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FEATURE FILM LIMITED PARTNERSHIPS: A PRACTICAL GUIDE FOCUSING ON SECURITIES AND MARKETING FOR INDEPENDENT PRODUCERS AND THEIR ATTORNEYS

John W. Cones †

I. INTRODUCTION

The limited partnership is still, and will always be, a useful vehicle for financing some feature films, despite its diminished tax benefits following the Tax Reform Act of 1986.¹ It can finance everything from the large, public, multi-picture offerings like Star Partners² and Silver Screen³ to the small, private, single-picture offerings like Backbone Productions, Ltd.⁴ This article is intended to serve as a practical guide for independent producers and their counsel on how to create and conduct a feature film limited partnership offering in compliance with the relevant laws.⁵

This article assumes that the independent producer is considering or has already decided to use the limited partnership as the financing vehicle for a film. Presumably, such an independent producer would already be aware of some of the following advantages of using a limited partnership: (1) the investors have limited or no participation in the day-to-day

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1. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), eliminated the investment tax credit and added the passive loss rules, among other things.

2. The Star Partners limited partnership (1987) entered into a joint venture with the film studio MGM/UA to fund *Bright Lights*, *Big City*; *Overboard*; *Moonstruck*; *Poltergeist III*; and *A Fish Called Wanda*.

3. The Silver Screen IV limited partnership in 1988 entered into a joint venture with The Walt Disney Company to fund *Beaches*, *The Good Mother*, *The Three Fugitives*, and *The Little Mermaid*.

4. Backbone Productions, Ltd., a 1989 California single-picture limited partnership, successfully funded the low budget horror/comedy *The Boneyard*.

5. A feature film limited partnership may involve partnership, federal and state securities, tax, and entertainment law.

management activities, enabling the general partner/producer of the feature film to select the picture he or she wants to produce and enjoy greater creative control over the project; (2) the investors are protected with limited liability and will generally not be liable for any monies in excess of their original investment; (3) the partnership is not taxed as a separate entity so that the few remaining tax benefits flow through to the limited partners, and the partnership avoids double taxation of the limited partnership's income; (4) the limited partnership offers greater flexibility in the structuring of the deal between the general partner/producer and the investors; and (5) record-keeping requirements are less burdensome than those required of a corporation.

II. CREATING THE ENTITY

A. *State Law*

The limited partnership must be formed pursuant to state law. Most states have some form of a limited partnership statute.⁶ The California statute regulating partnerships establishes filing requirements for all limited partnerships in California.⁷ In order to form a limited partnership in California, the partners must execute a partnership agreement, acknowledge and file a Certificate of Limited Partnership (CA LP-1 form) in the office of the Secretary of State, and pay the required filing fee. If the Certificate conforms to law, it is endorsed by the office of the Secretary of State and then filed. A certified copy of the Certificate is returned to the general partner(s).

The CA LP-1 form provides detailed instructions on completing the form. This form should be requested from the Secretary of State's office. It is also necessary to file Certificates of Amendment, Dissolution, and Cancellation with the Secretary of State reflecting corresponding changes during the existence of the limited partnership. The Secretary of State has prescribed forms for the various filings and the statute sets forth the requisite filing fees. In 1985, the California Secretary of State published a booklet entitled "Limited Partnership Division Information Handbook" which, although slightly out of date, is still helpful in understanding what is involved in creating the entity.⁸

The attorney may choose to use a support service for the CA LP-1

6. In California, it is the California Revised Limited Partnership Act, CAL. CORP. CODE §§ 15611-15723 (Deering 1990).

7. *Id.* §§ 15621-15628.

8. CALIFORNIA SECRETARY OF STATE, LIMITED PARTNERSHIP DIVISION INFORMATION HANDBOOK (1985). The handbook may be ordered by calling the Limited Partnership Division of the California Secretary of State's office in Sacramento at (916) 324-6769.

filing, particularly if urgency exists in creating the partnership.⁹ These services will prepare and file the CA LP-1 for a fee. Expedited filing may be important if, for example, the general partner/producer chooses not to create the partnership until the offering is funded, and he or she is under a deadline to begin pre-production. An escrow bank would probably refuse to transfer offering funds from the escrow account into a partnership account unless the limited partnership existed as an entity. In any case, using a service for filing the CA LP-1 is faster.

In addition to using the forms provided by the Secretary of State, an attorney planning to assist in the creation of a California limited partnership should review the provisions of the California Revised Limited Partnership Act.¹⁰ An excellent article on the California Revised Limited Partnership Act was written by Richard Harrock and updated by John Bonn for the California Continuing Education of the Bar program entitled *Organizing and Advising California Partnerships*.¹¹

In other states, one should consult the statute regulating the creation of limited partnerships and inquire with the secretary of state regarding the current forms to file and the required fees.

B. Topics Discussed in Limited Partnership Agreement

Typically, a feature film limited partnership agreement contains provisions relating to the formation of the partnership, its purpose and powers, contributions and capital, allocations, cash distributions and compensation, accounting policy, books and records to be kept, banking arrangements, management of the partnership, and specific powers and authority of the general partner(s). Other provisions address the following issues: whether rights to the film(s) stay with the partnership or revert to the general partners at a later time, indemnification, liability, reports to limited partners and others, assignment of interests in the partnership, amendments, dissolution, liquidation, notices, power of attorney, severability, applicable state law and purchaser representations.¹²

9. Parasec, Inc., located in Sacramento, is such a service and may be reached at (916) 441-1001.

10. CAL. CORP. CODE §§ 15611-15723 (Deering 1990).

11. Richard D. Harrock, *An Overview of the California Revised Limited Partnership Act*, in *ORGANIZING & ADVISING CALIFORNIA PARTNERSHIPS* (Cal. Continuing Education of the Bar, April 1989). A suggested book on partnerships for the lay person is DENNIS CLIFFORD & RALPH WARNER, *THE PARTNERSHIP BOOK—HOW TO WRITE YOUR OWN SMALL BUSINESS PARTNERSHIP AGREEMENT* (1988).

12. As a practical matter, drafting a limited partnership agreement from scratch is rarely done. Thus, anyone drafting such an agreement should obtain as many other similar documents as possible, from form books or other sources, and then adapt the appropriate language

C. *Naming the Partnership*

The name of a California limited partnership must contain at the end the words "limited partnership" or "LP."¹³ The partnership name may not contain a limited partner's name unless: (1) it is also the name of a general partner; or (2) the business of the limited partnership has been carried on under a name in which the limited partner's name appeared before the admission of that limited partner.¹⁴ The partnership's name may not be one that the Secretary of State determines is likely to mislead the public.¹⁵ Additionally, the partnership name cannot contain the words "bank," "insurance," "trust," "trustee," "incorporated," "inc.," "corporation," or "corp."¹⁶ Proposed names of limited partnerships may be reserved for a sixty-day period.¹⁷

D. *Time of Creation*

A practical consideration for the limited partnership is the time of its creation. Some practitioners prefer to form the partnership before the offering begins, while others prefer to wait until after the offering is successfully funded. Several advantages exist to creating the partnership before the offering is funded. It is inexpensive, and some feel it adds credibility to the offering. Additionally, if the partnership does not exist, interests in a limited partnership technically cannot be sold. Instead, one must sell pre-formation interests in a limited partnership to be formed. Thus, the disclosure document should accurately reflect the appropriate status of the entity and the character of the interests being offered. Moreover, waiting to form the limited partnership until the offering is funded may require a name change for the partnership if the preferred name is no longer available when the offering is completed.

On the other hand, forming the limited partnership prior to the start of the offering requires an original limited partner to resign and assign his or her interests in the limited partnership to investors whom the general partner accepts as limited partners. When the limited partnership is

to accurately reflect the law relating to the specific partnership arrangements and to limited partnerships in the state in which the partnership is being created.

13. CAL. CORP. CODE § 15612(a) (Deering 1990).

14. *Id.* § 15612(b).

15. Examples of names that may mislead the public are those that are the same as or resemble a name of any limited partnership that has previously filed a certificate of limited partnership, or a name that has been reserved by another limited partnership under California Corporations Code § 15613. CAL. CORP. CODE § 15612(c) (Deering 1990).

16. *Id.* § 15612(d).

17. *Id.* § 15613. Call the Limited Partnership Division of the Secretary of State's office at (916) 324-6769 to start the process of clearing or reserving a limited partnership name.

formed after the offering is successfully funded, the offering subscription agreement will often contain a power of attorney authorizing the general partner to sign the limited partnership agreement on behalf of the limited partners.

E. Conflicts of Interest

An attorney who is asked to prepare a limited partnership agreement and to assist in the preparation of a feature film limited partnership offering must be aware of the inherent conflicts of interest associated with such entities and offerings. These problems arise because of the large number of parties involved, who include the general partner(s), the partnership itself and the investors. This situation becomes particularly troublesome where several individuals or entities seek to serve as general partners for the proposed limited partnership. In such instances, the attorney should advise all parties concerned of the potential conflicts, encourage each to obtain the advice of their own counsel, make clear whom the attorney is representing, and obtain a written consent or waiver of any claims based on these conflicts. Additionally, the attorney should use any other tactics necessary to clarify the situation and protect the attorney and the others from the consequences of these potential conflicts.¹⁸

III. APPLICATION OF THE SECURITIES LAWS

A. Introduction

To understand why the federal and state securities laws are involved, we must first look at the definition of a security. Both the federal and state definitions primarily comprise listings of financial instruments or obligations generally considered to be securities.¹⁹ For example, neither the Securities Act of 1933 definition of a security nor the California Corporations Code definition of a security specifically lists the limited partnership. Rather, they use the term "investment contract," which encompasses a limited partnership.

In 1946, the landmark case of *SEC v. W.J. Howey Co.*²⁰ defined an investment contract. Since then, it has come to mean a transaction that involves four elements: (1) an investment; (2) a common enterprise; (3)

18. For additional information regarding the proper handling of such conflicts, see ORGANIZING & ADVISING CALIFORNIA PARTNERSHIPS (Cal. Continuing Education of the Bar, April 1989).

19. Securities Act of 1933, 15 U.S.C. § 77(b)(1) (1988); CAL. CORP. CODE § 25019 (Deering 1979 & Supp. 1990).

20. 328 U.S. 293 (1946).

an expectation of profit; and (4) this expectation being based primarily on the efforts of others.²¹ Similarly, in a film limited partnership: (1) investors (limited partners) invest their money, past services or property; (2) these limited partners join with the general partner(s) to conduct a common enterprise, such as the production of a movie or movies; (3) the investors hope to make money in the deal; and (4) their hope or expectation of profit is based primarily on the efforts of the general partner/producer who manages the enterprise.

The key element is the passive nature of the investor. It is safe to say that a security is probably created any time an investment vehicle is structured using a passive investor. Once it is clear that a security is involved, the federal and state securities laws apply to the transaction. Attempts to avoid compliance with the securities laws by calling an investment contract by another name, such as a general partnership or joint venture, will generally not succeed if subjected to judicial scrutiny. Promoters may be found liable for selling an unregistered security if no effort was made to register it because the investment contract is a security.

B. Overview of Federal and State Regulation of Securities

1. Dual Regulation

One of the first principles in this area of the law is that, unlike many other business activities, the offer and sale of a security is regulated by both federal²² and state government agencies.²³ The possibilities for fraud are great when dealing with what is often merely a piece of paper that a promoter claims has value. As a result, neither federal nor state government officials wish to relinquish their respective rights to regulate the field and protect the interests of their citizens. Thus, the attorney and the producer/client seeking to raise monies for a feature film project must accept the obligation of determining which federal and state securities laws apply to their transaction, and then comply with such laws.

Limited partnership sponsors commonly research the requirements of the federal laws and attempt to comply with them, but overlook the equally important applicable state securities laws and regulations. Obviously, this sort of oversight is to be avoided. Both federal and state gov-

21. *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

22. Securities and Exchange Commission (SEC), 450 5th Street, N.W., Judiciary Plaza, Washington, D.C. 20549, (202) 272-7450.

23. In the state of California, it is the California Department of Corporations, 3700 Wilshire Boulevard, Suite 600, Los Angeles, CA 90010, (213) 736-2741.

ernments have securities law enforcement divisions whose duty is to vigorously enforce their securities laws.

The underlying policy of securities regulation is to protect the investor. Although both governmental levels from time to time have made efforts to ease the regulatory burden on the issuers and sellers of securities through better coordination, these efforts may not be readily discernable to or appreciated by the producer/general partner.

In the event of a conflict between the applicable state and federal provisions, dual regulation requires that the attorney ascertain which provision establishes a higher standard and to comply with that higher standard. For example, if the available New York exemption limits "offers" to forty persons worldwide, while the federal provision permits "sales" to only thirty-five unaccredited investors and an unlimited number of accredited investors, the more restrictive New York rule would prevail.²⁴ The same would be true if the investor suitability standard for the offering differed between states or with the federal standard. The standard for the offering would be established by extracting the highest standard among those jurisdictions.

2. Public or Private Offering

After it is determined that a security in a limited partnership interest is to be sold, and after the general partner's obligations under both federal and state securities laws are understood, the security to be sold must be registered (or qualified for an exception from the registration requirement).²⁵ After the security is registered, it is commonly referred to as a public offering, since advertising and general solicitation of prospective investors is permitted. The security must be registered pursuant to detailed rules of the Securities and Exchange Commission at the federal level²⁶ and rules of the respective securities regulators in each state where the security may be offered or sold.

Alternatively, a producer may choose to sell the limited partnership interests in a private placement, which is known as a non-public, or exempt, offering. If a private placement is chosen, registration is not required because the offering is structured and conducted in a manner that qualifies it as an exemption from the securities registration requirement.

The Silver Screen and Star Partners offerings mentioned above are

24. N.Y. GEN. BUS. LAW § 352-g (McKinney 1984 & Supp. 1990).

25. Securities Act of 1933, Ch. 38, 48 Stat. 74, 78 (codified as amended at 15 U.S.C. § 77a).

26. Securities and Exchange Commission S-1, 17 C.F.R. § 239.11 (1990); Regulation A, 17 C.F.R. §§ 230.251-230.264 (1990).

examples of large public multi-picture limited partnership offerings. As such, they were registered. The Backbone Productions, Ltd. offering was a single-picture private placement.

3. Time and Expense of Public Offerings

It generally takes longer to begin actual sales with public offerings because the disclosure document (prospectus)²⁷ must be approved by the SEC. Additionally, each of the state securities regulators involved must approve the prospectus before sales may be effected. Public offerings require a minimum of thirty to sixty days to be approved, depending on the SEC's backlog of filings at the time.

A public limited partnership offering is also more expensive to conduct than the private offering because the legal, accounting and printing costs are typically greater.²⁸ Lawyers generally must spend more time putting together a public offering because it requires a higher, or at least different, level of expertise. Generally, more financial reporting requirements apply to a public offering; thus, accounting fees are often greater than for a private offering.

Printing costs are also significantly higher with a public offering because no limits are generally imposed on the number of investors. Therefore, the unit size is typically smaller (\$5,000 and in some cases \$2,500) and more investors are sought. On the other hand, limitations generally exist on the number of investors in a private offering. Therefore, the unit sizes are typically larger (\$10,000 to \$50,000 or more) than in a public offering and fewer disclosure documents are needed. The securities rules require that, in either case, a disclosure document be provided to each prospective investor. Depending on the size of the offering (i.e., the total amount of money being raised from investors), a public offering may involve the printing of thousands of disclosure documents. In contrast, a private offering may involve only the printing of several hundred disclosure documents. Additionally, the offering's competition may compel

27. Labeling the Disclosure Document: In securities terminology, the phrase "disclosure document" is the broader term used in describing the collection of information provided to a prospective investor in the limited partnership offering. The term "offering memorandum" is generally reserved for describing a private placement disclosure document. The "prospectus" usually refers to the disclosure document in a public (registered) offering. This article abides by those industry conventions. Some states, however, may still use the term "prospectus" to describe the disclosure document required by that state's exemption from registration. The federal Regulation A also uses the older, more traditional phrase, "offering circular," to describe its disclosure document.

28. See WILLIAM M. PRIFTI, *SECURITIES: PUBLIC & PRIVATE OFFERINGS* §§ 1:11-1:12, 1-22 (1983).

the typesetting of the public offering disclosure document (or at least the production of a "camera-ready" version from a laser printer), whereas the body of the private offering memorandum is generally photocopied.

Broker/dealer commissions and due diligence expenses in a public offering are limited by the NASD²⁹ standard of fairness.³⁰ Private offerings, on the other hand, generally receive more flexibility in setting commission levels. The marketplace will prevent commissions from becoming too high, however, since sophisticated investors realize that commissions and expenses paid to broker/dealers will not end up on the screen.

In both public and private limited partnership offerings, the issuer³¹ incurs some marketing costs, even if sales are conducted through broker/dealer firms. These marketing costs might include travel, phone, mail, courier, fax (facsimile) and other expenses, and will usually be greater in the public offering.

In registering a limited partnership offering with the SEC, the producer and attorney must follow the specific instructions of Regulation C under the Securities Act of 1933,³² and, depending on the amount of the investment sought, the disclosure guidelines of SEC Registration Forms S-1 or S-18 (with the corresponding items of Regulation S-K).³³ Small public offerings (\$1.5 million) can be conducted pursuant to Regulation A³⁴ under the Securities Act of 1933. While Regulation A is called an exemption, in reality it is a simpler form of public offering filed with the regional SEC office.³⁵

The space limitations of this article do not permit a thorough discussion of both public³⁶ and private offerings. Thus, the balance will focus on private limited partnership offerings that seek to exempt themselves from SEC and state securities registration requirements.³⁷

29. National Association of Securities Dealers, Inc. (NASD), 1735 K Street, N.W., Washington, D.C. 20006, (202) 728-8000.

30. Rules of Fair Practice, Appendix F, § 5, NASD Manual ¶ 2192.

31. In securities law, the term "issuer" means "every person who issues or proposes to issue any security"; "person" includes an individual, corporation or partnership. (See Securities Act of 1933, §§ 2(4), 2(2), 15 U.S.C. § 77b (1990)). Thus, in the context of a feature film limited partnership offering, the issuer of the security (the limited partnership interests) would be the partnership including its general partners.

32. 15 U.S.C. § 77a to 80c-3 (1990).

33. 17 C.F.R. §§ 229.001-229.800 (1990).

34. Regulation A, 17 C.F.R. §§ 230.251-230.264 (1990).

35. The SEC's Western Regional Office is located at 5757 Wilshire Boulevard, Suite 500 East, Los Angeles, California 90036-3648. The phone number is (213) 965-3998.

36. See PRIFTI, *supra* note 28, at §§ 1:11-1:12, 1-22.

37. For a sample Regulation A Offering Statement (for an off-Broadway production), see COUNSELING CLIENTS IN THE ENTERTAINMENT INDUSTRY 1985 at 295 (Practicing Law In-

C. Federal Scheme of Exemptions from Registration

The Securities Act of 1933 provides for several non-public offering exemptions from the securities registration requirement. The producer and his or her lawyer must choose the one that best suits the needs of the proposed offering.

1. Section 4(2) of the Securities Act of 1933

This traditional non-public offering provides a federal exemption from the registration requirement. It states, in relevant part, that "the provisions of section 5 [registration requirement] shall not apply to . . . transactions by an issuer not involving any public offering."³⁸ Unfortunately, little detail exists regarding the actual implementation of section 4(2). Most securities practitioners no longer rely on the exemption, except as an alternative to other available exemptions.

2. Section 4(6) of the Securities Act of 1933

This federal exemption also provides a non-public offering exemption from the securities registration requirement. However, it limits sales to accredited investors.³⁹ Section 4(6)⁴⁰ exempts from registration any [t]ransactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered does not exceed [\$5 million], if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf

Since an offering made pursuant to the section 4(6) exemption is restricted to accredited investors, an issuer relying on this exemption must ensure not only that purchasers are accredited, but also that offerees (prospective purchasers) are accredited. Feature film producers do not always know in advance whether they will be able to raise all of the money needed for their limited partnership from accredited investors. For these reasons, section 4(6) is probably not the best exemption on which to rely.

stitute Course Handbook Series No. 197). Copies of other Regulation A offering circulars may be obtained through the SEC.

38. Securities Act of 1933, § 4(2), 15 U.S.C. § 77d (1982).

39. See *infra* part III.D.1.h (Accredited Investors) for definition of accredited investors.

40. Securities Act of 1933, 15 U.S.C. § 77d(6) (1982).

3. Regulation D

Regulation D is the most commonly relied upon federal non-public offering exemption from securities registration.⁴¹ The SEC promulgated Regulation D in 1982, partly in response to complaints about the vagaries of reliance on section 4(2). Regulation D attempts to provide a more detailed set of guidelines for non-public securities offerings and thus to carve out a so-called "safe harbor." Its purpose is to set forth a set of rules that make it easier and therefore safer to comply with the securities laws when seeking to raise funds from private investors.

D. A Closer Look at Regulation D

With the adoption of Regulation D,⁴² the SEC regulation of private limited partnership offerings now consists of a series of eight rules—Rules 501-508—which provide for three substantive exemptions (Rules 504, 505, and 506) from the federal registration requirements of the Securities Act of 1933. Regulation D provides a means of exempting from the registration requirements of section 5 of the Securities Act of 1933⁴³ a securities offering that complies with the conditions and limitations imposed by the specific rule relied on pursuant to Regulation D.

1. Preliminary Concepts

a. Anti-Fraud Rules Still Apply

Regulation D transactions are not exempt from the federal anti-fraud, civil liability or other provisions of the federal securities laws. With respect to the anti-fraud rules, this means that where Regulation D does not provide specific disclosure guidelines (Rule 504, for example), the anti-fraud rules impose a minimum level of disclosure on any offering relying on the Regulation D exemption from registration.⁴⁴ This minimum disclosure level may also apply in addition to the specific disclosure guidelines imposed by Regulation D (e.g., in Rules 505 and 506).

Further, Regulation D itself requires that issuers provide "such further material information, if any, as may be necessary to make the information required under this regulation, in light of the circumstances under which it is furnished, not misleading."⁴⁵ Thus, the general part-

41. Securities Act Release No. 33-6389, Fed. Sec. L. Rep. (CCH) ¶ 34,404 (Mar. 8, 1982).

42. Securities Act Release No. 33-6825 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989). Rules 507 and 508 are effective as of April 14, 1989.

43. 15 U.S.C. § 77a (1982).

44. See *infra* part III.D.2.a (Anti-fraud Disclosure Obligations) and note 82 and accompanying text.

45. 17 C.F.R. § 230.499, preliminary note 1 (1990).

ner/producer in a feature film limited partnership offering must judge whether additional information exists that should be provided to prospective investors in the offering memorandum or elsewhere. This disclosure may be required in addition to adherence to the specific disclosure guidelines imposed by Regulation D or the anti-fraud provisions.

b. Civil Liability

The federal securities laws provide investors with a right to file a civil lawsuit in a court of competent jurisdiction and a right to recover damages.⁴⁶ Civil liability may provide an investor with a right of rescission, which is the right to demand that the investment contract be cancelled and that the investor's funds be returned. Such a rescission could be extremely awkward, if not disastrous, for the thinly capitalized movie producer who has already spent the investor's money on production of a film.⁴⁷

c. State Compliance/Dual Regulation

Reliance on Regulation D at the federal level does not eliminate the need for issuers "to comply with any applicable state law relating to the offer and sale of securities."⁴⁸

d. Non-Exclusive Election

Attempted compliance with any exemption in Regulation D does not act as an exclusive election. Therefore, the issuer may claim any other applicable exemption.⁴⁹ In other words, if an issuer fails for some reason to qualify for Regulation D, he or she may, in the alternative, qualify for an exemption provided by section 4(2) of the 1933 Securities Act.

e. Transactional Exemption

The Regulation D rules "provide an exemption only for the transactions in which the securities are offered or sold by the issuer, not for the securities themselves."⁵⁰ Thus, Regulation D is a transactional exemption.

46. 15 U.S.C. § 77k(a) (1982).

47. *See infra* part IX.C (Burden of Proof File).

48. 17 C.F.R. §§ 230.501-230.508 preliminary note 2 (1990).

49. *Id.* at preliminary note 3.

50. *Id.* at preliminary note 4.

f. Plan or Scheme to Evade Registration

Regulation D is not available to any issuer for "any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act."⁵¹

g. Numerical Investor Limitations and Counting Rules

Rules 505 and 506 each limit sales to no more than thirty-five non-accredited investors, but permit an unlimited number of accredited investors.⁵² Rule 504 does not impose a limit on the number of investors.⁵³

h. Accredited Investors

Rule 501 of Regulation D defines eight different types of accredited investors who may be excluded from the numerical count. These excludable investors include "[a]ny natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000."⁵⁴ Additionally, "[a]ny natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year"⁵⁵ may be excluded.

i. Foreign Purchasers

Certain foreign purchasers may be excluded from the Regulation D numerical count. Offers and sales of securities made outside the United States to foreign persons and effected in a manner that will result in the securities coming to rest abroad generally need not be registered under the 1933 Securities Act.⁵⁶

This interpretation may be relied on for such offers and sales even if coincident offers and sales are made under Regulation D in the United States. Thus, persons who are not citizens or residents of the United States would not be counted in the calculation of the number of purchasers. Additionally, proceeds from sales to foreign purchasers would not be included in the aggregate offering price.

51. *Id.* at preliminary note 6.

52. 17 C.F.R. §§ 230.505(b)(2)(ii), 230.506(b)(2)(i) (1990).

53. *Id.* § 230.504.

54. *Id.* § 230.501(a)(5).

55. *Id.* § 230.501(a)(6).

56. Securities Act Release No. 33-4708, 29 Fed. Reg. 9828 (1964).

j. Residence Sharing Relatives

Rule 501(e) also excludes from the numerical count “[a]ny relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser.”⁵⁷

k. Purchasing Entities

Regulation D provides that a corporation, partnership, or other entity is to be counted as one purchaser unless the entity was organized for the specific purpose of acquiring the securities offered and does not otherwise fit within the definition of an accredited investor.⁵⁸ Otherwise, each beneficial owner of equity securities or equity interests in such an entity would be counted as a separate purchaser for all Regulation D purposes.

Consequently, a general partner/producer relying on either Regulation D’s Rules 505 or 506 may sell limited partnership interests to thirty-five non-accredited investors and to an unlimited number of accredited and foreign investors, while counting certain residence-sharing relatives or purchasing entities as one investor. Private placement limited partnerships commonly provide for the sale of fifty or more limited partnership interests, anticipating that at least fifteen or more purchasers will not be counted against the exemption’s numerical limitation.

1. Offers and Sales Not Exceeding \$1 Million

Regulation D Rule 504 provides an exemption from registration for offers and sales of securities not exceeding \$1 million, as long as no more than \$500,000 of these sales are attributable to offers and sales of securities not registered under a state’s securities laws.⁵⁹ No specific disclosures are required under Rule 504; however, the anti-fraud rules apply. Rule 504 does require that an issuer provide purchasers with written disclosure of any resale restrictions within a reasonable time prior to the purchase.⁶⁰ Generally, such disclosure appears in the Required Federal and State Notices section and in the subscription agreement.

The Regulation D prohibitions against general advertising and resale⁶¹ do not apply to Rule 504 offers and sales of securities that are made: (1) exclusively in states that provide for registration and require the delivery of a disclosure document before sale; or (2) in states that

57. 17 C.F.R. § 230.501(e)(1)(i) (1990).

58. *Id.* § 230.501(e)(2).

59. *Id.* § 230.504(b)(2)(i).

60. Securities Act Release No. 33-6825 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989).

61. 17 C.F.R. § 230.502(c)-(d) (1990).

have no such requirements, as long as three criteria are met—(a) the securities have been registered in at least one state that has such requirements; (b) offers and sales are made in the state of registration in accordance with such requirements; and (c) the state-required document is delivered before the time of purchase to all purchasers in the states that have no such procedure.⁶²

To the extent a state's registration requirement calls for a lengthy disclosure document, the benefits of Rule 504 are reduced. Additionally, the judgment between what must be disclosed pursuant to the anti-fraud rules (in a Rule 504 offering) versus an S-18 level of disclosure (for a Regulation D Rule 505 offering) is often difficult to make on specific disclosure issues. Therefore, the author suggests that it is easier to comply with the Rule 505 disclosure requirements. The author recommends that a disclosure document meeting the S-18 (Rule 505) disclosure requirements be utilized even with a Rule 504 offering.

The Rule 504 aggregate offering price ceiling of \$1 million must be reduced by the aggregate offering price of all securities sold within twelve months before the start of and during the Rule 504 offering of securities, if the offering is made in reliance on any exemption under section 3(b) of the 1933 Securities Act (Rules 504 and 505 and Regulation A) or in violation of the registration requirement of section 5(a) of the 1933 Securities Act.⁶³ The ceiling must be lowered for section 3(b) sales and sales made in violation of section 5(a) within the past twelve months, whether or not these prior sales would be integrated with the sales under Regulation D and the integration principles discussed below.

Prior or contemporaneous sales under section 4(2) or Regulation D Rule 506 do not have to be deducted from the Rule 504 ceiling of \$1 million.

m. Offerings Not Exceeding \$5 Million

Regulation D Rule 505 provides an exemption from registration for limited offers and sales of securities not exceeding \$5 million.⁶⁴ In determining whether the \$5-million ceiling has been exceeded, the offering price of all of the issuer's securities sold within twelve months before the start of and during the offering of securities under Rule 505, and made in reliance on any exemption under section 3(b) or in violation of section 5(a), is combined with the current Rule 505 offering.⁶⁵ The purchase

62. *Id.* § 230.504(b)(1).

63. *Id.* § 230.504(b)(2)(i).

64. *Id.* § 230.505.

65. *Id.* § 230.505(b)(2)(i).

price of securities sold to accredited investors must be counted, although these investors are not included in the thirty-five purchaser limitation.⁶⁶ Also, despite the fact that the current Rule 505 offering involves equity securities, the \$5-million ceiling must be reduced by the proceeds received in a Rule 505 sale of debt securities within the past twelve months.⁶⁷

Sales pursuant to a Rule 505 offering are not permitted to exceed thirty-five non-accredited investors.⁶⁸ No limitation exists on the number of offerees. The Rule 505 exemption is not available for the securities of any issuer if certain persons involved in the offering, such as the issuer, its affiliates, or the underwriters, have been the subject of legal action for specified conduct.⁶⁹ This rule requires the issuer to be familiar with the background of all persons associated with the offering. The disclosure requirements, notice filing requirement, and general conditions described below also apply to a Rule 505 offering.

n. Offerings for More Than \$5 Million

Regulation D Rule 506 provides an exemption from registration for offerings exceeding \$5 million with no ceiling on the amount of money that can be raised.⁷⁰ Like Rule 505, the numerical investor limitation for a Rule 506 offering is thirty-five non-accredited investors.⁷¹ Unlike Rules 504 and 505, however, Rule 506 imposes an investor sophistication requirement on non-accredited investors.⁷² Immediately prior to the sale, the issuer must reasonably believe that each non-accredited investor, "either alone or with his [or her] purchaser representatives has such knowledge and experience in financial and business matters that he [or she] is capable of evaluating the merits and risks of the prospective investment."⁷³

The Rule 506 investor sophistication requirement for non-accredited investors can be met by requiring the prospective investor to complete an investor questionnaire. This questionnaire is designed to elicit information establishing the prospective investor's "knowledge and experience in

66. 17 C.F.R. § 230.505(b)(2)(ii) (1990).

67. Interpretive Release on Regulation D, Securities Act Release No. 33-6455, 48 Fed. Reg. 10045 (Mar. 10, 1983).

68. See *supra* part III.D.1.g (Investor Numerical Limitations and Counting Rules).

69. 17 C.F.R. §§ 230.252(c), 230.252(f) (1990).

70. *Id.* § 230.506.

71. *Id.* § 230.506(b)(2)(i).

72. *Id.* § 230.506(b)(2)(ii).

73. *Id.*

financial and business matters.”⁷⁴ Issuers utilizing investor questionnaires are permitted to rely on the answers so long as the issuers do not know or have reason to know that the answers are not correct. The disclosure requirements, notice filing requirement, and general conditions described below also apply to a Rule 506 offering.

2. Regulation D Disclosure and the Offering Memorandum

The information that must be provided to the prospective purchasers of a feature film limited partnership offering conducted pursuant to Regulation D, depends on the following two factors to determine whether Rule 504, 505, or 506 is invoked: (1) whether or not the offerees are accredited investors; and (2) the amount of the offering.

Very little specific information is required to be furnished to offerees in a Rule 504 offering⁷⁵ or to offerees who consist entirely of accredited investors. However, recall that the anti-fraud rules apply in both situations. Resale restrictions are specifically required to be disclosed in writing if an issuer sells securities under Rule 504, unless the offering is registered with the states.⁷⁶ Also note that many state exemptions that are designed to be compatible with Regulation D require the issuer to rely on Rule 505 or 506, but not 504. For these and other reasons stated herein, this author recommends avoiding the use of the Rule 504 offering except in very limited circumstances.

a. Anti-Fraud Disclosure Obligations

The sponsor (general partner/producer) of a feature film limited partnership must comply with the federal and state prohibitions relating to fraud, in addition to specific disclosure guidelines imposed by federal or state securities regulations which are tied to a given offering funding level. The anti-fraud provisions of the Securities Act of 1933 provide in part:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the

74. *Id.*

75. *Id.* § 230.504.

76. Regulation D, Securities Act Release No. 33-6825 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989).

statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.⁷⁷

Thus, to avoid fraudulent conduct in a securities offering, the issuer and all those representing the issuer must disclose all material⁷⁸ aspects of the transaction. Additionally, the issuer must avoid: (1) failing to state a material fact that is necessary to avoid misleading the investor about the issuer or the offering; and (2) making any untrue statement about a material fact.

The anti-fraud requirements are more likely to be met if everything that is disclosed about an offering is limited to a few documents that are prepared or reviewed by the securities attorney, and if no oral representation departs from the information presented in those documents. The issuer must resist the temptation to draft a "selling document" only. Instead, the issuer should draft a document that will enable the issuer to both sell the security and comply with Regulation D.

The anti-fraud requirement often creates tension between the securities attorney and the producer/client. Filmmakers tend to be oriented toward public relations and are likely to disclose only favorable information they may have about their film. On the other hand, the securities attorney is trying to prevent lawsuits from being filed by disgruntled investors. These lawsuits would likely include an allegation of securities fraud unless both good and bad information have been disclosed.

Not all so-called disgruntled investors are angry with the film's producer or believe the producer did something wrong. It may be that an investor in a film limited partnership is having financial difficulties unrelated to his or her investment in the film partnership. Often, when these investors discuss their financial situation with their attorney, the sizable investment in the film partnership attracts the attorney's attention. The attorney may decide to take a closer look at the transaction, hoping to uncover evidence justifying a lawsuit upon the grounds of securities fraud. The selling of an unregistered security without compliance with exemption requirements may provide such evidence. Thus, the risk that the general partner/producer may have to return the investor's funds provides a compelling reason for conducting a feature film limited part-

77. 15 U.S.C. § 77q(a) (1989).

78. The standard for what is "material" is whether the information would be considered important to a typical prospective investor in making the decision to invest in the offering. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).

nership properly.⁷⁹

Regulation D Rule 505 and 506 offerings require the disclosure of information specified in Rule 502. This information must be disclosed at a reasonable time prior to the sale of the security.⁸⁰

b. Disclosure Levels

The SEC has promulgated what it calls an integrated system of disclosure. This means that no matter what type of offering or amount of money is being raised, some parts of the same disclosure rules may apply. For Regulation D offerings up to \$2 million, the issuer must provide the same kind of information as is required in Part II of Form 1-A (the form used for Regulation A offerings), and provide a certified balance sheet dated within 120 days of the commencement of the offering.⁸¹ Regulation A⁸² has its own set of disclosure rules.⁸³

For Regulation D offerings up to \$7.5 million, the issuer must provide the same kind of information as required in Part I of a Form S-18 registration, except that only the financial statements for the most recent year must be certified.⁸⁴

For Regulation D offerings over \$7.5 million, the issuer must provide the same kind of information as required in Part I of the registration statement filed under the Securities Act of 1933 on the form the issuer would be entitled to use. Typically, this is registration Form S-1, the highest level of disclosure.

Under a Rule 505 or 506 transaction, the issuer must furnish to each purchaser a brief written description of any material information concerning the offering that has been provided by the issuer to any accredited investor.⁸⁵ Additionally, any such information requested by a purchaser in writing must be supplied to the purchaser within a reasonable time before his or her purchase. Technically, this could present a

79. Even though Regulation D Rule 504 does not include specific disclosure guidelines, summarized anti-fraud requirements apply to such offerings. It is suggested that, at a minimum, sponsors comply with the more specific disclosure guidelines of a Rule 505 offering because specific disclosure guidelines allow for greater predictability of compliance.

80. 17 C.F.R. § 230.502(b) (1990).

81. Regulation D Revisions, Securities Act Release No. 33-6758 [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,221 (Mar. 3, 1988).

82. Regulation A refers to the small public offering promulgated pursuant to section 3(b) of the Securities Act of 1933.

83. Regulation A, 17 C.F.R. §§ 230.251-230.263 (1990).

84. Regulation D Revisions, Securities Act Release No. 33-6758 [1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,221 (Mar. 3, 1988).

85. Regulation D, Securities Act Release No. 33-6825 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989).

timing problem if, after several purchasers subscribed to the offering, an accredited investor requested additional information that was not provided to the previous investors. To avoid this situation, issuers should make certain that the offering's disclosure is comprehensive from the very beginning and provides the same information to all prospective investors.

Rules 505 and 506 further require the issuer to provide each purchaser, within a reasonable time prior to purchase, the opportunity to ask questions and receive the answers concerning the offering.⁸⁶ Usually, a statement to this effect is included in the offering memorandum.

c. Regulation D Rule 505 (S-18) Disclosure Guide

As stated above, Regulation D requires that for offerings up to \$7.5 million, an issuer must furnish to all purchasers during the course of the offering and prior to sale, the same kind of information that is required in Part I of Form S-18.⁸⁷ However, only the financial statements for the issuer's most recent fiscal year must be certified by an independent public or certified accountant.⁸⁸

The following disclosure guidelines include a summary of the disclosure requirements of Part I of Form S-18. For more complete information, see the actual Form S-18 and the corresponding portions of Regulation S-K (with accompanying instructions), referred to in Form S-18.⁸⁹ Each item listed and discussed in this section begins with the mandated provisions of S-18, and is followed by the author's comments and additional suggestions regarding disclosure as it specifically relates to a feature film offering.

Some of the items are specifically mandated by Regulation D, while others are suggested as part of the issuer's obligation in meeting the anti-fraud disclosure requirements. Still others are included in an effort to complete the prospective investors' understanding of a feature film limited partnership offering. Not every item listed must be included in every film offering. From the perspective of compliance, however, the more disclosure the better. Moreover, the chances of conducting a successful

86. Regulation D, 17 C.F.R. § 230.502(b)(2)(D)(v) (1990).

87. Form S-18, in most instances, makes reference to various provisions of the SEC's Regulation S-K. Thus, most of the disclosure rules described here actually come from Regulation S-K. 17 C.F.R. § 230.502(b)(2)(B) (1990).

88. Regulation D, 17 C.F.R. § 230.502(b)(2)(B) (1990).

89. The SEC's S-18 disclosure guidelines are primarily drafted to apply to a corporate stock offering. Consequently, much of what is provided simply does not apply to limited partnership offerings or must be interpreted.

offering improve with the strength of each element of the film and its corresponding disclosure in the offering memorandum.

The author has prepared this checklist in order to provide producer/clients with a single list of the types of information that the producer/client will need to develop in consultation with the attorney for inclusion and disclosure in a typical private placement feature film limited partnership offering memorandum. The preparer of a feature film limited partnership offering should present as much credibility as possible in the offering disclosure and demonstrate that competent management and film production teams are in place.

The time required to prepare the offering memorandum is a direct function of the quantity and quality of information provided pursuant to this checklist, as well as how often information changes during the course of the memorandum's preparation.

i. External Cover

There is no requirement that the information required to be disclosed on the cover page must actually appear on the outside cover of the private placement offering memorandum. Thus, the producer/client has the option of preparing the external cover in whatever manner suits his or her personal taste. The choice of binding may influence this decision.

For example, the producer/client may choose the less expensive spiral binding, use a heavy, colored paper for the external cover, and prominently display the name of the offering on that external cover. Others sometimes prepare original art work for use on the external cover, including the miniature "one sheet" (sell sheet) for the movie. Still others use a spiral or other binding and a clear plastic external cover, which allows the information on the cover page to show through. Alternatively, a producer/client may choose to bind the offering memorandum with a more expensive "perfect" binding and utilize a coated type of heavy paper for the external cover. These are choices to be made by the individual producer/client in consultation with his or her printer.

ii. Cover Page

Pursuant to Regulation D, the following information must be included on the cover page, regardless of whether it is an external or internal cover page: (1) the approximate date of the proposed sale of the securities to the public; (2) appropriate cross-references to more detailed discussion elsewhere in the memorandum; (3) the name of the general partner(s) and the general partner's address and phone number; (4) the type and amount of securities being offered, e.g., limited partnership in-

terests or pre-formation limited partnership interests; (5) a brief description of the securities; and (6) where the securities are to be offered for cash, the information called for by the following table, in substantially the tabular form indicated, as to all securities (estimated, if necessary)—actual numbers used will differ, e.g., mini-maxi.⁹⁰

<u>Proceeds to Limited Partner</u>	<u>Public Price</u>	<u>Commissions</u>
\$ 22,500	\$ 25,000	\$ 2,500
Minimum		
\$1,350,000	\$1,500,000	\$150,000
Maximum		
\$1,800,000	\$2,000,000	\$200,000

Additionally, the following statement must be printed on the cover page in boldface capital letters, 10-point roman type, and at least two points leaded:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS OFFERING MEMORANDUM. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

Any specific legend or information required by law in any state in which the securities are to be offered must be included on the cover page. Where applicable, cross-reference should be made to the discussion in the memorandum relating to material risks in connection with the purchase of the securities. The date of the offering memorandum is also required on the cover page.

iii. Glossary

The limited partnership agreement traditionally includes a glossary or definitions section. This portion is necessary because many of the terms used in the limited partnership agreement are very precise or technical. Generally, defined terms appear in the private placement offering memorandum with initial capital letters to clue the reader that the definition of these terms appears in the glossary. The same definitions are generally carried over for use in the offering memorandum. Quite often, the

90. A mini-maxi offering may be utilized, for example, in situations where star "A" is substantially more expensive than the alternative star "B" and star "A" is to be hired if the maximum amount of the offering is achieved, but star "B" will be hired if only the minimum amount of funds are raised.

glossary also appears at the forefront of the offering memorandum to help its readers in understanding the terminology. In order to minimize repetition and save pages in what will already be an imposing document, the author opts for including the following notice on the backside of the cover page:

NOTICE

For the convenience of Prospective Purchasers, certain terms used in this Memorandum are defined in the Definitions section located in the forepart of the Partnership Agreement (Exhibit "A"). Such defined terms will appear in the Memorandum as capitalized terms.

iv. Table of Contents

No specific securities law disclosure requirements exist regarding the table of contents for a Regulation D offering, but the inclusion of such a feature is of practical importance. In order to make the offering memorandum a more readable document, it is important to place a table of contents at the very beginning. It is customary to include the table of contents on the back cover of a public offering prospectus. For a private placement, however, this author recommends placing the table of contents near the front to help direct the reader and to avoid confusing the private placement with a public offering.

v. Program Highlights

The Regulation D disclosure guidelines do not require program highlights, but this feature helps both the general partner/producer and prospective investors to quickly evaluate the film offering. Program highlights consist of a one-page list of the most important selling points regarding the movie and the partnership offering. The program highlights page is like a mini-summary of the offering and, like the offering summary, the information contained on the program highlights page must be accurate and not misleading. Additionally, the brief statements should refer the reader to the more detailed provisions in the memorandum. The program highlights page may be bound inside the offering memorandum or reprinted separately and included as part of the offering materials packet.

Typically, a program highlights page includes information such as: the number of films being funded by the partnership; whether specified film properties and completed screenplays are involved; the identity or description of the screenwriter, director, producer and executive pro-

ducer; a brief description of the nature of the film(s); whether the film(s) are designed to appeal to a broad or limited market; and whether name actors are to be used. Program highlights also include some statement about the level of experience of the people involved in putting together the package, the budget level of the films, the identities of the general partners, whether anything but cash will be accepted for the purchase of a limited partnership interest, the profit participation ratio between the general partner group and the limited partner investor group, whether that ratio changes after the investors recoup their original investment, and whether recoupment is defined as something other than a 100% return of invested capital. Other information on the program highlights page may include: whether a distribution deal is in place; whether the distribution deal provides any guarantees; what distribution approach is to be used; some statement about the tax consequences of an investment in the offering; whether the offering is a mini-maxi offering and, if so, the minimum and the maximum; what broker/dealer commissions are to be paid; the percentage of offering proceeds that will be used for offering expenses, including commissions; information about the escrow agent; and whether co-financing may be permitted.

vi. Summary

Disclosure under Regulation D requires that a summary of the information contained in the offering memorandum be provided where the length or complexity of the memorandum makes such a summary appropriate. These summaries may be either internal⁹¹ or external⁹² or both. In an interpretive release, the SEC offered the following guidance for the use of external summaries in a Regulation D offering: “[S]o long as the information is delivered prior to sale, the use of a fair and adequate summary followed by a complete disclosure document is not prohibited under Regulation D. Disclosure in such a manner, however, should not obscure material information.”⁹³

vii. Address and Telephone

The beginning of the offering memorandum must include the complete mailing address and telephone number of the principal executive officers of the partnership.

91. An internal summary is included within the offering memorandum.

92. An external summary is a separate document.

93. Answer to Question #40 in SEC Interpretive Release No. 33-6455.

viii. Risk Factors

A discussion of the principal factors that make the offering speculative or one of high risk must be set forth on the page immediately following the cover page. Insertion of a table of contents and a summary of the offering between the two should not be a problem.

ix. Organization Within Five Years

If the general partnership was organized within the past five years, the nature and amount of anything of value received or to be received by each limited partner from the general partner(s) must be furnished.

x. Plan of Business

The Regulation D Rule 505 disclosure guidelines require a description of the business done and intended to be done by the partnership, the principal products to be produced, and the principal markets for and methods of distribution of the products. The number of persons employed by the partnership, indicating the number employed full-time, must also be included. The partnership must provide a statement in narrative form indicating approximately how long the proceeds from the offering will satisfy cash requirements and whether, in the next six months, it will be necessary to raise additional funds to meet the expenditures required for operating the business of the partnership. The partnership must also describe those distinctive or special characteristics of the partnership's operations or industry that may have a material impact on the partnership's future financial performance.

The plan of business for a feature film limited partnership should cover the following topics: (1) general proposed activities; (2) significant current statistics regarding the movie industry in general, and specifically regarding independent production, including the date and source; (3) the partnership; (4) partnership management; and (5) the participants in the partnership, including the general partner/executive producers, board of directors, advisors, and consultants. Additionally, the following information relating to the partnership must be developed and disclosed: (1) the proposed name of the partnership; (2) the partnership address; (3) the term of the partnership—typically five to ten years for film; (4) the state in which the limited partnership is to be created; (5) the name of the general partner(s); (6) the residence, office address, and phone number of the general partner; and (7) partnership management information.

All persons who are committed to a film that is funded by the limited partnership offering must provide: (1) his or her name; (2) compen-

sation arrangements—cash, deferments, percentage participation, amount paid, when paid, and paid out of what source, e.g., partnership gross revenues or the general partner's share of net receipts; (3) narrative biography with age and dates of activities;⁹⁴ and (4) copies of letters of intent.⁹⁵

The business plan section should also include the following information relating to the specific film(s) to be produced by the partnership: (1) the tentative title of the film; (2) the screenwriter's identity and credits; (3) the screenplay synopsis (film description); (4) a history of the acquisition of the screenplay rights—amount paid, to whom, when, the nature of the agreement, and future obligations; (5) a copy of the option or literary acquisition agreement; (6) a descriptive phrase regarding the film's genre; (7) production information, including what shooting locations have been identified; (8) marketing and promotion plans (unit publicist, to distributors and to the public); (9) specific promotional themes (ad lines) for the movie; (10) an analysis of the picture's box office appeal—audience age, domestic versus foreign viewers, anticipated movie rating, etc.; (11) box office comparables; and (12) the source for this information. The choice of box office performances used for comparison (“box office comparables”) should be fairly balanced between similar successful and not-so-successful films.⁹⁶

Within the business plan section, an important sub-section pertaining to distribution should be included. It should discuss the following items: distribution-related activities conducted to date, specific plans for distributing the film, alternative distribution approaches, and distributor letters of interest. Additionally, agreements, guarantees or other arrangements with permission to disclose in the offering memorandum, and a production and distribution schedule should be included.

94. On all biographies, include age, dates, and years of experience. Be factual, i.e., eliminate the puffery. Do not use anyone's name in the memo without written permission. Disclose the nature of the commitment, i.e., what the person has agreed to do for the partnership and its picture, for each of these persons. Provide the biographies in narrative form. Avoid industry jargon where possible.

95. Letters of intent should include permission to use one's name in the offering (if permitted) and should indicate that the individual has read the script and is interested in doing whatever he or she has been asked to do. They should also specify all contingencies, such as: (1) the offering is successfully funded; (2) the partnership and the individual involved reach mutual agreement with respect to the individual's compensation; and (3) the individual's other commitments do not preclude his or her availability for the project when services are required.

96. Box office comparables may be provided as an exhibit to the offering memorandum instead of as part of the business plan.

xi. Significant People

The Regulation D Rule 505 disclosure guidelines require a listing of the names and ages of all of the directors, executive officers, promoters, control persons, and significant employees who are nominated or chosen to become such. The guidelines also require an indication of all of the positions and offices that each person holds within the partnership. Be sure to state each person's term of office and any period for which he or she has served. Additionally, describe briefly any arrangement or understanding between the individual and any other person pursuant to which he or she was, or is, to be selected as such. Last, state the nature of any family relationship between any of the above named persons, and describe the business experience during the past five years of each of the above named persons.

xii. Description of Securities

Regulation D requires that a brief description of the offered securities be provided. This requirement is more appropriate for corporate stock offerings, because little can be said about limited partnership interests besides the unit size and price.

xiii. Determination of Offering Price

The Regulation D disclosure guidelines require disclosure of the various factors considered in determining the offering price of the securities offered. Again, this requirement is not particularly appropriate for a limited partnership offering because the unit size and price is determined somewhat arbitrarily. Therefore, a statement to that effect is usually included.

xiv. Offering Information

In a feature film limited partnership offering, the following information relating to the offering is generally disclosed under a major heading such as "Offering Information": the date of the offering memorandum (which is the same date as the start of the offering); the closing date of the offering; the extension date of the offering (which is generally not more than one year from the date of the offering memorandum); and the total amount of the offering (which includes offering expenses plus film budget). Other information typically disclosed are the number of limited partnership units and the price per unit; payment terms for the units (cash or otherwise); whether half or fractional units will be sold and under what circumstances (e.g., according to the general partner's discre-

tion); the general partner's capital contribution, if any (e.g., cash, property, time, skill and effort, or rights to screenplay, at cost or otherwise); whether the transfer of rights to the screenplay was a general partner contribution or sale; whether the general partner will also be a unit holder; the minimum investment per investor (e.g., one unit); and the amounts and forms of all compensation to be paid to the general partners. Other disclosed information includes the following: the states in which sales of limited partnership units are expected; the division of the partnership net receipts between the general partner and the investor group, before and after recoupment (e.g., 98% to limited partners and 2% to the general partners before recoupment, and 50/50 after recoupment); whether additional stages of changing ratios between general partners and limited partners will be utilized; how recoupment is to be defined (e.g., 100% of original invested capital, 120%, 150%, or some other percentage); and whether special allocations for losses are to be used and what those percentages will be (e.g., the same as pre-recoupment for profits). Additionally, information relating to the following is disclosed: the frequency of cash distributions to be made to partners (quarterly or semi-annually); the percentage participation to be paid from partnership gross revenue or the general partner's share of partnership net receipts (distributable cash); the amount of the partnership organization fee to be paid to the general partner, if any; and the limited partnership management fee to the general partner, if any (e.g., a one-time management fee paid out of offering proceeds and/or annual management fees paid out of partnership gross revenues).

Escrow arrangements should also be disclosed in the offering information section. The following information should be included regarding escrow arrangements: the name of the escrow agent (which should be a fairly well-known bank); whether interest will be paid on the escrow account; if interest on the escrow account will be paid to investors following a successful offering as well as an unsuccessful offering; and the escrow account number. Specific instructions should be obtained from the escrow agent regarding to whom the check should be made payable.

xv. Use of Proceeds

The Regulation D Rule 505 disclosure guidelines require a statement of the principal purposes for which the net proceeds of the offering are intended to be used and the approximate amount intended to be used for each purpose. Where fewer than all the securities to be offered may be sold and more than one use is listed for the proceeds, indicate the order of priority of the purposes and discuss the partnership's plans if

substantially less than the maximum proceeds are obtained. In other words, if the offering is a mini-maxi (i.e., it sets out to raise at least a minimum amount of funds and possibly a maximum amount of funds), an estimated breakdown of the use of proceeds must be provided for both funding levels. Further, an explanation should be included as to what happens if an amount between the minimum and maximum is actually raised.

Details of proposed expenditures need not be given. Only a brief outline needs to be furnished. If any material amount of additional funds is necessary to accomplish the specified purposes for which the proceeds are to be obtained, state the amount and source of the other funds needed and their sources. If any material part of the proceeds is to be used to discharge indebtedness, set forth the interest rate and maturity of the debt. The partnership may reserve the right to change the use of the proceeds, provided that the reservation is due to certain contingencies that are specifically discussed, with alternative uses indicated.

In disclosing the estimated use of proceeds, the following suggested format may be used:

Offering Expenses

Organizational & management costs	\$ _____
Syndication expenses	\$ _____
TOTAL OFFERING EXPENSES	\$ _____
Story rights acquisition	\$ _____
Development stage	\$ _____
Film production budget	
Pre-production	\$ _____
Principal photography	
Above-the-line	\$ _____
Below-the-line	\$ _____
Post-production	\$ _____
Production sub-total	\$ _____
Contingency reserve ⁹⁷	\$ _____
Completion bond	\$ _____
TOTAL PRODUCTION BUDGET	\$ _____
Marketing/promotion, if any	\$ _____
Distribution (prints and ads, if any)	\$ _____
TOTAL OFFERING PROCEEDS	\$ _____

97. Do not include non-contingency items such as insurance, development, script or overhead costs in the contingency or completion bond calculations.

xvi. Executive Compensation

Regulation D Rule 505 disclosure guidelines require that compensation paid to general partners be furnished in tabular form. Generally, this information is repeated in the Limited Partnership Agreement and summarized in the offering summary.

xvii. Plan of Distribution of Units

The Regulation D Rule 505 disclosure guidelines require a brief outline of the plan of distribution of the securities offered. If the securities are to be offered through the selling efforts of broker/dealers, describe the plan of distribution and the terms of any agreement, arrangement, or understanding entered into with broker/dealers prior to the effective date of the offering memorandum. The description should include the volume limitations on sales, the parties to the agreement, and the conditions under which the agreement may be terminated.

If known, identify the broker/dealers that will participate in the offering, and state the amount to be offered through each. Briefly state the discounts and commissions to be allowed or paid to the dealers, including all cash, securities, contracts, or other considerations to be received by any dealer in connection with the sale of the securities. Additionally, identify any finder and, if applicable, describe the nature of any material relationship between the finder and the general partner or affiliates of the general partner.

Thus, information relating to the plan of marketing units should be included as a subsection in the offering information section of the memorandum. Film limited partnerships in a private placement will most likely be distributed on a "best-efforts" basis, as opposed to an "all or none" or "firm underwriting."⁹⁸

xviii. Motion Picture Industry Overview

A motion picture industry overview should be included to inform prospective investors who are not familiar with the industry about how the industry operates. This overview relates to the industry generally and not to the specific film(s) being funded by the subject offering. Typically, the overview will include an explanation of the various stages of film production and a description of how the money goes back to the investors, including the range of percentages deducted along the way and by whom. Industry trade publications and seminars are the best current source of this information.

98. See PRIFTI, *supra* note 28 § 3.09, at 3-12, 3-132.

xix. Federal Tax Discussion

The federal tax discussion in the private placement offering memorandum should summarize and set forth the tax counsel's discussion of all material federal income tax consequences associated with the acquisition, ownership, and disposition of the limited partnership interests. It should also include an overall evaluation of investing in the partnership. The discussion is not intended as a comprehensive analysis of every federal income tax consideration that may be relevant to prospective investors. In fact, the discussion should point out that the federal income tax consequences for each investor may vary.

Further, the discussion should point out that it does not address the state, local, or foreign tax laws that could affect the partnership or the purchasers of limited partnership interests. Accordingly, each prospective purchaser is cautioned that he or she should consult with his or her own tax advisor before acquiring any limited partnership interest. Tax counsel preparing such a discussion should include his or her opinions regarding the material tax issues raised by an investment in the offering.

xx. Miscellaneous Provisions

The next four sub-headings are mandated by the Regulation D disclosure guidelines, and may be included in a "Miscellaneous Provisions" section of the memorandum. In this section, provide information relating to the frequency that reports will be distributed to limited partners (e.g., a monthly report during the offering and film production). State who is handling legal matters and whether any portion of the legal fees are contingent on the success of the offering. Additionally, include arrangements that will be made to handle partnership management ("back office") responsibilities. These include state securities and broker/dealer compliance and commissions, exempt offering compliance and filings, the monitoring of accredited investors, investor communications and relations, confirmations, the preparation of the IRS form K-1's, distribution allocations, special allocations, unit assignments or transfers, SEC filings, and tax shelter registration. State whether these activities will be conducted primarily through the use of special computer software, staff, accountants, and/or attorneys.

xxi. Legal Proceedings

Regulation D Rule 505 requires a description of any pending legal proceedings, other than routine litigation incidental to the business, to which the partnership or its general partner(s) are a party or to which

any of their property is subject. Include the name of the court or agency in which the proceeding is pending, the date instituted, the principal parties involved, a description of the factual basis alleged to underlie the proceeding, and the relief sought. Include similar information regarding any proceedings known to be contemplated by governmental authorities.

xxii. Interests of Named Experts and Counsel

If named experts or counsel prepared statements or reports for use in connection with the offering, and they are to be compensated on a contingent basis, the arrangements must be disclosed under Regulation D Rule 505.

xxiii. Statement as to Indemnification

Regulation D Rule 505 disclosure guidelines require a brief description of any indemnification provisions made for the benefit of the general partners as part of the limited partnership agreement. The following statement must be included:

INSOFAR AS INDEMNIFICATION FOR LIABILITIES ARISING UNDER THE SECURITIES ACT OF 1933 MAY BE PERMITTED TO DIRECTORS, OFFICERS, OR PERSONS CONTROLLING THE GENERAL PARTNER PURSUANT TO THE FOREGOING PROVISIONS, THE GENERAL PARTNER HAS BEEN INFORMED THAT IN THE OPINION OF THE SECURITIES AND EXCHANGE COMMISSION, SUCH INDEMNIFICATION IS AGAINST PUBLIC POLICY, AS EXPRESSED IN THE ACT, AND IS THEREFORE UNENFORCEABLE.⁹⁹

xxiv. Financial Statements

Pursuant to the Regulation D Rule 505 disclosure guidelines, the financial statement of the partnership (issuer) must be provided and prepared in accordance with generally accepted accounting principles. The balance sheets of the general partners should be included as follows: if the general partner is a corporation, provide an audited balance sheet as of the end of its most recently completed fiscal year; if the general partner is an individual, provide a balance sheet of the natural person as of a recent date. The balance sheet of an individual general partner need not be audited.

In a registered offering, financial statements must be included in the

99. Regulation D, 17 C.F.R. § 229.702 (1991).

body of the disclosure document, but quite often they are treated as an exhibit in a private placement offering memorandum.

xxv. Exhibits

Regulation D Rule 505 provides its own form of direction for providing exhibits to the offering memorandum: "Exhibits . . . need not be furnished to each purchaser that is not an accredited investor if the contents of material exhibits are identified and such exhibits are made available to a purchaser, upon his written request, a reasonable time prior to his purchase."¹⁰⁰

Item 601 of Regulation S-K¹⁰¹ describes the exhibits that must be made a part of the offering memorandum. Included among these exhibits are the tax and securities opinions. Tax opinions provided by attorneys or accountants are generally expensive. This is due to the time required by the professional to properly review the structure of the offering and the disclosure document, draft the tax discussion, and render the actual opinion letter. Additionally, opinions expose the rendering entity or individual to liability. The American Bar Association¹⁰² and the Internal Revenue Service have established rigorous standards for these opinions.¹⁰³

In lieu of providing such a tax opinion, some attorneys suggest that the language of Regulation D Rule 502 G(2)(iii) may allow a general partner to avoid the expense of obtaining an attorney's tax or securities opinion as long as no prospective investor requests the opinions in writing. It is doubtful that the SEC would agree with this interpretation. The SEC's position is that a tax discussion and opinion are material issues that must be disclosed in the context of a limited partnership offering. Additionally, states require the inclusion of a tax opinion if the limited partnership interests are offered to non-accredited investors, on the ground that such an opinion is a material disclosure.

Other exhibits to the private placement feature film limited partnership offering include the limited partnership agreement, and the financial statements of the general partner and limited partnership. The exhibits may also include: a distribution agreement, if any; an attorney's opinion regarding the legality of the securities; financial projections and their accompanying assumptions; letters of interest and intent; box office comparables (if not included in the body of the memorandum); press

100. Regulation D, 17 C.F.R. § 230.502(b)(2)(iii) (1990).

101. Regulation D, 17 C.F.R. § 229.601 (1991).

102. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 346 (1982).

103. Final IRS Circular 230 (Feb. 23, 1984).

coverage (with permission to use) of the specific film project or its associated people, if any such press has been generated; and news article reprints relating to the industry in general.

xxvi. Additional Aspects of the Offering Memorandum

The following discussion provides additional observations regarding the preparation of the offering memorandum and accompanying promotional materials. When considered in conjunction with the required disclosures, this discussion will provide a comprehensive guide to disclosure for a feature film limited partnership.

xxvii. Preparing the Offering Memorandum

In addition to the partnership, securities, tax, and entertainment law implications of a feature film limited partnership offering, the preparation of a private placement offering memorandum is, at a minimum, a challenging word processing project. This non-legal aspect should not be approached without adequate preparation. Remember that some statements in a feature film private placement document will likely be repeated at different places in the document. Thus, when changes are made in one place, it is important to make the same changes elsewhere in the document.

2. Projections/Feature Film Revenue Stream

Financial projections are defined by the AICPA¹⁰⁴ as “estimates of financial results based upon assumptions which are not necessarily the most likely.”¹⁰⁵ Projections merely represent the preparer’s estimate (or, in some cases, several different estimates) of how much money may be generated by a film or returned to the investor as a result of the feature film limited partnership’s exploitation of its film. Projections are important for broker/dealers and prospective investors in analyzing a prospective investment in a feature film limited partnership.

The SEC provides specific guidelines for the use of projections in registered offerings. However, Regulation D and its associated disclosure rules make no reference to financial projections. In fact, approximately fifty percent of the feature film offerings in the author’s private collection of film offering memoranda do not contain financial projections.

104. American Institute of Certified Public Accountants.

105. The AICPA distinguishes between financial projections and financial forecasts, the latter being estimates of the most probable financial position, results of operations, and changes in financial position for one or more future periods.

Projections may be prepared by an accountant or accounting firm, a securities or entertainment attorney, a general partner/producer, or others with an understanding of the economics of the film industry. Projections prepared by a known accounting firm may have added value. Regardless of who the preparer is, it is important for projections to be easily understood by prospective investors.

Projections can be a safe and useful tool in marketing the offering, as long as the projections are based on a reasonable set of assumptions¹⁰⁶ that have been disclosed, and the prospective investors are not misled about what the projections represent. The most conservative approach to projections is to show at what point the offering would reach break-even. Another relatively safe approach is to calculate several different box office performance levels—poor performance, medium performance, and good performance.

IV. REGULATION D GENERAL CONDITIONS TO BE MET

Regulation D Rule 502 sets forth several general conditions that must be met under all three of the Regulation D exemptions.

A. *Integration*

The concept of integration in a securities law context requires that all sales that are part of the same Regulation D offering meet all of the Regulation's terms and conditions.¹⁰⁷ This provision seeks to eliminate the temptation to conduct several related small offerings under Rule 504 in an attempt to evade the application of requirements that would otherwise be imposed under Rule 505 or 506.

Generally, the integration problem will not arise in the context of a feature film limited partnership offering, unless the general partner/producer seeks to avoid the application of the numerical limitation on investors or the ceiling on the amount of money that can be raised by conducting such offerings. An integration problem may arise, for example, if the general partner/producer engages in the following activities all relating to the same film: conducting a developmental or preliminary offering, another offering for production funds, and a third offering for prints and advertising.

The integration concept also provides "safe harbor"¹⁰⁸ provisions,

106. Assumptions (facts assumed for purposes of calculating the financial projections) in a feature film context may include domestic box office performance, exhibitor's take, distributor and sub-distributor fees and expenses, partnership expenses, etc.

107. Regulation D, 17 C.F.R. § 230.502(a) (1990).

108. *Id.*

which may prevent application of the integration rule. The safe harbor provisions permit offers and sales to be made more than six months before the start of a Regulation D offering or six months after the completion of a Regulation D offering. They also provide that such offerings will not be integrated with the Regulation D offering, provided that during those six-month periods no offers or sales occur by or for the issuer of securities of the same or similar class.¹⁰⁹

In determining whether offers and sales may be integrated for purposes of the Regulation D exemptions, the following factors are considered: (1) Are the sales part of a single plan of financing? (2) Do the sales involve the issuance of the same class of securities? (3) Have the sales been made at or about the same time? (4) Was the same type of consideration received? and (5) Were the sales made for the same general purpose?¹¹⁰

B. Limitations on Resale

Limited partnership interests sold pursuant to Regulation D are still considered securities following the initial sale. Thus, they cannot be resold unless they are registered with the SEC. Additionally, they must be registered in each state where sales are anticipated unless they qualify for available exemptions from registration.¹¹¹

The issuer must exercise reasonable care to ensure that the purchasers are not underwriters who purchase from an issuer with the view to distribute the securities. According to Regulation D, "reasonable care" may be demonstrated by the following: (1) a reasonable inquiry to determine if the purchaser is acquiring the securities for himself or another person (generally by means of a purchaser representation in the subscription agreement); (2) written disclosure to each purchaser that the securities are not registered, and therefore, their resale is restricted (generally by means of a prominent notice or legend in both the Required Federal and State Notices section of the offering memorandum as well as in the subscription agreement); and (3) a legend inscribed on the certificate or document that evidences the securities, stating that they have not been registered, and referring to the restrictions on resale. Quite often a limited partnership offering does not provide a certificate evidencing the securities. Instead, an accompanying subscription agreement is evidence of the security.

109. *Id.*

110. *Id.*

111. A limited exception for state registered sales exists pursuant to Regulation D, Rule 504(b)(1). 17 C.F.R. § 230.502(a) (1990).

C. *Limitations on Manner of Offering*

Numerous limitations are placed on the manner in which an issuer conducts an offering of securities. Regulation D, federal securities statutes, the National Association of Securities Dealers (NASD), and state laws all place limitations on offerings, including feature film limited partnerships.

The following discussion provides the text of the Regulation D provisions that relate to the manner of offering, along with the SEC staff's interpretations of such provisions. This section is followed by a discussion of related issues, including issuer sales, broker/dealer compensation, private securities transactions, and finders fees, which are not specifically based on Regulation D provisions but may still impact the manner in which a private placement offering is conducted.

D. *Regulation D Limitations*

Regulation D places specific limitations on the manner in which sales of the limited partnership interests, or securities, can be conducted.¹¹² Section 502(c) states:

Except as provided in Rule 504(b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following: (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.¹¹³

The Regulation D prohibition against advertising has not generated as many requests to the SEC for clarification as the prohibition against general solicitation. Nonetheless, the SEC staff has interpreted the prohibition against advertising to mean that advertisements soliciting investment in a limited partnership cannot appear in foreign magazines and newspapers distributed outside the United States, if the offering is also

112. *Id.* § 230.502(c) (1990).

113. Regulation D Rule 504(b)(1) provides that the provisions of Rule 502(c) do not apply to offers and sales of securities under Rule 504 that are: (1) made exclusively in one or more states, each of which provides for the registration of the securities and requires the delivery of a disclosure document before sale; and (2) in accordance with those states' provisions. 17 C.F.R. § 230.504(b)(1) (1990).

made within the United States under Regulation D.¹¹⁴

The prohibition against general solicitation has prompted the most discussion and interpretation by the SEC staff. According to the SEC staff, procedures for a private offering will not run afoul of Regulation D Rule 502(c) if the issuer or broker/dealer's pre-existing relationship with the offerees was not established through a recent general solicitation.¹¹⁵ Further, the SEC conceded that "substantive relationships" may be established with persons providing satisfactory responses to questionnaires designed to determine their sophistication and financial circumstances. However, suitability questionnaires and new account forms must provide sufficient information for the broker/dealer to make the suitability evaluation.

In a no-action letter,¹¹⁶ the SEC's Division of Corporation Finance advised the firm of Bateman Eichler that its proposed solicitation, which was to be generic and avoid reference to any specific investment currently offered or contemplated for offering by Bateman Eichler, would not involve an offer of securities and would therefore not be prohibited by Regulation D. In its inquiry, Bateman Eichler represented that it would maintain records of all mailings so that no person who was originally contacted through the generic mailing would receive offering materials for a specific investment currently offered or contemplated. The mailing included a questionnaire designed to elicit financial and other information about the prospective customer in order to enable the broker to evaluate the suitability of future investments. The SEC advised Bateman Eichler that later offers to persons who responded to the mailings would not be deemed a general solicitation as a result of the initial solicitation, provided that "[a] substantive relationship had been established with the offeree between the time of the initial solicitation and the later offer."¹¹⁷

Another SEC no-action letter¹¹⁸ confirmed that satisfactory responses by strangers to an adequate questionnaire will itself establish the requisite pre-existing substantive relationship. Further, an isolated "cold call" in the offering process by a broker/dealer would probably not constitute a general solicitation that would destroy the Regulation D

114. *Briscoe, Grimes & Straus, Inc.*, SEC No-Action Letter, 17 *Sec. Reg. & L. Rep. (BNA)* No. 36, at 1632 (Aug. 20, 1985).

115. *E.F. Hutton & Co.*, SEC No-Action Letter, 17 *Sec. Reg. & L. Rep. (BNA)* No. 50, at 2193 (Dec. 3, 1985).

116. *Bateman Eichler, Hills Richards, Inc.*, SEC No-Action Letter, 17 *Sec. Reg. & L. Rep. (BNA)* No. 50, at 2193 (Dec. 3, 1985).

117. *Id.*

118. *H.B. Shaine & Co., Inc.*, SEC No-Action Letter, 19 *Sec. Reg. & L. Rep. (BNA)* No. 20, at 732 (May 1, 1987).

exemption.¹¹⁹

The issuer or broker/dealer firm, however, should maintain control over the number and qualifications of investors to whom limited partnership interests are privately offered. The more registered or issuer representatives participating in the offering, the greater the potential for attracting unsophisticated or otherwise unqualified investors; hence, the greater the need for a uniform and documented system for making such offers.

To accomplish the goals of control over the investor pool and uniformity in methodology, the issuer or broker/dealer firm should develop offering and investor selection procedures. These procedures should ensure that offering materials are sent only to prospective offerees with whom the issuer or broker/dealer firm has established a business relationship or to those who have indicated they wish to form a relationship. In these ways, the firm will know the prospective investor's suitability.

No investor should be offered securities in a private placement offering unless the issuer or broker/dealer firm has on file a New Account Form and a fully completed Suitability Questionnaire dated within the last year. Further, to ensure the private nature of the offering, strict and uniform distribution procedures should be followed. The issuer or its broker/dealer firm should provide detailed instructions to each upper-level management selling agent or registered representative, setting out the categories of persons who may be contacted in a private offering. Only authorized pre-offering and offering materials should be provided to the prospective investor.

If a prospective investor expresses an interest in a future offering, a confidential private placement offering memorandum should be sent to the registered or issuer representative for delivery to the prospective investor when the memorandum is ready.

For five years following the sale of such securities, the issuer or broker/dealer firm should maintain the following information¹²⁰ for each purchaser: (1) the source of contact or referral; (2) the nature of the relationship with the offeree; (3) previous investments with the issuer or broker/dealer; (4) the list of informational materials provided; and (5) a

119. The SEC has stated that if an offering is structured so that only persons with whom the issuer and its agents have had a prior relationship are solicited, the fact that one potential investor with whom there was no such prior relationship is called may not necessarily result in a general solicitation. Securities Act Release No. 33-6825 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,404 (Mar. 14, 1989).

120. The author recommends maintaining a file with all of the information gathered from various procedures discussed throughout this article.

copy of the client's Suitability Questionnaire on which the issuer or firm relied.

Offerees should be qualified on either the basis of information obtained through a pre-existing business relationship, or the data provided by the Suitability Questionnaire and the New Account Form, which indicate that the offeree not only desires to form a business relationship with the issuer or its broker/dealer firm but also has the requisite sophistication and financial resources to be a suitable purchaser. The SEC staff emphasizes the importance of the existence and substance of prior relationships between the issuer or its agents and those being solicited. It is crucial that substantive relationships be created with offerees and that these relationships exist prior to a solicitation relating to a private offering.

If any relationship has been established by a general solicitation or advertising, it is important that sufficient time elapse between establishment of the relationship and an offer, so that the offer is not considered to be made by general solicitation or advertising. If the relationship was established prior to the time the broker/dealer firm began participating in the Regulation D offering, an offer can be made without violating Rule 502(c).

In 1985, an Associate Legal Director of the SEC Division of Corporation Finance summarized the SEC's interpretation of Rule 502(c) as follows:

There is no requirement for a pre-existing relationship between the person making an offer to sell securities and the offeree. Rather, a pre-existing relationship is one factor among others to be considered in determining whether a general solicitation has been avoided. A broker/dealer firm does not have to have sold deals to an investor before selling the Regulation D offering, but should have gathered satisfactory responses to information-gathering techniques that indicate the broker/dealer may sell the security in an exempt transaction to the investor.¹²¹

SEC no-action letters do not address the limitation on the number of offerees. Rather, the no-action letters merely address the stage at which the offeror is soliciting potential offerees, and not a later stage when actual offers are made. Further, issuers may have difficulty trying to reproduce the factual circumstances involved in these no-action letters because they were written for broker/dealers. Issuers should conduct

121. E.F. Hutton, SEC No-Action Letter, 17 *Sec. Reg. & L. Rep.* (BNA) No. 50 at 2193 (Dec. 3, 1985).

general solicitations of potential offerees only at a time when the issuer is not actually conducting a private placement offering. They should not include in a general solicitation any information about a specific project that will be financed through a private placement at a later date.

E. Suggested Regulation D Soliciting Procedures

The following is a suggested procedure for soliciting under Regulation D:

1. The registered representatives or selling agents should make contact with prospective offerees at least several weeks before the issuer or broker/dealer firm starts to sell a specific private placement offering.
2. The registered representatives or selling agents should inquire as to the prospective investors' general interest in the type of investments being considered by the issuer or broker/dealer firm.
3. A New Account Card and Prospective Offeree Suitability Questionnaire must be completed and placed on file with the issuer or broker/dealer firm.
4. A designated principal of the issuer or broker/dealer firm must later examine the New Account Card and Prospective Offeree Suitability Questionnaire to determine whether the prospective investor is suitable for the subsequent private placement offering. Approval should be noted on the card.
5. If the designated principal approves the prospective investor as suitable, then and only then should an offering memorandum be checked out to the agent or representative for delivery to the prospective investor.
6. Once a specific offering has begun, no New Account Forms or Suitability Questionnaires dated after the date the issuer or broker/dealer firm began its participation in the offering should be approved for the offering that has commenced. Thus, no prospective investors represented by such forms and questionnaires may be approved. These prospective investors must wait until a later offering is begun.
7. A date for the issuer or the broker/dealer firm's participation in each offering must be established.
8. Dates should be affixed to each New Account Form and Suitability Questionnaire.
9. The designated principal should initial the approved space on each prospective investor's New Account Card and indicate for which offering the prospective investor is approved.
10. Any pre-offering materials, such as a general corporate brochure, should be approved by counsel. The materials should not in-

clude any information that could be construed as relating to a subsequent private placement offering. The fewer offering materials utilized, the better. It is safest to limit the offering materials to the offering memorandum, its accompanying exhibits, and a separate packet of subscription documents. The use of offering summaries, a program highlights sheet, or other sales materials should be strictly controlled in accordance with the procedures suggested above.¹²²

11. Issuers should review all procedures and activities relating to the private placement offering. Additionally, they should review all provisions of Regulation D and discuss with counsel any activities relating to the conduct of the private offering that may raise Regulation D compliance questions.

V. ISSUER SALES

As stated above, the issuer is the partnership in a feature film limited partnership offering. This partnership includes its general partners and upper-level management. Direct issuer sales of limited partnership interests are permitted under certain circumstances. However, if a person or entity engages "either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person," then the person or entity may be considered a broker/dealer. As such, they may be required to register as a broker/dealer with the SEC, the NASD, and in each state in which these activities occur.¹²³

Section 15(a)(1) of the Securities Exchange Act of 1934 requires that those defined as a broker or dealer must register.¹²⁴ Neither the officers and directors of a corporate general partnership nor an individual general partner for a limited partnership offering should be considered broker/dealers if their activities comply with provisions of Rule 3a4-1 of the Securities Exchange Act of 1934.¹²⁵ This rule requires that persons ef-

122. As a practical matter, it is much easier for large broker/dealer firms to develop new prospect lists for private placement offerings because they are continually developing new client relationships through public offerings and general corporate advertising that is not tied to a specific offering.

123. See definition of dealer in the Securities Act of 1933 § 2(12), 15 U.S.C. § 77(b)(12) (1988) and the definitions of broker and dealer in the Securities Exchange Act of 1934, 15 U.S.C. §§ 78(c)(4)-(5) (1988).

124. "It shall be unlawful for any broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered." Securities Exchange Act of 1934 § 15(a)(1), 17 C.F.R. § 240.3a4-1(a)(iii) (1990).

125. Rule 3a4-1 of the Securities Exchange Act of 1934 is often referred to as the issuer exemption to the broker/dealer registration requirement.

fecting issuer sales: (1) not be subject to a statutory disqualification; (2) not be compensated in connection with their participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities; (3) not be an associated person of a broker or dealer at the time of their participation; and (4) meet all of the following conditions:

(a) primarily perform, or intend primarily to perform, at the end of the offering, substantial duties for or on behalf of the issuer other than in connection with transactions in securities;

(b) were not brokers or dealers, or associated persons of a broker or dealer, within the preceding twelve months; and

(c) have not participated in selling an offering of securities for any issuer more than once every twelve months.¹²⁶

Individuals meeting this criteria are not deemed brokers or dealers. Therefore, they are not required to register pursuant to section 15 of the Securities Exchange Act of 1934. Counsel should review all relationships with all persons associated with the issuer or its general partners that fall within the scope of these rules to make sure that their status and activities comply with the rules.

VI. NASD GUIDELINES ON COMPENSATION

The NASD's Rules of Fair Practice specifically apply to public offerings, but some state regulators apply them informally to a Regulation D private placement. The NASD rules provide that NASD member broker/dealer firms or persons associated with these firms must not participate in a public offering of a direct participation program, such as a limited partnership offering, except in accordance with the NASD's Rules of Fair Practice.¹²⁷ These rules provide limitations on the amount of money that can be expended in conducting such an offering: "No [NASD] member [broker/dealer firm] or person associated with a member shall . . . participate in a public offering of a direct participation program if the organization and offering expenses are not fair and reasonable, taking into consideration all relevant factors."¹²⁸

In determining the fairness and reasonableness of organization and offering expenses, the arrangements are presumed to be unfair and unreasonable if the total amount of all items of compensation, from whatever

126. 17 C.F.R. § 240.3a4-1(a) (1990).

127. Rules of Fair Practice, art. III, § 34(a), NASD Manual (CCH) ¶ 2191, at 2159-3 (Jan. 1990).

128. Rules of Fair Practice, art. III, § 5(a), NASD Manual (CCH) ¶ 2192, at 2172 (May 1989).

source payable to broker/dealers or their affiliates, that are deemed to relate to the distribution of the public offering exceeds currently effective compensation guidelines for direct participation programs.¹²⁹ The NASD guidelines on compensation are 10% of proceeds received, plus a maximum of 0.5% for reimbursement of bona fide due diligence expenses.¹³⁰

Further, the NASD presumes offering arrangements to be unfair and unreasonable if organization and offering expenses, paid by a program in which a NASD member firm or an affiliate of a member firm is a sponsor, exceed currently effective guidelines for such expenses.¹³¹ The NASD guidelines limit offering expenses, i.e., organizational and syndication costs, to a total of 15%.¹³² The NASD also considers it unfair and unreasonable for commissions or other compensation to be paid or awarded, either directly or indirectly, to any person *engaged by a potential investor* (as opposed to the issuer) for investment advice as an inducement to the advisor to advise the purchaser of interests in a particular program, unless the person is a registered broker/dealer or a person associated with a registered broker/dealer.¹³³

In contracting with broker/dealer firms, issuers should make sure that the terms and actual implementation of the selling broker/dealer or managing broker/dealer agreements comply with the NASD rules for public offerings. In a private offering, use the NASD rules as a guide and look to the state exemptions for specific regulations regarding limitations or ceilings imposed on broker/dealer commissions. Recall that some states apply the public offering guidelines to private placements on an informal basis. Therefore, it may be necessary to call the securities regulators in each state and inquire about these limitations.

A. *Private Securities Transactions*

In dealing with persons who hold themselves out as broker/dealers or registered representatives of a broker/dealer firm, it is important to know as much as possible about their background and other affiliations. The NASD prohibits transactions in which an associated person (i.e., a person associated with an NASD member broker/dealer firm) sells a security to investors on behalf of another party without the participation of

129. *Id.* § 5(b)(1).

130. *Id.* § 5(b)(1) n.1.

131. *Id.* § 5(b)(2).

132. *Id.* § 5(b)(2) n.2.

133. Rules of Fair Practice, art. III, § 5(b)4, NASD Manual (CCH) ¶ 2192, at 2172 (May 1989).

the associated person's employer firm.¹³⁴

1. Applicability of the Rule

This rule applies to any situation in which an associate of a member proposes to participate in any manner in a private securities transaction.¹³⁵ "Private securities transaction" is defined broadly, and specifically includes private placement offerings.¹³⁶

2. Written Notice Requirement

The private securities transaction rule requires an associated person to provide written notice to the NASD member broker/dealer firm with which he or she is associated prior to participating in any private securities transaction.¹³⁷ The notice must include a detailed description of the proposed transaction and the individual's proposed role in it. Because the rule treats compensatory transactions differently, it is also necessary for an associated person to state whether he or she will receive selling compensation in connection with the transaction.¹³⁸

3. Transactions for Compensation

The most serious regulatory concerns relate to situations in which associated persons are receiving selling compensation and have an incentive to execute sales. They may do so without adequate supervision and attention to suitability and due diligence responsibilities. The rule requires that, in the case of transactions in which an associated person has or may receive selling compensation, a NASD member broker/dealer firm receiving written notice from one of its associated persons shall respond to the person in writing, indicating whether the firm approves or disapproves of the person's participation in the proposed transaction.¹³⁹

If the firm approves of the person's participation, the firm is then required to treat the transaction as a transaction of the firm, to record the transaction on the firm's books and records, and to supervise the person's participation in the transaction to the same extent as if the transaction were executed on behalf of the firm.¹⁴⁰ If the firm disapproves of a per-

134. Rules of Fair Practice, art. III, § 27, NASD Manual (CCH) ¶ 2178, at 2113-2 (July 1991).

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.*

139. Rules of Fair Practice, art. III, § 40(c)(1), NASD Manual (CCH) ¶ 2200, at 2186 (July 1988).

140. *Id.* § 40(c)(2) at 2186-87.

son's participation, the associated person is prohibited from participating in the transaction in any manner.¹⁴¹

4. Definition of Selling Compensation

The definition of "selling compensation" utilized pursuant to the private securities transaction rule is also broad in scope. The definition includes "any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security."¹⁴² This definition includes compensation received or to be received by one acting in the capacity of a salesperson or other capacity, specifically including the capacity of a general partner of a limited partnership.¹⁴³

The definition is intended specifically to address a practice in which persons associated with broker/dealer firms function as general partners (or upper-level management in a corporate general partner) in both forming limited partnerships and then selling limited partnership interests in private securities transactions. If the issuer is considering using the services of a person who is associated with a broker/dealer firm, the issuer should ensure that that person's activities comply with the above stated rules.

VII. MARKETING CONSIDERATIONS

The following discussion relates to the marketing of a feature film limited partnership offering. This discussion is intended to provide guidance on utilizing the services of broker/dealers in conducting an offering.

A. *How to Find Broker/Dealers*

A current list of all of the broker/dealer firms in North America is available in the Standard and Poor's "Red Book."¹⁴⁴ This listing is updated every six months.

B. *Broker/Dealer Due Diligence Kit*

Broker/dealers generally conduct a due diligence investigation of the offering entity in a limited partnership offering before they will agree

141. *Id.* § 40(c)(3) at 2187.

142. *Id.* § 40(e)(2) at 2187.

143. *Id.*

144. The telephone number of Standard & Poor's Security Dealers of North America is (213) 715-9000 in California and (212) 208-8702 in New York.

to be retained. The focus of this investigation is on the general partner, although the structure of the offering itself is also carefully reviewed. Some broker/dealer firms have an in-house due diligence department or officer.

A careful broker/dealer firm will send questionnaires to both the securities attorney and the accountant working with an issuer on a limited partnership offering. The broker/dealer will ask these trained professionals whether they have any knowledge of any securities or other criminal law violations by the issuer or its upper-level management. Many broker/dealer firms will ask for an up-front due diligence fee to cover the expenses of a due diligence investigation. Third-party due diligence services will also provide a due diligence analysis and report to the partnership for its use in marketing to broker/dealers.¹⁴⁵

An issuer can facilitate or expedite a due diligence investigation and reduce the expense associated with this investigation by preparing and providing prospective broker/dealers with a credible due diligence kit. Accordingly, prospects of the broker/dealer's taking on some or all of the offering's sales are improved.

C. Approaching the Broker/Dealer

Most broker/dealer firms are in the enviable position of being able to pick and choose from a wide variety of financial products. Therefore, it is difficult to gain the broker/dealer firm's attention if the feature film limited partnership offering is still in the concept phase and is structured improperly or packaged unattractively. Some broker/dealer firms indicate, however, that they would prefer to become involved in an offering at an early stage. Nonetheless, most will not spend time with a prospective issuer unless the offering materials are in nearly complete form.

D. Broker/Dealer Selling Agreements

Generally, an issuer seeking to sell a feature film limited partnership through broker/dealers will negotiate and sign a selling agreement with the broker/dealer firm or firms. As mentioned earlier, unless the offering is a large public offering, it will not be formally underwritten and will more likely be conducted on a "best-efforts" basis. It is possible for a general partner/producer to identify a broker/dealer firm who will serve as the managing broker/dealer for such an offering. In turn, this managing broker/dealer firm may help to put together a selling group of bro-

145. For example, Investment Research Institute, 3420 East Shea Boulevard, Suite 100, Phoenix, AZ 85028; (602) 996-3042.

ker/dealer firms and manage the offering. In this instance, a managing broker/dealer agreement will be negotiated, followed by execution of the selling broker/dealer agreements by the managing broker/dealer and the selling broker/dealer firms.

E. Form D Notice Filing Requirement

Rule 503 of Regulation D requires that a notice on the SEC's Form D be filed in connection with all offerings exempted pursuant to Regulation D. (The same form is used for section 4(6) offerings.) The initial Form D must be filed no later than fifteen days after the first sale of securities in an offering claiming an exemption under Regulation D. Rule 503 does not define when a sale actually takes place. The 1933 Securities Act, however, defines the term "sale" to include "every contract of sale or disposition of a security or interest in a security, for value."¹⁴⁶ Under this definition, a binding sales agreement or subscription agreement constitutes a statutory sale. Thus, the initial filing requirement would be triggered even before the offering broke escrow—i.e., before the offering closed.

Additionally, the SEC specifies¹⁴⁷ that the acceptance of subscription funds into an escrow account pending receipt of a minimum level of subscriptions triggers the Form D filing requirement.¹⁴⁸ The SEC reaffirmed this view in a second SEC release.¹⁴⁹ Nothing prevents an issuer from filing the initial Form D before the first sale. This policy would eliminate any worry or confusion during the excitement of the offering regarding meeting the fifteen-day deadline.

Five copies of Form D must be filed with the SEC and one of those must be manually signed. They must be sent to the United States Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of Form D may be requested from the SEC by calling (202) 272-7450. There is no federal filing fee for a Regulation D offering.

Amendments to Form D should be filed with the SEC during the course of the offering or upon its completion. Amendments need report only the name of the issuer and offering, the information requested in Part C of Form D, and any material changes from the information previ-

146. 15 U.S.C. § 77(b) (1988).

147. Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 33-6389, 47 Fed. Reg. 11251 (Mar. 16, 1982).

148. *Id.* at n.27.

149. Interpretive Release on Regulation D, Answer No. 82 of Securities Act Release No. 33-6455, 48 Fed. Reg. 10045 (Mar. 3, 1983).

ously supplied in Parts A and B. Part E and the Appendix need not be filed with the SEC.

Form D provides separate instructions and signature pages for federal and state notice filings, including an appendix using a chart format for state-by-state reporting. Some states, however, still require the use of their own forms for state exemption notice filings.

Failure to file Form D in a timely manner no longer voids the Regulation D exemption.¹⁵⁰ Rule 507, however, provides that the issuer may be disqualified from relying on Regulation D for future offerings if it or a predecessor or affiliate has been enjoined by a court for violating the filing obligation under Rule 503. Thus, it is still important that Form D be filed in a timely manner.

1. Good Faith Compliance

Regulation D Rule 508 provides that an immaterial failure in a reasonable and good faith compliance effort with respect to certain conditions imposed on a Regulation D offering will not prevent the issuer from relying on a Regulation D exemption.¹⁵¹

VIII. STATE SECURITIES REGULATION

As mentioned above, a feature film limited partnership offering must comply not only with the federal securities laws and regulations but also with state securities laws in each of the states in which the securities may be offered or sold.

A. Choice of States

It is very important to determine as early as possible in which states the producer/client anticipates sales of the limited partnership interests. Without knowing which states are involved, securities attorneys are unable to calculate with any degree of certainty what portion of the offering proceeds will be required to pay state filing fees. Additionally, each state may require different investor suitability standards for these offerings. A notice of these standards may need to appear in the investor suitability section of the disclosure document as well as in the subscription agreement. Further, many of the state exemptions to be relied on may require that specific "legends"—prominent written notices, usually in boldface all-capitals type—appear in the disclosure document. Certain states may

150. Regulation D: Accredited Investor and Filing Requirements, Securities Act Release No. 33-6825, 54 Fed. Reg. 11369 (Mar. 20, 1989).

151. *Id.*

also require that specific purchaser representations be included in the subscription agreement.

Unfortunately, producer/clients do not always know in advance which states will be involved, particularly if they lack previous experience as a general partner for a limited partnership offering. They must begin with a list of all prospective investors, including friends, family, acquaintances, and other contacts. Then, they may look to broker/dealers, finders, and list purveyors. They should also consider the states that tend to produce more film investors or are economically robust, the states in which the offering's broker/dealers are registered, and the attorney's analysis of state notice filing costs and exemption complexities. If, after the offering is begun, offers are made in states requiring state legends, purchaser representations, or investor suitability standards, these may be added by supplementing the disclosure document with a stick-on notice or an independent document (supplement).

For small limited partnerships, it is not economically feasible to attempt to clear a private placement offering for sale in many states, much less in all fifty states. Thus, the producer/client needs to work with the attorney in choosing the states in which sales of the particular feature film limited partnership interests are most likely to occur.

Each state has promulgated a set of exemptions from the state securities registration requirement. Each exemption contains a set of conditions and limitations that are imposed on the use of the exemption. In other words, the offering must comply with all of the conditions and limitations imposed on the use of a given exemption in order for the offering to avoid the registration requirement. Some of the conditions and limitations are mandatory, while others are not. Thus, in some instances, the failure to comply with a given condition or limitation voids the exemption and puts the partnership in the position of having sold an unregistered security. In most states, this is a felony giving rise to criminal liability, and constitutes a violation that may provide the limited partner investors with the civil right of rescission referred to earlier. In most instances, a careful reading of the specific language of the statutory or regulatory exemption resolves this issue.

B. Transactional Exemptions

State exemptions that are relied on for private placement feature film limited partnerships are, like the federal Regulation D exemption, transactional exemptions. This means that the exemption is available for the particular transaction in question: the sale of the limited partnership interest from the issuing partnership to the limited partner investor. The

exemption is not available for the security itself when it is sold in a subsequent transaction.

Generally, each state provides another set of exemptions for transactions involving securities, based on the form of the security. This additional set of exemptions, however, is generally unavailable for limited partnership interests. Therefore, in searching for the appropriate exemption in the state "blue sky" laws, the producer/client and/or attorney will be looking to qualify for each state's transactional exemptions.

C. Multiple Exemptions

Unfortunately, just as with the federal scheme of exemptions, each state usually provides several transactional exemptions from which a feature film limited partnership producer/general partner may choose. Thus, the producer/client and his or her attorney must take the time to analyze the offering to determine which exemptions in a given state are available and best suited for the specific offering. Factors that must be considered include the amount of money being raised, the number of prospective investors, filing requirements, filing fees, and other criteria.

Generally, if the offering relies on one of the specific rules within Regulation D at the federal level, the state exemptions will specify which state exemption is designed to be compatible with the federal Regulation D exemption. This does not always mean, however, that the offering must solely rely on the Regulation D-compatible exemption. In fact, good reasons sometimes exist for not doing so. Some of the exemptions, for example, do not require a filing with the state or the payment of a filing fee. Thus, if the offering qualifies for such an exemption, it may be advantageous to rely on that exemption and not the state's Regulation D-compatible exemption.

D. Types of Conditions and Limitations

The conditions and limitations imposed on the use of the state exemptions typically take the form of numerical limitations on the number of investors, a ceiling on the amount of money to be raised (known as an aggregate offering price limitation), an investor qualification requirement or suitability standards, and commission specifications relating to what may be paid and to whom. They also include limitations on the manner of conducting the offering, such as a prohibition on advertising or general solicitation, limitations on resales of the limited partnership interests, issuer qualification requirements, and notice of sale requirements (required filings and deadlines). Other conditions include the requirement that cer-

tain information be provided to prospective investors (disclosure requirements), required legends, and purchaser representation requirements.

E. Blue Sky Law Reporter

The four-volume Blue Sky Law Reporter, published by Commerce Clearing House,¹⁵² is the most convenient and current source of information at any given time for deciding which state exemption(s) to rely on and for determining what the corresponding conditions and limitations are. These books can usually be found at major law libraries or purchased with the update service through the publisher.

It is important to obtain current information on the state exemptions. With fifty states, changes occur all the time. Compliance with the wrong law can be just as disastrous as not complying at all.

F. Checklist for Private Placement State Securities Offering

The following information should be determined for each state in which sales of the limited partnership interests in an exempt offering are anticipated:

(1) Does the state have a transactional exemption(s) from the securities registration requirement?

(2) If so, what is/are these exemption(s) called—uniform limited offering exemption (ULOE), limited offering exemption, small offering exemption, etc.?

(3) What is the statutory citation for the exemption(s)?

(4) What is the citation for the corresponding state (blue sky) regulation?

(5) What is the Commerce Clearing House (CCH) Blue Sky Law Reporter paragraph number for the statute and the regulation?

(6) What is the name, title, address, and phone number of the state regulator and agency that regulates the sale of securities in the state? (This information may be found in the Finding List in volume 1 of CCH Blue Sky Law Reporter.)

(7) Is the state exemption tied to a specific rule of Regulation D, i.e., is compliance with Rule 504, 505, or 506 a condition precedent to using the state exemption?

(8) Does the state exemption limit the number of investors, purchasers, or offerees for the offering? Does the numerical limitation apply in that state alone or to the entire offering?

152. Commerce Clearing House, Inc., 4025 West Peterson Avenue, Chicago, Illinois 60646, (312) 583-8500.

(9) Does the exemption employ the accredited investor concept, i.e., are accredited investors excluded from the numerical count?

(10) Who else is excluded from the numerical count, i.e., what are the counting rules?

(11) Does the state exemption contain specific *disclosure* requirements for the offering?

(12) Are state investor suitability requirements imposed?

(13) Are there restrictions on the payment of commissions or other forms of transaction-related remuneration to persons for the sale of the security, e.g., to registered broker/dealers only? For instance, is there a ceiling on the amount that can be paid?

(14) Is there a ceiling on the total amount of the expenses of the offering, including broker/dealer commissions; e.g., expressed as a percentage of the total offering proceeds? Are the NASAA ("North American Securities Administrators Association") Guidelines on offering expenses imposed formally or informally on private placements?¹⁵³ Do NASD Guidelines on public offerings apply?

(15) Is a specific legend required and, if so, where must it be placed?

(16) Are there any specific purchaser representations or statements that must be elicited from the purchaser/investors and incorporated into the subscription agreement?

(17) Is there a notice of sales filing requirement?

(18) When is the filing required—pre-sale, post-sale, concurrent, or post-offering? What is the exact filing date requirement? What triggers the filing?

(19) What form is required to be filed—Form D or the state's own form?

(20) Is a copy of the offering memorandum and/or all sales materials required to be filed or does the state require that the issuer undertake to provide such materials on request?

(21) Are any other issuer undertakings (i.e., promises that would be included in the transmittal letter accompanying the filing) required?

(22) Is a filing fee required? If so, how much?

(23) What is the acceptable form of payment—check, certified check, cashier's check, etc.? To whom should the check be made payable? (This information may be found in the Finding List in Volume I of CCH Blue Sky Law Reporter.)

153. The NASAA is a group of state securities administrators who promulgate model state securities laws and industry disclosure guides, and work to promote federal/state security law compatibility. The Association's telephone number is (202) 737-0900.

(24) Is a consent to service of process form required? What form is acceptable—the standard U-2 Form or a specific state form?

(25) Will the state send a packet of their forms, along with a copy of the state exemption and any related regulations, upon request? Is there a fee for such a packet?

(26) Does the state have an isolated transaction exemption for just one or two sales? If so, how many sales are permitted under that exemption? Are such sales limited to non-issuers?

G. Checklist for California Limited Offering Exemption

The following information incorporates the above private placement blue sky checklist, and summarizes the California limited offering exemption most commonly relied on in California for Regulation D offerings. It is offered as an example of a state (Regulation D-compatible) transactional exemption.¹⁵⁴ This list merely sets forth the most commonly relied-on provisions of section 25102(f) and the administrative interpretations relating to it. Consequently, certain specific details of the statutes and/or regulations that apply to a given offering may have been omitted. This summary is prepared merely as an illustrative part of this article and must not be relied on for a given offering.

1. Transactional Exemption (as opposed to exemption for security itself): Yes.

2. Activity Covered: Offer or sale.

3. Type of Security: Any security (other than for pension or profit-sharing trust of issuer).

4. Tied to Specific Regulation D Rule: No.

5. Disclosure Requirements:

No specific disclosure requirements are provided by section 25102(f), except that a notice may be required as to the restricted transfer of securities.¹⁵⁵ The issuer must also comply with the state anti-fraud provisions. This entails disclosing all material aspects of the transaction, being accurate and truthful in what is disclosed, and not omitting anything that would be considered important by a reasonably prudent investor.

6. Required Legend:

“THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR THE CALIFORNIA CORPORATIONS CODE BY REASON OF

154. CAL. CORP. CODE § 25102(f) (Deering 1990).

155. CAL. CODE REGS. tit. 10, § 260.141.11 (1990).

a. A husband and wife, together with any custodian or trustee acting for the account of their minor children, are counted as one person.

b. A partnership, corporation, or other organization that was not specifically formed for the purpose of purchasing the security offered in reliance on this exemption is counted as one person.

c. Joint ownership is permitted under California Blue Sky Rule 260.102.12(c), but each joint owner of the security is counted as one purchaser unless otherwise provided for in the counting rules.

9. Investor Suitability:

Section 25102(f)(2) provides that all purchasers must either:

a. have a pre-existing personal or business relationship¹⁵⁸ with the offeror or any of its partners, officers, directors, or controlling persons; or

b. by reason of the purchaser's business or financial experience, or the business or financial experience of his or her professional advisors, be reasonably assumed to have the capacity to protect his or her own interests in connection with the transaction.¹⁵⁹

Professional advisors who are relied on to qualify an investor for suitability purposes must be unaffiliated with and not directly or indirectly compensated by the issuer or any affiliate or selling agent of the issuer.¹⁶⁰

A pre-existing personal or business relationship includes any relationship consisting of personal or business contacts of a nature and duration that would enable a reasonably prudent purchaser to be aware of the character, business acumen, and general business and financial circumstances of the person with whom the relationship exists.

10. Purchaser Representation:

The following is an example of a purchaser representation, which must be included in the subscription agreement and signed by each purchaser: "As a purchaser of the securities described in the accompanying

158. Note that the SEC interpretations of the Regulation D prohibition against general solicitation speak in terms of a pre-existing "business" relationship, not a "personal" relationship. Thus, the federal rule on this issue appears to be narrower than the California rule and would have to be complied with in a Regulation D offering.

159. Even though California uses the pre-existing relationship as one means of determining investor suitability, the federal approach under Regulation D is to consider the pre-existing relationship as one factor in determining whether a prohibited general solicitation has occurred. Even though California offers an alternative investor suitability standard (sophisticated investor), Regulation D Rule 505 would still require the pre-existing business relationship in order to avoid a general solicitation. The SEC's Regulation D Rule 506 also imposes an investor sophistication requirement.

160. See CAL. CODE REGS. tit. 10, § 260.102.12(g) (1990) for definition of professional advisor.

SPECIFIC EXEMPTIONS THEREUNDER RELATING TO THE LIMITED AVAILABILITY OF THE OFFERING. THESE SECURITIES CANNOT BE SOLD, TRANSFERRED OR OTHERWISE DISPOSED OF TO ANY PERSON OR ENTITY UNLESS SUBSEQUENTLY REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, AND THE CALIFORNIA CORPORATIONS CODE, IF SUCH REGISTRATION IS REQUIRED.”

7. Numerical Limitation on Investors:

Sales may be made to no more than thirty-five persons, including persons not in the state of California, but excluding:

a. persons who occupy a position with the issuer (or with the general partner of the issuer that is a partnership) with duties and authority substantially similar to those of an executive officer of a corporation;

b. any relative, spouse, or relative of the spouse of a purchaser who has the same principal residence as the purchaser;

c. persons who purchase \$150,000 or more of the securities offered, as long as one of the following three conditions are met:

(1) this person alone, or with his or her professional advisor, must have the capacity to protect his or her own interests in connection with the transaction under section 25102(f)(2);¹⁵⁶

(2) this person must be able to bear the economic risk of the investment; or

(3) the investment, including mandatory assessments, does not exceed 10% of the person's net worth or joint net worth with that person's spouse;¹⁵⁷

d. individuals whose net worth, or whose joint net worth with the individual's spouse, at the time of purchase exceeds \$1 million;

e. individuals whose income, or whose joint income with the individual's spouse, exceeded \$200,000 in each of the two previous years, and who reasonably expect an income in excess of \$200,000 in the current year, provided that the individual meets one of the three alternative requirements of paragraph c above.

8. Purchaser Counting Rules:

156. See *infra* part VIII.G.9 (Investor Suitability).

157. Note that Regulation D no longer includes the \$150,000 purchaser in the definition of an accredited investor; thus, this California counting rule cannot be relied on in a Regulation D offering. See Commodity and Securities Exchanges, Regulation D, 17 C.F.R. § 230.501 (1990).

disclosure document, I hereby represent that I am purchasing for my own account and not with a view to or for sale in connection with any distribution of the security.”

11. Manner of Offering:

The offer and sale is not to be accomplished by publication of any advertisement. Circulation of disclosure materials to offerees and purchasers is permissible, as long as the materials are deemed not disseminated to the public. Disclosure documents are not disseminated to the public if the issuer limits the circulation to:

a. persons reasonably believed to be interested in purchasing the securities; or

b. persons whom the issuer believes may meet the qualifications required of purchasers (i.e., investor suitability requirements); and

c. for persons described in both paragraphs b and c above, neither the issuer nor any person acting on its behalf may offer or sell the securities through any form of general solicitation or general advertising, including, but not limited to:

(1) advertisements, articles, notices, or other communication published in a newspaper, magazine, or similar media, or broadcast over television or radio; and

(2) seminars or meetings whose attendees have been invited by a general solicitation or general advertising.

12. Commission Restrictions:

No commission limitations are applied to offerings under the California limited offering exemption. However, selling expenses of the offering for registered (i.e., public) offerings are limited to 15% of the offering's gross proceeds. This limitation should be used as a rule of thumb with respect to exempt offerings.¹⁶¹

13. Selling Expenses:

The California limited offering exemption defines selling expenses to include: (1) the total underwriting and brokerage discounts and commissions (including fees of the underwriter's attorneys paid by the issuer) that are paid in connection with the offering; (2) all other expenses actually incurred by the issuer relating to printing, binding, cover art, mailing, salaries of employees while engaged in sales activity, escrow agent fees, experts' fees, and expenses of qualification of the sale of the securities under federal and state laws, including taxes and fees; and (3) any other expenses actually incurred by the issuer and directly related to the

161. CAL. CODE REGS. tit. 10, § 260.140.20 (1990).

offering and sale of the securities, but excluding accountants' and the issuer's attorneys' fees and options to underwriters.

14. **Broker/Dealer Registration Requirement:**

A broker/dealer is defined as any person engaged in the business of effecting transactions in securities in California for the account of others or for his or her own account. The term broker/dealer generally does not include an agent who is an employee of a broker/dealer or the issuer. The definition of agent under the California Corporations Code does not include an individual who merely represents an issuer in effecting transactions in securities exempted by section 25102.

The California Corporations Code requires registration of broker/dealers for dealing in securities. It prohibits broker/dealers from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any security in California unless the broker/dealer has first applied for and secured from the state commissioner a certificate, then in effect, authorizing the broker/dealer to act in that capacity.¹⁶²

15. **Finders' Fees in California:**

Like the California Corporations Code, California's limited offering exemption¹⁶³ provides that persons acting on behalf of an issuer must not "effect any transaction in, or induce or attempt to induce the purchase or sale of," any security in California, unless the agent has complied with rules of the California Securities Commissioner that apply to the qualification and employment of these agents.

In defining an "agent," the California Corporations Code excludes from the definition any individual who merely represents an issuer in effecting transactions in securities exempted by section 25102.¹⁶⁴ Therefore, under California law, persons effecting sales of limited partnership interests that are exempt under the California limited offering exemption¹⁶⁵ do not fall within the definition of "agent," and thus are not required to be registered or qualified as such.

Additionally, California's section 25102(f) and the regulations promulgated thereunder, unlike many other states' limited offering exemptions from securities registration, do not provide any limitations on who may be paid compensation for the sale of securities pursuant to the exemption. Thus, in California, it would appear that the limited offering exemption is not voided if compensation is paid to unlicensed persons—e.g., finders.

162. CAL. CORP. CODE § 25210(a) (Deering 1990).

163. *Id.* § 25210(b).

164. *Id.* § 25003.

165. *Id.* § 25102(f).

The California case law, however, narrows the circumstances under which finders may operate by holding that one who *negotiates* the sale (even a single or isolated sale) for an issuer of securities must be licensed as the issuer's agent.¹⁶⁶ Further, the California courts have held that an unlicensed person acts as a broker (and is therefore required to be licensed as a broker), where the person was authorized to procure prospective purchasers with whom the issuer could negotiate a sale, and *assisted in the sale* of the security by offering it at a certain price to the purchaser and *negotiating* with the purchaser for the sale over a period of months.¹⁶⁷

Subsequently, in *Nationwide Investment v. California Funeral Service*,¹⁶⁸ an investment company that negotiated the purchase of all of the outstanding securities of another company on behalf of a client, pursuant to a written contract, was held to have acted as a securities broker/dealer. Therefore, the company was subject to the licensing requirements set out in California Corporations Code section 25210, even though the securities themselves were exempt from the registration requirements. Under these circumstances, the written contract was held void and unenforceable, and the investment company could not recover compensation (a finder's fee) for its services as a so-called finder.

The *Rhode v. Bartholomew* case¹⁶⁹ provides additional guidance by pointing out that one who merely brings a buyer and seller together so that they may make their own contract without any aid from him may be regarded as a "middleman." However, he will be considered a broker if he takes any part, however slight, in the *negotiations*. Earlier, in *McKenna v. Edwards*,¹⁷⁰ the California court held that one not engaged in the business of dealing in securities, whose only activity consisted of the following, was entitled to promised payment for her services even though she had no broker's license: (1) soliciting a purchaser; (2) conveying to the issuer the suggestion of a possible buyer; and (3) arranging for a conference between the seller and the prospective purchaser (in which she did not participate and that resulted in an agreement for the sale of the security).

More recently, in the cases of *Tenzer v. Superscope, Inc.*¹⁷¹ and *Lynons v. Stevenson*,¹⁷² the courts continued to take the approach that the

166. *Evans v. Riverside Int'l Raceway*, 47 Cal. Rptr. 187, 192 (Cal. Ct. App. 1965).

167. *Rhode v. Bartholomew*, 210 P.2d 768, 772 (Cal. Dist. Ct. App. 1949).

168. 114 Cal. Rptr. 77 (Cal. Ct. App. 1974).

169. *Rhode*, 210 P.2d at 774.

170. 65 P.2d 810 (Cal. Ct. App. 1937).

171. 702 P.2d 212 (Cal. 1985).

172. 135 Cal. Rptr. 457 (Cal. Ct. App. 1977).

question of whether a so-called finder, or a person not licensed as a broker/dealer, acted as a broker, is a question of fact. This inquiry requires an examination of the finder's conduct after the introduction of the buyer and seller to determine whether he or she participated in their negotiations.

All of these cases focus primarily on the question of whether and under what circumstances one acting as a finder may successfully sue for compensation offered or promised by an issuer in the sale of a security. The decisions do not address the issue of whether the payment of compensation to finders may void the exemption from registration for the security transaction, presumably because the California limited offering exemption¹⁷³ does not contain such prohibitory language. In addition, none of these cases appears to focus on the question of other potential risks to the issuer of utilizing the services of a finder.

The primary risk to the issuer, other than possibly voiding the exemption in many states (but not in California), is the issuer's responsibility for proper supervision of the finder's statements made about the offering of the security in procuring a prospective purchaser. The issuer is responsible for any misstatements of material fact made by a finder to a prospective purchaser, which the prospective purchaser may have relied on in purchasing the security. These misstatements of material fact may provide a subsequent purchaser with grounds for a civil right of rescission of the purchase contract based on securities fraud.

Considering all of the above, an issuer proposing to utilize the services of a finder in the sale of a security exempt from registration under section 25102(f) should execute a written agreement with the finder. The agreement should provide that: (1) the activities of the finder are absolutely limited to the bringing together of the prospective purchaser and the issuer of the security, i.e., merely introducing the buyer and seller; (2) the finder is strictly prohibited from doing any act that may be reasonably considered by a court to consist of negotiating or participating in the negotiations for the sale of the security; (3) the finder must limit his or her statements regarding the offering only to those authorized in writing by the issuer; and (4) the finder will indemnify the issuer in the event the issuer suffers any damages due to the finder's actions.

No specific legal restrictions appear to exist regarding the form and amount of payment to securities finders in California in the context of a private placement. However, the issuer should consider by analogy what is typically paid to licensed broker/dealers and to those who hold them-

173. CAL. CORP. CODE § 25102(f) (Deering Supp. 1990).

selves out as finders. Finders are typically paid a smaller commission than broker/dealers, e.g., not more than 6% on the sale of a limited partnership interest.

Finders should not be used in the sale of securities in California unless the above limitations have been thoroughly discussed with the finders and a written pledge has been extracted from them, promising that they will comply with the above stated guidelines. This written agreement should include an indemnification provision in favor of the general partner/producer, although this clause may not necessarily be upheld in court. Be forewarned that California securities regulators have informally expressed the opinion, in private conversations with the author, that they believe it is virtually impossible for a finder to keep his or her activities within the narrow parameters of the so-called "finder's exemption" to the broker/dealer registration requirement.

16. Integration:

Under this exemption, offers and sales of securities made more than six months before the start of the offering, or made more than six months after the completion of the offering, will generally not be considered part of the same transaction. Therefore, they will not be integrated with this offering.

17. Notice Filing:

Notice, on either the California form or the Federal Form D, must be filed with or mailed to the Commissioner within fifteen calendar days after the first sale in California of a security in the offering.

18. Filing Fee:

The fee is based on a sliding scale ranging from \$25 to \$300, depending on the value of all the securities sold or intended to be sold in the entire offering. For example, the filing fee is \$300 if the value of the securities exceeds \$1 million. If the value of the securities is \$500,001 to \$1 million, the filing fee is \$150.

19. Form of Payment: Check.

20. To Whom Paid: Department of Corporations.

21. Consent to Service of Process:

California Form 260.165 must be filed, unless the issuer already has a consent to service on file with the Commissioner.

22. Cover Letter:

The filing should be accompanied by a cover letter indicating that the filing is made pursuant to section 25102(f). If a consent to service is not included, the cover letter must state that the issuer already has a consent to service on file with the Commissioner.

23. Address for Filing in Los Angeles:

State of California, Department of Corporations, 3700 Wilshire Boulevard, 6th Floor, Los Angeles, CA 90010.

24. Los Angeles Office Phone Number: (213) 736-2741.

25. Acknowledgment:

The California Department of Corporations supplies neither a receipt for submitted filing fees nor any other form of acknowledgment to confirm receipt of the filing. The cancelled check serves as the receipt for payment of fees. If an issuer desires an endorsed copy of the filed notice for its burden of proof file, the issuer must include an additional copy of the form and a self-addressed envelope at the time of filing, and request in the cover letter that the endorsed copy be returned in the self-addressed envelope.

26. Other State Exemptions/Coordination Problems:

Although state legislatures have made a good faith effort in the years since the passage of Regulation D (in 1982) to draft new state exemptions that are somewhat compatible with the federal exemption, numerous differences still exist in many cases. They create problems of coordination for the issuer of a multi-state offering. Thus, as mentioned earlier, it is very important to select in advance the states to be involved in an offering, and to thoroughly research and identify all of the conditions and limitations imposed on the use of the exemptions to be relied on in those states.

27. State Filing Deadlines:

One of the most aggravating and difficult requirements with which a producer/client must comply are the varying state notice filing deadlines. Georgia, for example, requires that a notice filing be effected with its securities regulators before an offer is made in the state.¹⁷⁴ A certificate of compliance is issued to the partnership or its general partners if the offering appears to comply with Georgia law. Other states require a filing contemporaneous with the first sale.¹⁷⁵ Many others ask for a notice filing after the first sale of the security in their state, usually within ten to fifteen days. Other states ask for the filing within a certain period of time after the close of the offering,¹⁷⁶ while other states do not require a filing at all.

Additionally, some of the state filing requirements are mandatory elements of the exemption. Thus, if the filing is not effected in a timely

174. GA. CODE ANN. § 10-5-9 (Michie 1990).

175. See, e.g., PA. STAT. ANN. tit. 70, § 1-203(d)(iv) (1990).

176. See, e.g., ILL. ANN. STAT. ch. 121.5, para. 137.4(G) (Smith-Hurd 1953).

manner, the exemption may be voided, subjecting the partnership and its general partners to the possibility of having sold an unregistered security in that state.

When investor funds are being raised during the course of a feature film limited partnership offering, it is sometimes difficult to ensure that the producer/client meets the various filing deadlines. For instance, if an attorney takes on responsibility for these filings, it is not always easy to get the producer/client to inform the attorney as to when sales occur and in which states.

During the course of an offering, the producer/client may also make an offer or effect a sale in a state that is not mentioned in the disclosure document. If this occurs, the disclosure document may have to be supplemented and the sale may have to be rescinded until it can be properly effected in accordance with the conditions and limitations of that state's exemption.

The proper conduct of such an offering in several states requires excellent communication and coordination between the producer/client and the securities attorney. Alternatively, a well-trained administrative staff person working for the production company or partnership may help to solve these state notice filing coordination problems.

IX. ADDITIONAL PRACTICAL CONSIDERATIONS

A. *Offering Management Tasks*

Many first-time feature film limited partnership general partner/producers must be aware of a number of activities that are more purely associated with managing the limited partnership offering, as distinguished from producing and distributing a feature film. In preparing the offering memorandum, the partner/producers should do the following:

- (1) arrange for printing and binding, including art work, if desired;
- (2) identify and select an accountant to prepare the required financial statements and set up the partner capital accounts;
- (3) prepare the broker/dealer due diligence kit, if any;
- (4) prepare the promotional materials to accompany the offering memorandum;
- (5) prepare sell sheets (mini one sheets);
- (6) produce a video tape for promoting the offering, if desired;
- (7) determine whether financial projections for the movies will be used and who will prepare them;
- (8) collect useful and appropriate industry articles for use as exhibits or additional handout materials;

- (9) establish escrow policies, negotiate the escrow agreement, and decide who will handle the arrangements for and set up the escrow account;
- (10) identify and contract with the managing and/or selling broker/dealers;
- (11) establish investor suitability standards for the offering;
- (12) identify and solicit prospective investors;
- (13) maintain the offering memorandum log;
- (14) review all investor subscription documents for completeness and to determine if prospective purchasers meet offering suitability standards;
- (15) calculate and pay broker/dealer commissions, if any;
- (16) make accredited versus non-accredited investor determinations for numerical limitations purposes;
- (17) monitor unit sales and state filing deadlines, which trigger state notice filings;
- (18) prepare and file state notice filings with appropriate materials for each state, and pay the state notice filing fees;
- (19) register the offering as a tax shelter with the IRS, if appropriate;
- (20) set up systems to insure compliance with federal and state securities laws; and
- (21) create and maintain an offering burden of proof file.

B. Partnership Management Fee

A partnership management fee is often paid to the general partner for the general partner's time, skill, and effort expended in managing the partnership. This fee is often paid on a one-time basis out of the offering proceeds. In other limited partnerships, the partnership agreement will provide for an annual partnership management fee, first paid out of the offering proceeds and, in subsequent years, paid out of gross partnership revenues.

C. Burden of Proof File

As stated earlier, the issuer's first obligation in the context of limited partnership offerings and most other securities offerings is to register the securities. Alternatively, however, the issuer may seek to comply with all of the conditions and limitations imposed on available exemptions from the registration requirement. Because the exemption is the exception to the rule, and because statutes and case law relating to these exemptions so provide, the burden of proving compliance with the exemptions is on

the individual or entity claiming the benefit of such exemption.¹⁷⁷

For example, if a disgruntled investor sues the general partner of a limited partnership for securities fraud or other claims, the only three elements of a prima facie case that the investor-plaintiff generally has to prove are: (1) that the general partner sold him or her a security (and an interest in a limited partnership is almost always a security); (2) that the investor-plaintiff paid money or other valuable consideration for the security; and (3) that the security was not registered with the appropriate securities regulatory authorities.

Once the prima facie case is established, the burden of proof shifts to the general partner/defendant, who will most likely have to concede points (1) through (3) above. Then, the general partner/defendant will have the burden of showing that it was not necessary to register the security, since the offering qualified for available exemptions from the registration requirement. Proving this will require evidence. Documentary evidence is preferred to the mere testimony of the general partner.

Thus, one of the general partner's objectives in conducting a limited partnership offering is to accumulate as much documentary evidence as possible showing the offering's compliance with all applicable federal and state exemptions from the securities registration requirement. This documentary evidence may include the offering memorandum, the offering memorandum log (to show that the offering was truly a limited offering and not a general solicitation), a record of the pre-existing relationship with investors, a record of the general partner's evaluation of each investor in terms of suitability, a complete set of properly completed subscription agreements, copies of all investor checks, copies of the federal Form D filing, copies of each state's notice filing, a copy of the IRS tax shelter registration (if any), a copy of the escrow agreement, accounting records demonstrating proper use of all of the offering proceeds, and copies of investor newsletters along with other communications such as confirmations.

D. Initial Costs of the Offering

In a typical feature film limited partnership offering, the general partner/producer will find it necessary to involve some or all of the following professionals and entities for support: lawyers, accountants, printers, broker/dealers and escrow banks. Each of these may require payments to be paid prior to funding the offering. Additionally, many of

177. See *Securities & Exch. Comm'n v. Ralston Purina Co.*, 346 U.S. 119, 123 (1953).

the states in which sales may be effected require a fee at the time the notice filing is effected.

To the extent that the issuer will conduct direct sales to prospective purchasers or lend support for broker/dealer sales, out-of-pocket expenses may be paid up front by the general partner/producer. Some or all of these "up-front" costs may be reimbursed to the general partner/producer out of the offering proceeds of a successful offering if the limited partnership agreement so provides. However, it may be necessary to limit the reimbursement to a certain percentage of the offering proceeds, and reimburse the balance out of partnership gross revenue. This will ensure that a high percentage of the offering proceeds (85% or more) is used to produce the film, rather than to pay the expenses of the offering.

X. CONCLUSION

The objective of this article is not to suggest that the limited partnership is the best way for any particular independent feature film producer to finance his or her film. That decision depends on a number of variables, including the nature of the project, the extent to which it has been developed, the market conditions at the time of the offering, and the resources of the specific independent producer.

The author also does not suggest that the vehicle of the limited partnership is the easiest way to finance a feature film. In the author's view, no easy way exists to finance feature films. Each method, however, has advantages and disadvantages associated with it.

Producers should be wary of persons who represent that they have a detailed understanding of all of the varying methods of film finance. These persons claim to be able to authoritatively advise a producer as to which method is the best for any given project. Most experts who have any bona fide expertise in the field of film finance, including this author, have expertise limited to one or a few methods of film finance.

The objective of this article *is* to provide some useful and practical information relating to feature film finance via the limited partnership. Thus, this article may aid the prospective independent producer who is already committed to, or is seriously considering, the use of the limited partnership as the vehicle for financing a feature film in conducting the offering effectively and within the requirements of the law.

Feature film limited partnership offerings that are properly conducted contribute to the credibility of similar offerings. Additionally, they promote a higher level of investor confidence and ensure a greater likelihood of investor participation. Industry trends, the quality of specific film projects, and the producers' level of success in the approach to

distribution may be the only remaining significant factors influencing investor decisions. If the limited partners ultimately determine that they have received a reasonable return on their investment, they will be willing to invest in the producer's next picture, or possibly in another independent producer's project.

