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BANK FINANCING OF A MOTION PICTURE PRODUCTION

Jill Mazirow Eshman †

I. WHAT IS BANK FINANCING OF A MOTION PICTURE PRODUCTION?

Bank financing of a motion picture is one of many ways to fund the cost of making a film. Another common means of financing the production of a motion picture is to sell partnership interests, limited or general, and share the cost, the upside potential and the downside risk with the other investors. Bank financing, however, enables a producer to maintain all of the upside potential, as well as the downside risk. As described below, financing banks do not share in any of the box office upside potential or downside risk.

Generally, a producer has acquired all rights in and to the motion picture, including theatrical, video, and television — free and pay, as well as the worldwide right to distribute the film in the various media. Before the film is produced, a producer may pre-sell some or all of the distribution rights to the film, because the bank provides financing for the motion picture based on these executed distribution contracts.

Under the terms of a distribution agreement, the distributor is obligated to pay to the producer a certain amount of money for the distribution rights upon the completion and delivery of the film, or the negative, by a specific date. This type of transaction is called a “negative pick-up.” This article addresses the issues and concerns involved in financing a “negative pick-up.”

A. Approaching the Bank for Financing

A producer should approach a bank for production financing of a “negative pick-up” transaction after the producer has the following in place: (1) a resume; (2) an executed distribution agreement; (3) a budget for the film; (4) a cash flow schedule for the film; and (5) a bond company that is willing to bond the completion and delivery of the film to the distributor.

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1. The Producer as the Borrower

The producer's resume generally serves informational purposes only, and is therefore optional. It is, however, recommended. In most instances, the producer forms a single-purpose corporation to serve as both the borrower and the production company for the film being financed. (The borrower is hereafter referred to as the producer.) A single-purpose corporation generally has no assets and no financial statements for a bank to analyze.

As discussed below, the bank looks to the distributor rather than to the producer as its primary source of repayment. The bank, however, is still concerned with the experience of the individual producer. The producer's experience helps to assure the bank that the film will be completed and delivered in a timely manner, and establishes the character and creditworthiness of the individual producer. Despite the foregoing, the producer is liable for its own indebtedness if the distributor — the primary source of repayment — fails to pay.

2. The Executed Distribution Agreement

As a condition to lending money to the producer, the bank requires the producer to assign to the bank the right to receive payment from the distributor pursuant to the distribution agreement. The receipt of those funds is the primary source of repayment of the producer's indebtedness. Therefore, the bank takes the credit risk of the distributor — the risk that the distributor will honor its distribution agreement and have the ability to pay upon the completion and delivery of the picture.

The bank "discounts" the distribution agreement to determine the amount of money that the bank is willing to lend to the producer. "Discounting" a contract involves an analysis of the agreement to determine the minimum amount payable by the distributor, a determination of the circumstances under which the distributor would be relieved of its payment obligations, and an assessment of the distributor's creditworthiness. Creditworthiness varies depending on, among other things, whether the distributor is a major studio or an independent production company.

If the bank is not comfortable with the distributor's creditworthiness, the bank may require the distributor to obtain a stand-by letter of credit naming the bank as the beneficiary. A letter of credit adds to the costs of the transaction for the distributor. However, the letter of credit fees may be negotiated between the distributor and the producer, or the acquisition price of the distribution rights may already reflect the creditworthiness of the distributor. Once the bank determines the mini-

mum amount payable by the distributor to the producer, the circumstances under which the distributor would be relieved of its payment obligations, and the distributor's creditworthiness, the bank determines the amount of money that it is willing to lend (the "Loan Amount").

3. The Budget of the Film and the Cash Flow Schedule

Based upon the discounted value of the distribution agreement and the timing of the film's production, the bank determines the amount of interest that it requires to be reserved from the Loan Amount to pay the bank the interest due on the outstanding indebtedness. In addition to the interest reserve, the bank deducts from the Loan Amount the loan fee, the cost of the legal fees, and the bond fee, generally prior to the first advance of funds to the producer.

The net amount is the amount of money available to the producer for the production of the film. Based on the budget, this net amount of money may be insufficient to complete and deliver the film to the distributor. In this case, the producer may elect to pay out-of-pocket the loan fee, the legal fees, and the bond fee prior to the first advance. If funds are still insufficient, the producer may have to contribute more of its own funds to the production. These funds must be applied to the production before the bank's funds are used, for the reasons discussed below concerning the completion bond.

The costs of the fees involved in bank financing may represent a large percentage of the Loan Amount, depending on the size of the film's budget. The loan fee may range from one-half percent (.5%) to three percent (3%). The interest rate and the amount of the loan fee amount vary from transaction to transaction, depending on the particulars of the transaction, including the relationship of the producer to the bank. Interest rates at most banks will range from Prime plus one-eighth percent (1/8th%) to Prime plus one percent (1%). Some foreign banks, however, may offer rates below Prime.

With respect to the legal bills, the producer pays for its own legal representation as well as for the bank's legal representation. The bank's legal counsel prepares all of the documentation for the loan transaction, which is quite extensive. As such, the legal bills generally average between \$28,000 - \$35,000 for a relatively "simple" transaction involving only one distributor. Depending upon the particulars of a transaction, however, the legal bills could amount to \$100,000 or more, particularly if more than one distributor is involved in a transaction.

The bond fee is generally equal to three percent (3%) to five percent (5%) of the total budget of the film, with half of the fee payable upon the

closing of the loan transaction, and the remainder payable in the event that the bond is called upon. The entire amount of the bond fee, however, whether it is three percent (3%) or five percent (5%), is deducted from the Loan Amount to determine the amount available for the budget of the film. Once the first half of the bond fee is paid upon closing, the remaining half of the bond fee is withheld from the Loan Amount as a reserve.

4. The Completion Guarantor and the Completion Bond

In addition to the credit risk of the distributor, the risk exists that the producer will not successfully complete and deliver the film to the distributor in a timely manner. The risk of unsuccessful completion and delivery of the film is not a "credit" risk and is therefore not a risk that a bank will assume. The party who assumes the risk of timely completion and delivery of the film is the completion guarantor.

The completion guarantor guarantees to the bank, via a completion bond, that the film will be completed and delivered to the distributor in accordance with the delivery schedule. This schedule is agreed upon by the producer, the bank, the distributor, and the completion guarantor prior to the closing of the loan transaction. In the event that the completion guarantor fails to deliver the film to the distributor in accordance with the delivery schedule, whether it is due to a late delivery of the film or to abandonment of the film by the producer and the completion guarantor, the completion guarantor pays the bank an amount that in most instances equals the amount of the producer's outstanding indebtedness.

Prior to the completion bond's becoming effective, the completion guarantor requires that the full amount of the budget be available for the production of the film. A committed loan from a bank will satisfy this requirement. If, however, the interest reserve or the bond reserve renders the Loan Amount insufficient to cover the cost of the film budget, the completion bond is effective only upon the contribution by the producer or some other third party of additional funds to the budget on the front end of the transaction. These extra funds must be placed in a designated bank account prior to the closing of the loan transaction. More often than not, it is the producer who pays out-of-pocket for these additional monies.

In addition to the completion bond, most banks also require a "cut-through" endorsement from the completion guarantor. A "cut-through" endorsement is an endorsement from the completion guarantor's reinsurer that guarantees the performance of the completion guarantor. In the event that the completion guarantor is unable to meet its financial

obligations to the bank, the reinsurer pays these obligations. Therefore, the reinsurer must be an acceptable credit risk for the bank. When the bank accepts the completion guarantor, it has also evaluated and accepted the credit risk of the reinsurer.

II. COLLATERAL FOR BANK FINANCING OF A "NEGATIVE PICK-UP"

A. *Primary Source of Repayment*

The primary source of repayment of the producer's indebtedness is the distributor's payment of what is commonly referred to as the "distribution advance." The bank's collateral is a first priority security interest in all rights in and to the motion picture, including all distribution rights that are currently granted and those that may be granted after the funding of the loan but prior to repayment of the loan.

Two situations occur in which a bank would want to exercise its rights as a secured party and foreclose on its collateral. The first situation is where the producer and/or the completion guarantor fail to complete and deliver the film in accordance with the delivery schedule, and as a result, the distributor is not obligated to pay the distribution advance, and the completion guarantor defaults on its obligation to pay the sums payable to the bank pursuant to the completion bond. Further, the "cut-through" insurer fails to pay the completion guarantor's obligation pursuant to the "cut-through" endorsement.

The second situation in which a bank would want to exercise its rights as a secured party is where the film is completed and delivered in accordance with the delivery schedule, but the distributor still does not pay what it is contractually obligated to pay, and the producer fails to repay its indebtedness because of the lack of funds. In this situation, the completion guarantor is not liable because it satisfied its obligations when the film was completed and delivered to the distributor in accordance with the delivery schedule.

In the first situation in which the film was not completed and delivered and, therefore, the distributor was not in default, the bank will offer the distributor the right to bid for the distribution rights to the film. In many instances, in fact, the bank is required to offer to the distributor, pursuant to the inter-party agreement, the right to bid for the distribution rights to the film. In some cases, the distributor is not obligated to pay an amount greater than the originally contracted-for distribution advance.

In the second situation, where the film is completed and delivered in accordance with the delivery schedule, but the distributor defaults and

fails to pay the contracted-for advance, the bank has no obligation to the distributor and must find another distributor to buy the distribution rights to the film. This situation can be avoided if the bank requires the distributor to provide the bank with a letter of credit in an amount equal to the distribution advance. The letter of credit should provide that the bank is entitled to draw under the letter of credit if the film is completed and delivered in accordance with the delivery schedule.

III. DOCUMENTATION

A. Standard Documentation

The documentation involved in financing a "negative pick-up" agreement includes the standard loan documents any bank would require when making a loan, among the other documents described below. Standard documents include a credit and security agreement, a promissory note, borrowing resolutions, an opinion of borrower's counsel, and corporate or partnership documents of the borrower. Documents that are specific to picture financing are the copyright mortgage and assignment, Uniform Commercial Code Form 1 ("UCC-1") financing statements, the copyright report and opinion, the title report and opinion, the laboratory pledgeholder agreement, and the inter-party agreement.

The copyright mortgage and assignment transfers to the bank, as security for the loan, all of the producer's right, title and interest in and to the copyrights. Additionally, it transfers all cash and accounts receivable in and to the particular screenplay and motion picture based upon or derived from the film the bank is financing. The copyright mortgage and assignment is recorded with the United States Copyright Office located in Washington, D.C. By recording this document, the bank puts the world on notice that it has a security interest in the particular film.

The UCC-1 financing statements should be filed with the Secretary of State of California, and generally with the Secretary of State of New York and the County of New York. Additionally, UCC-1 financing statements should be filed with the Secretary of State of each state where the movie is being filmed. While the current law provides that one may perfect a security interest in a copyright by recording a mortgage of copyright in the United States Copyright Office, most attorneys still file with the Secretary of State as a matter of precaution.

The copyright report provides a history of the ownership of the rights involved. Generally, the report is issued by a service that specializes in copyright searches. The copyright opinion is typically issued by an attorney with expertise in reviewing copyright history, who states who

currently owns the rights in the film. The owner of the rights in the film should be the bank's producer.

The title report states the history of use of the title for the film. The title opinion states whether the particular title in question is safe to use or whether clearances from other parties may be required. Often, the service and attorney who perform the copyright search and opinion also prepare the title report and opinion.

The laboratory pledgeholder agreement provides for the laboratory to act as a holder of the film, including all negatives, for the bank's benefit. The agreement also provides that the laboratory cannot remove the film without the bank's prior written consent, and that any security interest the laboratory may have in the film to assure itself of payment for its services is junior to the bank's lien. This agreement is executed by the laboratory, the bank, the producer, and the completion guarantor.

B. The Inter-Party Agreement

Aside from the promissory note and the credit and security agreement, the most important document in financing a "negative pick-up" is the inter-party agreement. It is the document that creates a contract between the bank and the distributor. It is also the controlling document that allocates the risks of the transaction to each party involved. The inter-party agreement is negotiated and executed by all parties involved in the transaction — the bank, the producer, the distributor, and the completion guarantor. If more than one distributor is involved in a transaction, each distributor may have a separate inter-party agreement.

While no one "standardized form" document is used in the industry, the inter-party agreement usually covers the following issues:

1. *Notice of Assignment; Acceptance and Acknowledgment.* The inter-party agreement notifies and instructs the distributor to pay directly to the bank the distribution advance and any other amounts, such as overages, that the distributor may be obligated to pay the producer. The agreement contains an acknowledgment by the distributor that it is obligated to do so. The distributor is also obligated to notify the bank of the receipt of any conflicting notices regarding the payment of the distribution advance or any other amounts owed.

2. *Application of Assigned Receipts.* The inter-party agreement also provides that the bank, upon receipt of the distribution advance, is to apply the funds to the repayment of the producer's indebtedness. Further, it sets forth the notices and actions the bank must take upon the repayment of the loan.

3. *Payments to Bank; Rights of Setoff.* One of the most important

provisions of the inter-party agreement states that the distributor is to pay the distribution advance to the bank without offset, counterclaim, withholding, right of cross-collateralization, or the right to set up reserves, provided that "effective delivery" — delivery made in accordance with the delivery schedule — is made to the distributor. Further, any failure of the producer to observe or perform any representation, warranty, term or condition, other than the failure to make "effective delivery," does not excuse the payment of the distribution advance by the distributor to the bank.

4. *Acknowledgment of Priority.* The inter-party agreement sets forth the order of each party's security interest in the screenplay and the film and the rights in and to the distribution agreement. Until the bank is repaid the outstanding indebtedness, it is always in first position with respect to its collateral. The completion guarantor and the distributor are generally in second and third position, respectively. In the event that the distributor defaults and fails to pay the distribution advance when due, or it has been determined that the distributor is not obligated to pay the distribution advance, all of the distributor's distribution rights under the distribution agreement terminate and the rights revert to the producer, the bank, or the completion guarantor, depending upon the particular situation.

5. *Distribution Agreement.* The inter-party agreement provides that the distribution agreement is in full force and effect and that no changes may be made to the distribution agreement without the bank's prior written consent.

6. *Credit and Security Agreement.* All parties agree that the producer remains responsible for the performance of all obligations under the credit and security agreement and that the distributor has no obligations under the credit and security agreement.

7. *No Performance Required of Bank or Completion Guarantor.* The agreement generally contains a provision that the producer remains responsible for its obligation under the distribution agreement and that neither the bank nor the completion guarantor shall have any obligations under the distribution agreement.

8. *Additional Agreements.*

a. "Effective Delivery." A provision stating what constitutes "effective delivery" under the inter-party agreement is always included. The definition of "effective delivery" may vary from the distribution agreement to the inter-party agreement, but the definition provided for in the inter-party agreement controls.

b. Cost Overruns Prior to Delivery. The inter-party agree-

ment provides that the completion guarantor shall pay all costs of producing, completing and delivering the film, subject to the terms and conditions of the completion bond and to the extent not paid by the producer and to the extent the completion guarantor is made aware of these costs. Therefore, if the film exceeds its budget prior to completion, it is the producer's primary responsibility to pay for these costs. The completion guarantor is secondarily liable for the costs.

c. "Chain-of-Title." As between the bank and the distributor, the distributor acknowledges that it has approved the "chain-of-title." This means that the distributor may not refuse to pay the distribution advance to the bank because of any deficiency or claim, proceeding, or judgment with respect to any literary material, or because the producer has not obtained the title to or license to use the story, script or other rights in connection with the film, or because of any claim that the film infringes on the rights of others. In addition to the foregoing acknowledgment, the bank may require an indemnity from the producer for any and all liability or damage arising out of the "chain-of-title" of the film or title to the film.

d. Distributor's Rights in the Event of Failure to Deliver. As described above, a clause generally provides for the consequences in the event that "effective delivery" of the film is not made to the distributor, and the bank is not repaid by either the producer or the completion guarantor. In exercising its rights as secured party, the bank is obligated in most instances to first give the distributor a right to negotiate with the bank for the purchase of the distribution rights.

e. Approvals. The bank will attempt to have the distributor approve as many elements of the distribution agreement as possible that are subject to the distributor's approval, such as the script or a director.

f. *Force Majeure*. Most inter-party agreements provide for a thirty-day extension of the "effective delivery" date for a delay caused by acts of God, such as an accident, fire, or explosion, or due to strikes, war, or enactment of any law.

9. *Arbitration*. The arbitration provision is one of the most important provisions in the inter-party agreement. The parties agree to arbitrate if a dispute arises over whether or not "effective delivery" has been made. Generally, this is the only issue the bank is willing to arbitrate because it is the only issue that triggers payment to the bank. If the arbitrator finds that "effective delivery" was made, the distributor is obligated to pay the distribution advance. If the arbitrator deems that "effective delivery" was not made, it is the producer's and/or the completion guarantor's responsibility to pay the bank. The arbitration provision can

be quite lengthy because of cure periods and notice provisions. Arbitration is an issue that the parties and their attorneys extensively discuss and debate.

10. *Miscellaneous Provisions.* The remainder of the inter-party agreement generally sets forth the notice, governing law, jurisdiction provisions, and other common general contract provisions.

IV. CONCLUSION

The relationships among the bank, the producer, the distributor, and the completion guarantor are critically important aspects of motion picture bank financing. The bank seeks the comfort of the familiarity and the trustworthiness of each party. This assures the bank that each party will cooperate in a timely manner to resolve any conflicts in the transaction and that the bank will recoup its funds in the event the transaction goes awry. If the parties are unwilling to cooperate after a transaction fails, even the most well-documented transaction will result in an inefficient resolution. The importance of the parties' relationship cannot be stressed enough.

Despite the costs and expenses incurred on the front end of a bank transaction and the amount of time involved in negotiating, documenting and closing the transaction, it can be very lucrative to the producer to bank-finance a motion picture, especially if the film is successful at the box office. Provided the bank has the expertise to efficiently negotiate, document and close a transaction of this type, the bank can also profit, particularly because most motion picture production loans are outstanding for a relatively short period of time — nine months to two years. More often than not, bank financing of a motion picture results in a win/win transaction for both the producer and the bank.