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Carlos Ruiz de la Torre

Towards the Digital Music Distribution Age: Business Model Adjustments and Legislative Proposals to Improve Legal Downloading Services and Counter Piracy

*Carlos Ruiz de la Torre**

* JD Candidate, The University of New Mexico Law School. Winner of The GRAMMY Foundation® Entertainment Law Initiative 2006 Writing Competition.

Faced with ever-decreasing revenues since the emergence of Napster in 1999,[1] the music industry has reacted to the development of peer-to-peer ("p2p") file-sharing with a wide-variety of approaches aimed at eradicating illegal downloading. The industry's strategies have included lawsuits against p2p providers and users, sabotage tactics to corrupt illegal download sites, application of digital rights management ("DRM") technology to prevent or limit copying, lobbying for favorable legislation,[2] agreements between universities and legal online providers to provide students with "free" legal music, and educational campaigns to better inform the public about copyright law and the impacts of illegal downloading.[3] These strategies have been fairly effective in discouraging illegal downloading; for example, Grokster, Ltd., announced in November 2005 that it would discontinue its decentralized file-swapping site and restructure itself as a licensed service in the wake of the United States Supreme Court's June 2005 decision in *Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd.*[4]

However, some commentators have observed that trying to eradicate illegal file sharing is not unlike trying to sandbag a flooding Mississippi river: complete success will remain elusive. These skeptics predict that: (a) illegal file sharing will increase as more households buy computers and install high-speed internet, and (b) new illegal p2p sites will inevitably emerge, domestically or abroad, to replace the latest dismantled Grokster and provide consumers access to illegal downloads. Nevertheless, complete eradication of illegal downloading is not entirely necessary to maintain the prosperity of the music industry. A minimal level of illegal file sharing by committed pirates is to be expected, and will not prevent the music industry from creating a legitimate digital marketplace that is comparatively more attractive for consumers than the illegal file-sharing networks.

To successfully adapt in the age of digital music distribution, current strategies to discourage piracy can continue to be implemented, but ultimately the music industry and Congress must establish a marketplace that will allow legal downloading services to flourish and offer a comparably more attractive service than their

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1. *See* Justin Hughes, *On the Logic of Suing One's Customers and the Dilemma of Infringement-Based Business Models*, 22 CARDOZO ARTS & ENT. L.J. 725, 726-27 (2005).

2. *Id.* at 726.

3. *Id.* at 746.

4. 125 S. Ct. 2764 (2005); *see* John Borland, Last Waltz for Grokster, CNET News.com, Nov. 7, 2005, http://news.com.com/Last+waltz+for+Grokster/2100-1027_3-5937832.html.

illegal counterparts. Section I of this paper discusses benchmarks that must be achieved to improve the legal downloading services. Section II discusses aspects of the current legal and licensing regime that serve as impediments to implementation of the legal downloading service business model. Section III proposes a legislative agenda to reform the marketplace, achieve the goals articulated in Section I, and maintain competition and profitability for the players in the evolving digital music distribution market.

I. THE MODEL LEGAL DOWNLOADING SERVICE

To make legal downloading services more attractive than their illegal counterparts, the music industry must accomplish *two primary goals*: (a) offer a larger catalogue of downloadable music and (b) allow for compatibility of devices used by consumers for downloading, playback, and storage. Additionally, a competitive marketplace should ensure that online music providers will: (1) offer individual songs in addition to albums; (2) set affordable prices for downloads; (3) allow for reasonable personal uses of downloads by consumers, including the ability to make limited copies of recordings; (4) offer incentives, like sponsored downloads and prizes; and (5) provide security from computer viruses.

The greatest impediment to the success of the online music services has been their inability to offer a sufficient amount and variety of downloadable music to compete with the offerings on illegal file-sharing sites. An estimated 870 million songs are currently available illegally, as opposed to 1 million legally.[5] To offer more extensive catalogues online, partnerships and increased cooperation among the various industry players are needed, as well as legislative changes, to be discussed in Sections II and III below, to allow for more streamlined and cost-effective licensing procedures.

With respect to compatibility of devices for downloading, playback, and storage, Apple's iTunes online music store ("iTunes") and the iPod portable music player ("iPod") are good examples of proprietary product designs that do not aid in the struggle against piracy. While the selection for portable music players is broad and includes CD players, other MP3 players, and MiniDisc players, the iPod is the only portable music player authorized and licensed by Apple to play music securely encoded with Apple's Advanced Audio

5. International Federation of the Phonographic Industry (IFPI), Digital Music Report 2005: Facts and Figures, http://www.pro-music.org/musiconline/news050119c.htm (last visited Apr. 14, 2005).

Coding ("AAC") codec.[6] To recapture customers from the illegal file-sharing networks, reverse-engineering for the limited purpose of achieving interoperability should be permitted and will be discussed further in Sections II and III below.

II. LEGAL IMPEDIMENTS TO ATTAINMENT OF THE TWO PRIMARY GOALS

A. Difficulties Faced by Legal Downloading Services in Clearing Licenses

Digital downloads, referred to in Section 115(d) of the Copyright Act as digital phonorecord deliveries ("DPDs"), are digital audio transmissions that result in a specifically identifiable reproduction of a phonorecord on a recipient's hard drive.[7] As such, DPDs share the same basic ownership qualities as physical compact discs, in that they result in a permanent copy of a song that can be privately replayed any number of times. Although digital music can also be accessed via streaming transmissions, whereby no reproduction is made in connection with the transmission, this paper focuses on DPDs and the business environment that is needed to more effectively market them.[8]

When a legal downloading service seeks to make a DPD available to the public, it must secure four licenses: (a) the composition copyright owner's right to reproduce[9] and distribute the composition; (b) the sound recording copyright owner's right to reproduce and distribute the recording; (c) the composition copyright owner's right to authorize public performances of the composition; and (d) the sound recording copyright owner's right to authorize public performances of the digitally transmitted sound recording.[10] Copyright law is presently unsettled with respect to whether DPDs

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6. Some commentators have suggested that Apple's symbiotic linking of AAC encoded music between iTunes and iPod potentially violates antitrust regulations. *See* Eddy Hsu, *Antitrust Regulation Applied to Problems in Cyberspace: iTunes and iPod*, 9 INTELL. PROP. L. BULL. 117 (2005).

7. *See* 17 U.S.C. § 115(d) (2000); AL KOHN & BOB KOHN, KOHN ON MUSIC LICENSING 1298 (3rd ed. 2000).

8. Also outside of the scope of this essay are tethered and ephemeral downloads (as they fall outside of the Copyright Act's definition of DPDs) and issues pertaining to Internet radio.

9. Throughout this essay, references to the reproduction right also simultaneously refer to the distribution right.

10. *See* KOHN & KOHN, *supra* note 7, at 1311-14.

implicate public performance rights;[11] nevertheless, a prudent legal downloading service should seek licenses for the performance rights to avoid potential liability for copyright infringement. Composition copyrights are generally owned by music publishing companies and/or the composers themselves; sound recording copyrights are commonly owned by record companies. However, in the United States, it is typical for licensees to go through three separate licensors in seeking clearances to make a DPD available for download: (a) the composition reproduction right is licensed via the Harry Fox Agency; (b) the composition performance right is licensed via one of three performing rights societies, ASCAP, BMI, or SESAC;[12] and (c) the sound recording reproduction and performance rights are generally licensed directly via the record companies or via distributors such as the Independent Online Distribution Alliance or CDBaby's digital distribution arm.[13] For historical reasons, and in the case of ASCAP because of an anti-trust consent decree, neither the performing rights organizations nor Harry Fox have been capable of licensing both the performance and reproduction rights on behalf of composition copyright owners.[14]

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11. Congress should clarify the issue of whether DPDs implicate performance rights so that online providers can operate with greater certainty and potentially also increase the offerings on their catalogues. While music publishers insist that every DPD represents a public performance (and the record companies tend to concur on this point), the U.S. Copyright Office has taken the position that DPDs do not implicate performance rights, that composition copyright owners already receive compensation for licensing their reproduction right in connection with DPDs, and that the practice of demanding additional royalties for the performance right amounts to "double-dipping." *Id.* at 1318; *see Digital Music Licensing and Section 115 of the Copyright Act: Hearing before the Subcommittee on Courts, the Internet, and Intellectual Property of the H. Comm. on the Judiciary,* 109th Cong., 2d Sess. 21-26 (Mar. 8, 2005) (testimony of Jonathan Potter, Executive Director, Digital Media Association), *available at* http://judiciary.house.gov/Oversight.aspx?ID=104 (follow "Hearing PDF (Serial No. 109-6)" hyperlink). The Digital Performing Rights in Sound Recordings Act of 1995 created a limited sound recording performance right for digital audio transmissions, codified in Section 106(6) of the Copyright Act. Assuming that DPDs implicate performance rights, DPDs would be classified as interactive transmissions because the recipient selects the download; thus, pursuant to the Copyright Act, a voluntary license must be negotiated with the recording copyright owners. Eric Leach, Do the Right Thing, Electronic Musician (2001), http://emusician.com/mag/emusic_right_thing/index.html.

12. See KOHN & KOHN, *supra* note 7, at 1307-08.

13. David Kostiner, *Will Mechanicals Break the Digital Machine?: Determining a Fair Mechanical Royalty Rate for Permanent Digital Phonographic Downloads*, 27 HASTINGS COMM. & ENT. L.J. 653, 665 (2005).

14. *See generally Copyright Office Views on Music Licensing Reform: Hearing Before the Subcommittee on Courts, the Internet, and Intellectual Property of the H. Comm. on the Judiciary*, 109th Cong. 8-10 (Mar. 8, 2005) (testimony of Marybeth Peters, Register of Copyrights, Copyright Office), *available at* http://judiciary.house.gov/Oversight.aspx?ID=181 [hereinafter Peters] (follow "Hearing PDF (Serial No. 109-28)" hyperlink).

To further complicate the licensing process, each of the three potential licensors utilized by the copyright owners employs its own particular procedures and royalty rates. The blanket license offered by the performing rights societies is no doubt the most streamlined and efficient of the licensing processes: a licensee is periodically charged a fee in exchange for a blanket license to use all of the compositions in the respective performance rights society's catalogue; the society then takes surveys to determine which compositions were performed during the year and allocates the total collected revenue among the particular songs performed in a particular medium, paying out royalties to publishers and composers accordingly.[15] The performing rights organizations also offer comprehensive listings to potential licensees of the compositions in their catalogues. In contrast, licensing via the Harry Fox Agency or recording companies is inherently more complicated, because each composition or recording desired must be specifically requested by the licensee on an individual basis, not on a blanket basis. Moreover, these licensors do not always represent the publishers or record labels in licensing these types of rights and they do not offer comprehensive listings of their catalogues.

Legal downloading services also face challenges and risks in securing licenses for certain musical works for which it is difficult to ascertain who in fact controls the rights. This problem may arise, for instance, in connection with split copyrights where co-owners have agreed not to license the work without the express agreement of all co-owners; other thorny examples include terminated rights and reversionary rights. In each of these scenarios, online providers seeking to make hundreds of thousands of songs available for legal download become vulnerable to statutory penalties for offering the songs online, even if they arguably used every commercially reasonable effort to discover the identity and location of the copyright owner.

Royalty rates vary among the four categories of licenses. Composition reproduction rights may be obtained via a compulsory mechanical license,[16] whereby monthly royalties are paid to the composition copyright owner(s) at the current statutory "penny" rate of 9.1 cents per song or 1.75 cents per minute of playing time, whichever is greater.[17] Alternatively, and more commonly, licensees and the Harry Fox Agency negotiate a substitute royalty rate and

15. KOHN, *supra* note 7, at 1307.

16. 17 U.S.C. § 115(a) (2000).

17. U.S. Copyright Office, Copyright Royalty Rates: Section 115, the Mechanical License, http://www.copyright.gov/carp/m200a.html (last visited Apr. 14, 2006).

payment schedule.[18] Royalty rates for the sound recording reproduction right and the performance rights are negotiated on a voluntary basis, and copyright owners may even refuse to grant licenses.

The mechanical royalty rate commonly paid to composers by record companies is the "three-quarter rate," or three-fourths of 9.1 cents, pursuant to the controlled composition clause of a typical recording contract.[19] This arrangement is generally beneficial for record companies in the context of traditional phonorecord reproductions, but in the context of DPDs, where wholesale prices are less than that of CDs as a result of reduced distribution costs on the internet, record companies realize reduced profits but are still obliged to pay composers the same royalty. This can become expensive for record labels, especially for the smaller, independent labels that tend to provide the most diverse music to the public. Consequently, recording companies are often forced to limit the repertoire available for download on their websites as well as the repertoire that they license to legal downloading services, resulting in a legal downloading marketplace that has fewer offerings than the black market p2p sites.

B. Reverse-Engineering Provisions in the DMCA

Jurisdictions throughout the United States and around the world have addressed the problem of anti-competitive business practices in software markets by allowing reverse engineering for the limited purpose of achieving interoperability.[20] Reverse engineering is the process of taking a competitor's finished product apart and working backward to determine how it was made. In the context of the music industry, reverse engineering would resolve the anticompetitive implications of the symbiotic linking of iTunes and iPod, for example, by allowing competitors to reverse-engineer software that allows downloads from sites other than iTunes to be

18. Voluntary mechanical composition reproduction licenses are the norm because of the burdensome monthly payment provisions of the compulsory license and competition among composers. Kostiner, *supra* note 13, at 659 (citing DONALD PASSMAN, ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS 213 (Simon & Schuster 4th ed. 2000)).

19. Kostiner, *supra* note 13, at 659-60.

20. *See, e.g.*, Lexmark Int'l, Inc. v. Static Control Components, Inc., 387 F.3d 522, 550-51 (6th Cir. 2004) (permitting reverse engineering to provide printer cartridge compatibility); Sega Enters., Inc. v. Accolade, Inc., 977 F.2d 1510, 1514 (9th Cir. 1992); Copyright Amendment (Computer Programs) Bill of 1999 (Austl.); Council Directive 91/250, 1991 O.J. (L 122) 42-46 (EC), *available at* http://www.wipo.int/clea/docs_new/en/eu/eu020en.html; H.K. Ord. No. 92 (1997); Republic Act 8293 of 1996 (Phil.); Copyright (Amendment) Bill of 1998 (Sing.).

played on the iPod, as well as other music players. Such a result would lead to the availability of compatible devices necessary to compete with the black market.

However, U.S. copyright law does not expressly permit the reverse engineering of DRM to allow competitors to gain access to proprietary music files and DPD playback devices. The Digital Millennium Copyright Act ("DMCA") criminalized the circumvention of technical anti-piracy measures intended to protect intellectual property, but created an exception permitting the circumvention of copy control technology to enable "interoperability of an independently created computer program with other programs . . . ."[21] "DMCA's reverse engineering exemption is unlikely to apply to attempts to produce compatible players because [downloaded] music files may not qualify as 'computer programs.' "[22] "A conflict has already erupted between Apple and RealNetworks [] over . . . software, called Harmony, that allows RealNetworks users to play their downloads on the iPod, as well as other devices."[23] RealNetworks claimed that Apple was monopolizing the market for DPDs "and that Real[Networks] was entitled to reverse engineer Apple's DRM to gain device interoperability; Apple accused Real[Networks] of hacking its proprietary system."[24]

III. LEGISLATIVE AGENDA TO ATTAIN THE TWO PRIMARY GOALS

A. Strategy to Make Available Larger Catalogues of Downloadable Music

1. Blanket Licenses for Composition Reproduction and Performance Rights

Rather than require DPD licensees to go through multiple licensors, transaction costs would likely be minimized if licensees could go through a single entity to license both the reproduction and performance rights inherent in a musical composition copyright. Presently, licensees seeking to license the reproduction and

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21. 17 U.S.C. § 1201(f).

22. Deborah Tussey, *Music at the Edge of Chaos: A Complex Systems Perspective on File Sharing*, 37 LOY. U. CHI. L.J. 147, 208 n.262 (2005).

23. *Id.* (citing Laurie J. Flynn, *Apple Attacks RealNetworks Plan to Sell Songs for iPod*, N.Y. TIMES, July 30, 2004, at C3).

24. *Id.*

performance rights inherent in a digital audio transmission of a sound recording can secure both via negotiation with the record company; however, licensees seeking to license the reproduction and performance rights inherent in a composition copyright must enter into separate agreements with Harry Fox (for the reproduction rights) and one of the performing rights organizations (for the performance rights). The functions of Harry Fox and the performing rights organizations could be merged to allow for more efficient "one-stop shopping" on the part of licensees.

The newly created entities authorized to license composition reproduction and performance rights would be known as music rights organizations ("MROs").[25] Existing performance rights societies would automatically become MROs, and other entities could also serve as "MROs if they obtain the necessary authorization from the copyright owner[s]."[26] The MROs would license composition reproduction and performance rights on a blanket basis because blanket licenses eliminate transaction costs involved in negotiating individual licenses and lead to wider availability and use of the catalogued compositions by licensees; therefore, composition copyright owners stand to earn more royalties via blanket licenses than they do under individual licenses.[27] An MRO's recovery of statutory damages for the infringement of a work would be predicated upon the MRO's having listed the work in its comprehensive catalogue and upon the MRO's designation by the composition copyright owners as the only entity authorized to license the particular composition. Although composition copyright owners would retain the ability to enter into direct licenses with licensees, the increased efficiency of the single licensing entity would provide an incentive for owners to utilize the MROs.

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25. This proposal has been suggested by Marybeth Peters, Register of Copyrights, Copyright Office. Peters, *supra* note 14, at 21-22.

26. *Id.* at 22.

27. Supporters of individual licenses may argue that blanket licenses are only utilized in connection with public performance rights because it is so difficult to track performances in nightclubs, restaurants, etc., and that composition reproduction rights should not be subject to a blanket license because it is possible to document each time a phonorecord is downloaded. However, royalties from blanket licenses need not be disbursed based solely on surveys of works that were performed/reproduced during a given year; it would be possible to input detailed records of downloaded phonorecords to more accurately disburse the blanket reproduction license fees.

2. Safe Harbor to Protect Legal Downloading Services From Infringement Lawsuits

To address the difficulties in identifying copyright owners, Congress should enact legislation to establish a "safe harbor," whereby online music providers could pay into a fund, administered by an entity such as the Library of Congress, from which "[a]rtists and other copyright holders who later demand compensation for the use of a particular song could be paid . . . ."[28] Coupled with the requirement for MROs to offer comprehensive listings of the works in their catalogues, a safe harbor provision would provide legal downloading services with a greater degree of security to operate by minimizing the risks inherent in licensing split copyrights and other works, where it is difficult to ascertain who in fact controls the rights and where failure to identify a copyright owner exposes online providers to liability for copyright infringement. Consequently, online providers would be in a position to offer a larger catalogue of legally downloadable music.

3. Enactment of a Percentage-Based Compulsory Royalty Rate

Record companies would be more inclined to make their recordings available online if the compulsory royalty rate for composition reproduction rights were set as a percentage of the wholesale price of the recording; the same percentage-rate would apply regardless of the medium of distribution (i.e., CDs vs. DPDs). "Most other countries set the mechanical royalty as a percentage of the work's wholesale value in order to ensure that the rate maintains its purchasing power under inflationary pressure. This method also allows room for new means of [digital] distribution . . . ."[29] Because distribution costs involved in marketing DPDs are minimal compared with physical distribution of the same compositions, a percentage mechanical royalty rate would allow for composers to be paid proportionally less in connection with DPDs. For example, if a record label's wholesale income "is [17%] less for a DPD than for the physical sale an album," the composer would accordingly be paid 17% less than

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28. This proposal has been suggested by Dick Boucher (D - Va.) of the House Judiciary Subcommittee on Courts, the Internet, and Intellectual Property. Molly M. Peterson, *Smith: Online Copyright Bill Unlikely To Move This Year*, CONG. DAILY, 2005 WLNR 14419936 (Sept. 13, 2005).

29. Kostiner, *supra* note 13, at 661; *see also* Amy Ai Dac Lam, *Internet Music Downloads: A Copyright Owner's Protection of Royalties in the United States and Abroad*, 34 SW. U. L. REV. 267, 274-75 (2004).

what he would earn in royalties for a physical reproduction.[30] To protect composers from record labels who might elect "to sell a [DPD] at [such] a low value so as to cause the composer's set percentage-share to be far below the current statutory value," the percentage-based royalty might also be coupled with a floor: a minimum penny-rate amount to ensure that composers get paid something, even when record companies engage in price wars to gain market-share of the download market.[31] Although at first glance this arrangement might seem to shortchange composition copyright owners, the composers would ultimately realize greater profits, because record labels would make more songs available for download and, ultimately, more songs would be purchased overall.

4. Application of the Blanket Compulsory License and Percentage-Rate Royalty to Sound Recording Copyrights

Although record companies would probably resist the idea, reduced transaction costs and greater efficiency would likely result if the formula of blanket compulsory licenses and percentage-rate royalties were also applied to sound recording copyrights. In a world where the same MROs that license composition rights could also license sound recording reproduction and performance rights on behalf of recording companies, online providers could potentially go through a single source to secure each of the four rights associated with DPDs. The statutory royalty rate range, consisting of a percentage-rate ceiling and penny-rate floor as discussed above in connection with composition reproduction rights, could also be successfully applied to the licensing of sound recording rights. Recording companies would have to relinquish some control with respect to setting the terms of licenses, but would potentially gain increased revenues due to reduced transaction costs and increased sales of DPDs overall.

B. Strategy to Encourage the Development of Compatible Devices

To provide flexibility to consumers and to assure continued competition in the online music distribution market, Congress should clarify the text of Section 1201(f) of the DMCA to permit reverse-engineering for purposes of achieving interoperability of DPD files and devices for DPD playback, storage, and downloading. Said statute

30. Kostiner, *supra* note 13, at 668. A percentage-rate in the area of 12.7% would assure that composers continue to earn the same royalties that they have historically earned for physical reproductions of their works. *Id.*

31. *Id.* at 665.

permits the circumvention of copy control technology only "to achieve interoperability of an independently created computer program with other programs." In addition to allowing reverse-engineering for purposes of enabling computer programs to exchange information, such measures should specifically be authorized in connection with attempts to achieve interoperability of independently created DPD files and devices for DPD playback, storage, and downloading. Such a clarification would give a green light to activities like RealNetworks's efforts to achieve interoperability with the iPod, and would ultimately lead to the availability of compatibility-enabling software necessary to compete with the black market.

IV. CONCLUSION

Legal downloading providers are aspiring to offer services that are altogether more attractive than that of the illegal file-sharing networks, but their success has been limited by the amount and variety of music that record labels and publishers are willing to make available to consumers via antiquated licensing procedures. Additionally, the proprietary product designs disseminated by companies seeking to gain a foothold in the digital distribution market ultimately constitute a further impediment to the success of the online distribution business model since consumers understandably desire flexibility in their uses of DPDs.

Congress can aid the music industry in improving these aspects of the legal downloading services by establishing a more streamlined licensing regime, creating a safe-harbor from potential infringement lawsuits to legal downloading services, instituting more equitable compulsory royalty rates, and permitting reverse-engineering for purposes of achieving interoperability of DPD files and devices. By implementing these legislative changes, the music industry will finally be able to offer legal downloading services that can compete with the illegal file sharing networks and will be in a position to win back the customers lost to piracy.