SORTING THROUGH THE CONFUSION REVISITED: A FURTHER LOOK AT RECORDING AGREEMENT PROVISIONS IN THE DIGITAL ERA

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CHAPTER 11

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I. INTRODUCTION

> *Like when peanut butter first met chocolate and ice cream was first plopped on top of an edible wafer cone, wireless and music are a natural and historic fit. But more importantly, I truly believe this marriage of technology and art has the potential to bridge cultural divides and bring peoples of the world together like few inventions before it.*
>
> Steve Largent, President and C.E.O., CTIA – The Wireless Association[2]

Well, there you have it. The wireless delivery and consumption of recorded music is both on par with the invention of the wheel *and* the cultural equivalent of a Reese's Peanut Butter Cup.

Mr. Largent's hyperbole aside, it is undeniable that, since "Sorting Through the Confusion"[3] (hereinafter, "Sorting") first was published in 1999, the global recorded music industry increasingly has shifted away from the compact disc as its primary delivery medium, in favor of newer formats that utilize the internet and wireless technology. However, according to the Recording Industry Association of America's ("RIAA's") 2005 Consumer Profile, as of 2005, full-length CD still comprised 87% of the market for recorded music. By comparison, digital downloads comprised 5.7% of that market.[4]

Still, in 1999, the compact disc remained the recording industry's profit engine of choice. During that year, there were 938,900,000 full-length CD sales, net of returns, along with 55,900,000 CD singles sold, according to the RIAA. By 2001, however, both of those figures dropped to 881,900,000 and 17,300,000, respectively.[5] The one-year decrease in CD single sales from 2000 to 2001 represented a 49.4% decrease. By 2005, those numbers had dropped precipitously to 705,400,000 and 2,800,000, respectively.[6]

By comparison, single track downloads and album downloads were not even *measured* by the RIAA until 2004. In that year, there were 139,400,000 single a la carte downloads, and 4,600,000 album downloads. The following year, the last year for which the RIAA currently has data, 366,900,000 individual tracks were downloaded, along with 13,600,000 albums (163% and 198% increases, respectively).[7] Among the factors likely contributing to the increased amount of digital exploitation of music were the development and improvement of hardware technologies such as Apple's seemingly ubiquitous iPod and its host of competitors, along with the increased use of broadband-based delivery mechanisms.

However, what should be even more exciting to labels, recording artists, music publishers and songwriters alike is that the aforementioned developments were not, by any means, the end of the line. As noted above, sales of recorded music via mobile phones and other hand-held devices also have grown by staggering amounts in just the last couple of years. According to the International Federation of the Phonographic Industry ("IFPI"), the sale of recorded music via mobile devices represents 40% of record companies' digital revenues, especially in terms of increased sales of master ringtones.[8] Master tones are so crucial to the recording industry in the United States that the RIAA, as of June 14, 2006, now grants Gold and Platinum awards for master ringtones in virtually the identical manner the organization certifies traditional album and single sales.[9]

When one considers the fact that many hand-held devices, like the desktop personal computers that preceded them to market, now support audio-visual content such as full television shows and advertisements, it would appears safe to assume that the digital marketplace likely will continue to expand by leaps and bounds for the foreseeable future. Couple that with ever-increasing sales of competing entertainment platforms as video games (in all their various incarnations) and DVDs, and ever-decreasing CD sales, and it is no great intellectual leap to determine that the major record labels are hard at work figuring out how to turn all this chaos into a significant return on their investments.

So, in light of the foregoing, what exactly have the major labels[10] done in response?

The first thing they did was to summon all their lawyers and charge them with adapting their recording agreement templates to reflect the current marketplace. The result of that effort has been, from the perspective of the artists' bar, nothing short of a vast digital land-grab.

The second thing they did was to reconsider (and, in certain instances, *reconfigure*) the very nature of their contractual relationships with their artists. The various means to such ends have varied among majors, from provisions as seemingly mundane as applying the otherwise applicable album rate to distributions of permanent, a la carte downloads, to those as simple as a non-exclusive right to participate in income generated from endorsements, sponsorships and other marketing opportunities brought to the artist by the

label, to the more far-reaching, such as EMI's near-partnerships with Robbie Williams and the heavy rock band, Korn.

However, the labels' efforts did not go unnoticed by the community of recording artists, and, in certain instances, were paralleled by the formation of various artists' rights groups, the agendas of which included not only contractual improvement but also legislative overhaul as it related to the laws governing the music industry. Still other artists, dissatisfied with lobbying and other grass-roots efforts to affect change in this arena, have instead resorted to the courts. The most recent legal salvo dealing with record industry accounting practices, discussed in greater detail, below, is the recent class action suit against Sony BMG and its predecessors-in-interest brought by the members of The Allman Brothers and Cheap Trick[11], in which the plaintiffs allege that their record companies have breached their agreements with the artists by accounting for digital exploitations of recordings not as licenses, but rather as record sales. [Both of these approaches are discussed in greater detail, below.]

The desire to avoid these sorts of conflicts, arising out of the inherent ambiguity of older recording agreements with respect to then yet-to-be-developed technologies (a running theme of Sorting itself), also has led directly to the shifts in recording agreement language and label practices that are becoming more common today, as the labels attempt to deal with and ultimately eliminate ambiguity. This article, therefore, analyzes the real-world impact of recent developments in the digital realm, such as those described above, on the modern recording agreement, using the essential organization of Sorting as its template. The article also will address the labels' contractual efforts to shore up their bottom-line numbers by expanding their reach further into the commercial lives of their artists than ever before.

II. RECORDING AGREEMENT PROVISIONS

As was the case in Sorting, the analysis below is broken down into categories reflecting those provisions of standard recording agreements most significantly affected by the new technologies of digital distribution and the Internet.

A. Definitions of "records," "configurations," "formats," etc.

As an initial matter, it remains critical to analyze the definitions of the terms "Record," "Phonograph Record," "New Technology Configurations" and the like. Because royalties generally are paid on net sales of Records, it is important to interpret what is meant by a "Record" in the first place.

As the author noted in Sorting, one label's definition of a "Record," circa August 1999, included by its terms digital deliveries without the need for implications or complicated analysis:

> all forms of reproductions, transmissions or communications of Recordings (including without limitation direct delivery to consumers via broadcast, cable, telephonic, Internet or satellite transmission) now or hereafter known, manufactured, distributed transmitted or communicated primarily for personal use, home use, school use, juke box use or use in means of transportation, including records of sound alone and audiovisual Recordings and interactive media (e.g., CD-ROM).

Along the same lines, consider another definition which separated the definition of a "Record" from a "Phonograph Record." A "Record" was defined as:

> all forms of reproductions, transmissions or communications of Recordings now or hereafter known, manufactured, distributed, transmitted or communicated primarily for home use, school use, jukebox use or use in means of transportation, including without limitation, Records embodying or reproducing sound alone and Audiovisual Records.

The same agreement defined a "Phonograph Record" as:

> a Record as embodied by the manufacturer and/or distributor in a physical, non-interactive Record configuration (e.g., vinyl LP's cassettes, compact discs, videocassettes) prior to its distribution to the consumer, as opposed to the transmission or communication of a Record to the consumer prior to being embodied in a physical Record configuration, whether or not it may at some point be embodied in a physical Record configuration, by the consumer or under the consumer's direction or control.

In this manner, the latter agreement explicitly distinguished between tangible Phonograph Records manufactured by the label and a more general concept of Records, which more broadly included the subset of Phonograph Records as well as digitally transmitted Records. Obviously, the value of such a bipartite definition was and is that it eliminated virtually all ambiguity as to whether the term "Record" includes digital distributions/transmissions. Such an explicit division of the concept of a record into physical distributions and virtual transmissions makes it clear

that both forms of exploitation are intended to be covered by the definition.

However, consider the following set of definitions from an agreement from early in 2006, starting with the definition of "Record" or "record" itself:

> ... every form of reproduction, transmission or communication of Master Recordings, whether now known or unknown, embodying sound alone or sound accompanied by visual images, including, without limitation, discs and tapes of any configuration or format, digital storage media or any kind, AV Records, Electronic Transmission Records and other New Media Records.

The 2006 agreement defined "Electronic Transmission Records" as follows:

> ... a Record distributed, transmitted or communicated via Electronic Transmission[12] and, for the avoidance of doubt, shall be deemed to include transmission or communication of Records by cybercast, webcast or any other type of so-called audio or audio-visual "streaming."

Clearly, this provision is intended to clarify that the label is laying claim to control not only the transmission of a record by means of an a la carte download, but also by more seemingly "ephemeral" means, such as streaming. "New Media Records" are defined in the 2006 Agreement as follows:

> ... all Records (including AV Records) in the following configurations: mini-discs, digital compact cassettes, digital audio tapes, laser discs, solid state memory devices, digital versatile discs (i.e., "DVD's"), compact discs capable of bearing visual images (except for Enhanced CD and CD-Plus, but including, without limitation, CD-ROM), Records sold via "point-of-sale" manufacturing/reproduction, Electronic Transmission Records and any other configurations other than conventional vinyl records, cassette tapes and audio-only compact discs, whether such Records are interactive (i.e., where the user is able to access, select or manipulate the materials therein) or non-interactive, and whether now known or hereafter devised.

Note how the terminology of the 2006 agreement encompasses a much broader list of media by which records can be delivered. The label also goes to great lengths to clarify that the definition of record (i.e., a recording that is subject to the agreement) clearly includes activities such as streaming and webcasting which, to the untrained eye/ear, may appear to be more of a performance than the transmission of a record, thereby rendering the record in question subject to the label's control.

Additionally, it remains critically important to consider the related set of definitions for "new media" or "new technology" records, as well as for "audiovisual records" or "videos," because, as discussed in Section II(b)(2), below, many agreements still, to this day, provide a reduced royalty (and often reduced publishing royalties) for such formats. Moreover, it is typical to exclude such sales when determining sales-based royalty escalations or other success-measuring formulae.

B. Royalty provisions

From the artist's viewpoint, the recording agreement provisions most directly affected by the development of digital download and other new technologies remain those dealing with royalty calculation and payment. While virtually all royalty provisions may be affected in one way or another by the new media application concerned, the following categories are among the most important to address.

1. "Net sales" through "normal retail channels" and related issues

Virtually all recording agreements provide, in one way or another, that the top-line royalty rate applies only to net sales of records through normal retail channels in the United States. Royalty provisions are typically initiated with language such as:

> Company agrees to pay to Artist a royalty at the rates set forth below based on one hundred percent (100%) of net sales through normal retail channels of phonograph records embodying Masters, computed on the SRLP of such records (except as otherwise provided herein), as follows....

The following provides another example from a different agreement:

> The royalty rate (the "Basic U.S. Rate") in respect of Net Sales of Records (other than Audiovisual Records) consisting of entirely Master Recordings hereunder during the respective Contract Periods specified below and sold by [Company] or [Company]'s Licensees Through Normal Retail Channels in the United States ("USNRC Net Sales") shall be as follows....

Section I.a, above, addressed the need to analyze the definition of a "record" as to whether digital downloads would qualify as royalty-bearing sales in the first place. It remains equally important to determine whether the definition of "normal retail channels" includes sales via the Internet (whether in the form of digital downloads or sales of physical media through Internet retailers such as Amazon.com).

A typical definition from an earlier agreement (and one that likely will not fall out of use in lower-level, first drafts any time soon) provided that:

> "Sales Through Normal Retail Channels" means sales other than as described in paragraphs 7.02 (except that the fact that a Record is a compact disc shall not in and of itself render such a sale not through normal retail channels provided it meets all other requirements therefor) 7.03, 7.04, 7.06, and 7.07.

Predictably, among the records excepted from the above definition were records in a "New Technology Configuration." Another agreement specified that:

> "Net sales through normal retail channels" means net sales of records hereunder through [Company]'s principal distributor(s) in the country in question for resale through record stores or other retail stores for which a royalty is paid hereunder excluding, without limitation sales or distributions referred to in Schedule A hereto (such net sales in the United States, but within the territory, are sometimes referred to herein as "USNRC" net sales and such net sales and such net sales outside the United States are sometimes referred to herein as "ROW NRC" net sales).

This definition would, on its face, exclude digital downloads, to the extent that such sales do not occur through the record company's "principal distributor" "through record stores or other retail stores." From the artist's perspective today, it is well worth arguing that Internet retailers selling physical records qualify as "record stores or other retail stores." While one would think it unfair to contend that full-priced sales through such on-line retailers constitute anything other than sales through normal retail channels, the above definition would at least provide for an argument by the label that the online retailers are not "stores," thus providing for the opportunity of shifting sales through such retailers into a reduced royalty category.

One agreement from late 2005 defines its concept of "normal trade channel" sales as follows:

> ... Top-Line Records Sold through normal retail distribution channels and specifically excluding, without limitation, any exploitations described in paragraphs (b) through (f) of Exhibit B. For the avoidance of doubt, NTC Sales shall include Top-Line Records sold in physical configurations by on-line retailers and by means of digital download.

The 2006 agreement, referred to above, takes it even a step further and captures mobile sales, in defining "Normal Retail Channels" as follows:

> ... "Normal Retail Channels," in reference to sales of Records hereunder, means sales of Records (including AV Records) hereunder by Company's primary distributor or distributors in the territory concerned through normal channels of retail distribution in such territory for the relevant type of Records being distributed and, for the avoidance of doubt, *sales of Electronic Transmission Records and all other New Media Records made by Company or any of its Affiliate/Principal Licensees' distributors through an internet or mobile retailer or service provider shall constitute the sale of Records though Normal Retail Channels for all purposes hereunder, including, without limitation, for purposes of [calculating record royalties] and [the recording fund minimum/maximum formula].* [Emphasis supplied.]

This provision clearly reflects the increased traction of various, recently developed digital and other means of commercial exploitation, and, it appears that record companies increasingly are allowing for the notion that there really is very little difference to the label between brick-and-mortar and online sales, if the label is receiving its full wholesale price.

The implications of this development are potentially far-reaching, especially in terms of whether or not internet-based sales of compact discs and digitally distributed recordings generally apply for purposes of calculating thresholds at which royalty escalations come into operation, whether or not such sales benefit from such escalations once the increased rates have taken effect, the amounts of future advances that are based on prior sales history and foreign sales deductions. The prevalence of the use of normal retail channel net sales as the benchmark for royalty escalations and advance calculations clearly will remain a significant issue as digital delivery becomes

an even more broadly accepted form of music distribution.

Therefore, the value and application of such provisions very much are affected (or at least *should* be affected) by the popular adoption of digital distribution and other new media. First, to the extent that sales in such formats do not qualify as net sales through normal retail channels, they may not count toward the escalation plateau or the so-called "mini-max" formula. Second, for the same reason, such sales may not qualify for escalated royalties even once the relevant sales plateaus have been reached. Today, insofar as the trend appears to be inching toward the broader inclusion of such sales within the concept of sales "through normal retail channels," it would appear that the issue slowly is being resolved in the artists' favor.

As to foreign sales, as noted in Sorting, with the rapid adoption of the borderless world wide web as a shopping forum, even if digital exploitations eventually are established as firmly within the generally accepted convention of "net sales through normal retail channels," one still should continue to question whether sales to consumers physically located outside of the U.S. *ought* to be treated differently from sales to U.S. consumers. Currently, U.S. content owners still authorize their foreign digital distribution partners essentially on a territory-by-territory basis, and the individual deals, including their charges and pricing schemes, vary accordingly. The same holds true, at least for the time being, with respect to direct mail distribution based on Internet purchases, although the author of Sorting initially presumed that shipping costs eventually would be paid directly by the consumer, in addition to the retail price, so that no economic distinction could be drawn between sales to U.S. and foreign consumers. Although such a situation may still develop in the future (in which digital distribution arrangements effectively become worldwide licensing deals), and there eventually may come a day in which there is no meaningful distinction between domestic and foreign exploitation in the digital realm, for now, given the undeniable existence of certain regional differences, the status quo essentially remains.

There are additional royalty-related issues that remain contentious, to say the least, as discussed in greater detail, below. Therefore, in representing recording artists, one must continue to monitor the interplay of these two crucially important concepts, to ensure that the increasing prevalence of on-line sales of various configurations of recordings is captured for the artist's benefit.

2. Format reductions for "new media" and "direct sales"

As suggested above, virtually all agreements provide for reduced royalties in the case of both "new media" records and records sold directly by the record company. To the extent that digital downloads arguably could fall into both categories, it is possible that a double reduction could take place, depending on the precise wording of the particular agreement.

At least one major label has modified its standard form agreement to include the concept of "Cybersales," and has specified that royalties for such sales shall be reduced as follows:

> With respect to Records and other exploitations sold directly to consumers (i) by Company in the United States, (ii) or by a Principal Licensee outside the United States, or by their respective licensees throughout the Territory (e.g., licensed web sites), other than by distribution of physical Records to consumers, (e.g., without limitation, the downloading or other conveyance of Artist's performances in Master(s) or Video(s) concerned via telephone, satellite, cable, direct transmission over wire or through the air, and on-line computer sales) (collectively, "Cybersales"), the royalty rate shall be eighty percent (80%) of the otherwise applicable Basic U.S. Rate, Escalated U.S. Rate, or Foreign Rate. Such royalties shall be computed on the basis of eighty-five percent (85%) of Net Sales of such Records in the United States.

Accordingly, the effective royalty rate for such sales is no higher than 68% of the otherwise applicable rate, and may be subject to further reduction. Based on this reduction, the artist is being paid one-third less royalties, while the label is theoretically being paid the full retail price for such sales, rather than the typical wholesale price.

The following typical example of a new media reduction from one major label recording agreement does not specifically reference digital distribution:

> Notwithstanding anything to the contrary contained herein, the royalty rate for any Record in a New Technology Configuration shall be eighty percent (80%) of the otherwise applicable royalty rate set forth in this agreement.

The following example from another agreement, uses a slightly different reduction mechanism:

> With respect to sales of new configurations, the retail list price of the record concerned shall be deemed to be seventy-five percent (75%) of the retail list price of the

> configuration concerned, but in no event greater than the retail list price of [Company]'s or [Company]'s regular foreign distributors' (as applicable) best-selling equivalent configuration.

The first provision, above, applies a reduced royalty to new media formats, whereas the second provision applies a contrived reduced retail list price. The net result on the artist's royalty rate for the sales concerned, however, is identical.

Record companies point to R&D and other potential increased costs of new media formats. One possible compromise that takes into account such concerns is reflected in the following provision, which is taken from a different agreement:

> With respect to New Technology Configurations, the royalty rate shall be eighty-five percent (85%) of the otherwise applicable rate. Notwithstanding the foregoing, starting on the commencement date of the semiannual accounting period immediately following the semiannual accounting period in which royalty-bearing USNRC Net Sales of the entirety of [Company]'s catalogue of Albums in the form of a particular configuration (or in the form of a particular mode of transmission or communication) of a New Technology Configuration (including Albums in such form which embody Masters hereunder) equal or exceed during such semiannual accounting period twenty-five percent (25%) of those royalty-bearing USNRC Net Sales, your royalty rate on such particular configuration embodying Masters hereunder shall be one hundred percent (100%) of the otherwise applicable rate.

This provision would at least prevent the application of a royalty reduction once a new medium achieves broad acceptance, R&D costs have been recovered and the costs of manufacturing the new format have been reduced.

An even more recent example, however, breaks out its defined "Electronic Transmission Record" (or "ETR") for separate treatment in the same manner as traditional "album" sales are treated, although it deals with New Media Records in a manner similar to that of the immediately preceding agreement:

> The royalty rate on any New Media Record (other than ETR's) will be 75% of the otherwise applicable rate. Notwithstanding the foregoing, at any such time (if any) that annual unit sales of Records in any particular configuration of New Media Record comprise at least 20% of the annual units sales of all Records through Normal Retail Channels in the Territory, upon the commencement of the immediately following semi-annual royalty accounting period, the royalty rate applicable to such configuration of New Media Record shall be increased prospectively to 85% of the otherwise applicable rate.

3. Container chargers/packaging deductions and other "phantom" deductions, past and present

As noted in Sorting, one provision of a typical major label recording agreement that comes across as counter-intuitive in the realm of digital distribution of records is the royalty base price reduction for imputed "container charges" or "packaging deductions." In Sorting, it was noted that such deductions bore no relation to the actual cost associated with packaging, because digitally distributed records involve no packaging whatsoever (other than "packaging" such as memory, CD-Rs, hard disks or physical media purchased separately by the consumer). Nevertheless, most older agreements (and, indeed, some current versions) still provide that the packaging deduction for new media records (which, as noted above, generally include digitally delivered records), regardless of whether such records have packaging at all, is identical to the highest level of deduction, that applied for CDs (usually 25%).

Interestingly, since the beginning if this decade, at least two major distribution companies have moved to an allegedly more "transparent" method of computing record royalties. It is now undeniable that those changes were due in large measure to the aforementioned grass-roots efforts of artists' groups who brought some antiquated and unfair accounting practices not only to the attention of the industry press and other professionals, but also to that of concerned state legislators.

The most well-known example of those groups was and is the Recording Artists Coalition ("RAC"), which sought, among other initiatives, to bring about true legislative change, in both the federal and state governmental arenas. Due largely to the lobbying and publicity efforts of RAC, in 2001 and 2002, California's Senate Select Committee On the Entertainment Industry and Senate Judiciary Committee held a series of hearings on many record industry practices, including accounting and related issues, which in part resulted in a public commitment from at least two of the major distribution groups at the time (Universal and BMG) to reform their accounting practices,[13] and, ultimately, resulted in California

Governor Arnold Schwarzenegger's signing into law The Recording Industry Accounting Practices Act, which went into effect on January 1, 2005.[14] Since that time, an increasing number of major record companies have begun to base their new agreements (and, in many instances, the new iterations of renegotiated existing agreements) on the ostensibly more objectively measured wholesale price; 100% of net sales rather than some contractually reduced subset; a full CD royalty, rather than "R&D"-funding reduced rate of days long since past; and, the absence of a packaging deduction.

In fairness, therefore, it must be acknowledged that there have been more than a few, very public instances in which the record companies (or at least some of them) have responded to a substantive outcry from the creative community. A certain amount of that may be due to an institutional desire to streamline the accounting process in a time in which the conventional wisdom about the industry's economic model seems to have unraveled, at least partially. And, a certain amount of that reaction may very well reflect institutional fears of (and a proactive effort to control) the unknown: the outcome of new or yet-to-be-imposed legislation, or, indeed, the result of a lawsuit by an established artist with the courage and the means to take on the institution in an effort to exploit the inherent ambiguity of stale and inherently ambiguous contractual provisions.

C. The Battle Is Joined: Is the Digital Exploitation of a Sound Recording A Sale or a License?

Virtually all recording agreements still provide that when the record label licenses master recordings to third parties for commercial exploitation, the artist will share in 50% of the label's net receipts under that license. To date, downloads of popular music made available to the public have, for the most part, been offered through the various digital download companies, such as Apple's iTunes, Napster, Yahoo! Music Unlimited, MTV's Urge service and others. These companies generally enter into agreements with the major labels (and dozens of independent labels) to obtain the right to transmit masters digitally to consumers.

The relevant question has been, and remains, "How should artists be compensated for such exploitations?" Therein lies perhaps the most controversial issue facing the artists' bar today, as elucidated in the Allman case, and previously in the case of Third Story Music's 2005 suit against Warner Music Group, on behalf of writer/composer Tom Waits, concerning virtually the same issue.

Most recording agreements still provide, as a general proposition, that an artist receives 50% of the label's net receipts, to the extent attributable to the artist's masters -- an amount that almost certainly will differ from (and in most cases dramatically exceed) the typical artist royalties generated from sales of physical albums. However, the major record labels, obviously in anticipation of the growth of digital downloading, predictably structured their deals with internet service providers and other digital outlets so as to avoid even the slightest appearance of a licensing relationship, in some instances even structuring the deal as a quasi-consignment relationship. After all, it is most definitely in the label's interests to share revenues even at the highest applicable album rate, which in most cases will not exceed 20% of the applicable royalty base price, than to have to give up 50% of its net receipts from license income. However, many observers have viewed such declared "non-license" relationships to be so much fiction. After all, in any other setting (e.g., in the absence of the "percentage of net receipts language" common to so many recording agreements), the contractual obligations walk, talk, act and quack like a license.[15]

The following license provision is a relatively typical, if stripped-down, example that one would expect to have seen in virtually any major label agreement up until the last couple of years.

> [With respect to] Masters licensed to third parties by Company or Company's Foreign Affiliates on a flat fee, royalty rate or cent rate basis for any type of use not specifically covered elsewhere in this paragraph 2, Company shall credit Artist's royalty account with one-half (1/2) of Company's net receipts.

Pursuant to the agreement from which this provision is derived, sales of masters through third-party licensees do not count as net sales through normal retail channels. Accordingly, as discussed above, such sales do not count toward achieving royalty escalation plateaus or for purposes of calculating mini-max advance formulas.

The following examples reflect treatment of third-party licenses on a "50% of net receipts" basis:

> The royalty rate for Masters licensed by Company or a Principal Licensee to a Person for use in the distribution of Records shall be fifty percent (50%) of Net Receipts solely attributable to such Masters.
> Flat-fee Licenses: Subject to paragraph 34 of the Agreement, royalties will be 50% of [Company]'s net receipts from such licenses.

The following is an example of such a provision from a 2005 agreement:

(a) With respect to the following Records and/or exploitation of Master Recordings, the royalty to be accrued hereunder shall be a sum equal to fifty percent (50%) of Company's net receipts with respect to such exploitation: (i) Records derived from Master Recordings hereunder sold through record clubs or similar sales plans whether operated by Non-Affiliated Third Parties or otherwise; (ii) licenses of Master Recordings to Non-Affiliated Third Parties for sales of Records by such licensees through direct mail, mail order or in conjunction with TV or radio advertising, including through methods of distribution such as "key outlet marketing" (distribution through retail fulfillment centers in conjunction with special advertisements on radio or television), or by any combination of the methods set forth above or other methods; (iii) licenses of Master Recordings to Non-Affiliated Third Parties on a flat-fee or other royalty basis, provided that with respect to such licenses the royalty shall in no event be greater than the royalty which would be payable to Artist by virtue of applying the applicable pro-rata artist royalty rate with respect to such Master Recording license; (iv) licenses to Non-Affiliated Third Parties for promotional or commercial use of Audio-Visual Recordings described in paragraph 5.02, excluding blanket licenses to exploit Company 's Audio-Visual Recording catalog; and (v) use of the Master Recordings for background music, synchronization in motion pictures and television soundtracks and Records derived therefrom whether produced and/or distributed by Non-Affiliated Third Parties or otherwise, and/or use on transportation facilities.

However, even in those situations in which the record company calculates an artist's share of income from digital distributions on the basis of the label's net receipts, the trend is for newer agreements to apply either (a) the otherwise applicable album-format rate, or (b) the otherwise applicable rate for the configuration concerned (e.g., album, single, etc.). Consider the interplay of the broad 50/50 net receipts language above with the immediately subsequent provision from the same agreement dealing with electronic transmissions of masters recordings:

(b) In the event that Company shall distribute or authorize other Persons to distribute Records by means of (i) a so-called "permanent" download (whether or not such download is transferable to a portable device or such download can be "burned" to CD or other format), (ii) by making Master Recordings hereunder available through subscription services, and/or (iii) any Records in which Company distributes or authorizes any other Person to distribute as a so-called: (A) "stream" (i.e., for simultaneous playback, and not in a downloadable format); or (B) "conditional" download (i.e., any download where the access to the content expires or is "timed-out" when the consumer's subscription or other similar service lapses); (iv) any Ancillary Website Exploitation and; (v) any other form of Electronic Transmission for which a rate is not otherwise specifically set forth herein, the royalty to be accrued hereunder in respect of such exploitation *shall be determined by applying the applicable royalty rate and Royalty Base set forth herein for an equivalent Record; however, the following deductions shall not apply when computing Artist's royalty with respect to any such "permanent" downloads: (1) Container Charges (as set forth in paragraph 13.10 below); (2) new technology deductions (as set forth in paragraph 7.04(b) above); and (3) free goods (as set forth in paragraphs 13.21(a)(ii) and (iii) below)*. For the avoidance of doubt, whether a particular Record is distributed (by means of a "permanent" download, through portable subscription services or through other means of Electronic Transmission per this paragraph 7.06(b)) as an individual Master Recording or such Master Recording is part of an entire Album, the royalty that shall be accrued hereunder shall be the applicable Album royalty rate pursuant to the terms set forth herein. [Emphasis supplied.]

(c) In respect of any exploitation of Mobile Materials for which Company receives a royalty or other payment which is

directly attributable to such Mobile Material, your royalty shall be an amount equal to a percentage of Company's net receipts from such royalty or other payment, which percentage shall be the applicable royalty rate set forth herein for an equivalent Record, adjusted by the appropriate territorial reduction where the exploitation of the Mobile Material is in a country outside the United States.

The following is another example from a 2006 agreement of a different label group:

(f) With respect to any of the following exploitations of a Master by Company, its customers, or its licensees, Company shall credit Artist's royalty account hereunder with an amount equal to a percentage of Company's Net Receipts which is the same percentage as the percentage of the U.S. Basic Rate or foreign rate, as applicable, for Albums, or in the case of Videos the rate set forth in paragraph 6(b) of the Main Text sold for distribution in the country concerned:

(i) any electronic transmission of a Master, including without limitation, a so-called, "digital phonorecord delivery" or "stream";
(ii) any exploitation of a Master in a subscription or subscriber based service (excluding a Record Club) and for which the fees received are specifically allocated to such Masters; or
(iii) any inclusion of a Master on the hard drive or other memory-like device that is installed into the device prior to the sale to the consumer (e.g., Masters preloaded onto computer hard drives or ringtones preloaded onto mobile phone memory chips) whether such preloaded Masters may be accessed with or without any other transmission transaction.

(g) Provided that a royalty or other payment is not otherwise provided for such uses elsewhere in this Agreement, in respect of any Ancillary Exploitation for which Ancillary Exploitation Company receives a royalty or other payment that is readily and directly attributed to such Ancillary Exploitation, Company shall credit Artist's royalty account hereunder with an amount equal to fifty percent (50%) of Company's Net Receipts from such Ancillary Exploitation. Notwithstanding anything to the contrary in this paragraph (g), any Ancillary Digital Use as part of the same commercial transaction as an exploitation of a Master, for which Company receives or is credited with a royalty or other payment that is readily and directly attributable to such combined exploitation, shall be treated as a sale of a Master for purposes of calculating the payments payable to Artist hereunder.

(h) For purposes of paragraphs (f) and (g) of this Exhibit B, "Net Receipts" shall mean the gross amount received by or credited to Company which is specifically and exclusively allocable to the Master(s) and/or Ancillary Exploitation(s) concerned, less any costs incurred by Company with respect to the production and/or exploitation of such Master(s) and/or Ancillary Exploitation(s), including but not limited to production costs, taxes, payments with respect to any underlying musical compositions, and payments due under Company's agreements with any applicable unions or guilds. If any such cost is attributable to both (i) Masters and/or Ancillary Exploitations hereunder and (ii) to Masters and/or Ancillary Exploitations not produced hereunder, then such costs shall be allocated by reasonable apportionment.

Finally, as noted above, at least one major label simply treats electronic transmissions effectively as if they purely were album sales, and applies the otherwise applicable rate to the otherwise applicable royalty base price for such a sale. That same company further hedges its bet in bifurcating the more traditional treatment of third-party license fees and the like along the lines of whether or not the use relates to a traditional phonograph record use. For license revenues from synchronization use in commercials, TV, or films, the artist is credit with the expected 50% of the label's net receipts. However, for masters so licensed for use in the manufacture and distribution of records (e.g., soundtrack and other compilation

records, third party record club sales, and the like), the artist's royalty is the lesser of (a) 50% of the label's net receipts, and "... (b) the royalty that would be payable hereunder if the Record concerned had been manufactured, distributed and sold by Company or its Affiliate/Principal Licensees to such third party in the applicable territory."

Such provisions as those more recent examples noted above most likely are less advantageous to the artist than a 50/50 split of the label's net receipts, unless the artist's effective royalty rate is equal to or greater than 50% of attributed net receipts. Also, to the extent that the total of such net receipts is less than the royalty base price, the artist's bottom line will be lower than normal, while the label's net may be higher (because the record company is likely to have fewer costs associated with the generation of net receipts from licensed uses of masters than with its direct distribution of physical media; of course, the label may be losing its profits from manufacturing and distribution).

Obviously, the key area of debate exists in the situation described in Allman. To wit, what is the extent of a record company's obligation when the agreement pre-dates the advent of the digital marketplace as it currently exists? Indeed, what happens when the provisions of the agreement in question pre-date the advent of the Internet itself, or the personal computer?

In Allman, the plaintiffs have literally touched on virtually all of the core economic elements of treating digital downloads as record sales. The complaint alleges that characterizing digital exploitations as revenues from record sales (thereby allowing for the application of container charges, audiophile deductions, royalty reserves and the wrong royalty rate entirely), rather than as income from licenses, amounts to a systematic and intentional breach of contract, applicable to literally thousands of potential class members.

It would serve the artists' bar well to watch the Allman case closely. Clearly, the major record labels are, as the insertion of more current digital exploitation and internet-related provisions inevitably become part-and-parcel of the renegotiations of older recording contracts.

D. Into the Great Wide Open: Web-specific, Mobile and Other "Ancillary Exploitation" Provisions In Recent Agreements

Predictably, provisions attempting to deal directly with Internet-related issues have been appearing in many major label forms. As record labels grapple with the new digital age, strange and unfamiliar provisions appear to be cropping up at every turn. Some already have been referenced, including new defined terms such as "Cybersales," as well as distinctions between time-honored terms such as "Records" and "Phonograph Records" (which, until recently, were used interchangeably). Other provisions, such as those set forth below, have been added to standard agreements to ensure that the record label has the right to use an ever-broader array of the artist's material, both musical and non-musical in nature online and via other delivery media.

Here is an example of a clause from a 2005 major label agreement that reflects the importance of the mobile marketplace:

> In addition to the Master Recordings described in paragraph 2.02(a) above, during each Contract Period, Artist will perform for and Grantor will record and deliver at least ten (10) Master Recordings embodying Artist's vocal messages each with an approximate playing time of between two (2) and twenty (20) seconds in length (depending on the text and intended use) intended for use on and in connection with mobile electronic devices, including, without limitation, mobile telephones or personal digital assistant (or other personal communication devices), which uses shall include, without limitation, use as so-called "voice ringers", "voice messages" and "voice ringbacks" (such uses being collectively referred to herein as "Voice Messages") as Company shall reasonably request. Grantor and Company shall mutually determine the text of each Voice Message prior to the recording thereof. Grantor shall deliver such Voice Messages simultaneously with and as a component of the delivery of the Minimum Recording Obligation with respect to each Contract Period.[16]

Query whether or not such recordings, to the extent they are non-musical, are the proper subject matter of a recording agreement. However, the new issues and questions raised are not limited merely to the expanded use of new forms of recordings. For example, a 2006 agreement provides as follows:

> (f) Without limiting the generality of any of Company's rights under this agreement, Company and its licensees shall have (i) the exclusive right, and may grant other Persons the right, to use reproductions or adaptations of packaging artwork, pictorial and graphic materials used for marketing or publicity, and other materials owned or controlled by Company or its licensees, whether or not

incorporating Artist's names (including, without limitation, professional, group, or other assumed or fictitious names or sobriquets used by Artist), portraits, pictures, likenesses and logos, in connection with digitally distributed products and services as described in paragraph 9(f)(ii) hereof; and (ii) the exclusive right, and may grant other Persons the right, to use spoken word Recordings of Artist's performances described in paragraph 9(g) below in connection with digitally distributed products and services (*e.g.*, digital content distributed via cellular phones, personal computers and other consumer electronic equipment and so-called interactive voice response services). Company and its licensees shall have no obligation to pay any additional compensation to Grantor or Artist or any other Person in connection with Company's or its licensees' uses under this paragraph, except as provided in paragraph (g) and (h) of Exhibit B hereto. For purposes of this agreement, uses by Company or its licensees as described in this paragraph are hereby defined as "Ancillary Digital Uses".[17]

(g) During the Term, at Company's request, Grantor agrees to cause Artist to perform for the recording of brief audio, visual, and/or audiovisual Recordings of spoken-word messages and fan greetings suitable for use in connection with digital products and services and/or digital media platforms (*e.g.*, Internet and wireless).

As with the major label's early swipes at internet-focused provisions, there are several identifiable problems with these new media provisions. First, because they are relatively untested, it remains important to consider how they will impact the rest of the agreement, which may not have changed to account for the new terms. For example, it is important to test the digital transmission-specific provisions against definitional distinctions between "Records" (which may include digital downloads, streaming, master ringtones, voice tones, ring-back tones and the like) and "Phonograph Records" (which may not) in order to ensure that no unexpected results are yielded. Second, because both the technology and ideas about business models are changing so rapidly, it is equally likely in 2006 as it ever has been that the terms introduced in today's agreements may be outdated tomorrow.

The latter problem suggests that both labels and artists' representatives should seek to make agreements more flexible with respect to new media issues, including leaving room for future good-faith discussions concerning new issues as they develop and mature, and, where possible, an obligation to amend in light of general policy changes. However, the broader, more philosophical inquiry goes to the following issue: what, exactly, are the labels are doing even dabbling in areas (traditional merchandise; visual graphics generally; screen savers; digital wallpaper; non-musical audio recordings; etc.) that are only tangentially related to the sale of recorded music?

A simple response to that question is that, in light of the fiscal malaise in which the industry finds itself, labels are starting to test-drive new relationships with artists at least partially in an effort to shore up an eroding bottom-line. Viewed from another angle, the labels claim (and, in numerous instances, rightly so) that they are the engine driving most individual artists' success stories. It is the labels' resources, the labels' product and promotional pipeline, and the labels' creative and marketing teams (the argument goes) that create the stars. And yet (the argument continues), the labels are the first ones that are cut out of the ancillary income streams to which they claim to add the most value: touring, merchandise sales, endorsements, music publishing and the like.

A further response, from the growth side of the business, is that the record labels increasingly are being required to deliver such additional digital goodies to their distributors in order to stay competitive in the marketplace. Digital distributors want the extras: the voice tones; the album artwork, the photo stills, the exclusive artist wallpaper, as added bait for their customers. Query whether or not non-musical and non-phonorecord-related materials (e.g., non-musical voice tones; still photographs other than from album artwork; etc.) *should* come from the label at all.

III. NEXT STEPS: WHERE DO WE GO FROM HERE?

As technology advances, seemingly with each passing day,[18] and as consumers continue to be bombarded by an ever-increasing array of choices competing for their available time, energy and money, record label executives must be both wringing their hands with anxiety and, in the instance of a few putative visionaries, licking their chops in anticipation of the possibility of successfully filling the fiscal void left by decaying CD sales.

In the meantime, one can expect to see a continuing effort by record labels (along with the attendant push-back by artists' representatives) to find new ways to extract as much revenue from the market as possible, even if it means continually changing the basic contractual model in order to do so. As noted above, some recent examples, such as EMI's deals with Robbie Williams and Korn, Interscope Geffen

A&M's deal with Pussycat Dolls, and Warner Bros.' deal with My Chemical Romance, increase the depth to which a record label participates in an artist's career on matters not traditionally within the purview of a major record label: tour ticket sales revenue, merchandising revenue and/or, in certain instances, music publishing.[19] Speaking about EMI's involvement in such types of deals, David Munns, the chief executive officer of EMI Recorded Music North America, is quoted as saying, "This is the direction that the music business is going.... The music and records we produce drive an artist's career. But our margins are under threat and our marketing costs are getting more expensive. We should share in the other revenue streams that are created."[20]

Of course, such all-encompassing, theoretically mutually beneficial opportunities may be only available at economically meaningful levels to artists such as Korn and Robbie Williams, who already have significant fan, ticket buying and customer bases, or who are the beneficiaries of pop-cultural phenomenon status, such as the Pussycat Dolls. In the interim, one can realistically expect to see smaller scale attempts on behalf of the label's to shore up their bottom lines, based on essentially the same rationale as that espoused by Mr. Munns. The relevant inquiry seems to be the following: beyond funding, marketing and distributing recorded music, are the labels adding value to justify a deeper reach into their artists' pockets? What can a label do (indeed, what *should* a label do) to jump-start new, mutually beneficial opportunities for its artists? If it does so, and record sales increase, should the label enjoy any further participation beyond the margin on increased sales?

Recent examples of some of the newer provisions have included such requirements as non-exclusive merchandising rights provisions, such as the following:

> In the event that Company procures tour sponsorships, merchandising arrangements or other sources of income for Grantor or Artist, which Grantor or Artist, as applicable, approves and accepts (other than income relating to the exploitation of Records hereunder), all monies in connection with such arrangements shall be paid to Company, and Company shall within thirty (30) days of Company's receipt of such monies, pay Grantor or Artist, as applicable, (without regard to the recoupment status of Grantor's account hereunder) an amount equal to the monies received by Company, less ten percent (10%) of such monies, which Company shall retain for its own account.

Regardless, it remains important not to focus on individual provisions of a particular agreement related to new media in a vacuum. Rather, one must analyze the provisions as parts of a system, considering the interplay among them, with an eye at all times on the fluid marketplace, in order to obtain an accurate comparison of their overall impacts. Today, it is just as certain as it was when Sorting Through The Confusion initially was published, that the coming months and years will see many changes in the standard forms used by the major record labels as they relate to new technologies, and, in particular, the Internet and mobile, handheld devices.

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[1] © 2006 Robert A. Rosenbloum and Steven S. Sidman. Mr. Rosenbloum and Mr. Sidman are shareholders in the Entertainment Practice Group of Greenberg Traurig, LLP. Mr. Rosenbloum practices in the areas of entertainment and intellectual property law, with a focus on new media issues related to the music industry. Mr. Sidman practices transactional entertainment law, focusing on the music industry.

[2] Recording Industry Association of America. "RIAA Launches New Gold and Platinum Award For Ringtones." http://www.riaa.com/news/newsletter/061406.asp.

[3] Rosenbloum, Robert A. "Sorting Through The Confusion: Interpreting Standard Recording Agreement Provisions In The Digital Era." 1999. Sorting analyzed various traditional recording agreement provisions, culled from various major label deals, and their treatment of numerous issues related to the digital exploitation of sound recordings and the underlying musical works, at a time when the digital marketplace truly was in its nascent stages. Examples cited in Sorting included some from the months immediately preceding the article's publication, although others were cited from much older agreements. The upshot of the article was that the treatment of novel digital issues by the major record companies lacked uniformity and predictability. In the older agreements, that was due to the fact that the technologies at issue simply did not exist at the time the agreements were struck. The newer agreements' provisions represented the labels' initial struggles with how to navigate (and how to *monetize*) essentially uncharted digital waters.

[4] Recording Industry Association of America. "2005 Year-End Statistics." http://www.riaa.com/news/newsletter/pdf/2005yrEndStats.pdf.

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] International Federation of the Phonographic Industry. "Global Digital Music Sales Triple to US$1.1 Billion in 2005 As New Market Takes Shape."

http://www.ifpi.com/site-content/library/worldsales2005-pr.pdf.

[9] Recording Industry Association of America. "RIAA Launches New Gold and Platinum Award For Ringtones." http://www.riaa.com/news/newsletter/061406.asp. Interestingly, the beneficiaries of these new certifications are not merely current releases, such as T-Pain's standard-in-the-making "I'm N Luv (Wit A Stripper)," but also truly timeless pop cultural offerings as Marvin Gaye's "Let's Get It On" and AC/DC's "Back In Black."

[10] These players now number four: EMI, Sony BMG, Universal Music Group and Warner Music Group; one fewer than existed at the time of Sorting's publication.

[11] Allman et. al v. Sony BMG Music Entertainment, Inc., United States District Court, Southern District of New York, No. 06 CV-3252 (2006) (hereinafter, "Allman").

[12] It is instructive to note the breadth of the 2006 agreement's definition of "Electronic Transmission," to wit: "... the distribution, transmission or communication over a communication medium, including, but not limited to, wired and/or wireless systems, Websites, broadband, narrowband or other, Internet, satellite, optical fiber wire or cable, whether now known or hereafter devised, from one location to a remote location, in such a manner that the content, when received at the remote location, is sufficiently permanent or stable to permit it to be perceived, reproduced or otherwise communicated to the recipient at such remote location, without regard to whether such content is simultaneously performed in an audible fashion during such distribution, transmission or communication."

[13] Statement of the Recording Artists Coalition, at http://www.recordingartistscoalition.com/issues_accountingpractices.php.

[14] CAL. CIV. CODE §§ 2500-2501 (Deering 2004). The legislation codified a number of audit rights for recording artists, *notwithstanding anything to the contrary in their recording agreements*. Among those rights were the right to actually conduct an audit, to retain a qualified royalty auditor to conduct such an audit on a contingency basis, and the right to audit the label's books and records within three (3) years after the end of the royalty earnings period under the applicable agreement. Interestingly, no such corresponding leglislation applies to audits of the music publishing industry, which, by its very nature, collects and distributes revenue arising out of the commercial exploitation of musical works embodied in the sound recordings by the very companies whose accounting practices are subjected to the attendant leglislation.

[15] Music publishers, for example, typically structure their deals with such portals as licenses, and, indeed, actually refer to them as "licenses."

[16] The applicable royalty provision for such uses provides as follows: "In respect of any exploitation of Mobile Materials for which Company receives a royalty or other payment which is directly attributable to such Mobile Material, your royalty shall be an amount equal to a percentage of Company's net receipts from such royalty or other payment, which percentage shall be the applicable royalty rate set forth herein for an equivalent Record, adjusted by the appropriate territorial reduction where the exploitation of the Mobile Material is in a country outside the United States."

[17] The applicable royalty provision for such uses provides as follows: "Provided that a royalty or other payment is not otherwise provided for such uses elsewhere in this Agreement, in respect of any Ancillary Exploitation for which Ancillary Exploitation Company receives a royalty or other payment that is readily and directly attributed to such Ancillary Exploitation, Company shall credit Artist's royalty account hereunder with an amount equal to fifty percent (50%) of Company's Net Receipts from such Ancillary Exploitation. Notwithstanding anything to the contrary in this paragraph (g), any Ancillary Digital Use as part of the same commercial transaction as an exploitation of a Master, for which Company receives or is credited with a royalty or other payment that is readily and directly attributable to such combined exploitation, shall be treated as a sale of a Master for purposes of calculating the payments payable to Artist hereunder."

[18] For example, it was just announced on September 5, 2006 via most major media outlets that the seemingly omnipresent myspace.com website/on-line community would start allowing recordings to be sold on its site. One week prior, on August 30, 2006, Universal Music Group announced that it had struck a deal to license its catalogue of recordings to SpiralFrog, in exchange for an advance against and a portion of SpiralFrog's revenues from advertisements that run prior to and during downloads which are otherwise free to the end-user.

[19] "EMI Takes a Stake in a Band," Los Angeles Times, at http://www.latimes.com/business/la-fi-korn12sep12,0,886363.story?track=tottext.

[20] *Id.*