The Future of MONEY

Los Angeles lawyer Schuyler M. Moore (seated) offers guidance on new developments in film financing to Morgan Freeman and Lori McCreary

page 20
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20 The Future of Money
BY SCHUYLER M. MOORE
New, creative solutions for the movie funding puzzle may involve more direct approaches to investors and more verifiable accounting.

28 Songs in Contention
BY JANA MOSER
Politicians who use copyrighted songs for campaigns should consider securing not only the rights but also the permission of the artists.

Plus: Earn MCLE credit. MCLE Test No. 224 appears on page 31.

34 Fast Forward on Crowdfunding
BY SHAHROKH SHEIK
The regulatory requirements of equity crowdfunding may not keep eager filmmakers from using it as a new financing tool.

DEPARTMENTS

10 Barristers Tips
A motion for sanctions under Section 128.7 can defeat frivolous suits
BY JEREMIAH T. REYNOLDS

11 Practice Tips
Understanding the law of spec scripts and derivative works
BY LEE S. BRENNER AND EDWARD E. WEIMAN

15 Tax Tips
How the Health Care Act affects the taxation of loan-out corporations
BY BRADFORD S. COHEN, CHARLES K. KOLSTAD, AND Y. JENNY KIM

44 Closing Argument
The gender factor of Marriage of Facter
BY PETER M. WALZER

42 Index to Advertisers

43 CLE Preview
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No matter where in the spectrum a film company may find itself—from a first-time independent filmmaker to an 80-year-old movie studio—financing projects is the first order of business. Discovering funding sources, identifying appropriate structures through which such financing will flow, and complying with government regulations is an endless cycle. For the studio, much of that effort is aimed at mitigating risk; for the independent, the very existence of the project depends on whether funding can be obtained.

One approach is to develop funding structures that avoid the “Hollywood accounting” problem. Schuyler M. Moore’s article discusses the box financing method that ties “the investor’s return directly to a percentage of the gross domestic box office receipts received by the theaters for the film.” As he concludes, box financing “raises the curtain of doubt that surrounds Hollywood accounting and leaves a spotlight on the glamour and thrill of owning a piece of a film.”

Box financing is a viable option for studios and well-heeled independents, but it may not be useful for smaller film companies. A new form of financing may be more suited for independents: crowdfunding. Moore questions whether the regulatory regime undergirding Congress’s authorization, and the SEC’s forthcoming rules are too burdensome to be useful for financing motion pictures. In his analysis, Rule 504 of Regulation D is a more manageable safe harbor for raising funds for film productions with budgets not exceeding $1 million. On the other hand, Shahrokh Sheik notes that whether equity-based crowdfunding is an exciting new financing tool depends on how the SEC’s rules are ultimately structured.

Equally important to the issue of financing is that of ownership rights, and primarily, the ability to control the destiny of a project. One of the battle lines lies between Hollywood and Washington. Political candidates have often used popular music in campaigns—often without the permission of artists, who are increasingly likely to complain about the unauthorized use of their music. Jana Moser’s article analyzes when—if ever—politicians can use these musical works without the artists’ consent.

Another important issue relating to ownership rights arises in the case of spec scripts, which are unpublished scripts written on “speculation.” Many spec scripts are based on preexisting works, and the question arises as to whether the spec writer has any rights against the owner of the original material if the original owner uses the spec script without authorization or compensation to the spec writer. Lee S. Brenner and Edward E. Weiman urge practitioners to carefully advise their writer-clients of the risks of writing spec scripts.

Finally, tax policy has broad implications for the entertainment industry, and the 2010 Health Care Act is a case in point. That law’s new Medicare contribution tax on investment income and increase to the employee’s portion of compensation income affects loan-out corporations, which are prevalent in the entertainment industry. Bradford S. Cohen, Charles K. Kolstad, and Y. Jenny Kim share planning strategies in their Tax Tip that may be used to minimize adverse tax implications.

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A Motion for Sanctions under Section 128.7 Can Defeat Frivolous Suits

ONE OF THE MOST FREQUENTLY OVERLOOKED methods for attacking complaints lacking legal merit or evidentiary support is a motion for sanctions under Code of Civil Procedure Section 128.7, which is modeled on Rule 11 of the Federal Rules of Civil Procedure and requires that an attorney or party sign all pleadings, petitions, motions, or similar papers. The signature acts as a certification that 1) the pleading is being presented for a proper purpose, 2) the claims, defenses, and other legal contentions are warranted by existing law or by a nonfrivolous argument for a change to existing law or the creation of new law, and 3) the allegations and factual contentions have evidentiary support or are likely to have such support after a reasonable opportunity to investigate. It should be emphasized that an attorney who signs a pleading is personally certifying that 128.7’s requirements are met. Whether Section 128.7 has been violated is determined by an objective standard of conduct. A violation of Section 128.7 can result in substantial monetary and nonmonetary sanctions.

Courts have looked at a variety of factors to determine the reasonableness of the attorney’s prefiling inquiry, such as the cost of the investigation and how much time was available to conduct the investigation. Other relevant factors include “the extent to which the attorney had to rely on his or her client for the factual foundation underlying the pleading, motion, or other paper; whether the case was accepted from another attorney; [and] the complexity of the facts.”

Some courts have noted that an experienced attorney should be held to a higher standard of conduct than a less experienced attorney.

Section 128.7 requires the party seeking sanctions to comply with a two-step process for presentation to the court. The notice of motion and motion must first be served on the party against whom sanctions are sought, but not filed with the court. The party against whom sanctions are sought has 21 days to withdraw the offending pleading after receiving a sanctions motion, the court is directed (in most cases, 60 days from when the action is filed, unless the general appearance of each party against whom the motion is directed (in most cases, 60 days from when the action is filed, unless a court finds good cause to shorten the period).

Attorneys who are served with motions for sanctions under Section 128.7 run the risk of having sanctions imposed against them personally and their law firm unless the offending pleading is dismissed or withdrawn. In Burkle v. Burkle, the court of appeal affirmed sanctions of $32,970 against attorneys (and their client) for improperly filing a civil action seeking to enforce certain interim orders from a family law proceeding. After noting that an award of sanctions is reviewed for an abuse of discretion, the court affirmed the sanctions award, holding that there was “no authority” for the filing of the civil action and that the “attorneys were well aware of the applicable precedents” precluding such an action.

In Eichenbaum v. Alon, the trial court awarded sanctions against attorneys (and their client) in the amount of $4,268 for filing a frivolous amended complaint. Although the attorneys ultimately dismissed the amended complaint, the court of appeal found that the trial court was still empowered to award sanctions. The court of appeal found the amended complaint frivolous because it sought to name a deceased individual as a defendant.

The threat of substantial sanctions is a major incentive for an attorney to dismiss a frivolous pleading. Indeed, if there is doubt as to whether the prefiling investigation was adequate, the attorney should take advantage of the “safe harbor” period by withdrawing the offending pleading and seeking leave to file an amended pleading that meets 128.7’s standards. But if the attorney refuses to withdraw the offending pleading after receiving a sanctions motion, the court is authorized to strike the pleading as a nonmonetary sanction for violation of Section 128.7. Thus, Section 128.7 can sometimes be a more efficient option than a motion for summary judgment.

There is no hold period at the beginning of an action for serving a motion for sanctions under Section 128.7. By contrast, a motion for summary judgment in California cannot be filed until 60 days after the general appearance of each party against whom the motion is directed (in most cases, 60 days from when the action is filed, unless a court finds good cause to shorten the period).

A motion for summary judgment must be served no less than 75 days before the hearing date, but a motion under Section 128.7 can potentially be heard approximately 40 days after service of the motion. Furthermore, a motion under Section 128.7 does not require preparation of a separate statement of undisputed material facts. For these reasons, attorneys should consider Section 128.7 for dismissal of frivolous cases.

2 See id. at 975-76.
3 See id. at 976-77.
4 See Advisory Committee Notes on 1993 Amendment to Federal Rules of Civil Procedure.

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THE SPEC SCRIPT has been a Hollywood staple for a long time. This year, QED International (an independent production house) paid $1 million for the spec script for The Fury. Other well-known spec script success stories include the movies American Beauty, The Matrix, Basic Instinct, Lethal Weapon, and Butch Cassidy and the Sundance Kid. For the aspiring screenwriter, the spec script can be the path to a successful career.

A spec script is an unpublished screenplay or teleplay that the author has written “on speculation,” without a deal in place. Often, an unknown, aspiring screenwriter creates a spec script with the hope that a studio or production company will option it, buy it, or at least hire the writer for some other work. The hope is that the work (and the writer’s talent) will be discovered, a movie will be made, and a career will be forged.

Many spec scripts are sequels, remakes, or prequels to an already existing movie; episodes of an existing television series; or adaptations. The writer of a spec script may expect that his or her work enjoys a measure of legal protection. However, if the spec script utilizes elements of existing works, that expectation may not be realistic. In fact, the writer may be liable for copyright infringement because the copyright owner of the original work owns the exclusive right to prepare derivative works. In addition, California’s idea submission law does not protect those who “blurt out their ideas” by submitting unsolicited work without first making a deal.

Given how few truly original story ideas exist, it is not surprising that authors of spec scripts may believe that their work was stolen to create a television episode, movie, or other work. California offers some protection under the law of “idea submission,” which implies a contract between the author and the recipient. In order to plead and prove an implied contract in the idea submission context, however, a plaintiff must demonstrate that 1) the plaintiff clearly conditioned the offer to convey the idea upon the obligation to receive payment if the idea was used by the defendant, 2) the defendant, knowing the condition before knowing the plaintiff’s idea, voluntarily accepted disclosure (i.e., the offeree must have had the opportunity to reject the attempted disclosure if the conditions were unacceptable), and 3) the defendant used the idea.

Despite the availability of an implied contract claim, it is well established that a plaintiff who offers a work for reasons other than for sale does not have an implied contract claim. In Faris v. Enberg, for example, the plaintiff submitted an idea for a sports quiz show to famed sports announcer Dick Enberg in the hope that Enberg would agree to host the show. When Enberg later appeared as the host of a quiz show called Sports Challenge on KTLA television, Faris sued. The court rejected Faris’s breach of implied contract claim, primarily because he never told Enberg that his idea was for sale. Instead, Faris submitted the work for reasons other than an attempt to sell the work itself. Instead, Faris sought to interest Enberg in hosting the show.

The court in Faris found support for its opinion in the oft-repeated quote from Desny v. Wilder that “[t]he idea man who blurs out his idea without having first made his bargain has no one but himself to blame.” As the court in Desny made clear, “The law will not imply a promise to pay for an idea from the mere facts that the idea has been conveyed, is valuable, and has been used for profit; this is true even though the conveyance has been made with the hope or expectation that some obligation will ensue.” In Faris, the court explained this potential trap more succinctly: “It would be entirely inconsistent with Desny to hold that an implied-in-fact contract could be created because a telephone call was returned or because a request was made for an opportunity to read the work that was unconditionally submitted.”

California idea submission law thus will not provide protection for the author who sends around his or her work without a bargain for payment in place. Similarly, the author of a spec script as a writing sample does not have a claim for an implied contract if the spec
have dismissed copyright infringement claims at the summary judgment stage when they are premised upon the alleged copying of an unauthorized derivative work.\textsuperscript{20}

For example, in Pickett v. Prince, the defendant was the artist known as Prince, who in the early 1990s changed his name to an unpronounceable symbol to which he owned the copyright. (Later, Prince changed his name back to Prince.)\textsuperscript{21} Without Prince's permission, the plaintiff made a guitar in the shape of the copyrighted Prince symbol.\textsuperscript{22} Thereafter, Prince used a guitar that was "quite similar" to the plaintiff's guitar, and the plaintiff sued Prince for copyright infringement.\textsuperscript{23}

Writing for a unanimous panel, Chief Judge Richard A. Posner of the Seventh Circuit explained that the plaintiff "could not make a derivative work based on the Prince symbol without Prince's authorization" because Prince, as the copyright owner, had the exclusive right to prepare derivative works.\textsuperscript{24} The court concluded that the plaintiff had no claim for copyright infringement because "the only copyright that [plaintiff] claims Prince infringed is a copyright that [plaintiff] had no right to obtain, namely a copyright on a derivative work based on Prince's copyrighted symbol."\textsuperscript{25} Indeed, the court found that it was Prince who had a copyright infringement claim against the plaintiff because the plaintiff violated Prince's right to prepare derivative works.\textsuperscript{26}

In an equally relevant case, a federal court refused to permit a copyright infringement claim to proceed when the plaintiff created an unauthorized derivative work based upon the defendant's pre-existing movie. In Anderson v. Stallone, the plaintiff wrote a 31-page treatment titled Rocky IV, which he hoped would be used as a sequel to the movie Rocky III.\textsuperscript{27} Sylvester Stallone is the copyright owner for the first three Rocky movies.\textsuperscript{28} In writing his treatment, the plaintiff "appropriated the Rocky characters" from the previous films without Stallone's permission.\textsuperscript{29} In particular, the plaintiff featured Rocky, Adrian, Apollo Creed, Clubber Lang, and Paulie in his spec treatment. The plaintiff met with MGM and discussed the possibility that his treatment would be used as the script for Rocky IV.\textsuperscript{30}

The court found that the plaintiff's treatment constituted an unauthorized derivative work because the treatment used the characters from the underlying Rocky movies and simply built on the experiences of those characters. As such, the plaintiff's treatment infringed Stallone's copyright.\textsuperscript{31} The court concluded that the plaintiff could not maintain a copyright infringement claim based upon the spec treatment and dismissed the claim against Stallone and the other defendants.\textsuperscript{32} The court stated that no authority allowed a plaintiff "to sue the party whose work he has infringed upon for infringement of his infringing derivative work."\textsuperscript{33} The court also ruled that the plaintiff had gained no copyright protection for any portion of the treatment, explaining that "generally no part of an infringing derivative work should be granted copyright protection."\textsuperscript{34}

The maker of an unauthorized derivative work cannot expect to win a suit against the copyright holder, but can the maker sue anyone else for infringement of that work? Put differently, "Given infringement of the original, can the infringing derivative author nevertheless assert rights against third parties who copy the derivative material?"\textsuperscript{35} The answer is yes, in limited circumstances. If the new derivative material is capable of existing separately (such as new lyrics for an existing melody), "suit may be brought against a third party for infringement of the separate material."\textsuperscript{36} If not, there is no copyright protection for the derivative work, and suit may not be brought against any third party.\textsuperscript{37} With unauthorized spec scripts based upon an existing work, the infringing material likely is "inextricably intertwined with the pre-existing material" (or "pervades the entire work") and, as such, protection for the unauthorized derivative is not available because doing so would give exclusive rights in material that violates the initial author's copyright.\textsuperscript{38}

For example, in Sobhani v. @Radical Media, Inc., the plaintiff was an aspiring director of commercials and created a series of spec commercials that were based upon pre-existing copyrighted commercials for Jack-in-the-box restaurants.\textsuperscript{39} Indeed, the plaintiff's proposed commercials bodily appropriated the Jack character from previously existing copyrighted commercials.\textsuperscript{40} The plaintiff sent his spec commercials to a number of companies, including the defendant. Several months later, the defendant produced a commercial that was similar to the plaintiff's commercials and that contained an element almost identical to the plaintiff's spec work. Notably, the defendant did not own the underlying Jack-in-the-box works but had been hired to produce the new commercial.\textsuperscript{41}

The defendant argued that the plaintiff's spec commercials were unauthorized derivative works and, therefore, the plaintiff could not maintain a suit for their infringement. The court agreed and reasoned that the plaintiff's spec commercials were clearly unauthorized derivative works, as evidenced by the fact that they used a copyrighted character.\textsuperscript{42} The court also stated that the plaintiff was not entitled to copyright protection for even the new elements of his spec commercials.\textsuperscript{43}
The rationale for this principle of law is clear—a copyright owner has the exclusive right to prepare derivative works based upon the owner’s copyrighted work. As a result, a person has no right to make a derivative work based upon a copyrighted work without the copyright owner’s authorization. If the rule were otherwise, copyright owners could be subject to an endless series of infringement suits by people who unlawfully copied the copyright owner’s work. Such an absurd result is not permitted under copyright law.

As one court explained, Section 106(2) of the Copyright Act “most certainly precludes the author of an unauthorized derivative work from suing the author of the work which he has already infringed.” As Judge Posner explained in Pickett, “If anyone can make derivative works based on the [underlying, copyrighted work], we could have hundreds of [plaintiffs], each charging infringement by the others.” For this reason, the Copyright Act sensibly concentrates the right to make derivative works in the owner of the original work. The author of an unauthorized derivative script faces additional challenges in establishing the legal elements for a claim for copyright infringement, in particular, that the defendant used protectable creative elements that did not preexist the creation of the author’s derivative work. To establish copyright infringement, a plaintiff must show that 1) he or she is the owner of a valid copyright and 2) the defendant copied elements of the copyrighted work that are subject to copyright protection. Assuming the plaintiff is the owner of a valid copyright (which likely will not be the case when dealing with an infringing unauthorized derivative work), the plaintiff bears the burden to prove unlawful copying. To do so, the plaintiff must show both that the defendant had access to the plaintiff’s work and that there is a substantial similarity of protected expression between the plaintiff’s work and the defendant’s work.

To prove access, the plaintiff must establish that the defendant had a reasonable opportunity to view the plaintiff’s work. In order to prove unlawful copying, the plaintiff must establish that the works are substantially similar in terms of protected expression. However, before it engages in any determination of whether unlawful copying occurred, the court must disregard unprotected elements, such as basic stock ideas and concepts and situations and incidents that flow naturally from generic plot lines.

A court must also remove from consideration any elements that the defendant created prior to the time that the defendant had access to a plaintiff’s work. “Elements...that were created prior to access to a plaintiff’s work are to be filtered out at the first stage of
the substantial-similarity analysis, just as nonprotectible elements are.” As such, even if the plaintiff was authorized to create a spec script, before engaging in any determination of whether unlawful copying occurred, a court must remove from consideration any elements that the defendant created prior to the defendant’s access to the plaintiff’s script. Given that it is the defendants who created the underlying work (for example, a television series), the defendant will be in a position to introduce scores of scripts, writers’ notes, and episodes of the underlying series that pre-existed access and probably pre-existed the creation of the plaintiff’s work. Under the rationale that pre-access materials could not have been copied, pre-existing elements would be filtered out of any copyright infringement analysis. Elements constituting scenes a faire (the elements that flow naturally from pre-existing work) also would be filtered out. Once the filtering process is concluded, it may be very difficult for a plaintiff even to articulate what material the defendant allegedly stole from the spec script, much less anything that would be protectable.

The aspiring screenwriter who creates a spec script for an already existing television series (or for a movie sequel, prequel, or remake) should be forewarned of the risk of unlawful copying occurring. At the very least, however, writers should be advised of the risks associated with this process from a copyright perspective. Moreover, both writers and recipients should be mindful of the legal standards necessary to support a claim for implied contract so that the offer and acceptance of the work will satisfy these requirements if the parties desire.


4 Id.

5 Desny, 46 Cal. 2d at 739.

6 Id.

7 Faris, 97 Cal. App. 3d at 319.


19 Id. (The plaintiff had no claim against owner of underlying work for copyright infringement when his work was an unauthorized derivative work.); Anderson v. Stallone, 1989 U.S. Dist. LEXIS 11109 at *15, 31-32 (1989).


21 Pickett, 207 F. 3d at 403-04.

22 Id. at 404.

23 Id.

24 Id. at 406.

25 Id.

26 Id. at 407.


28 Id. at *25.

29 Id. at *24-25.

30 Id. at *3, *48.

31 Id. at *24-25.

32 Id. at *25-32.

33 Id. at *26.

34 Id. at *29-32.

35 PATRY, 2 PATRY ON COPYRIGHT §3:59 (2010).

36 Id.

37 Id.

38 Id.


40 Id. at 1238.

41 Id. at 1236.

42 Id. at 1238.

43 Id. at 1239-40.


46 Pickett, 207 F. 3d at 406.

47 Id.


51 Cavalier v. Random House, Inc., 297 F. 3d 815, 822 (9th Cir. 2002).


53 Murray Hill Publ’ns, Inc. v. Twentieth Century Fox Film Corp., 361 F. 3d 312, 326 (2004); see also Benjamin v. Walt Disney Co., 2007 U.S. Dist. LEXIS 91710, at *11-20 (2007) (filtering out any similarities “evident in the pre-access material”).
How the Health Care Act Affects the Taxation of Loan-Out Corporations

THE USE OF LOAN-OUT CORPORATIONS is prevalent in the entertainment industry. Some advisers prefer to use a C corporation as the loan-out corporation, while others prefer to use an S corporation. In both cases, the loan-out corporation would have a service contract with a third party, pursuant to which the loan-out corporation provides the services of a specified individual (typically the sole shareholder-employee) to that third party. These third-party contracts frequently provide for payments to the loan-out corporation that are defined in terms of profits. Those payments are often paid to the loan-out corporation even after the retirement or death of the shareholder-employee. In addition, the shareholder-employee frequently enters into an employment agreement with the loan-out corporation under which his or her estate would continue to be paid compensation by the loan-out corporation after his or her death.1

There are at least five categories of payments that may be received by a loan-out corporation: 1) payments from film or television projects that have been released, aired, or syndicated, 2) payments from music projects for which the records have been released, 2) payments from projects that are in production but not yet released or aired, 4) payments from projects that are developed during the life of the shareholder, and 5) payments from projects that are developed after the death of the shareholder.

Accordingly, when a loan-out corporation receives service payments from the entertainment companies, it would generally pay out a substantial portion of its income to its shareholder-employee in the form of compensation subject to employment taxes. Any remaining income would typically be distributed to the shareholder as a distribution that is intended to not be subject to employment taxes. The amount of compensation typically is higher in the case of C corporation loan-out corporations than in the case of S corporations, in order to reduce the combined corporate and individual level of income taxes.

Effective January 1, 2013, the 2010 Health Care Act imposed an additional 3.8 percent Medicare contribution tax on investment income.6 Additionally, the act increased the employee portion of the Medicare tax on compensation income by .9 percent to 2.35 percent.4

The 2010 Health Care Act imposed an additional 3.8 percent Medicare contribution tax on investment income. Additionally, the act increased the employee portion of the Medicare tax on compensation income by .9 percent to 2.35 percent.

Reasonable Compensation

As pass-through entities, S corporations generally do not pay federal entity-level tax on their taxable income.10 Instead, taxable income and other attributes are allocated among the shareholders, who report the items and pay the corresponding tax on their personal income tax returns.11 This S corporation flow-through income has an employment tax advantage over sole proprietorships, partnerships, and LLCs, since the IRS has held in Revenue Ruling 59-221 that a shareholder’s share of S corporation net income is not treated as self-employment income.12 Therefore, S corporation shareholder-employees are motivated to minimize their salary in favor of distributions, which are not subject to payroll or self-employment tax.

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In light of these potential employment tax savings, the IRS has long challenged attempts by shareholder-employees to minimize compensation in favor of distributions. In Revenue Ruling 74-44, the IRS held that distributions that two sole shareholders of an electing S corporation arranged to receive instead of reasonable compensation for services they performed constituted wages that are subject to payroll taxes. These decisions make it clear that the IRS has the power to reclassify purported S corporation distributions as disguised wages when stated compensation payments are unreasonably low. Accordingly, if an S corporation shareholder provides services to the S corporation, he or she should receive an adequate or reasonable amount of compensation for these services.

In contrast, C corporations are taxed as separate entities for federal income tax purposes. Accordingly, income earned by a C corporation is normally taxed at the corporate rate using the corporate income tax rates, and any distributions made to shareholders are taxed again at the stockholders’ tax rates as dividends. Because of these two levels of tax, a C corporation may be a less desirable form of business than the other business entities (e.g., partnerships, sole proprietorships, LLCs, or S corporations). Additionally, in order to maximize the double tax that C corporations incur, the IRS tends to argue that certain payments by C corporations are in fact disguised dividends, rather than compensation. In order to avoid double taxation, shareholders of C corporations are motivated to minimize their dividends in favor of compensation. However, the C corporation shareholder’s compensation must be considered “reasonable” in order to prevent the IRS from reclassifying the income as dividends. Section 162 allows compensation to be deducted as an “ordinary and necessary” expense of doing business if the compensation is 1) “reasonable in amount” and 2) “based on services actually rendered.”

Active Participant
If the shareholder-employee meets one of the material participation tests provided for in the Treasury regulations, that shareholder-employee would be viewed as actively participating in the S corporation’s trade or business. Treasury regulations provide that an individual’s activities will be considered to be regular, continuous, and substantial activity if any of the following seven tests is satisfied: 1) participation in the activity is for more than 500 hours during the tax year, 2) participation in the activity for the tax year constitutes substantially all of the participation in the activity by all individuals, including those who do not own interests in the activity, 3) participation in the activity is for more than 100 hours during the tax year and the individual’s participation in the activity for the tax year is not less than the participation in the activity of any other individual, including individuals who are not owners of interests in the activity, 4) there is significant participation in the activity (generally 100 hours) for the tax year, and the individual’s aggregate participation in all significant participation activities during the tax year exceeds 500 hours, 5) there is material participation in the activity for any five tax years (whether or not consecutive) during the 10 tax years immediately preceding the tax year under consideration, 6) there is material participation in a personal service activity in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor for any three tax years (whether or not consecutive) preceding the tax year under consideration, or 7) based on all the facts and circumstances, participation in the activity is otherwise regular, continuous, and substantial during the tax year.

Section 1411 Implications
If one of the above material participation tests is met, the income allocated by the S corporation loan-out to the shareholder-employee would not be subject to the additional Medicare contribution tax. However, the active trade or business exception does not apply to dividends paid by C corporations. Thus, any dividends paid by a C corporation loan-out corporation would be fully subject to the additional Medicare contribution tax.

Even after retirement, in many cases the loan-out corporation’s shareholder-employee will continue to receive payments for his or her prior services after his or her retirement. The shareholder-employee could also receive payments from projects that are developed after retirement but during the life of the shareholder. If the shareholder-employee previously would have been considered a material participant in the loan-out corporation’s trade or business, the shareholder-employee should continue to be eligible to receive compensation for those prior services under the deferred compensation provisions in the employment contract. The shareholder-employee’s prior activity should continue to be considered “regular, continuous, and substantial.” Consequently, the deferred compensation the shareholder receives from an S corporation or C corporation loan-out should avoid the 3.8 percent Medicare contribution tax but instead be subject to the 2.35 percent employment tax. Furthermore, the income from the S corporation should also be considered active and thus not subject to the 3.8 percent Medicare contribution tax, while dividends from the C corporation, typically smaller in amount, would be subject to the 3.8 percent Medicare contribution tax.

When a shareholder-employee dies, the Section 1411 implications become more unclear. For trusts and estates, the new 3.8 percent Medicare contribution tax is imposed on the lesser of 1) undistributed net investment income or 2) the excess of a) adjusted gross income (as defined in I.R.C. Section 67(e)) over b) the dollar amount at which the highest trust-estate tax rate starts to apply (currently under $12,000).

The shareholder-employee’s estate may continue receiving salary payments from the loan-out corporation for prior services even after his or her death. The shareholder-employee would have been in a “trade or business in which capital is not a material income-production factor,” and thus would have qualified as an active participant in the loan-out corporation’s business in prior years. Presumably, the salary income the shareholder-employee, and ultimately the shareholder-employee’s estate, receives from the loan-out corporation should continue to qualify as income that is not subject to the 3.8 percent Medicare contribution tax but instead is subject only to employment taxes. Although as a general rule it is often quite difficult for estates to qualify as materially participating in a trade or business, the absence of authority on this issue allows for the activity during the life of the decedent to be taken into account when determining the estate’s activeness. Compensation received under the employment agreement from a C corporation loan-out would be subject only to employment taxes, while dividends would continue to be subject to the additional Medicare contribution tax.

If the decedent met one of the material participation tests provided by the Treasury regulations, most significantly the five-out-of-ten-years test, the estate could be viewed as actively participating in the loan-out corporation’s trade or business. Accordingly, if the decedent was actively participating in any five years during the 10 tax years immediately preceding the tax year under consideration, the estate may be considered an active participant in the loan-out corporation’s trade or business, and hence deferred compensation payable to the estate would not be subject to any Section 1411 Medicare contribution tax or any employment tax.
In cases in which the shareholder-employee performed the services and dies before receiving all the income, the salary income would be considered income in respect of a decedent (IRD).23 Broadly speaking, IRD is money owed to a decedent at the time of death that would have been included in the decedent’s gross income had the decedent lived to collect.24 The fair market value of IRD must be included in the decedent’s estate, subject to estate tax. In addition, stock of an S corporation attributable to IRD assets is not eligible for a basis step-up to fair market value on the date of the decedent’s death, unlike other assets.

**Retirement Plans and Deferred Compensation**

Distributions from qualified retirement plans and qualified deferred compensation plans are not considered net investment income for purposes of the 3.8 percent Medicare contribution tax.25 However, the distributions could be considered modified adjusted gross income. If the S corporation shareholder-employee dies without receiving the distributions, the distributions are IRD. The IRS also has ruled that proceeds of an individual retirement account (IRA) and qualified retirement plan benefits that were payable to the decedent’s trust upon the decedent’s death were considered to be IRD.26

The shareholder-employee should maximize his or her deductible contributions to IRAs, qualified retirement plans, and qualified deferred compensation plans. Additionally, when the estate receives plan distributions upon the death of the shareholder, those amounts will also be exempt from the 3.8 percent Medicare contribution tax, because distributions from certain qualified retirement plans or arrangements are not included in the definition of net investment income for purposes of Section 1411.27

With the enactment of Section 1411, an S corporation loan-out corporation is further incentivized to maximize paying out its income in the form of distributions rather than compensation during the shareholder’s lifetime. When the shareholder-employee is an active participant in the S corporation’s trade or business, distributions paid out to the shareholder during his or her lifetime will not be subject to the traditional employment taxes or the new 3.8 percent Medicare contribution tax. Rather, only reasonable compensation paid out to the shareholder-employee would be subject to the 2.35 percent employee portion of the Medicare insurance tax. Accordingly, with higher employment taxes beginning in 2013 and no Section 1411 Medicare tax on amounts flowing through to active S corporation shareholder-employees, active S
corporation shareholder-employees will have even more reasons to convert potential compensation amounts into S corporation income allocations and distributions. However, shareholders must make sure that the minimum compensation standard is met, so as to avert any challenges by the IRS.

In the case of shareholder-employees of C corporation loan-outs, the shareholder-employee will be paid substantially all of the corporation’s pretax income as deductible compensation in order to reduce the possible double taxation of income. As a result, this type of corporation would distribute only a small dividend that would be subject to the additional Medicare contribution tax. The salary would be subject only to the additional employment income tax. These complex issues become even more so in the case of loan-out corporations that own copyrights and other intangible assets.

1 Although most loan-out corporations are service corporations that only receive current and deferred compensation payments from third parties, some loan-out corporations own copyrights or other intangible assets and receive royalty payments in addition to compensation payments. The Medicare tax issues arising from these mixed-use loan-out corporations are more complex and merit separate analysis. 2 Note that frequently, musicians receive payments that are titled as royalties, but which in fact are really deferred compensation for prior services.

of whether a loan-out corporation owns copyrights is necessary to determine the character of the income and whether it is subject to §1411. 3 The Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

4 On November 30, 2012, the Treasury Department issued proposed regulations (REG-13057-11) that provide guidance under I.R.C. §1411 for individuals, trusts, and estates. 5 I.R.C. §1411(a)(1), (a)(5). For purposes of §1411(a)(5), qualified plans or arrangements are those described in I.R.C. §§401(a), 403(a), 403(b), 408, 408A, or 457(b) (qualified pension, profit-sharing, and stock bonus plans; qualified annuity plans; annuities purchased by §501(c)(3) organizations or public schools; individual retirement accounts; Roth individual retirement accounts; and eligible deferred compensation plans).

6 I.R.C. §1411(c)(2). Proposed Treasury regulations provide that the material participation rules of I.R.C. §469 will apply for purposes of determining whether a taxpayer materially participates in an I.R.C. §162 trade or business for purposes of determining whether such trade or business is described in I.R.C. §1411(c)(2)(A). Prop. Treas. Reg. 1.1411-5(b); Pre-amble to Prop. Treas. Reg. 1.1411 (REG-13057-11). Also, I.R.C. §469(c) defines passive activities as trade or business activities in which the taxpayer does not “materially participate.” A taxpayer is not treated as materially participating in an activity unless his or her involvement in the operations of the activity is “regular, continuous, and substantial.”

7 The 2010 Health Care Act imposes increases on the Medicare insurance portion of both the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA) taxes effective for tax years beginning after December 31, 2012. But for the 2010 Health Care Act, employers and employees would have been subject to 1) an old age, survivors, and disability insurance (OASDI) tax of 6.2% of covered wages up to the taxable wage base ($110,100 in 2012) and 2) the hospital insurance or Medicare tax of 1.45% of all covered wages, for a maximum total employment tax rate of 7.65% (for the first $110,000 plus 1.45% on all remaining covered wages).

8 Under the 2010 Health Care Act, the total Medicare taxes paid by both the employee and the employer will increase to 3.8% (the employee at 2.35% and the employer at 1.45%) on earnings that are in excess of the threshold amount. Consistent with this, the 2010 Health Care Act increased the Medicare tax portion of the self-employment tax by .9% from 2.9% to 3.8% on earnings that are in excess of the threshold amount.

9 The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 for single individuals. I.R.C. §§3101(b)(2); 1401(b)(2).

10 I.R.C. §§164(i), 1402(a)(12).

11 Under California law, an S corporation is subject to a 1.5% tax on the S corporation’s net income (in addition to the tax imposed on the shareholders) whether or not the income is distributed. Rev. & Tax CODE §23802(b). The 1.5% California state tax is deductible at the federal level.

12 I.R.C. §1366.

13 Rev. Rul. 74-44, 1974-1 CB 287.

14 Radtke v. United States, 712 F. Supp. 143 (E.D. Wis. 1989) (The taxpayer was the sole shareholder and director of a law firm established as an S corporation, and the court found that the dividends that the taxpayer withdrew represented wages subject to payroll taxes.); Spicer Accounting Inc. v. United States, 918 F. 2d 90 (9th Cir. 1990) (The Ninth Circuit held that a taxpayer’s service to his accounting firm, an S corporation, was substantial, noting that as the lone CPA in the firm, the taxpayer was the only person capable of signing tax returns, performing audits, and preparing letters, and that distributions paid to the taxpayer were classified properly as compensation subject to payroll taxes.).

15 Note that in general, most entertainment companies will withhold payroll and income taxes from payments to LLCs or partnerships unless all the members or partners are corporations.

16 Treas. Reg. §1.469-5T(a)(1).

17 Treas. Reg. §1.469-5T(a)(2).

18 Treas. Reg. §1.469-5T(a)(3).

19 Treas. Reg. §1.469-5T(a)(4) and (c).

20 Treas. Reg. §1.469-5T(a)(5).

21 For these purposes, performing arts is defined to not to include the “behind the camera” writers, producers, and directors.

22 Treas. Reg. §1.469-5T(a)(6).

23 Treas. Reg. §1.469-5T(a)(7).

24 I.R.C. §1411(a)(2).

25 Additionally, there is no step-up in basis in the S corporation stock at the time of the shareholder’s death.


27 I.R.C. §1411(a)(5).


29 See supra note 5 and accompanying text.
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FILM FINANCING is always evolving due to technological changes, legal developments, market forces, and, sadly, the pillaging of prior investors, so it is critical to keep abreast of the latest developments. The two constant forces driving film financing are blockbuster optimism and the sexiness of the industry. These two forces lead to a drastic oversupply of film production; approximately 800 films are produced each year, while only 100 or so are released by MPAA members. The sad fact is that most films lose money. Thus, the challenge for producers is to find the next wave of financing from investors who are willing to overlook—or are immune to—the economic foibles of the industry.

One example of nimble producers who successfully ride these waves is the team of Morgan Freeman and Lori McCreary. Over the last 20 years, they have used almost every financing device to make films. Additionally, they have positioned themselves at the forefront of the technological revolution through their investment in pioneering companies such as ClickStar (an early VOD company) and Digiboo (like Redbox but with digital download to a USB flash drive).

Due to the dearth of alternative sources of financing, there recently has been a resurgence of film companies raising capital through securities offerings (referred to as private offerings) that are exempt from registration with the SEC. These private offerings can range all the way from small offerings of several hundred thousand dollars to large offerings of hundreds of millions of dollars, as long as all the investors are “accredited investors” meeting certain net worth or income tests. Because investors in private offerings are willing to assume much more risk than a lender, private offerings can work for companies that are unable to obtain conventional financing. The JOBS Act of 2012 affects these private offerings by loosening the restrictions on what companies raising capital (known as issuers) can do.

**JOBS Act**

One section of the JOBS Act permits crowdfunding, which is aimed at equity or debt offerings of not more than $1 million through “funding portals,” envisioned as Web sites that match investors to investments. (Investment crowdfunding is not to be confused with philanthropic crowdfunding through Web sites such as Kickstarter, since philan...
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 Investors are limited to how much they can invest in a 12-month period in all crowdfunding investments, based on the amount of their net worth or income. For investors with more than $100,000 of annual income or net worth (and it appears that the new worth test excludes the investor’s principal residence), the limit is 10 percent of the greater of either amount. The funding portal must 1) ensure that the investors review investor education material and confirm that they understand that they can lose their investment, 2) run a background check on every officer, director, and more than 20 percent shareholder of each issuer, 3) ensure that invested cash is released to the issuer only once the required minimum raise to close is reached, 4) register with the SEC, and 5) be a member of a self-regulating crowdfunding securities association. A funding portal cannot 1) pay anyone to identify potential investors, 2) offer investment advice or recommendations, 3) solicit investments in listed offerings, 4) compensate anyone based on sales of listed offerings, or 5) handle investor funds or investments. The issuer must file extensive information about itself with the SEC, the funding portal, and investors, including a business plan, intended use of the investment, the capital structure of the issuer, the terms of the offering, the basis for valuation of the investment being offered, the risks involved, and the names of its officers, directors, and more than 20 percent shareholders. The law also requires financial information in a particular format, depending on the amount of the offering, ranging from tax returns for offerings of not more than $100,000, to reviewed financials for offerings of not more than $500,000, and to fully audited financials if the issuer is seeking to raise more than $500,000. This last requirement almost always will be cost-prohibitive. There is a three-week holding period between the date that the offering material is submitted to the SEC and the date that invested cash can be accepted. No advertising is permitted, except for “notices which direct investors to the funding portal.” The issuer must file annual financials with the SEC and its investors. The issuer and its directors, executive officers, CFO, and any person who offers the security is liable to the investors for the full amount of their investment for any inaccurate or omitted material fact in the offering material. The potential liability under this provision is more expansive than under other exemptions from registration. There is a one-year restriction on transfers of the investment by investors, other than under narrow exceptions. 

As a result, the theoretical benefit of meeting this mass of restrictions and qualifications, compared to relying on an existing exemption for offerings up to the same $1 million limit, is meager. Crowdfunding offerings can be used to permit investment by widows, orphans, and other investors who are not accredited investors, and the crowdfunding exemption overrides state securities laws, except for the requirement to pay any applicable filing fees in the state of the issuer’s principal place of business or where investors making more than 50 percent of the investment reside.

Rule 504 The alternative to all this lunacy is to just rely on SEC Rule 504, which exempts offerings of not more than $1 million to whomever, as long as the issuer discloses all material facts, does not commit fraud, does not advertise, and files Form D with the SEC. Nothing more is required. For Rule 504 offerings, the issuer also must comply with state securities laws, but for most of them, the issuer simply is required to limit the offering to under 35 investors who either have a pre-existing relationship with the promoter or who are financially sophisticated (or are represented by someone who is).

Another section of the JOBS Act makes a significant change to offerings to accredited investors by requiring the SEC to issue regulations permitting general solicitation and advertising, as long as the issuer takes reasonable steps to verify that the purchasers are accredited investors (as opposed to accepting a self-serving declaration, which is permitted for offerings that do not have general solicitation or advertising). An accredited investor is one of the following: A natural person whose net worth (together with his or her spouse, if any) exceeds $1 million at the time of the purchase (excluding the investor’s principal residence). A natural person who had an individual income in excess of $200,000 (or $300,000 if married) in each of the two most recent years, and who reasonably expects an income in excess of that amount in the current year. An entity that has over $5 million of gross assets that was not formed for the specific purpose of making the investment, or an entity owned solely by one or more of the foregoing.

While the crowdfunding exemption is a bust, the new rule allowing advertising to accredited investors is significant, at least once the SEC gets around to issuing regulations permitting it. Indeed, the day may come when movie theaters run trailers for upcoming investment offerings in film deals rather than for upcoming films. 

In addition, the JOBS Act permits offerings to accredited investors through funding portals as long a couple of requirements are met. First, the funding portal must either register as a broker-dealer or not receive or pay any compensation in connection with the sale of listed investments. Second, the funding portal cannot have possession of customer funds or investments. If these requirements are met (which are far less stringent than the requirements for funding portals under the crowdfunding exemption), the funding portal may provide ancillary services, such as 1) due diligence services, so long as such services do not include, for separate compensation, investment advice or recommendations to the issuers or investors and 2) the provision of standardized documents to the issuers and investors, so long as the funding portal does not negotiate the
terms of the issuance for and on behalf of third parties, and so long as issuers are not required to use the standardized documents as a condition of using the service.

Advertising

Another recent trend is the influx of equity from advertisers. Advertisers are being pushed out of television by TiVo, DVRs, and VOD, and they are fighting back by investing equity in films and TV series in order to integrate their product into the message in a way they can control. Many advertisers have set up dedicated entertainment divisions to produce or invest in films. The cost of a film can be less than these companies spend to sponsor a major sports event, but, in addition to the advertising benefit they receive, when they invest equity, they stand to make their money back and even make a profit.

The boundaries of this trend are being pushed by Hasbro, which was so enthralled with the success of its toy line from the Transformers movies that it invested in the film Battleship (based on a Hasbro board game) and has gone to the logical extreme of opening its own studio on the lot at Universal for creating TV shows for a network it co-owns with Discovery Communications. In the extreme sports realm, Red Bull dominates with its sponsorship of and content creation for everything from snowboard competitions to parachute jumps from space. Similarly, Proctor & Gamble and Wal-Mart recently sponsored a family-oriented TV series that includes product placements and presentation credits.

Product placement alone is not fully satisfactory to advertisers for a number of reasons. In particular, they cannot control the exact contours of whether and how their product will be used, and they cannot control the content of the film itself. They often are chagrined to find that the final film contains more violence, sex, or other objectionable content than they contemplated, leaving them concerned about possible negative associations with their product.

When advertisers invest in and own the films, they have control over the creative aspects of the film itself and, specifically, the use of their products, and they do not risk being left on the cutting room floor. This alone is a compelling reason for advertisers to take this step. But there are even more compelling reasons. All the money in the world spent for product placement and associated advertising is just that—money spent. While the advertisers hope that product sales will increase, there is no other source for recoupment of this expenditure. When advertisers instead invest in a film, they have a source for recoupment of their investment, plus a profit if the film works. A little money goes a long way. Advertisers do not need to finance 100 percent of a budget; they need only plug the gap, which might be a small portion of the budget of a film.

Financing by Retailers

An extremely important recent development is the disintermediation of the studios through the creation of content by companies that have a direct link to consumers, including companies that deliver content through digital means. An early pioneer of this approach was ClickStar, a VOD company founded by Freeman and Intel, with the goal of releasing films via VOD on the same day as the theatrical release. The film 10 Items or Less was made specifically as a trial of this approach. This trend is accelerating on many fronts, including the creation of content by Internet companies (Netflix and YouTube), theater chains (Open Road), premium cable channels (Showtime), and DVD retailers (Wal-Mart). These companies are a vibrant, important source of new financing that bypasses studios and standard distribution channels. Rather than going to Cannes to attempt to presell a film to foreign distributors, film producers now can knock on Netflix’s door and ask it for production financing.
Retailers generally pay on delivery (or even later in installments), so it is necessary for the producer to borrow against these payment commitments. This brings with it a reliable method of banking presales, and there has been a bit of a learning curve to get the retailers familiar with standard presale banking documentation, such as notices of assignment and interparty agreements.

**Foreign Distributors**

In an effort to acquire studio films for their home markets, foreign distributors, in addition to entering into presales, have made equity investments in films. For example, to create Hemisphere, a consortium of foreign distributors invested equity in a slate of large-budget studio films in exchange for distribution rights in their home territories in addition to a share of worldwide profits. An advantage to the foreign distributor is that its risk is spread over the film’s worldwide revenues, instead of the distributor being subject only to the risk of the film’s success or failure in its home market. These transactions are common for theatrical and television productions and go by a variety of names, including “split rights,” “coproduction,” and “joint venture,” among others. For tax purposes, these transactions may be treated as dual-resident partnerships. A host of attendant tax issues should be worked through in advance of each deal.

**State Tax Credits**

The most important development in film financing over the last decade is the drastic expansion of state tax credits for film production. Revelations used this approach to obtain New York tax credits for *The Magic of Belle Isle*. These state tax credits come in two basic flavors: those that are assignable and those that are not. The assignable tax credits can be sold to third parties, and an entire industry has evolved around brokering these tax credits. For the nonassignable tax credits, the state typically refunds the production company the amount of the credit that is not offset against the production company’s state tax liability. The nonassignable tax credits are much more difficult to monetize. Generally, the production company has to seek a loan from a third party secured by the potential tax refund. It is difficult but not impossible for lenders to obtain direct payment of the tax refunds, so assignable tax credits are far preferable to nonassignable ones.

While state laws vary, their basic premise is to permit a tax credit for costs incurred in the state. Not surprisingly, producers attempt to classify as much of their costs as possible as being incurred in the state, including many costs that are difficult to source to any particular location, such as completion bond fees, financing costs, and overhead. The real benefit occurs when the state permits payments to actors, the director, and producers to qualify. Some states limit the amount of annual tax credits they permit, which drastically reduces the attractiveness of shooting in those states, since the producer may not be assured of the tax credit.

In the nascent days of these tax credits, production companies were able to sell or borrow against the tax credits for approximately 70-75 percent. Through increased competition, this percentage has gradually crept up to over 85 percent for credits that are payable within one year.

California has joined the state tax credit fray with a film production tax credit of its own, but it does not quite live up to its billing and has a number of limits that make it generally unworkable for independent producers. For independent films, the credit is 25 percent of qualified costs. The production company for an independent film may make only one sale of the credit, so brokers acting as financiers must be careful to structure the transaction as a loan and not as a purchase and resale of the credit. The credit is not refundable, so the sale of credits for independent films is thus the only
way to raise actual financing for the production of a film.

The IRS has put a damper on the state tax credit party by issuing a Chief Counsel Advice that holds that the receipt of the proceeds from the sale of state tax credits is immediately taxable, but so far producers do not seem aware of it.

Section 181

IRC Section 181 (which had expired at the end of 2011) is back again, thanks to the fiscal cliff legislation, which oddly reenacted Section 181 retroactive to the beginning of 2012, although it is hard to see how this could encourage film production in the United States before reenactment in 2013. For films that commence principal photography prior to December 31, 2013, and that are produced in the United States, Section 181 permits an immediate 100 percent write-off, known as the film deduction, for the first $15 million of the cost as paid or incurred, regardless of whether the particular expenses are incurred after 2013.

Many people assume that Section 181 operates the same as similar tax provisions in foreign countries, which are usually used as part of sale-leaseback transactions to net the film production about 10 percent of the budget of a film. However, this benefit is created from double dipping on these cross-border transactions. Each side of the transaction, residing in a separate country, claims the right to deduct the cost of the film and applies its own tax laws. The problem with Section 181 is that any film company using it is subject to tax in the United States, so there is no cross-border double-dipping opportunity. Thus, whatever Section 181 gives with one hand (deductions for investors), it takes away with the other (deductions for the film company). The film company may raise 10 percent of the budget from investors under a Section 181 deal only to find that it is now taxed on 100 percent of the gross receipts, such as pre-sales, without any offsetting deduction for production costs. It is possible to avoid this problem with some fancy footwork, but it usually imposes a high degree of tax risk on one party or the other.

Box Office Financing

The financial overhaul bill passed in June 2010 banned box office futures from being traded on a publicly traded exchange as commodities, putting them in a rarefied league with only one other prohibited item: onions, a relic of onion grower hysteria in the 1950s. However, film financing transactions based on box office results (known as box financings) are likely to resurface as private swaps.

Many film companies want to reduce their risk on films, particularly big-budget ones. Reducing risk avoids having the company go bankrupt if the film flops, and it permits the company to spread precious cash over a wider number of films. From 2002 to 2008, a great way for film companies to hedge risk was to raise equity through private equity funds. But these transactions dried up in 2008 and may not come back to the same level, mainly because the managers of these funds felt victimized by their perception (right or wrong) of opaque Hollywood accounting practices. Fund managers now shudder when offered a share of a film’s net profits. Eddie Murphy’s great quip—calling a share of net profits “monkey points”—best summarizes the current perception of what it means to invest in films. It is for this reason that the market for film financing from private equity funds is kaput. Financially strong film companies can, of course, raise debt financing, but debt does not shift risk. What is needed is equity financing.

An approach that would revitalize the market for equity investment in films is to end the accounting miasma and tie the investor’s return directly to a percentage of the gross domestic box office receipts received by the theaters for the film. This approach raises the curtain of doubt that surrounds Hollywood accounting and leaves a spotlight on the glamour and thrill of owning a piece of a film. With this approach, all an investor would have to do is open a copy of an entertainment trade journal. Accounting statements and audits would be history. The film company would pay the investor the specified percentage of the domestic box, even though there is only an indirect link between the domestic box and the film company’s ultimate net profits. From the film company’s perspective, box financing hedges risk, which is good. Box financing is something everyone can understand, so it would open the investment door to the general public. It could be done across a slate of films or film-by-film, with investors investing in particular films of their choice.

A simple example may best illustrate this suggestion. Assume that a studio seeks to produce a $100-million film but limit its risk to $50 million. It raises $50 million of equity from an investor and agrees to pay the investor a payment equal to 50 percent of the domestic box. If the film flops and comes in with a domestic box of $10 million, the studio pays the investor $5 million, keeps the $45-million balance, and is happy. If the film has a domestic box of $100 million, the studio pays the investor a break-even payment of $50 million, and the studio is happy because it will keep worldwide rights and profits from a successful film. If the film scores big and has a domestic box of $200 million, the studio pays the investor $100 million, and the studio is still happy because it accepted that possibility as a tradeoff for reducing its risk.

In order for box financings to work, the investment must be refundable with interest if the film is not made with the promised cast or director or does not get a theatrical release on a minimum number of screens by a specified date. Because the film company will be required to make payments to the investor regardless of actual net profits received, the film company will have to either have a strong enough balance sheet to make the investor happy or hold the investment in escrow until the domestic box results are in, precluding the investment from being used to cash flow production. Even if the investment is escrowed, the investor still will be relying on the film company to pay any amounts owed to the investor in excess of the investment if the domestic box is high enough. These factors would tend to make a transaction to box financing easier for the studios, but it is not beyond the reach of well-heeled independents.

A huge advantage to the studios is that box financing eliminates audits and litigation, and this has become increasingly important given the recent string of losses that the studios have suffered in profit participation cases. A plaintiff’s lawyer need only say, “Hollywood accounting” for jurors to get the message. Box financing ends all that. Box financings will not be publicly traded, and this fact should eliminate all the regulatory complications involved in having box office futures traded on an exchange.

The film financing landscape is rapidly changing, and what works today may well be obsolete tomorrow. It presents an ever-moving target that requires matching the right financing at the right time with the right companies, based on the particular facts and circumstances of a project, so flexibility is the key to success.

2 Morgan Freeman is represented by Jason Sloane at Sloane Offer Weber & Dern.
5 See JOBS Act, tit. III—Crowdfunding.
7 JOBS Act, tit. II.
9 Securities Act of 1933 §4(A) (codified at 15 U.S.C. §§77a et seq.).
10 REV. & TAX. CODE §32685.
11 IRS Chief Counsel Advice 201147024 (Sept. 16, 2011).
THE FIRST presidential candidate had a theme song. George Washington’s was “Follow Washington.” Thomas Jefferson blasted John Adams by referring to the Alien and Seditions Acts as a “reign of terror” in “Jefferson and Liberty,” while Adams warned that “Slavery’s comin’, knavery’s comin’ / plunder’s comin’...If John Quincy not be comin’!” in “Little Know Ye Who’s Coming.” In 1932, Franklin Roosevelt adopted an existing song for his campaign. Following an immediately panned speech by Judge John E. Mack, who was introducing Roosevelt, his political advisers demanded that a song be played to act as a buffer before he took the stage. They selected “Happy Days Are Here Again” from the 1930 musical Chasing Rainbows, and it became the theme of Roosevelt’s campaign and the Democratic Party for several years. Following Roosevelt, several politicians began appropriating Broadway show tunes for their theme songs. In 1952, Irving Berlin—author of “White Christmas,” “God Bless America,” and “There’s No Business Like Show Business”—modified a song from the musical Call Me Madam as Dwight Eisenhower’s campaign hit “They Like Ike.” The song proved to be an instant hit, resulting in the slogan “I Like Ike” appearing on campaign buttons, posters, and pamphlets, and leading to the follow-up tunes “I Still Like Ike” and “Ike for Four More Years.”

The first presidential candidate to receive some backlash for unauthorized appropriation of Broadway tunes was Republican nominee Barry Goldwater, whose 1964 campaign commissioned a rewrite of the song “Hello, Dolly.” The musical’s producer, David Merrick (a Democrat), notified the campaign that it was violating copyright law. Notably, Goldwater’s opponent, Lyndon Johnson, successfully asked an original Dolly cast member to perform “Hello, Lyndon” at the 1964 Democratic National Convention in Atlantic City. This appropriation went without complaint. Since that time, politicians have increasingly experienced com-
plaints from artists who have not condoned a particular use of their songs. Recent examples include Newt Gingrich’s use of Survivor’s 1982 hit “Eye of the Tiger,” Mitt Romney’s use of K’Naan’s “Wavin’ Flag,” and Michele Bachmann’s use of Tom Petty’s “American Girl.”

There are several reasons for the increase in artist complaints about the unauthorized use of music in political campaigns. First, the phenomenon is widely reported. The more that publications report on artist complaints, the more aware people become of the issue. Artists, in turn, may be more likely to assert their intellectual property or moral rights against politicians whose political agendas do not match their own. Additionally, artists’ lawyers are becoming increasingly creative in drafting cease-and-desist letters to political campaigns, with some adopting newsworthy language. In the famous letter from the Silversun Pickups to presidential candidate Mitt Romney, counsel stated, “As the former governor [of] the state of Massachusetts, a graduate of Harvard Law School, and candidate for U.S. President, we’re pretty sure you are familiar with the laws of this great country of ours. We’re writing because we, like you, think these laws are important.”

The cease-and-desist letter to Romney was itself newsworthy, but the letter also became famous in its own right for its similarities in style and wording to a letter sent on behalf of guitarist Joe Walsh to a Republican congressional candidate also named Joe Walsh. Finally, social media are changing the way Americans experience political campaigns. News stories, reactions, and commentaries are spilled into social media in a real-time national conversation, allowing stories to spread in a way heretofore unseen. While those with legal backgrounds may weigh in on artist complaints with insight about proper music licensing, the general public forms and expresses opinions based on an artist’s right to choose what is done with his or her music.

In light of the publicity that artists’ demands are receiving, it is surprising that so few lawsuits have been filed. One reason for this may stem from the nature of politics. Politicians rely on popular opinion to win an election, so they may perceive the costs of opposing an artist in court as outweighing the benefits associated with using the music to conjure excitement and support from constituents. This affords artists a great deal of leverage when requesting that a politician cease using a musical work in a campaign, even when the law may not necessarily be on the artist’s side. On the other hand, politicians may feel they have little to lose by opposing an artist’s claim in court. For example, California senator Charles DeVore argued unsuccessfully that his use of songs released on Don Henley’s 1984 Building the Perfect Beast in a series of campaign videos was fair use.

Copyright

Advances in technology have increased the potential for liability that politicians face. Politicians no longer rely solely on campaign appearances or static advertising through posters, slogans, and signs. Campaigns now rely on videos distributed over the Internet.

Copyright infringement and related claims over a Web video that criticized Barack Obama’s energy policy while Browne’s “Running on Empty” played in the background. As politicians continue to use music for the dual purposes of campaign appearances and videos, they will have to consider the extent of possible liability for both, and whether traditional defenses protect those uses.

In the campaign scenario, a politician typically makes an entrance to a song designed to characterize and elevate the politician’s public persona and agenda. Thus, for example, in 2008 Sarah Palin, whose high school nickname was Sarah Barracuda, adopted Heart’s “Barracuda” during the Republican National Convention. Heart’s lead singers, Ann and Nancy Wilson, immediately requested that the Republican campaign cease its use of the song, stating, “The McCain campaign did not ask for permission to use the song, nor would they have been granted that permission. We have asked the Republican campaign publicly not to use our music. We hope our wishes will be honored.” The McCain-Palin campaign refused to cease its use of “Barracuda,” however, and the Wilson sisters further condemned Palin’s use of the song through a public statement:

Sarah Palin’s views and values in NO WAY represent us as American women. We ask that our song “Barracuda” no longer be used to promote her image. The song “Barracuda” was written in the late 70s as a scathing rant against the soulless, corporate nature of the music business, particularly for women. (The “barracuda” represented the business.) While Heart did not and would not authorize the use of their song at the RNC, there’s irony in Republican strategists’ choice to make use of it there.

Typically, the unauthorized use of a song would subject the user to potential liability for copyright infringement, warranting compliance with a cease-and-desist issued by the copyright holder. In Palin’s case, however, the McCain campaign had obtained licenses to play the song through a performing rights organization (PRO), which licenses the public performance of musical works on behalf of the copyright owner. Examples of PROs include the American Society of Composers, Authors, and Publishers (ASCAP); Broadcast Music, Incorporated; and the Society of European Stage Authors and Composers.

Politics

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Obtaining the license for “Barracuda” through ASCAP allowed the McCain campaign to freely use the song without first seeking Heart’s permission.

Alternatively, a political campaign can rely on licenses held by the venue itself for use of a song. In that case, the license is held by the venue (for instance, a sporting arena) and applies to all events that take place there. This presents a greater potential for liability in the case of a political campaign, however, because venue licenses are often limited to a specific type of event, for example, hockey or basketball games. If a political campaign utilizes a song licensed for a sporting event but not for a political rally, that campaign will potentially be subject to copyright liability for its unauthorized use of the song.

Another limitation of a PRO license is in the substance of the license itself. As the words “performing rights organization” suggest, a PRO licenses the right to perform a song; it does not grant the right to use the song in an advertisement or a promotional video. Thus, a politician requires a separate synchronization license from the publisher to use the song in an ad. McCain’s 2008 campaign demonstrated precisely this problem when it used “Running on Empty” in a widely circulated ad without obtaining a synchronization license. In the ad, the Republican National Committee (RNC), the Ohio Republican Committee, and McCain mock Obama’s suggestion that the country could conserve gasoline by keeping automobile tires properly inflated, while Browne’s “Running on Empty” plays in the background. Displeased by his involuntary association with the Republican Party, Browne filed suit in the Central District of California alleging copyright infringement, vicarious copyright infringement, violation of the Lanham Act, and violation of California’s common law right of publicity.8 As the complaint notes, “Defendants did not obtain a license, or seek or receive Browne’s permission to use the Composition in the Commercial.”

The McCain campaign did not deny that it had not first sought a license for its use of “Running on Empty.” Rather, the campaign argued that the song’s use in the video qualified as fair use:

> Given the political, non-commercial, public interest and transformative nature of the use of a long-ago published song, the miniscule amount used and the lack of any effect on the market for the song (other than perhaps to increase sales of the song), these claims are barred by the fair use doctrine.9

McCain moved to dismiss the complaint on this ground, arguing that the fair use doctrine barred Browne’s copyright claim as a matter of law.10 As the court noted, however, courts analyze fair use as a mixed question of law and fact. Consequently, a court must typically make factual determinations or rely on undisputed or admitted material facts to conduct the fair use analysis. Because a motion to dismiss is limited to allegations in the complaint, and the court does not make factual findings or deem facts undisputed or admitted, fair use is rarely analyzed at a preliminary stage. The Browne court followed this precedent and declined to analyze fair use on McCain’s motion to dismiss. As the court noted, “The mere fact that Plaintiff’s claim is based on Defendants’ use of his copyrighted work in a political campaign does not bar Plaintiff’s claim as a matter of law.”11 Although the fair use question might have been addressed at the summary judgment stage of the litigation, the validity of this argument was never tested in court because the parties settled in 2009, and McCain issued a formal apology.12

McCain was not entirely unfounded in his motion to dismiss on the basis of fair use, however. In Keep Thomson Governor Committee v. Citizens for Gallen Committee, a political committee brought suit against its adversary for copyright infringement after the adversary used a 15-second sample of a song that the plaintiff had specially commissioned, and in which the plaintiff owned all copyright interests.13 At the request of the defendants, the court held a hearing on whether the plaintiff was entitled to injunctive relief to enjoin the defendants’ mocking use of the sample.14 While acknowledging the plaintiff’s exclusive right to duplicate or prepare a derivative use of the copyrighted work in its advertisement, the court stated, “[T]he exclusive right of a copyright holder must be weighed against the public’s interest in dissemination of information affecting areas of universal concern.”15 However, the court also emphasized the First Amendment implications at issue in the case:

> In the context of this case, the Court must be aware that it operates in an area of the most fundamental First Amendment activities. Discussion of public issues and debate on the qualifications of candidates are integral to the operation of the system of government established by our Constitution. The First Amendment affords the broadest protection to such political expression in order to assure the unfettered interchange of ideas for the bringing about of political and social changes desired by the people. Although First Amendment protection is not confined to the exposition of ideas, there is practically universal agreement that the major purpose of that Amendment was to protect the free discussion of governmental affairs, including discussions of candidates.

Addressing the first factor of fair use, or the purpose and character of the use, the court stated that the defendants’ use of the plaintiff’s political advertisement was “clearly part of a political campaign message, non-commercial in nature, and First Amendment issues of freedom of expression in a political campaign are clearly implicated.”16 As for the nature of the copyrighted work, the court noted that it was itself part of a political campaign message. The court found the amount and实质性 of the portion used in relation to the copyrighted work as a whole was negligible, as the infringing work took only 15 seconds of a three-minute recording, and the effect of the use on the copyrighted work’s potential market was similarly “nil.”17

Though the Keep Thomson court’s analysis suggests that politicians may enjoy a decidedly lenient privilege in their use of copyrighted works for political communications, more recent court decisions have not shared the Keep Thomson court’s emphasis on the First Amendment. In Henley v. DeVore, musician Don Henley claimed that politician Charles DeVore infringed the copyrighted songs “The Boys of Summer” and “All She Wants to Do Is Dance” with two political advertisements featuring variations on those songs, called “The Hope of November” and “All She Wants to Do Is Tax.”18 DeVore worked with his Internet strategist, Justin Hart, to utilize the plays on Henley’s songs during his 2010 campaign for one of California’s seats in the U.S. Senate. In the “The Hope of November” video, Hart downloaded a karaoke version of “The Boys of Summer,” supplied the vocals in Henley’s style, and produced the video by compiling images of Obama, Nancy Pelosi, and a few others.19 After Henley learned of DeVore’s video, he sent YouTube a takedown notice pursuant to the Digital Millennium Copyright Act, with which YouTube promptly complied. DeVore then sent a counter-notification to YouTube, requesting that the video be reposted on the ground that it constituted parody.20 Around this time, the DeVore campaign released the “All She Wants to Do Is Tax” video, which criticized Barbara Boxer and cap-and-trade and global-warming policies.21 As with “The Hope of November,” Hart supplied vocals and paired the song with a video he created using online images and videos of Boxer, Al Gore, and the Disney character Scrooge McDuck.22 Henley filed suit shortly thereafter, and the parties eventually made it to summary judgment regarding DeVore’s contention that his use of the songs constituted fair use.

The Henley court’s analysis deviates from
Two presidential candidates appropriated the song “Hello, Dolly,” but only one received a complaint from the copyright holder.

True
False

3. In a 2010 case, candidate Charles DeVore successfully argued that his use of two songs written by Don Henley was fair.

True
False

4. A politician may play a song at campaign functions without the songwriter’s permission so long as the politician secures a proper license.

True
False

5. A performing rights organization can license the right to perform a song as well as use it in a promotional video.

True
False

6. Venue licenses for songs are often limited to specific types of events.

True
False

7. The John McCain campaign obtained a proper license for “Barracuda.”

True
False

8. In Brown v. McCain, singer-songwriter Jackson Browne brought the following claims against McCain: A. Copyright infringement. B. Violation of the Lanham Act. C. Violation of California’s right of publicity. D. All of the above.


True
False

10. Under the purpose-and-character factor, courts consider the extent to which a new work is transformative.

True
False

11. In Henley v. DeVore, the court drew a distinction between satire and parody of protected works.

True
False

12. The fourth element of fair use analysis concerns the effect of the use upon the potential market for or value of the copyrighted work.

True
False

13. In which case did the court emphasize the First Amendment implications of political expression?
A. Browne v. McCain.
B. Keep Thomson Governor Committee v. Citizens for the Galen Committee.
C. Henley v. DeVore.
D. Miller v. Ford.

14. The Henley v. DeVore court found that the defendant’s use of Don Henley’s songs constituted parody.

True
False

15. The McCain defendants moved to dismiss the trademark claim on the ground that the Lanham Act cannot be asserted if the speech is political and therefore noncommercial.

True
False

16. In Browne v. McCain, the court found that Browne’s trademark claim was barred under the artistic relevance test.

True
False

17. The right of publicity of a song’s author may be infringed even if a campaign purchases public performance licenses.

True
False

18. Twenty-five states recognize the right of publicity with a statute.

True
False

19. The Browne v. McCain court denied the McCain defendants’ Anti-SLAPP motion to strike Browne’s claim for right of publicity because the claim was not based on protected activity.

True
False

20. Politicians may avoid lawsuits by copyright holders for use of a song by simply securing the artist’s blessing before making use of a song.

True
False
the *Keep Thomson*’s tone almost immediately. Rather than wax poetic about First Amendment principles, the *Henley* court noted that fair use has been described as “a privilege” that allows artists “to improve upon, comment on, or criticize prior works.”23 Rather than merely recite the Copyright Act’s four fair use factors verbatim, as did the *Keep Thomson* court, the *Henley* court explained the meaning courts have ascribed to the four factors. Examining the first factor, which is the purpose and character of the use, the court noted that courts consider the extent to which the new work is “transformative,” or adds something new, with a further purpose or different character, as well as whether the new work was for or not for profit. The court noted that in the context of the fair use analysis, parody has been considered transformative because it provides socially valuable criticism or commentary of the subject work.24 The second factor—the nature of the copyrighted work—reflects a recognition that creative works are “closer to the core of intended copyright protection” than informational and functional works.25

Parodies are permitted to draw from the most creative expressions because they “almost invariably copy publicly known, expressive works.”26 The third factor concerns whether the amount and substantiality of the portion used in relation to the copyrighted work as a whole are reasonable in relation to the purpose of copying. The parodist needs to use at least some portion of the original because the effectiveness of the parody depends on its ability to mimic or “conjure up” the original. Finally, the court explained that the fourth factor asks whether actual market harm has resulted from the defendant’s use, and whether unrestricted and widespread conduct of the sort engaged in by the defendant would result in a substantially adverse impact on the potential market for the original or its derivatives. Because the author is unlikely to permit the use of his or her work to criticize or ridicule that work, a parody is unlikely to supplant the market for the original or its derivatives.

Addressing the argument of the DeVore defendants that their works constituted parody, the court held that the defendants’ use of the songs constituted satire, not parody. The defendants borrowed from the plaintiff’s work not to comment on the plaintiff or his work but rather to address separate subjects, i.e., Obama and his supporters in the case of “The Hope of November” and Boxer, taxation, global warming, and the proposed cap-and-trade program in the case of “All She Wants to Do Is Tax.”27 As to amount and substantiality, the court noted that it was “undisputed” that both “The Hope of November,” and “All She Wants to Do Is Tax” borrowed heavily from the originals.28 Karaoke tracks formed the background of each song, while Hart supplied vocals with different lyrics. The melodies, rhyme scheme, and syntax of the originals and imitations were identical.29 Because “All She Wants to Do Is Tax” was “almost entirely” satirical in nature, it lacked the parody justification for the extent of its appropriation.30 Although the court acknowledged that “The Hope of November” might have a greater parodic character than “All She Wants to Do Is Tax,” it nevertheless stated that the song’s copying went far beyond what was “reasonably necessary” and noted that it far surpassed the amount previously found to be fair use for a parody.31

Finally, the court found a likelihood of negative impact on the market for the originals because advertisers might be deterred from using Henley’s music because it had been used before, and because the satirical nature of “All She Wants to Do Is Tax” might supplant the market for satirical versions of “The Boys of Summer.”32

The difference between the *Keep Thomson* court’s and the *Henley* courts’ analyses is likely attributable to more than simply a different set of factual circumstances. As leading copyright experts have noted, the fair use analysis is increasingly falling into common patterns of cases, which have been called policy-relevant clusters.33 A court will more likely determine that an infringing use is fair use when the infringer has criticized or commented on the original work, rather than merely relied on the goodwill of a popular song. If the commentators are correct, and cases like *Henley* are representative of the fair use analysis vis-à-vis political advertisements utilizing songs to convey their messages, political campaigns will need to diligently secure appropriate licenses to avoid costly litigation. This includes a synchronization license issued from the music publisher and, if the original or master recording is used, a master use license issued from the record company.

**Trademark**

Even if a politician secures the appropriate licenses to use a particular song, he or she may nevertheless face opposition by an artist who does not want his or her music associated with that politician or political ideology. One argument the artist may utilize is that by using the song, the politician is falsely suggesting that he or she is sponsored or endorsed by the artist. Such a claim is grounded in trademark law under Section 43(a) of the Lanham Act, which protects against false representations regarding the origin, endorsement, or association of goods or services through the wrongful use of another’s distinctive mark, name, trade dress, or other device.34

This argument was asserted by Browne in *Browne v. McCain*, who claimed that McCain “intentionally used Browne’s identity and persona in the Commercial to confuse the public into thinking that Browne sponsors, endorses, and is associated with Defendants, and specifically McCain, when they knew that Browne does not endorse or sponsor Defendants or McCain.”35 As with the copyright claim, McCain moved to dismiss this claim on the ground that the Lanham Act applies only to commercial speech and cannot be asserted if the context of the speech is political. As the court noted, however, the Lanham Act applies to both commercial and noncommercial speech.36 Moreover, the court stated, the political arena is one in which consequences of consumer confusion can be most dire; as such, the court rejected the argument that a plaintiff may not assert a Lanham Act violation for the unauthorized use of songs in political campaigns.37

McCain also argued that Browne could not assert a Lanham Act claim because the song was used in an expressive work, and thus was barred under the First Amendment and artistic relevance test.38 The Ninth Circuit analyzes a Lanham Act claim based on use of a mark in an artistic work under the Second Circuit’s Rogers artistic relevance test, developed to address the competing interests of the First Amendment’s protection of artistic works and trademark protection. Under this test, an artistic work’s use of a trademark that otherwise would violate the Lanham Act is not actionable “unless the [use of the mark] has no artistic relevance to the underlying work whatsoever, or, if it has some artistic relevance, unless [it] explicitly misleads as to the source or the content of the work.”39 The court found that Browne’s claim was not barred under the First Amendment and artistic relevance test for several reasons. First, McCain had not shown that the commercial was an artistic work, requiring application of the test in the first instance. Second, the First Amendment and artistic relevance test does not bar a Lanham Act claim merely because the work at issue is based on noncommercial, political speech. Finally, the court noted that in any case, it would have difficulty applying the artistic relevance test at the motion to dismiss stage.

Notably, the strength of an artist’s trademark claim will depend largely on the extent to which the politician utilized the artist’s song. Courts are unlikely to find a genuine case for false endorsement if a politician has used a song only once or twice at isolated events. On the other hand, if a politician embraces a song (for instance, the McCain
campaign’s recurring use of “Barracuda” to introduce Palin, there is a greater possibility that the song or artist will be associated with the politician in the public’s mind. As cease-and-desist letters and public statements indicate, this is precisely the sort of false association they are concerned with protecting against in the first instance.

Right of Publicity

Finally, an artist can argue that the politician’s unauthorized use of music constitutes a violation of his or her right of publicity under state law. Like trademark, even if a campaign purchases public performance licenses from the PROs (and is therefore legal from a copyright perspective), it may still be infringing an artist’s right of publicity. Though not all states recognize a cause of action for right of publicity, as of this writing, nineteen states recognize the right of publicity via statutes, while twenty-eight recognize a common law right of publicity. In California, a plaintiff must show the defendant knowingly used his or her likeness for a commercial purpose, without permission, resulting in damages. While several courts have found that an artist’s right of publicity is violated when his or her songs or likeness is used without authorization, the unauthorized use of music in political campaigns presents the possibility that some uses may constitute protected speech.

Nevertheless, at least one court has dismissed the argument that as political speech, a campaign’s use of a song is protected as a valid exercise of free speech. In Browne, Browne asserted a right of publicity claim, stating, “Browne’s distinct and readily identifiable voice is widely known and associated with Browne. As such, Defendants’ unauthorized use of Browne’s voice in the Commercial invoked Browne’s identity in the minds of the public.” Recognizing the possibility that McCain’s use of Browne’s song might be protected as free speech, the RNC brought a special motion to use Browne’s common law right of publicity claim under California’s Anti-SLAPP statute. Under this statute, a defendant may make a special motion to strike a state law claim designed to chill the defendant’s right to engage in his or her work. The news stories and case law reveal a push and pull between artists and politicians when the latter use the former’s work to promote their campaign efforts. Oftentimes, politicians have secured the appropriate copyright licenses only to face public ridicule by artists or, as becoming increasingly common, cease-and-desist letters, and even lawsuits. On the other hand, artists may have valid trademark and right of publicity claims when a politician becomes associated with a particular artist or song in the public’s mind. As these disputes continue to make headlines and spur public discourse, the simplest solution may simply be to secure both the intellectual property rights and the artist’s blessing before a campaign makes use of a song.

14 Id. at 960.
15 Id. at 961.
16 Id.
17 Id. at 1156-57.
18 Id. at 1160.
19 Id.
20 Id.
21 Id.
22 Id. at 1161.
23 Id. at 1163.
28 Id. at 1080.
31 Id.
32 Id.
33 Id. at 1080.
35 Id.
37 Id.
TWO MILLION DOLLARS in 10 hours is what the creators of the television series Veronica Mars raised via crowdfunding to develop a movie based on the show. While this may be an exception to the norm, the success of Veronica Mars is one of many examples of how valuable crowdfunding can be for film financing. Crowdfunding is a form of raising money from the public, typically through small individual contributions to fund personal, philanthropic, or commercial endeavors.

Recent legislation has created an opportunity for equity-based crowdfunding to become a useful financing tool for producers of independent feature films, documentaries, and other creative endeavors. Legal limitations on the sale of securities have generally limited crowdfunding to donations, but Title III of the recent JOBS Act created an exemption to federal securities laws to permit crowdfunding equity investment, including for entertainment projects. While the act mandated the SEC to issue the regulations within 270 days after passage, the commission has missed the deadline and is not expected to issue the final rules until later this year.

Once the SEC rules are implemented, small businesses and startups will be able to raise up to $1 million annually via crowdfunding through authorized broker-dealers or registered intermediary Web sites called funding portals. With the potential to provide investors with a financial return, equity-based crowdfunding is a new method of financing for independent film producers, and as such has already attracted interest. Since the JOBS Act passed in April 2012, approximately 6,800 domains have been registered with the word “crowdfunding” in the name. Donation-based crowdfunding has already proven successful. Arts-oriented projects generated around $66 million through donation-based crowdfunding in 2011, and the industry overall grew from $1.5 billion in 2011 to $3 billion in 2012.

However, obtaining equity crowdfunding will entail significant business and legal considerations for filmmakers, funding intermediaries, and investors. For example, what are the practical applications and limitations of the proposed crowdfunding exemption? A founding partner of Kramer Holcomb Sheik LLP, a litigation and transaction law firm in Century City, Shahrokh Sheik practices corporate, entertainment, and intellectual property law.
4th Annual Golf Outing
Monday, June 17, 2013
Tournament Players Club (TPC) at Valencia, CA

ON-COURSE CONTESTS
• Million Dollar Hole-in-One (Shot-of-a-Lifetime Raffle)
• $100,000 Hole-in-One (Shot-of-a-Lifetime Raffle)
• Putting contest - 50’ putt with a $2,500 prize
• Hole-in-One on 9th hole
• Three (3) additional Hole-in-One Prizes on Holes 4, 11 & 16
• Closest to pin
• Longest drive
• Straightest drive
• Low net and low gross prizes and other team prizes

EVENT SCHEDULE
• Registration begins at 9:30 a.m.
• Driving Range & Putting Green opens at 9:30 a.m.
• Putting Contest Starts at 10:45 a.m.
• Golf: NOON Shotgun Start
• Lunch and beverages on your cart
• Social Hour while watching the Shots-of-a Lifetime at approximately 5:00 p.m.
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for film financing? Will the transaction costs and procedures of equity-based crowdfunding outweigh the potential benefits? If equity-based crowdfunding entails higher transaction costs and investment caps, why not simply rely on donations? Before addressing these questions, a review of applicable film-financing issues and donation-based and equity-based crowdfunding is necessary.

**Film Financing and Crowdfunding**

The solicitation of funds from passive investors in exchange for a financial interest in an entertainment project raises federal and state securities compliance issues. The touchstone of a security “is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.” Passive investors are not actively involved in the management of the undertaking and invest in exchange for an economic interest.

The distinction between active and passive investors is important because it dictates what financing options are available as well as what the associated transaction costs will be. For example, a film producer who raises money from active investors (who act, for example, as executive producers and have approval rights over major decisions or other defined, sufficient forms of participation) is likely able to avoid dealing with federal and state securities law disclosure requirements and investor eligibility limitations. In contrast, equity investment offerings to passive investors either must be registered with the SEC and the appropriate state agency, or the offerings must qualify for an exemption and comply with any applicable state securities requirements.

Crowdfunding typically deals with passive investment offerings. Donation-based crowdfunding does not involve the sale of securities to investors, and those who donate do not receive a financial interest in the project. Donation crowdfunding therefore allows for low transaction costs. While donation-based crowdfunding has proven to be a successful financing tool, it has drawbacks, the most prominent of which are the lack of financial return and regulatory oversight. Equity-based crowdfunding, on the other hand, involves a potential return on investment and a detailed legal framework intended to protect investors. Filmmakers interested in equity-based crowdfunding need to be familiar with this framework.

**The Crowdfunding Exemption**

The recent equity-based crowdfunding exemption was added as the new Section 4(6) of the 1933 Securities Act. The law will allow issuers to raise up to $1 million in a 12-month period from qualifying investors and through authorized intermediaries. For offerings up to $100,000, the issuer must provide the intermediary (broker-dealer or funding portal) with its income tax returns for the prior year and certified financial statements. For offerings greater than $100,000 but less than $500,000, the issuer must provide financial statements reviewed by an independent public accountant in accordance with professional standards and procedures defined by the SEC. For offerings greater than $500,000, the issuer must provide audited financial statements.

Regardless of the funding amount, the issuer must provide 1) the issuer’s name, legal status, address, and Web site address, 2) the names of its officers and directors and of any person holding more than 20 percent of the shares of the issuer, 3) a description of the issuer’s business and anticipated business plan, 4) a description of the stated purpose and intended use of the proceeds, 5) the target offering amount, 6) the price to the public of the value of the securities, and 7) a description of the ownership and capital structure of the issuer. These requirements apply to all Section 4(6) offerings.

Additionally, issuers may not advertise the offering except for notices that direct investors to intermediaries. Issuers may not compensate promoters unless authorized by the SEC rules, and issuers must file annual reports with the SEC as well as provide financial statements and reports to investors. Issuers must also comply with any additional rules set by the SEC.

Issuers that are not eligible to crowdfunding under the new law include non-U.S. companies, required public reporting companies, investment companies (as defined under the Investment Company Act of 1940), mutual funds, private equity funds, asset management vehicles, business development companies, and companies disqualified under proposed rules similar to Rule 262 of the Regulation A exemption (the “bad actor” disqualifications).

Limits will apply to investors as well as issuers. Generally, investors with an annual income or net worth of less than $100,000 can invest up to the greater of $2,000 or 5 percent of their annual income or net worth. Investors with an annual income or net worth of $100,000 or more can invest up to 10 percent of their annual income or net worth that does not exceed $100,000. The investment cap applies to all Section 4(6) transactions in a 12-month period.

Under Section 4(6), crowdfunding transactions must be conducted through an intermediary (i.e., a registered broker or funding portal). Funding portals are specifically defined under the law to facilitate Section 4(6) transactions. Thus, most Section 4(6) offerings are unlikely to involve registered brokers, as the potential liabilities and transaction costs may outweigh the potential commissions. Most offerings will likely go through funding portals, which are essentially third parties that list crowdfunding opportunities and provide matching services.

Under the JOBS Act, Section 4(6) intermediaries—i.e., funding portals—are obligated to ensure that each investor receives, reviews, and acknowledges understanding of the disclosure materials and completes an investor questionnaire that affirms the investor’s ability to bear the risk of the investment. In addition, the intermediary must perform a background and securities enforcement check on the issuer, make the issuer’s disclosures available to the SEC and investors no later than 21 days before the first sale of
securities, and ensure that no investor exceeds the maximum allowable investing limit. Funding portals must also take adequate steps to protect the privacy of investors, refrain from compensating parties for providing identifying information on potential investors, and refrain from having any financial interest in an issuer using the intermediary’s services.

In addition to registering with the SEC, funding portals must also become members of a registered national securities association, the only one of which is the Financial Industry Regulatory Authority. Funding portals also may not offer investment advice or recommendations; solicit purchases, sales, or offers to buy the securities offered or displayed on their Web sites or portals; compensate employees, agents, or other persons for solicitation or sale of securities displayed or referenced on the Web sites or portals; or hold manage, possess, or otherwise handle investor funds or securities.8

Issuers may not access the funds until the target amount is reached. Securities purchased under Section 4(6) transactions may not be transferred within a 12-month period from purchase unless the transfer is to the issuer, an accredited investor, or a family member, or is part of an offering registered with the SEC. Additionally, securities sold pursuant to Section 4(6) are “covered securities” under Section 18(b)(4) of the Securities Act of 1933, and therefore are preempted from state securities regulations. On the other hand, states in which the issuer’s principal place of business is located, and states in which more than 50 percent of the securities are sold may require a notice filing and fee.

Once the SEC passes the rules governing Section 4(6), there will be no shortage of funding portals ready to facilitate equity-based crowdfunding. However, it remains to be seen whether the regulatory framework will lead to widespread usage or simply create unreasonable transaction costs that will deter independent producers and small businesses.

Donation or Equity

Whether seeking donations or equity, filmmakers can consider crowdfunding as a financing option, particularly in situations in which traditional financing options are unavailable. For example, crowdfunding can pay for movies with very small budgets. For motion pictures with larger budgets, crowdfunding can be a source of development funds, bridge financing, pre- or post-production funds, or prints-and-advertising funds. Donation-based crowdfunding has already become a popular way for independent filmmakers to raise funds. For example, producers of the Charlie Kaufman film...
Anomalisa raised over $400,000 in September 2012 via crowdfunding,9 and more than 15 films selected for screening in the 2013 Sundance Film Festival were crowdfunded.10

Donation-based crowdfunding appeals to people who are motivated to donate based on the artistic or humanitarian nature of the project and have no expectation of financial return. These offerings do allow people to donate in return for nonmonetary consideration. For example, producers of the yet-to-be released film The Canyons, starring Lindsay Lohan and James Deen, managed to raise $150,000 in one month through donation-based crowdfunding by offering rewards such as a script critique from the film’s director, Paul Schrader, or a one-week workout session with the film’s writer, Bret Easton Ellis.11 Popular donation-based crowdfunding sites for filmmakers include Kickstarter and IndieGoGo.

The benefits of donation-based crowdfunding include the low transaction costs and minimal disclosure requirements. However, certain factors may make donation-based crowdfunding unappealing. For example, there is little to no legal oversight, which may deter those desiring greater assurances. Moreover, the filmmakers may find it burdensome to deal with a large number of small investors.

**Equity Crowdfunding for Filmmakers**

Questions remain as to how practical equity-based crowdfunding under Section 4(6) will actually be, particularly as a new financing tool for filmmakers. Critics of the proposed law argue that it places overly burdensome obligations on intermediaries and that the compensation may not be commensurate with the costs and potential liabilities.12 While the SEC has yet to issue the final rules implementing Section 4(6), the JOBS Act sets forth a rather detailed framework for how the equity crowdfunding offerings will operate. Even still, filmmakers looking to raise capital through Section 4(6) will likely have many questions regarding how to properly conduct such an offering.

For example, can a filmmaker raise funds through donation-based and equity-based crowdfunding? The two methods are not mutually exclusive. Section 4(6) does not prohibit issuers from pursuing a donation-based crowdfunding and equity-based crowdfunding offering for the same project. Film projects, music albums, and video games may be ideal for concurrent donation and equity-based crowdfunding. In addition to broadening the potential investor base, a dual campaign may cross-promote the project and provide grass-roots marketing. It may also be possible for a filmmaker to use equity crowdfunding in conjunction with other securities exemptions. The Section 4(6) exemption limits the aggregate amount sold “to all investors” by the issuer to $1 million within a 12-month period. Accordingly, sales pursuant to other exemptions arguably do not count against the $1 million cap.

What are the differences between a Section 4(6) offering and an offering pursuant to Rule 504, which also has a $1 million cap, 12-month period, and no limit on the number of investors? The two exemptions are similar in many ways, and in fact, Rule 504 arguably entails fewer disclosure requirements. However, unlike Section 4(6) offerings, Rule 504 offerings may only be offered to investors who are sophisticated.
with which the issuer has a pre-existing relationship. Another potential conflict exists under Regulation D, Rule 504—which allows for general solicitation—because issuers under Section 4(6) are specifically prohibited from advertising the offering except to direct investors or intermediaries. Simultaneous use of other exemptions may therefore be risky unless the offering can be divided into separate transactions without running afoot of the integration doctrine. Under this doctrine, issuers may not circumvent registration requirements by claiming separate exemptions for one or more parts of a transaction that in reality belong to a single financing plan.

The SEC uses a five-factor test to determine when to treat separate offerings as part of a single transaction. The five-factor test for integration examines whether the offerings: (1) are part of a single financing plan, (2) involve the same type of security, (3) are made around the same time, (4) provide the same form of consideration, and (5) are for the same general purpose. Given the breadth of the five factors, application of the integration doctrine can be unpredictable, and not all five must be met for offerings to be integrated. In fact, the SEC has indicated that any one or more of the factors may be determinative. Therefore, issuers with multiple but related offerings must ensure there is a clear and legitimate rationale against integration.

The Integration Doctrine

Filmmakers seeking to use Regulation D exemptions to finance a film’s production budget in excess of the $1 million cap will likely be limited by the integration doctrine. Theoretically, filmmakers may be able to separate the offering into different transactions by conducting one offering to raise funds for the development stage of a film and another for the production stage. In order to avoid integration, the two offerings will need to be sufficiently distinguished. A producer may seek development funds to acquire rights to a literary property and commission a screenplay to sell to a studio, talent agency, or production company, and pay investors with the proceeds of the sale. However, these circumstances are not common with independent films, as the development and production activities are often tied together operatively and financially.

May a producer issue a Section 4(6) offering for development and production funds for a film and subsequently may a distributor issue a Section 4(6) offering for print and advertising funds for the same film?

For example, a distributor may decide to conduct equity-based crowdfunding to support the prints-and-advertising costs for a slate of films it acquires. If the maker of a film that is licensed to the distributor has also raised funds via equity crowdfunding, the two offerings can be argued to be different transactions, even though they are associated with the same film. While the issuers may be different, the securities laws exempt transactions. Therefore, the integration doctrine must be applied, and conducting two Section 4(6) offerings in this context would likely be permissible.

Issuers must also be aware of the disclosure obligations and advertising limitations. First, an issuer is defined as “any person who is a director or partner of the issuer, and the principal executive officer or officers, principal financial officer, and controller or principal accounting officer of the issuer (and any person occupying a similar status or performing a similar function) that offers or sells a security in a transaction exempted by the provisions of Section 4(6), and any person who offers or sells the security in such offering.” Therefore, issuers can theoretically be liable for any material misstatements or omissions in connection with an offering by its key officers, directors, and employees. Defenses available to issuers include proof that the investor had actual knowledge of the misstated or omitted information or should have been aware of the information had the investor taken reasonable care and inquiry.

How will filmmakers be permitted to promote the offerings to potential investors? The JOBS Act prohibits issuers from advertising the offering except for directing investors to the intermediaries—that is, registered broker-dealers or funding portals. However, funding portals are prohibited from soliciting purchasers, but broker-dealers are not. The JOBS Act also prohibits the use of a promoter unless the terms of the promoter’s compensation are disclosed in the issuer’s disclosure materials. Given the regulatory framework, what is likely to evolve are funding portals with specific areas of focus, such as independent films, or music, video games, or restaurants. Portals will not necessarily promote specific offerings but rather types of offerings to targeted investors.

Another area of concern for filmmakers is
the potential to lose the exemption after receiving money in excess of the aggregate amount for Section 4(6) transactions. The rules place the burden on the intermediary to ensure that this does not occur. The JOBS Act, however, specifically allows issuers to raise the defense that they did not know that an investor exceeded the cap, and that in the exercise of reasonable care, they could not have known. Therefore, as long as the intermediary complies with the SEC guidelines, the exemption should presumably apply regardless of whether funds are received from ineligible investors. Concerns such as these may be clarified by the final SEC rules.

Depending on how the final SEC rules are structured, equity-based crowdfunding may be either an exciting and valuable new financing tool for filmmakers and other entrepreneurs or an overly burdensome and costly undertaking. Some commentators have opined that the mandatory disclosure and regulatory requirements make equity crowdfunding too complicated and expensive. The SEC may, however, structure equity crowdfunding rules to protect investors while providing a valuable new fundraising source for issuers. Given the constant demand for additional sources of financing by filmmakers and the growing success of donation-based crowdfunding, the Title III exception will very likely be used to make movies. Given the massive anticipation and preparation from those who are eager to participate in equity-based crowdfunding ventures, the rules and procedures will likely evolve over time to facilitate a burgeoning new form of capital finance.

8 17 C.F.R. §230.504.
14 17 C.F.R. §230.504.
15 17 C.F.R. §230.502(a).
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TAP: Deposition Skills Workshop

ON SATURDAY, MAY 18, Trial Advocacy and the Litigation Section will host a workshop providing introductory and intermediate instruction on how to take and defend depositions in California state court actions. The first part of the program will be a lecture with questions and answers covering the rules relating to oral depositions, how to pin down the deponent, how to defend a deposition, the use of deposition testimony in trial, and developing a deposition strategy. The second part is a workshop in which participants practice taking and defending the deposition of a plaintiff in a civil action for negligence and receive constructive feedback on their performance. Participants receive a deposition outline that they can use to take and defend a deposition. The outline organizes the deposition process into a user-friendly format. Written course materials will be distributed via e-mail prior to the first class, so a correct e-mail address at the time of registration is needed. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby lots. On-site registration and lunch will begin at 1 p.m., with the program continuing from 1:30 to 5:30. The registration code number is 011964.

$250—CLE+ member
$350—LACBA member
$500—all others
3.75 CLE hours

Second Annual International Arbitration Conference

ON SATURDAY, MAY 18, Trial Advocacy and the Litigation Section will host a workshop providing introductory and intermediate instruction on how to take and defend depositions in California state court actions. The first part of the program will be a lecture with questions and answers covering the rules relating to oral depositions, how to pin down the deponent, how to defend a deposition, the use of deposition testimony in trial, and developing a deposition strategy. The second part is a workshop in which participants practice taking and defending the deposition of a plaintiff in a civil action for negligence and receive constructive feedback on their performance. Participants receive a deposition outline that they can use to take and defend a deposition. The outline organizes the deposition process into a user-friendly format. Written course materials will be distributed via e-mail prior to the first class, so a correct e-mail address at the time of registration is needed. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby lots. On-site registration and lunch will begin at 1 p.m., with the program continuing from 1:30 to 5:30. The registration code number is 011964.

$250—CLE+ member
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Introductory TAP (i-TAP)

STARTING TUESDAY, MAY 7, Trial Advocacy and the Litigation Section will host a program on May 7, 9, 14, 16, 21, and 23, Tuesday and Thursday nights from 5:30 to 8:30 p.m. This is one in a series of courses offered by LACBA’s acclaimed Trial Advocacy Project (TAP), through which attorneys can get trial experience fast. Designed specifically for attorneys who have little or no trial experience, this six-evening course provides introductory trial advocacy instruction, emphasizing participant mock trial performance and constructive feedback. Receive instruction on basic trial skills and perform a jury trial. Learn to mark exhibits, lay evidentiary foundations, deliver opening statements, conduct direct and cross-examinations, and deliver closing arguments. Classes will be taught at the LACBA-Executive Presentations Mock Courtroom. The course instructors are seasoned prosecutors with local prosecutorial agencies. There are no prerequisites or interviews for course admission. Successful completion of this course meets the prerequisites for admission to our five-week Traditional TAP course, taught annually in the fall. Completion and certification from Traditional TAP qualifies participants for a pro bono practicum with a local prosecutorial agency trying criminal cases. Written course materials will be distributed via e-mail prior to the first class, so a correct e-mail address at the time of registration is needed. The program will take place at the Los Angeles County Bar Association, 1055 West 7th Street, 27th floor, Downtown. Parking is available at 1055 West 7th and nearby lots. The registration code number is 011857.

$995—LACBA member
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16.5 CLE hours, including 1 hour in ethics
The Gender Factor of Marriage of Facter

FAMILY LAW DISPUTES can easily lapse into a battle of the sexes. This became clear to my partner, Christopher Melcher, and me when we tried to reach a consensus with various amicus committees to file a request to depublish part of a recent decision, Marriage of Facter,¹ but we were never able to get a consensus. The women members voted against filing an amicus brief, and the men voted for it. Facter sets aside a waiver of spousal support in a 1994 premarital agreement. The court held that the sentence in the agreement that waives spousal support was unconscionable. The court compared the income, assets, education, and standard of living of the parties at the time of execution of the agreement and of enforcement and found a significant disparity between the parties at both times. We contended that the law in 1994 required the court to examine those circumstances only as they stood on the date of the agreement. We were also concerned that the court did not define “unconscionability” for purposes of a premarital agreement.

A little background on prenups may be in order. California adopted the Uniform Premarital Agreement Act in 1986. The provision in the act relating to the limitation on spousal support was not adopted by our legislature. Many practitioners believed that one could not limit spousal support in an agreement because there was no specific statutory authorization. In 2000, the California Supreme Court weighed in on this issue in Pendleton and Fireman² and held “no public policy is violated by permitting enforcement of a waiver of spousal support executed by intelligent, well-educated persons, each of whom appears to be self-sufficient in property and earning ability, and both of whom have the advice of counsel....” In 2002, the legislature clarified the law relating to limitations on spousal support in premarital agreements by enacting Family Code Section 1612(c), which allows for a limitation of spousal support but specifically requires that for the limitations to be enforceable, a party must be represented by independent counsel. The code states that unconscionability will be determined at the time of enforcement. Some states refuse enforcement if the waiver of spousal support would make the claimant eligible for public assistance; other states hold that the court may set aside a waiver if it is necessary to avoid undue and unforeseeable hardship, and still others hold that the standard is whether extreme circumstances warrant a set-aside. The courts look at several different factors: What level of hardship must there be to justify setting aside the support provision? Must the circumstances have changed since the execution of the agreement? Must those circumstances be unforeseeable? When there must be an award of support, what are the criteria for determining amount and duration? Unfortunately, the Facter court did not address any of these issues, and the court did not create a clear standard.

When we voiced our concerns to our colleagues about whether this opinion was good law, we found that the viewpoints were divided along gender lines. The female faction wanted to make it easier for parties to void an agreement that waives spousal support. They like the Facter opinion because it does not restrict a trial court’s wide latitude in setting aside a clause limiting spousal support in a premarital agreement. These attorneys contend that prenups hurt women and that courts need to have the ability to determine whether the waiver is fair. The opposing view is that parties who enter into these agreements with the advice of counsel should be held to their promises unless the terms of the agreement or the way in which it was negotiated shock the conscience of the court. It is important that prospective spouses be able to make an enforceable premarital agreement that they can both rely upon. The legal standard for setting aside a limitation on spousal support should be clear, as it is in many other states.

It is not only men who want to limit their liability to pay spousal support. Successful women also want this right, and they enter into prenups. The common view, however, is that women are more vulnerable than men and they need the protection of the courts. Unfortunately, a vague standard as to the meaning of the word “unconscionability” will lead to considerable litigation over the enforceability of prenups. This loose standard will cost parties money, and it will bog down an already overburdened court system. It also fosters a paternalistic view of women as being unable to protect themselves in a premarital agreement that was negotiated at arm’s length.

Since we were unable to get consensus, our firm sent a letter on its own asking the California Supreme Court to depublish the section of the opinion dealing with unconscionability. Those of us who draft prenups regularly want clear guidance on what provisions of an agreement will be enforceable and why.

It is not clear who will win this battle. Men and women see these issues differently, but the battle lines are changing as more women want the ability to enter into a contract that can be enforced. Perhaps a word to both sides is in order: Be careful what you wish for—an ironclad rule can bring harsh results, and a loose one creates uncertainty. Courts will continue to wrestle with these issues as prenups become more common. Perhaps the best the court can do is to strike a balance—and maybe that was what the Facter court was trying to do.


Peter M. Walzer is the founding partner of Walzer & Melcher LLP, which specializes in premarital agreements and family law appeals.
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