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Limited Partnerships as Film Financing Vehicles

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COMMENT

LIMITED PARTNERSHIPS AS FILM FINANCING VEHICLES

I. INTRODUCTION

The summer of 1994 was good for Hollywood, setting a new record for box office receipts. Heralded as a record-breaking movie season, the summer of 1994 grossed $2.2 billion in revenues, up slightly from the previous summer's $2.1 billion. In fact, "Tinseltown" has emerged as one of the bright spots in this recession-battered United States economy, growing 10% from 1992 and adding $4 billion to the total figure for United States exports. High gross revenues, however, have not resulted in high profits. As The Economist put it, "talk of profitability leaves Hollywood nervous and defensive." Lackluster profitability is partly attributable to the "relentless growth" of production and marketing costs. For example, in 1992 the average cost of making a movie rose by 10% to $28.9 million. Add to that the cost of marketing, which averaged $13.5 million per film in 1992, and making a movie becomes a very expensive proposition.

The "tidal wave of runaway costs" in making a movie has been attributed partly to the advent of pay television and other markets for films. With these newer markets, even unsuccessful films can be salvaged by a video or cable afterlife. The potential profitability of these markets

3. Id.
4. Id.
5. Id.
6. Id.; see also infra p. 81.
9. Id. at 205.
pushed the industry to spend more, based on the belief that costs would ultimately be recouped. However, while some markets, such as cable and pay-per-view, have provided a nice cushion for failures, the average cost of many films has been impossible to recoup. For instance, in 1992, the average box office revenue for a movie was $10.1 million, only one-third of the average cost of making and distributing a movie.

Despite high risk and disappointing returns on many films, limited partnerships have proven to be useful financing vehicles for films. The use of limited partnerships has long been a popular way to raise money for independent film makers who often struggle to obtain financing for their projects. Due to the higher risk caused by rising costs of production and marketing, even the major studios have increasingly relied on limited partnerships to finance films. Through public offerings, and increasingly through private placements, limited partnerships such as Delphi Film Associates, Silver Screen Partners and Touchwood have successfully financed many films. However, for every successful limited partnership there have been unsuccessful ones. Consequently, there has been a rise in the number of suits filed by disappointed investors against general partners, brokers, and other professionals associated with unsuccessful limited partnerships. Recently, the decision in *Central Bank of Denver v. First Interstate Bank of Denver* limited the remedies available to investors by restricting aiding and abetting liability under Rule 10b-5.

This Comment presents a historical perspective of limited partnerships and argues that since the Supreme Court decision of *Central Bank of Denver*, the use of limited partnerships to finance films has become increasingly risky to investors. Part II of this Comment discusses the

10. *Id.*
11. *Id.*
12. See infra pp. 82-83.
16. See Hard Time for Film Business, 8 *Ent. Law & Fin.*, no. 8, at 1 (1993) ("A bright spot in all this is the growing success of entertainment companies in raising money through private placements, rather than public offerings.").
formation of limited partnerships, the impact of the Tax Reform Act of 1986 on the future of limited partnerships and their use to finance film projects. Part III of this Comment reviews the evolution of securities law applicable to limited partnerships. First, the discussion establishes the limited partnership’s interest as a security. Next, this Comment distinguishes between the registration requirements of public offerings and private placements. Then, this Comment reviews the issue of fraud in the purchase or sale of securities under Rule 10b-5 by first examining primary liability followed by a consideration of the risk of professional liability under the secondary theory of aiding and abetting prior to Central Bank of Denver. Finally, this Comment analyzes Central Bank of Denver and concludes that the Court’s limitation on aiding and abetting liability greatly increases the risk of investing in limited partnerships used to finance films. However, the Court left open the question whether Congress would enact legislation to revive the private cause of action for aiding and abetting liability, thus limited partnership financing may not be the risky proposition it now seems.

II. BACKGROUND

A. Formation of Limited Partnerships

The limited partnership as a major investment vehicle was first used in the nineteenth century as a means to achieve limited liability without forming a corporation. It was later used primarily by wealthy investors and entrepreneurs as a tax shelter vehicle. Limited partnerships have been used to finance such ventures as “orange groves, satellite transponders, timber stands and movie productions.”

One of the principal advantages of a limited partnership is that it reduces the limited partners’ general liability to the amount of their capital contribution. Additionally, a limited partnership, although subject to certain reporting requirements, is treated as an aggregation of its

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21. Id.
partners, thus it is not a taxable entity. Rather, partnership income is taxed at the partner's level in proportion to each partner's capital contribution, which enables the partners to avoid double taxation of partnership income. More importantly, the limited partners may share the tax results of the limited partnership's operation as though the limited partnership did not exist.

One of the main disadvantages of investing in a limited partnership is that the limited partnership must file a certificate disclosing the identity of the limited partners and the amount of their liability. This certificate must then be made available for continuous public inspection. In addition to the certificate requirement, the limited partners are required to refrain from any participation in the management or control of the business. Despite the minimization of liability for limited partners, these restrictions and other factors explain why the limited partnership remains a specialized business structure employed by more sophisticated investors.


Limited partnerships enjoyed favorable tax treatment prior to the passage of the Tax Reform Act of 1986. This favorable tax treatment was, in fact, the main driving force behind the formation of many highly leveraged, unsound limited partnerships. Publicly held companies also began using the limited partnership form for financing purposes. Fearing a large-scale loss of corporate tax revenue through the widespread use of limited partnerships created to avoid taxes, Congress passed the Tax Reform Act of 1986. The Tax Reform Act of 1986 removed the tax shelter benefit by removing the ability to use excess losses or credits to reduce income from other sources.

25. I.R.C. § 701 (West 1990) ("A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.").
27. ULPA § 2(1)(a), supra note 23.
28. ULPA § 2(1)(b), supra note 23.
29. ULPA § 4, supra note 23 ("The contributions of a limited partner may be cash or other property, but not services.").
31. Ribstein, supra note 20, at 838.
Under the provision, losses generated by "passive activities" cannot be applied against any income from other income-producing activities. This means that losses from limited partnerships could no longer be applied to shelter income from other passive income producing activities. Despite the elimination of this tax shelter, limited partnerships are still viable business structures. However, the focus has been on profitability rather than on the sheltering of income.

C. Use of Limited Partnerships To Finance Film Projects

The use of limited partnerships to finance films is not a new concept. For example, between 1985 and 1990, Disney raised nearly $1.5 billion through a series of limited partnerships. The use of limited partnerships enabled Disney to transform itself into a major studio by allowing Disney to produce twelve to fifteen films a year without risking much of its own capital. In fact, Disney is the only major studio that has not needed to use its own cash or borrow from a bank.

Limited partnerships can finance either single projects or "blind pools." With a portfolio of films, it is more likely that at least some of the films will be successful and will help compensate for the unsuccessful films. The benefit to investors of these large portfolio partnerships is diversification and risk reduction. For instance, Touchwood Pacific Partners I financed such box office hits as "Father of the Bride" and "The Hand That Rocks the Cradle." The same partnership also financed such less-than-memorable films as "Ernest Scared Stupid," "Newsies" and "Noises Off." These portfolio partnerships are typically designed to be

33. Passive activities are defined as income-producing activities in which the taxpayer does not materially participate. I.R.C. § 469(d)(1) (West 1990).
34. I.R.C. § 469(a) (West 1990).
38. Laura Landro, Three Movie Studios Plan Two Offerings Of Partnerships for Up to $180 Million, WALL ST. J., Feb. 6, 1985, at 7.
41. Harris, supra note 37, at D1.
42. Id.
eight-to ten-year investments, with minimized downside risk and an upside profit potential.\textsuperscript{43}

Despite the benefit of diversification and risk reduction that large portfolio limited partnerships provide, there is criticism that these partnerships are not sound investments.\textsuperscript{44} According to the terms of the Silver Screen IV prospectus, approximately 50\% of the box office receipts are retained by the theater owner, at least half of the remainder is paid to the distributor, and the production costs and the general partners' fees get paid before the investors can receive any return on their investment.\textsuperscript{45}

Notwithstanding media criticism,\textsuperscript{46} the Silver Screen Partnerships yielded a respectable rate of return on investment of approximately 18\%.\textsuperscript{47} However, the Silver Screen Partnerships appear to be an exception. De Laurentis Film Partners, a publicly traded movie partnership, filed for reorganization under Chapter 11 of the United States Bankruptcy Code in 1987, and its shares were trading at eighteen cents in July of 1989, down from $16.25 a share when the partnership first went public in 1987.\textsuperscript{48} According to one analyst, movie partnerships that do produce returns usually yield rates similar to those on Treasury bills.\textsuperscript{49}

Despite the potential for losses, many limited partnerships formed to finance films have been very successful in raising capital. Silver Screen IV, for instance, successfully met its goal of $400 million through a public offering.\textsuperscript{50} This occurred despite negative publicity regarding the poor

\textsuperscript{43} "The downside risk is the loss of all or most of the invested capital." Cohen, supra note 40, at 536 n.19. "Upside profit potential affords the investor an opportunity to share in any and all profits without any significant limitations." Id. at n.20.

\textsuperscript{44} See, e.g., Lisa Gubernick, Mickey Mouse's Sharp Pencil, FORBES, Jan. 7, 1991, at 40 ("While the upfront fees to Silver Screen's promoters have been handsome, the returns to the limited partners have been modest."); Laura Jereski, So You Want To Be In Pictures, FORBES, Mar. 21, 1988, at 36 ("The Silver Screen versions show a whole new dimension in using other people's money."). The scathing March 1988 article in Forbes magazine led Silver Screen Management Services to sue Forbes for libel. The trial court in New York dismissed the case, finding that the article consisted of opinions based on facts which were "free of material error." Court Dismisses Libel Action Against Forbes Magazine Arising From Article On Financing of Walt Disney Films By Silver Screen Limited Partnerships, ENT. L. REP., Mar. 1992.

\textsuperscript{45} Jereski, supra note 44, at 37.

\textsuperscript{46} See supra note 44.

\textsuperscript{47} Richard Turner, Movies: Disney to Get $600 Million From Japan to Make Movies, WALL ST. J., Oct. 23, 1990, at B1. But see Earl C. Gottschalk, Jr., Your Money Matters: Film Partnerships Are Often Star-Crossed, FORBES, July 12, 1989, at C1 ("investors would have made more money by just investing in Disney common stock" which rose four-fold between 1983 and 1989).

\textsuperscript{48} Gottschalk, supra note 47.

\textsuperscript{49} Id.

\textsuperscript{50} Jereski, supra note 44, at 36.
performance of Silver Screen II, and that Silver Screen IV's structure provided for a lower return than Silver Screen II. Some attribute the successful sale of Silver Screen IV and other limited partnerships to the glamour of owning a piece of a movie, "which appeals to the vanity of unsophisticated investors." 51 Whatever the reason, limited partnerships, as a vehicle for financing films, play a vital role in the movie industry.

III. SECURITIES LAW ISSUES APPLICABLE TO LIMITED PARTNERSHIPS

A. A Limited Partnership Interest as a "Security"

If a limited partnership interest is considered a "security" under the federal securities laws, several issues must be addressed. 52 Among the most important are (1) the registration requirements under federal and/or state securities laws, (2) the consequences of not complying with such registration requirements, which include a private remedy of rescission or an enforcement action by the Securities and Exchange Commission ("SEC") and/or one or more states, and (3) the anti-fraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act"), which are applicable regardless of whether a security is exempt from registration.

Section 2(1) of the Securities Act of 1933 (the "Securities Act") and Section 3(a)(10) of the Exchange Act define a "security" as a "certificate of interest or participation in any profit-sharing agreement" or an "investment contract." 53 "[P]articipation in a profit-sharing agreement" is not broader in its meaning than an "investment contract." 54

The Supreme Court in SEC v. Howey 55 enunciated a test for determining whether an instrument is an "investment contract" or a security. An instrument is a "security" if it constitutes [1] an investment

51. Fun and Profit, ECONOMIST, Oct. 29, 1988, at 23; see also Gottschalk, supra note 47 ("[M]ajor value [of movie limited partnerships] is 'limited to the cocktail circuit . . . so you can tell a friend you have a piece of a hit picture'" (quoting Steven Bleier)); Randall Smith, All That Glitters in Movie Deals Doesn't Lead To a Pot of Gold for Investors in Partnerships, WALL ST. J., Mar. 4, 1987, at 63 ("[M]oney isn't everything. . . . [A]n interest in movie partnerships provides people with more psychic income and boasting privileges than a stock . . . .") (quoting Harold Vogel).


53. Securities Act § 2(1); Exchange Act § 3(a)(10).


55. 328 U.S. 293 (1946).
of money "in a common enterprise," with the expectation of profits, derived "solely from the efforts of the promoter or a third party." The first two prongs of the test, along with the fourth prong, are usually easily satisfied, while the third prong has proved to be more problematic. Since a purchase of a limited partnership interest constitutes an investment of money, the first prong of the test is readily satisfied. In addition, limited partnerships, by definition, satisfy the common enterprise requirement because the Revised Uniform Limited Partnership Act requires two or more persons to form a limited partnership with at least one as the general and one or more as limited partners. Finally, a limited partnership's interest usually satisfies the fourth prong of the test because limited partners are not permitted to take an active part in the management of the limited partnership's business. Thus, they rely on the "efforts of others."

The third prong requires that the investment be made "with expectation of profits" through "either capital appreciation resulting from the development of the initial investment . . . or a participation in earnings resulting from the use of investor's funds," even where the venture is primarily undertaken for its tax shelter benefits. However, most courts do require that "profits" include some economic return, holding that tax benefits alone will not constitute "profit" as intended by the Howey test. Even a mere attempt to earn economic profit, though largely tax motivated, satisfies the "profit" requirement for a number of courts. However, some courts hold that tax benefits alone can constitute "profit" for purposes of the Howey test. If the structure of Silver Screen Partners IV is

56. Id. at 301.
57. The Revised Uniform Limited Partnership Act has been adopted by most jurisdictions.
58. Howey, 328 U.S. at 299.
59. Id.
63. See, e.g., Kolibash v. Sagittarius Recording Co., 626 F. Supp. 1173, 1179 (S.D. Ohio 1986) (holding that, where "tax benefits are the primary or dominant economic inducement for investing, such tax benefits may properly be considered 'profits.'")); Investors Credit Corp. v. Extended Warranties, Inc., [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,343, at 92,257-59 (M.D. Tenn. 1989) (holding that the purchase of an aircraft with an expectation of tax benefits which would accrue from ownership of the aircraft constituted the purchase of a security).
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typical, then limited partnerships formed to finance films are likely to be deemed "securities."

B. The Registration Requirement

1. Public Offerings

Interests in limited partnerships that are determined to be securities can be sold either through a public offering or a private placement. If a public offering is chosen, the securities must be registered pursuant to the Securities Act64 and the rules of each state where the securities may be offered or sold.65 The costs of complying with the registration requirements can be very high. For instance, the underwriters' fees account for approximately 10% of the public offering price.66 Moreover, there are additional costs for filing fees and legal, accounting, and printing expenses.67 Reporting requirements of the Exchange Act68 also add to these costs. These reporting requirements include the filing of annual reports and other reports containing specifically prepared financial statements and detailed information about a wide range of subjects.69 Perhaps due to the high costs associated with public offerings, the current trend in raising capital for films is toward the use of private placement.70

2. Private Placements: Section 4(2)

Securities sold through a private placement are exempt from the registration requirements discussed above. Section 4(2) of the Securities Act provides that the registration requirements do not apply to "transactions


65. In 1985, Silver Screen Partners II was required to return $4.7 million to 700 to 900 Massachusetts investors for failing to register its offering with the state. Silver Screen Agrees To Return $4.7 Million In Partnership Funds, WALL ST. J., June 5, 1985, at 20.


67. Id. at 30 (filing fees are paid to the SEC, the National Association of Securities Dealers, Inc., and the states in which the securities are sold).

68. Exchange Act § 15(d). These reporting requirements include the filing of "[a]nnual and other reports, containing specially prepared financial statements and detailed information about a wide range of subjects." SODERQUIST, supra note 66, at 31.

69. SODERQUIST, supra note 66, at 31.

70. See Hard Time for Film Business, supra note 16, at 1.
not involving any public offering."71 This statutory exemption is the most important available to issuers of limited partnership securities.72

SEC v. Ralston Purina Co.73 is the leading case enumerating the requirements for a private placement. The Supreme Court set forth guidelines for differentiating between a public offering and a private placement. The Court found that the applicability of the exemption provided by Section 4(2) "should turn on whether the particular class of persons affected needs the protection of the act."74 The class of persons are "those who are shown to be able to fend for themselves."75 The Court then discussed the satisfaction of that requirement in terms of access on the part of the offeree to the "kind of information which registration would disclose."76

"Building on these concepts, [lower] courts have developed flexible tests for the private offering exemption."77 For instance, the Fifth Circuit found the following factors to be relevant: (1) the number of offerees and their relationship to each other and to the issuer, (2) the number of units offered, (3) the size of the offering and (4) the manner of the offering.78 In comparison, the First Circuit has offered a slightly different list of criteria: "Sales may . . . be exempted . . . if a private offering is made in which the purchasers (1) are limited in number, (2) sophisticated, and (3) have a relationship with the issuer enabling them to command access to information that would otherwise be contained in a registration statement."79

The Ninth Circuit focuses on: "(1) the number of offerees, (2) the sophistication of the offerees, (3) the size and manner of the offering and (4) the relationship of the offerees to the issuer."80 Of these factors, the requirements of offeree sophistication and availability of information are now generally recognized.81 Therefore, the current trend of using private placements rather than public offerings in raising funds for films is expected to continue.

71. Securities Act § 4(2).
72. SODERQUIST, supra note 66, at 134.
74. Id. at 125.
75. Id.
76. Id. at 127.
77. SEC v. Murphy, 626 F.2d 633, 644 (9th Cir. 1980).
78. Doran v. Petroleum Management Corp., 545 F.2d 893, 900 (5th Cir. 1977); Hill York Corp. v. American Int'l Franchises, Inc. 448 F.2d 680, 687-89 (5th Cir. 1971).
80. SEC v. Murphy, 626 F.2d at 644-45 (citations omitted).
C. Fraud in the Purchase or Sale of Securities

In the wake of the recession and the collapse of various markets, unhappy investors facing considerably depreciated limited partnership interests have turned to the courts to recoup their losses. In addition to the partnerships' officers or employees, accountants, attorneys, brokers, and other professionals have borne the brunt of the investors' frustration. By 1990, the Justice Department received more than 21,000 referrals from government agencies looking to recover damages for savings and loan failures.

I. Rule 10b-5: Primary Liability

Disappointed investors have filed civil actions against general partners, brokers, and other professionals for violations of Section 10(b) of the Exchange Act and SEC Rule 10b-5. These suits have alleged misrepresentations and omissions. The section provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any
sentation or failure to disclose risks associated with the investments by the general partners and brokers. Moreover, through April 1994, the lawsuits allege aiding and abetting by other professionals who were involved with in offerings.

Although security law provides several antifraud remedies, the most important remedy seems to be found in Rule 10b-5. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 was enacted to include the purchase of securities to the general anti-fraud provisions. The previous provision only covered fraudulent sales of securities.

Originally, neither Section 10(b) itself nor the general anti-fraud provisions of Rule 10b-5 expressly authorized a private cause of action for violation of Section 10(b)'s provisions. Nevertheless, the courts did not delay in finding an implied private right of action under the rule.

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89. Sections 11, 15, and 17(a) of the 1933 Act are also anti-fraud provisions which supply express and implied private remedies.
91. Securities Act § 17(a).
92. Rule 10b-5 was drafted rather hastily by combining the numbered subdivisions of Securities Act Section 17(a), which describe various kinds of prohibited conduct, with portions of the Exchange Act Section 10(b), which contained the language "in connection with the purchase or sale of any security... any manipulative or deceptive device or contrivance." The same day the rule was drafted, the Commissioners passed it without any comment, except for Sumner Pike, who said, "Well, we are against fraud, aren't we?" SODERQUIST, supra note 66, at 237 (quoting from Proceedings, Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967)).
In 1946, a district court in Pennsylvania found that an implied private action exists under the rule.\(^6\) However, the Supreme Court halted the expansion of the rule in *Blue Chip Stamps v. Manor Drug Stores*\(^7\) and *Ernst & Ernst v. Hochfelder*.\(^8\) The scope of private right of action has since been further limited.\(^9\) Thus, investors in limited partnerships, including those who finance films, face an increased chance of risk from their limited avenues of recovery.

a. The "In Connection With" Requirement

In order for Rule 10b-5 to apply, the conduct prohibited must be made "in connection with the purchase or sale of a security."\(^\text{100}\) But as the Third Circuit noted, "[a]lmost without exception, [federal courts] have found compliance with the 'connection' requirement even where fraudulent conduct is implicated only tangentially in a securities transaction."\(^\text{101}\)

b. Standing: "Purchaser-Seller" Requirement

Under the *Birnbaum* rule,\(^\text{102}\) a private plaintiff must be a purchaser or seller of securities in order to have standing to sue under Rule 10b-5. Notwithstanding the rule, the lower courts have allowed some exceptions.\(^\text{103}\)

In its first "purchaser-seller" requirement case,\(^\text{104}\) the Supreme Court recapitulated *Birnbaum*’s limited scope, reasoning that the absence of the requirement would lead to various evils.\(^\text{105}\) This made it clear that the Court’s view of Rule 10b-5 was no longer broad and expansive. As a result, investors in limited partnerships were further restricted in their recoupment of investment losses.

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99. See *HAZEN*, *supra* note 81, § 13.2.
100. Ketchum v. Green, 557 F.2d 1022, 1025 (3d Cir. 1977).
101. *Id.* at 1026.
103. One exception recognized by courts is the forced-seller exception. Here, a shareholder is put in the position of a forced seller. *SODERQUIST*, *supra* note 66, at 246.
105. *Id.* at 725.
c. Proving the Element of Reliance Under 10b-5

A great deal of litigation involving limited partnerships considers the issue of investor reliance on material misstatements or omissions under Rule 10b-5.\(^{106}\) In *Affiliated Ute Citizens v. United States of Utah*,\(^{107}\) the Supreme Court found that:

> [u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that facts withheld be material . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.\(^{108}\)

Once materiality of the omission is established, the defendant is allowed to rebut the presumption by proving that the plaintiff did not rely on the omissions.\(^{109}\)

Reliance is presumed even in the absence of any proof that a plaintiff relied individually on a defendant's misstatement or omission under the "fraud on the market" theory. As articulated in *Blackie v. Barrack*,\(^{110}\) the theory postulates:

> A purchaser on the stock exchanges . . . relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price — whether he is aware of it or not, the price he pays reflects material representations.\(^{111}\)

Under the "fraud on the market" theory, even if the plaintiff cannot show that she relied on a defendant's misstatement, reliance on the misstatement is presumed. Yet in film financing, investors are often aware at the outset of the high risk of potential loss associated with limited partnerships. This theory was later accepted by the Supreme Court in *Basic Inc. v. Levinson*.\(^{112}\)

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108. Id. at 153-54.
110. 524 F.2d 891 (9th Cir. 1975).
111. Id. at 907.
In addition to reliance, the plaintiff must also allege and prove that she would not have lost money if the facts had been as stated in the offering materials. For example, in Bastian v. Petren Resources Corp. the court held that the failure to allege loss causation was fatal. Thus, the complaint had to be dismissed. In that case, the plaintiffs sued under Rule 10b-5 alleging that they would not have purchased their interests in oil and gas limited partnerships but for alleged material misstatements and omissions in the defendants' offering materials relating to the defendants' integrity and competence. Yet the court held that investors failed to satisfy the causation requirement since they neglected to include a "reason why the investment was wiped out." Consequently, an investor in limited partnerships has the increased burden of proving loss in order to recover.

d. Fault Required

One of the refinements that generally made Rule 10b-5 less useful to private plaintiffs is the requirement of fault. With this additional requirement, investment in limited partnerships has remained a high risk. In Ernst & Ernst v. Hochfelder, the Court found that scienter, rather than mere negligence, was required to support a verdict for a private Rule 10b-5 plaintiff. In its discussion, the Supreme Court specifically left open the question of whether recklessness by itself would be sufficient to constitute scienter. However, some courts that have addressed the issue have found that recklessness constitutes scienter.

2. Rule 10b-5: Professional Liability Under the Secondary Theory of Aiding and Abetting

In addition to primary liability under Rule 10b-5, professionals were sued under Rule 10b-5's secondary theory of aiding and abetting. The explosion of such suits had been so phenomenal and payouts so daunt-
ing that accountants worried that "[t]he possibility that no firms [would] be willing to take on clients in risky industries." The Court addressed the professionals' concerns and held in *Central Bank of Denver* that aiding and abetting did not exist under Rule 10b-5; thus reducing the vulnerability of professionals to liability.

a. The Aiding and Abetting Standard Prior to *Central Bank of Denver*

In *Ernst & Ernst v. Hochfelder*, the Supreme Court had expressly reserved the issue of whether there was an implied right in a private action under Rule 10b-5 to assert claims against one who aids and abets the primary violator. In that case, the lower court had held an accounting firm liable as an aider and abettor for negligently failing to conduct a proper audit of a brokerage firm whose president defrauded its shareholders. The Supreme Court reversed the circuit court, holding that scienter was required for a 10b-5 violation. The Court, however, did not reach the question of aiding and abetting:

In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under Section 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the rule, nor the elements necessary to establish such cause of action.

On the other hand, the circuit courts actively dealt with liability for aiding and abetting. In formulating the doctrine of aiding and abetting,
the courts adopted a varying formulation of Section 876 of the Restatement of Torts. The elements of aiding and abetting included: "(1) violation of the securities laws by a primary party; (2) knowledge of that violation by the secondary party; and (3) 'substantial assistance' rendered to the primary party by the secondary party." Therefore, limited partnership investors had the potential to recover from "deep-pocket" sources, in lieu of the primary source who most likely had lost money in the investment as well.


In 1994, the Supreme Court finally addressed the scope of Section 10(b) aiding and abetting in order to resolve the continuing confusion. In Central Bank of Denver v. First Interstate Bank of Denver, the Court held that Section 10(b) prohibits investors from filing suits charging that someone "aided or abetted" deceptive acts involving stock or bond transactions. Writing for the majority in a 5-4 ruling, Justice Kennedy noted that statutory text controls the definition of conduct covered by the Securities Exchange Act's general anti-fraud provision. Further, the majority also found that Section 10(b) prohibits the making of a material misstatement or omission, or the commission of a manipulative act, but it does not prohibit aiding securities fraud.

The case before the Court arose after investors sued participants in a 1988 sale of municipal bonds. The suit, brought after the issuing authority defaulted on the bonds, named, among others, Central Bank of Denver, which had served as trustee for the offering and had allegedly helped defraud investors. The Tenth Circuit held that bondholders could sue the Central Bank of Denver. In reversing, the Supreme Court rejected an array of arguments by investor advocates and the SEC,
including the notion that an expansive reading of Section 10(b) is consistent with the broad policy objectives of the securities laws.\textsuperscript{134}

In a dissenting opinion, Justice Stevens pointed out that, when applying Section 10(b), courts assumed that a statute passed to protect a particular group, such as investors, conferred on members of the group a right to sue violators.\textsuperscript{135} He opined that “[the Court] should . . . be reluctant to lop off rights of action that have been recognized for decades, even if the judicial methodology that gave them birth is now out of favor.”\textsuperscript{136}

Although the main beneficiaries of this ruling have been lawyers, accountants and other financial advisers commonly swept into “vexatious” investor lawsuits, alleging securities fraud,\textsuperscript{137} the court left open the possibility that aiding and abetting may again become viable.\textsuperscript{138} Thus, although the risk of loss in limited partnerships has increased due to the holding in \textit{Central Bank of Denver}, Congress could feasibly enact legislation reviving aiding and abetting liability by investors against “deep-pockets.” Accordingly, if Congress enacted such a statute, the attractiveness of limited partnerships as a film financing vehicle could increase in the future.

3. Damages and Penalties in 10b-5 Cases

As a result of the general failure of limited partnerships, investors were forced to seek damages from “deep-pockets” to recoup their losses. However, despite the large number of cases brought under Rule 10b-5, damage issues are far from resolved.\textsuperscript{139} The Supreme Court has never provided guidelines for setting damages, and lower courts have differed on which damage formulation would be appropriate.

\begin{footnotesize}
\begin{enumerate}

\item[134.] Id. at 1451.
\item[135.] Id. at 1456.
\item[136.] Id. at 1460.
\item[137.] See Monroe v. Hughes, 31 F.3d 772, 776 (9th Cir. 1994); Twiss v. Kury, 25 F.3d 1151, 1558 (11th Cir. 1994).
\item[138.] \textit{Central Bank of Denver}, 114 S. Ct. at 1452. The Court held in pertinent part:

It does not follow . . . that Congress’ failure to overturn a statutory precedent is a reason for this Court to adhere to it. It is “impossible to assert with any degree of assurance that congressional failure to act represents” affirmative congressional approval of the [Court’s] statutory interpretation. . . . Congress may legislate, moreover, only by passage of a bill which is approved by both Houses and signed by the President . . . Congressional inaction cannot amend a duly enacted statute. \textit{Id.} (quoting Patterson v. McLean Credit Union, 491 U.S. 164, 175 n.1 (1989)).
\item[139.] SODERQUIST, \textit{supra} note 66, at 259.
\end{enumerate}
\end{footnotesize}
Generally, there are three approaches for measuring damages. The most commonly used approach is the "out-of-pocket" measure. This approach determines damages by looking at the difference between the price paid or received and the actual value of the securities at the time of purchase or sale. This measure is problematic because valuation must often be resolved by expert testimony, which may substantially differ.

Next, the "causation-in-fact" approach allows for the "recovery of damages caused by erosion of the market price of the security that is traceable to the tippee's wrongful trading." Although this approach attempts to limit damages to the actual harm suffered by a plaintiff, it involves very difficult problems of proof.

Finally, the "disgorgement" measure allows the recovery of "any post-purchase decline in market value of the investor's shares up to a reasonable time after he learns of the tipped information or after there is a public disclosure of it." This recovery, however, is limited to the "amount gained by the tippee as a result of his selling at the earlier date rather than delaying his sale until the parties could trade on an equal informational basis." When the constraints of the disgorgement measure are not applied, a defendant who has made only a negligible profit through inside trading is subject to the possibility of limitless damages.

IV. CONCLUSION

Against the backdrop of the highest grossing year for the movie industry, limited partnerships as film financing vehicles have had mixed results. Explosive growth in recent years of film production and marketing costs have eaten into the bottom line of already risky film financing limited partnerships. Consequently, many have been criticized as unsound investments.

Limited partnerships were first developed in the nineteenth century as a means to limit individual liability and diffuse tax consequences. However, with the Tax Reform Act of 1986, Congress removed the tax

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140. Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980).
141. HAZEN, supra note 81, § 13.7.
142. Id. § 13.7 n.31.
143. Id.
144. Elkind, 635 F.2d at 171.
146. Elkind, 635 F.2d at 172.
147. Id.
148. SODERQUIST, supra note 66, at 260.
benefit of limited partnerships. Limited partners may no longer use excess losses or credits from one source as a means of reducing income from other sources.

Under current law, limited partnerships investors have recourse against the misrepresentation or omission of risks by general partners, brokers and other professionals under a theory of primary liability. Prior to April 1994, investors could recover by alleging secondary liability against professionals such as attorneys and accountants involved in the transaction. However, the Supreme Court in Central Bank of Denver held that current law cannot be read to include secondary liability for aiding and abetting. Thus, following Central Bank of Denver, film investors have restricted avenues of recovery for losses incurred as a result of unprofitable limited partnerships. The possibility of recovering from secondary “deep-pocket” sources has been entirely foreclosed, effectively increasing the overall risk associated with investment in limited partnerships.

Notwithstanding the risks of investment, the glamour of the industry continues to lure investors into film-financing limited partnerships.

Heaja M. Kim*

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PRINT AND ADVERTISING COSTS OF NEW FEATURES 1982-92*

PERCENTAGE CHANGE IN COSTS FROM PREVIOUS YEAR

Legend of Costs
- Combined Costs
- Advertising Costs
- Printing Costs

AVERAGE PRODUCTION COSTS, GROSS REVENUE, AND PROFITS 1980-92

Legend of Averages
- Production Costs
- Box Office Gross
- Net Profit/(Loss)

*Salomon Brothers, United States Equity Research, The Filmed Entertainment Industry: It's a Small World... After All 24 (1993).
## Motion Picture Association of America Average Negative Costs Versus Box Office Revenue, 1980-92 (Dollars in Thousands)*

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Films</th>
<th>Average Production Cost per Film</th>
<th>Percent Change in Production Costs from:</th>
<th>Net Profit (Loss)</th>
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</thead>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Prior Year</td>
<td></td>
</tr>
<tr>
<td>1980</td>
<td>233</td>
<td>$9,382.5</td>
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<td>$11,796</td>
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<tr>
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<td>4.5</td>
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<tr>
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<td>$11,884.8</td>
<td>0.3</td>
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</tr>
<tr>
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<td>$10,064</td>
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</table>

Average Box Office Gross per Film

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