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Leo Strauss, Jr.

FOREIGN INCOME IN THE MUSIC INDUSTRY

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The record and music industries have grown tremendously and have become much more sophisticated in recent years. At one time a music publisher merely listened to a song and if he liked it he acquired the copyright. A recording artist or a recording A & R man would record those songs that he happened to like. Those who were lucky had their share of hits. This normally does not work any more, although it does in certain localized contexts. The record industry is big business and spans national borders as well as continents, affecting and bringing into contact with each other persons living around the globe. It should be recognized and treated as such.

Unfortunately, there is a tremendous lack of communication and understanding in the international area. Americans know their American business adequately. But they become confused when they start dealing with European, Canadian, and Far Eastern companies. I would like to discuss some various aspects of these international dealings.

The United States record industry, as a basis of reference, is over a billion dollar market today. That represents more than a doubling of the industry in the last ten years, with an equivalent growth in the publishing industry. As a comparison, domestic film distribution is just about a billion dollars. The record industry now in the United States is bigger than domestic films!

With that as a basis of reference, the United Kingdom is roughly 10 per cent of the United States market. Statistics indicate it to be from 60 to 125 million dollars, disregarding the recent devaluation. The higher figure is perhaps more accurate. Germany has shown a tremendous growth to over 10 per cent of the United States market value. This is the equivalent of 125 million in 1968. France and Italy together probably have less than 10 per cent. Canada is considered as being about 7 per cent of the United States, because most people refer to that percentage as they are comparing Canadian income with United States income. But the Canadian market itself is probably

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*Attorney and Accountant, New York City.

All too often American record companies work on a philosophy that if their American record sales break even, that is, when their cost is no more than their record sales, they are delighted because their licensee income in record clubs and foreign licenses provides the margin of profit. There is a tremendous amount of money overseas. Unfortunately, it isn't all being realized.

Now, how do you go about trying to realize some of that money? Normally, and this applies to both the record industry and the music publishing industry, when you are first beginning, you enter into an agreement with a foreign licensee. You assign songs, a catalogue, or records and also the right to produce and manufacture the records in a given territory. This perhaps is the very best way for a small and growing company to start. Take advantage of their native talent in a foreign country, their knowledge of the market, their contacts and ability to exploit it. As you grow, you may find that you are outgrowing him.

You then take the next step to enjoy the benefit of getting additional revenues. This step is forming a joint company with a particular foreign publisher or foreign record company in which each shares perhaps 50 per cent of the net profits after repatriating royalty income. There are certain problems with this if one tries to drive too hard a bargain, and all too often many American record companies have been doing this. At one time, it was a 50-50 profit split. Now many American companies are trying to get 75 or 80 per cent, at which point it is not economical for the foreign company to participate. Thus the company will concentrate on other catalogues. You then have one of two choices. First, you may renegotiate your arrangements and recognize that you have been taking unfair advantage to the point your profits are diminishing, although you have been receiving a greater percentage of profits. You have not realized as many actual dollars because the foreign company has not been putting out all its effort. Second, you may form your wholly owned company. This has been done more and more by the successful record companies who have entered the foreign market and formed a subsidiary corporation in major foreign markets, which basically are Western Europe and Japan. In Japan it has only been in the last two years that the foreign companies have been allowed to go in on a 50-50 participation with local companies. That is why just recently American companies have started to combine with Japanese companies. But in most other areas of the world you are now allowed to form your wholly-owned corporation.

What are the prime sources of income in foreign countries? Most of the money comes from performances and record royalties, as it does here in the United States. In the foreign countries the royalties are normally based on a percentage of the retail selling price. The United Kingdom until recently was 6-1/4 per cent, and negotiations are taking place to raise that percentage. In Germany it is 8 per cent of 93 per cent of the records manufactured. This is one of the most stringent rules in the world. In Italy and France it is also 8 per cent. In Japan it is equivalent to 2 cents a record. Total royalties that flow into publishers of foreign countries can vary depending upon the mix of the product. For example, in Japan, mechanicals may be half of the total performance. The record companies, in most of Europe, are entitled to public performance royalties, as are the publishers. That is not true at the present time in either the United States or Japan.

Normally, in the United States copyright royalties are paid to the composers and authors on a basis of 50 per cent of the mechanicals and synchronizations that are received. There is a sliding scale based on so many cents for sheet music and folios. Normally the public performance royalties flow directly to the writers from ASCAP and BMI. In many instances lately, the stars of the industry or the most popular songwriters have been able to negotiate with their publishers whereby they get part of the publishers' performance income; thus, in certain cases the publisher may even have higher than a 50 per cent payout which will result in a cost squeeze if he is not operating and functioning properly. Overseas, normally, the payout to composers is less than to the publishers.

It is difficult to get meaningful statistics for record companies' sources of income because in the United States such companies as CBS, RCA, and Capitol own their own record clubs so that that revenue would be mixed into the actual record sales. They are very reluctant, obviously, to release divisional sales figures. For those other companies that receive fees or license royalties from record clubs, the mixture varies depending upon the type of catalogue they have. I would say that in most record companies the royalties from licensees--that is, foreign and record club income, grouped on financial statements as license income--run from 10 to 20 per cent of total income. That sounds high, and it is high in many cases because you have closer to 10 per cent of the total market because most people tend to ignore the French Canadian market. It is a lucrative and popular market. For some unknown reason the French Canadians buy a larger percentage of records than the rest of Canada. Thus, it is not unusual to have a French Canadian record sell two hundred thousand records, a very large number considering the relatively small number of people in Quebec Province.

The South American area is still very small, but it's growing. It's an area that has not been exploited properly by the United States companies, and one which should be investigated and invested by those in the record industry. There are, however, certain problems in repatriating money from Argentina and other South American countries. But it is often possible to do it. One method is to establish a Mexican subsidiary, because the South American country may let money pass into Mexico. From there the money can flow into the United States normally. Incidentally, Mexico itself is a growing market. It has a stable standard of living. The peso is a solid currency, and it's a growing country.

Looking toward the Far East, Japan is the second or third largest industrial country in the world and has a population of approximately one hundred million people, which is about half that of the United States. The young there buy records, and American type records at that! The reception that the folk singers have been receiving in Japan has been just utterly phenomenal.

This applies not only to Japan, but also to all of Southeast Asia. Even Indonesia has a market of little over one hundred million people. India has a population of over half a billion. Admittedly, there are poverty problems, but still records in respectable quantities are sold. It's interesting to note that in a town called Kuala Lumpur in Malaysia, there is a record company that neglected to pay royalties. Only recently the Harry Fox office representing United States publishers obtained a settlement from that company, collecting copyright royalties in United States dollars of well over five figures. Thus, regardless of the standard of living throughout the world, the record-buying public, especially the teenagers, manage to get the dollars, the pesos, the rupees, the yen, whatever it is, to buy the records. It is a fantastic market, and it is one that the industry should really explore, invest in, and eventually proceed to maximize profits.

to remember that gross income from these sources, except for any artist royalties, becomes net income. As to records sold, there is the cost of producing and pressing the record as an expense.

Foreign income, however, is dependent on current tastes. At one time, United States songs were extremely popular in Europe, and then along came the Beatles and English songs became popular. Now it's beginning to switch back. It's truly an international market and to give statistics on one year becomes meaningless when you compare it to the subsequent year or previous year. In most American record companies the way to maximize the foreign record income is to have the song sung in the language of each licensed territory. Thus, those artists who can sing in a foreign language give the full impact of their style as well as the song. If this cannot be done, the record company may be able to get the adaptations of a local artist.

It's interesting to note that in Japan, the LP record sales are largely of American artists singing in English and not in Japanese. However, in the area of 45's, there has been a tremendous growth of local artists. At one time approximately 60 or 70 per cent of the records were performed by Americans. Now some 60 to 70 per cent are performed by local talent. This again relates back to the theory of having your own record company abroad so that you can "cash in" on the local market. Perhaps you can find a song which originated overseas but can be adapted for the United States domestic market.

In most countries performing fees exceed mechanical fees. As a point of reference, the publishers in the United States have gross domestic performance fees of about 72 million dollars. Gross mechanical fees run about 45 million dollars. However, after the administrative cost of the collection agencies is deducted, this disparity is not as great because the mechanical fees collected bear a 3-1/2 per cent administrative fee, whereas the performance fees run as high as 20 per cent.

In the United Kingdom, mechanical and performing fees as a ratio are as follows: performing fees are two-thirds of the total and mechanical fees are one-third. In Germany, it's about 55 per cent to 45 per cent. In France the performing fees are much higher than in Germany, approximately 80 per cent of the total. On a world wide basis for one large international publisher, the mechanical collections ran 38 per cent, performances produced 32 per cent, and sheet music ran 25 per cent. These statistics may mean nothing considered alone, but if you are in those markets it may lead you to possible areas of exploitation.

Now to discuss the nature of contracts used in the foreign music business. There are certain areas to consider when entering into any contract or agreement with any foreign subsidiary or licensee. First, know the business policies and marketing concepts of the country with which you are dealing. For example, in Japan there are any number of contracts that provide that royalties are to be based on sales. This is not the normal method of accounting in Japan! Normally they report 80 per cent of movement from the factory to their wholly-owned branches in connection with copyright royalties. Thus, they have a tendency to use these same figures when they are reporting on licensee income. If that method is one that you are willing to accept, make sure that it is mutually understood. If you don't want that arrangement, be positive that they understand that you do not want it and specifically set forth the exact terms. The possibility exists that even if the language drawn in the contract is clear, the Japanese licensee will continue to report on 80 per cent. You may be willing to accept it because Japanese companies experience a 20 per cent return factor, but if you feel you have the type of catalogue that would not normally experience a 20 per cent return, you may not want to accept it. Understand the market and make the appropriate provisions in the licensing contract.

Be careful when you enter into a licensing deal to prevent getting involved in some sub-licensing. Occasionally, when you enter into a licensing agreement you get 50 per cent of the mechanicals the agent collects and 50 per cent of the performances. Also, do not give a foreign operator a territory beyond which he can service himself. If you give him an extra territory he may take that territory and sub-license it to somebody else and that sublicensee will pass on the 50 per cent to him. He will in turn pass on 50 per cent of that. Consequently, you end up with only 25 per cent. That is obviously not the best way to maximize profits. Thus, I think it would be very advantageous to spell out in specific detail the territories you are granting in the contract. For example, there have been any number of contracts entered into before World War II which granted catalogues to companies in England. The companies' territories were defined in the contract as the British Commonwealth of Nations. Is there anybody in the record industry or the music industry today who can definitively state the extent of the British Commonwealth of Nations as meant in these contracts drawn before World War II? Set forth specifically the territories you are covering and have language to protect these territories if they become independent or merge with another country, forcibly or voluntarily.

Another area that should be provided for is what is known as "black box money." This pertains both to record companies and also to publishers. Black box money is certain monies that the foreign societies distribute to their members. Normally distributions are made on a per song basis. But there is a certain amount of revenue that is not distributed on a per song basis: the so-called "black box" money. That money is distributed as a percentage of a total distribution to each publisher or record company. Sometimes it is actual performance money; sometimes it represents interest earned on investments by the performing society or the mechanical collection society. The tendency of the foreign company is, frankly, not to pay this money unless you insist and unless you set forth in the contract that you are entitled to it.

Another area of dispute is the so-called "no charge" or "freebie" record. This is a marketing concept which started in the United States, for better or worse, by which record companies give a certain number of "free" records. Normally, in this country it is 300 singles for every 1,000 the distributor buys. On LP's, it ranges from one for every six to one for ten. The record company, when accounting to the copyright owner, artist, or the licensor, tends to treat this as a nonroyalty item. However, this is really a discount; these records are eventually sold to the ultimate consumer. Avoid any problems simply by providing for royalties on such shipments in the contract. Publishers in the United States have consistently collected copyright royalties through the Harry Fox office, but it is still a problem in certain parts of the world.

Another area you may wish to provide for if you are a domestic record company licensing in a foreign country is the right to prevent remixing your product. Can they take two of your records and get the best of a certain artist? Would you like them to do that? Can you allow them the right to do that under the contracts you have with your artists? You must set forth these limitations in any agreements you enter into with the foreign licensee.

Somewhat related to that is a tie-in-sale, a worldwide practice. Here, the record company, in order to promote its product, may go to a manufacturer of high fidelity components, a tape manufacturer, or an automobile company, and agree to sell a certain number of records or tapes in order that the aforementioned business distribute them free with their record sets or hi-fi components, or whatever. This is an excellent method of exploiting the label for the manufacturer, but there may be a problem as far as accounting for royalties. This becomes a problem especially if there are separate series of records with a different label. Since most contracts call for royalties to be paid under retail list price or retail selling price, what is the retail list price? What is the retail selling price for a record that is not being sold except as a component or as a package deal with a hi-fi unit? The solution to these problems should be provided for in the contract.

Another problem area is reserves. In many cases there is a tendency to maintain a reserve against future returns, especially if you have to account on a per record basis as some contracts require. Most contracts of course are on a catalogue basis, but this problem will arise when a licensee's contract expires. The licensee will have shipped records, and it is concerned about getting returns after they have made a final accounting, as they will not have future sales to apply against these returns. Consequently they would like to provide reserves against future returns. This is not the most ethical practice, but it is a practice that you must be aware of. If you don't want to permit it, negotiate it at contract time. Know the facts beforehand and have an understanding of the problem.

Another trouble some areas have is the sale of discontinued merchandise or overstocked inventory. The record or tape company that has an inventory faces the problem of what to do with it. They can grind it up and get a few cents per pound of vinyl; but most companies in the United States and now throughout the world sell these records to what is known as the "secondary market." These discontinued records are sold in Woolworth's, other variety chains, and elsewhere. The question is, are you entitled to full royalties? Are you entitled to the initial royalties agreed to or royalties based on a new, lower selling price? Negotiate! If you do not want to permit them to sell discontinued merchandise because it will harm the reputation of your label, set it forth in the contract. You may have to give up an advantage elsewhere in the contract, because you have to recognize that they have a problem.

If the record company has an inventory of jackets, a similar problem arises. For example, assume the company has an inventory of jackets in which they have invested 15 to 20 cents. They know they can press a record for 25 or 27 cents. They can sell it in the so-called secondary market for 50 to 75 cents. They know, disregarding any royalties, that for an investment of perhaps 27 cents they can get a cash flow of 75 cents; therefore, they will manufacture records to sell them as discontinued records. We would all agree that this is not a practice that should be encouraged; rather it is one that should be discouraged. Again, protect yourself by appropriate specific provisions in the contract.

After you have covered all of these points, be sure to look over your agreement to ascertain that the agreement is what you intended. For example, I conducted an examination under a certain contract, the language of which provided, in essence, that the licensee agreed that if any deductions are made by the government for taxes on money earned by the owner in the licensee's country, the licensee was to add the amount of such deductions to monies it would send to owner. A close reading of that clause discloses that, in effect, the licensee is indemnifying the licensor for any withholding taxes or income taxes which existed in this country. It was a very advantageous clause for the owner, but it was a very onerous clause for the licensee and probably was not meant to be interpreted that way--a case of poor draftsmanship.

Similarly, another contract provided for royalties based upon 5 per cent of the retailer's price less tax and the cost of the jacket. The cost of the jacket was defined as not to be in excess of 6-1/2 per cent of the royalties due under this contract. That was clearly a mistake and should have been 6-1/2 per cent of the retail selling price. This obviously was not the intention--the industry standard is 6-1/2 percent of the selling price. In this instance, the contract was reformed after the error was called to the attention of the owner and the licensee, but it could have proved most costly to the licensee.

In another situation, the contract provided for royalties to be paid at "5 per cent of 90 per cent of the retail price of the record, less the cost of the jacket." Five per cent of 90 per cent of the retail selling price of 5 American dollars per record would be approximately 22-1/2 cents. The cost of the jacket may be 15 cents. Just by the position of the comma in the contract, the recipient was technically only entitled to 7-1/2 cents, whereas the intent was to subtract the cost of the jacket from the 5 dollar cost price. Read the contracts and know what you may or may not be signing!

In summary, my appeal to you Nashvillians is to know the markets and to know what your involvement is. It's a complicated field, but it is a challenging field. It also is a rewarding and interesting field. Ten years ago most of the songs produced in Nashville were not even played more than 250 or 300 miles from Nashville. Now I see country and western royalty statements covering countries with such disparate cultures as Iceland, Ireland, and Italy. The market is there, so make the most of it!