ADVENTURES IN THE MOVIE BUSINESS

FIDELITY AND SURETY IN HOLLYWOOD

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EASTERN BOND CLAIMS MEETING - MAY 19, 2003
FAIRMOUNT COUNTRY CLUB
Chatham, NJ 07928

I. INTRODUCTION

In calendar year 2002, 467 films were released in the United States. Box office receipts in the United States exceeded $9.5 billion US, and the international box receipts were $9.6 billion.[1] One movie alone, *Spiderman*, made over $400 million. These amounts only include the actual box office receipts and do not include revenues from ancillary revenue streams such as concessions, DVD, video cassette, pay-per-view or premium cable. It should come as no surprise that revenues (and the financing necessary to produce the products that generate these revenues) have proven to be a fertile source of premium revenue for the insurance and surety industries. One prominent publication has estimated that film production-related premiums have recently exceeded the threshold of $100 million per year.[2] With this premium, however, comes the risk of loss. At least one publication has estimated that the London market's exposure to film financing losses is approximately £2 billion sterling.[3]

The theatrical release is still considered by the industry to be the most important stage in the life cycle of a film. The performance of a film in the theaters and for the critics can have a great impact on its performance in the secondary markets. The theatrical release venue, however, is by no means the most profitable. According to a September 2000 research report generated by the international investment bank ABN Amro, global box office revenues account for only 26 percent of the wholesale revenues for a film released today. In contrast, worldwide video rentals and sales now account for 46 percent of the total wholesale revenues for a film.

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[1] See, Motion Picture Association, 2002 MPA Market Statistics.

[2] See, Charles E. Boyle, *Hollywood and the Insurance Industry,* INSURANCE JOURNAL WEST, September 11, 2001.

[3] See, Freshfields, Bruckhaus, Deringer, *Film Financing—Who Bears the Risk?* March 2002.

A closer examination of the home video market illustrates its strength. According to figures compiled by Ernst & Young for the DVD Entertainment Group, licensed copies of 182 million movies and music videos were shipped in 2000, a 90 percent increase over 1999. Consumer spending on video in 2000 was approximately $20 billion, while movie ticket sales were only slightly more than one-third of that amount, $7.5 billion. In fact, the top grossing title of 2000—Buena Vista's *Tarzan*—grossed $268 million in video sales and rentals alone. That is $15 million more than the top movie of the same year, Universal's *The Grinch*, took home at the box office.

The insurance industry and the movies have co-existed for quite sometime. Any movie production is subject to risks and naturally the movie business has sought the assistance of insurance coverage regarding those various risks. For example, some of the largest employers in the State of California are actually movie payroll services. These services retain individuals on a per production basis as employees of the company and "lease" their services to the movie production company that is involved in the filming of a particular picture. These companies are usually on the cutting edge of any issue arising out the workers' compensation area.

In addition, accidents will happen and the movie set has been the scene of many high profile injuries from actors killing themselves with blanks to the temple to stuntmen becoming paralyzed or losing limbs due to a ill-planned action sequence.

Movies, and those in the movie business, are the frequent subject of lawsuits involving copyright violations, thefts of intellectual property and even trade secrets.

All of the foregoing risks can be covered by insurance right down to the most fundamental and basic form of insurance, that insuring the negative of any film production from disappearance or destruction.

Aside from the insurance industry's involvement with the day-to-day aspects of the movie business, insurers have also, through both fidelity and suretyship, been involved in the business of making movies.

II. FIDELITY ISSUES AND THE ENTERTAINMENT INDUSTRY

All industries and all businesses within those industries have characteristics that make them susceptible to victimization by dishonest employees and persons acting in concert with those dishonest employees. The film industry is no exception. The industry's heavy reliance upon outsourcing and third-party vendors creates greater opportunities for graft and kickback schemes than might otherwise exist in businesses and industries that kept all of the out-sourced functions "in house." Related to this is an informal corporate culture and informal internal controls that magnify the opportunities. Finally, the continued exploitation of a property through several product and format cycles creates multiple layers of revenue generation. The following factual hypothetical illustrate how these can combine to create a large fidelity loss.

A. Big Studio vs. Walla

Williams began working at Big Studio in 1989 as a general clerk. He was good at his job and in the course of three years worked his way up to the post of accounts payable manager. It appears that Williams became embittered against his employer because he claimed that a supervisor had informed him that he had no potential for promotion because of an illness he had.

Not long thereafter, Williams began cutting checks to a company called Video Aid. This was a genuine company but did not actually provide services to Big Studio. Video Aid was owned by Williams' cohort and co-conspirator, Walla. Over the next two years, Williams and his co-conspirator used this scheme to misappropriate nearly $1.3 million from Big Studio.

Williams perpetrated the scheme as follows: He would prepare phony Video Aid invoices and then forge signatures of Big Studio employees for the purchase requisitions for the orders. After the invoices were approved, Williams personally generated the checks. At that time, the machine stamped the necessary signature on the check. After delivering these checks to his co-conspirator, Walla, all that remained for Williams to do was to erase the paper trail. He accomplished this through the use of a subordinate's computer access code. He would then change the name of the payee shown in the system and then delete the name Video Aid from the system, retrieving the cancelled checks. He was aided in this scheme by a breakdown in the internal control system, which allowed him to circumvent a vendor approval requirement and also a check reconciliation system, which did not include a review of the actual physical checks.

Williams' supervisors did not know him to have any income other than his relatively modest regular salary at Big Studio. It was, however, generally known that he spent lavishly on modern art purchases, drove a variety of luxury German automobiles and entertained often and lavishly. Additionally, Williams' supervisor knew that Williams tended to give personal attention to some checks, rather than relying on the studio's automated systems. Nonetheless, Big Studio claimed that it did not actually discover the loss until after Williams' death, when a co-worker found the cancelled checks in Williams' home.

When Walla, the co-conspirator, was confronted with the checks, he confessed to the scheme, though he professed to a lack of recollection as to the exact amount of the loss.

A number of evidentiary and coverage issues complicated the claim. Initially, the destruction or alteration of the computer records, the "original" supporting documentation and the checks removed the most reliable evidence. This forced the parties to turn to secondary evidence, such as the co-conspirator's "confession." A number of cases have held that confessions can be admissible as evidence against a fidelity insurer subject to attack on other evidentiary grounds, such as bias and lack of foundation. Indeed, such cases have allowed such statements as proof as to both the existence and the amount of the loss.[4] In the Walla hypothetical, however, the principal's cohort professed to a lack of recollection as to the amount of the defalcation. This forced the insured to rely upon secondary evidence of banking records in an effort to reconstruct its principal's finances and thus to identify by check number the checks the principal employed to perpetrate the scheme.

A further potential complicating factor arose from the possibility that the principal's conspicuous consumption and his supervisor's knowledge of that could be deemed to be "discovery" triggering an early termination of coverage as to him. Was that knowledge "suspicion" or "discovery"?[5]

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[4] See, e.g., American Mutual Liability Insurance Co. v. Thomas & Howard Company, 228 F.2d 550 (4th Cir., 1955); G.M. McKelvey Co. v. General Casualty Company of America, 142 N.E. 2d 854 (Ohio, 1957); Alexander Grant's Sons v. Phoenix Insurance Co. of New York, 267 N.Y. Sub 2d 220 (1966); Letendre v. Hartford Accident & Indemnity, 236 N.E. 2d 467 (N.Y., 1968); Lumbermen's Mutual Casualty Co. v. Renuart-Bailey-Cheely Lumber & Supply Co., 387 F.2d 423 (5th Cir., 1968); Oscar Gruss & Son v. Lumbermen's Mutual Casualty Co., 422 F.2d 1278 (2nd Cir., 1970); Trade Development Bank v. Continental Insurance Co., 469 F.2d 35 (2nd Cir., 1972).

[5] See, Gulf USA Corp. v. Federal Insurance Company, 259 F.3d 1049 (9th Cir., 2001), see generally, Clore, Keeley, *Discovery of Loss, the Contractual Predicate to a Claim, Financial Institutions Bonds* (2nd Ed.) Chap. 4 (ABA 1998).

B. Big Studio vs. Petit

In late 1996, Big Studio received an anonymous letter stating that Petit, the studio's director of the International Theatrical Prints Services Division, was approving false invoices for payments by the accounts payable department. The studio's investigation revealed a two-part scheme by which Petit was believed by the studio to have diverted more than $6 million from the company involving numerous vendors, company employees, and phony companies over the course of ten years.

The general method of the phony invoice scheme was that Petit would supply outside vendors with information they were to use to prepare invoices; Petit would then approve the invoices and submit them to the accounts payable department. Pursuant to Petit's approvals, the accounts payable department would issue checks to these vendors. The vendors would cash the checks and split the proceeds with Petit.

In addition, he offered a garden-variety kickback scheme for ongoing business. His kickbacks would take the form of a percentage of invoices, lavish gifts and vacations, and other improper gratuities.

The claim generated a number of coverage issues. With respect to the fraudulent invoice scheme, once it was established that the employer did not receive any value for the payment, the loss was relatively easy to establish.

The "kickback" scheme was the larger of the elements and the more difficult to establish. Initially, the studio in fact did "legitimate" business with these vendors. Indeed, even the "dishonest" transactions involved services that were actually rendered to the employer, albeit at a grossly inflated price.

The studio took the position that the valuation for this portion of the claim should be the full amount of the consideration paid by the studio. It attempted to supplement this proof by showing the cost structure of the department's transaction after it discovered Petit's activity and argued that this corroborated the value of the claim as postulated by the studio. The carrier correctly took the position that the use of the profit and loss calculation under the circumstances was not proper, citing to the "inventory" exclusion of the policy involved in the claim. (While full discussion of the exclusion is beyond the scope of this paper, readers are commended to more detailed overviews of the clause.) [6]

A thornier issue was presented as to the extent of the coverage for the kickbacks actually received by the employee. A number of cases have held that the bribe or kickback itself is a loss. These cases follow the line of argument that states that inasmuch as the third party would have performed the service for the principal amount less the kickback, the kickback itself as paid by the employer represents a measure of the loss.[7]

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[6] See, e.g., Hugh Reynolds and Terrence Brookie, "Historical Perspective, Development and Application of the Inventory and Profit and Loss Exclusion Clauses", Paper 7 of the *Collected Papers* presented at the ABA Commercial Crime Policy Institute, November 14-15, 1996; see also, Prager & Bear v. Federal Insurance Company, 66 Cal.App.3d 970 (1977); Security Insurance Co. of Hartford v. Wilson (10th Cir., 1986) 800 F.2d 232, 233; Fidelity & Deposit Co. of Maryland v. Southern Utilities, Inc. (11th Cir., 1984) 726 F.2d 692, 695; Mapes Casino, Inc. v. Maryland Casualty Company (D. Nev., 1968) 290 F.Supp. 186, 193.

[7] See, e.g., Fink v. Wiseman (1932) 132 Cal.App. 724, 733; Boston Securities, Inc. v. United Bonding Co., 441 F.2d 1302, 1304 (8th Cir., 1971), affirming 309 F.Supp. 1270; Eagle Indemnity Co. v. Cherry, 182 F.2d 289, 300 (5th Cir., 1950). *Accord,* see, Sears, Roebuck & Co. v. Blade (S.D. Cal., 1953) 110 F.Supp. 96, Sears, Roebuck & Co. v. Blade (S.D. Cal., 1954) 123 F.Supp. 131, *modified* in Sears, Roebuck & Co. v. Metropolitan Engravers (9th Cir., 1956) 245 F.2d 67; Sears, Roebuck & Co. v. Blade (1956) 139 Cal.App.2d 580, 595. Courts in other jurisdictions are in accord. See, Donemar, Inc. v. Malloy (1930)

Query whether the rationale of these cases applies where the full price of the transaction and the nature of the goods and services is disclosed to persons not involved with the scheme and that the transaction is agreed to nonetheless? Can it be said that the "secret profits" rationale of the above-referenced authority applies where the insured actually does not care whether or not the price is inflated? Under such an analysis, carriers have argued that the principal's conduct cannot be said to be an actual cause of the payment, but rather the insured's indifference as to the price. Insured's counsel may argue that such "indifference" is predicated upon a belief that the principal has negotiated the best possible price or, at a minimum, is not benefitting personally from the transaction.

C. Flat Top Entertainment/Deal Memos

Losses involving the entertainment industry are not limited to production companies or studios themselves. Indeed, financing banks are susceptible to scams arising out of film deals. In this hypothetical, an insured bank lent money to "Flat Top Entertainment, LLC," a film production company, in reliance upon certain deal memos, notices and an acknowledgment of assignment (collectively referred to as "Notices"), which were procured by Brian Taylor, a managing member of Flat Top. The Notices purported to reflect agreements with foreign distributors regarding licensing of production projects. The notices were, however, fabricated from whole cloth.

Believing in the veracity of the documents, the bank made loans to the producers of a television series. Although there was no forgery with respect to the actual loan documents them-

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252 N.Y. 360, 169 N.E. 610; In re Browning's Estate (1941) N.Y.S.2d 319; Commonwealth of Pennsylvania v. Insurance Company of North America (1981) 60 Pa.Commw. Ct. 379, 436 A.2d 1067; Fidelity Savings & Loan Association v. Aetna Life & Casualty Corp. (N.D. Cal., 1977) 440 F.Supp. 862, *aff'd* 647 F.2d 933 (9th Cir., 1981).

selves, it was after the fact discovered that the producers of the series were none other than Taylor and his fellow principals at Flat Top. In an ironic twist, the loans were all expressly non-recourse.

The bank brought suit against the bonding company to collect the entire balance on the loans. The bank's theory was that if the bank had known that the documents were fabricated, it would not have made the loans. The bank alleged damages in the amount of all of the outstanding loan balances for the disbursements made after the first loan, whether or not the subsequent loans were based on legitimate or fabricated Notices. The theory underlying this claim was that the bank would not have done business with Flat Top had it known that the Notices were fabricated on any of the production loans. The financial institution bond contained a standard loan exclusion that provided, in pertinent part, that the bond excluded: "Loss resulting directly or indirectly from the complete or partial non-payment of, or default upon, any Loan or any transaction involving the Insured as a lender or borrower, or extension of credit, ... except when covered under Insuring Agreements (A), (D) or (E)."

No bank employee was involved in the scam, thus eliminating Insuring Agreement (A). The fact that the Notices were pure fabrications, i.e., were fraudulent in that they contained fraudulent information, made coverage problematic for the insured. Case law has held that where the document bearing fraudulent representations is fabricated from whole cloth, the loss will be deemed caused by those representations rather than a consideration bearing upon the genuineness of the document itself.[8] Moreover, the insured's claim was further complicated by

[8] French American Banking Corp. v. Flota Mercante Gran Columbiana, S.A. (S.D.N.Y., 1990) 752 F.Supp. 83, 90, *aff'd.* 925 F.2d 603, and Reliance Insurance Co. v. Capital Bancshares (5th Cir., 1990) 912 F.2d 756, 757.

the fact that reported opinions considering the scope of the documents covered by Insuring Agreements (D) and (E) have tended to narrowly construe those documents.[9]

These three hypotheticals illustrate some of the potential sources of fidelity claims connected with the film industry, as well as some of the claim handling and investigative issues that can arise with respect to them. The informality of the industry and the lack of internal controls, combined with the prevalence of outsourcing, operate to create loopholes which the alleged principals in the Petit and Walla claims were able to exploit. This same lack of internal controls, and the destruction of records of the insured that they facilitated, also made the proof and the adjustment of the claimed losses more difficult. Additionally, the multiple levels of revenue streams that a given product is capable of generating created enough of an opportunity for exploitation in the Petit hypothetical. The presence of third party financing and the involvement of special purpose production entities combined with the informality of the transactions at issue to create the opportunity for the alleged malfeasance in the Flat Top hypothetical. Understanding of these business conditions within the entertainment industry will be helpful at the risk management, underwriting and claim stage in limiting the possibilities of such losses, and in their proper adjustment once they occur.

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[9] See, e.g., FDIC v. Fidelity & Deposit Co. of Maryland, 827 F.Supp.385 (5th Cir. 1995), *aff'd.* 445 F.3d 969; KW Bancshares v. Syndicates of Underwriters at Lloyd's, 965 F.Supp. 1047 (W.D. Tenn. 1997); Merchants National Bank of Wynona v. Transamerica Insurance Co., 408 N.W. 2d 651 (Minn.App. 1987). Cases involving other fidelity coverages are generally in accord. See, e.g., Hobart Mfg. Co. v. Fidelity & Deposit Co. of Maryland (6th Cir. 1966) 360 F.2d 453, 456; The Von's Companies v. Federal Insurance Company (C.D. Cal. 1998) 57 F.Supp.2d 933, 945, *aff'd.* (9th Cir. 2000) 212 F.3d 489; see generally, Haley, "Clause E: the Continued Importance of Defined Terms and Causation Requirements," *Financial Institution Bonds*, 2d Ed., Clore, Ed (ABA, 1998).

III. SURETIES GO TO THE MOVIES

Aside from being involved with the fidelity aspects of the movie business, insurers have also taken on responsibilities with respect to the actual financing of films. In a standard tripartite surety relationship, many large insurance companies have undertaken the obligation of guarantying the delivery of motion pictures to banks or other large financial institutions.

The focus of this part of the paper will be on the product commonly marketed to assure independent film production, the "completion guaranty."

A. Completion Guaranties

A Completion Guaranty is a product marketed, generally by a surety, and generally through an agent, to financial institutions which lend money to independent film producers who might otherwise not have the resources to make a motion picture. A film completion guaranty is a surety relationship in that it meets the standard definition contained at hornbook law. If a surety is "one who answers for the debt, default or miscarriage of another", then the guarantor meets that definition in that they make themselves available should the production company fail to deliver, in a timely fashion, a motion picture thereby jeopardizing the repayment of a loan extended by a bank to that production company.

Under the standard Completion Guaranty scenario, the bank or the lender is the "obligee", the production company is the "principal" and the "bonding company", usually acting as an agent for an insurer, is the "obligor."

Given the increase in film and tape production, the completion bond business has hit the "big time".[10]

B. Independent Film Financing

Normally, one associates movie production with the movie studios. This is generally true. Studios like 20th Century Fox, Warner Brothers, Disney, etc., will provide the funds necessary to make their own films. Therefore, if it costs Disney $125 million to make *Toy Story*, Disney will provide that money based upon its own reserves and revenues. Though co-production is not unheard of, and is apparently becoming more popular, the risks taken in the movie business are usually taken by the movie companies themselves.

The same is not true for independent film making. By its very nature, independent film making generally involves small production companies with similarly sized movies. That is, the budgets may be substantially less than your average Hollywood production and the means of making those movies will be limited as well.

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[10] In 1999, International Film Guarantor, a limited partnership between Fireman's Fund and Near North National Group, bonded over $1 billion in aggregate budgets. See, "Billion Dollar Budget Bonders", *Daily Variety*, Nov. 27, 2000.

For an independent production, monies will have to come outside of the traditional sources. Independent productions will rely in large part on equity investments by individual investors or by venture capital companies. Even then, sources for production money may be limited. Because of this, many independent film companies will have to rely upon a traditional lender, such as a bank, to give them the money to make their movie.

Lending money for movie production is not widespread in the banking industry and it is generally limited to just a few of the larger banks, along with some "boutique" banks which actually have separate divisions which deal in film financing. For example, Comerica Bank, one of the largest in the country, does have, headquartered in Los Angeles, a division which specifically handles independent film production requests. Another company, the Lewis Horwitz Organization, is actually a division of a larger bank which specializes in assessing and underwriting loans to production companies.

Given the inherent risks in any movie, even one involving big name stars and high production values, the banks are necessarily wary of giving money to producers. The reason for this is, in part, because of the nature of the production companies themselves.

While there are a few independent film companies, generally every movie production commences with the creation of a limited liability corporation charged with nothing more than the making of a movie. That is, a shell entity is created through which monies are funneled for the production of a specific movie. For example, if you were making the movie "The Claims Handler", you would create, as a first step, a limited liability corporation entitled something along the lines of "Claims Handler Productions." That limited liability company has absolutely no assets and its only purpose is to get money so that it can spend that money to make the movie.

Given the nature of a production company, a bank would have to think twice about lending money to that company because, if at the end of the day the money is gone and there is no movie, there is not going to be anyway to get repaid. As a consequence, the bank has taken several steps to try and guaranty repayment of the extended credit.

The first way in which the bank garners some measure of security is through what is called a "pre-sale." A pre-sale is exactly that. The production company has presented the idea for the movie to the various potential customers and those potential customers have indicated, generally through contract, their desire to purchase that film at a set price in the future when it is completed. Normally these pre-sales are done for distribution rights in certain distinct areas.[11]

For example, you may sell the distribution rights to the completed film "The Claims Handler" to a company in Italy for distribution in the Italian market. Because it is a big world, you would also have the ability to sell the Spanish market, the Luxembourgian market, the Far East and any other countries you can think of. Armed with these pre-sales, an independent film producer will then approach the bank for a loan to allow that producer to make the movie. The pre-sales will be tendered to the bank as a form of collateral. That is, if your budget for "The

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[11] Until recently a lot of money for independent films was coming from Germany due to a loophole in their tax laws which allowed investments in movie productions to act as a tax shelter. See, Greg Bernstein, "Film Finance 2002", The Business of Film, May 2002.

Claims Handler" is $20 million and you already have $10 million in pre-sales for foreign rights, the bank will assess that collateral and determine what the outstanding risk might be. While pre-sale rights to certain countries may be given credit for 100 cents on the dollar, certain other less "reliable" countries may not be afforded full credit. In any event, the bank will assess the amount of pre-sales to determine whether or not its risk has adequately been covered.

The bank will also look for equity investments should there be a shortfall between the pre-sales and the ultimate budget of the film. Therefore, if the ultimate budget of the film is $20 million, and you have successfully garnered $10 million in pre-sales, a bank may expect to see up to $10 million in equity commitments from other investors. In this way, the bank maximizes its security for its extension of credit.

In some very limited circumstances, and this was especially true in the mid-1990s, banks were issuing what is called "gap" financing. That is, if as an independent film producer your film was budgeted at $20 million and you had $10 million in pre-sales and $8 million in equity investment, the bank would consider financing the film even though there was a "gap" of $2 million between the budget and the security. As can be expected, banks made a lot of money off of this financing for sometime, but later started losing bucket-loads of money and it is not nearly as prevalent as before.[12]

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[12] See, Greg Bernstein, "Where Does the Pecuniary Loss Guarantee Fit Into The Financing Picture?", The Business of Film, May 1998.

Even despite the existence of pre-sales and equity investments, a bank will, as a final step, seek a completion guaranty before extending any credit to an independent film producer. This the bank does out of an abundance of caution to make sure that its loan is more fully secured.

C. What Is A Completion Guaranty?

According to standard industry thinking:

> A motion picture completion guaranty is a written contract that guaranties a motion picture will be finished and delivered on schedule and within budget. . . . In general, a completion guaranty ensures banks and financiers that:
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> 1. The producers will complete and deliver the film in keeping with the screenplay, budget and production schedule that the bank or financiers approve; or
>
> 2. The completion guarantor will complete and deliver the film in keeping with pre-approved screenplay and production schedule, and advance such sums in excess of the pre-approved budget necessary to do so; or

3. In the event production of the film is abandoned, the completion guarantor will fully repay all sums invested in the film by the bank or financiers.[13]

Obviously, the best case scenario for the surety is number 1 listed above. Under options 2 and 3, the surety is going to lose money.

D. The Underwriting Of A Completion Guaranty

Given the fact that a completion guaranty is a form of suretyship, you might think that the standard underwriting considerations apply. However, the three "Cs" normally invoked in any suretyship situation (capital, capacity and character), are of little value when considering a risk in the movie business.

In terms of "character" and "capacity", the underwriter must of course assess the track record of the individual who is making the movie. What is the producers past experience and success? Is this producer capable of doing what they are trying to do with respect to this particular film? Are all of the proper elements in place to make this film succeed?

The character and capacity of the individual producer associated with the production is an even greater concern in the movie business because the "capital" aspects of any production company are severely underwhelming. As previous stated, a production company is

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13 International Film Guarantors website, http://www.ifgbonds.com.

usually a limited liability corporation which has no assets other than the bank loan which it is going to take to make the film. Therefore, unless some personal guaranties are secured (and this is often the case), there will be no resort to anything other than the movie itself should things fall apart. The only collateral existent would be the actual negative stock of the film as well as any pre-sales. However, if the film was never completed, then pre-sales are of no use to anyone seeking to cash out collateral. Similarly, the shot footage will likewise be basically worthless.

As one would expect, insurers are generally not in a position to assess the risks and benefits of making any particular film. There is very little expertise in this area and the task of assessing underwriting risks must necessarily be borne by companies and people that make their living in the film business. For this reason, while completion guaranties will generally be backed by an insurer, the negotiation and underwriting of a completion guaranty will usually be undertaken by what is called in the business a "bonding company." While those involved in the surety industry may think of a "bonding company" as an insurer, that is not the case with respect to film completion guaranties. Instead, the bonding company is a business that has been created specifically for the purpose of assessing independent film production risks, underwriting those risks, and negotiating a price for the undertaking of those risks.

The bonding company will be familiar with the other players in the independent film business and will be on the lookout for what it perceives to be quality productions. If the bonding company is approached by an independent film maker for purposes of securing a completion guaranty, the bonding company will undertake its own evaluation of the budget, the screenplay, the actors, and other key "elements", to determine whether the film is viable at the budget set. If the bonding company believes that the budget is adequate, and that pre-sales and equity are sufficient, the bonding company will then prepare an underwriting report which it will forward onto its insurer.

The insurer will then generally have someone in its underwriting department who will be conversant on the underwriting of films and who will give their thumbs up or down to the production. If it is a thumbs up, then the commitment to go forward is in place and, in exchange for costs and a premium, a film completion guaranty will be issued. In this regard it is important to note that only the amount necessary to actually complete the proposed film will be bonded by the completion guarantor. There are other budget considerations which may be important at some later time, after the completion of the film and after the film has made money, however, only the actual "strike price" will be bonded under the guaranty. Therefore, if a bank lends $20 million to make a film and only $15 million is necessary for purposes of completion of that film, the bonding company will undertake only the risk of that $15 million and not the entire loan.

E. The Paperwork

A completion guaranty is by now a standard form wherein certain numbers and amounts are plugged in. The most important part of the completion guaranty will be the budget which is agreed upon by the parties as the amount "bonded" or guaranteed. That budget will list the amount required for each particular element of the film production and will also, generally, list a 10% contingency which is retained for backup and security purposes.

Along with the completion guaranty, the parties will usually execute what is called a "Producer's Agreement", which in essence states that if the producer for whatever reason cannot finish the motion picture and is viewed to be in default of its obligations, the bonding company itself may step in and take whatever action is necessary to insure that the film is done on time and at the budget price. This particular document is interesting in that it actually makes the bonding company the agent of the producer for purposes of film completion. This is opposed to the completion guaranty wherein the bonding company acts as the agent of the insurer for purposes of that particular contract.

Premiums for completion guaranties are as varied as the film productions themselves. Many bonding companies charge a flat fee based upon the production budget, i.e. \$100,000 for every \$10 million in production. Other companies charge a percentage of the overall budget and the percentage charge will vary from bonding company to bonding company. In addition, some bonding companies will take more in "premium" as a form of security deposit, rebating the premium at the completion of production should there be no claims against the bond.

While obviously, the best scenario for the surety is a picture delivered on time and under-budget, that is not always the case.

F. <u>What Is Delivery?</u>

The key date in any completion guaranty is the delivery date of the film. Set out in the completion guaranty will be a date in the future by which the completed film must be "delivered" to a designated sales agent for purposes of marketing. If the movie is not delivered by the scheduled delivery date, then the obligations of the guarantor are triggered and the guarantor would be responsible for the repayment of the loan extended by the bank.

As can be imagined, many disputes arise over what exactly constitutes "delivery." Typically, delivery is defined in the contract in a manner whereby the film must be in the hands of a sales agent who will then undertake the process of securing a domestic distribution deal for the film. Generally, domestic distribution deals are done only after the film is completed and after the distributors (read large movie studios) have had an opportunity to look at it. But delivery does not end there.

Not only must the completed film be in the hands of the sales agent, but it is also necessary that the movie meet certain minimum criteria. That is, if it is supposed to be a color film, it better be in color. If the movie is supposed to have Al Pacino in it, then it must have Al Pacino. If the movie is supposed to be about a boy who befriends an extraterrestrial and hides him in his closet, then the movie had better be "ET".

By far, the biggest area of potential dispute between the bonding company and the financial institution will be regarding the delivery of the motion picture.

That is not to say, however, that the parties are unreasonable in their expectations. If the delivery date for a motion picture does not appear practical given the current status of the film, and if the bank is satisfied that the film is being made in accordance with the various elements that will be necessary to ensure repayment of the loan, then the bank will in most cases provide an extension of time within which to provide delivery. This appears to be standard operating procedure.

While banks will cooperate in terms of providing an extension of time to deliver a film, if an extension of time is required to deliver a film, this will usually mean that the bonding company will be involved, contributing either its time or its money, or both.

G. What If There Is A Problem?

As in any suretyship agreement, despite the best underwriting, problems will on occasion develop. This is true in the movie business as well. Problems are usually as a result of delay and delays can be caused by a variety of things including bad weather, the destruction of sets or locations, illness to actors and even political insurrections. While delays are not good, and delays will cost money, these are not the worse situations. The real problems arise in situations where the film is simply running out of money.

For whatever reason, budgets are not always accurate and there may not be enough money to complete the film as planned. Though a lack of adequate funds may be the result of bad planning, dishonesty (producers skimming money) or extravagance (so called "enhancements" to the film), responsibility for any shortfall in the budget will ultimately find its way to the completion guarantor. This, of course, makes sense when we consider the production company has no assets and, unless there is a personal guaranty involved, will have no further incentive to put money into the picture other than to perhaps salvage its reputation, which may now be damaged beyond repair anyway. At this point, the bonding company will get involved and will attempt to make the best of a bad situation. Oftentimes, the bonding company will be viewed as adversarial to the "artistic" aspects of the film and that may make matters worse. The goal of the bonding company is to get the picture made as quickly and as cheaply as possible. That is not, of course, the goal of the people actually working on the movie, many of whom have put their careers and reputations on the line.

There is no question but that the biggest problem concerning the failure to deliver a picture on time and at budget is a director with great aspirations. While the bonding company tends to see the movie as "product", which must be done and completed on time, a director may have a more artistic view of the production and may want to take more time and expend more funds than might otherwise be necessary for the basic completion of the film. In this case, a very adversarial relationship may develop between the actual makers of the movie and the people whose job it is to see that the movie is done on time and at budget.

While there are countless examples of bonding companies who have provided completion guaranties which resulted in the successful completion of a motion picture, there are also numerous examples of pictures that were described in some industry publications as troubled and eventually caused losses to the guarantors. Examples in this latter category would be "Malcolm X", "The Adventures of Baron Munchhausen", "The Ninth Gate" with academy award winning director Roman Polansky and "The Devil and Daniel Webster", starring Anthony Hopkins. One film, "Don Quixote", was even abandoned before it could be completed. This is rare in the movie business but it does apparently happen. In fact, in a very ironic twist, the movie "Don Quixote" and its ultimate abandonment was itself the subject of a movie not too long ago.[12]

Recently, there have been a number of large losses in the completion guaranty arena.[13] Bonds are, based upon conversations with those in the film business, getting harder to come by. What the cause of the recent spate of bond calls may be is unclear. One observer of the London market has stated:

> Perhaps we did not look at the full picture. The entertainment industry is generally successful overall because a few blockbusters make all the money, covering losses for the many films that do not break even. In 2001, the top 4% grossing films accounted for 40% of the U.S. box office.[14]

The movie business seems to be very much one where the "haves" have and the "have-nots" don't. Again, underwriting based on character is key and an agent who knows the film industry, its players and its unique set of circumstance is indispensable.

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[12] *"Lost in LaMancha"*, an IFC production, directed by Keith Fulton and Louis Pepe.

[13] For example, in the April 21, 2003 *"Business Insurance"*, there was an article detailing a court order requiring AXA Reassurance, S.A. to pay $14.4 million to Chase Manhattan Bank for loans arising out of the 2000 Burt Reynolds movie, *"The Crew"*.

[14] Alan Chalk, *"Destroying Value in An Insurance Company"*, The Actuary, April 2003.

Many companies have dipped their toes in this water and for many years it was very lucrative. Recently, however, insurers have been, to quote former film producer Sam Goldwyn, "staying away in droves". This may be the result of some big hits on these risks or it may be related to general cutbacks in underwriting due to losses in other areas of business. The need still exists, however, and whether the final script for independent film production guaranties will have a happy ending remains to be seen.

IV. <u>CONCLUSION</u>

Like any large business sector, the film industry presents much in the way of opportunities for savvy insurers. Many products have been developed over the years in an attempt to garner studio monies. Fidelity and surety have not been excluded. Given the nature of the business, it appears that the film community will continue to seek insurer assistance in cutting risks and picking up the pieces when disasters happen. This is especially true in the independent film production arena where, without the assistance of the financial wherewithal of large insurers, dreams may never find their way to the screen.[15]

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[15] The assistance of Mark Krone, Esq., Anderson, McPharlin & Conners, in the preparation of this paper is gratefully acknowledged.