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Will Mechanicals Break the Digital Machine? Determining a Fair Mechanical Royalty Rate for Permanent Digital Phonographic Downloads

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WILL MECHANICALS BREAK THE DIGITAL MACHINE?: DETERMINING A FAIR MECHANICAL ROYALTY RATE FOR PERMANENT DIGITAL PHONOGRAPHIC DOWNLOADS.†

David Kostiner‡

I. INTRODUCTION

Should the mechanical royalty for permanent digital phonorecord deliveries ("DPDs") be set at the currently defined statutory rate or as a percentage of the wholesale value of the download? As music services such as iTunes, Napster, and Rhapsody log millions in downloading sales each month, record companies are watching the wholesale and retail values for music fall, while the mechanical royalty rate owed to composers for a fully owned, nonstreamed DPD remains the same as that for a physical reproduction.† The success of these online music services depends, in part, on the amount and variety of music record labels are willing to make available to consumers for download. If the mechanical royalty rate paid to composers is disproportionate to the wholesale income realized by record labels, those labels may decide to decrease the availability of their online catalogs, depriving the public of an exciting, economical, and convenient method of purchasing music.

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Digital music can be accessed by either streaming or downloading. Downloading, the focus of this note, results in a permanent copy of a song, stored on the receiving machine's hard drive, which can then be burned to a compact disc or transferred to another storage medium.\(^2\) In contrast, an interactive stream is a user-selected song played in real time. No permanent copy of the file is made on the receiving hard drive, which requires the song to be re-streamed for every performance.\(^3\)

Section 115(c)(3) of the Copyright Act recognizes the availability of compulsory licenses for all DPDs, as well as the ability of composers to negotiate with licensees either individually or through common agents (called mechanical rights agents, such as the Harry Fox Agency), but stops short of defining a statutory royalty rate, as it has for physical reproductions.\(^4\) Section 801 of the Copyright Act defines the objectives by which to establish mechanical royalties. The potential benefits to the public and fair compensation to the copyright holder need to be balanced against the potential impacts of the rate on the music industry.\(^5\) These objectives were followed during the initial fixation of the statutory rate, but recent rate courts have not been so faithful. Instead they have used historical methods and benchmarks that often do not correspond with each other.\(^6\) Moreover, the Copyright Royalty Panel, the body charged with deciding the appropriate mechanical royalty rate for a DPD, has yet to address the matter.\(^7\) To date, Congress has simply established that the compulsory license provision of § 115, which currently applies a mechanical royalty rate of $0.085 per reproduction, includes phonorecords delivered by means of a digital transmission.\(^8\)

2. Michael A. Einhorn & Lewis Kurlantzick, Traffic Jam on the Music Highway: Is It a Reproduction or a Performance?, J. COPYRIGHT SOC‘Y U.S.A. 417, 425 (2001). These files are often protected by "codecs," proprietary technological controls meant to prevent piracy by allowing a file to be transferred only a certain number of times.


4. Id. § 115(c)(3). The Harry Fox Agency is a publishing rights clearing house often used to reduce transaction costs in the issuance of mechanical licenses. See DONALD PASSMAN, ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS 221–22 (Simon & Schuster 4th ed. 2000).


6. Einhorn & Kurlantzick, supra note 2, at 420.


I propose that the United States adhere to international norms by setting the mechanical royalty rate ceiling as a percentage of the wholesale value of a DPD. The directives of § 801(b) should be applied to the changing valuation of online music to fairly compensate authors for the use of their compositions. Viewing the matter from an economic perspective, efficient licensing should ensure that one form of delivery is not unduly burdened by copyright administration and disproportionate royalty rates. If two technologies are asymmetrically burdened by mechanical royalty rates, the market will not be able to effectively determine the efficiency of each method. The relative decrease in wholesale income earned by a label from a DPD, as compared to a physical reproduction, requires a proportionate decrease in the mechanical royalty for such a download. Any other payment of mechanical royalties will create an unprecedented burden to new models of digital delivery, which promise to expand the availability and sales of music, with a corresponding boon to composers.

This comment will look into the history and policy of compulsory mechanical royalties, explore their application in the digital world, and apply the objectives set forth by Congress to propose a fair mechanical rate for a permanent DPD. Lower wholesale prices, despite increased efficiencies in delivery, promotion, and retailing, suggest a proportionately lower mechanical royalty rate. The viability of independent labels, which often release less popular and less profitable records, requires this reassessment. Due to declining compact disk sales and piracy, levying a disproportionate mechanical royalty on direct phonorecord downloads in the quest to compensate composers may deprive those same artists of a vital outlet for their work.

9. See, e.g., Section 115 of the Copyright Act: In Need of an Update?: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the House Comm. on the Judiciary, 108th Cong. 37-38 (2004) [hereinafter testimony of Sherman] (testimony of Cary Sherman, President, Recording Industry Association of America) (testifying that a similar percentage-based mechanical rate would be ideal for "multisession" compact discs, where several versions of the same composition are reproduced on one compact disc for extra value to the consumer).


11. See Einhorn & Kurlantzick, supra note 2, at 425 n.39. See generally id. at 430–34.

12. See testimony of Sherman, supra note 9, at 38.

13. A discussion of the different types of DPDs defined by the Copyright Act, including the meaning of "tethered," can be found infra Part II.E.
II. BACKGROUND OF MECHANICAL ROYALTIES

A. The Two Copyrights Inherent in a Recorded Song

A recorded composition gives rise to two copyrights: one in the sound recording and one in the underlying composition embodied in the recording. 14 A sound recording is defined by the Copyright Act as the fixation of musical sounds by any method from which they can be "perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device." 15 As a result, one underlying composition may be recorded several times in separate sound recordings, each owned by a different copyright holder. 16

In contrast, the author of the composition underlying the recording enjoys a separate set of rights, regardless of how many times it is recorded by different artists. 17 Included in these rights are the exclusive rights to reproduce, adapt, publicly perform, and distribute the work. 18 However, the § 115 compulsory license allows others to cover a composition under certain conditions, such as paying a prescribed royalty to the composer. 19 This powerful limitation to the composition copyright holder’s exclusive rights is meant to ensure the availability of compositions to the public, while still giving fair compensation to the composer for his work. 20

B. Balancing Compensation with Availability

In the 1909 Copyright Act, Congress granted composers the right to control mechanical reproductions of their songs. This was done in response to White-Smith Music Publishing Co. v. Apollo Co., in which the Supreme Court found that copying a player piano scroll did not constitute infringement of the exclusive reproduction right of the underlying composition. 21 By establishing a mechanical royalty,

15. Id. § 102; see also id. § 101 (defining "sound recordings" further).
16. Id. § 102(a).
17. Id.
18. Id. § 106.
19. See id. § 115(a). A "cover" is the subsequent recording of an original composition by an artist other than the original composer. Section 115 gives subsequent artists the right to reproduce, and distribute the composition, though the new arrangement may not "change the basic melody or character of the work," nor may it be protected as a "derivative work." 17 U.S.C. § 115(a)(2) (2000).
20. See generally id. § 801(b).
21. White-Smith Music Pub. Co. v. Apollo Co., 209 U.S. 1, 17–18 (1908). It is interesting that the same impetus that compelled the establishment of the mechanical royalty
Congress granted owners of the copyright in a musical work the right to benefit from the mechanical reproduction of their work, so named because of the mechanics involved in a player piano. However, this benefit was offset by a relinquishment of exclusive control via the compulsory license.

Section 115 of the Copyright Act stipulates that if a nondramatic musical composition has been fixed lawfully in a sound recording and previously distributed under the authority of the copyright owner, it can be covered by any interested artist. However, the artist must pay either a mechanical royalty prescribed in § 115, initially capped at $0.02 per reproduction, or a lower negotiated rate agreed to by the composition's copyright holder. This compulsory license was established to avoid possible monopolies on music publishing. In 1907, the actions of the Aeolian Company spurred Theodore Roosevelt and Congress to counter what they thought to be an unregulated monopoly. Aeolian had signed exclusive agreements to produce piano rolls for eighty-seven music publishers for a 10% commission. Congress felt that Aeolian, if allowed to continue this practice, could gain the exclusive rights to the piano rolls of all music publishers, blocking others from the business and eliminating competition. The compulsory license removes a composer's ability to exclude others from using a work, eliminating Aeolian's ability to monopolize the mechanical reproduction of compositions, while at the same time compensating the composer for the use of his work.

rate—advances in music reproduction technology—are now working to make the current mechanical royalty less equitable.

22. PASSMAN, supra note 4 at 211.
24. Id. § 115(a)(1).
25. See id. § 115(c). In the 1909 Copyright Act, the mechanical royalty rate was capped at $0.02. 17 U.S.C. § 1(e) (1909) (amended 1976).
27. Id.
28. Id. It is interesting that Aeolian’s “monopoly pricing” was actually less favorable to Aeolian than the statutory rate is to composers today. At today’s rate, a composer (or publisher) earns $1.02 per record (with an average of 12 songs per record, multiplied by the current statutory mechanical rate of $.085 per song) on a compact disc with a wholesale value of $8.00, resulting in a 12.75% commission for the use of the work. The statutory mechanical rate of $.085 per song became effective January 1, 2004. Todd Brabec & Jeff Brabec, CD Mechanical Royalties for 2004 and 2005, THE AM. SOC’Y OF COMPOSERS AND PUBLISHERS, at http://www.ascap.com/musicbiz/ascapcorner/corner15.html (last visited Sept. 1, 2004).
30. See Kravis, supra note 26, at 273.
However, because of the burdensome monthly payment provisions of §115 and competition among composers, the statutory terms are rarely followed. As described above, the statutory mechanical rate represents a ceiling for voluntary negotiations between the publisher, the composition's copyright holder, and the licensee. A common example of this is the Controlled Composition clause discussed below.

C. Mechanical Royalties for Controlled Compositions

When an artist writes a composition that appears on his or her own record, and the sound recording is owned and released by a record company, the mechanical royalty for that composition is usually governed by a controlled composition clause. In these circumstances, the owner of the sound recording copyright, usually the record company, negotiates a mechanical royalty to be paid to the composer as part of an exclusive and perpetual license to reproduce and to distribute the recording. However, due to superior bargaining power and industry standards, this royalty is usually limited by both the amount of compositions paid on the album, usually ten out of an average of twelve songs on an album, and a fractional value of the statutory mechanical royalty, typically three-fourths. In addition, many recording agreements apply a 20% deduction to the royalty in return for free goods distributed to promote the sale of the record. It is unlikely that this many albums are actually given away. The provision is often used as a pretext for questionable accounting, but the practice has become industry standard.

These deductions do not transfer well to the downloading industry where songs are usually purchased individually, making it difficult to limit the amount of songs per record for which the company must pay mechanical royalties. This is complicated further by the fact that songs are easily previewed for free online, reducing

31. See Passman, supra note 4, at 213.
32. Id. at 214.
34. Id.
35. Wallace Collins, Confronting Controlled Composition Clauses: Pitfalls in Mechanical Royalty Rate, 12 ENT. L. & FIN., July 1996, at 3.
36. See Passman, supra note 4, at 91–94.
37. Id.
38. Id. at 228.
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the need for free goods. The result is that labels selling the same number of songs digitally earn less money, after paying the appropriate mechanical royalties, than they would by selling those songs in the physical world. While free goods and other standard deductions are the result of bargaining disparities, the overall loss in income from the cessation of the practice combined with a less equitable mechanical royalty ratio might disrupt an already fragile music industry, and in particular, under-funded independent labels.40

D. Setting the Mechanical Rate for Physical Sound Recordings

Initially, the Copyright Act of 1909 established the mechanical royalty rate at $0.02 per reproduction.41 At first, statutory rate increases were delayed by competing lobbying interests. Congress realized that the issue of rate increases could not be addressed “by the normal legislative process.”42 In 1976, Congress delegated the authority to make such rate changes to an independent Copyright Royalty Tribunal.43 After an increase in 1976 to $0.04 per composition, the Tribunal set a periodic schedule, which led to the current rate of $0.085 per song up to five minutes in length, or $0.0165 per minute of playing time, whichever is higher.44

In § 801 of the Copyright Act, legislators defined the following factors as those which should be considered by the Tribunal in determining the mechanical rate: (1) maximizing the availability of diverse creative works to the public; (2) affording the copyright owner a fair income in order to encourage creative activity; (3) not jeopardizing the ability of the copyright user to earn a fair income under existing economic conditions and to charge the consumer a reasonable price for the product; (4) reflecting the relative roles of the copyright owner and the copyright user in the product made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets for creative expression and media for their communication; and (5) minimizing any

39. Id. at 94.
40. See testimony of Sherman, supra note 9, at 39 (citing a 25% decline in sales of recorded music products of the past three years, forcing labels to slash artist rosters and support for new artists).
42. Recording Indus. Ass’n of Am. v. Copyright Royalty Tribunal, 662 F.2d 1, 4 (D.C. Cir. 1981).
43. Id. at 5.
44. See Brabec & Brabec, supra note 28.
disruptive impact on the structure of the industries involved and on generally prevailing industry practices.\textsuperscript{45}

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 distribution, allowing technology to improve both consumers' experience and opportunities for remuneration to artists and composers. The United States, however, performs the same function by adjusting the rate periodically, with an eye on the Consumer Price Index ("CPI"), and ignoring economic changes brought on by huge advances in technology.\textsuperscript{46} Despite a consistent CPI value, newer modes of digital distribution have completely different wholesale and retail prices than physical distribution of the same compositions. Applying the same mechanical royalty rate unfairly punishes newer modes of music distribution, artificially inflates costs, and fails to provide a level playing field by which consumers and record companies can value the new technology.\textsuperscript{47} Furthermore, continued reliance on the CPI to determine the mechanical rate for a DPD ignores Congressional objectives set forth in § 801, which seek to balance incentives to composers with the continued viability of the current music industry structure, and to provide consumers with reasonably priced and diverse products.\textsuperscript{48}

\textbf{E. Establishing a Mechanical Royalty Rate for a Digital Phonorecord Delivery}

Digital phonorecord delivery ("DPD") is defined in the Copyright Act as "each individual delivery of a phonorecord by the digital transmission of a sound recording which results in a specifically identifiable reproduction."\textsuperscript{49} This definition purposely excludes noninteractive, real-time streaming of a sound recording.\textsuperscript{50} It

\begin{itemize}
  \item \textsuperscript{46} Recording Indus. Ass'n of Am., 662 F.2d at 10 n.24, 11. It is interesting that the same factor that compelled establishment of the mechanical royalty rate, advances in music reproduction technology in the form of piano rolls, is now working to make the current mechanical royalty less equitable.
  \item \textsuperscript{47} See Einhorn & Kurlantzick, supra note 2, at 420.
  \item \textsuperscript{49} Id. § 115(d).
  \item \textsuperscript{50} Id. ("A [DPD] does not result from a real-time, non-interactive subscription transmission of a sound recording where no reproduction of the sound recording or musical work embodied therein is made . . . to make the sound recording audible.").
\end{itemize}
also excludes incidental recordings, which are created when a transmission is temporarily stored while being distributed to a user. 51 An example of this would be ephemeral storage on a satellite prior to transmission to a purchaser on earth. 52 A third variant of digital transmission, also distinct from a DPD, is the tethered download. 53 A tethered download exists when a user licenses the performance rights to a sound recording, as well as the underlying composition, only as long as she subscribes to a given service. 54 The licensee does not own the copy, as she will not be able to retain it past a certain period in time, and cannot make copies of the recording for personal use. 55 For example, a tethered download will not be accessible on a hard drive after the owner is no longer a subscriber to the music service from which the song was downloaded. 56 This comment will focus on nontethered, nonstreamed downloads, as they share the same ownership qualities as a physical compact disc, as opposed to interactive streaming downloads, which are akin to an on-demand radio station. 57

The Copyright Act describes a method of payment for DPD mechanical royalties after January 1, 1998 as based on voluntary negotiations between the copyright owner and anyone entitled to obtain a compulsory license. 58 In the absence of a negotiated agreement, a binding compulsory rate will be set by a Copyright Arbitration Royalty Panel (CARP). 59 Recently, a proposal has been made to replace the CARP with a set of three Copyright Royalty Judges, who would be more familiar with the subject matter at hand. 60 Regardless of the determining body, rates are to be established de novo, with no precedential effect given to the mechanical rate for non-digital delivery. 61 The objectives are the same as those given by

52. Id.
54. Id.
55. Id.
56. See id.
58. Id. § 115(c)(3)(A)(ii), (B) ("[A]ny copyright owners of nondramatic musical works . . . may negotiate and agree upon the terms and rates of royalty payments under this paragraph . . . .").
59. Id. § 115(c)(3)(D).
61. See generally id. at 5-8.
Congress to the initial Copyright Royalty Tribunal codified in § 801 of the Copyright Act.  

F. Downloading Services

Apple’s iTunes music service sold its one hundred millionth song in July of 2004. That song, ironically, was a remix by the copyright-flaunting producer, DJ Danger Mouse.  

Rhapsody listeners pay for over 28 million streams a month and Jupiter Research foresees a $3 billion online music industry by 2008.  

These new music services represent a monumental change in the course of legal downloading on the internet.  

Dozens of companies, as disparate as Starbucks and Walmart, now feature music downloading services which are expected to represent over 33% of all music sales within 4 years.  

They aggregate content directly and through independent distributors from all of the major labels and many of the independent labels, selling songs from $0.79 to $0.99 a download, and $9.99 per album.  

The attraction to these services is the promise of a celestial jukebox: legal, virus-free, affordable music at one’s beck and call.  

Recent statements by Apple CEO, Steve Jobs, indicate that a primary goal of Apple’s iTunes Service is to find lesser known, more obscure titles by artists whose works are out of print, or who do not command the attention through high sales volumes as their more mainstream colleagues.  

This puts special emphasis on digital distribution for such composers and artists. If the mechanical royalty rate for a DPD

66. Wharton School of the University of Pennsylvania, supra note 64.
68. Id. at 48.
is not cost effective for labels to make these more obscure recordings available online, independent and less popular composers and artists will feel the greatest impact.

Similarly, consumers face what seems to be a never-ending rise in the retail price of a compact disk. Via online music stores, consumers are able to download full albums for almost half the price of a retail compact disk. Disproportionately high mechanical royalties will hurt consumers and their ability to access inexpensive and diverse music.\footnote{See Roberts, supra note 67, at 48.}

Furthermore, as the market grows, consumer demand will continue to define the retail price of a DPD. Real Networks' Rhapsody service has set their download retail price at $0.99 and has recently promoted a half-price sale to increase listenership.\footnote{Telephone Interview with Kevin Arnold, CEO and Founder, Independent Online Distribution Alliance (June 2, 2003) [hereinafter Arnold]; Jefferson Graham, Real Says Digital Song Sale Doubled Market Share, USA TODAY, Sept. 8, 2004, available at http://www.usatoday.com/money/industries/technology/2004-09-08-real_x.htm (updated Sept. 9, 2004).} In fact, Downloadpunk.com has set its wholesale rate as a percentage of the retail price of a song, which itself is chosen by the label. While this gives the label wide latitude to establish its wholesale income, the current static mechanical royalty rate punishes labels who hope to drive sales with affordable downloads. Clearly, competition will continue to alter the valuations of DPDs and reliance on a static statutory rate will prove inequitable.\footnote{SIDNEY A. SHAPIRO & JOSEPH P. TOMAIN, REGULATORY LAW AND POLICY: CASES AND MATERIALS 24 (LEXIS Law Publishing 2d ed. 1998).} The result of a static mechanical rate will be that a label's profit margin from the sale on a DPD will vary from one service to another. This arrangement would provide the composer with a steady stream of income that is not consistent with the amount actually received by the label. A solution to this would entail setting the mechanical rate as a percentage of the wholesale income of a label, ensuring equal footing to both the label and the artist. This would provide a fair return for musicians and record labels alike, regardless of the retail or wholesale price of the download, which will likely vary as the market determines the appropriate value of DPDs.

One danger of the percentage model is that a record label may decide to sell a recorded song at a low value so as to cause the
composer's set percentage-share to be far below the current statutory value, as is possible via the Downloadpunk.com model described above. Perhaps, the solution to this is to establish a floor for the mechanical royalty, as opposed to the current ceiling. This would allow the composer to earn an established percentage of the composition's wholesale value, while protecting him from below cost sell-offs or other discount, mid-priced or budget liquidations. The choice then would be up to the label, rather than copyright law, as to whether it wants to pay a disproportionate amount of the recorded composition's wholesale value to the composer.

At the very least, sales in the digital medium will represent a significant portion of music purchased worldwide. Major and independent labels from across the globe are supplying content to dozens of services, either directly or through more efficient aggregators such as the Independent Online Distribution Alliance or CDBaby's digital distribution arm. Clearly, a fair mechanical royalty rate for DPDs must be established which promotes science, thus giving the public access to recorded content by fairly compensating composers, while continuing the existence of the independent labels upon which they depend.

III. APPLYING COPYRIGHT ACT SECTION 801 TO THE DIGITAL MUSIC INDUSTRY

For the purposes of establishing a fair mechanical royalty, the sale of a digital download entails different parameters than that of a physical reproduction. The wholesale value of a DPD is significantly lower than the top-shelf, or undiscounted, wholesale price of a single song sold via physical distribution. This suggests that fair compensation to the songwriter would entail defining the mechanical royalty rate for a DPD as a percentage of the wholesale value earned by the record label, rather than applying the current mechanical royalty rate of $0.085 per reproduction. In the next section, the

73. See Menell, supra note 65, at 66.
75. See U.S. CONST. art. I, § 8 (referring to "science" as that which is protected by copyrights, as opposed to the "useful arts" which is protected by the patent system); see also 17 U.S.C. § 801(b)(1) (2000) (discussing the need to consider impacts to the music industry while setting the statutory mechanical royalty rate).
76. Telephone Interview with David Katznelson, Owner and President, Birdman Recording Group (Mar. 10, 2004) [hereinafter Katznelson].
77. See Brabec & Brabec, supra note 28.
statutory language of § 801 will be applied to the realities of digital downloading to assess whether the current statutory rate or a percentage-based model treats composers and record companies more fairly. During the assessment, the Congressional goal of promoting creative output for the benefit of the public will also be considered.

A. Maximizing the Availability of Diverse Creative Works to the Public

It is well documented that copyright protection provides an incentive to create, without which the public would lose a valuable benefit. It stands to reason that the more an artist is paid for a work, the larger the incentive, and perhaps opportunity, he has to create the work. Although it is easy to dismiss art as an aesthetic and recreational pastime, the cost and time spent writing and recording compositions is significant, and this investment would clearly be facilitated by an increase in the value of those compositions. If the mechanical rate were to be raised or lowered, it would likely affect the availability of diverse creative works to the public.

However, the importance of independent labels to the diversity of available music should also be considered. When analyzing the impact on artists and record labels due to sales of direct downloads, it is helpful to use independent labels as a model because they rarely own their own distribution companies, which is a large factor in the wholesale value of a record.

Major labels are often owned by parent corporations with subsidiary distribution companies. This reduces distribution costs for both physical product and DPD sales, a luxury not available to independent labels. However, to support these vast infrastructures and maximize profits, major labels focus on only the most profitable releases. It is the smaller, more experimental labels that provide the most diversity to the public, and for this reason, must be protected

79. Id.
82. See DeLange, supra note 81.
83. See Tangborn, supra note 81.
from overly burdensome royalty rates.\textsuperscript{84} Without a mechanical royalty that considers independent labels' thin margins, artists will have fewer avenues to promote and distribute their work, and the public will suffer as a result.\textsuperscript{85}

\textbf{B. Affording the Copyright Owner a Fair Income in Order to Encourage Creative Activity}

Under the current mechanical rate for compact discs, a composer will earn $0.085 per composition physically sold on a compact disc, phonograph record, tape recording, or any other physical embodiment of a composition, ignoring controlled compositions clauses.\textsuperscript{86} Assuming an independent recording company receives $0.67 as wholesale income per composition on a physical record and assuming there are twelve compositions paid on a record with a wholesale value of $8.00, the songwriter would realize a 12.7\% share of the wholesale price of the recording. In contrast, an $0.085 mechanical rate would represent a 15.5\% share of an independent label's $0.55 wholesale income per DPD.\textsuperscript{87}

Typically, digital music services sell downloads to consumers for $0.99, while they pay distributors $0.65 for the right to do so. Distributors retain 15\%, less than most physical distribution rates of 20-25\%, while paying $0.55 wholesale to the record label.\textsuperscript{88} Since the label's wholesale income is 16.7\% less for a DPD than for the physical sale of an album, affording the copyright owner a fair income would require lowering the mechanical royalty rate by 16.7\% to $0.07 per composition directly downloaded. This way, the composer is earning 12.7\% of the wholesale value of a song, regardless of whether it is downloaded or sold as a physical record.

This analysis ignores the controlled composition clauses inherent in most independent and major label recording agreements. However, labels can still attempt to negotiate similar terms, perhaps by only paying mechanical royalties on ten of every twelve compositions purchased as a DPD. Percentage deductions could also be applied, as

\textsuperscript{84} Telephone Interview with Jordan Kurland, Owner and President, Zeitgeist Artist Management and Seventeen Reasons Recording Co., a subsidiary of the Universal Music Group (Jan. 19, 2004).

\textsuperscript{85} Id.

\textsuperscript{86} See Brabec & Brabec, supra note 28.

\textsuperscript{87} See Arnold, supra note 71. The $0.55 wholesale rate factors in a 15\% commission for digital distribution, which involves encoding, data entry, digital delivery, reporting, accounting, and blanket license negotiation.

\textsuperscript{88} Id.
the $0.07 rate would be a default ceiling, similar to the current compulsory rate for physical records. The dubious free goods deductions would be more difficult to justify, but labels will likely find ways to charge artists for any physical recording or co-op advertising done in conjunction with downloading services. Setting the mechanical royalty rate of a DPD as a percentage of the wholesale value rewards artists and supports avenues for their creativity, independent labels, while leaving the current economic balance between labels and artists unaffected.

C. Avoid Jeopardizing the Ability of the Copyright User to Earn a Fair Income Under Existing Economic Conditions and Charge the Consumer a Reasonable Price for the Product

Previous increases in the mechanical rate were justified by increases in the cost of living, increases in wholesale prices of recordings, and other economic factors. Clearly, there is no difference in the cost of living between the two mediums of distribution because the composer is being compensated for both the direct digital and the hard copy reproductions at the same point in time, depending only upon whether the composition is sold through an online music service or a brick and mortar retailer. In addition, since the same recording is simply being sold digitally either over the internet or in the form of a compact disc, the cost of producing the sound recording itself remains constant. Therefore, this prong of the analysis is less relevant to the discussion of comparable equity, as nothing has changed due to the different medium of delivery. More pertinent, however, will be the economic benefits realized by record companies and the allocation of those benefits to songwriters.

Retail DPDs sell for $0.99 each on most services, with some selling for as little as $0.79. Compare these DPD prices to an average retail price of $1.41 per track for a compact disc, assuming a

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89. A co-op advertisement is a retail store advertisement done in bulk, whose expense is shared by several artists on a label or several labels serviced by the same distributor (who passes the cost on to the labels). Andrew C. Selden, An Analysis of Cooperative Buying Associations—Including New Concerns for Franchise Systems, 37 BUS. LAW. 1569 (1982). It is the policy of every major downloading service to refuse co-op advertising, or payment for artist placement. See, e.g., Derek of CD Baby, supra note 69. However, marketing and profit pressures make this an open question in the future.


91. See Wharton School of the University of Pennsylvania, supra note 64.
$16.99 retail price.92 Clearly, the lower price of a DPD is a benefit to the consumer representing a turnaround in the rising price of music.93 In fact, the ability to buy downloads as singles, rather than full albums, is one of the downloading services' main appeals.94 Instead of having to find a record store that carries obscure works and to purchase a full record, a buyer can download individually chosen singles from services with unprecedented variety.95 This affordable choice benefits artists, composers, labels, and consumers because it is likely to result in more music purchased overall.96

If the mechanical rate is set too high, many labels, especially independents, may choose not to make their music available online because of the smaller margins that result from paying composers the inflexible statutory fee.97 Though more sales may result, if a company loses money on each sale, the successful introduction of digital downloading as a viable retail alternative to consumers will not be profitable, and labels will opt not to participate.98 If the intent of the Copyright Act is to be followed, the royalty rate should provide an incentive to create for the benefit of the public.99 Failure to correlate the mechanical royalty rate of a DPD to the wholesale value of a composition may quash a burgeoning market, which is both cheaper and more diverse than what consumers currently experience in the physical world.100

D. Reflect the Relative Roles of the Copyright Owner and the User With Respect to Relative Creative Contribution, Technological Contribution, Capital Investment, Cost, Risk, and Contribution to the Opening of New Markets for Creative Expression and Media for Public Communication

There are many changes in the costs and risks inherent to digital as opposed to physical distribution. Not only does a phonograph

92. See Katznelson, supra note 76.
93. See Arnold, supra note 71.
94. See Katznelson, supra note 76.
96. This is based on the economic assumption that in a competitive market, demand grows as price decreases. See Shapiro & Tomain, supra note 72, at 25.
97. See id.
98. See generally Section 115 of the Copyright Act: In Need of an Update?, supra note 9, at 41.
100. See generally id.
record, compact disc, or cassette actually have to be manufactured, but it has to be shipped, promoted, sold, and then potentially returned. The same issues do not exist for the sale of a DPD. There are no packaging or shipping costs, promotion can be done as easily as a website link, transactions are seamless and efficient, and there is no need for reserves to account for potential customer returns.

The following sections detail the efficiencies of digital music that somewhat counter the smaller margins realized by labels for the sale of a DPD.

1. Manufacturing and Shipping Costs

As technology has matured costs of manufacturing and packaging compact discs has dropped dramatically. The average cost of manufacturing and printing is approximately $0.48 per compact disc. Costs may be even lower when done in bulk by a major label. Regardless of historically low manufacturing costs, these costs quickly add up on very large production runs of compact discs and comprise 6% of every wholesale unit and erode profit margins. These costs make the distribution of less popular artists cost prohibitive because a significant investment is required for even the most limited release, especially when shipping charges to the thousands of disparate major and independent retail music outlets across the country are considered. The problem is compounded even further in the case of worldwide releases. Due to the cost of manufacturing and shipping compact discs for availability across the world, only select artists are released worldwide, usually in collaboration with a foreign distributor, resulting in fewer opportunities for independent artists and composers. If the product of less well-known artists is not available in a given city or country, these artists will be less likely to tour, therefore earning less money, and reducing the exposure of the artist in that part of the world.

Manufacturing and shipping costs are negligible in the sale of a digital download. Digital music data is transmitted either via the

101. See Passman, supra note 4, at 81.
102. "Reserves" are a percentage of records sold for which royalties are contractually withheld from the artist for a certain amount of time by a record label to account for potential returns. See Passman, supra note 4, at 96.
103. See Tangborn, supra note 81.
104. Assuming a wholesale price of $8.00. See id. (establishing the wholesale price of a record to be $7.00–$9.00).
internet or physically within hard drives containing tens of thousands of tracks. 106 There are certain costs in encoding a sound recording; moreover, they are one-time expenses. 107 Record companies keep much more of the wholesale price of their products due to the seamless delivery of encoded content, usually by a distributor or third-party services such as Loudeye. 108 These savings could be considered as a potential offset to the less favorable mechanical royalty ratio that would be experienced by a label if the mechanical rate were to remain the same. 109 In addition, the worldwide availability of content allows the artist or composer freedom to appear in numerous countries without restrictions due to poor product distribution. Not only will consumers be able to purchase a composer's music from any computer worldwide, but they will also have access to a composer or artist's entire repertoire, rather than to only the titles the record company or distributor finds to be the most profitable or popular.

Complicating this efficiency for record labels is the lack of a standard recording contract term. However, many record labels contractually include a 20% packaging deduction to standard recording agreements. This serves to pass the costs of packaging, but not manufacturing, to the artist, though the actual cost of packaging can hardly be as high as $3.40. 110 Though the inapplicability of this clause to the sale of a DPD may result in a more equitable scenario for artists, it will remove a windfall labels have enjoyed for years and further reduce the profit margin in the sale of a DPD. As economic theory suggests, if the marginal costs of a sale are not recouped by a label, it may cease to make recordings available online, thus eliminating a cheap, diverse alternative for consumers, and a lucrative means of income for composers and artists. 111 While charging artists inflated packaging costs should not be defended, any overall reduction in label margins may significantly impact their ability to survive, especially those not benefited by large economies of scale.

106. See Arnold, supra note 71.
107. Id.
108. Id.
109. See generally Easley et al., supra note 105.
110. 20% of a hypothetical (though common) retail price of $16.99.
111. See Shapiro & Tomain, supra note 72, at 25.
2. Distribution Fees

Once a compact disc is manufactured, it must be distributed to retail outlets worldwide, usually by entities owned by the parent company of the record label, or by independent distributors who retain a commission or fee for the service.\textsuperscript{112} For purposes of this analysis, an independent distribution service will be used as an example. Individual distribution services are generally not owned by the labels they distribute; therefore, there are no economies of scale to distort the real costs of distribution.\textsuperscript{113} However, independent distributors operate within the same price structures as major distribution companies when selling their content to physical record stores, which allows for an accurate comparison of wholesale and retail prices across independent and major labels.\textsuperscript{114}

Independent physical distribution company agreements, although they vary, often stipulate the purchase of compact discs from record companies for $8.00 each.\textsuperscript{115} The distribution company then sells the compact discs to retail stores for up to $10.00 each, an 18–20% mark-up, and the retail stores often sell a compact disc to the consumer for $15.99–18.99.\textsuperscript{116} In comparison, independent digital distributors, such as the Independent Online Distribution Alliance, retain only 15% of the wholesale price paid to a label, as compared to the 20–40% retained by a physical distributor.\textsuperscript{117} If a song sells for $0.99 through an online music service, it will pay the digital distributor $0.65. The distributor retains 15% of the wholesale price, and pays $0.55 to the record company.\textsuperscript{118} At first glance, this lower distribution fee should allow the label to profit more from a DPD than it would from the sale of a physical recording and help to excuse inequities in the mechanical rate.

Even though independent digital distribution is more economical, the lower retail valuation of $0.99 for a DPD drops the wholesale value as well, while the companies’ over-head remain

\textsuperscript{112} Ed Christman, Caparro Eyes Warner Music Group for EDC Dream, BILLBOARD MAG., Apr. 19, 2003, at 5.
\textsuperscript{113} See id.; Elliot Goldman, Indies Have More Chance to Shine, BILLBOARD MAG., June 26, 1993, at 6.
\textsuperscript{114} See generally Section 115 of the Copyright Act: In Need of an Update?, supra note 9, at 38.
\textsuperscript{115} See Tangborn, supra note 81.
\textsuperscript{116} See Passman, supra note 4, at 203.
\textsuperscript{117} See Arnold, supra note 71.
\textsuperscript{118} Id.
constant. Despite efficiencies, the record company still realizes a lower wholesale price for a downloaded composition than it does for a physical sale of the same song. If not made a percentage of this wholesale rate, the mechanical royalty will represent a greater percentage of the wholesale value of a DPD than it does for the sale of a composition on a physical product, therefore decreasing the incentive for record labels to make their catalogs available for sale online. This disincentive would hurt both composers and consumers by decreasing diversity and creating higher music prices.

3. Promotional Costs

Every shipment of product through a distributor to a hard copy retail store must include a certain amount of free goods or promotional records, posters, etc. from the record company in order to drive sales of records. Free goods sometimes represent 5% to 10% of the amount of records shipped to the store. These items cost money to manufacture, ship, and distribute and sometimes entail the use of street teams or promotional companies hired to promote a record on behalf of the label. Many times street teams are comprised of active fans of the artist, while other times independent promoters are hired to put up posters or flyers at concert venues advertising an album or release.

Digital phonorecord delivery eliminates many of these costs. Instead of promotional compact discs, most online music services provide consumers free thirty-second clips of songs to sample before purchase. Printed materials do not factor as heavily in the promotion of music sales online either, since information posted on a

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119. Assuming a retail value of $1.49 per song on a physical, 12-song compact disc retailing for $17.99.

120. A record company realizes $0.66 per song physically reproduced (after distribution costs) as compared to $0.55 received for the sale of a distributed DPD. These monetary values are derived by dividing an average wholesale price of a physical record ($8.00) by an average number of songs on a record (12) to come up with $0.66. See Tangborn, supra note 81 (establishing the wholesale price of a record to be $7.00-$9.00); Arnold, supra note 71 (establishing the wholesale value of a distributed DPD to be $0.55).

121. See testimony of Sherman, supra note 9, at 38–40.

122. See id.

123. See Passman, supra note 4, at 94.


webpage involves little raw material. The result of these promotional efficiencies is that record companies do not have to expend the same amount of resources to promote a digital download as they do for a hard copy sale.\footnote{126} 

Although these efficiencies benefit labels charged with promoting albums, artists and composers share in the benefits as well. Standard record deals often require artists to recoup at least half of the costs of independent promotion involved in the marketing of their products.\footnote{127} Independent promotion is defined as any marketing performed by persons outside of the record company. An example of independent promotion is the marketing performed by the street teams and promotional crews referred to above.\footnote{128} Lower costs will mean less money for artists to recoup before they can realize profits from sales. Most independent and major label records feature artists who also write the songs on their records; therefore, the marketing efficiencies benefit both composers and labels, and should not be factored in when determining the equity of continuing to apply the statutory rate of $0.085 for a DPD.

Another consideration is that real world marketing will not cease due to digital distribution. Consumers will still need to be drawn to artist web pages on the music services, and although the web offers many opportunities for cheap marketing, record companies will still need to invest a fair amount of money to break an artist, whether it is for print ads, radio advertising, posters and billboards, or co-op advertising on the music services.\footnote{129} This indicates that promotional savings due to digital distribution will not be a panacea for the escalating promotional costs seen today. This is another reason why marketing savings due to online promotions is not dispositive when considering the fairness of the current statutory rate applied to DPDs.

\footnotesize\begin{itemize}
\item \footnote{126} See, e.g., id.
\item \footnote{127} See Passman, supra note 4, at 108. The term “recoup” refers to the repayment of any monetary advances or recording costs paid by the label to or on behalf of the artist. Generally artists recoup debts at their “all-in” royalty rate, commonly 12–15% of the retail price of a record sold, subject to various deductions such as the “free goods” deductions discussed above. Id.
\item \footnote{128} See Scherzer, supra note 124.
\item \footnote{129} See DeLange, supra note 81.
\end{itemize}
E. To Minimize Any Disruptive Impact on the Structure of the Industries Involved and on Generally Prevailing Industry Practices

Independent labels make up a growing percentage of total record sales worldwide. They are a valuable alternative to major labels, which, because of their size and marketing expenditures, require releases to appeal to the least common denominator in order to recoup the money invested in the release. These independent labels lack size, capital, major media marketing power, radio access, and the efficiencies of having in-house distribution and manufacturing, and often have razor thin margins. In addition, independent labels lack the political lobbying power of the Recording Industry Association of America ("RIAA") and other music industry groups. Similar to the plight of artists who are not adequately represented to lawmakers, independent and corporate interests are not always the same.

A drop in the wholesale value of their releases could even further reduce the viability of independent labels. Contrary to Congressional intent codified in Copyright Act § 801, applying the current statutory rate to a DPD would likely cause a disruptive impact to the independent record industry. Already hampered by piracy and file sharing, independent labels cannot afford to have their margins diminished any further. Assigning the mechanical royalty rate as a percentage of the lowered wholesale value of a download would most fairly maintain regular industry practices and would fairly compensate both composers and record labels so that both may survive and benefit the public. A failure to do so might reduce the landscape of creative output to only those artists who reach a threshold of popularity. Even worse, the current legal download industry might suffer due to reduced label profits and the resulting reluctance to make music available online.

IV. CONCLUSION

Overall, it is clear that Congressional intent requires a lower mechanical royalty rate for DPDs than that for compact discs. While digital technology provides much efficiency in the promotion

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130. See Goldman, supra note 113.
131. See Passman, supra note 4, at 111.
132. See id.
and manufacture of materials, the market wholesale rate is 16.7% lower for a DPD than for a physical compact disc.\(^{136}\) To be fair to composers and continue to reward them at a similar rate, the statutory ceiling should reflect the lower wholesale value of a DPD as compared to that of a physical product.\(^{137}\) If different modes of distribution require disproportionate payouts to composers via the mechanical royalty, consumers and record companies will not be able to fairly evaluate the value of the distribution method. In addition, the difficult business environment experienced by less well-funded independent labels requires that the application of the mechanical rate to new media be tailored to support their existence. If the mechanical rate is not set as a percentage of the wholesale value of a DPD, labels will likely consolidate further, or choose not to sell content online, therefore restricting the availability of music to the public that is low-cost and highly diverse.

This comment is not meant to discount compensation for composers, nor is it meant to vindicate corporate label interests. Instead, its intent is to strike a balance between the interests of authors and the ability of independent labels to flourish and continue to provide an outlet for diverse creative minds. Even for major labels, tightening margins will result in risk-taking in signings and less investment in new artists, leading to a decrease in diversity.\(^{138}\) Advances in technology, which hold huge potential benefits for composers, record labels and consumers, should not be punished by disproportionate mechanical royalties. In addition to restricting the availability of such works to the public, contrary to the Congressional intent of § 115, this would disadvantage the very composers that the mechanical royalty was meant to protect. These are real concerns, and while artists, composers, consumers, and labels will experience benefits with the availability of paid DPDs, we must balance all interests in establishing a fair mechanical rate.

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136. 16.7% is the percent change of the DPD wholesale rate of $0.55 and the wholesale rate of a physical song of $0.66. See Arnold, *supra* note 71 (establishing a DPD wholesale rate of $0.55); and *see supra* note 120 and accompanying text.
138. See, *e.g.*, testimony of Sherman, *supra* note 9, at 39.