and that no other person has any direct or indirect beneficial interest in the securities. *See* Elkins & Meeks, *supra* note 66, at A-52.

72. Rule 501(e) sets forth the method of calculating the number of purchasers of an offering. Rule 501(e)(1)(i) through (iv) contains broad exclusions regarding purchasers, the most important of which is the "accredited investor" (501(e)(1)(iv)) provision of Rule 501(a).

73. The Rule 501(a) definition of accredited investor takes into account such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management, and combines and repeats the provisions of the definition under § 2(15) of the Securities Act and Rule 215 thereunder, with some modification.

The enumerated categories of accredited investors are as follows:

(1) institutional-type investors; (2) private business development companies as defined in § 202(a)(22) of the Investment Advisers Act of 1940; (3) organizations described in § 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000; (4) directors, executive officers, or general partners of the issuer or his general partner; (5) persons whose individual or joint net worth at the time of the purchase exceeds $1,000,000; (6) persons who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expect an income in excess of $200,000 in the current year; or (7) entities in which all of the equity owners are accredited investors. Rule 501(a).

74. Rule 501(e)(1)(i) through (iii) contains other broad exclusions regarding the calculation of the number of purchasers and provides that in some instances, multiple purchasers may be counted as one. Some of the possible combinations of purchasers that may be counted together are purchasers and their organizations; relatives of purchasers that live in the same residence; and the trusts, estates, and corporations in which a purchaser and such relatives own at least 50% of the beneficial interests. Business entities are counted as individual purchasers under Rule 501(e)(2). If the entity was formed for the limited purpose of purchasing the securities of the particular offering, the beneficiaries will be counted separately.

2. Integration

Rule 502(b) provides that distinct offerings must be kept separate to retain their exempt status. In the event they are integrated, they could exceed the exemption limits and be disqualified from the benefit of the exemption. This rule prevents an issuer from circumventing section 5 registration requirements by dividing an unqualifying single offering into a series of sub-offerings, and claiming an exemption for each. In the case of feature-length motion picture financing, this problem generally will not arise because of the narrow purpose of the limited partnership, *i.e.*, producing the particular motion picture.[75]

3. Information requirements

If sales are made only to accredited investors, no specific information is required to be furnished to purchasers.[76] If sales are made to one or more unaccredited investors, however, the disclosure requirements of Rule 502(b)(2) must be satisfied with respect to all purchasers.[77] For most private offerings, a copy of the agreement and other important documents will be attached to the Private Placement Memorandum, and together, will include all of the necessary information regarding the offering.[78] Such a memorandum may be prudently circulated[79] to inform potential investors of the investment opportunity.[80]

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75. A potential problem could arise, however, if the issuers later decide to distribute the film themselves and offer interests in a distribution company established to distribute the film that is the object of the first offering. To avoid this potential problem, the issuer should avoid making the offerings too close together as outlined in Rule 502(a). Another option is to carefully document the distinguishing characteristics of the separate offerings in the event their separateness is challenged.

76. Rule 502(b)(1)(i).

77. Rule 502(b)(1)(ii). Rule 502(b)(2)(i) details what information must be furnished, depending on the size of the offering. For most offerings, this will be similar to the information required in Part I of Form S-18, except that only the financial statements for the issuer's most recent fiscal year must be certified by an independent certified or public accountant. For a more detailed analysis of the information requirements of Rule 502(b)(2), see Elkins & Meeks, *supra* note 66, at A-33 through A-39.

78. The information in the memorandum, as well as the other principal documents must harmonize.

79. *See infra* notes 81-83 and accompanying text.

80. The memorandum should disclose all factual, financial, and legal information regarding all aspects of the offering—positive and negative. Because independent motion picture production is an historically high-risk investment, this fact must be prominently disclosed. Prudent counsel will ensure that such disclaimers are placed at two locations in the memorandum: on the opening page and in the body. For an example of such an opening page and disclaimer, see G. GOODELL, *supra* note 14, at 22. For an example of

4. Manner of offering

Rule 502(c) prohibits offers or sales through general solicitation or advertising, or seminars whose attendees have been invited through those means.[81] The prudent circulation of a Private Placement Memorandum,[82] however, describing the investment in detail, does not necessarily constitute a general solicitation or advertising.[83]

5. Limitations on resale

Securities acquired in a Regulation D transaction have the status of securities acquired under section 4(2) and cannot be resold without registration under section 5 absent an exemption.[84] An investor that purchases for the purpose of selling the securities at a later date could be classified as an "underwriter" under the Securities Act, which would disqualify the entire offering from the registration exclusion. To ensure that this does not happen, Rule 502(d) enumerates precautions that the issuer should take.[85]

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what should be included in the memorandum, see *id.*, at 23-35. The memorandum can be the most potent sales tool the issuer has. If properly drafted, it will fulfill its purpose of notifying the prospective investor of the high-risk nature of film investing, while communicating the desirability of investing in the particular film project.

81. *See also* 17 C.F.R. § 230.146 (1986).

82. *See supra* notes 76-80 and accompanying text.

83. Care must be taken not to circulate the memorandum too widely and violate the prohibition. "Too widely" has reference to the nature of the prospective purchasers, and the issuer must be careful to approach primarily just those who qualify. The inclusion of too many unqualified persons could render the effort a general solicitation, disqualifying the offering from the benefit of the exemption. For a more detailed analysis of the limitations on the manner of offering, see Elkins & Meeks, *supra* note 66, at A-39 through A-43.

84. Rule 502(d).

85. The issuer must make "reasonable inquiry" to determine if the purchaser is acquiring the securities for himself or for others. Rule 502(d)(1). The issuer should also make a written disclosure to each purchaser and place a legend on the securities stating that they are not registered and that their transferability is restricted. Rule 502(d)(2)-(3). Further, the issuer should ensure that such resale restrictions are outlined in detail in the agreement and the subscription agreement. The issuer will be held to a "reasonable care" standard in determining whether it allowed an underwriter to purchase its offering.

6. Filing the notice of sales—summary

Rule 503 requires that copies of the Form D notice of sales of securities be filed with the SEC to apprise it of an exempt offering under Regulation D.[86]

The small offering exemption provided under section 3(b) is an excellent method of raising capital to produce feature-length motion pictures with production budgets below $5,000,000. If a larger budget is required for the production of the film, the section 4(2) private placement exemption, which contains no limitations on the amount that can be sold in the offering, is available.

B. The Section 4(2) Private Placement Exemption

Section 4(2) of the Securities Act[87] exempts transactions "not involving any public offering" from the section 5 requirement of registration. To create a "safe harbor" for the section 4(2) exemption, the SEC promulgated Rule 506 of Regulation D. If every requirement of Rule 506 is met, compliance is assured, and the exemption will be secure.[88] However, noncompliance with Rule 506 does not necessarily preclude the availability of the section 4(2) exemption.[89] As with all of the exemptions discussed in this article, prudent counsel should seek to qualify an offering under as many exemptions as possible to ensure exempt status in the event of disqualification under the first.[90]

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86. The notice must be filed within 15 days of the first purchase and sent to the SEC's principal office in Washington, D.C., located at 450 Fifth Street, N.W., Washington, D.C., 20549. The information required in Form D is basic to the nature of the offering and its principals. Copies of Form D are available from the Public Reference Branch of the SEC's main office or any of its regional offices. Sales made specifically under Rule 505 must include on Form D an "undertaking" by the issuer to furnish the SEC, on written request, with the information that the issuer must make available to unaccredited investors. This requirement is not burdensome.

87. 15 U.S.C. § 77d(2) (1982).

88. Rule 506(a), (b).

89. Preliminary Note 3 to Regulation D.

90. Rule 506 contains no limitation on the dollar amount of an offering and precludes no particular class of issuer. Rule 506 does limit the number of purchasers to 35 (other than excluded categories of purchasers), [*see supra* notes 71-74 and accompanying text] who must meet a "sophistication" test. The same exclusions for accredited investors and certain other combineable purchasers exist for Rule 506 as for Rule 505. No "sophistication" requirement is present for Rule 505 purchasers; however, this requirement should be observed in some detail to ensure compliance with Rule 506.

1. Nature of purchasers—the "sophistication" test

Rule 506(b)(2)(ii) requires that the issuer "reasonably believe" immediately prior to making any sale that each unaccredited investor either alone or with his "purchaser representative"[91] has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.[92] Absent meeting the business sophistication standard, minimal financial requirements of the potential unaccredited investor[93] are generally prescribed by the issuer of the securities.[94]

2. Other requirements and limitations

As with Rule 505, Rule 506 is subject to the integration guidelines set forth in Rule 502(a),[95] the information requirements of Rule 502(b),[96] the limitation on the manner of offering of Rule 502(c),[97] the limitations on resale set forth in Rule 502(d),[98] and the filing of notice of sales requirements under Rule 503.[99] If all of the requirements of Rules 501 through 503 and the specific requirements of Rule 506 are complied with, the safe harbor of Rule 506 will be available, and will shelter the issuer from the necessity of registering the offering under section 5.[100]

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91. The qualifications of such a person are prescribed in Rule 501(h). The issuer of the securities must "approve" the purchaser representative as one who is qualified under the rule.

92. The SEC has provided little guidance in determining what constitutes qualification under the rule, so issuers should require that prospective purchasers or their purchaser representatives complete, sign, and return questionnaires designed to elicit that information.

93. Again, care must be taken that a limited number of unaccredited investors are approached concerning, or included in, the offering or the exemption could be lost. *See supra* notes 71-74 and accompanying text.

94. This protects the issuer against possible claims of taking advantage of unaccredited investors' lack of business sophistication.

95. *See supra* note 75 and accompanying text. The same rules apply to Rule 506 as Rule 505.

96. *See supra* notes 76-80 and accompanying text. The same rules apply to Rule 506 as Rule 505.

97. *See supra* notes 81-83 and accompanying text. The same rules apply to Rule 506 as Rule 505.

98. *See supra* notes 84-85 and accompanying text. The same rules apply to Rule 506 as Rule 505.

99. *See supra* note 86 and accompanying text. The same rules apply to Rule 506 as Rule 505 except for the "undertaking" requirement.

100. These requirements do not place a great burden on the issuer, and therefore

C. *The Section 4(6) Accredited Investor Only Exemption*

Section 4(6) of the Securities Act[101] provides an exemption from the registration requirements of section 5 for offers or sales by an issuer made solely to accredited investors.[102] This exemption is subject to compliance with the section 3(b) aggregate offering price limitation,[103] the section 4(2) ban on general advertising or public solicitation,[104] the Form D filing requirements of Rule 503,[105] and *probably* the Rule 502(d) restrictions on resale of the securities.[106] Another limitation of the section 4(6) exemption is that its definition of "accredited investor" is governed by section 2(15) and Rule 215, which do not contain the Rule 501(a) "reasonable belief" standard. Therefore, an issuer that makes a sale to a purchaser whom he reasonably believes (after taking necessary precautions) is an accredited investor, will lose his section 4(6) exemption status for the entire offering if the SEC determines the purchaser was not an accredited investor. Needless to say, counsel should advise extreme caution in screening accredited investors under the section 4(6) exemption.

Although somewhat narrow in its availability, the section 4(6) accredited investor only exemption provides an excellent vehicle for capitalizing a limited partnership formed for the purpose of producing a feature-length motion picture if such affluent investors can be procured.

D. *The Section 3(a)(11) Intrastate Exemption*

Section 3(a)(11) of the Securities Act[107] exempts from section 5 registration requirements offerings made solely to residents of the same state as the issuer.[108] The exemption has been

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the exemption provided under § 4(2) from the registration requirements of § 5 is a source of capital that should be seriously explored by the producer of a feature-length motion picture with a production budget in excess of $5,000,000.

101. 15 U.S.C. § 77d(6) (1982).

102. It is possible to lose the § 4(6) exemption if just one offer is made to an unaccredited investor; therefore, extreme care need be taken to avoid such an eventuality.

103. Currently $5,000,000. *See supra* notes 67-86 and accompanying text.

104. *See supra* notes 81-83 and accompanying text.

105. *See supra* note 86 and accompanying text.

106. *See supra* notes 84-85 and accompanying text. Although on its face § 4(6) must comply only with the first three provisions mentioned in the text, the SEC staff has informally taken the position that securities acquired in a § 4(6) transaction are "restricted securities." *See* Elkins & Meeks, *supra* note 66, at A-6.

107. 15 U.S.C. § 77c(a)(11) (1982).

108. The issuer and offerees must meet residency requirements—the securities must be "offered and sold only to persons resident within a single State or Territory, where

narrowly construed when considered separately from SEC Rule 147,[109] which creates a "safe harbor" under section 3(a)(11) by establishing objective criteria for assuring compliance with the statute.[110] Under Rule 147, an individual offeree or purchaser is a resident of the state of his principal residence.[111]

The section 3(a)(11) exemption is narrow in its application due to its purely "intrastate" nature; however, in a state with sufficient capital resources, the limited partnership might be well-advised to seek exemption under this umbrella to capitalize an offering.

E. Non-Applicability to Other Provisions and Regulatory Schemes

The exemptions enumerated above apply only to the registration requirements of section 5 of the Securities Act.[112] It is important that counsel ensure that offerings do not run afoul of any of these laws to avoid possible disqualification from the use of the desired exemptions.[113]

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the issuer of such security is such person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." *Id.*

109. 17 C.F.R. § 230.147 (1986).

110. Rule 147 basically defines whether an issuer is a resident of, and doing business in, the state in which all offers and sales are made, and whether an offeree or purchaser is a resident of that state. Under Rule 147, an issuer is doing business within a state only if (1) 80% of its gross revenues are derived from activities within the state, (2) 80% of its assets are located within the state, (3) 80% of the proceeds from the offering are used for activities within the state, and (4) its principal office or place of business is located within the state. 17 C.F.R. § 230.147(c) (1986).

111. A business entity offeree or purchaser is a resident if its principal office is located within the state, regardless of where it may be doing business. 17 C.F.R. § 230.147(d) (1986). Counsel should ensure the availability of the § 3(a)(11) exemption by clarifying the status of a particular offering in regard to integration and limitations on resale under the statute.

112. They do not necessarily exempt an offering from the following provisions of law and regulatory schemes: state blue sky laws; state and federal antifraud provisions; state and federal broker/dealer regulations; state and federal investment company regulations; state and federal investment adviser regulations; state and federal legal investment laws; registration under § 12 of the Exchange Act [15 U.S.C. § 781 (1982)]; registration under the Trust Indenture Act of 1939, as amended [15 U.S.C. §§ 77aaa through 77bbb (1982)]; avoidance of tax-shelter regulations of the Internal Revenue Code of 1954; the margin regulations under § 7 of the Exchange Act [15 U.S.C. § 78g (1982 & Supp. II 1984)]; and other federal marginal regulations; or numerous other federal, state, and local laws governing the regulation of businesses. An in-depth treatment of these categories of law as they could apply to the exemptions enumerated above is beyond the scope of this article. For a general guide of what to watch for, see generally Elkins & Meeks, *supra* note 66, at A-7 through A-11.

113. To ensure qualification for the exemptions treated in greater detail above,

VI. Tax Consequences

A. *Before 1976*

Before the Tax Reform Act of 1976 (1976 Act),[114] very liberal tax advantages were allowed to film investors. Independent film production was heavily financed by high-income taxpayers seeking to shelter their income from high tax rates. Nonrecourse financing of a majority of the investment, with a relatively small amount of the investor's capital being put "at risk," provided "leveraging" of the investment to reap higher tax-sheltering benefits than the actual amount of capital invested warranted. The allowances for the Investment Tax Credit,[115] depreciation,[116] and associated deductions were all based on the leveraged amount of the investment instead of the capital actually invested or put at risk. This windfall resulted in high-income taxpayers seeking film investments not for the soundness of the individual projects as income generating business opportunities, but merely for the available tax-sheltering benefits. Wishing to induce taxpayers to invest in projects based on sound business principles rather than on artificial tax advantages, Congress sought to eliminate the "leveraging" aspects of film investment in the 1976 Act.

The 1976 Act restructured the law to limit the investment tax credit, depreciation, and business deductions to amounts of capital that were actually at risk. The use of nonrecourse loans no longer produced leveraged tax benefits because that money was not at risk.[117] This change eliminated the major incentive to invest in film production, leaving only the viability of the business project itself with its nonleveraged tax benefits to attract investment capital.

B. *The Tax Reform Act of 1986*

The limited tax advantages that survived the 1976 Act were effectively eliminated in the Tax Reform Act of 1986 (1986

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counsel should ensure strict compliance with all of the requirements enumerated in those exemptions. Regulation D, for example, contains no safe harbor for good faith or substantial compliance. Prudent counsel should guard that full documentation of compliance with the requirements of each exemption is retained in the event of a challenge. *See generally* Elkins & Meeks, *supra* note 66, at A-11, A-12.

114. Pub. L. No. 94-455, 90 Stat. 1520 (codified at I.R.C. §§ 280, 465 (1982)) (§ 280 repealed in 1986).

115. *See infra* note 120 and accompanying text.

116. *See infra* note 121 and accompanying text.

117. I.R.C. § 280 (1982).

Act).[118] Generally, Congress exchanged tax advantages for lower rates[119] in the 1986 Act in a further effort to discourage tax-sheltering investments and to encourage profit motivated investing of new-found disposable income. The 1986 Act completely repealed the Investment Tax Credit,[120] slowed the accelerated depreciation schedules of the Accelerated Cost Recovery System (ACRS),[121] and eliminated the practice of reducing "non-passive" income with losses and credits from "passive" income.[122] The severely-curtailed tax advantages that remain operate against a maximum personal tax rate of only twenty-eight percent.

With the virtual elimination of most tax incentives to invest in film production, the primary incentive that remains for investors, besides the glamour associated with any aspect of movie-making, is to make a profit. The profit history of independent film production is not encouraging. This history, however, could be distorted because of the tax-advantage investing that provided the impetus for the production of most films—including many with predictably no commercial value—prior to the 1986 Act. Now that most motion pictures will be funded based on perceived commercial merit, perhaps the ratio of films made, to profitable ventures, will narrow.

C. Pass-through to Limited Partners

Although the tax advantages of film investing have been greatly reduced, limited partnerships still enjoy the same benefits that are available to other businesses. Unlike a corporation, however, a limited partnership is not treated as a separate taxable entity for federal income tax purposes. The income is taxed only once; at the individual level. The income, gains, losses, de-

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118. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended throughout sections of the I.R.C.).

119. The 1986 Act reduced the tax rate ceilings for individuals to 28%, and to 34% for corporations.

120. The Investment Tax Credit was a first year reduction of an investor's tax liability by up to 6.66% of the total amount of capital at-risk in the investment.

121. I.R.C. § 168(e)(5) (1986). ACRS had allowed disproportionate amounts of depreciation to be claimed in earlier years and complete recovery (depreciation) of the investment over a five-year period. I.R.C. § 168 (1982) (amended 1986).

122. "Passive" income is defined as income derived from trade or business activities in which the investor does not materially participate. I.R.C. § 469(c) (West Supp. 1987). The investor may, however, deduct losses from passive activities from the income of other passive activities. I.R.C. § 469 (West Supp. 1987).

ductions, and credits obtained by a limited partnership are passed through directly to the limited partners, and treated separately on their own individual tax returns. A limited partner with a diversified portfolio may still offset passive income[123] with passive losses, receiving some sheltering benefit.

D. Dissolution

Reasons for the dissolution of a limited partnership are numerous. The dissolution of a successful venture will typically be governed by the terms of the agreement, but unforeseen events could trigger a dissolution by operation of law.[124] This is a persuasive reason for utilizing a carefully drafted agreement, although one is not generally mandated by law.[125] Because of the long and uncertain "useful" life of a completed motion picture, the dissolution of the partnership should be covered in great detail in the agreement. This will hopefully avoid delays in the distribution of the partnership's assets.

Factors such as film distribution agreements, box-office success, and literary property rights will affect the terms of the agreement governing the period of dissolution. Therefore, in addition to carefully drafting the agreement to ensure a smooth and efficient dissolution, counsel should ensure that contracts affecting these factors be drafted with an eye toward a smooth transition from vigorous business activity to prompt and effective dissolution.

VI. CONCLUSION

Although the tax benefits of independent feature-length motion picture financing have disappeared, and with them, a great deal of the capital that was formerly made available for

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123. A limited partner may also offset some "active" profits in certain limited circumstances, *e.g.*, investments in historic or pre-1936 real property and in new or rehabilitated low-income housing. Falk, *supra* note 41, at A-4.

124. An inexhaustive list of triggering events is contained in ULPA §§ 10(c), 16(4), and 20; *see generally*, UPA §§ 29 and 31. The UPA contains a more inclusive list of triggering events. Some of these events include: expiration of the term of the partnership, agreement of the parties, legal disability or withdrawal of a general partner, bankruptcy, or court order. Falk, *supra* note 41, at A-47 through A-49.

125. A limited partnership does not cease to exist at the time of dissolution. During the dissolution period the partners wind up the business of the partnership by "liquidating its assets, paying its debts, and distributing to the general and limited partners the partnership's retained earnings, paid in capital, and any other remaining assets." Falk, *supra* note 41, at A-49.

such projects, the limited partnership remains the best source of capitalization for independent film production. The unregistered offerings afforded to independent film producers via the limited partnership are an excellent source of capital if, as with any other proposed business venture, investors can be attracted to the project by its fiscal soundness and commercial appeal. This circumstance is not all bad in light of the fact that under the former system, most films were never viewed by paying audiences.

James L. Thompson