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The Basics of Pre-Sale Film Financing

This article focuses on the basics of pre-sale film financing, including the parties involved, the documents one should expect to see, and certain of the more important issues.

The Producer

The independent film company (referred to as the "producer" in this article) owns or controls the rights necessary to produce the film (i.e., screenplay, literary rights, etc.). The producer typically retains the services of all the above and below-the-line personnel, including cast members, director, individual producers, executive producers, line producer, department heads, crew, etc. Typically, each is hired by the producer pursuant to a separate written contract specifying the services to be rendered, compensation (fixed and contingent) to be paid, and credit to be awarded. Also, the contracts should provide that the services to be rendered are a work-made-for-hire in favor of the producer.

Two of the most important documents the producer is responsible for generating are the budget and the cash flow schedule. The budget must contain line items for all anticipated expenditures in connection with the production of the film, including all above-the-line and below-the-line costs. In addition, because the film is to be pre-sold, the services of a completion guarantor must be obtained (discussed below) and the fee to be paid to such guarantor (typically 3% of the budget) and an adequate contingency reserve (typically 10% of the budget) must be included in the final budget. The cash flow schedule is used to determine the cash requirements of the producer during the course of production. Usually, the schedule of production loan draws available to the producer is determined by the bank in accordance with the cash flow schedule.

Sales Agent

On occasion, the producer itself will attempt to pre-sell the right to exploit the film in one or more territories (usually foreign). More typically, the producer will retain the services of a reputable sales agent to sell the film. The sales agent usually attempts to accomplish this task by directly contacting the distributors to offer the film or participating in film festivals / markets where the film is presented to myriad potential buyers.

In exchange for this service, the producer agrees to pay the sales agent a fee and reimburse certain expenses incurred by the sales agent. Expenses are usually capped somewhere between $50,000 and $200,000, with $100,000 being typical. Typically, the fee runs from a low of 5% of sales to a high of 40% (depending on the budget of the film), but is usually in the 15% range. On occasion, the sales agent will require the producer to advance a portion of the fees and / or expenses, but more often all fees and expenses are to be recouped by the sales agent out of sales.

The sales agent agreement usually contains a list of "ask" and "take" prices for each territory and sets forth a mechanism by which the producer will have some control over the decision to enter into an agreement with a particular distributor. Given that the producer intends to finance the movie with a bank (which will require a completion bond from a completion guarantor), the agreement should provide that, prior to entering into a distribution agreement, the sales agent will seek the consent (if required to do so) of the bank and the completion guarantor. The agreement also should provide that the sales agent

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fee is not earned until a long-form distribution agreement is entered into with each distributor, a notice of assignment and distributor's acceptance acceptable to the bank and the completion guarantor is entered into with each distributor, and the minimum guarantee is paid in full. The agreement should provide that the sales agent will defer its fees (and perhaps expenses) until the bank has recouped its loan in full. Often this is a heavily contested issue that sales agents are loathe to accept. An often-reached compromise is that the sales agent agrees to defer a portion (typically half) of its fees, but little if any of its expenses. Finally, if the sales agent insists on being granted a security interest in the film in order to secure the payment of its fees and expenses, the agreement should provide that the sales agent will subordinate such security interest to the interest of the bank, the completion guarantor, all applicable guilds, and all applicable labs. Having the sales agent agree to the foregoing in the sales agent agreement will make the negotiation of the interparty agreement (discussed below) far easier.

Distributors

Most pre-sold films are acquired on a territory-by-territory basis, typically defined by a combination of geographical area and language (i.e., German-speaking Europe, French-speaking territories of the world, etc.). However, multi-territory deals are becoming commonplace (i.e., Pan-European rights).

The film typically is acquired pursuant to a deal memo and long-form distribution agreement. In combination, they set forth fundamental issues, including territory, term, rights, minimum guarantee, overages (royalties payable by the distributor to the producer once the distributor has recouped the minimum guarantee and its expenses), and expenses. The minimum guarantee is an advance the distributor agrees to pay (typically the majority of which is payable on delivery of the film) against future overages. However, the contractual obligation to pay the minimum guarantee is what the producer "banks" with the bank in order to finance the film. Depending on the reputation and solvency of the distributor, the bank may accept (without discount) the contractual obligation alone as security for repayment of the production loan (i.e., if the minimum guarantee is $1 million, the bank will lend the producer 100% of such amount (inclusive of its interest and fees) against the contractual obligation of the distributor to pay the minimum guarantee on delivery). However, wherever possible, it behooves the producer to obtain a stand-by letter of credit from the distributor in an amount equal to the minimum guarantee, which letter of credit the bank is far more likely to accept as collateral.

All (or a majority) of the minimum guarantee is usually payable on "delivery." The bank and the completion guarantor prefer that this be defined as providing the distributor with a notice of availability, which informs the distributor that the agreed upon film materials are available for delivery and also demands immediate prior payment therefore from the distributor. On the opposite end of the spectrum, the distributor wants actual delivery of (and at least lab access to) the physical elements of the film, the opportunity to inspect the elements, and the right to reject the elements if they are technically deficient. Usually, a highbrid compromise is reached giving the distributor lab access to the physical elements, and the right to inspect them, and the producer / completion guarantor is given the right to cure any claimed defect. If, following this process, no agreement is reached, the matter is submitted to expedited binding arbitration (usually American Film Marketing Association or American Arbitration Association) for determination of whether or not delivery has been made and whether or not the minimum guarantee is then payable.

In order to insure that the foregoing requirements are met, and that the minimum guarantee payment is paid directly to the bank (in partial satisfaction of the production loan), the bank and the completion guarantor will insist that the distributor execute a notice of assignment and distributor's acceptance in favor of the bank and the completion guarantor (while preserving whatever rights and remedies the distributor might otherwise have against the producer under the distribution agreement). In addition to spelling out the methodology of delivery (including a bare minimum of delivery items) and directing the distributor to make payment directly to the bank (until otherwise notified by the bank), the notice of assignment and distributor's acceptance typically includes a waiver by the distributor of any essential elements contained in the distribution agreement (e.g., that Tom Cruise must star in the film). It also typically provides that the grant of exploitation rights in the film to the distributor is not effective until the minimum guarantee is paid in full and that any security granted to the distributor is subordinate to that of the bank, completion guarantor, applicable guilds, and applicable labs. Given that a bank will not lend against a distribution agreement, and a completion guarantor will not bond a film unless the foregoing covenants are obtained from the distributor, the producer should include as many as possible of them in the distribution agreement, or, at a minimum, have the distributor contractually agree to execute the notice of assignment and distributor's acceptance provided by the bank and completion guarantor.

The Bank

A number of banks, both domestically and abroad, provide production loans collateralized by distribution agreements with distributors. Typically, these banks charge an upfront fee for making the loan together with interest (often LIBOR plus one or two percent). In order to secure the loan, the producer enters into a practically non-negotiable loan agreement with the bank providing for the making of the loan in accordance with the budget and cash flow schedule approved by the bank and the completion guarantor. The producer also must execute other documents in favor of the bank, including a security agreement, copyright mortgage, and UCC-1 granting the bank a first-position security interest in the film and all assets of the producer. In addition, the producer must obtain a notice of assignment and distributor's acceptance (discussed above) from each of the distributors. On occasion, the bank will lend the producer funds that are not collateralized by existing pre-sales ("gap financing"). In order to obtain gap financing, amongst other things, the producer must retain the services of a reputable sales agent that will provide estimates for unsold territories in amounts sufficient to cover the unsecured portion of the loan.

On the first draw down of the production loan, the bank pays itself all fees due to it plus all expenses (e.g., legal fees, etc., incurred to date). In addition, it sets up an interest reserve equal to the total amount of anticipated interest in connection with the loan. Finally, it also pays the completion guarantor its fee in full.

The Completion Guarantor

Prior to making the loan, the bank will insist on receiving a bond from a reputable completion guarantor. The bond is not a guarantee of payment, it merely insures the bank that one of two things will happen in connection with the film: If the producer is unable to complete and deliver the film to the sales agent and / or the distributors, the completion guarantor will take over the film and complete delivery, or if it is unable to do so, it agrees to repay the production loan in full to the bank.

In order to achieve this result, the completion guarantor requires the producer and various third parties to execute documents in its favor. From the producer, the completion guarantor obtains a completion agreement, which, among other things, gives the completion guarantor the right to take over production and delivery of the film. From the individual producers, the director, and, on occasion, certain cast members, the completion guarantor obtains inducement letters making these individuals agree to conform to the budget and production schedule for the film. Pursuant to a security agreement, mortgage of copyright, and UCC-1, the completion guarantor also takes a second priority security interest (subordinate only to the bank's) in the film and the assets of the producer. Also, it insists on being a beneficiary of the notices of assignment and distributor's acceptances. To further protect its interest, the completion guarantor requires the producer to obtain certain insurance policies (either directly for the benefit of the completion guarantor or naming the completion guarantor as an additional insured), including essential element insurance (if applicable), E&O insurance, general liability insurance, negative insurance (insurance specifically protecting the physical elements of the film), etc.

The Interparty Agreement

As can be seen from above, the parties, and the numerous contracts they have entered into, form a tangled web of varying rights and obligations. In an effort to bring some sense of order to the chaos, the parties enter into an interparty agreement, probably the most fundamental contract of any film financed by pre-sales. The interparty agreement sets forth the relative priority of the parties' security interests in the film (bank first, completion guarantor second, sales agent third and producer last). It also specifies how insurance proceeds will be applied and in what order of priority each party will recoup their respective investment in the film. In order to accomplish this last goal, the interparty agreement provides for the establishment of a collection account to be administered by the bank in which all proceeds derived from the film will be deposited and paid out in accordance with the agreement. The interparty agreement also sets forth those delivery items that the completion guarantor will guarantee delivery of and the methodology by which delivery will be made to the sales agent (if applicable). It also provides for a dispute resolution mechanism (usually binding AFMA or AAA arbitration). Finally, the parties agree that if there is a conflict between the interparty agreement and any of the other documents, the interparty agreement will control. However, all parties typically reserve their respective rights against the producer.

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