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ARTICLES

ONE PRODUCER'S INSIDE VIEW OF FOREIGN AND DOMESTIC PRE-SALES IN THE INDEPENDENT FINANCING OF MOTION PICTURES

Arnold Kopelson †

† Arnold Kopelson won an Academy Award in 1986 for his production of *Platoon*. He began his professional career in 1959 with the New York law firm of Cravath, Swaine & Moore while attending New York Law School, from which he received a Juris Doctor degree in 1959. He practiced entertainment and banking law, and later specialized in motion picture financing. Through 1970, he acted as special counsel to Chemical Bank and other banks and lending institutions in entertainment lending transactions.

In 1972, with Anne Feinberg, whom he married in 1976, Kopelson formed Inter-Ocean Film Sales, Ltd. ("Inter-Ocean") to represent independent motion picture producers in the licensing of their films throughout the world. Afterward, Kopelson pioneered the concept of theatrically distributing, in foreign markets, films that were expressly made for television, and began a long-term representation of ABC, the television network. He continued to practice law until 1982.

In 1979, Kopelson formed a joint venture with Boston-based General Cinema Corporation for motion picture production. Together they produced several films, including *Lost and Found*, starring George Segal and Glenda Jackson, with Inter-Ocean distributing the films to all territories outside of the United States and Canada. Since the formation of his production company, Kopelson has either executive-produced, produced, or packaged more than a dozen motion pictures, including *Porky's*, one of the most financially successful films in the history of the motion picture business.

Kopelson's production of *Platoon* received four Golden Globe Awards, the Independent Spirit Award for Best Feature, and won Academy Awards for Best Picture, Best Director, Best Sound, and Best Editing. *Platoon* joined the ranks of the most financially successful films of all time.

In 1987, Kopelson executive-produced a supernatural thriller entitled *Warlock*, starring Julian Sands, Richard E. Grant, and Lori Singer. Its recent success has inspired the domestic distributor to develop a sequel slated for production in 1992.

In 1989, Kopelson produced *Triumph of the Spirit* on location at the Auschwitz-Birkenau concentration camps in Poland. Critically acclaimed, *Triumph of the Spirit* was directed by Robert M. Young, and stars Academy Award nominees Willem Dafoe, Edward James Olmos, and Robert Loggia.

In November, 1989, Kopelson executive-produced the Touchstone Pictures release *Fire Birds*, a \$20-million production featuring the Apache AH-64 helicopter. *Fire Birds* was co-financed and licensed by Inter-Ocean in the foreign markets, and stars Nicholas Cage, Tommy Lee Jones, and Sean Young.

In November, 1990, Kopelson produced the Warner Brothers release *Out for Justice* starring Steven Seagal, which had a domestic theatrical gross of nearly \$40 million. At the writing of this article, the film was about to begin its foreign release.

I. INTRODUCTION

In June, 1991, acrimonious litigation arose between French state-owned Credit Lyonnais Bank ("CLB") and Italian financier Giancarlo Parretti over CLB's recall of loans to Parretti's company Melia International ("Melia").¹ In 1990, Parretti had used Melia as a vehicle in his CLB-financed \$1.33-billion takeover of United States film studio Metro-Goldwyn-Mayer/United Artists ("MGM/UA").² Parretti's merger of MGM/UA with his Pathe Communications group created MGM-Pathe Communications Company ("MGM-Pathe").³ CLB revoked loans worth \$358 million because Melia had failed to make required interest payments.⁴

Currently, Kopelson is developing with Warner Brothers the mystery-thriller *Don't Say a Word*, which was published in May, 1991, by Pocket Books and is being adapted by Donald Stewart (*Missing, Hunt for Red October*). Also in development with Warner Brothers is: *The Fugitive*, based on the highly successful television series that starred David Janssen; Sidney Sheldon's next novel, which is currently being written; and *Falling Down*, an action-drama written by Ebbe Roe Smith, to be directed by Joel Schumacher and to commence photography in March, 1992.

Most recently, Kopelson acquired the Stephen Hunter novel *Minute of Angle*, which will be published by Bantam Books in 1992, and is currently being developed at Universal Pictures.

Kopelson is a member of the New York and California State Bar Associations, the Academy of Motion Picture Arts and Sciences, and the Executive Committee of the Producer's Branch of the Academy.

Kopelson has written several articles on the subject of motion picture financing, and lectures on filmmaking at the Tisch School of the Arts at New York University, the University of California at Los Angeles, the University of Southern California, New York Law School, the Writers Guild of America, and at various film festivals throughout the world.

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1. *Parretti Loses Court Case, Maybe Control of MGM*, REUTERS, Oct. 4, 1991 (Financial Report). Melia International has interests in communications, real estate, travel agencies, and hotels. In June, 1991, it had its Amsterdam listing suspended for failure to disclose necessary financial information. *Id.* See also Larry Black, *Parretti's MGM Saga Nears Its Climax; Deportation and Disgrace Face the Deposed Studio Chief*, THE INDEPENDENT, Oct. 8, 1991, at 27.

2. Black, *supra* note 1; *Parretti Loses Latest Case in Ongoing Legal Battle*, REUTERS, Oct. 10, 1991 (Financial Report). Parretti's Melia International controlled MGM. *Parretti Starts New Dutch Court Case*, REUTERS, Oct. 8, 1991 (Financial Report).

3. Black, *supra* note 1.

4. *Parretti Starts New Dutch Court Case*, REUTERS, Oct. 8, 1991 (Financial Report). CLBN's outstanding loans to Parretti-controlled companies amounted to \$888 million in July, 1991. *Parretti Loses Court Case, Maybe Control of MGM*, REUTERS, Oct. 4, 1991 (Financial Report).

Financial officers at MGM/UA had claimed that the studio was insolvent from the moment Parretti took control because of his strained money-raising methods to fund the acquisition. Following the takeover, Parretti reportedly transferred money without regard for the studio's financial health and sold valuable studio assets at below-market prices to European companies he controlled. These included marketing rights to the studio's titles, including *Annie Hall*, *West Side Story*, and the *James Bond*, *Rocky*, and *Pink Panther* series. Additionally, Parretti allegedly gave away the European rights to the lion—MGM's famous roaring logo—

In October, 1991, a Rotterdam district court held that the bank had rightfully recalled the loans granted to Melia.⁵ The decision allowed CLB to take control of MGM-Pathé by claiming shares of the movie company that Melia had pledged as security for the loans.⁶ Parretti, however, is still the studio's majority shareholder.⁷ In the United States, CLB filed suit to bar Parretti from participation in the management of MGM-Pathé,⁸ and Parretti filed a countersuit.⁹

After this litigation began, CLB's senior management in Paris halted all lending by its subsidiary in Rotterdam, Credit Lyonnais Bank Nederland ("CLBN"). The Paris bank also banished several of its senior executives to far eastern branches and "retired" others. All of these developments surprised and alarmed independent filmmakers worldwide. Credit Lyonnais Bank has come under intense scrutiny as a result of its MGM-Parretti connection, and is embroiled in a scandal of major proportions.¹⁰

One might think that the activities of a small bank branch in Holland would have little or no effect on the independent film business. In actuality, the negative impact has been profoundly significant. During the last ten years, CLBN had been the foremost lender to independent

for 30 years royalty-free for use in sports car racing and by a start-up company owned by Parretti's wife. Meanwhile, interest payments to Credit Lyonnais Bank went unpaid. In April, 1991, CLB loaned MGM-Pathé another \$145 million in operating funds in exchange for a lien on Parretti's holdings and his replacement as chairman by Alan Ladd, Jr., a veteran film producer and son of a well-known actor. Black, *supra* note 1.

In April, 1991, MGM stood on the brink of bankruptcy, which forced it to delay the release of *Thelma and Louise*, its largest profit-maker of the year. Black, *supra* note 1. The studio has announced a \$100.6-million net loss in the first quarter of its financial year, compared with a total loss of \$9.8 million the previous year. Alan Friedman, *CBS Delays Results Announcement*, FIN. TIMES, Oct. 10, 1991, at 28; WASH. POST, Oct. 11, 1991, at F2.

5. *Parretti Loses Court Case, Maybe Control of MGM*, REUTERS, Oct. 4, 1991 (Financial Report). Following the court's ruling, Melia suspended Parretti from its management board for taking numerous important actions without consulting other board members. *Pathé's Parretti Suspended from Melia Board*, REUTERS, Oct. 4, 1991 (Financial Report). When Parretti appealed his suspension to an Amsterdam district court, the court rejected his challenge and refused to reinstate him as a member of Melia's management board. *Briefly: Entertainment*, L.A. TIMES, Oct. 11, 1991, at D2; *Parretti Starts New Dutch Court Case*, REUTERS, Oct. 8, 1991 (Financial Report).

6. *Briefly: Entertainment*, L.A. TIMES, Oct. 11, 1991, at D2.

7. *Pathé Wins Ruling to Name Four Directors*, REUTERS, Oct. 13, 1991 (Financial Report).

8. The bank alleges management hubris, incompetence, fraud, and self-dealing by Parretti. Black, *supra* note 1.

9. *Parretti Loses Court Case, Maybe Control of MGM*, REUTERS, Oct. 4, 1991 (Financial Report). The Delaware Chancery Court has denied CLB's motion to block Parretti from filling four vacant seats on the board of MGM. *Pathé Wins Ruling to Name Four Directors*, REUTERS, Oct. 13, 1991 (Financial Report).

10. Black, *supra* note 1.

filmmakers throughout the world. CLBN had financed numerous independent films produced in the United States, including the author's *Platoon*.¹¹

Throughout the history of film production, independent financing has been achieved by one or a combination of methods. One method has been the formation by a group of investors of a limited partnership or corporation, to which each investor contributes capital or a combination of loan plus capital. In exchange for this contribution, each investor receives units or shares entitling him or her to a portion of the profits derived from the exploitation of the film.

Another method has been the device of a "negative pick-up" with a major studio. Under this arrangement, the studio enters into an agreement with a producer in which the studio agrees to pay a fixed amount upon delivery of all of the elements comprising the motion picture. The agreement sets forth the requisites for payment, which include approval of: (1) the screenplay on which the motion picture is based; (2) the budget; (3) the producer; (4) the director; (5) the principal members of the cast; (6) the editor; and (7) the composer. For payment to be made, no deviation from the approved elements may occur. The amount that the studio pays to the producer is generally the film's total budget, which includes a fee to the producer for his services. The negative pick-up agreement, when combined with a completion guaranty, serves as collateral for a bank loan to provide the necessary funds to physically manufacture the motion picture. It is not uncommon for the studio's bank to provide this funding to the producer.

This article, however, explores an alternative means of financing: the pre-sale of rights in and to a motion picture as a device to totally fund the "negative cost," or the cost of manufacturing the film negative of a motion picture.¹² This article provides a look at independent film financing through foreign and domestic pre-selling. It first summarizes the development of pre-sales to finance independent motion pictures. It then describes successful pre-sale packages, and problems that can be avoided.

11. *Platoon* won the 1986 Academy of Motion Picture Arts and Sciences Award for Best Picture for its depiction of the personal battles fought by American soldiers in the Vietnam War. In accepting the award before a televised audience of an estimated one billion people, the author made a point of thanking Credit Lyonnais Bank and its director of entertainment, Frans Afman, for providing money when it was needed to produce the film in the Philippine jungle. No Oscar recipient had ever thanked his bank before. The acknowledgment illustrated the important role CLBN played in independent film production.

12. In other words, the negative cost equals the above-the-line and below-the-line costs, plus interest charged thereon by the bank. See also *infra* part III.B.4 (discussing above- and below-the-line costs).

It concludes with a perspective on the future of pre-sales and implications for the independent film industry.

II. HISTORICAL BACKGROUND OF PRE-SALES

Films that are *not* independently financed, or studio-financed, are generally produced by a movie studio through total funding of the film's negative cost in exchange for the studio's acquisition of worldwide distribution rights to the film in all media. "Independent financing of motion pictures" in this article refers to financing done by means other than total studio financing of a motion picture.

The early wizard of independent film production was Dino De Laurentiis.¹³ In 1966, Fred Sidewater, who then headed De Laurentiis' company, arranged for the first bank loan against the collateral of foreign contracts with Banca Commerciale Italiana. The contracts were generated from the licensing of the motion picture *Three Faces of a Woman*, which starred Saroya, the former empress of Iran.

In the 1970s, De Laurentiis established a network of independent film distributors in every country and then pre-sold to these distributors the rights to distribute his films in their territories. This enabled him to assemble a package of contracts from distributors in foreign territories, from which he gained cash to make his films.

Each contract granted the distributor theatrical rights¹⁴ or television rights. Video, cable and satellite transmission did not exist at the time. In some cases, the rights to all media would be taken by one distributor or parceled out to more than one distributor. The distributor generally paid a ten or twenty percent down payment in cash, and agreed to pay the balance upon delivery of the film. The licensor and licensee shared the profits, if any, on a negotiated basis.

The contracts with foreign distributors accounted for approximately fifty to sixty percent of the negative cost of the film to be produced. De Laurentiis then pre-sold the distribution rights to his film to a major studio for distribution in the United States and Canada. When combined with the foreign contracts, this distribution arrangement provided the funds necessary to make the film. In most cases, it yielded an up-front profit because the sales generally exceeded the total negative cost.

13. Prior to becoming a film producer, the author was an attorney practicing entertainment and banking law in New York and California. During that time, the author had the opportunity to observe De Laurentiis' method of financing movies. De Laurentiis is responsible for producing such films as *The Valachi Papers*, *Serpico*, *Desperate Hours*, and *King Kong*.

14. Theatrical rights are those that permit exhibition of a film in 35 mm or 70 mm in theatres.

Banks in the United States, however, did not wish to engage in financing films based on the collateral of foreign distribution rights. Enter Frans Afman, who headed the entertainment division of Credit Lyonnais Bank Nederland in Rotterdam.¹⁵ Although he was a banker, Afman completely understood the power of independent distributors. He realized that contracts with well-financed distributors generally providing for the issuance of letters of credit, combined with a contract with a major studio for domestic distribution rights, collectively supplied the entire negative cost of producing a film. More importantly, Afman recognized that CLBN would be fully secured in any loan it made to a filmmaker, if the distribution agreements were combined with a completion guaranty.

A completion guaranty assures that the motion picture will be completed and delivered to distributors that have acquired distribution rights, all in accordance with an approved screenplay, budget, shooting schedule, and other designated elements. The guaranty takes the form of a surety agreement or bond that allows the bonding company, when it deems itself insecure, to take any of the following actions: (1) make loans to the production company, which is required to complete delivery in accordance with the distribution agreement(s); or (2) exercise its right to take over a film as the irrevocable agent of the producer to finish the film. The completion guaranty runs in favor of a bank or other financier, and provides it with the certainty that the motion picture will be completed and delivered in compliance with the distribution agreements so that payments contracted under them will be achieved. In the alternative, the guaranty assures the bank that the bonding company will pay the bank its unpaid loan to the production company.

During the 1970s and 1980s, Afman gradually built solid relationships with every well-known producer in the business. He also discovered which distributors could be trusted. The last decade saw producers flying in and out of Rotterdam to meet with Afman to discuss film financing by CLBN. Afman's record of success and the yield he produced for the bank were extraordinary.¹⁶ As a result of Afman's belief in the safety of contracts and letters of credit as collateral, CLBN became the foremost bank in entertainment lending in the world.¹⁷ Each motion pic-

15. Credit Lyonnais Bank is based in Paris, with offices throughout the world.

16. Afman, an outspoken critic of Credit Lyonnais Bank's involvement with Parretti, resigned from his position at CLBN in 1988. He became a consultant until 1991, when he severed all of his ties with the Bank. Currently, he is Managing Director of the Financial Services Department of International Creative Management, a powerful Beverly Hills-based theatrical agency.

17. Credit Lyonnais Bank Nederland's movie-industry financing amounted to 10% of its \$20-billion portfolio. Black, *supra* note 1.

ture project stood on its own, and the bank was usually one hundred percent fully secured. This was called "project financing."

The pre-sale method of financing became a popular alternative to financing by major studios. It launched such production companies as Carolco Pictures, Inc., which was responsible for the *Rambo*¹⁸ films and more recently *Terminator 2*.¹⁹ It also spawned a number of production companies, such as Cannon Films (now Cannon Pictures, Inc.), Nelson Entertainment²⁰ (whose library was bought by New Line Cinema, an independent production company that actively engages in the pre-sale method of financing), Arnold Kopelson Productions and its affiliate, Inter-Ocean Film Sales, Ltd., all of which worked closely with Frans Afman and CLBN.

Lord Lew Grade was another prominent figure in the area of independent film financing. Grade created ITC Pictures, which was very powerful in the 1970s. He produced films²¹ with large budgets on the scale of those produced by studios, but he and De Laurentiis each retained one hundred percent ownership of their respective films. Both producers accomplished this through the device of pre-sales.²² With the method of studio financing, by contrast, the studio would have provided the entire negative cost of the motion picture but would have owned one hundred percent of the film, with the producer merely earning a fee and receiving a share of the profits, if any.

III. PRE-SALES

A. *How Pre-Sales Work*

The term pre-sale is a misnomer, because it does not relate to a sale at all. Instead, a pre-sale is a licensing of certain defined rights to a motion picture, granted before²³ or during principal photography, and generally before completion of post-production. The essence of a pre-sale is that the distributor/licensee enters into a contract in which he agrees to pay money to acquire rights to a film without the benefit of having seen it as a completed motion picture. The licensee makes his decision based on

18. *FIRST BLOOD* (Carolco Pictures 1982); *RAMBO: FIRST BLOOD II* (Carolco Pictures 1985); *RAMBO III* (Carolco Pictures 1988).

19. *TERMINATOR 2: JUDGMENT DAY* (Carolco Pictures 1991).

20. Nelson Entertainment now operates as Sultan Entertainment, which distributes home videos.

21. These films include *Cassandra Crossing*, *March or Die*, and *The Medusa Touch*.

22. The pre-sale method of film financing was so effective that, in 1976, the author and his wife, Anne, formed Inter-Ocean Film Sales, Ltd., in order to engage in similar types of transactions.

23. Hence, the term "pre"-sale.

a "package" submitted to him by the producer. Fortunes are sometimes made on the licensee's bet that the elements of the package will result in a profit-making film rather than a loss.

Licensees agree to purchase rights before they have had the opportunity to view the merchandise on the theory that the early bird catches the worm. A licensee seeks to secure an important film for distribution in his country before a studio or competitor distributor has had a chance to license the same film. The price that the licensee will pay before he has seen the film is generally less than the amount he would have to pay for the same film in completed motion picture form.

The following illustrates the early bird theory. Recently, a foreign-based distributor known to the author quickly secured the rights to a motion picture that he learned about during the very early stages of pre-production. The distributor agreed to pay \$1 million as an advance for all the rights to the film in his territory. A major studio then bought the distribution rights to the remaining countries in the world. Had the distributor not acted so quickly, he would not have secured the film for his company. The film he pre-bought is now budgeted for nearly twice the original amount anticipated at the time the license was consummated. Therefore, the distributor secured the film, which a major studio would have taken for its territory, at a reduced price.²⁴

B. Requisite Elements of a Pre-Sale Package

1. Screenplay

A pre-sale package must include certain elements before a licensee will consider making a pre-buy offer. The first key to a successful package is the screenplay. The screenplay must have a well-defined beginning, middle and end. Screenplays succeed more often when the writers have followed the amusing advice of Pulitzer Prize winner George Abbott:²⁵ "Find a tree, get the actor up the tree, get him down from the tree." If the material is well-written, producers are better able to package the project because the director and movie stars will relate to the story and want to be involved.²⁶ Producers look for a strong rooting

24. The parties' identities must be kept confidential because this film has not yet been released.

25. Author and director George Abbott's many credits include *Pajama Game*, *On the Town*, and *Damn Yankees*, all of which he co-wrote and directed. He won a Pulitzer Prize for *Fiorello*.

26. The author's production company, Arnold Kopelson Productions, and its affiliate, Inter-Ocean Film Sales, Ltd., receive 50 to 100 submitted screenplays each week. Because most of the material is unsuitable, the company rejects nearly all of the submissions.

interest in the central character and a protagonist who wins at the end of the story. In other words, producers and, more importantly, audiences like “up” endings. Screenwriters far too often overlook this simple formula for success.

2. Producer

A successful pre-sale package can never consist merely of a screenplay, but must include several other elements. In addition to the screenplay, the package must comprise, at a minimum, a producer with the reputation of having successfully produced commercial films in the past. If the licensee is unfamiliar with the producer, a well-known sales organization suffices as a substitute. A sales organization is a company that represents numerous producers of independent motion pictures in parceling out distribution licenses in all media throughout every country in the world.

3. Actor or Writer/Director

After the elements of screenplay and producer are in place, the most important ingredient must be added. This element is a “bankable” actor, preferably, or at least a distinguished writer/director. An actor is bankable if a major studio believes that the actor can “open a movie.” This means that the actor will draw an audience to the initial opening of the movie the studio plans to finance and distribute. A successful opening increases the prospects of a successful release. The term “bankable” is really a misnomer because the studio has no assurance that an actor who starred in a commercially successful film will experience similar success with a subsequent film. Nor will a bank advance funds for production solely because a “bankable actor” is included in the package.

Today, some actors who “open a movie” are Harrison Ford, Arnold Schwarzenegger, Michael Douglas, Dustin Hoffman, Clint Eastwood, Richard Gere, Tom Cruise, Bruce Willis, Julia Roberts, Mel Gibson, Barbra Streisand, Woody Allen, Eddie Murphy, Kevin Costner, Robert DeNiro, Steven Seagal, Danny DeVito, Sylvester Stallone, Al Pacino, Robert Redford and Michelle Pfeiffer. It is clear that the inclusion of one or a combination of these names, when coupled with a good screenplay and important director, in a package being sold to foreign distributors and to a major studio for a domestic negative pick-up, will assure bankable deals.

The licensee must be convinced not only that the package is an attractive commercial venture, but also that the producer will actually produce and deliver the film on the date set forth in the license agreement,

because the licensee will include the film in its release schedule.²⁷ This presupposes that the producer has financing in place or has the ability to obtain it.

4. Budget

In order for a package to be pre-sold, the motion picture to be produced must be budgeted to cover both "above-the-line" and "below-the-line" costs. Above-the-line costs include payment to the writer(s) of the book and/or screenplay on which the film is based; the salaries and expenses of the producer, director, and principal cast; travel and living costs; and fringe benefits that are required under applicable guild agreements. Below-the-line costs are the remaining expenses required to physically produce and deliver the film. These include costs of set design and construction, special effects, set dressing, wardrobe, make-up and hair dressing, lighting, camera rental, sound equipment, transportation, music, laboratory processing, film stock, editing and post-production. If independently produced, the below-the-line costs should include the cost of a completion guaranty from an insurance company.²⁸ The guaranty is an essential element in obtaining bank loans predicated on pre-sales.

The following illustrates some typical above-the-line costs. A screenplay written by a well-known writer, including rewrites, generally amounts to approximately \$500,000 to \$1 million. A well-known director commands an average salary of \$1.5 to \$3 million. The principal cast member would most likely receive a salary of \$3 to \$5 million. A co-star would be paid between \$750,000 and \$1.5 million. In light of the cost of these above-the-line items, and depending on the screenplay requirements regarding location and special effects, the below-the-line cost would amount to approximately \$10 million. At a minimum, the all-in, or entire, budget would total between \$15 and \$20 million.

5. Financing

A portion of the financing must be in place before pre-sales can be attempted. The producer must either have paid for the screenplay or have it under option²⁹ from the screenwriter. The director and at least one principal member of the cast must be contracted to perform in the

27. The release schedule is the schedule that the licensee gives to theatres setting forth the dates that particular films will be delivered for exhibition.

28. *See supra* p. — (discussing completion guaranties).

29. Producers often buy an "option" from screenwriters, which gives the producer the right to produce a motion picture based upon the screenplay.

film. Only after these elements have been secured is the package considered to be in place and able to be offered to distributors.

Consequently, the producer is obligated at the point of commencing pre-sales to pay significant sums toward the elements comprising the package. The producer borrows the necessary funds from a bank under personal lines of credit if he or she is financially able to do so. If unable to borrow the money independently, the producer must consider joining a partner who possesses the requisite financial resources.

Assuming an all-in \$15 million budget for what a studio believes is an exciting project, a major studio will probably agree to pay \$7.5 million for the domestic rights to the project. Major studios generally agree to advance fifty percent of the negative cost of a motion picture to secure distribution rights in all media for the United States and Canada. For example, the author recently produced *Fire Birds*, a motion picture starring Nicholas Cage, Sean Young, and Tommy Lee Jones. A studio advanced fifty percent of the negative cost for the United States and Canadian rights, and foreign pre-sales accounted for the remaining fifty percent.

It is fair to say that the balance of the \$15-million negative cost in this example will be achieved from the sale of distribution rights in just five territories abroad. For example, theatrical distributors in Japan will probably agree to pay approximately \$2.25 million; in Germany, \$1.25 million; in Italy, \$1 million; in France, \$1.25 million; and in the United Kingdom, \$2.5 million; totalling \$8.25 million toward a total budget of \$15 million. When other rights such as television, video and cable are added, the result in most instances will yield a greater sum, so that the guaranties for each country may vary from the numbers set forth here. For example, the amount secured in Italy may amount to \$2.5 million by including the television, video, and pay television rights; the United Kingdom, however, may yield \$1.5 million instead of \$2.5 million. When all guaranties are added together, it is still possible to achieve the total of \$8.25 million.

Historically, each country accounts for a specific percentage of worldwide gross receipts when a film is distributed. Therefore, if Japan receives 14.3% of foreign theatrical revenue, a pre-sale of Japanese theatrical distribution rights calls for a minimum guaranty payment by a Japanese distributor of 14.3% of the negative cost of the film. Other percentages of interest are: Germany 10.6%, Italy 7.1%, United Kingdom 8.6%, and France 10%.³⁰ These figures represent percentages of

30. These figures were compiled by the Motion Picture Association of America.

foreign theatrical income and do not take into account television, home video, or pay television revenues. Since the above numbers are approximate, it must be remembered that they are merely a guide to what distributors will actually pay.

C. Advantages of Pre-Selling

Financing through pre-sales has several advantages to the producer. First, the producer owns the negative to the film in perpetuity. As the owner, the producer may negotiate a fifteen- or twenty-year license to a major studio for distribution rights in the United States and Canada. In the foreign territories, distributors accept licenses for five- to seven-year terms. Shorter rather than longer licenses are more favorable to the producer, who can re-license renewal rights at the expiration of the license for additional license fees. When studios finance a film, in contrast, they own the rights to it in perpetuity.

Second, the producer owns one hundred percent of the income from all territories in the world that have not bought licensing rights to the film. In the example above, only Japan, Germany, Italy, France, and the United Kingdom were licensed in order to achieve the requisite \$7.5 million, thus preserving all distribution rights to the remaining unlicensed territories. As a result, the income from all of the remaining territories in the world go directly to the producer.

The third advantage is that the producer has successfully raised the negative cost of the film without cross-collateralization of income. Cross-collateralization means that worldwide profits are applied against worldwide losses—i.e., profits made in one country must offset losses in another country. For example, if a film generates enormous profit in Japan, but loses money in the United States because it has one financier—the studio, the Japanese profits will go toward offsetting the studio's losses in the United States. If the film is unreleased in the United States, the producer will not receive the Japanese profits until the studio releases the film in the United States and recoups its costs, which may never occur.

Pre-selling, however, allows for the establishment of separate profit centers in each country of release. A loss in the United States will not offset profits from Japan. Nor are the profits from a particular country retained until worldwide profits are achieved. Monies representing profit earned by the independent distributors begin to flow within months of the film's release.

Last, but not least, the producer has the advantage of retaining the

freedom to make the film without intervention of the studio's creative personnel.

D. A Licensee's Payment Obligations

The licenses described in this article are either mere contractual obligations to pay or are supported by letters of credit (L/C) issued by a bank. Under a letter of credit, the licensee's bank substitutes its credit in exchange for the licensee's agreement to make payment on the completion of certain events. Therefore, the licensor looks to the licensee's bank, rather than the licensee, for payment. In effect, the licensor borrows on the commitment of the bank that issued the letter of credit.

By contrast, a licensee's mere contractual agreement to pay presents to the licensor's bank a different credit problem from that of lending against a letter of credit. The licensor's bank must determine whether the licensee's promise to pay is creditworthy. At issue is the financial integrity of the licensee rather than of the licensee's bank. The bank assesses whether the licensee's financial statement supports and justifies his commitment to the licensor.

If the licensor's bank determines that the licensee is creditworthy, the licensor's bank will lend against the licensee's contract to pay. The bank sets up a reserve of between fifteen- and twenty-five percent and lends to the licensor the remaining face value of the contracts. However, the lending bank generally has recourse to the licensor for repayment if the licensee fails to make the contractual payment.

Under a contractual agreement to pay, a licensee must pay the balance of the minimum guaranty to the licensor upon receiving notification that the negatives and/or prints, trailers, and advertising materials are ready for delivery.

E. Pitfalls of Pre-Selling

1. An Example

Consider a situation in which a producer pre-sells distribution rights to his or her film to a foreign distributor for a particular territory. The contract calls for a mere contractual obligation to pay rather than for payment by letter of credit. The producer discounts, or has the bank lend to his or her account, the amount of this particular contract, less the reserve, and commences production of the film. Prior to formal delivery of the film, the distributor who has pre-bought the film decides, for some reason, that it no longer wants the film. The distributor notifies the licensor that it is prepared to forfeit its deposit, and will not be paying the

balance of the minimum guaranty. Of course, the producer will advise the distributor that the distributor is not only breaching the contract, but is also proposing that a third party—the producer's bank—rather than the producer, receive the balance of the minimum guaranty.

The distributor still refuses to make payment. What is the effect? The bank will demand repayment of its loan from the producer because, under its loan agreement, the bank has recourse to the producer. The likelihood of the bank's instituting legal proceedings against the distributor in a foreign territory for collection is highly remote. Therefore, the producer will be forced to repay the bank loan and seek payment from the distributor.

The producer's failure to pay could result in the bank's foreclosing on the negative of the film or attaching the film and its proceeds. This is because banks traditionally file financing statements in appropriate jurisdictions after entering into a security agreement with a producer. These financing statements set forth as collateral the negative of the film and all pre-print materials, as well as the proceeds derived therefrom. The bank also enters into a laboratory pledgeholder's agreement with the producer's laboratory that holds the negative of the film. Under this agreement, the laboratory holds all of the elements of the film as pledgeholder for the lending bank.

2. Avoiding Pitfalls

A producer may avoid this problem by first becoming familiar with the distributor's financial background. The producer should ask whether the distributor has ever defaulted on obligations to other producers; how many films the distributor licenses each year; and whether the distributor is well-financed. The producer may not know the answers, but he or she can employ the aid of a sales organization that is familiar with distributors in foreign countries. A distributor who decides it does not like a film it has pre-bought is less likely to default in payment to a well-known sales organization because it knows that such unprofessional conduct will affect its future dealings with the sales organization. As a general rule, a producer should always attempt to obtain letters of credit in pre-sales transactions in order to avoid an occurrence of the above.

F. Pre-Selling Today

Pre-selling of foreign territories reached its peak during the 1980s. During that time, several well-known producers with extensive financial resources announced a slate of productions, sometimes numbering more than a dozen. In each case, the director and cast were set. Problems

arose, however, when many of the films that were pre-bought at very high minimum guarantees failed to produce revenue at the box office, particularly in American theaters. These films, including those with action-adventure themes, were more particularly suited for foreign audiences and did not find a large audience in the United States.

Distributors experienced further financial problems as they were required to buy all of a producer's films sold in a package, rather than being allowed to choose the ones they really wanted. Inevitably, this forced many foreign distributors to close their doors. Others who had the strength to survive became extremely cautious in their purchasing activities.

Today, a producer cannot plan to pre-sell rights to certain major markets of the world unless a package is extremely strong. The large minimum guaranty that the producer seeks is only one of the problems distributors face. The enormous cost of releasing films in major territories makes it crucial for the distributor to be correct in its selection of films. For example, it costs between \$500,000 and \$3 million to launch a film in Japan.

Therefore, before agreeing to a pre-sale, a distributor will require a package that includes a well-known director and movie stars who are well-received in its territory. This gives the distributor more power when it advertises the film. Any deviation by the distributor from this formula could cause it significant loss.

It is far simpler to license to a Japanese distributor a film with a \$30-million negative cost and to achieve a minimum guaranty of between \$3 million and \$4.5 million, than it is to license a low-budget film and seek to obtain \$250,000 as a minimum guaranty. The higher the budget, the less the chance that the licensee will default, because only the more prominent and well-financed distributors can afford higher-budget films. These licensees are usually the largest or second-largest distribution company in a particular country. When a producer offers a big-budget film to one of these distributors, they do not discuss whether the distributor wants the film. That is a given. They discuss only the price and terms of payment. Consequently, it is easier for a producer to set up the financing for a \$30-million-budget film than for one with a \$10-million budget.

The essential element of effectively financing a motion picture through pre-sales is the producer's ability to first set up an arrangement with a studio for distribution in the United States and Canada. Because these territories will represent approximately fifty percent of the contracts to be pledged to a bank, failure to obtain such a deal would prove fatal to the project. Therefore, the independently-produced film must be

of the same size and quality as films totally financed by a studio. This generally rules out low-budget productions, which necessarily do not include well-known directors and stars.

Additionally, foreign distributors are comforted when they know that the film being offered to them is being distributed by a major studio in the United States. This implies that the project will be of high quality and further assures the distributor that the "major," or studio, will generally spend between \$10 and \$15 million to promote the American and Canadian releases. A box office hit in these territories becomes known to moviegoers in other parts of the world.

III. CONCLUSION

A. *Pre-Sales and Entertainment Attorneys*

What is the relevance of pre-selling to the attorney specializing in entertainment law? The entertainment lawyer establishes a very close working relationship with the producer client. It transcends the relationship that generally exists between a corporate client and an attorney. The difference is that the entertainment client will call on the lawyer for advice regarding how to finance his or her project.

The lawyer can advise a producer client that he or she may finance a film through pre-selling without giving up total control and ownership to a major studio if the client's project is budgeted at approximately \$15 million or more. Additionally, if the client is not yet well-known in the producing community, the lawyer can advise the client to take the project to other producers who may agree to work with the client in funding the package and pre-selling the project.

B. *The Future of Pre-Sale Financing*

Recently, Credit Lyonnais Bank incurred losses potentially running into the billions of dollars when it strayed beyond project financing and engaged in unsecured lending to borrowers who were uncreditworthy or mismanaged. CLBN's loss has had a rippling effect on other banks, making it difficult to attract some financial institutions to the pre-sale method of lending. This has forced many independent producers to make their films with major studios.

Does all of this mean that independent financing of motion pictures has ground to a halt? Certainly not. Recently, Carolco Pictures, Inc. ("Carolco") spent \$87.5 million to produce *Terminator 2*. This sum represents a \$51-million direct negative cost and a total of \$36.5 million to buy out various gross participants. Carolco had in place \$91.5 million of

“pre-sold” contracts comprising \$30.5 million in domestic contracts and \$61 million in foreign contracts, which were all pledged to its banks. Banks operating in the United States, Europe, and Japan still appreciate the safety of project financing.

Recently, one of the leading banks in the United States announced that, after studying the foreign markets and its distributors, it will engage in project financing and accept foreign contracts as collateral.³¹ Other banks are also engaging in project financing and accepting foreign distribution contracts as collateral.³² Two major European banks—Berliner Bank, A.G. and Banque Internationale à Luxembourg—have created a London-based company to develop proposals for film and television loans that the two banks will underwrite. The new group is called Film Investment and Loan Management Services, Ltd. (“FILMS”).³³ This new venture is seeking loan packages composed of domestic and/or foreign contracts and will not be making working capital loans.

Banque Paribas (“Paribas”), a \$200-billion-asset bank headquartered in Paris with branches in sixty countries, has also moved into motion picture lending. Michael Mendelsohn, Paribas’ Vice President, Media-Entertainment Finance Group, confirmed to the author that the bank recently closed a loan based on the security of a domestic distribution agreement with a Walt Disney company and a package of foreign contracts. The total of these contracts did not cover the loan, but Paribas extended further credit based on estimates of additional expected distribution agreements. In this case, the borrower was able to demonstrate to the bank that a number of unsold countries would eventually conclude deals sufficient to justify an exposure to the bank.

The foreign market promises to become an even greater source of revenue than in previous years. Peter Hoffman, president and CEO of Carolco Pictures, Inc., recently predicted that “an average Hollywood A-title movie with star value will reap \$10 million in foreign pay-T.V.

31. This announcement was made by John Miller, Chemical Bank’s Managing Director, Entertainment Division, at a panel discussion sponsored by the Los Angeles County Bar Association on October 15, 1991, at the Beverly Wilshire Hotel.

32. These include Mercantile National Bank and Daiwa Bank, both located in Los Angeles. Recently, Daiwa Bank was reported to have committed to a sizable proportion of Paramount’s \$45-million budget for the film *Columbus*. Paramount reportedly paid \$9 million for the United States rights to the Ridley Scott film. The balance is being provided by Daiwa’s extension of credit based on foreign distribution contracts as well as the Paramount commitment. See Mark Schilling & Angus Mitchell, *Daiwa Bank Boards Scott’s Columbus*, SCREEN INT’L, Oct. 4-10, 1991, at 4.

33. Rich Zahradnik, *Euro Banks Join to Finance FILMS*, HOLLYWOOD REP., Oct. 16, 1991, at 4.

within three years.”³⁴ This represents a tripling of present income levels, and banks will seek this type of lucrative collateral. It is clearly more difficult to independently finance motion pictures after the CLBN debacle, but films continue to be produced with independent money, and banks continue to lend production funds against contracts with distributors. The future is clearly bright.

34. Robert Marich, *Hoffman Maps Out Laser Frontier*, *HOLLYWOOD REP.*, Sept. 20, 1991, at 3.