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## The Hollywood Shuffle: Protecting Film Investors

Mark Litwak

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The

## HOLLYWOOD

Shuffle:

**Protecting  
Film  
Investors**

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ilm investors face a number of potentially serious economic risks every time they fund a movie project. Combine the whims of audience taste with unscrupulous or inexperienced filmmakers, throw in the inherent risk of any investment, and you've got a fantastic script for a disaster picture. Equal parts art and business, the motion picture industry has born witness to the fact that creating a marketable film product will always be risky. Unlike many manufactured products, there is no formula for churning out a series of hits in assembly-line fashion. The major studios regularly release big-budget flops made by top writers, filmmakers, and stars; for every *Forrest Gump* there are 10 *Hudson Hawks*. Independent producers fare no better.

By Mark Litwak

In Los Angeles, the city of a thousand stories, many tales are told by financiers who complain they have been cheated by producers or distributors. As would be expected in any industry grossing about seven billion dollars annually at the domestic box office, the movie business attracts more than its fair share of disreputable characters. The glamour of the business ensures a steady stream of star-struck investors motivated by non-financial concerns. This combination of the unsavory and inexperienced often produces hand-shake deals made without the proper investigation and due diligence. Consequently, experienced investors often refuse to even consider film-related investments. This is unfortunate because an intelligent investment in a motion picture can earn substantial returns.

Although risky, the potential return from a hit can be enormous. *The Blair Witch Project* was produced for a paltry \$40,000 yet it grossed \$142 million at the domestic box office.<sup>1</sup> In this age of media overlap, the once hard lines between movies, music, and games have become blurred. Not only can a film earn revenue from box office receipts, but also from numerous sources of ancillary income, including television, home video, merchandising, music publishing, soundtrack albums, sequels, and remakes.

The potential rewards available to a film investor can far outweigh the risks - if the investor knows which questions to ask, what to demand, and when to listen. As an attorney who represents investors as well as filmmakers, I have learned that

there are ways to reduce the risk of film investments. In essence, an investor can greatly reduce his or her exposure to risk by taking three fundamental steps: conducting thorough research, analyzing the marketability of the project, and obtaining sound legal guidance.

In essence, an investor can greatly reduce his or her exposure to risk by taking three fundamental steps: conducting thorough research, analyzing the marketability of the project, and obtaining sound legal guidance.

*"The facts Ma'am. Just the facts."*

## **DUE DILIGENCE**

Thorough investigation of all the participants involved in any investment deal is of the utmost importance. Just as an experienced investor would research a corporation before purchasing a share of its stock, an attorney should check into the reputation and track record of any producer or distributor with whom her client contemplates doing business.<sup>2</sup> Background checks should involve such things as speaking to filmmakers and investors who have done business with a candidate,

reviewing a candidate's previous work, and even obtaining court records to see if the candidate or his company has been sued. Simply put, research will greatly increase the odds that your business partner will be a person of integrity who brings the necessary skills, expertise, and resources to the endeavor. One of the easiest ways to determine the professionalism of a potential partner is his track record.

The importance of the track record of the film's producer or distributor cannot be understated. A prudent film investor should never back a filmmaker or production team that does not possess the proven skill needed to make a professional-looking movie. While the rewards of such a venture are potentially high, the risk involved in investing in a first-time filmmaker is great. You are safer backing filmmakers who have completed at least one short or a feature-length work. Filmmaking possesses

such a tremendous learning curve that a filmmaker with many films to her credit will be immeasurably more professional, prepared, and understanding in dealing with you and your potential business relationship. I recently met a novice filmmaker who completed production only to discover that his movie was shot with a defective lens. Fixing the problem would require tens of thousands of dollars in additional expenditures. Obviously, this is not to say that a first-time director will never be professional or will never make a hit movie. Quentin Tarantino's film, *Reservoir Dogs*, was a critical and commercial success. However, it is

safe to say that such success is the exception rather than the rule.

## FULL DISCLOSURE

Federal and state security laws are designed to protect investors. Offerings to the public generally require prior registration with the Securities and Exchange Commission (SEC) or a state agency.<sup>3</sup> So-called private placements are limited to persons with whom the offeror has a pre-existing relationship.<sup>4</sup> Even if registration is not required, the anti-fraud provisions of the security laws require that the offeror make full disclosure of all facts that a reasonably prudent investor would need to know in deciding whether to invest.<sup>5</sup> The information disclosed should include a detailed recitation of all the risks involved in developing, producing, and marketing a movie. Avoid offerings that appear to violate this requirement by making less than full and truthful disclosure. Carefully review the prospectus.

*"All dressed up and no where to go."*

## IDENTIFY THE FILM'S POTENTIAL MARKET

As a money-making investment, a film is only as good as its potential market. As self-evident as this statement may seem, investors may be tempted to allow personal feelings about a project's statement or a director's vision to influence their financial decision to invest. An attorney should strive to remind her client that a film investment must be viewed as a business venture like any other. Toward that end, the attorney and her client should review all the factors affecting the mar-

ketability of a film. Although a comprehensive list would be impossible, the four most important factors are the genre of the film, the theme of the film, the talent involved in the project, and the vision and goals of the director.

Certain types of film are inherently more marketable, and therefore more profitable, than others. There is a very limited market, and only modest potential revenue, to be earned from short films, documentaries, black and white films, and foreign language films. An investor should recognize, however, that such films may cost less than other films and therefore could be a good investment for beginning investors with limited funds.

It can be difficult to divine the commercial prospects of a film. Several years ago, I agreed to represent a black and white film about boxing. The film won several awards at festivals, received wonderful reviews, and had several big-name actors in the cast. Despite my efforts, I was unable to generate much interest among distributors for a black and white film. As a result, when another client of mine told me he was thinking of financing a black and white film about mathematics, I discouraged him. He ignored my advice and backed a movie called  $\pi$ , which became a huge hit, earning considerable revenue.

The choice of film stock (or videotape) also plays an important part in the marketability of a film. Distributors and exhibitors, including the top festivals, have traditionally been prejudiced against motion pictures that were shot on anything but 35mm film. A growing trend, however, is for independent produc-

ers to utilize digital cameras that allow them to significantly reduce production costs. In fact, the Sundance Film Festival recently began exhibiting movies on the latest digital projectors which have a resolution comparable to 35mm film projectors.

The theme of a film also shapes its marketability. Certain themes, topics, and genres can be difficult, if not impossible, to sell. Religiously-themed pictures, for example, can easily offend audiences and scare away distributors. The 1999 film *Dogma* perfectly illustrates how a seemingly bankable hit—young, hot director and stars plus big Hollywood money—can have serious problems finding a distributor based solely on that film's Catholic themes. Other hard sells include cerebral comedies that can be difficult to export because their humor may not translate; films with a great deal of violence that may be shunned by European television, a prime market for independents; and films with explicit sex that may not pass censorship boards in certain countries.

Some films have \$20 million openings based solely on the name above the title. In contrast, independent films without name actors may be difficult to sell. Of course, name recognition varies around the world. For example, a film like *The Arrival*, starring Charlie Sheen, did only limited business in the U.S. but made over \$100 million overseas. The star of an American television series may be a big name in the United States but unknown abroad. On the other hand, some actors have a large following abroad—such as Baywatch's David Hasselhoff in Europe—yet are less famous in the United States. There are several

publications that can be consulted to determine the commercial appeal of actors.<sup>6</sup>

In a more indirect way, the director of the film may ultimately determine the marketability of the final product. A filmmaker who shows no concern about making a movie with audience appeal may leave an investor with nothing more than an expensive home movie. This is not to say that the only films one should invest in are low-brow fare like *Dumb and Dumber*. A well-made "art film" like *Elizabeth* can win awards and make a handsome return on investment. Likewise, an investor must ensure that the filmmaker has a sharply defined audience in mind. For example, I once watched a wonderful Lassie-type family film spiced with four-letter words. The filmmaker apparently hadn't considered that his film could not be sold as a family market because of the vulgar language, and it was too soft a story to appeal to teens and adults. A film's profitability can easily be lost in a filmmaker's vision; the investment attorney must work with her client and the filmmaker to keep that from happening.

*"Let's make a deal"*

### **CONGRUENCE OF INTERESTS**

Basic business tenets provide that it is best to invest in an endeavor when everyone shares the risks and rewards. A filmmaker who receives a large fee from the production may financially prosper from a film that returns nothing to the investors. As a result, an investor should only back a filmmaker willing to work for a modest wage and share in the success of the endeavor through a deferment or profit participation. Not

only does this arrangement equalize the risk and reward, it helps focus filmmakers on the ultimate goal of producing a profitable movie. For example, beginning filmmakers might receive a minimal salary during the year it takes them to produce a film. They might also receive a deferred payment, which is an additional amount usually payable after the investors recoup their capital investment. In addition, most filmmakers receive a significant share (5-50 percent) of the "back-end", or profits, derived from the picture, if any. Similarly, an investor can take comfort investing in a motion picture on the same terms as a distributor when both parties recoup at the same time. An attorney should be wary of an investment deal in which other parties will benefit while the client takes a loss.

### **UNDERSTAND THE PARAMETERS OF A FAIR DEAL**

Usually, investors are entitled to recoup all of their investment first, before payment of deferments or profits. Many times investors are allowed to recoup as much as 110 percent or more of their investment in order to compensate them for interest and inflation. A film's profit is declared after the payment of all debts, investor recoupment, and payment of deferments. Once those payments are made, the profit is generally then halved between the producer(s) and the investors. Thus, investors who provide 100 percent of the financing are usually entitled to 50 percent of the profits. The 50 percent share of profits is reduced by whatever profits are granted to third-party profit participants, such

as the writer, director, and stars.

### **OBTAIN ALL PROMISES IN WRITING**

Any first-year law student can explain the importance of reducing all promises and agreements to writing. In the fast-paced business of filmmaking, the written agreement is not just important, but essential. Even though California courts may enforce an oral contract, a film investor should never accept oral assurances from a producer or distributor. The cost of litigating the existence of an oral agreement will certainly be more expensive and time consuming than if the investor has a written contract in hand. If they promise to spend \$50,000 on advertising, get it in writing; if there is not enough time to draft a long-form contract, demand a letter reiterating the promises. Retain copies of all correspondence, contracts, and any promotional literature. If a filmmaker makes fraudulent statements in order to induce your client to invest, you will have a much stronger case if such statements are in writing.

**R**equiring all agreements to be in writing not only protects your client's interest, but it can also reveal the poor business practices of potential partners before those issues affect the deal. Filmmakers who make handshake deals may handle other aspects in a sloppy manner. The most egregious oversight is failing to obtain the necessary contracts needed to fully secure ownership to their motion picture. In order to have a complete chain of title to a film, one needs to secure written contracts with many parties including actors, writers, and composers. Filmmakers

need to obtain the following essentials: 1) Depiction releases from all actors who are identifiable in the film. This release may be part of the actor employment agreement. 2) Written employment agreements with everyone who makes a creative contribution to the film, such as writers, cinematographers, or composers. These agreements must state that services are being provided on a work-for-hire basis and the copyright to the work product vests in the production company or producer. 3) License agreements to incorporate any copyrighted work in the movie, such as music, still photos, and stock footage. Filmmakers who neglect such legal niceties place their investors at risk.

### **SECURE AN ARBITRATION CLAUSE**

All contracts should provide that any disputes will be subject to binding arbitration rather than litigation, with the prevailing party entitled to reimbursement of legal fees and costs. Investors should also have their filmmakers demand an arbitration clause when contracting with distributors. Although the investor is not a direct party to such contracts, filmmaker disputes with a distributor can affect the investor's bottom line. The filmmaker is invariably the financially weaker party in negotiations with the distributor; often the filmmaker cannot even afford to retain an attorney or pay court costs in order to bring a suit. If the filmmaker lacks a viable means of protecting his inter-

ests, he may be forced to watch from the sidelines as a distributor ignores the terms of a distribution agreement and pockets revenue from the film.

The arbitration clause should contain certain specific provisions. The clause should provide that the award is final, binding, and not appealable. Otherwise, trial costs

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may be avoided only to incur large legal bills on appeal. The parties should also specify the venue for any arbitration and may want to agree on the number of arbitrators and their qualifications.<sup>7</sup>

Several different organizations oversee arbitrations. Most entertainment industry arbitrations are conducted under the auspices of either the American Arbitration Association (AAA)<sup>8</sup>, or the AFMA

(formerly known as the American Film Marketing Association but now simply known as AFMA)<sup>9</sup>, a trade organization representing the interests of international distributors. The AAA has a well-defined system of procedural rules and maintains numerous offices across the nation and in many foreign countries. AFMA is the entity that organizes the American Film Market (AFM) held each February in Los Angeles. AFMA arbitrations usually occur in Los Angeles, but they can be held during an international film market or in a foreign city. All of the AFMA arbitrators are experienced entertainment attorneys.

Under AFMA rules, if a filmmaker wins an award and the distributor refuses to comply with its terms, the filmmaker can have that distributor barred from participation in future AFM's. Since AFM is one of three major international film markets, the inability to participate may severely damage the business prospects of a company. This remedy is particularly useful if the distributor's assets are abroad and difficult to reach under the authority of American law. The threat of being barred from

AFM may convince a distributor to obey an arbitration award. Some disreputable individuals, however, have sought to avoid awards against them by abandoning their distribution company—often a shell corporation—and then establishing a new enterprise. Conducting their business under a new name, they exploit another wave of filmmakers, fully expecting to abandon the new company when the law catches up with

them. To prevent such behavior, the AFMA has created a personal binder that can be enforced against distribution executives. If an executive signs this binder, and his company fails to comply with an arbitration award, the executive can be personally barred from future AFM's.

## **INTEREST ON LATE PAYMENTS**

In addition to providing remedial measures for contract disputes, an investment attorney must also remove any incentive for a producer or distributor to retain the investor's money. In some states, courts do not award pre-judgment interest to a prevailing party, unless there is a provision in the contract providing for it. Thus, if you become embroiled in a dispute with a distributor who is unlawfully holding \$100,000, and, after four years of litigation you win the case, the court may award you only the original \$100,000. Therefore, an attorney should always consult the law of the state in which the contract will be written and performed. If the state does not provide for pre-judgment interest, a provision guaranteeing such should be written into the contract.

## **COMPLETION BOND**

A completion bond guarantees that if a film goes over budget, the investor will not confront the dilemma of either putting up more money or owning an unfinished film. A completion guarantor—an insurance company that insures the production

against budget overruns—will issue a bond only after thorough investigation. Such companies as the Motion Picture Bond Company and Worldwide Film Completion have developed expertise in the area. Their investigation includes closely

reduce his percentage of the profits if the company allowed him to complete the film. This oversight by the completion bond provides both financial and personal peace of mind to the investor.

*"Keep your eyes open."*

## **TAKE AN ACTIVE ROLE**

With the creation of the Limited Liability Company, . . . an investor can be one of the managers of the enterprise yet maintain limited liability. Thus, the investor can have a vote on critical decisions such as approval of the script, cast, budget, and distribution agreements.

As a shareholder in a corporation, or limited partner in a partnership, an investor has very limited control over the management of the enterprise. In the past, investors who wanted limited liability had to be willing to pay the price of accepting limited control. With the creation of the Limited Liability Company (LLC), however, an investor can be one of the managers of the enterprise yet maintain limited liability. Thus, the investor can have a vote on critical decisions such as approval of the script, cast, budget, and distribution agreements. By being actively involved in the production, an investor will be better able to monitor the performance of the

reviewing the production personnel, script, and budget and assessing whether they think this team of individuals can bring in this script within the shooting schedule and proposed budget. The completion bond company usually is quite diligent in its review because if the film goes over budget, the bond company is financially responsible. James Cameron experienced just how involved a completion bond company can become. While filming the monstrosously successful *Titanic*, Cameron went over budget and was forced to

filmmaker and discover problems while there is still time to remedy them. This allows investors with more financial savvy than the filmmakers to oversee many of the important business decisions. First-time investors may want to bring in or consult with an experienced producer, attorney, or producer representative. In addition, an LLC avoids the problem of "double taxation" faced by a more traditional corporate structure. In a regular corporation, the company would be taxed on all income and then the investors

would be taxed individually based on their share of the profits. In an LLC, the company is not taxed for its income, only the individual investors pay personal income tax based on their profits.

## **MAKE SURE FUNDS ARE SPENT ON PRODUCTION**

During fund raising, filmmakers commonly set up an escrow account to hold investor funds. The money stays in the escrow account until the filmmaker raises the minimum amount necessary to produce the film. If the filmmaker cannot raise enough money, the funds in escrow are returned to the investors. By depositing money in an escrow account, investors are protected because they know none of their capital will be spent unless and until all the money needed to produce the film has been raised.

After funds are disbursed for production, there should be a system of checks and balances in place to ensure that all monies are properly spent and accounted for. A budget and cash flow schedule should be approved before disbursement. Production funds should be placed in a separate segregated account and not commingled with the filmmaker's personal funds. All checks withdrawing funds from the account should be signed by two individuals. Investors may want one of the signatories to be a trusted person selected to represent them.

## **RETAIN MASTERS**

The production company should retain possession of all master elements. Original film negatives, video masters, sound masters, art-

work, still photos, and slides should not be delivered directly to a distributor. Instead, the distributor should be given a "lab access letter" which enables it to order copies of the motion picture so the distributor can fulfill orders. Master elements should be retained by the producer for a number of reasons:

1. Masters may be irreplaceable. If lost or damaged, the producer will incur a substantial expense to replace them, if they can be replaced.
2. In the event of a dispute, it is best for the producer to control the materials. If the distributor has defaulted, for instance, the filmmaker may have a right to terminate the agreement and seek a new distributor. The filmmaker will need access to the materials, however, in order to make delivery to a new distributor.
3. If your initial distributor has become bankrupt, only costly and lengthy court action can extricate your materials from bankruptcy proceedings.
4. You may need to allow several distributors access to your materials. Typically, independent filmmakers enter into multiple distribution deals. While one deal is concluded with an international distributor (also known as a foreign sales agent) outside North America, one or more deals may also be made with a domestic distributor in the United States and Canada. The best solution when dealing with multiple distributors is to place the materials in a profes-

sional laboratory. Each distributor is then granted a lab access letter enabling it to order copies.

5. You can discourage cheating by keeping masters in a laboratory and having the lab report to you how many copies have been duplicated. Suppose that at the end of one year, the lab reports to you that 10 film prints have been made. You review your producer reports and see eight sales reported. This is a red flag alerting you that sales may have been made that were not reported. Most filmmakers would not know if their film had been licensed in, for example, Malaysia.<sup>10</sup> Distributors do not request copies of films without an order in hand. Typically, they receive full payment for the film before they manufacture a duplicate and ship it.

In selecting a laboratory for deposit of your materials, choose one that charges competitive rates and has experience duplicating films for international distribution. Buyers in certain countries, such as Germany, are notoriously finicky and often reject films on the grounds of poor technical quality. It is also a good idea to select a lab not ordinarily used by the distributor. A lab in the habit of filling orders for a regular client may not bother checking to see if that distributor has authority to order copies. Moreover, such a lab might inadvertently release the master to the distributor. Similarly, the filmmaker should always deliver the master directly to the laboratory only after the laboratory and distributor have signed a lab access letter. If

you deliver materials to the distributor, and the distributor places them with a lab, the laboratory may treat the distributor as the owner of the film.

The lab access letter should include language permitting the filmmaker to receive copies of all invoices or periodic reports disclosing the nature and amount of duplication performed. Some filmmakers insist that the laboratory ship all copies directly to the territory buyers. The distributor will probably insist that the lab access letter be irrevocable for the term of the distribution deal. The distributor will want to retain access to the materials in order to fulfill any orders arising from its licenses.

## **OBTAIN AND REGISTER A SECURITY INTEREST**

Generally speaking, a security interest gives the secured party rights in some designated collateral. In the movie and television industry, film lenders may want to secure their financial interests by obtaining a security interest in the film negative

and master materials. Likewise, investors may want their filmmakers to protect themselves by having distributors grant a security interest. The collateral here is the proceeds derived from commercial exploitation of the film. By obtaining a security interest, the filmmaker will have rights superior to those held by unsecured creditors. This can be a tremendous benefit if the distributor goes bankrupt. In such an event, the proceeds derived from the sale of the distributor's assets, including the right to distribute the investor's film, will be paid to the filmmaker first.

It is important not only to have a written security agreement, but also to record it properly. The security interest agreement should be included in a clause within the distribution agreement. A separate long and short form security agreement is also signed by the parties, as well as a UCC-1 form, which is signed and recorded with the Secretary of State where the collateral or distributor is located.<sup>11</sup> The security interest should also be recorded with the Copyright Office at the Library of Congress in Washington, D.C.

## **DON'T INVEST MORE THAN YOU CAN AFFORD TO LOSE**

Finally, any investor must understand that investing in a film is a highly risky endeavor. Investors should never invest more than they can afford to lose. The complete loss of an investment should not appreciably affect the investor's standard of living. ♦

The author thanks Joshua Ferguson for his assistance in preparing this article.

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<sup>1</sup> BASELINE Box Office Grosses as of November 9, 1999.

<sup>2</sup> Film Distributors can be researched by visiting the "Filmmaker's Clearinghouse," sponsored by Mark Litwak, Film Arts Foundation, the Association of Independent Video and Filmmakers, and MOVIE MAKER MAGAZINE. The survey form and responses can be found at: Entertainment Law Resources: <<http://www.marklitwak.com>>.

<sup>3</sup> See 15 U.S.C. § 77 (1999).

<sup>4</sup> See 15 U.S.C. § 77(d) (1999).

<sup>5</sup> See 15 U.S.C. § 77(k) (1999).

<sup>6</sup> The Ulmer Guide (contact point: [julmer@primenet.com](mailto:julmer@primenet.com)) surveys financiers, sales agents, and other industry insiders. Also, the HOLLYWOOD REPORTER (213) 525-2087 publishes a "Star Power" guide.

<sup>7</sup> It is common for the parties to have disputes resolved by a single arbitrator who is an entertainment attorney.

<sup>8</sup> <<http://www.adr.org>>.

<sup>9</sup> <<http://www.afma.com>>.

<sup>10</sup> One way to monitor which countries have licensed a film is to place the music on the soundtrack with a music publisher (which could be a publishing company the producer establishes), and make sure the publisher has entered into an agreement with ASCAP, BMI, or one of the other music collection agencies. These agencies collect public performance royalties when the film is exhibited on television in the United States, and in theaters and television abroad. If the music is registered with such an agency, and royalties from Malaysia are remitted, for example, this alerts you that a sale to Malaysia has been made.

<sup>11</sup> See e.g. CAL. U. CON. CODE § 9401 (1984).