

# The Spotify Paradox: How the Creation of a Compulsory License Scheme for Streaming On-Demand Music Platforms Can Save the Music Industry

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## I. INTRODUCTION

Since the digitization of audio recordings into MP3 format, and the advent of affordable, portable MP3 players, the music industry has been forced to evaluate complex copyright and intellectual property issues. The recent emergence of cloud-based data storage and computing suggests that the next frontier will be centered on streaming rights for audio recordings. Though Napster and iTunes prompted local storage of users' proprietary music files, the growing trend points toward subscription-based models. Services like Pandora,<sup>1</sup> iHeartRadio,<sup>2</sup> Last.fm,<sup>3</sup> Spotify,<sup>4</sup> Rdio,<sup>5</sup> Beats Music<sup>6</sup> and now, even iTunes<sup>7</sup> collect a fixed, recurring fee in exchange for unlimited access to streamed content.

This paradigm shift represents the next evolutionary step in an industry that has already greatly outpaced legislation intended to govern its markets. The future of this market turns on the licensing scheme that providers and record labels are able to agree upon. U.S. law provides for compulsory licensing fees, determined in accordance with various factors.<sup>8</sup> Some providers opt, instead, to negotiate alternative licensing schemes.<sup>9</sup> This note explores the impact of copyright law upon interactive streaming music services and proposes a modified compulsory licensing scheme intended to bring both content owners and distributors to the negotiation table. This proposed statutory rate is devised to create licensing fees more reflective of the market rate than those currently produced in a courtroom.

The note proceeds as follows: Section II provides a broad overview of the history of digital music distribution; beginning with Napster, then the iTunes Music Store and finally the current transition to streaming music as the future medium of distribution. Section III provides a broad overview of the U.S. Copyright Act as it pertains to digital music distribution and compulsory licensing. Subsequently, in Section IV,

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<sup>1</sup> See "About Pandora®," PANDORA, <http://www.pandora.com/about> (last visited Oct. 6, 2014).

<sup>2</sup> See "Welcome to iHeartRadio," iHEARTRADIO, <http://news.heart.com/articles/about-iheartradio-390884/welcome-to-iheartradio-6906244/> (last visited Oct. 6, 2014).

<sup>3</sup> See "About Last.fm" LAST.FM, <http://www.last.fm/about> (last visited Oct. 6, 2014).

<sup>4</sup> See "About Us," SPOTIFY, <https://www.spotify.com/us/about-us/contact/> (last visited Oct. 6, 2014).

<sup>5</sup> See "About Rdio," RDIO, <http://www.rdio.com/about/> (last visited Oct. 6, 2014).

<sup>6</sup> Note, Beats Music—which offers a service similar to Spotify—was formerly known as MOG. It was purchased by Beats Electronics LLC, and was subsequently acquired by Apple for approximately \$3 Billion, in the Summer of 2014, see Press Release, Apple Inc., Apple to Acquire Beats Music and Beats Electronics (May 28, 2014) <http://www.apple.com/pr/library/2014/05/28Apple-to-Acquire-Beats-Music-Beats-Electronics.html?sr=hotnews.rss>; see also "Features," BEATS MUSIC, <http://www.beatsmusic.com/features> (last visited Oct. 6, 2014) (describing the Beats Music player and how the product works for consumers).

<sup>7</sup> See "iTunes Radio," APPLE, <https://www.apple.com/itunes/itunes-radio/> (last visited Oct. 6, 2014).

<sup>8</sup> The Copyright Act of 1976, 17 U.S.C. §§ 106, 114–115 (2006).

<sup>9</sup> Dan Graziano, *Apple's 'iRadio' hits another roadblock, WWDC launch might be delayed*, BGR (May 17, 2013), <http://bgr.com/2013/05/17/apple-iradio-launch-delayed-rumor/>; see also Caleb Garling, *Spotify tries to bulk up for negotiations with record labels*, SFGATE (March 25, 2013) <http://blog.sfgate.com/techchron/2013/03/25/spotify-tries-to-bulk-up-for-negotiations-with-record-labels/>.

the focus shifts to an analysis of the new streaming music service Spotify<sup>10</sup> and its available financial information. This section draws a comparison between Spotify and Netflix and explores the complications faced by the company in negotiating and renegotiating for content licenses. Section V provides a review of the literature surrounding compulsory licenses with regard to streaming music and video providers. The analysis then shifts to an examination of Pandora Radio and the difficulties associated with compulsory licensing in its current form. This note then proposes a new compulsory licensing scheme which is intended to incentivize both parties to engage in good faith negotiations. This scheme creates a license based on distributor revenue, which is then taxed at a progressive rate relative to the net revenue of the distributor. This tax rate decreases as its share of distributor income decreases. Thus, content owners as well as content distributors stand to gain as the share of net revenue paid in royalties declines. Finally, Section VI discusses potential new entrants to the digital streaming music distribution market as well as the recently announced “six-strikes plan,” before offering general conclusions.

## II. ILLEGAL DOWNLOADING LOCALLY STORED MEDIA, AND THE RISE OF STREAMING MUSIC

### A. *The Digitalization of Music, and the Rise of Locally Stored Content.*

As bandwidth grew to accommodate the growing uses for the Internet, so too did the size of transferrable files. Capitalizing upon this, on June 1, 1999, the peer-to-peer (“P2P”) file sharing software Napster was launched,<sup>11</sup> and grew immediately in popularity.<sup>12</sup> The creation of P2P services brought forth interesting questions of contributory infringement; however, this new phenomenon also radically transformed music consumption and delivery. Specifically, Napster and the ensuing transition to locally-stored, digitally downloaded music turned the album-oriented music production business model on its head.

Unsurprisingly, the Recording Industry Association of America (“RIAA”) filed suit against Napster, less than a half-year after its release.<sup>13</sup> Fourteen months later, the 9th Circuit effectively issued Napster’s death warrant in staying an injunction handed down by the District Court in *A&M Records, Inc. v. Napster, Inc.*<sup>14</sup> Yet, Napster’s

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<sup>10</sup> Note, subscription-based on-demand music alternatives to Spotify exist, which provide the same basic service, including: Rdio, Beats Music, and others. To properly narrow the scope of this note, the focus is on Spotify. However, the considerations and recommendations throughout apply to its competitors, as well.

<sup>11</sup> Spencer E. Ante, *Inside Napster: How the Music Sharing Phenom Began, Where it Went Wrong, and What Happens Next*, BLOOMBERG BUSINESSWEEK (Aug. 14, 2000), [http://www.businessweek.com/2000/00\\_33/b3694001.htm](http://www.businessweek.com/2000/00_33/b3694001.htm).

<sup>12</sup> See *id.*

<sup>13</sup> *A&M Records, Inc. v. Napster, Inc.*, No. C 99-05183 MHP, 2000 WL 573136, at \*1 (N.D. Cal. May 12, 2000) (stating that plaintiffs originally filed suit on Dec. 6, 1999).

<sup>14</sup> *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1029 (9th Cir. 2001) (affirming in part the district court’s ruling that Napster could be held both vicariously and contributorily liable for copyright

impact on the music industry has substantially outlasted its existence. In addition to a new *expectation* of free music content, Napster eased users into a new status quo of digital music ownership. Consumers that might have been reticent to convert their music library to an all-digital collection were lured in by the carrot of free content—this trend toward digitalization of music libraries has proven to be lasting. All but gone were the days of physical album sales, and with them, the high-margins that the record labels had grown accustomed to.<sup>15</sup>

### B. *The Road to Legitimacy: Digital Media in Light of A&M Records, Inc.*

Following *A&M Records, Inc.*, Napster was unable to establish a tenable, legal business model capable of rising to its previous popularity, and in September 2002, a bankruptcy court in Delaware blocked the sale of the company to a German investor, at which point the company ceased operations.<sup>16</sup> Similar P2P music (and media) sharing companies quickly rushed in to fill this void.<sup>17</sup> However, most of those companies were eventually either shut down or altered to operate as legitimate entities.<sup>18</sup>

#### 1. Failure to Subscribe: Initial Reluctance Toward Subscription Models.

In an effort to capitalize upon digital music distribution, major record labels, as well as smaller independent companies, began establishing digital media stores. Sony teamed up with Universal Music Group to provide Pressplay — an online subscription based service.<sup>19</sup> Simultaneously, AOL Time Warner, Bertelsmann Music Group and EMI worked alongside RealNetworks to create a similar product, called MusicNet.<sup>20</sup> Both software platforms provided access to streaming music content, but continued access required users to maintain their subscription.<sup>21</sup> Moreover, the two services refused to cross-license to one another, forcing potential users to choose between two mutually exclusive music catalogs.<sup>22</sup> Neither platform gained traction,

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infringement).

<sup>15</sup> Tshepo Mokoena, *Album Sales Fall to Lowest Ever in US*, THE GUARDIAN (Jan. 16, 2014), <http://www.theguardian.com/music/2014/jan/16/physical-album-sales-fall-lowest-ever-level>.

<sup>16</sup> Benny Evangelista, *Napster Runs out of Lives - Judge Rules Against Sale*, SFGATE (Sept. 4, 2002), <http://www.sfgate.com/business/article/Napster-runs-out-of-lives-judge-rules-against-2774278.php>.

<sup>17</sup> Examples include: LimeWire, Grokster and KaZaa, as well as BitTorrent clients, such as µTorrent, Xtorrent and Vuze (Azeureus), which allow for piecemeal downloading of large files from numerous users simultaneously.

<sup>18</sup> See *Metro-Goldwyn-Mayer Studios Inc. v. Grokster, Ltd.*, 545 U.S. 913, 919 (2005) (holding that Grokster, by inducing copyright infringement, could be held liable for the resulting acts of infringement by third parties); *Arista Records LLC v. Lime Grp. LLC* 784 F.Supp.2d 398, 409-410 (S.D.N.Y. 2011) (granting summary judgment against P2P software, Limewire, for inducement of copyright infringement); *UMI Recordings, Inc. v. MP3.com, Inc.*, 92 F.Supp.2d 349, 352 (S.D.N.Y. 2000) (deeming MP3.com's users' uploading, storing and streaming of personally owned digital media not to be "fair use").

<sup>19</sup> WALTER ISAACSON, STEVE JOBS 395 (2011).

<sup>20</sup> See *id.*

<sup>21</sup> See *id.*

<sup>22</sup> See *id.*

due largely to poor user interface, as well as to the convenience of piracy, and a newly fostered consumer expectation of free access to music.<sup>23</sup>

For its part, the legal system had begun plugging the loopholes, and defining copyright frontiers in the digital space to keep piracy [at least somewhat] in check.<sup>24</sup> Yet, no convenient, legitimate and viable alternative arose. Enter, Steve Jobs.

### C. *Legitimacy in a Sea of Piracy: The iTunes Music Store.*

Levering its bargaining power as a result of the recently introduced iPod, and pointing out the repeated failures of the record industry to capitalize upon digital music delivery, Steve Jobs of Apple Computers began courting record executives, with an eye toward creating a consolidated, digital, online delivery service for music files.<sup>25</sup> While some companies were receptive to Apple and to iTunes, others unsurprisingly refused.<sup>26</sup> One executive went so far as to demand that Apple pay the labels a royalty for each iPod sold, claiming that the music was driving hardware sales.<sup>27</sup> Yet, in the end, Jobs was able to persuade all of the major record labels to enter into an agreement to sell music online.<sup>28</sup>

The Apple iTunes Music Store was launched with iTunes 4.0 on April 28, 2003.<sup>29</sup> Initially, the online store offered individual song downloads for \$0.99 and whole album downloads for \$9.99.<sup>30</sup> When compared to the average suggested list price of a CD in 2002 of \$14.99, major record labels proved willing to accept a 33% decrease in price—a non-negligible reduction in overall margins.<sup>31</sup> Further, this agreement effectively cut the record labels out of the distributional loop; a market that they had controlled since the creation of the vinyl record. Indeed, the record labels were quite

<sup>23</sup> See *id.* at 396. In fact, PC World Magazine went so far as to dub the two competing services the ninth worst tech product of all time, on its list of the bottom 25. See Dan Tynan, *The 25 Worst Products of All Time*, PCWORLD (May 26, 2006), [http://www.pcworld.com/article/125772/worst\\_products\\_ever.html](http://www.pcworld.com/article/125772/worst_products_ever.html).

<sup>24</sup> Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (1995); see also Digital Millennium Copyright Act, H.R. 2281, 105th Cong. §§101-02 (1998) (enacted).

<sup>25</sup> See *id.*

<sup>26</sup> See *id.* at 400.

<sup>27</sup> See *id.*

<sup>28</sup> See *id.* at 401. The deal was negotiated absent a royalty per iPod sold, in part because Jobs and Apple possessed the leverage that iPods would prosper regardless of whether they were filled with legal or illegal content; rather, it was Jobs' prerogative to attempt to create a legal system of licensing.

<sup>29</sup> Press Release, Apple, Inc., Apple Launches the iTunes Music Store (Apr. 28, 2004) (<http://www.apple.com/pr/library/2003/04/28Apple-Launches-the-iTunes-Music-Store.html>).

<sup>30</sup> Interestingly, a model nearly identical to that proposed by Apple was first propagated by Latin-music download site Ritmoteca, with support from major labels. Yet, Ritmoteca predated Napster, and as such, was unable to sustain operations when free music became the expectation. This example underscores the importance of timing, and the role that this played in the establishment of the iTunes Store. See Liela Cobo, Ritmoteca Pacts with BMG, Sony, BILLBOARD, Dec. 16, 2000, at 10; see also Company Overview of Ritmoteca.com, Inc., BLOOMBERG BUSINESSWEEK (Aug. 22, 2014) <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=113297>.

<sup>31</sup> The Communications & Strategic Analysis Dep't of the Recording Industry Ass'n of America, *The CD: A Better Value than Ever* (2007), available at <http://76.74.24.142/F3A24BF9-9711-7F8A-F1D3-1100C49D8418.pdf> (citing the suggested retail price for CDs dating back to 1983).

willing to compromise in what would soon redefine legal music downloading, just four years after Napster induced the digital music paradigm shift.

The iTunes Music Store was an immediate success, exceeding half-yearly projections within just six days.<sup>32</sup> On April 3, 2008, less than five years after its inception, iTunes became the largest music retailer in the United States.<sup>33</sup> For nearly a decade, iTunes and its consumer ownership rights model have been the industry standard.

Where Napster weakened consumer need for the security that accompanied physical album possession, the iTunes Music Store then legitimized digital music within a song-by-song purchasing framework. This had the effect of further eroding both the market for traditional physical albums ownership, and of upending album bundling norms in the recording industry. Against the backdrop of numerous failed subscription platforms, this digital ownership business model has proven to have significantly more staying power. Indeed, Jobs vehemently insisted that subscription music distribution models were destined to fail.<sup>34</sup> However, many of the initial failures of subscription models were due, in large part, to entrenched consumer fears about non-ownership. Personally owned and locally stored files represented a happy medium between pay-per-month services and physical CD ownership. This stopgap was necessary in order that subscription models might someday become tenable.

#### D. *Streaming and the Future of Digital Music Service.*

Until relatively recently, few legal subscription-based music-streaming services proved capable of garnering substantial traction, particularly in light of the market share retained by Apple. A host of web-based streaming music services emerged in the wake of Napster, including: The Hype Machine, SoundCloud,<sup>35</sup> Last.fm, iHeart-Radio, and Pandora Radio. However, these services operate primarily to facilitate exposure to new songs, terrestrial radio content, remixes, and music that is similar to users' tracked preferences (as indicated by proprietary algorithms). Some platforms provide access to original content, whereas others distribute copyrighted content. However, none of these services provide listeners autonomy to pre-select and listen to copyrighted musical works in advance.

In 2008, the streaming music service Spotify launched in Europe. It quickly gained widespread popularity, and in 2010, the service expanded to the United States. Spotify has now amassed over 24 million active users (of whom 6 million are

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<sup>32</sup> See ISAACSON, *supra* note 12, at 403.

<sup>33</sup> Press Release, Apple, Inc., iTunes Store Top Music Retailer in the US (Apr. 3, 2008) (<http://www.apple.com/pr/library/2008/04/03iTunes-Store-Top-Music-Retailer-in-the-US.html>).

<sup>34</sup> See ISAACSON, *supra* note 12, at 397. Jobs stated in an interview with Rolling Stone that he thought that "you could make available the Second Coming in a subscription model and it might not be successful." Jeff Goodell, Steve Jobs, ROLLING STONE, Dec. 3, 2003, *available at* <http://www.rollingstone.com/music/news/steve-jobs-rolling-stones-2003-interview-20111006>.

<sup>35</sup> Note, both The Hype Machine and SoundCloud facilitate the distribution of *user-uploaded, original works*, and therefore, do not pay royalties to the original copyright holders for the songs published on the websites.

paying),<sup>36</sup> a global library of 20 million songs<sup>37</sup> (compared to the 26 million songs licensed globally by iTunes),<sup>38</sup> and a valuation of \$3 billion.<sup>39</sup> Yet, the company and its early successes are predicated upon a business model that is unsustainable. Spotify's business model requires that the company take massive losses while providing free content in an attempt to attract users. As the company's consumer base and revenue stream become more established, access to free content is discontinued, thus decreasing costs and, in theory, turning a profit.

However, this model is complicated by variable licensing costs. Spotify, much like other streaming content providers, is constantly engaged in licensing negotiations with content owners, across numerous labels, in multiple countries. As Spotify's market share becomes more established, and revenue streams are proven, larger content owners will possess increasing amounts of leverage over digital distributors. These entities can threaten to withdraw licensure absent a hiked-up royalty structure. This note proposes a statutory licensing system intended to mitigate this problem.

### III. THE COPYRIGHT AND DIGITALIZATION

#### A. *Statutory Background*

Where compulsory licenses were once applied to both patents (oft as an antitrust remedy)<sup>40</sup> and to copyrights, they are now applied almost exclusively to copyright protected, nondramatic, musical works. The U.S. Copyright Act of 1976 enunciates the exclusive rights granted to copyright owners.<sup>41</sup> The Act draws a distinction between "musical works" and "sound recordings."<sup>42</sup> Typically, record labels own the right to the sound recording, whereas composers possess the right to the musical work, or the composition.<sup>43</sup> These two rights receive disparate treatment at law. Only the owners of the right to the musical work are compensated for songs played over

<sup>36</sup> *Spotify Fast Facts*, SPOTIFY.COM, (Dec. 6, 2012), <https://spotify.box.com/s/73srj5dsyxxhmrspbb1>; see also Paul Sloan, *Spotify: Growing Like Mad, Yet So Far to Go*, CNET, [http://news.cnet.com/8301-14013\\_3-57573394/spotify-growing-like-mad-yet-so-far-to-go/](http://news.cnet.com/8301-14013_3-57573394/spotify-growing-like-mad-yet-so-far-to-go/) (Mar.12, 2013, 6:00 AM)).

<sup>37</sup> See *Spotify Fast Facts*, *supra* note 28. Note, however, this statistic represents the aggregate number of songs licensed internationally, and country-by-country catalog sizes vary. *Id.*

<sup>38</sup> Press Release, Apple, Inc., Apple Unveils New iTunes (Sept. 12, 2012) (<http://www.apple.com/pr/library/2012/09/12Apple-Unveils-New-iTunes.html>).

<sup>39</sup> Tim Bradshaw & Andrew Edgecliffe-Johnson, *Spotify in Top League with \$3bn Valuation*, FIN. TIMES, <http://www.ft.com/intl/cms/s/0/e11c1344-2e98-11e2-9b98-00144feabdc0.html#axzz2K4NCQBny> (last updated Nov. 15, 2012, 12:24 AM).

<sup>40</sup> *United States v. Glaxo Group Ltd.*, 410 U.S. 52, 64 (1973); *Besser Mfg. Co. v. United States*, 343 U.S. 444, 447 (1952); *United States v. General Electric Co.*, 115 F. Supp. 835, 843-46 (D.N.J. 1953); *United States v. Glaxo Group Ltd.*, 410 U.S. 52, 64 (1973).

<sup>41</sup> Note, compulsory licenses were originally established in the Copyright Act of 1909. See The Copyright Act of 1909, Pub. L. 60-349, 35 Stat. 1075 (Mar. 4, 1909; repealed Jan. 1, 1978). However, in the interest of brevity, this note limits the discussion to the Copyright Act of 1976 and subsequent legislation.

<sup>42</sup> Copyright Act of 1976, 17 U.S.C. §102(a)(2), (7) (2010); AL KOHN & BOB KOHN, KOHN ON MUSIC LICENSING 1465 (4th ed. 2010).

<sup>43</sup> See KOHN, *supra* note 34, at 1466.



terrestrial radio.<sup>44</sup> The original justification for this differential treatment was the notion that radio plays drive physical album sales, from which sound recording rights owners profit. However, the digitalization of music distribution has upended this model.

Sections 114 and 115 of the now-amended Copyright Act establish compulsory licensing exceptions to the exclusive rights granted to copyright holders.<sup>45</sup> These compulsory licenses have evolved and adapted to changes in technology; first with the enactment of the Digital Performance Right in Sound Recording Act of 1995,<sup>46</sup> and then with the Digital Millennium Copyright Act of 1998.<sup>47</sup>

### B. *Digital Performance Right in Sound Recordings Act*

In response to industry-wide fears that the Copyright Act did not sufficiently protect owners' sound recording rights in the face of digitalization, Congress passed the Digital Performance Right in Sound Recordings Act ("DPRA"), which amended sections 106, 114 and 115.<sup>48</sup> The DPRA was enacted with the intent of protecting copyright holders—artists, record labels and any other parties—from potentially adverse outcomes as a result of new technology.<sup>49</sup> One such way that this act protected rights holders was through the creation of a new digital public performance right.<sup>50</sup> The DPRA created a complicated categorization criteria for the types of services that would and would not be eligible to license works compulsorily.<sup>51</sup> This system placed streaming music into one of the following three categories of: (1) interactive services, (2) non-interactive subscription services and (3) non-interactive non-subscription digital audio services.<sup>52</sup> Each of these different types of service was accompanied by a different licensing requirement in correspondence with their likelihood and tendency to supplant traditional content distribution.<sup>53</sup>

<sup>44</sup> John Villasenor, *Digital Music Broadcast Royalties: The Case for a Level Playing Field*, ISSUES IN TECHNOLOGY INNOVATION, Aug. 2012, at 1, 3 (noting that the exemption of broadcast radio from the new performance right in a sound recording was crucial to the passage of both the DMCA and the DPRA).

<sup>45</sup> See 17 U.S.C. §§114-115; KOHN, *supra* note 34, at 733.

<sup>46</sup> Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (1995) [hereinafter DPRA].

<sup>47</sup> Digital Millennium Copyright Act, H.R. 2281, 105th Cong. §§101-02 (1998) (enacted) [hereinafter DMCA].

<sup>48</sup> See DPRA.

<sup>49</sup> S. REP. NO. 104-128, at 10 (1995); see also W. Jonathan Cardi, *Über-Middleman: Reshaping the Broken Landscape of Music Copyright*, 92 Iowa L. Rev. 835, 850 (2007).

<sup>50</sup> See KOHN, *supra* note 34, at 739; see also *Bonneville Int'l Corp. v. Peters*, 153 F. Supp. 2d 763, 766-768 (E.D. Pa. Aug. 1, 2001). Note, in an attempt to address the issue of *downloadable* music files, the act also expanded the scope of the pre-existing compulsory mechanical license provision, in order to encompass recreation and distribution of musical works in sound recordings via digital transmission. KOHN, *supra* note 34, at 739; see also *Bonneville Int'l Corp. v. Peters*, 153 F. Supp. 2d 763, 766-68 (E.D. Pa. Aug. 1, 2001).

<sup>51</sup> *Bonneville*, 153 F. Supp. 2d at 766-68.

<sup>52</sup> See *id.* at 767-68.

<sup>53</sup> See *id.*



### 1. Interactive Services

Interactive services receive little benefit from the Copyright Act, as a result of the DPRA. After the DPRA's enactment, providers of interactive services were required to obtain authorization from the owner of the sound recording copyright in order to provide access to digital music. The DPRA did not provide a compulsory licensing provision for these services. Given the substitutability of on-demand music recordings, interactive service providers must contract directly with record labels. "Interactive music" was defined by the DPRA as a service that "...enables a member of the public to receive, on request, a transmission of a particular sound recording chosen by ... the recipient."<sup>54</sup>

### 2. Non-Interactive Subscription Services

Non-interactive *subscription* services must also pay a royalty to the owner of the sound recording copyright (in contrast to terrestrial radio, which pays only the owner of the musical work copyright). However, the DPRA allowed non-interactive subscription services access to a compulsory license fee structure for the copyright of the sound recording.<sup>55</sup> This royalty rate was to be set by a Copyright Arbitration Royalty Panel of judges.<sup>56</sup>

### 3. Non-Interactive Non-Subscription Services

Lastly, digital transmissions by non-interactive non-subscription based services fell outside of the scope of control of the owner of the sound performance copyright under the DPRA.<sup>57</sup> Thus, just as with terrestrial radio, sound recording copyright owners were not compensated for the use of their music by these types of services.

## C. *The Digital Millennium Copyright Act*

Three years after the enactment of the DPRA, Congress enacted the Digital Millennium Copyright Act ("DMCA"), primarily to address growing concerns over illegal downloading, and to tailor U.S. copyright law to more closely comport with internationally agreed upon standards.<sup>58</sup> The DMCA further modified section 114 of the Copyright Act; most notably, by modifying the exceptions to the exclusive right in sound recordings.<sup>59</sup> Specifically, the carve out for non-interactive non-subscription services was narrowed, forcing many providers of these services to now pay a sound performance royalty in addition to the musical work royalty.

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<sup>54</sup> DPRA, § 3(j)(4), (1995); *see also* Copyright Act of 1976, 17 U.S.C. § 114(j)(7) (2006).

<sup>55</sup> *See* DPRA § 4(3)(A).

<sup>56</sup> *See* DPRA § 5(d). Note, that this panel was later phased out by and supplanted with the three-judge Copyright Royalty Board ("CRB") pursuant to the Copyright Royalty and Distribution Reform Act of 2004.

<sup>57</sup> *See* DPRA § 3(d).

<sup>58</sup> *See* DMCA.

<sup>59</sup> *See id.* DMCA § 114.

## 1. Expanded Definitions

The DMCA amended Sections 114 and 115 of the Copyright Act to alter the compulsory licensing exceptions to the exclusive rights granted to copyright holders.<sup>60</sup> In particular, the DMCA altered the original three distinctions carved out by the DPRA, expanding the definitions of both *interactive services* and *non-interactive subscription services* to take account of the rapidly evolving landscape of landscape of online streaming content.<sup>61</sup> This expansion increased the pool of interactive services, which cannot obtain a compulsory license. Interactive services are now defined in the Copyright Act as a service “that enables a member of the public to receive a transmission of a program specifically created for the recipient, or on request, a transmission of a particular sound recording, whether or not as a part of a program, which is selected by or on behalf of the recipient.”<sup>62</sup> This definition expanded interactive services to encapsulate services that stream “specially created” programs, in contrast to the ‘on-demand’ characteristics of interactive services as defined by the DPRA. The interpretation of the term interactive service is still not a concrete rule, and the Copyright Office insists that webcasters be evaluated on a case-by-case basis.<sup>63</sup> The Second Circuit—in the only circuit opinion on the issue of interactive services—did little to clarify the definition.<sup>64</sup>

As in the DPRA, non-interactive services continue to be categorized as either subscription or non-subscription based. However, the DMCA alterations expanded the class of services that qualify as non-interactive subscription services—and are thus obliged to pay for a statutory license to the sound recording copyright—to include services previously exempt as non-subscription non-interactive services.<sup>65</sup> Hence, services that formerly received treatment equitable to that received by terrestrial radio stations are now forced to pay higher licensing fees to maintain operations.<sup>66</sup> The DMCA had the effect of enlarging the scope of both exclusive sound recording copyright licenses (by changing the definition of interactive services) and the class of services that now must pay a sound recording royalty in order to broadcast.

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<sup>60</sup> See *id.* DMCA § 114-15; see also KOHN, *supra* note 34 at 1473.

<sup>61</sup> Steven M. Marks, *Entering the Sound Recording Performance Right Labyrinth: Defining Interactive Services and the Broadcast Exemption*, 20 LOY. L.A. ENT. L. REV. 309, 327 (2000).

<sup>62</sup> Copyright Act of 1976 § 114(j)(7); see also DMCA § 114(j)(7).

<sup>63</sup> Public Performance of Sound Recordings: Definition of a Service, 65 Fed. Reg. 77,330 (Dec. 11, 2000).

<sup>64</sup> *Arista Records, LLC v. Launch Media, Inc.*, 578 F.3d 148, 164 (2d Cir. 2009) (determining that the defendant webcaster, LAUNCHcast, did not offer a service that was predictable or might serve to supplant album purchases by the listener, but offering little in the way of a bright line rule to be applied in future cases).

<sup>65</sup> *Bonneville Int’l Corp. v. Peters*, 153 F.Supp.2d at 769 (citing to H.R. Rep. No. 105-796, at 80 (1998) (Conf. Rep.))

<sup>66</sup> See *id.* (noting that congress left intact the exemption for “nonsubscription broadcast transmission[s],” thereby preserving preferential treatment for terrestrial radio (quoting Copyright Act of 1976 § 114(d)(1)(A)) (alteration in original)).

## 2. Dichotomous Compulsory Royalty Standards

Within the fee structure for compulsory licenses, the DMCA established two standards for assessment of these royalty rates: (i) the old 801(b) standard which included four factors, leading to a standard designed to achieve a “reasonable estimate of the marketplace derived benchmark” and (ii) the new “willing buyer/willing seller” standard.<sup>67</sup> The former, more broadcaster-friendly standard was applied to satellite radio broadcasters and any “preexisting subscription service[s].”<sup>68</sup> Whereas, the latter standard is applied to subscription services created after the passage of the DMCA and certain “eligible non-subscription transmissions.”<sup>69</sup> The new “willing buyer/willing seller” standard creates significantly higher royalty rates to be paid out by content distributors. For example, Pandora is eligible for compulsory licensing under the willing buyer/willing seller standard. Sirius XM, however is under the old 801(b) standard.<sup>70</sup> The implications of these differing rates on the two companies’ profitability are substantial.<sup>71</sup>

Spotify (and related platforms) allows users to preselect the songs that will played to them in advance. These services are classified as interactive, and are therefore ineligible for compulsory licenses. Notwithstanding the inapplicability of either standard to interactive streaming music services, the divergent royalty rate outcomes across these two standards created by the DMCA highlight the severe ramifications of seemingly benign differences in language.

### D. *The Copyright Royalty Board and Increased Rates*

Six years after the enactment of the DMCA, the Copyright Royalty and Distribution Reform Act of 2004 amended Chapter 8 of the Copyright Act, phasing out the Copyright Arbitration and Royalty Panel, and supplanted it with a three judge panel of Copyright Royalty Judges (“CRJs”) appointed for staggered six year terms.<sup>72</sup> This panel establishes the royalties to be paid by eligible broadcasters who opt not to negotiate alternative pricing schemes, such as Pandora, Rhapsody, Live365 and Last.fm. On March 2, 2007, the Copyright Royalty Board (“CRB”) issued a ruling, which hiked up rates in lock step each year thereafter.<sup>73</sup> In advance of the published opinion, the decision

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<sup>67</sup> See DMCA § 405; Villasenor, *supra* note 36, at 4-8.

<sup>68</sup> See Villasenor, *supra* note 36, at 4 (quoting Copyright Act of 1976 § 114(j)(11)).

<sup>69</sup> See *id.* at 4 (quoting Copyright Act of 1976 § 114(j)(6)).

<sup>70</sup> See *id.* at 4-5 (noting that Sirius XM falls under the DMCA statutory carveout, as a “preexisting subscription service,” and therefore qualifies for the old 801(b) standard).

<sup>71</sup> See *infra* Part V.A.

<sup>72</sup> Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-419, 118 Stat. 2341 (2004) (codified as amended at 17 U.S.C. §§801-802(2004)).

<sup>73</sup> See Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24084, 24096 (May 1, 2007) (establishing a pay play per user royalty rate of \$0.0008 for 2006, 0.0011 for 2007, 0.0014 for 2008, \$0.0018 for 2009, and \$0.0019 for 2010) (may be located at <http://www.loc.gov/crb/fedreg/2007/72fr24084.pdf>); see also Final Determination of Rates and Terms, Docket No. 2005-1 CRB DTRA at 46 (Feb. 16, 2005) (providing judicial memorandum outlining decision) (may be located at <http://www.loc.gov/crb/proceedings/2005-1/rates-terms2005-1.pdf>).

drew significant criticism for establishing unsustainable royalty rates.<sup>74</sup> An appeal for rehearing was denied.<sup>75</sup> In response to this rate hike, the Internet Radio Equality Act which sought to equilibrate royalties paid by webcasters and terrestrial radio providers - was proposed with some support, though the act has since been abandoned.<sup>76</sup> However, lobbying efforts by Internet radio providers garnered sufficient legislative attention as to secure the passage of the Webcaster Settlement Acts (of 2008 and of 2009), which permitted Internet radio companies to negotiate with the royalty collection organization SoundExchange<sup>77</sup> for royalty rates outside of the compulsory rates established by the CRB.<sup>78</sup> Companies that did not elect to renegotiate were subject to the rates set out by the CRB. Recently, in 2012, the Internet Radio Fairness Act was proposed, which similarly sought to lower royalty rates paid by digital radio providers to rates comparable to those paid by terrestrial radio broadcasters.<sup>79</sup> However, this act failed to pass, and supporters appear to have abandoned efforts to ush the law through Congress.<sup>80</sup>

Royalty rate setting has been a contentious issue since the passage of the DPRA. Record labels and content owners are constantly pressing for increased revenue streams, while webcasters seek to carve out a profitable business model within these confines.<sup>81</sup> Moreover, judges struggle to properly estimate reasonable rates, given the inherently inestimable traits of the government-enacted copyright monopoly.<sup>82</sup> While legislation has attempted to correct for market inefficiencies, these measures are oft slow moving, and in the fast-paced environment of technological innovation,

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<sup>74</sup> Hiawatha Bray, *Royalty Hike Could Mute Internet Radio: Smaller Stations Say Rise Will Be Too Much*, THE BOSTON GLOBE, (Mar. 14, 2007) [http://www.boston.com/business/technology/articles/2007/03/14/royalty\\_hike\\_could\\_mute\\_internet\\_radio/](http://www.boston.com/business/technology/articles/2007/03/14/royalty_hike_could_mute_internet_radio/); Olga Kharif, *The Last Days of Internet Radio?* BLOOMBERG BUSINESSWEEK (Mar. 7, 2007) <http://www.businessweek.com/stories/2007-03-07/the-last-days-of-internet-radio-businessweek-business-news-stock-market-and-financial-advice>.

<sup>75</sup> David Oxenford, *Copyright Royalty Board Denies Rehearing Motions—Next Stop, Court of Appeals*, BROADCAST L. BLOG (Apr. 16, 2007) <http://www.broadcastlawblog.com/2007/04/articles/internet-radio/copyright-royalty-board-denies-rehearing-motions-next-stop-court-of-appeals/>.

<sup>76</sup> Internet Radio Equality Act, H.R. 2060, 110th Cong. (1st Sess. 2007).

<sup>77</sup> SoundExchange is “the non-profit performance rights organization that collects statutory royalties from satellite radio (such as SIRIUS XM), internet radio, cable TV music channels and similar platforms for streaming sound recordings. The Copyright Royalty Board, which is appointed by The U.S. Library of Congress, has entrusted SoundExchange as the sole entity in the United States to collect and distribute these digital performance royalties on behalf of featured recording artists, master rights owners (like record labels), and independent artists who record and own their masters.” See SOUNDExchange, [www.soundexchange.com](http://www.soundexchange.com) (last visited Apr. 7, 2013).

<sup>78</sup> Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974 (2008); Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926 (2009).

<sup>79</sup> Internet Radio Fairness Act, H.R. 6480, 112th Cong. (2nd Sess. 2012).

<sup>80</sup> Glenn Peoples, *Pandora Stops Internet Radio Fairness Act Legislation Efforts, to Focus on CRB.*” Billboard (Nov. 25, 2013) <http://www.billboard.com/biz/articles/news/digital-and-mobile/5800772/pandora-stops-internet-radio-fairness-act-legislation>.

<sup>81</sup> See Report of the Copyright Arbitration Royalty Panel Docket No. 2000-9 CARP DRTA 1 & 2, 10-18 (Feb. 20, 2002) [http://www.copyright.gov/carp/webcasting\\_rates.pdf](http://www.copyright.gov/carp/webcasting_rates.pdf) (detailing the interested parties in the webmaster settlements, as well as the substantial arguments submitted by both sides).

<sup>82</sup> See *id.* at 38-42, (discussing the theoretical economic arguments and attempting to weigh these interests against the negotiated agreements).

such delays can be damning for upstart companies. It is against this backdrop that both Spotify and Pandora should be analyzed. More specifically, these companies must navigate intricate and cumbersome statutory provisions; provisions which are intended to balance the interests of entrenched copyright owners on the one hand and innovative companies who seek to usurp markets traditionally cornered by those rights holders on the other (*i.e.* webcasters and streaming music service platforms).

#### IV. SPOTIFY, STREAMING SUBSCRIPTIONS, AND THE FUTURE

The on-demand music platform, Spotify, has risen meteorically from a small European start-up based out of Stockholm, Sweden to a multinational distributor of digital media.<sup>83</sup> The company's proprietary software platform provides a streamlined user interface, which has experienced enormous growth worldwide.<sup>84</sup> Early on, Spotify focused its resources and attention on the mobile market, and released applications for both Apple and Google (Android) phones in 2009.<sup>85</sup> Like many new technology companies, Spotify operates under a so-called *freemium* model, whereby basic, ad-funded services are offered to users free of charge, and premium features are offered at a cost.<sup>86</sup> This model has enabled the company to rapidly accumulate users, many of whom opt to pay for the premium service.<sup>87</sup> In the US alone, the company has nearly doubled in subscription base in the past year.<sup>88</sup>

##### A. *Losing Upfront: The Spotify Business Model*

This *freemium* model of customer accumulation is expensive. Spotify must pay licensing fees to copyright holders (record labels) for each song played, whether offered to a paying, or to a non-paying customer. Financial documents for Spotify Ltd.<sup>89</sup> indicate that while the company has dramatically grown its revenues, it nonetheless posted a substantial loss in each of the first two years since its introduction to the United

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<sup>83</sup> Steven Bertoni, "Spotify's Daniel Ek: The Most Important Man in Music" *Forbes* (Jan. 4, 2012) <http://www.forbes.com/sites/stevenbertoni/2012/01/04/spotify-daniel-ek-the-most-important-man-in-music/>.

<sup>84</sup> Yinka Adegoke, "Spotify Now Has 10 Million Paid Subscribers, 3 Million in the U.S. (Exclusive)" *Billboard*, (May 21, 2014) <http://www.billboard.com/biz/articles/news/digital-and-mobile/6092226/spotify-now-has-10-million-paid-subscribers-3-million>.

<sup>85</sup> Andres Sehr, *Spotify Mobile Demo at Google Android I/O*, SPOTIFY BLOG (May 28, 2009, 9:06 AM) <https://www.spotify.com/us/blog/archives/2009/05/28/spotify-mobile-demo-at-google-android-io/>; Spotify App Approved for iPhone, BBC NEWS (Aug. 27, 2009, 7:19 PM), <http://news.bbc.co.uk/2/hi/technology/8225731.stm>.

<sup>86</sup> See Definition of 'Freemium', INVESTOPEDIA, <http://www.investopedia.com/terms/f/freemium.asp> (last visited May 14, 2013); Fred Wilson, My Favorite Business Model, A VC (Mar. 23, 2006) [http://www.avc.com/a\\_vc/2006/03/my\\_favorite\\_bus.html](http://www.avc.com/a_vc/2006/03/my_favorite_bus.html) (see comments section for coining of the term "freemium" to describe business models in which a bare-bones product is provided for free while more select features are provided on a paid basis).

<sup>87</sup> See *id.*

<sup>88</sup> See Sloan *supra* note 28.

<sup>89</sup> Spotify Ltd. is a subsidiary of parent company Spotify Technology SA.

States.<sup>90</sup> In 2010, the company reported a net operating loss of approximately \$37.5 Million, and in 2011, this loss grew 57% to \$59 Million.<sup>91</sup> Such losses are common to companies in their infancy stages. However, in traditional marketplaces, the costs to such companies are often relatively fixed. These costs are typically kept down by the fungibility of the component goods. Yet, in markets for copyright protected content, goods are not readily interchangeable. The collection of all U2 recordings cannot be used as a reference point when attempting to value the collection of all Kelly Clarkson recordings, except perhaps to set a price ceiling. Thus, the non-substitutability of content creates a market susceptible to wildly varying price schemes. This in turn threatens Spotify's ability to become profitable in the long term, as the costs of licensing are apt to rise with the company's profitability. In effect, the way in which copyrights are structured with respect to digital media allows content owners to free ride—in some ways—upon upstart distributors; by allowing these platforms to create a sustainable business model, and then enjoying the profits established by that model, with little capital input. Content distributors have little in the way of recourse.

This potential negotiation impasse is further complicated by the fact that streaming music as provided by Spotify threatens to eventually supplant content purchases entirely. Unlike Pandora, or Last.fm, which provide exposure to new content, but do not allow users to repeatedly choose to listen to their favorite songs, Spotify provides an on-demand interface. Spotify therefore risks cannibalizing content sales, as opposed to driving them. Conflicting reports and statements have been issued regarding this perceived cannibalization. Spotify CEO, Daniel Ek contends that like Pandora and other online radio services, Spotify drives album sales.<sup>92</sup> Quantitative surveys performed by the research firm The NPD Group have produced mixed conclusions. An initial report showed that Spotify has led to a 13% decline in propensity to purchase new music,<sup>93</sup> more recently however, preliminary findings by the Group suggest that Spotify users are twice as likely to purchase songs from iTunes or Amazon than other consumers.<sup>94</sup>

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<sup>90</sup> *Private Company Financial Report: Spotify, Ltd.*, PRIVTCo, 8 (2012) available at <http://www.private-company/spotify-ltd> (providing balance sheet, financial information, funding history, prior litigation and other business related information for Spotify Ltd.).

<sup>91</sup> See *id.* (Note, also, that this net operating loss tracks to—and even outpaces—the growth in revenue. Revenues in 2011 were up 51% from 2010, compared to a 57% increase in net operating loss).

<sup>92</sup> Eliot Van Buskirk, *Daniel Ek on Spotify, Community and Music's Future*, GRAMMY.COM (Feb. 2, 2012), 2:15 PM, <http://www.grammy.com/news/daniel-ek-on-spotify-community-and-musics-future> (in which Spotify's co-founder stated that "All the information available points to streaming services helping to drive sales.").

<sup>93</sup> Paul Resnikoff, *Study: Spotify Is Detrimental to Music Purchasing*, DIGITAL MUSIC NEWS (Nov. 15, 2011), <http://www.digitalmusicnews.com/permalink/2011/11/15/cannibal> (reporting NPD Group findings that access to streaming music services has led to a decrease in propensity to purchase albums among the two most dedicated demographics).

<sup>94</sup> Paul Resnikoff, *Spotify Users Are Twice as Likely to Purchase a Download*, DIGITAL MUSIC NEWS (Sept. 20, 2012), <http://web.archive.org/web/20120924052559/http://www.digitalmusicnews.com/permalink/2012/120920spotifynpd> (reporting preliminary NPD Group research which points to a significantly higher propensity to purchase music on iTunes and Amazon among Spotify users).



While the impact of streaming on-demand music service on record sales is debatable, there is at least an intuitive notion that this service serves to supplant sales.

Thus, the non-substitutability of digital media, and the potential for decreased content sales create substantial leverage for content owners during negotiation. Indeed, Spotify's current licensing fees to the major labels reportedly require that the company pay the higher of \$200 Million, and 75% of revenues, annually, substantially limiting Spotify's ability to create a profitable business in the near or the medium term.<sup>95</sup>

Recent history has highlighted the large record labels' reluctance to adapt to changing market conditions. If streaming subscription services do in fact begin to displace traditional content, efforts to stymie this transition will likely serve to push more consumers into different - and perhaps illegal - market alternatives.

### B. *Netflix: Pioneering Streaming Content*

In many ways, Spotify's rapid rise, as well as the complexity of content license renegotiations track closely with the case of Netflix. Netflix must negotiate with content owners in order to establish rights to stream movies and television shows, much like Spotify does to obtain rights to music. Netflix's recent history underscores the potential rate hike as streaming content distributors become more profitable.

In 1997, Reed Hastings founded Netflix, Inc., upending the traditional movie-rental business model by creating a subscription-based mail-order movie rental service, instead of the traditional pay-per-use model.<sup>96</sup> However, as technology progressed, Netflix quickly sought to incorporate streaming content into its business.<sup>97</sup> Initially, content acquisition was complicated, as many major studios had already sold the digital distribution rights for movies to premium television networks.<sup>98</sup> Thus, Netflix was forced to engage directly with these networks, most of which viewed the upstart company as a potential threat to their business.<sup>99</sup> Nevertheless, Netflix was able to secure these rights and established a profitable streaming service.

Recently, Netflix renegotiated these distribution rights with many of the larger studios and content owners.<sup>100</sup> The new, current contracts are structured as fixed-length,

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<sup>95</sup> Eric Eldon, *Spotify is Having a Good 2012: Revenues Could Reach \$500M As It Expands The Digital Music Market*, TECHCRUNCH (Nov. 10, 2012), <http://techcrunch.com/2012/11/10/spotify-is-having-a-good-2012-revenues-could-reach-500m-as-it-expands-the-digital-music-market/>.

<sup>96</sup> Francois Brochet, Suraj Srinivasan & Michael Norris, *Netflix: Valuing a New Business Model*, HARVARD BUSINESS SCHOOL No. 9-113-018 (2013).

<sup>97</sup> *See id.* at 3.

<sup>98</sup> *See id.*

<sup>99</sup> *See id.*

<sup>100</sup> *Netflix Announces Strategic Multi-Year Agreement with Miramax*, Reuters (May 16, 2011), <http://www.reuters.com/article/2011/05/16/idUS77868+16-May-2011+PRN20110516>; *NBCUniversal and Netflix, Inc. Renew Multi-Year TV and Film Content Agreement*, Reuters (July 13, 2011), <http://www.reuters.com/article/2011/07/13/idUS177431+13-Jul-2011+PRN20110713>; *Mexico's Televisa Agrees Netflix Lat-am Deal*, Reuters (July 26, 2011), <http://www.reuters.com/article/2011/07/26/televisa-netflix-idUSN1E-76P22L20110726>.



fixed price deals as opposed to revenue sharing agreements.<sup>101</sup> This structure allows content creators to enjoy the upside of fixed profits, without the associated risk of revenue sharing. Given content owners' exclusive right to proprietary content, Netflix (as well as Spotify, and any other interactive digital media distribution platforms) must engage in negotiations to acquire rights to this content. Yet, because relatively little law governs these negotiations, and because the marginal cost to owners of licensing additional content is non-existent, content owners are free to license at very low rates for companies seeking to develop a market share, and then hike these rates up as those companies become more profitable.<sup>102</sup> Indeed, this appears to be the case with Netflix. From the beginning of 2008 up to the end of 2009, the cost of content licensing was relatively stable at approximately \$50 million per quarter.<sup>103</sup> In 2010, costs rose steadily up to approximately \$207 million by quarter 4. However, in the second quarter of the subsequent year, content acquisition costs skyrocketed to \$632 million, and fell off only slightly, to \$560 million in the following quarter.<sup>104</sup> In this same timeframe Netflix's stock price saw a precipitous decline from approximately \$295 per share in July of 2008, to \$63 per share just five months later in November.<sup>105</sup> This decline appears to bear at least some inverse correlation to the costs of content acquisition.<sup>106</sup>

Given the monopolistic nature of copyrights, there is a natural tendency toward this sort of scheduled fee-hike by content owners after a market has been established, and proven to be profitable. Netflix has been at least partially victim to this phenomenon. In the near future, interactive streaming music services will likely observe a similar trend in rights negotiations and renegotiations with record labels.

### C. *Reconciling Netflix: The Digital Distributor's Paradox*

In light of the financial figures presented above, Spotify seems to be similarly susceptible to a rate-hike cliff like that imposed upon Netflix. Indeed, the similarities between the two companies are striking. Both Spotify and Netflix provide unlimited access to content, for a recurring fee, as opposed to the personal ownership model

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<sup>101</sup> See *id.*

<sup>102</sup> Note, however, that this dilemma does not exist between producers and distributors of a non-IP good for which there is a fixed marginal cost, as the producers must sell for at least a marginal cost.

<sup>103</sup> See *id.* at 12. (refer to Exhibit 6)

<sup>104</sup> See *id.*; see also, *Netflix Announces Strategic Multi-Year Agreement with Miramax*, REUTERS (May 16, 2011), <http://www.reuters.com/article/2011/05/16/idUS77868+16-May-2011+PRN20110516>; *NBCUniversal and Netflix, Inc. Renew Multi-Year TV and Film Content Agreement*, REUTERS (July 13, 2011), <http://www.reuters.com/article/2011/07/13/idUS177431+13-Jul-2011+PRN20110713>; *Mexico's Televisa Agrees Netflix Latam Deal*, REUTERS (July 26, 2011), <http://www.reuters.com/article/2011/07/26/televisa-netflix-idUSN1E76P22L20110726>.

<sup>105</sup> This decline represented a 78.6% drop in Netflix's valuation.

<sup>106</sup> Note, however, that there are numerous complicating factors leading to both the increase in content costs and the decline in share price. Notably, these factors include the expansion into international markets, and the accompanying increased content costs, as well as the short-lived and ill-fated decision to sever Netflix's streaming subscription services from its DVD rental subscription service (though the latter decision occurred near the trough of Netflix's valuation decline).

employed by other digital services, such as the iTunes Store. Moreover, these subscription fees are relatively low, so as to attract users—many of whom still operate under the presupposition that ‘music should be free.’<sup>107</sup> This ‘Napster effect’ has impacted digital music as well as other types of media. Yet, Spotify and Netflix differ in ways that suggest that this rate-hike might be even more pronounced for Spotify, than for television and movie content distributors.

### 1. Differing Revenue Streams Across Industries

One striking way in which music and video content differ from one another is the process of release. Traditionally, films are promoted and then released into theaters, where consumers pay a premium fee to view. Until recently, it was only after these movies were distributed across the country—or the world—in theaters that the film would be distributed digitally on the Netflix’s platform.<sup>108</sup> Similarly, television programming is [often] disseminated by a broadcasting company, and then in some cases the content is streamed through the company’s proprietary platform.<sup>109</sup> It is typically only at the conclusion of a season of a particular show that platforms such as Netflix receive rights to distribute this programming.<sup>110</sup> The music distribution market, unlike the markets for mainstream film and television content distribution, does not have this same initial revenue stream. While music is promoted, and albums may be sold at a higher price initially, there is no primary or secondary revenue stream for such content.

This market differentiation magnifies the likelihood that new streaming music services such as Spotify will be subjected to a rate-hike at renegotiation. For movie and television content generators, Netflix’s platform is only relevant to distribution after the aforementioned limited release. Further, this time period after movies are digitally released is when piracy becomes a much more significant threat.<sup>111</sup> Thus, video content creators experience a significant upside in allowing companies like Netflix to distribute their content in a way that can be monetized; particularly, given the initial release revenue streams, upon which distributors have no adverse impact.

Record labels and musical content generators, who typically own the sound recording, and not the public performance right, have no significant alternative revenue

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<sup>107</sup> Indeed, such fees must be kept low, as the rate must compete with the cost of piracy: free.

<sup>108</sup> See Richard Lawler, “Netflix and IMAX Will Get ‘Crouching Tiger 2’ on the Same Day,” *Engadget* (Sept. 29, 2014) <http://www.engadget.com/2014/09/29/netflix-crouching-tiger-2/> (noting that this is the first time that Netflix has participated in a ‘day-and-date’ release, though the company intends to continue to pursue such opportunities).

<sup>109</sup> Often, this streaming service is advertiser-funded, i.e. ABC, NBC, Hulu, etc. see “About Us” HULU, <http://www.hulu.com/about>; “NBC Full Episode App” NBC.COM, <http://www.nbc.com/nbc-app>; “Shows” ABC.COM <http://abc.go.com/shows> In other cases, it is an associated subscriber benefit, i.e. HBO, see “Product Tour” HBOGo <http://www.hbogo.com/product-tour/>.

<sup>110</sup> “Quick Guide: How Does Netflix Decide What’s on Netflix” Netflix (June 6, 2013) <https://www.youtube.com/watch?v=Vvp0Uh9gx58>.

<sup>111</sup> Geoffrey Fowler, “Pirates Prey on Blu-Ray DVD Format,” *Wall Street Journal* (Nov. 17, 2008) available at <http://online.wsj.com/articles/SB122688367525432273>.

stream.<sup>112</sup> While Spotify and other platforms might serve to bring illegal users to a legitimate marketplace, just as Netflix serves to combat piracy, there is also a substantial risk of cannibalization of legitimate users who would otherwise *purchase* content in album format, or at least as a single. Both alternatives are more profitable to content owners than streaming, even streaming repeatedly. Thus, because Spotify and related services compete with sound recording copyright owners' primary revenue source, it follows that these owners may press digital distribution platforms for potentially exorbitant rights premiums.<sup>113</sup>

The lack of a well-defined alternative revenue stream for musical content creators differentiates the market from its video counterpart, and renders content owners more likely to impose a licensing rate-hike upon distribution platforms like Spotify as soon as a profitable business is established.

## 2. The Unbundling of Music Content

In addition to the differential revenue streams between music and video content, the two types of content differ in another way which cuts toward upped licensing rates for music distribution services relative to video content distributors: bundling. Television and films present content in a narrative structure, which requires that the whole of the film or episode (or even season) be viewed in order for the consumer to gather some sense of resolution. Music, however, can be (and has been) unbundled from album format into individual songs. While some albums may be written in a semi-narrative structure,<sup>114</sup> the large majority of albums are not; and, even those that are parsed into separate songs.

The unbundling of songs from albums is a direct outflow of Napster. Yet, it was institutionalized by Apple with the iTunes Store, which allowed users to pay for and download songs individually, and charged a decreased marginal rate for album sales.<sup>115</sup> Irrespective of its origins, that consumers can now choose to disaggregate songs from albums and purchase in a piecemeal structure has further eroded the once lucrative profit scheme record companies had established. Spotify, too, panders to this consumer desire, granting users the ability to select individual songs, with no limitations.

As a result of unbundling, the money and resources allocated by labels and content producers into the production of albums remains relatively constant, though the

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<sup>112</sup> Note, live performance might be considered an alternate revenue stream; though, the market is highly differential in nature to the limited theatrical release market for movies discussed herein.

<sup>113</sup> Note, this argument can be construed as keying into the fungibility of streaming music in comparison to digital media ownership, as compared to the seemingly severable markets and uses of theatrical versus personal or private consumption of movies.

<sup>114</sup> See THE BEATLES, SGT. PEPPER'S LONELY HEARTS CLUB BAND (Capitol Records 1990) (1967); THE WHO, TOMMY (MCA 1996) (1969); DAVID BOWIE, THE RISE AND FALL OF ZIGGY STARDUST AND THE SPIDERS FROM MARS (Virgin Records 1999) (1972); PINK FLOYD, THE DARK SIDE OF THE MOON (Capitol Records 2011) (1973). THE WHO, TOMMY (MCA Records 1996) (1969).

<sup>115</sup> ISAACSON, *supra* note 12, at 401 (Initially, songs sold in the iTunes Music Store cost \$0.99 while albums cost \$9.99, regardless of the number of songs).

returns to such content are diminished, and are more focused about individual songs. In a sense, less popular songs that would not otherwise have been made absent the album structure are losses to these labels. Labels and content owners will thusly look to recoup these losses. One such way is to charge a higher license premium per song, and thereby allow royalties from popular songs to partially subsidize less popular ones. This tends toward a growth in the licensing fees currently paid by digital distributors, which implies much higher licensing fee demands at renegotiation.

These factors taken in conjunction with the nature of intellectual property licensing—specifically, that the marginal cost of an additional license is effectively zero—create a potential for content owners to drastically increase the fees charged to Spotify and similar services as those companies become more established. Given that the problem is an outflow of statutory protections devised to “promote the Progress of Science and useful Arts,”<sup>116</sup> attempts to address might be best effectuated by statutory redress.

## V. TOWARD A SOLUTION: COMPULSORY LICENSING

### A. *Pandora, and the Perils of Compulsory Licenses*

Compulsory licensing as modified by the DMCA was intended to allow Internet radio providers and certain distributors of digital music to continue to operate while ensuring that the interests of content owners, as well as those of artists and composers, were protected. Yet, in practice, the law has served to encumber Internet radio providers with exorbitant royalty rates.<sup>117</sup> This renders such services’ business models unprofitable and thwarts new entrants into the market, thereby decreasing competition and innovation. No company is more illustrative of the unsustainability of this system than Pandora Radio.

Pandora was founded in 1999 as Savage Beast Technologies.<sup>118</sup> At the core of the company was a proprietary database called the Music Genome Project: a human tabulated catalog of characteristics for each song created. Initially, the company struggled to build a coherent business model, flirting with venture capital firms and attempting to formulate a vehicle through which the Genome Project could be

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<sup>116</sup> U.S. CONST. art. I, § 8, cl. 8.

<sup>117</sup> Associated Press, *New Pandora CEO Faces Royalty Fight with Artists*, BILLBOARD, (Sept. 12, 2013) <http://www.billboard.com/biz/articles/news/5694958/new-pandora-ceo-faces-royalty-fight-with-artists>; Ben Sisario, *Fight Builds Over Online Royalties*, NEW YORK TIMES, (Nov. 4, 2012); Andy Fixmer, *Pandora Is Boxed In by High Royalty Fees*, BUSINESSWEEK (Dec. 20, 2012) [http://www.nytimes.com/2012/11/05/business/media/fight-growing-over-online-royalties.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2012/11/05/business/media/fight-growing-over-online-royalties.html?pagewanted=all&_r=0).

<sup>118</sup> EDGAR Search Results, U.S. SEC & EXCHANGE COMM’N, <http://www.sec.gov/edgar/search-edgar/companysearch.html> (query “P” in the field designated “CIK or Ticker Symbol” and follow “Find Companies”; see title of the company for purposes of former filings); Stephanie Clifford, *Pandora’s Long Strange Trip*, INC. (Oct. 1, 2007), [http://www.inc.com/magazine/20071001/pandoras-long-strange-trip\\_pagen\\_2.html](http://www.inc.com/magazine/20071001/pandoras-long-strange-trip_pagen_2.html).

adapted. While initial focus was on business-to-business transactions, in 2005, the company made the decision to pursue consumer markets, instead.<sup>119</sup>

Pandora opted to stake the company on an online radio service that would incorporate users' preferences as determined by algorithms that utilized the Music Genome Project.<sup>120</sup> Under the DMCA, Pandora qualifies for compulsory licensing. Thus, unlike Spotify, who negotiates with each individual copyright holder, Pandora can avoid the costly and cumbersome back-and-forth with each individual content owner. Instead, Pandora is able to focus human capital on categorizing every recorded song ever created and copyrighted. Yet, because Pandora operates under the "willing buyer/willing seller" licensing framework, these rates verge on punitive.<sup>121</sup> Terrestrial radio does not pay any royalties to owners of the sound recording, and pays only a musical work royalty.<sup>122</sup> Satellite radio pays a fee based on revenue.<sup>123</sup> However, Pandora pays what amounts to a very substantial share of its revenue to owners of the sound recording right.<sup>124</sup>

The royalty hike issued by the CRB in 2007 threatened to further push Pandora into the red, and prompted a swift lobbying reaction by streaming internet radio providers across the country.<sup>125</sup> Though Pandora and others were afforded the opportunity to renegotiate with SoundExchange, these negotiations were carried out in the shadow of an already favorable rate increase for content owners; thus allowing SoundExchange to heavily anchor negotiations.<sup>126</sup> The impact of these rate hikes by the CRB illustrates the state of flux that webcasters exist in. Even under the current compulsory system, rate increases have proven steep. Moreover, as discussed above, the determination of these rates are premised upon the subjective interpretation of the meaning of the "willing buyer/willing seller" framework.

Pandora's financial statements indicate that the company has "incurred significant net operating losses . . . since [its] inception in 2000" and as of the January 2012,

<sup>119</sup> See Clifford, *supra* note 118.

<sup>120</sup> See "About Pandora," *supra*, note 1; see also Clifford, *supra*, note 118.

<sup>121</sup> John McDuling, *Why the Music Industry is Trying and Failing - to Crush Pandora*, QUARTZ (Apr. 21, 2014) available at <http://qz.com/197344/pandora-and-the-music-industry/>; see also Ben Sisario, *Pandora and Spotify Rake in the Money and Then Send It Off in Royalties*, N.Y. Times (Aug. 24, 2012) available at <http://mediadecoder.blogs.nytimes.com/2012/08/24/pandora-and-spotify-rake-in-the-money-and-then-send-it-off-in-royalties/> (noting that Spotify purportedly pays approximately 70% of revenue in licensing fees, though financial documents indicate that this number may in fact be as high as 97% of revenue).

<sup>122</sup> See *supra* Part III.B.2.

<sup>123</sup> See *id.*

<sup>124</sup> See McDuling, *supra*, note 121.

<sup>125</sup> Jacqui Cheng, *NPR Fights Back, Seeks Rehearing on Internet Radio Royalty Increases*, ARSTECHNICA (Mar. 20, 2007) available at <http://arstechnica.com/tech-policy/2007/03/npr-fights-back-seeks-rehearing-on-internet-radio-royalty-increases/>; Kendra Marr, *Shaken Internet Radio Stations Face Specter of New Fees Sunday*, WASHINGTON POST (July 13, 2007) available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/07/12/AR2007071202169.html>; Jeff Cox, *Internet Radio to Fight Royalty Ruling*, CNNMONEY (Mar. 15, 2007) available at [http://money.cnn.com/2007/03/14/technology/radio\\_streaming/?postversion=2007031410](http://money.cnn.com/2007/03/14/technology/radio_streaming/?postversion=2007031410).

<sup>126</sup> Pandora Media, Inc., Annual Report (Form 10-K), at 9 (Jan. 31, 2013) (hereinafter Pandora 10-K).

the company has an accumulated deficit of \$101.4 Million.<sup>127</sup> Pandora's revenues have increased significantly in recent years.<sup>128</sup> Yet costs are assessed on a per-play basis, thus effacing the potential for increasing returns to scale.<sup>129</sup> Further, per-play rates increase in each successive year.<sup>130</sup> Therefore, increased subscriptions do not combat the rising costs of service, and the entirety of the shortfall must be procured from advertisement revenue, or from hiked up subscription fees.<sup>131</sup>

Pandora exemplifies the complexity of operating under a compulsory licensing regime. It also underscores how susceptible similar streaming services are to small variations in royalty rates. The dichotomous rate setting standards, the CRB, and the Webcaster Settlement Acts highlight the pitfalls of establishing royalties in a courtroom. A royalty setting mechanism that creates a framework about which the distributors and licensors can negotiate, with incentives built in, might do well to combat the problems presented above with respect to Pandora. Such a system would also help to mitigate the problem of delayed hostage taking by content owners after distributors like Spotify create tenable business models.

## B. *Proposed Alternatives*

Recent scholarship has highlighted the disparate effects of differing rates across distributional mediums. Much of the literature analyzes the problem broadly. In response to this thorny licensing issue, numerous solutions have been submitted. Legislation aimed at achieving parity is oft proposed, though rarely successful. On the extreme end, one author advocates for a scheme similar to that proposed by the Section 115 Reform Act (SIRA),<sup>132</sup> which would have created a blanket compulsory license, applicable to all digital reproduction and distribution services, irrespective of gradations of interactivity.<sup>133</sup> This rate would have been set by the CRB, and would have negated protracted licensing negotiations, thereby increasing certainty in the digital distribution marketplace.<sup>134</sup> Yet, such an analysis paints the problem with too broad a brush. As detailed above, compulsory licenses carry with them significant

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<sup>127</sup> See *id.* at 14 (explaining that the company has "... incurred significant operating losses in the past and may not be able to generate sufficient revenue to be profitable").

<sup>128</sup> See *id.* at 74.

<sup>129</sup> Under the pay-per-play royalty scheme, increased user base implies essentially a 1:1 increase in associated costs; thus, prohibiting Pandora from experiencing increasing returns to scale and fixing marginal cost irrespective of company size.

<sup>130</sup> See 72 Fed. Reg. 2084, 24096 (May 1, 2007).

<sup>131</sup> In light of consumer expectations of free content, the elasticity of demand for subscription access to Pandora is likely very high and subject to large fluctuations relative to price increases.

<sup>132</sup> Section 115 Reform Act, H.R. 5553, 109th Cong. (2006) (the bill was never enacted, and thus expired).

<sup>133</sup> Patrick A McKay, *Ending the Power to Say No: The Case for Extending Compulsory Licensing to Cover Digital Music Reproduction and Distribution Rights* 12 (unpublished comment), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1692336](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1692336) (last visited Nov. 8, 2014).

<sup>134</sup> See *id.* at 17.

issues, and are invariably inefficient for one party, as they are not a true market rate.<sup>135</sup>

Others have similarly voiced support for modified versions of statutes brought before Congress. In 2009, the Performance Rights Act was introduced, but subsequently failed to pass.<sup>136</sup> The act would have created a sound recording fee for terrestrial radio. In anticipation of this bill, an alternative arrangement was suggested whereby an opt-out provision would be added to the Act, which would have allowed artists to choose not to receive sound recording royalties.<sup>137</sup> However, this proposal overstates the practical impact that such an 'opt-out' provision might have on licensing costs. Few artists would willingly opt out of receiving compensation for their work. The establishment of an affirmative choice to be exempted from the royalty pool would seem to garner little support, and even less practical traction.

Another policy issue that has been pointed to in the struggle over compulsory licensing is the lack of a comprehensive net neutrality statute.<sup>138</sup> Record labels hold out hope for preferential broadband speeds, which would thus allow providers to charge increased rates for downloading and streaming over broadband.<sup>139</sup> This would significantly alter the cost equation for digital media providers and shift more bargaining power toward labels and toward broadband providers.<sup>140</sup> Hence, absent net neutrality legislation, labels and content owners will not fully engage in licensing negotiations.<sup>141</sup>

With respect to Spotify, one author discusses the implications of the lack of a compulsory license for interactive services upon the platform, and related services.<sup>142</sup> After going on at length about the complicated and cumbersome process of licensing as it currently operates, the article proposes three changes aimed at streamlining the process of content acquisition and creating more equitable treatment for artists as well as webcasters: (i) enact a net neutrality act to "force" record labels to the table, (ii) create one singular performance right for each work, and create a "one-stop" licensing agency for these rights; and (iii) set a compulsory *minimum* licensing rate to protect artists' compensation from racing to the floor.<sup>143</sup> This solution is an ambitious proposition that would do well to curb some of the ills and inefficiencies of the current copyright system. Practically, however, it is unrealistic, as it implies an overhaul of much of the Copyright Act, and the companies and industries predicated upon the Act. Though

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<sup>135</sup> See *supra* Part III.

<sup>136</sup> Performance Rights Act, H.R. 848, 111th Cong. (2009); see also Performance Rights Act, S. 379, 111th Cong. (2009).

<sup>137</sup> Jessica L. Bagdanov, Internet Radio Disparity: The Need for Greater Equity in the Copyright Royalty Payment Structure, 14 CHAP. L. REV. 135, 158 (2010).

<sup>138</sup> Casey Rae-Hunter, Better Mousetraps: Licensing, Access, and Innovation in the New Music Marketplace, 7 J. BUS. & TECH L. 35 (2012); John Eric Seay, *Legislative Strategies for Enabling the Success of Online Music Purveyors*, 17 UCLA ENT. L. REV. 163 (2010).

<sup>139</sup> See Rae-Hunter *supra* note 109, at 59.

<sup>140</sup> See *id.* at 59-60.

<sup>141</sup> See *id.*

<sup>142</sup> See Seay *supra* note 109, at 169.

<sup>143</sup> See *id.* at 173-75.



numerous articles discuss streaming music within the context of compulsory licensure,<sup>144</sup> few propose a tenable solution with practical applicability. A solution should be tailored to slightly modify the law in its current form in order to facilitate fairer negotiation of licensing rates for interactive services without radical legislative change.

### C. *A New Compulsory License Scheme*

Given the potential for this ‘hostage-taking’ rate setting paradox discussed above, as well as the fact that streaming music platforms continue to experience substantial losses, there is a need for a solution that brings both parties—content owners and content distributors—to the table, and incentivizes these parties to engage in good faith negotiations. As Pandora demonstrates, compulsory licenses in their current iteration are no panacea for this hostage-taking problem. However, a scheme in which the royalty rate is set at a level punitive to webcasters and then taxed progressively would serve to create a more equitable distribution of bargaining power between the negotiants.

As evidenced by the case of Pandora, compulsory licensing rates set a price floor for one party; in this case, it is the record labels. In the current framework, content owners can insist on receiving a minimum of the compulsory rate, and thus come to the table with significantly more bargaining power than distributors. Compulsory rates provide an institutionally codified anchor to which subsequent negotiations are tethered. This anchor point allows the party for whom the rate is favorable to walk away from negotiations at any point. Moreover, given the CRB’s adherence to its own prior rates set in assessing the forward-looking rate, there is *only upward* variation from year to year.

#### 1. Capping Compulsory License Fees for Content Owners

A model which negates the inequitable distribution of bargaining power discussed above will allow negotiations to more accurately mirror the fair market value of content licenses. In order to create such a model, the penalty for failing to bargain must be similar to both parties. To accomplish this, a compulsory rate must first be set so as to prohibit profit realization by digital distributors. Thus, this note proposes implementing a compulsory licensing fee that tracks to digital content distributors’ net revenue.<sup>145</sup>

By setting the compulsory license equal to each individual platform’s net revenue, digital distributors will have an obvious incentive to negotiate with content providers. Under this scheme, a failure to negotiate would imply no prospect of profitability. Moreover, because this rate will track with net revenue each year, there

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<sup>144</sup> See *id.* See also Rae-Hunter, *supra* note 109; McKay *supra* note 104.

<sup>145</sup> Note, this article proposes a statutory licensing system intended to apply to interactive services, though these recommendations might likewise be incorporated into current statutory licensing provisions, disaggregated by interactivity. Because the rate of this proposed system is tacked to distributor net revenue, it is much more widely applicable than traditionally proposed ‘blanket licenses,’ which do not address the differential value of differing types of streaming music services.

is not a promise of profitability in subsequent years. Thus, absent some negotiated agreement, content distributors would refrain from inputting capital or labor into a losing business model. The equation for the default compulsory licensing fees to each company is straightforward, and would look as follows:  $\pi = \frac{C}{R}$ , Where  $\pi$  represents net revenue to the distributor, and  $C$  is the cost of content licensing. Setting a cap on licensing fees that does not exceed the net profits sufficiently penalizes holdout distributors by negating profits. However, it does not apportion a disproportionate amount of bargaining power to content owners by allowing those entities to bankrupt distributors with royalty fees above distributor net revenue.

*a. Setting a Minimum Royalty Rate*

While this compulsory rate is intended to facilitate negotiations, there exists a clear potential for digital distributors to abuse the rate. First, platforms might refuse to negotiate for licenses in their infancy, as losses are likely to ensue while the company seeks to establish a market. Here, a compulsory rate that mirrored net revenue would provide upstart companies with free content rights, allowing them to write off costs of expansion against the costs of content. Second, there is the potential that platforms might operate in a manner that is not purely profit seeking. For instance, a company might emerge to provide access to content at a minimal price, sheltered from internalizing the appropriate licensing costs. Such a company could operate with a neutral balance sheet in perpetuity and offer artificially inexpensive content.

To mitigate the risk of such exceptions, a minimum royalty rate might be established by the CRB. This rate should relate to the industry-wide compulsory royalty rate. The CRB might require all interactive, streaming, digital content providers to submit their annual net revenue figures as well as the number of subscribers, and set a rate that corresponds to the median<sup>146</sup> of this revenue figure, adjusted to a per-subscriber basis.<sup>147</sup> This rate would thus prevent the scenarios discussed above; new companies would be subject to a minimum compulsory license rate, and companies attempting to provide artificially inexpensive or free content would be forced to operate for a loss.

Imposing a minimum levy would sufficiently protect content owners from predatory distributors. Moreover, new platforms could not usurp longer-standing digital distributors' market share by counterbalancing early losses with free content.

## 2. Taxing Licensing Fees: Encouraging Market Forces

The creation of a benchmark compulsory fee structure that tracks to distributors' revenues sufficiently incentivizes licensees to engage in good faith negotiations with content owners. However, content owners would have little reason to reciprocate. By imposing a punitive levy on the licensing fee, labels and license holders will then

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<sup>146</sup> Alternatively, the median might be supplanted with some other percentile or the arithmetic mean, though the mean is subject to downward bias.

<sup>147</sup> Note: To ensure that this minimum rate is not downwardly biased by recent entrants, the CRB might consider only companies that have existed for a minimum amount of time (e.g., 3 years or more).

have a strong incentive to likewise engage in negotiation with digital distributors. Such a tax would look as follows:

$$\tau = \begin{cases} \alpha \left[ 1 - \left( \frac{\pi - \ell}{\pi} \right) \right] & \pi > 0 \\ \alpha & \pi < 0 \end{cases}$$

Here,  $\tau$  represents the tax rate to be applied to licensing fees,  $\alpha$  represents some sort of a discount rate,<sup>148</sup>  $\pi$  represents the net revenue of the distributor *excluding licensing fees* and represents the licensing fees paid by the distributor to the content owners.<sup>149</sup> The impact of such a system is that the proportion of taxes as a share of the licensing fees decreases as the negotiated rate declines. As the licensing fee decreases relative to net revenues, the size of the tax approaches zero. Alternatively, as the licensing rate share of net revenue increases the tax rate approaches the maximum rate established,  $\alpha$ . This system builds in a punitive increasing marginal tax rate.<sup>150</sup> Hence, both parties experience upside by negotiating. This system of taxation would create a strong incentive for content owners to more carefully examine the amount demanded in licensing fees, as additional fees would be taxed at an increasing rate. The tax paid under this scheme could be used to fund the CRB and any other entities involved in rate setting, and also to police infringement. Indeed, such an earmark would go a long way toward establishing self-sufficiency within institutions, and could provide a much needed boon to the policing of copyright infringers.

### 3. Consumer Subsidized Negotiations

The core tenet of this scheme is a new tax, which would be shouldered by the parties to the licensing agreement, and thusly passed on [at least in part] to the end consumer. Therefore, this tax could be interpreted as providing for consumer-subsidized negotiations. Yet, this tax would also serve to break down the barriers to entry into the distributional chain, providing diversity as well as an increased number of platforms in competition with one another, and thus, innovation within the field. Additionally, the system as a whole will likely lead to content costs that are more reflective of their true market value. Hence, while this ‘subsidy’ may be factored into the market price of consumer access to content, that price will likely be cheaper than the current market rate, even if a proportion of this price is a levy.<sup>151</sup> Moreover, if used

<sup>148</sup> Alternatively,  $\alpha$  can be viewed as the maximum tax to be levied upon the net revenue of the distributional platform.

<sup>149</sup> Alternative schemes of taxation could be envisioned, such as a quadratic or logarithmic function, which would exhibit decreasing returns to increased licensing fees. This equation is merely illustrative of the principal of increasing marginal taxation on license fees.

<sup>150</sup> To make this tax rate more or less punitive to content owners, the value of  $\alpha$  can be modified up or down. Alternatively, the entire equation can be either squared or square rooted, which would create accelerated or decelerated marginal tax increases respectively as the rate nears its supremum.

<sup>151</sup> Jean-Charles Rochet & Jean Tirole, *Platform Competition in Two-Sided Markets*, 1 J EUR. ECON.

to fund the CRB and copyright governance bodies, the capital collected as a result of this ‘subsidy’ might provide the CRB and other copyrighted entities more autonomy, and self-sufficiency. These outflows provide tangible benefits to consumers.

The idea of taxing digital distribution markets in order to adequately compensate copyright holders is not a novel one.<sup>152</sup> Professor Netanel envisions a comprehensive plan whereby Internet service providers, hardware and software manufacturers, and various other industries which are utilized in P2P file sharing are taxed in order to adequately compensate copyright holders for the shortfall in revenues as a result of digital music sharing.<sup>153</sup> As his comment is quick to point out, this system would penalize infrequent users disproportionately to high volume downloaders.<sup>154</sup> However, the detrimental impact of such cross-subsidization could be mitigated, and would likely be outweighed by the net social benefit.<sup>155</sup> Professor Fisher builds upon this model and likewise proposes a system of taxation devised to compensate copyright holders.<sup>156</sup> He proposes viewing media content as a public good, which could be taxed either (i) in accordance with Professor Netanel’s plan of taxing components and broadband providers, or (ii) as an add-on to the Federal Income Tax.<sup>157</sup> These levies are intended to do away with free-riding (by way of under-policed piracy) by creating a partially subsidized public market for media content. Hence, while any tax of the nature presented herein would likely be passed along to listeners, there are reasons to believe that this plan would produce a net positive effect upon the market.

## VI. LOOKING FORWARD: NEW MARKET ENTRANTS

### A. *Google: Streaming Music—Spotify Style*

Recently, Google announced Google Play All Access, a streaming music client intended to compete directly with Spotify.<sup>158</sup> While interactive music streaming services are present already in the market, none possess the wealth, resources or bargaining power that Google does. Given these factors, it stands to reason that Google might have been able to obtain favorable licensing rates from content providers.

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ASS’N 990, 992 (2003) (which discusses the phenomenon of “multihoming” in distributional markets involving a multi-sided platform. When end consumers subscribe to multiple platforms—such as both Visa and MasterCard in credit card markets—this has the overall effect of decreasing prices paid by consumers, while simultaneously increasing prices paid to the platform by vendors).

<sup>152</sup> Neil W. Netanel, *Impose a Noncommercial Use Levy to Allow Free Peer-To-Peer File Sharing*, 17 HARV. J.L. & TECH. 1 (2003); WILLIAM W. FISHER III, PROMISES TO KEEP 216 (2004).

<sup>153</sup> See Netanel, *supra* note 125, at 43.

<sup>154</sup> See *id.* at 67.

<sup>155</sup> See *id.* at 72-73.

<sup>156</sup> See FISHER, *supra* note 125, at 216-17.

<sup>157</sup> See *id.*

<sup>158</sup> Tom Cheredar, *Google Announces its Spotify Competitor; Google Play Music ‘All Access’—‘Radio Without Rules’*, VENTUREBEAT (May 15, 2013 9:57 AM) <http://venturebeat.com/2013/05/15/google-announces-google-music-all-access-streaming-service-radio-without-rules/>; Robert Buddon and Robert Cookson, *Google Looks to Beat Music Rivals*, FINANCIAL TIMES (Feb. 22, 2013 5:13 AM) <http://www.ft.com/cms/s/0/48fab814-7d16-11e2-adb6-00144feabdc0.html#axzz2PoYV66yB>.

Moreover, the company's engineering resources imply that a Google platform will bring significant added innovation to the market.

But, Google's announcement is not necessarily positive news for the industry. Given publicly available financial information on Spotify (as well as Pandora), this market is not a profitable one, and more entrants will serve to drive individual platforms' losses up, as opposed to equilibrating profits (which would ordinarily be the case in an under-served market). Indeed, because Google can endure larger losses for longer, this may even crowd out current content providers such as Spotify. This in turn could potentially allow Google to establish a monopoly.

Yet, there are reasons to be skeptical of Google's ability to gain traction. For one, as a late entrant, it lacks the first mover advantage.<sup>159</sup> More importantly, Google has previously attempted to enter the music market.<sup>160</sup> Google Music has proven incapable of attracting a substantial customer base, despite the company's extremely broad user base for its other products.<sup>161</sup> Thus, while Google's entry into the interactive streaming music market signals increased attention on the issue of streaming rights, it is late to enter a market that shows little promise of profit under the current licensing landscape.

## B. *Apple Targets Digital Radio Service*

Similarly, on June 10, 2013, Apple announced that it, too, would enter the streaming music market, with iTunes Radio.<sup>162</sup> However, unlike Pandora, Apple has elected not to operate within the statutory licensing framework. The licensing agreement distributed to independent record labels was leaked online.<sup>163</sup> Though the terms contained in these agreements differ slightly from those agreed to by larger record labels, the agreements are suspected to be similar.<sup>164</sup> That the highest valued

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<sup>159</sup> See Marvin B. Lieberman & David B. Montgomery, *First Mover Advantages*, 9 STRATEGIC MGMT. J. 41 (1988) (positing that first entrants into a market experience significant advantages as a result of this early entry); see also Ryan Mac, *Google Continues to Play Catch-Up With All Access Music Service as Critics Sound Off*, FORBES (May 16, 2013, 9:00 AM), <http://www.forbes.com/sites/ryanmac/2013/05/16/google-continues-to-play-catch-up-with-new-music-service-as-critics-sound-off/> (chiding Google for bringing little value add to the marketplace, and instead rolling out a product nearly identical to Spotify, and other interactive subscription services).

<sup>160</sup> *Google Music is Open for Business*, OFFICIAL GOOGLE BLOG (Nov. 16, 2011) <http://googleblog.blogspot.com/2011/11/google-music-is-open-for-business.html>; *Introducing Google Play: All Your Entertainment Anywhere You Go*, OFFICIAL GOOGLE BLOG (Mar. 6, 2012) <http://googleblog.blogspot.com/2012/03/introducing-google-play-all-your.html>.

<sup>161</sup> Matt Rosoff, *Google Music is a Flop*, BUSINESS INSIDER (Feb. 23, 2012, 1:35 PM), [http://articles.businessinsider.com/2012-02-23/tech/31089929\\_1\\_google-music-android-music-locker-service](http://articles.businessinsider.com/2012-02-23/tech/31089929_1_google-music-android-music-locker-service).

<sup>162</sup> Press Release, Apple Inc., Apple Announces iTunes Radio (June 10, 2013), (<https://www.apple.com/pr/library/2013/06/10Apple-Announces-iTunes-Radio.html>).

<sup>163</sup> Hannah Karp and Jessica E. Lessin, *Apple Spells Out iTunes Radio Terms*, WALL STREET JOURNAL (Jun. 26, 2013), <http://blogs.wsj.com/digits/2013/06/26/apple-spells-out-itunes-radio-terms-for-record-labels/>.

<sup>164</sup> See *id.*

company in the world<sup>165</sup> is unwilling to accede to statutory rates should signal that this rate hardly reflects the price that would be achieved in a marketplace populated by “willing buyers” and “willing sellers.”

Apple’s entrance into the marketplace has had numerous implications. Unlike the relatively new market for on-demand streaming music, digital radio was well established at the time that Apple entered (Pandora has a user base of approximately 125 million, compared to only 24 million for Spotify).<sup>166</sup> Because iTunes is the digital music hub for the overwhelming majority of consumers, thanks in part to Apple’s closed system of integration with its hardware, Apple was able to immediately establish a broad user base.<sup>167</sup> The introduction of an adaptive streaming radio to iTunes supplanted some of Pandora’s market share, though Pandora still retains its position atop the market.<sup>168</sup> As indicated above, however, such competition is more likely to drive up platforms’ losses than it is to create healthy competition. Further, like Google, Apple’s bargaining power implies more favorable licensing terms—which indeed appears to be the case, according to released licensing agreements. This entrance, therefore, has served to further crowd an already saturated marketplace. In addition, Apple’s corporate goal of selling hardware, rather than software (like iTunes Radio) implies that the company will not act in the best interests of the market, but instead in accord with what will best drive its hardware sales.

Yet, there are reasons to favor Apple’s entrance as well. The company has long been among the world’s most innovative technology companies. Apple’s entrance into the streaming radio market has brought with it the company’s signature emphasis on interface. Going forward, the company might also convince record labels to license at more reasonable rates, which Pandora might use in subsequent negotiations—perhaps leading to more reasonable rates throughout the market. At a minimum, Apple’s entrance has drawn more attention to the shortcomings of streaming music licensing.<sup>169</sup>

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<sup>165</sup> *The Financial Times Global 500 for 2012*, FINANCIAL TIMES (Dec. 31, 2012), <http://www.ft.com/intl/cms/2a53e388-569a-11e2-aa70-00144feab49a.pdf> (as of the close of the 2012 fiscal year, Apple retained the highest market capitalization in of any company in the world).

<sup>166</sup> See Pandora 10K, *supra* note 99, at 3; see also Lambert, *supra* note 27.

<sup>167</sup> See Tom Cheredar, *iTunes Radio Already Has 20M Users a Month After September Launch*, VENTUREBEAT (October 22, 2013) available at <http://venturebeat.com/2013/10/22/itunes-radio-has-20m-users-a-month-after-launching/>.

<sup>168</sup> See Samantha Nielson, *Pandora Media Manages to Withstand Competition from iTunes Radio*, MARKET REALIST (Apr. 14, 2014) available at <http://marketrealist.com/2014/04/pandora-withstands-competition-itunes-radio/>.

<sup>169</sup> Steve Knopper, *Will iTunes Radio Benefit Musicians*, ROLLING STONE (Sept. 20, 2013) available at <http://www.rollingstone.com/music/news/will-itunes-radio-benefit-musicians-20130920>; Neil Hughes, *Revised Music Royalty Rules Could Hurt Apple’s Beats Music, iTunes Radio*, APPLEINSIDER (Aug. 15, 2014) available at <http://appleinsider.com/articles/14/08/15/revised-music-royalty-rules-could-hurt-apples-beats-music-itunes-radio>.

### C. *The Six Strikes Plan: A Boon to Legal Alternatives*

Also of interest is a collaborative effort to curtail online piracy. Recently, five national Internet service providers reached an agreement with content owners to actively police copyright infringement amongst subscribers, called the ‘six-strikes’ plan.<sup>170</sup> The agreement establishes a non-profit entity, the Center for Copyright Infringement, comprised of multiple representatives with varying interests.<sup>171</sup> Though details regarding the agreement, as well as the consequences of repeated offenses are unclear and appear to be inconsistent across Internet service providers, the core objective of the plan is to severely limit perpetual copyright offenders from infringing upon or illegally distributing intellectual property.<sup>172</sup> In addition to inconsistency across providers, initial reports indicate that the consequences to repeated downloading in violation of copyright provisions will lead to a temporary service slowdown or to online copyright education courses prior to resumption of service.<sup>173</sup>

This plan has drawn criticism from advocates for all sides involved.<sup>174</sup> The plan as currently understood appears relatively toothless, with mild penalties in exchange for reduced consumer privacy—a hotbed issue. Yet, the plan could be a first step toward a more comprehensive plan of decreasing copyright infringement over the Internet. The fact that an agreement has been reached intimates concern over potential legislation. Rather than be subject to uncertain outcomes, the two sides opted to negotiate privately, to create a solution acceptable to both parties’ interests. The efficacy of this new agreement will have a bearing on the strength and scope of subsequent negotiations.

Irrespective of the relative strengths and weaknesses of the agreement, the practical outflow of the six strikes plan is an increase in the cost of copyright infringement. That Internet subscribers will be punished for infringing activities (irrespective of the triviality of such consequences) will decrease such behavior for the marginal consumer. This increase in the cost of piracy will thus lead to a substitution away from illegal consumption and toward legal alternatives. Such a shift should lead to an increased demand for legal alternatives, which in turn will push their price up,

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<sup>170</sup> Dan Graziano, *ISPs Reveal Details of Their ‘Six-Strikes’ Anti-Piracy Alert Systems*, YAHOO! NEWS (Feb. 28, 2013, 12:40 PM), (<http://news.yahoo.com/isps-reveal-details-six-strikes-anti-piracy-alert-174050676.html>) (listing the five participating ISPs as AT&T, Comcast, Cablevision, Time Warner Cable and Verizon).

<sup>171</sup> Matthew Ingram, *Should You Fear the ‘Six Strikes’ Anti-Piracy*, BLOOMBERG BUSINESSWEEK (Feb. 27, 2013), <http://www.businessweek.com/articles/2013-02-27/should-you-fear-the-six-strikes-anti-piracy-rule> (“[R]epresentatives from such agencies as the Internet Education Foundation and the Future of Privacy Forum.”).

<sup>172</sup> See *id.*

<sup>173</sup> See *id.*

<sup>174</sup> See, e.g., John Tarnoff, *We Don’t Need Six Strikes*, HUFFINGTON POST (Mar. 7, 2013, 4:02 PM), [http://www.huffingtonpost.com/john-tarnoff/we-dont-need-six-strikes\\_b\\_2831489.html](http://www.huffingtonpost.com/john-tarnoff/we-dont-need-six-strikes_b_2831489.html); Darlene Storm *Worried About Six-Strikes? Copyright Alert System is “Damned Hard to Trigger”*, COMPUTERWORLD (Apr. 29, 2013, 3:40 PM), <http://blogs.computerworld.com/privacy/22122/worried-about-six-strikes-copyright-alert-system-damned-hard-trigger>.



and allow the cost of legal music consumption to more accurately reflect the market price of this commodity.

In its current iteration, the six strikes plan may provide only marginal deterrence. However, this policy represents an important first step toward private regulation of copyright infringing activity over the internet. In theory, subsequent negotiations will address the shortcomings of the current agreement, and continue to improve the process of policing infringing activity. Such policing will benefit content owners, as well as distributors by forcing the price of accessing such content to mirror the market rate, absent the dilutive effects of piracy. Moreover, in the long-term, the effect of such agreements will benefit consumers as well, by ensuring that the rate of return to composers continues to incentivize the production of quality music.

## VII. CONCLUSION

Increased access and availability of high speed Internet—as well as the digitalization of music (and most other forms of media)—has altered the landscape of content creation, protection, and distribution. While locally stored digital content was the norm for the past decade, the increased access to broadband internet and the myriad of methods of distribution—from streaming radio to YouTube—has begun to erode consumer need for physical or even digital copies of music files. Many consumers, particularly new and younger entrants to the market have proven willing to absorb content in an on-demand fashion without actual or constructive possession of the sound recording. As such, streaming music seems the logical future of content distribution.

Spotify and services like it are the outflow of market transformation and technological adaptation in one of the most progressive markets in recent history. In order to continue to adapt, and to adequately address consumer preferences and expectations, the law will need to again address a highly technical and difficult legal issue: rate setting for sound recordings—specifically, for on-demand streaming services. This note proposes a scheme which would penalize both content owners and distributors equally for failing to negotiate licensing rates through a system of progressive taxation. Moreover, the increased governmental revenue resulting of this system could be used to fund both the rate setting agency and efforts to police infringing activity. A system that seeks to facilitate free-market rate setting negotiations would do well to address many of the current issues confronting digital distribution in the music industry. While content owners might be reluctant to sacrifice current established rates and revenue streams, such sacrifice is necessary in order to adapt to the ever-changing market for music. Reticence should be expected on behalf of an industry established upon a government-endorsed monopoly. Yet, the exclusive right granted by copyright is intended to incentivize future creation of content, not limit consumer access to music or stifle innovation. Copyright policy should reflect this goal. One such way is through the establishment of a compulsory licensing framework that limits either party's ability to anchor to a potentially deleterious rate.

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