SETTING UP THE PRODUCTION COMPANY

The first step in forming a production company is often to create a *business entity*, such as a limited liability company (LLC), limited partnership (LP), or corporation. There are many advantages to setting up a business entity:

- You can divide the financial risk among several people. The members, partners, or shareholders of a business share in the company’s profits and losses.

- Your company is considered a *legal person* and as such can enter into contracts, bring lawsuits, and hold intellectual property rights, such as the copyright to a film.

- You can separate your personal finances from the company’s finances.

- You may die someday, but your company doesn’t have to. Some kinds of businesses can last forever, and ownership interests in those companies, such as shares or membership interests, can be passed down from generation to generation.

And perhaps most important:

- You can avoid personal lawsuits! If your company breaches a contract or infringes a copyright, it will be the company that will pay the damages, *not* the company’s officers or individual members. However, this *limited liability* protection is only offered with certain kinds of business entities (see the information that follows).

**BUSINESS CONCEPTS**

**Limitation of Liability**

Some business entities, such as LLCs, corporations, and LPs, allow their members to limit their liability to the amount that they are invested in the company. The members of such companies are not personally liable for the debts or other legal claims against the company.

So, for example, if an LLC or corporation is sued for breach of contract, the most that each member or shareholder can lose is the amount of his or her investment in that company. If the company is bankrupt and has no more assets, the company’s creditors cannot collect the company’s unpaid debts from the personal assets of its members.
It is important to note, however, that the limitation of liability a company’s owners (its members, shareholders, or partners) might enjoy is not ironclad. There are situations in which a court will allow creditors to “pierce the corporate veil” (a term used for LLCs and LPs as well as corporations) and hold the company’s owners personally liable for the debts of the company. Courts may pierce the corporate veil:

- If the company’s members or shareholders have used the company to commit fraud.
- If the company’s members or shareholders have treated the company as their alter egos—in other words, if the members fail to keep proper company records, mix their personal finances in with the assets of the company, or undercapitalize the company, leaving it without sufficient assets to perform normal business functions.

**Respondeat Superior**

Keep in mind that an employer, such as a production company or producer, is generally legally responsible for the actions of its employees and agents performed during the scope of their duties.\(^1\) This is the *respondeat superior* doctrine.

This means that if your employee gets into a car accident while picking up cast and crew members, your company is responsible for paying the damages from any lawsuit that may arise. Similarly, if your art director infringes somebody’s copyright in creating a painting for your movie set, your company is responsible. Furthermore, if your employee or agent enters into a contract with a third party on your company’s behalf, your company may be bound by that contract. Here the employee vs. independent contractor distinction really matters. (See “Independent Contractor or Employee?,” p. 165.) Liability for the actions of independent contractors, unlike employees, often doesn’t transfer to the contracting party except for:

- Inherently dangerous activities
- Activities that can’t be delegated
- Where the contracting party exercises control over the manner in which the independent contractor performs the work.\(^2\)

If you have a limited liability entity (such as an LLC, LP, or corporation) and your company hires an employee, your *company*, and *not you personally*, will be responsible for paying the legal damages that result from your employee’s actions. On the other hand, if the employee was hired by you rather than by your limited liability business, *you personally* will be responsible for paying all claims, legal costs, and damages.

It is extra work to set up and run a limited liability business, but it may save you from having to sell your house to pay for a lawsuit caused by an employee’s actions.
Keep in mind that it’s not always clear just who is an employee and who is an independent contractor. You may think you are working only with independent contractors, but you could in fact be managing employees. For help with these distinctions, see Appendix D, “A Filmmaker’s Guide to Labor and Employment Law,” p. 393.

**TYPES OF BUSINESS ENTITIES**

The first step in establishing your business is selecting the type of company you will establish. Producers typically do business as one of the following kinds of companies:

- Sole proprietorship
- General partnership
- Limited partnership
- C corporation
- S corporation (S corp.)
- LLC

Some business entities, such as the sole proprietorship or the general partnership, do not require any legal formalities to start up. Other kinds of businesses, such as the LLC, the LP, or the corporation (S or C corp.), can only be created by filing and registering with the state government.

*TIP:* This book cannot cover all the legal requirements for creating a business; there are entire books devoted to that subject alone. The filmmaker is encouraged to seek an attorney who is experienced in setting up business organizations.

**Sole Proprietorship**

The *sole proprietorship* is the default form of business. You are sole proprietor—automatically—the moment you start doing business by yourself, without having formed another kind of company.

There are some advantages to being a sole proprietor:

- Virtually no legal paperwork is involved.
- Decision making is easy because there is only one member of the company—you.

However, there is one huge disadvantage to sole proprietorships:

- There is no limitation of liability. If your business is sued, you are sued. If the business defaults on its debts, you personally must pay the debts.
A general partnership may be formed when two or more people work together to own and operate a business for profit. There is usually no government filing required to create a general partnership, although it is recommended that partners have a partnership agreement or other contract which lays out the partners’ respective rights and duties.

A partnership carries with it certain legal implications, such as:

- **Fiduciary duty.** Each partner has a heightened legal duty of loyalty and good faith toward his or her partners.

- **Unlimited personal liability.** Generally, each partner is personally liable for the debts and obligations his partners incur within the scope of the partnership business.

- **Partnership property.** Unless there is a partnership agreement that says otherwise, the partnership—and not the individual partners—will own all property acquired by partnership funds, brought into the partnership, or contributed to the partnership.

- **Partnership proceeds.** Unless there is a partnership agreement that says otherwise, all partners will share equally in the income and losses of the partnership, regardless of the amount of work they actually do in the management of the business.

Two or more people who work together in a common business enterprise are often surprised when the court determines that they are in fact partners in a general partnership.

One variation on the general partnership is the LLP, not to be confused with the LP (discussed in a moment). Because the right to form an LLP is often restricted to professionals, such as doctors, lawyers, and architects, it will not be discussed in this book.
CAUTION! Be very careful when deciding to do business as a general partnership! Because general partners must answer for the debts of the other partners incurred during the scope of the business, choosing the wrong partner can get you into personal financial trouble.

For example, Carlos and Kim are general partners in KimCarlos Productions, a startup motion picture company hoping to find financing for their first motion picture, *Broken Beer Bottle Blues*.

For the film, Kim decides that she needs to do extensive research on the effects of drinking and depression. Over a two-month period she lives in a neighborhood bar, pounding back expensive imported beer and videotaping herself with the latest high-definition video camera, purchased with an eye toward using it for the film. Needless to say, she runs up quite a bar tab and electronics bill. When her creditors come a-knockin', they can attempt to collect the debt from Carlos personally as well as from KimCarlos Productions and Kim personally.

Joint Venture

A *joint venture* is a special type of general partnership, one formed for a particular and limited purpose. Producers and writers often use joint ventures to combine the forces of two existing production companies for a particular project, such as coproducing a film, writing a screenplay, or creating a television pilot.

To have a joint venture, the joint venture partners must have (1) a common business purpose, such as the writing and exploitation of a screenplay; (2) shared profits and losses; (3) an express or implied contract to work together; and (4) an equal hand in controlling the relationship.

Limited Partnership (LP)

A *limited partnership* is a partnership in which some of its partners may enjoy liability protections:

- The business is owned by two classes of partners: general partners and limited partners.
- Only the general partners are personally liable for all the debts of the business. For this reason, there must at least one general partner.
- Only general partners may obligate the business (authorize the business to enter into contracts, authorize loans, settle lawsuits, hire and fire, etc.).
- Limited partners are liable only to the extent of their investments, but they have no management authority.
- A person may be both a general and a limited partner at the same time.
- A state government filing of articles of organization is required to form an LP.
- Though not generally required, a partnership agreement is recommended.
Corporation

There are two types of for-profit corporations: \textit{C corporations} and \textit{Subchapter S corporations} (aka “S corps”). The features common to both kinds of corporations are:

- The corporation is owned by its shareholders and managed by its board of directors and officers.
- Someone can be both a shareholder and a director or officer.
- Directors, officers, and managers legally obligate the business (they can cause the business to enter into contracts, authorized loans, settle lawsuits, hire and fire, etc.).
- All shareholders enjoy limited liability status.
- A corporation is created by filing articles of incorporation with the state government.
- Ownership interests are conveyed by the corporation issuing shares or by a shareholder transferring shares to another person.
- Bylaws dictate how the corporation governs itself.

The two big differences between the S corp and the C corp are as follows:

- The C corp can have an unlimited number of shareholders, whereas the S corp is limited to 75 shareholders.
- The C corp is subject to “double taxation,” which means that the corporation is first taxed and then the individual shareholders are taxed. The S corp, like partnerships, LLCs, and sole proprietorships, are only taxed at the individual income level.

Limited Liability Company (LLC)

The limited liability company, also known as an LLC, has become the business entity of choice for most small film production companies. This is because it has the limited liability advantages of the corporation with the flexibility of a partnership. Its features include:

- The LLC is owned by its “members.”
- The LLC may be managed directly by the members (in the case of a “member-managed” LLC) or by managers whom the members appoint (in the case of a “manager-managed” LLC).
- Like the shareholders of a corporation, the members and managers enjoy limited liability status.
- State filing, called the \textit{articles of organization}, is required to form a LLC.
- Taxation is on the individual member level, similar to the S corp, the partnership, or the sole proprietorship.
- The rules dictating how the business is run are largely driven by the \textit{operating agreement}, which is a very flexible and highly customizable contract between the members of the LLC.
- In addition to contributing cash, members may also agree to contribute services to the company, such as directing the movie or writing the script, or to
contribute property, such as the copyright to the screenplay or the ownership of the camera or the use of an editing system.

**FORMING AN LLC**

- LLCs are typically formed by filing articles of organization with the secretary of state in the state in which your business is located. At this point, you will need to elect whether your LLC is a member-managed or manager-managed LLC.
- An *operating agreement* should be negotiated, agreed upon, drafted by a lawyer, and signed by the LLC’s members. The operating agreement usually governs the company’s structure, the duties and obligations of each of the company’s members, the amount and manner of the members’ contributions to the LLC, the way finances are handled, and the way voting is determined. Many states require the operating agreement to be signed within a certain time after the articles of organization have been filed.
- If you are planning on raising money with your LLC (usually done by offering LLC membership interests to investors), you should have your securities attorney carefully review, and preferably draft, your operating agreement. See “Investors and Securities Laws,” p. 56.
- Some states have an additional formation requirements. New York, for instance, requires LLCs to publish their formation in two local newspapers within 120 days of formation, designated by the county clerk. Failure to do so results in a suspension of your ability to do business in New York.

The Company as Owner of the Film

Regardless of which business entity the producers ultimately form, the filmmakers must conduct all business related to the making of the film in the name of the company. This means that:

- Everything should be paid for out of a company bank account, not a personal bank account.
- The copyright and other film assets should be transferred to and owned by the production company.
- When making the movie, it is the company that should enter into contracts required for making the film. *It is critical that you first form your LLC and execute your operating agreement before entering into contracts on behalf of the company!* Make sure to sign all contracts in your capacity as company owner, partner, member, manager, shareholder, and so forth. *Do not* sign them without indicating your company status.

**Example:** “Don Simmons, Managing Member, Sprocket Films, LLC.”

- The company, and not the individuals who own the company, should rent, own, or purchase all the equipment.
- The company should hire all performers and crew members.
• Records of membership, partnership, or shareholder interests must be meticulously kept. Each owner’s percentage of ownership must be tracked and records adjusted as new owners join the company. Ownership interest increases and decreases each time owners invest more capital in the company.

Failure to adhere to these and other critical rules could erase the limited liability protections that the company enjoys.

**LOAN-OUT COMPANIES**

*Loan-out companies* are often used by actors and above-the-line crew members. A loan-out company is a company formed for the sole purpose of providing the services of an artist to a production company. Loan-out companies are typically either LLCs or Subchapter S corps.

When a production company is hiring an artist who has his or her own loan-out company, the production company is actually hiring the loan-out company, which in turn is providing the services of the artist.

Any contract with that artist must be drafted so that the contracting party is, in fact, the loan-out company. *Example:* “Production Company, Inc., agrees to employ Lender, Actor’s Loan-Out, LLC, *f/s/o* the Performer, Andie Actor.”

Additionally, all contracts with loan-outs should include an *inducement clause* at the end of the contract. (See Appendix C, “Inducement Clause,” p. 387.)

Keep in mind that loan-out companies should still be required to transfer copyrights and other intellectual property to the production company that engages them under production contracts, just as individuals are required to do. (See “Work Made For Hire,” p. 344.) *Example:* Davida Director has a loan-out company, Dodo, LLC. Peanut Pictures, Inc., engages Dodo, LLC, to provide the directing services of Davida for the film *The Laughing Legume*. Under its director’s services contract with Peanut Pictures, Inc., Dodo, LLC, must still agree that all work done by Davida is done as a work made for hire with Peanut Pictures as the copyright owner.

If the production company is seeking financing in the form of state production incentives, such as tax credits, hiring an actor or director through their loan-out company may require additional guarantees from those workers that their respective loan-out companies will be registered to do business in the state granting the tax credits. (See “Eligibility Requirements,” p. 64).

**Loan-out company terminology:**

• *f/s/o* is a common abbreviation for the term “for services of.”

• *Lender* is typically the defined term that refers to the loan-out company.

• *Inducement* is a promise by the artist that she will perform the services required by the production company as though she were hired directly by the company rather than through her loan-out company.

**THE BOTTOM LINE:** Before you open your doors as a production company, you should form a limited liability business to protect your personal assets.