Bloomberg BNA

Mergers & Acquisitions Law Report™

Reproduced with permission from Mergers & Acquisitions Law Report, 19 MALR 100, 1/18/16. Copyright © 2016 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

INTELLECTUAL PROPERTY

Corporate Transactions in the Entertainment Industry: Special Considerations for Copyright Assets

BY CAROLYN J. CASSELMAN

In the landscape of prospective M&A and financing transactions, entertainment properties offer a potentially attractive package, particularly for buyers and investors drawn to a steady stream of income, a known universe of assets and the added perk of curb appeal. Negotiating such deals, however, requires crafting a diligence process and risk analysis suited to the unique characteristics of copyright assets. Careful consideration should be given to variables such as the selection of properties that will be subject to diligence scrutiny, the nature and duration of existing exploitation, and the impact of third-party participations and rights on future value and exploitation. Experienced counsel can provide oft-needed guidance in designing and implementing the diligence review–including selection of the diligence sample, review of ''in bound'' chain of title, supplementation of primary diligence sources with third-party search reports, and analysis of ''outbound'' rights and money. This article is geared primarily towards transactions concerning film library properties, namely, seasoned assets comprised of existing works.

Carolyn Casselman is a Counsel at Paul, Weiss, Rifkind, Wharton & Garrison LLP, New York.

Issues specific to other asset classes or asset packages where a material portion of the works remain to be produced are briefly highlighted where applicable.

Selection of an Appropriate Sample

Unless the asset portfolio is relatively small, diligence will likely encompass only a portion of the total properties. For library assets, this entails selecting a sampling of titles based on criteria that vary depending on deal-specific priorities; in some instances, simply reviewing a slice of the top earning properties won't provide a fully nuanced understanding of the asset portfolio. For library assets, value is likely to be based on the reasonably foreseeable income generated by existing uses; more generally for entertainment properties, valuation may also assess opportunities for new revenue by such means as re-booting franchise properties, exploiting new distribution channels or securing new advances from third parties for exploitation of rights after the expiration of existing third-party arrangements. The selection process for the diligence sample should take into account the particular value analysis of the contemplated transaction, including whether income is evenly spread across assets or concentrated in top earners.

The diligence process should provide comfort as to the quality of the chain of title for the portfolio rights taken as a whole. Gaps in the chain of title of individual properties may indicate risk that a competing claim to that title may emerge, and, more broadly, may also suggest a somewhat carefree attitude towards building and maintaining the subject assets. Assessing whether chain of title gaps present a material issue involves consideration of the relative expected value of the titles where chain of title risk is exposed as well as the potential nuisance factor of either cleaning up title defects (which may be necessary in order to enter into new exploitations of the properties, since subsequent grantees may make satisfactory chain of title a condition precedent) or defending against a competing claim. In addition to limiting exploitation opportunities, title defects

COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1098-4720

carry the further risk of diverting management time and resources to remedial tasks, rather than maximizing revenue of the assets.

A final consideration in selecting a diligence sample is deal structure. Business practices in the entertainment industry give rise to several different ways in which the subject content assets may be owned or controlled, including acquisition of finished product (either on a title-by-title basis or by means of a larger acquisition transaction such as the purchase of an entire library), production or co-production, or license of distribution or other exploitation rights. The manner and method by which properties have been acquired may impact deal structure, owing in part to possible limitations on the assignability of intellectual property contracts and the nature of opinions that may be rendered. Assembling a diligence sample that encompasses the range of ways the current owner has come to control the portfolio assets may flush out both structuring and disclosure issues, and will offer a more complete understanding of inbound chain of title.

Inbound Chain of Title Review

A key task of the diligence process is to confirm that the chain of title for the particular rights at issue reaches from the instance of creation to the current owner (so-called ''inbound'' chain of title). For example, it may be the case that the copyright registration of a particular title is in the name of a third party, or the work may have multiple contributors of copyrightable content.

To facilitate this review, the current owner (*e.g.*, seller or issuer) should provide chain of title documents for the properties in the diligence sample. These documents are likely to include some or all of the following: underlying rights agreements; service agreements, particularly for writing and directing services, but sometimes also for other ''A-list'' talent such as actors; co-financing and co-producing agreements; acquisition agreements (both for individual titles but also transaction documents for any multi-title purchases), and distribution agreements.

With respect to underlying rights agreements, key data points include identifying the scope of rights granted, available distribution channels and media, and any conditions or circumstances that may trigger lapse of the rights, whether as a result of default, expiration or copyright termination. With respect to this latter issue, if the subject assets have material exposure to the potential for rights owners to effect termination under the United States Copyright Act, counsel with particular expertise in this area should be consulted.

Review of service agreements (*i.e.*, agreements with directors, designers, and other talent) should confirm that – consistent with widespread practice in the television and film industries – such services have been rendered on a work-for-hire basis and none of the creative contributors separately control rights or can exercise material ongoing approvals. In other spheres of the entertainment industry, primarily publishing and live stage, the individual author may retain the copyright in his or her work, and in particular this may mean confirming the potential buyer or investor understands the impact this may have on any intended new exploitations of existing properties.

Co-financing agreements are common arrangements in the entertainment industry whereby two or more parties finance the production of a project and allocate the various rights between them (these agreements are also sometimes be described as co-producing agreements, a more nebulous term that may encompass the co-financing relationship described here but also any manner of arrangements between parties who either control certain rights or require a certain association with the project because of relationships with talent, money or other rightsholders). Co-financiers typically split rights according to the parties' specific interests or expertise; for example, in the case of a film, one party may receive domestic distribution rights while the other receives international, or the parties may divide the rights based on the various distribution channels, *e.g.* theatrical, home-video, and the ever-increasing variety of digital options such as electronic sell-thru, pay per view and streaming. Counsel will want to review a sampling of co-financing agreements to gain comfort that rights built into valuation calculations are in fact allocated to the current owner or issuer, not the co-financing counterparty.

Assembling a diligence sample that encompasses the range of ways the current owner has come to control the portfolio assets may flush out both structuring and disclosure issues, and will offer a more complete understanding of inbound chain of title.

If a meaningful portion of the asset package has been acquired rather than produced or co-financed, then counsel should have an opportunity to review the acquisition agreements to determine both the scope of rights that were purchased from the seller as well as the liabilities that were assumed by the purchaser. Similar to the goal in reviewing co-financing documents, diligence should seek to confirm that these acquisitions transferred rights consistent with both the valuation and, in any transactions requiring disclosure, descriptions in the prospectus and other marketing materials. Liabilities should be reviewed with an eye towards identifying potential to hamper the flow of revenue, restrict exploitation of the subject titles, or divert resources from exploitation to defense of claims. Diligence should also confirm that acquisitions were properly recorded with the Copyright Office; although recordation is not necessary to consummate an acquisition transaction, recordation does serve to put third parties on notice of the change of ownership and is part of evidencing good chain of title.

Some or all of the asset revenue stream may be comprised of inbound distribution rights, meaning that the properties are primarily owned or controlled by a third party, but the seller or issuer has the ability to exploit the property in specified territories or through enumerated distribution channels as a result of an inbound license with the third-party owner. Review of distribution agreements (which in some instances may be wrapped into a co-financing relationship) should aim to confirm

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1098-4720

that the duration of the granted rights is accurately reflected in the valuation or the timeline of the transaction (for example, if a consistent revenue stream is needed to service transaction payment obligations). For distribution agreements that renew, counsel may want to note whether there are any notices, performance milestones or payments required to effect such renewal. Finally, to the extent that the potential appeal of the subject assets is finding new means of exploitation, review of distribution agreements can give insight into whether any as-of-yet unexploited rights are available to generate new revenue streams.

Structuring Issues

Review of inbound chain of title documents may also impact deal structure, particularly in the potentially tricky area regarding the transferability of copyright licenses. Many contracts dealing with rights in entertainment properties will be governed by California law, and thus subject to the Ninth Circuit's much-criticized but still standing decision in *Nike v. Gardner*. Counsel may wish to give careful attention to any assignment or sublicense restrictions governing inbound rights. Under the *Nike* rubric, notwithstanding that an exclusive license is considered a transfer of ownership under the United States Copyright Act, an exclusive copyright license that is silent as to the ability of the licensee to assign or sublicense the subject rights is deemed to prohibit such transfer absent the consent of the licensor (and obviously an agreement with an express restriction on assignment or sublicense would also be problematic). This may necessitate the use of deal mechanics to appropriately transfer proceeds in the event certain rights or agreements cannot be transferred.

Search Reports as Supplement to Review of Other Documents

Supplemental to review of the primary chain of title documents, it can be helpful to engage a third-party search service to prepare copyright search reports of titles in the diligence sample to determine whether the public record accords with the documentation provided by the asset owner. It is common practice in the entertainment industry to record assignments, exclusive licenses, liens, and notices of other corporate transactions that bear on the chain of title such as mergers or acquisitions, with the United States Copyright Office. If the search report of the Copyright Office records reveals unexpected liens, assignments or other activity that would impact either ownership of rights or cash flow, it merits inquiry and further discussion with the target. Frequently these colloquies turn up matters that can be remedied – liens that should have been released but were not, license agreements that were recorded but subsequently expired – but in some instances, genuine and serious flaws in the chain of title emerge that may result in restructuring or revaluation of the transaction.

Outbound Rights and Money

Although major content owners may self-distribute properties in key distribution channels or territories, in many cases distribution will occur through one or more agreements with third parties; these are so-called "outbound" agreements. Review of outbound agreements should focus on the duration of the existing arrangements, available channels of distribution and third party participations.

The expiration or termination of an outbound distribution agreement could disrupt incoming revenue while a new distribution arrangement is negotiated, thus causing the assets to lie fallow. This risk is particularly acute if the assets are licensed *en masse* to a third-party distributor on an exclusive basis. Or, conversely, counsel may identify a distribution agreement with subpar financial terms or lacking incentive for the distributor to actively market the assets, which may be problematic if the agreement has significant time to run on the term. Furthermore, if the valuation model calls for an expansion of the distribution channels through which the assets are exploited, it may be useful to confirm that rights to exploit the properties in the new distribution channels have not already been granted to an existing distributor, or if such rights have been granted but are not yet being exploited, that the terms of the governing distribution agreement are in fact likely to result in new revenue streams.

Frequently there are third party participants such as directors, star actors, co-financiers and underlying rights holders who share in the revenue stream derived from exploitation of outbound rights. Any revenue modeling should take into account these participations, but for assets where a small number of properties are responsible for a material portion of the income, diligence may also wish to confirm whether these participations escalate based on certain performance thresholds.

In addition, counsel may also want to consider any instability risks of distribution counterparties. Poor performance, insolvency or bankruptcy of a distributor will materially impact the revenue. Even if the circumstances are serious enough to constitute breach under the terms of the distribution agreements, termination is not a simple-fix solution, and finding a new distributor and negotiating a new distribution agreement can be a complex and time consuming process.

Future Projects

If the subject assets include projects that have yet to be produced, the risk calibration of the transaction expands to include the likelihood that a portion of both available cash and management attention will be dedicated to production activities, not just exploitation of existing assets. It is more difficult to project the income stream of a project that has not yet made a debut in the marketplace, although sequels, remakes or other derivatives of already established titles will generally be considered less risky than fresh projects. One way to address the unique aspects of these types of asset classes is to incorporate tailored deal mechanics, such as specifying parameters for new projects (*e.g.* budget range, MPAA rating, or overall caps on the number of new projects in active development) and limiting such activity if certain revenue or performance triggers are breached.

If any projects in the portfolio are currently in production or in the process of gearing up, it may be appropriate to inquire whether completion bonds have been acquired; completion bonds are a form of insurance whereby, broadly speaking, a third party is given the

right to take over if production on a project has stalled. Although completion bonds are not a panacea for production risk (and are not always available), they can provide some measure of comfort that at a minimum, there will be finished product that can be exploited, and thus some revenue can result from the production expenditure. Diligence of future projects should also include a review of relevant underlying rights and service agreements to confirm that the production timeline appears to be consistent with applicable option periods for necessary rights and availability of key personnel and to confirm that payments for rights and services are within reasonable and customary industry parameters.

Summary

Although entertainment properties carry certain risk because of the subjective and changing taste of consumers and the ever-evolving landscape of media platforms, a diligence process led by knowledgeable counsel can assist parties in properly structuring a transaction to reflect realistic valuation and performance assumptions and, if applicable, preparing a prospectus and marketing materials that accurately represent both the appeal and risks of such assets. In addition, a deal team that has been engaged in a thorough and communicative diligence effort will be better equipped to effectively negotiate terms that are responsive to identified issues.

 COPYRIGHT © 2016 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1098-4720