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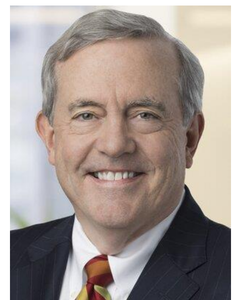
Lights, Camera, Real Estate: Preparing For Film Facility M&A

By **Thomas Kearns and Kenneth Silverman** (December 9, 2024, 6:07 PM EST)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TV and film production facilities are typically created by real estate entrepreneurs, but they operate and are valued very differently from typical commercial real estate properties.

While the financing of the construction of studios may follow a traditional real estate development track and is often secured by a mortgage on the real property underlying the business, their purchase and sale are usually treated more like the sale of an operating business.

For this reason, there are some key differences in approaches when dealing with the possible sale or acquisition of a production facility given the nature of the assets. This may be especially important to consider now as the film and TV industry struggles to recover from a number of issues, including multiple strikes and a decline in production.

One principal question to address early on with respect to a proposed purchase/sale transaction is whether to structure the transaction as an asset sale or a merger.

While most typical commercial property sales are done as asset sales, operating businesses are often structured as mergers. A merger significantly simplifies the transfer of the various contracts and noncontractual relationships to the buyer.

Contracts with third parties for the use of the facilities often have exclusions from the consent requirements for mergers involving the sale of the entire business, but perhaps more importantly the merger format simplifies the buyer's transition to successfully operating the facility.

Sellers generally prefer a merger or an equity sale, as all liabilities related to the facility and operating business, subject to negotiated exclusions, transfer to the buyer upon closing.

Mergers do bring some complications. For example, all liabilities of the existing business bind the buyer. So, how does a buyer protect itself? If a sale is structured as an asset sale, the delivery of a deed to the real property at closing typically cuts off liabilities, thereby protecting the buyer from old claims unless they "run with the land."

A merger agreement can, however, provide extensive representations about the operations of the business, its financial conditions and statements and known or potential liabilities.

A helpful development in recent years is the emergence of representation and warranty insurance products. The insurer covers certain risks arising out of a breach of a representation or a warranty by the seller subject to negotiated deductibles and caps.

While the premium payable for the insurance can be significant, prospective buyers can try to negotiate shared responsibility for the premiums as it benefits both sides. The policy can significantly reduce friction between the buyer and seller, both at the contract negotiation stage and post-closing, and gives the buyer significant comfort as to the collectability of any post-closing claims for breaches of representations and warranties.

Including representation and warranty insurance in a sale transaction increases due diligence costs because the insurer will leverage the prospective buyer's due diligence efforts when reviewing a proposed transaction for coverage, but its benefits generally outweigh the additional costs.

But, of course, even without such insurance, the parties can provide for post-closing survival of representations and warranties and negotiate indemnification terms.

Mergers also permit a buyer to evaluate whether title insurance for the real property is needed at the closing. A merger gives the benefit of any existing title policy to the buyer. Depending on the circumstances, a buyer may be satisfied with that title coverage and forgo a new policy, thereby saving a significant premium payment.

A production facility transaction often involves reviewing local economic development and tax credit regulations in addition to the basic due diligence investigation in sale transactions.

While the story of a particular film or TV show might be based in one locale, it has long been common practice to film it in an entirely different location due to convenience or, more often lately, costs, including the availability of tax credits and the availability of non-union crews. A story set in New York is often filmed in Vancouver, Toronto, Alabama, or yes, even Hungary.

The easy mobility of the industry has caused municipalities to treat film production facilities as local generators of wages and other income resulting, hopefully, in a net gain over the cost of the economic development program or tax credits.

Prospective buyers and their lawyers should understand the existing legal and political landscape affecting the facility.

For example, economic development programs are often implemented pursuant to a long-term lease between the municipality or its agency and the property's operator. Those leases typically have narrow use restrictions and sometimes contain provisions that grant applicable agencies approval rights over prospective buyers and profit-sharing mechanisms upon a sale.

One key structural component of any transaction is that while commercial real property is often valued based on the existing rent roll, most TV and film producers do not sign long-term leases — they often agree only to short-term agreements, less than a year, with rights to extend.

Diligencing those arrangements can be more involved than the typical commercial lease review. Which producers have relationships with the facility? How often are the producers repeat customers? Has the

facility been updated with the latest technological equipment? Do the seller and the facility have a good reputation in the industry?

Successful production facilities are often expanded periodically over the years, sometimes with expansions funded by different capital sources. Parts of the business may be operated as an equipment rental business that operates separately from the real estate assets through a different entity.

Since a buyer will typically want to acquire all aspects of the business that takes place at the production facility, each separate property parcel and segment of the operating business and its ownership needs to be reviewed by all parties and an allocation of values must be done for several reasons.

First, local real property transfer taxes may apply to the real property portion of the assets and not to the equipment business and vice versa for sales taxes.

Second, the different segments of the businesses may have different lenders and investors, and good faith valuations of the various business segments can become critical.

Third-party appraisals can be helpful to quell distrust among the different groups of investors. Other times, the broker or investment banker handling the sale can guide the parties to a good faith resolution of the allocation of the overall purchase price.

A property development idea gestated by a real estate investor may, over time, transition with the addition of complementary business lines, such as equipment and services, into a full-fledged operating business with an exit strategy that has more in common with typical non-real-estate operating companies than the usual real estate asset sale.

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