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WHAT TO EXPECT FROM COLORADO'S NEW ARTIST CO. STRUCTURE

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PEOPLE

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Colorado recently enacted the Colorado Artist Company Act, a first-of-its-kind statute creating artist companies, or A-Corps — a variant of a Colorado limited liability company with certain artist-friendly default provisions. The act became effective on Aug. 12.

Generally, artist companies, or A-Corps, are distinguished by two nonwaivable requirements: (1) Artists must control 51% of the voting power and have the sole right to approve matters relating to the sale and licensing of artistic works and (2) each artist who creates artistic work owned by the A-Corp has a reversionary right in that work.

In sum, the act provides a prebuilt entity that favors artists, but limitations on investor participation may limit widespread adoption.

INVESTOR RESISTANCE EXPECTED

Time will tell what appetite exists for nonartist investors in artistic ventures. Sophisticated investors will likely reject the A-Corp's defining attributes. This may especially be true in art that is exploited through continuous exercise of the copyright over time — think recording artists who monetize their recordings one performance or one stream at a time.

If an investor or other third party seeking to do business rejects the A-Corp form, the entity may be required to dissolve, whereby the artists would receive distributions of their artistic works and both artists and the company would be required to transfer and assign their intellectual property rights and other assets, before the investor agrees to make a substantial investment, or before a promoter agrees to take on the act.

The A-Corp's defining attributes may make deals a little trickier. The artists' reversionary right acts as an encumbrance on the entity's assets. Unlike with traditional liens, complications will arise as no centralized registry linking works to A-Corps and their artist members exists. Artists will need to proactively document the creation process, so the attachment of the reversionary rights can be tracked.

The investor's inability to vote on artistic matters could also prove problematic in that investors will have no vote in determining whether, when and how to monetize the A-Corp's assets, even if a 49% investor convinces one of the artists to their cause. This could make it difficult for the investor to ensure a fair return.

Multi-artist groups pose their own governance and reversionary right tracking issues. Artist counsel may consider using a separate entity, A-Corp or otherwise, above the investment A-Corp, although investor counsel will likely balk at the decreased visibility into intra-artist dealings.

Investors may be more likely to find an acceptable A-Corp where the artistic output of the organization is monetized through the sale of tangible art, as opposed to the license of copyrights. Tangible art can be easily tracked, liquidated and secured and presents fewer questions about creative contributions and reversionary rights. A tangible art venture can be positioned as deriving profit by engaging in separate sales of individual pieces of art.

Unlike the recording business, where investors receive a return through repeated exercise of the copyright over a long period of time, each earning a small royalty, in the sale of tangible art, the investor's return is realized all at once in a single transaction.

The risk, therefore, of losing the engine of the business' profits to the artist's reversionary right only persists with respect to unsold inventory. While the investor would still not be able to force the sale of artistic inventory, concerns can be somewhat ameliorated by the investor obtaining an interest that ensures that any up-front investment is recouped with a fair return before profits are returned to the artists.

INTERPLAY WITH FEDERAL COPYRIGHT LAW

As a new statutory regime, interplay with the Copyright Act is uncertain. For example, artist members may be required by the A-Corp's artistic mission to assign or license their artistic works to the entity. Unlike true work-for-hire, which is exempt from termination, these contractual transfers remain subject to federal termination rights under Title 17 of the U.S. Code, Section 203. The choice between full assignment and exclusive license may affect how termination rights apply.

Investor counsel may also want to negotiate a royalty or other form payout upon a liquidity event, i.e., preferred investor equity or guaranteed returns, but from an intellectual property

perspective, a state-mandated reversion mechanism reallocating copyright ownership at dissolution may face Section 301 preemption challenges. Creditors or successors may argue the scheme grants rights equivalent to federal copyright. The preemption overhang remains unresolved.

TAX CONSEQUENCES

Practitioners should also be wary of the likely tax consequences. First, to the extent artists contribute preexisting works to the entity, the statute's framework allows the artists to value those works. Those values may not be consistent with the works' fair market value, as required by the Internal Revenue Code.

One must also keep in mind that A-Corps will not be able to utilize S-Corp treatment, as the reversionary right will give rise to disproportionate interests in the company assets, resulting in a second class of ownership interest.

Further, once those reversionary rights are exercised, either upon dissolution or as set forth in the operating agreement, the distribution of the artistic work would be deemed a capital distribution. Assuming the company can achieve the statutory distribution hurdle, the asset's presumably low basis could result in capital gains to the artist, with no cash to pay the resulting tax.

CONCLUSION

In sum, A-Corps could be useful for small-scale artistic ventures dealing principally in tangible artwork that can accommodate outside investment. However, challenges could arise when more complicated business plans or capital structures are involved or contemplated. Time will tell if and how this new entity form will be accepted and adopted.