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Compulsory Licensing vs. the Three "Golden Oldies"

Property Rights, Contracts, and Markets

by Robert P. Merges

Executive Summary

From its inception in the U.S. in the early 20th century, compulsory licensing has been seen as a means of making intellectual works available by reducing some of the transaction costs associated with obtaining permission to use copyrighted material. There are now increasing calls for compulsory licensing for digitized works on the Internet, particularly music.

Conceptually, a compulsory license falls midway between granting full copyright, which gives owners broad control, and denying copyright protection altogether.

Rather than allowing musicians, artists, and other copyright owners to negotiate licensing terms for use of their works, a compulsory license forces copyright owners to allow use of their works under legislatively set prices and restrictions on use.

When warring groups sound the alarm over excessive control via copyright on the one hand and insufficient incentives to create on the other, compulsory licensing seems a reasonable compromise. Compulsory licensing seems to pay off big in the short term by reducing the need for individual buyers to locate, negotiate with, and pay individual sellers. Compulsory licensing supposedly addresses the "market failure" of high transaction costs.

But markets for digitized works do not suffer from market failures. Furthermore, the Internet has reduced the transaction costs that once served as a key rationale for compulsory licensing. Recent developments suggest that fears of excessive control of digital content are overblown. Without enhancing compulsory licensing, the digital landscape is diverse, as the case of music demonstrates. There is free music, temporarily free music, and low-cost music online. Offline, music companies are lowering the prices of CDs.

The influence costs associated with compulsory licensing schemes make them a more expensive mechanism for setting prices. Private negotiations are much cheaper and more flexible over the long term.

In the digital realm, we have not yet abandoned the basic building blocks of all creative endeavors—property rights, contracts, and voluntary markets—and we therefore retain the preconditions for future growth and diversification.

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Introduction

Near the beginning of the Internet revolution, I called for patience in intellectual property (IP) policy, despite the controversy generated by the ease of sharing copied digital content, such as music, movies, and electronic books.[1] As is well known, the Internet not only provided everyone a printing press, but file-sharing applications like Napster and Kazaa have made content like music and movies freely available and, therefore, have made producers of such content reluctant to fully embrace the Web as a distribution channel.

Intellectual property rights were indeed going to cause bottlenecks in the commercial distribution of digital content of all kinds. But, based on historical examples, any attempt to circumvent the sometimes slow process of market formation via the mechanism of property rights would likely leave society worse off. In other situations seemingly intractable bottlenecks had been eased by the formation of cooperative organizations made up of the holders of multiple and disparate property rights, such as ASCAP (the American Society of Composers, Artists and Publishers), formed to clear copyrights in the early days of radio. I sang the praises of these voluntary, private organizations, especially compared to legislative compulsory licensing schemes designed to do an end-run around private bargaining.

Despite mounting cries for compulsory licensing to facilitate the distribution of digital entertainment and information, I have not changed my tune. Indeed, the Promised Land of widespread digital distribution is upon us in many areas, and very nearly so in others. There is still a dearth of legitimate music, television, and blockbuster movies offered online by their creators. But we will be judged wise for avoiding abrupt changes in our IP system that replace voluntarism and trade with forced sharing, such as expanded compulsory licensing of content. In the digital realm, we have not yet abandoned the basic building blocks of our creative industries—property rights, contracts, and markets—and have therefore retained the conditions for future growth and diversification. There will still be times when the expedient of market circumvention, such as compulsory licenses, may sound appealing, but we would be wise to avoid it.

Where We Are Now

Let's examine music, since so much of the fuss is centered on the downloading of copyrighted music. Some observers have suggested compulsory licensing as a means of making music widely available for download. Rather than allowing musicians, artists, and other copyright owners to negotiate licensing terms for use of their works with content distributors and consumers, a compulsory licensing regime would impose a mandatory licensing system to force copyright owners to allow use of their works under legislatively set prices and restrictions on use. The making of cover songs provides a familiar non-Internet example: if the White Stripes wanted to cover "Lawyers, Guns and Money" by the late Warren Zevon, they would pay the statutory fee and the copyright owner would have to allow them to use the song.

But expanded compulsory licensing for online media would be ill advised. While there have been years of reluctance by media companies, today anyone can legally download music from all five of the "major" record labels for as little as 49 cents per song. Depending on the service, one can listen to a song once, capture it for multiple plays in a set period of time, or "burn" it onto a customized, personal CD.[2] Consumers can also listen to a "live stream" of music selected by an Internet DJ, with royalties paid to the songwriters.[3] Of course, anyone can still go to a record store and buy a CD.

In addition, consumers can legally download generous amounts of free music. Many talented musicians make their work available, cost-free, over the Internet. Some offer a portion of their work for free, hoping to generate enough buzz about their music that lis-

teners are willing to pay for more later (for a concert ticket or a CD). This online distribution model increasingly constrains the price of the "legitimate" downloading services referred to above, particularly as mainstream artists embrace it as an alternative to traditional recording companies.

The Curious Appeal of Compulsory Licensing

Now, with such ample content available, one would think things are working fairly well, growing pains aside. Visionary businessman Steve Jobs evidently thinks so: he recently guided Apple Computer—a hardware company—into the vibrant and competitive market for music downloading.[4]

Compared to the hue and cry of only a few years ago, when the record labels were widely criticized for "not getting" the Internet, the outlook today seems promising. One of the last things one might expect is a call for a radical overhaul and government involvement in the distribution mechanisms of music and other digital content. Yet that is exactly what we are hearing, most prominently from well-respected legal scholar Lawrence Lessig.[5] In his recent book, *The Future of Ideas*, Lessig outlines a plan for compulsory licensing of copyrighted works, a strategy that would require movie and music companies to allow anyone to download and use digital works, as long as they made payments to copyright holders under a federal statute.[6]

Wayne Rosso, president of Grokster, a peer-to-peer (P2P) file-sharing company, exemplifies a similar viewpoint, but from the perspective of an impatient vendor. Consider this exchange between Rosso and an interviewer:[7]

> *Interviewer*: A lot was made in the media about your speech at the *Financial Times* new media conference recently. You used the opportunity to attack the recording industry for not licensing their music to P2P companies like yourself. Tell us more about why you think they should license music to Grokster.
> *Rosso*: It's not so much that they should license to Grokster, it's more a call for blanket compulsory licensing of some kind. At the moment content licensing negotiations are a one-way street. And what has happened is that record companies have used their content to slow the growth of ecommerce and the Internet until they can figure out how to co-opt the technology. Simply put, they want to own or control the technology themselves.

Let us consider Lessig's proposals for a moment. Lessig calls for a new look at compulsory licensing as a compromise that allows media companies to secure "compensation without control."[8] He argues that, in the past, Congress and the courts often balanced the interests of technological innovators against established content owners by creating compulsory licensing schemes. Examples include the early player piano industry (the occasion for the first compulsory license) and the satellite television industry, which grew by rebroadcasting the signals from established broadcast TV stations. Lessig argues that Congress has so far largely overlooked compulsory licensing in the Internet arena, which he suggests is a bad thing.

Lessig's concern for balance with respect to rights in the creation of intellectual property and its use by others is right on the mark. Ideas and other intellectual property should not be locked up in perpetuity. His idea of creators making voluntary contributions of intellectual works to a low-restriction "creative commons,"[9] for example, is a creative and novel response to the risk of over-appropriation of intellectual property, which he and others worry about. Under the creative commons approach, the creators of digital work (e.g., photo, story, or drawing) can offer their work to others for copying and reuse, but can also limit others' uses in any of a number of ways, such as for noncommercial

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exploitation only. Lessig apparently sees compulsory licensing as a similarly flexible and beneficial policy for making intellectual works widely available. But compulsory licensing, although often regarded as a reasonable compromise, is not a policy that will bring about balance between creation, use, and profit in the long run. Markets will tend to be superior in their beneficial impact on the creative process and output. Compulsory licenses, being creatures of federal statute, tend to be less flexible and more susceptible to political manipulation than market-based transactions. The costs that are saved by a compulsory license in the short run are usually more than offset by the inefficiencies that it causes over time.

Despite the difficulties it can cause, Lessig and Rosso are certainly not alone in advocating compulsory licensing. Since its inception in the United States in the early 20th century, compulsory licensing has been appealing for two reasons. First, as Lessig notes, compulsory licensing does separate "compensation from control." Conceptually, it falls midway between granting full copyright, which like all property rights gives owners very broad powers, and denying copyright protection altogether. Whenever warring groups sound the alarm over, on the one hand, domination via copyright, and, on the other, insufficient incentives to create works in the first place, compulsory licensing seems a reasonable compromise policy.

That policy, however, is less reasonable than it first appears. As noted, the first compulsory license statute in the U.S. was enacted to prevent a single large firm from dominating the market for player piano rolls.[10] Piano rolls were used to create music in player pianos. When piano rolls were held to be copyrightable by the Supreme Court, Congress legislated a compulsory license in accord with the wishes of piano roll companies worried that the dominant firm in the industry would lock up the rights to all popular music as embodied in piano rolls. Even today, the legacy of the piano roll wars lives on in the "mechanical" compulsory license, as this statutory license is now called. Under it, any recording artist can record a new version (often called a "cover") of an existing song composition as long as he or she pays a statutory compulsory license fee to the owner of the composition.[11] In this way, a statute created long ago to address an industry now long dead continues to undergird transactions in an important modern industry. As described later in this paper, the statutory royalty rate for covers was well below what many believed the market rate would have been, which is precisely the sort of legislative lock-in that occurs when market participants are channeled into statutory licensing instead of voluntary, arm's-length deals negotiated to fit the dynamics of individual buyers and sellers.

The second reason compulsory licensing is attractive is that it pays off big in the short term. It reduces initial transaction costs by eliminating the need for individual buyers to locate, negotiate with, and pay individual sellers. This "market failure" rationale is most plausible where markets are unlikely to form because sellers deem it not worthwhile to spend the resources necessary to reach a certain group of buyers. At least under the market conditions prevailing when it was passed, the compulsory license for isolated, remote satellite TV viewers might have fit such a description. But obviously most markets for copyrighted works are not nearly so "thin"—so this justification for compulsory licensing would rarely arise. And it certainly does not apply to Internet-based markets, since this medium represents one of the most powerful transaction cost-*reducing* forces ever seen in the music, publishing, and related industries.

Nonetheless, calls for compulsory licensing for music are creating considerable chaos with respect to the licensing and pricing of streamed and downloaded music over the Internet. There is a good argument that a sweeping move toward compulsory licensing would lower some of the transaction costs associated with the distribution of digital works—in the short term. The time and trou-

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ble that go into assembling large blocks of digital content would be saved—for now. And users would be free to "rip, mix, and burn" to their hearts' content, secure in the knowledge that it was legal as long as they paid whatever fee was required under the statute. This instantaneous "market making" of the compulsory licensing process would no doubt be a boon to users in the short term. Music fans, for instance, have had to wait almost 10 years since the advent of the popular, commercial Internet for the rollout of cheap, simple music downloading sites such as Listen.com and Applemusic.com.[12] This seems to be quite a long wait for large record labels to finally recognize the potential of Internet music distribution and for a single entity such as Apple to negotiate with all the labels for access rights to their content. But the instant market making of a compulsory license will be detrimental to long-run intellectual property markets.

Overblown Fears about "Content Control" Drive Compulsory Licensing Demands

Much of the hand-wringing over copyrights in digital content centers on the notion of *control*. Some content owners and sellers express grave concerns that the Internet undermines the control that they can exercise over their works and derivations of them. Peer-to-peer file sharing, the clearest example of loss of control over distribution and pricing, has led to progressive escalation of penalties for copyright infringement.[13] Copyright critics, by contrast, bemoan the tightening of copyright owners' control represented by the Digital Millennium Copyright Act of 1998 and other recent legislation.[14] Note the paradox here: Content owners think the Net takes away control, while Lessig and others believe digitization is cementing owners' control over content. In fact, both are partly correct, which is one reason market resolution of disputes over distribution must be allowed to play out. Put simply, the participants in the media revolution disagree over the optimal property rights regime, and there is no way to instantly sort out settlements and contracts that will properly evolve over time. Maintaining the traditional legal pairing of property rights and contracts, which usually leads to market formation, seems like a safer course than mandates or new market intervention to correct for past market intervention.

It is true that property rights confer a measure of control—they would not be much use if they didn't. But the specter of total, omnipresent control is what has the critics worried. These fears may well be unjustified, however. Even the strongest digital rights management system one might contemplate falls far short of total control over the information it protects from unwanted copying.[15] Putting aside the ever-present threat that a copy management system will be "hacked" or "cracked," there are many manifestations of digital content that cannot be effectively controlled by a rightholder. For example, if I download a movie about a great wizard who is shipwrecked on a remote island, the movie distributor can control my use in many ways. I may be permitted to watch it only once, or may have to pay royalties for subsequent uses. My copy of the file may become inoperative after a period of time. I may not be able to capture and extract still images from the movie and copy them to my own computer, and so on.

But as law professor Polk Wagner of the University of Pennsylvania argues, it would be prohibitively expensive for the movie's owner to prevent me from referring to the movie in conversations with my friends, or speaking about the movie as I teach a classroom full of students, or even borrowing broad themes from the movie in writing a short story.[16] The digital record of the work can be controlled, but it is much more difficult to police the lingering thoughts about the movie or my expression of them, in reviews, critiques, and conversations. Of

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course, the content owner could assign a private investigator to each viewer of the movie, to make sure none of these activities crossed the "infringement" line, but that would be expensive indeed.

Clearly, absolute control over intellectual property is almost unthinkable. A key question is whether a right-holder exerting more control over a protected work might (perhaps counterintuitively) increase the total output of creative works. In a regime where tight digital control over downloaded movies is possible, the copyright owner may feel comfortable distributing it more widely than he does in today's environment of easy copying. This may spark more indirect—and hence perfectly legal—derivative creations. For example, someone may be inspired by the general themes in the movie to write a novel or short story. Or a controversial copyrighted photograph may spark debate over its content, or about free speech in general.[17] Wagner's argument is that the total volume of cultural discourse—very broadly defined—may rise under a regime of greater control. Such potential gains could be undermined by a compulsory licensing regime, however. If content owners decide not to distribute some works digitally, or never to produce them at all because of a perceived loss of control or unfair statutory fee, we will be worse off. A rigid compulsory license will often underreward creators or constrain novel distribution strategies.

If digital diversity is the goal, the current system seems not to be doing too badly.

Growing Diversity—Without Compulsory Licensing

The Lessig agenda—"compensation without control"—seems to spring at least partly from an overriding concern that society not permit the same concentration of economic power (and therefore cultural influence) in the Internet arena as some perceive in conventional media such as television. The "control" argument is based on Lessig's view that content is increasingly concentrated in the hands of big media companies. A compulsory license is necessary, it is argued, to offset this growing power.[18] It certainly is true that some firms have pursued a strategy of aggregating content, with the idea that large libraries create "synergies" of various kinds. (The AOL/Time Warner merger was justified on that basis, although even it has since been plagued by a range of problems.) Compulsory licensing proposals based on this concern aim to strip property right holders of their power to control the use of content while preserving their right to compensation.

In the main, current conditions suggest that underlying fears of concentration and control are perhaps overblown. The digital landscape is wildly diverse, as the case of music makes amply clear. There is free music, temporarily free music, and low-cost music online. Music companies are lowering the prices of CDs. There is fully secured and protected music, available for downloading only with serious restrictions on use, copying, and distribution. There is partially secured music, available for a fee for downloading and then useable without restriction. There is even relatively cheap downloading of an entire album directly from the recording artist, without record label, distributor, or retail store.

This digital smorgasbord has evolved within the confines of strong intellectual property rights, whatever one may feel about the appropriateness of that regime as it currently exists. Of course one might argue that regime is undermined by the ease of copying itself. Nonetheless, if digital diversity is the goal, the current system seems not to be doing too badly. Would a sweeping reform really help?

Why Compulsory Licensing Is No Solution

Diversity already springs from the "Golden Oldies" of property rights, contracts and markets. But there are other reasons to oppose compulsory licensing as a path to greater diversity. These stem from the way compulsory licensing works in practice as

opposed to theory. In particular, compulsory licensing mechanisms suffer from two inherent weaknesses: (1) overcomplexity and inefficiencies generated by bureaucratic price-fixing and influence-seeking (the "too many moving parts" phenomenon), and (2) inflexibility, or the problem of legislative lock-in.

Problem 1: Too Many Moving Parts

In our legal system, creative works are generally protected by intellectual property rights.[19] That means that potential users of information must obtain permission from the rightholder before copying, performing, or otherwise using it.[20] If a user fails to do so, the rightholder can halt the unauthorized use and recoup royalties or damages. In terms of legal theory, this remedy against unauthorized use is the essence of a property right, whether tangible or intangible.

Our system also permits another arrangement, the compulsory license, whereby the rightholder does not have the right to prevent unauthorized use. Under this arrangement, the user can "infringe" the right all he wants; he is however required to pay a government-specified fee to the rightholder.

In practical terms, the underlying, crucial difference between the two arrangements is *who gets to set the price of the information*.[21] In the first regime, much like a typical property right, the creator/owner of the information gets to set the price or not sell. The user must obtain permission from the owner. This permission will be granted only when the user is willing to pay what the owner thinks fair in exchange for the legal right to use the information.

In the second arrangement, the government plays a role in setting the price. This determination can take one of several forms. Congress may simply legislate a fixed price for certain types of intellectual works, as it has done for users of musical compositions who want to record a new version of the composition. This may be thought of as a "price schedule" license. Or a more complex procedure may be mandated. For example, for certain types of copyrighted works Congress has set up a royalty arbitration panel that hears testimony from both owners and users before setting a price.

Once they are set up—which is usually where the proponents of compulsory licenses begin their analysis—the price schedule type of compulsory licenses can work quite smoothly for a time. The problem is that *setting up the schedule may be very costly*. Lessig's call for "compensation without control" sounds appealing, but the process of determining fair compensation is expensive and time consuming. And there is the additional problem that a schedule set up to meet *today's* conditions may quickly become outdated—and yet, because of the vagaries of the legislative process, be very hard to change. Even at the outset, compulsory license negotiations involve an additional cost not present in everyday market transactions. In the case of legislated price schedules, members of Congress must be educated about details of the industry. Parties with an economic interest in the outcome of the schedule-setting obviously have a major stake in this education process. In fact, they have an incentive to skew the "education process" in their favor and are therefore willing to expend significant sums of money on lobbying. All interested parties are aware of this, of course, which leads them to expend significant sums on the process. Economists who study these sorts of processes even have a term for such expenditures: they call them *influence costs*.[22]

A key difference between market negotiation and legislative wrangling over price is the level of influence costs involved in each. In general, parties to a private bargain are willing to expend some resources to enhance their bargaining position, but there are limits. It would make no sense to try to persuade a seasoned record company executive to agree to a deal that falls far outside of industry norms, for example. The same is not true, however, in the legislative context. Members of Congress do not know the details of content industry operations. They do not know industry "rules of thumb." Also, the setting of a rate schedule will affect many future transactions, which means that both parties

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may well find it desirable to escalate the influence game well beyond anything normally seen in a private bargain. A royalty schedule, in other words, is like a very big and almost permanent "contract," and so will justify far more negotiation expenditures than a typical negotiation for a specific purpose, to last a limited time, between two private parties. Finally, a rate schedule is a "one shot" transaction; thus, there is no opportunity to "even up" bargaining over a series of transactions, a process that would encourage the parties to stop fighting today in expectation of making up ground in future deals.

Influence costs are also significant in compulsory licenses that set up a process rather than a one-time rate schedule. The recently concluded (though still contested) copyright arbitration involving Internet "webcasters" is a case in point. Webcasters, unlike traditional broadcasters, must pay royalties for the public performance of sound recordings—that is, recorded versions of songs, such as a track from a CD.[23] Traditional broadcasters do not pay such a royalty, under a longstanding rule that record labels and other sound recording producers have lived with for many years. Because webcasting, unlike traditional broadcasting, can make it easy to record music, the music industry pushed for the right to receive royalties on webcasts. This was implemented in the Digital Performance Right in Sound Recordings Act of 1995.[24] Substantial revisions appeared in the Digital Millennium Copyright Act of 1998,[25] but implementation of the royalty was delayed several years to let copyright owners and webcasters negotiate.

During this period, thousands of small webcasters operating on shoestring budgets sprang up. Under applicable law, the Librarian of Congress (via a procedure described in the next paragraph) finally set royalty rates, asking webcasters to pay 0.07 of a cent per song played. Many small webcasters protested, saying that it would put them out of business. In response, Congress passed the Small Web-casters Settlement Act in 2002, which created a new plan under which webcasters could instead pay a percentage of their revenue as royalties. Negotiations between one group of small webcasters and the Recording Industry Association of America set that rate at between 8 percent and 12 percent of stations' revenue.[26]

The webcaster arbitration was conducted under the Copyright Act's Copyright Arbitration Royalty Panel procedure. The goal of the webcasting CARP was to establish prices that Internet webcasters would pay to record labels and other owners of sound recording copyrights.[27] The webcasting CARP stretched over several years and cost millions of dollars. But the CARP's proposal was deemed unacceptable by some parties, who appealed the panel's decision. The upshot? According to one copyright system expert:

> A decision was rendered by the Librarian in the webcasting rate proceeding—the "CARP of the century so far" (to quote from the Register of Copyrights). The Office rejected the CARP's decision, and the Librarian issued a modified ruling. No one was happy. All the parties appealed to the D.C. Circuit. Several parties approached Congress and a statute was enacted further modifying at least part of the Librarian's decision. Total costs for this CARP, including attorneys fees and witness costs, were in the millions of dollars (some estimates as high as $25 million).[28]

The ongoing complexity and cost of this CARP led several of the parties to back proposals to replace the CARP process with a new and better procedure for establishing licensing fees. These new proposals reveal defects in the current system that shed interesting light on the problems of compulsory licenses in general. For example, one idea is to replace the three-member CARP tribunal with a single "copyright judge."[29] However, opponents of this proposal expressed anxiety about lodging so much power in a single individual who could not be removed from

office for seven years under the terms of the bill.[30] Indeed, the proposal to establish such a copyright "czar" shows how far a compulsory licensing regime strays from a true market system. Another concern was "appealability," an obvious issue in light of the multiple appeals to different political arenas that followed the webcasting CARP decision. Finally, and most ironically, the parties expressed a strong desire to establish a system that reduced the costs of compulsory licensing proceedings and promoted private party settlement prior to the completion of full-blown arbitration proceedings.[31] The irony here is that there is an alternative to CARP tribunals that very effectively promotes private party negotiation of price schedules without expensive and cumbersome government-mandated tribunals: private property rights.

To summarize: compulsory licensing schemes invariably involve significant influence costs that make them generally more expensive as a mechanism for setting prices. Private party negotiations are more flexible and likely much cheaper on average over the long term.

Problem 2: Legislative Lock-In

Another problem with compulsory licenses is that they can easily become outdated and unreflective of supply and demand. But unlike private contracts (which are usually more short-lived than legislation and can in any case always be renegotiated), legislation is exceedingly hard to get rid of or change. Industry participants thus run the risk of being tied to an outdated pricing structure. This is the problem of legislative lock-in.

Advocates of compulsory licensing schemes envision a simple, fair system, to be enacted rapidly and straightforwardly by reasonable, fair-minded policymakers. Their plea seems reasonable and straightforward to them: they want Applemusic.com without the 10-year wait and without the control that property rights confer on established content distributors. But a legislative compromise will likely be locked in longer than 10 years, to the detriment of many involved.

Simplicity is desirable, but legislating is an ugly process. Judging by recent history, legislation produces ugly results in copyright matters as well. A prime example is the Digital Millennium Copyright Act of 1998. This legislation was the result of interest group deal-making so Byzantine that it boggles the mind of even David Nimmer, author of the most comprehensive and widely used copyright law treatise, who has decried the "absurdly complex"[32] effects of this "fiendishly complicated"[33] piece of legislation. You might recall that this is the legislation that was originally designed to clarify and update the copyright law in light of the Internet. It wound up being a hugely complex piece of lawmaking that created broad new areas of copyright liability for those who produce and distribute technologies capable of breaking copy protection schemes. The act legislated in detail in areas such as Internet service provider (ISP) liability for infringing content supplied by subscribers. The patchwork of industry-specific provisions that major content providers were induced to include in exchange for agreement to the basic structure of the act suggests the kind of complexity that would attend any comprehensive compulsory licensing statute covering Internet content. Indeed, any bill in this area can be expected to quickly reopen the same issues that vexed participants in the DMCA process.

As messy as it is, legislation that does pass is likely to be very difficult to get rid of later. This poses perhaps the greatest threat of all.

Legislative lock-in explains why compulsory licensing rates—such as those for recorded musical compositions and, in the past, jukebox performances[34]—periodically fall so far behind market rates. For example, the statutory rate for recorded compositions did not change between the 1909 Copyright Act and the 1976 Copyright Act, despite the massive growth in the music recording industry during that era.[35] In practice, then, compulsory licensing has led to price stagnation. Although it is impossible to prove that this led directly to reduced output of copyrighted

Compulsory licensing has led to price stagnation.

works, it surely had some effect—if nothing else, by undercompensating composers for works that consumers valued highly.

Proponents of a compulsory licensing scheme for the Internet point to it as one way to bypass the power of media content "dinosaurs." But if history is any guide, compulsory licensing is likely to hatch as many dinosaurs as it bypasses. Consider webcasting, for instance. As things stand, webcasters have to compete for business on the same basis as radio stations—song selection, disk jockeys, and so forth. The dawning compulsory licensing regime prevents a webcaster from trying a radically new strategy. What if a startup webcaster offered a premium royalty rate to song composition owners who wanted their music played via an interactive service over the Internet, perhaps in exchange for the *exclusive* right to stream music in this medium? (Compulsory licenses by their nature make all works available nonexclusively.) Would composers and music publishers give this "premium" webcasting channel a try? Would consumers like it? We will probably never find out. Because "compensation" has been decoupled from "control," we will get the same brand of competition in webcasting that we do in radio. So while webcasters could compete on format, number and type of advertisements, and the like, they could not compete on the basis of exclusive content.

A related area of the entertainment industry, the use of copyrighted songs as background music in movies and TV shows, provides a stark contrast to the compulsory model. For historical reasons, there is no compulsory license for the incorporation of a song into the action and events of a movie or TV show.[36] Movie and TV producers must negotiate directly with the owners of copyrights in music or their agents.[37] Exchanges in this area demonstrate all the attributes of a robust market: direct negotiations, wide price differentials, and above all a variety of competitors.[38] The volume of licensing in this area,[39] and the variance in price and other terms, demonstrates convincingly that copyrighted content can form the basis of fluid, functional markets—without recourse to a compulsory license.

How Markets Solve the Licensing Dilemma through Voluntary Associations

As inefficient as they can be, compulsory licenses might still be justifiable if there were no good alternative. But the state of digital distribution is no case of "market failure" justifying government intervention. In the intellectual property arena, compulsory licenses are in fact rarely, if ever, necessary. Private rightholders have ample incentives to get their content to a paying audience and have proven adept at getting together to form collective rights administration organizations to resolve IP transaction bottlenecks. This has been true over the years in a number of industries, beginning with song composition owners—songwriters and music publishers—in the 1920s.[40] Radio broadcasters found themselves liable for copyright infringement for the public performance of song compositions. There was serious concern about the costs of locating and dealing with all the individual holders of song copyrights. A classic example of the need for compulsory licensing seemed to be in the making. And yet it was not: the copyright holders formed ASCAP, a collective rights organization (CRO) that drew together all the copyright holders and offered a single "package license" to radio stations. Because of the CROs, no compulsory license was necessary for music compositions played over the air. Similar CROs have since emerged in other places and industries. These specialized private organizations bundle together copyrights and distribute royalty payments to individual members.

There is no reason to believe that CROs will not emerge in the Internet arena. Indeed, there is evidence that some are in the making already. For example, various "clearinghouse" sites offer the works of individual content creators in a "one-stop-shopping" format—similar in some ways to the package

Private rightholders have ample incentives to get their content to a paying audience.

licensing of ASCAP. Even the webcasting public performance rights subject to a compulsory license administered by the CARP have spawned a new CRO, SoundExchange. SoundExchange was formed by record labels and other copyright holders to receive public performance royalties and distribute them to member organizations. While this organization emerged in the shadow of the compulsory license enacted by Congress, there is no reason to believe it would not have come into being to administer strictly private property rights, just as ASCAP did in the 1920s. Such an organization could perform the same collection and distribution functions, with one important difference: its members, and not Congress, would determine the price and other terms under which webcasters could use the members' public performance rights.[41] Along with more flowering of content, the added bonus would have been that the significant "influence costs" incurred in the rate-setting process could be saved. It is ironic indeed that in the age of digital "disintermediation," right holders have had to deal with a formidable middleman—first Congress and then the webcasting CARP.

Antitrust Issues

Because collective rights organizations bring competitors together in an industry-wide organization, the unfortunate impulse of policymakers is to regard such entities as effective cover for a cartel. For example, when asked his opinion of SoundExchange, the recording industry's attempt at collaboration to collect license fees for performers, Rep. James Sensenbrenner (R-WI) said it "sounds like an antitrust violation to me."[42] The history of ASCAP, moreover, is tightly intertwined with numerous antitrust investigations.[43] Despite these concerns, collective rights organizations are usually tightly constrained in function by their members. Many are also subject to competition, the best guarantor against consumer harm. BMI (Broadcast Music Incorporated), a collective rights organization founded years ago by media companies specifically to compete with ASCAP, is a good example. There is every reason to believe that multiple collective rights organizations may well emerge and that average prices for copyrighted works will drop if they do.

Nevertheless, the threat of antitrust investigations and litigation looms over every collective rights organization. For this reason, record labels asked for and received explicit legislative exemption from the antitrust laws in forming SoundExchange to deal with webcasters.[44] While understandable, this step is in some ways unfortunate. It does nothing to dispel the antitrust fears of other firms wanting to form such collectives. Future proponents of new organizations, for example in movies, may even feel compelled to emulate the music industry, with the perhaps unfortunate consequence of making congressional approval a de facto requirement for the formation of a collective rights organization and retaining Congress as a middleman.

A better approach would be for the courts to make it very clear that under antitrust law, collective rights organizations are presumptively exempt from antitrust liability. Antitrust suits against them ought to be dismissed at the summary judgment stage. Collective action across firms is simply a prerequisite for the formation of markets in certain IP-intensive industries, and antitrust law ought to reflect that markets have plenty of room for cooperation as well as competition.

Conclusion

A competitive market, combined with the existence of property rights such as those prevailing today, will foster a wide spectrum of market strategies regarding how much to protect intellectual creations. The widely touted advantages of a compulsory license will very likely materialize without putting content providers into a legal straightjacket that will undercompensate some of them and lock all of them into a rigid structure that will be difficult to change as time goes on.

Policymakers should leave creativity to the musicians.

Policymakers should leave creativity to the musicians. The best course here is to stick with the Golden Oldies—property rights, contracts, and markets. These institutions have stood the test of time. They are very likely the best choices in the Internet setting too.

How do we translate these general guidelines into specific recommendations? Given the analytics of compulsory licensing, and starting where we find ourselves today, three initial policies are in order:

- Repeal the digital public performance right compulsory license, and let SoundExchange and any competitors that may arise deal directly with webcasters.[45]
- Resist appeals to legislate more compulsory licenses.
- Continue to apply liberal antitrust rules to collective rights organizations.[46]

With these policies in place, the three Golden Oldies can be expected to play well in this new setting, as they have so well in others.

Notes

1. Robert P. Merges, "Contracting into Liability Rules: Intellectual Property Transactions and Collective Rights Organizations," *California Law Review* 84 (1997): 1293.

2. To be fair, music download services offer an ever-changing array of options and restrictions on the downloading and "burning" of music onto CDs. See, for example, applemusic.com; and "Listen.com Halves CD Burning Cost," *Internet News,* February 13, 2003, http://www. Internetnews. com/ec-news/article.php/1583661.

3. As explained later in this paper, songwriters whose compositions are played by online webcasters are paid through collective rights organizations such as ASCAP, just as they are when their music is played on conventional radio and TV broadcasts. Some webcasters, however, are required to pay royalties to record companies in addition to songwriters, under the Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, November 1, 1995, 109 Stat 336, codified at 17 U.S.C. sections 106(6) and 114(d)-(j); and the Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat 2860 (1998), codified in scattered sections of 17 U.S.C. See "How Markets Solve the Licensing Dilemma through Voluntary Associations," later in this paper.

4. Laurie J. Flynn, "Apple Offers Music Downloads with Unique Pricing," *New York Times*, April 29, 2003, p. D1.

5. See Lawrence Lessig, *The Future of Ideas* (New York: Vintage Books, 2001).

6. Ibid., pp. 241–58.

7. Ciarán Tannam, "Interview with the President of Grokster," *MP3Newswire.net,* April 30, 2003, http://www.mp3newswire.net/stories/2003/grokster. html.

8. Lessig, Chapter 11.

9. See www.creativecommons.org.

10. See Merges, "Contracting into Liability Rules."

11. 17 U.S.C. § 115 (2003).

12. See generally Saul Hansell, "E-Music Sites Settle on Prices. It's a Start," *New York Times*, March 3, 2003, p. C1.

13. See, for example, P2P Piracy Prevention Act of 2002, H.R. 107th Cong., 2d Sess. (July 25, 2002).

14. Pub. L. No. 105-304, 112 Stat. 2860 (Oct. 28, 1998), codified at scattered sections of 17 U.S.C. For critiques of this and related legislation, see Pamela Samuelson, "Toward a 'New Deal' for Copyright for an Information Age," *Michigan Law Review* 100 (2002); and David Nimmer, "Back from the Future: A Proleptic Review of the Digital Millennium Copyright Act," *Berkeley Technology Law Journal* 16 (2001): 855.

15. Digital rights management (DRM) refers to technologies that encase content in secure electronic "envelopes," which users can open only with permission of the content owner. This permits the distribution of content on a for-profit basis over the Internet. Various automated use limitations and user rights may be encoded into the DRM. See http://www.law.berkeley.edu/institutes/bclt/drm/resources.html; and Mark Stefik, "Shifting the Possible: How Trusted Systems and Digital Property Rights Challenge Us to Rethink Digital Publishing," *Berkeley Technology Law Journal* 12 (1997):137.

16. Polk Wagner, "Information Wants to Be Free: Intellectual Property and the Mythologies of Control," *Columbia Law Review* 103 (2003): 995.

17. Ibid., p. 1009.

18. Lessig, pp. 118–19.

19. "Creative works" loosely refers to the subject matter of intellectual property. Various doctrines in intellectual property law distinguish between ideas and their embodiments.

20. A narrow exception exists where permission is likely to be too expensive to be worthwhile, or where it may be withheld because the potential user will criticize or satirize the work. These "market failure" scenarios are thought to justify copyright's "fair use" exception to infringement. See Wendy Gordon, "Fair Use as Market Failure: A Structural and Economic Analysis of the Betamax Case and Its Predecessors," *Columbia Law Review* 82 (1982): 1600; and Robert P. Merges, "Are You Making Fun of Me? Notes on Market Failure and the Parody Defense in Copyright," *American Intellectual Property Law Association Quarterly Journal* 21 (1993): 305.

21. See Robert P. Merges, "Of Property Rules, Coase, and Intellectual Property," *Columbia Law Review* 94 (1994): 2655.

22. On this concept, see Paul Milgrom and D. J. Roberts, "Bargaining Costs, Influence Costs, and the Organization of Economic Activity," in *Perspectives on Positive Political Economy*, ed. James E. Alt and Kenneth A. Shepsle (Cambridge, MA: Cambridge University Press, 1990); Paul Milgrom and John Roberts, *Economics, Organization and Management* (Upper Saddle River, NJ: Prentice Hall, 1992), pp. 192–94.

23. Technically, Congress for the first time gave the owners of sound recording copyrights—typically record companies—the exclusive right to publicly perform their sound recordings in a digital audio transmission, which means primarily the transmission of the work over the Internet. See 17 U.S.C. 106(6). This right varies depending on the context: for subscription services, the right translates into a compulsory license under 17 U.S.C. § 114(d)(2); for "interactive services," there is a mandatory requirement to negotiate a "voluntary" license; and for Internet transmissions of regular, traditional "over-the-air" broadcasts, there is no legal liability at all. For analysis and critique of this complex structure, see David Nimmer, "Ignoring the Public, Part I: On the Absurd Complexity of the Digital Audio Transmission Right," *UCLA Entertainment Law Review* 7 (2000): 189

24. P.L. 104-39, 109 Stat. 336 (995).

25. P.L. 105-304, 112 Stat 2860 (1998).

26. See generally, "Recent Legislation Copyright Law—Congress Responds to Copyright Arbitration Royalty Panel's Webcasting Rates—Small Webcaster Settlement Act of 2002, P. L. 107-321, 116 Stat. 2780 (To Be Codified at 17 U.S.C. § 114[F]-[G])," *Harvard Law Review* 116 (2003): 1920.

27. The CARP covered only royalties to the owners of sound recording copyrights, usually record labels, and not to songwriters for musical compositions. Musical composition royalties for webcasting are collected by collective rights organizations such as ASCAP and BMI, just as they are for conventional radio. ASCAP for example offers its own license to webcasters where companies pay on the basis of revenue generated from advertising and site traffic, which comes out to about 1.6 percent of a site's revenues, http://www.ascap.com/ weblicense/.

28. Copyright Royalty and Distribution Reform Act of 2003: Hearing before the Subcommittee on Courts, The Internet, and Intellectual Property of the Committee on the Judiciary, House of Representatives, 108th Cong., 1st Sess., H.R. 1417, April 1, 2003 (Statement of Michael J. Remington, former staff counsel, IP Subcommit-tee, House Committee on the Judiciary), pp. 28, 31.

29. Ibid.

30. Ibid. (Statement of Robert A. Garrett), pp. 9, 10:

> [T]he parties [I represent—sports leagues and other suppliers of digital content] are unanimous in their support for a decisionmaking body that consists of three individuals, rather than one copyright royalty judge. They also support specific measures that will help reduce costs and promote voluntary settlements, which we believe should be another principal goal of the legislation.

31. Ibid., at 14:

> [The Joint Sports Claimaints, or JSC, interest group, consisting of sports leagues such as Major League Baseball, the NBA, and the like] strongly believes that one of the goals of the copyright royalty arbitration process should be to discourage litigation and to encourage voluntary settlements among the parties to disputes. Existing policies and procedures, by raising bars to settlements at various points in the process, have had precisely the opposite effect. Examples include the policies and procedures dealing with confidentiality of negotiated agreements, the technical distinction between settlements arrived at before and after the initiation of CARP proceedings, and the Office's practice of permitting those who fail

> to participate in a proceeding the opportunity to oppose settlements by proceeding participants and to require the initiation of new CARP proceedings. [We] strongly support adding provisions to the [proposed Act] to eliminate these barriers to settlement.

32. David Nimmer, "A Riff on Fair Use in the Digital Millennium Copyright Act," *University of Pennsylvania Law Review* 148 (2000): 673, 675.

33. Nimmer, "Ignoring the Public, Part I" p. 189.

34. Jukeboxes were exempt from paying royalties to songwriters until the 1976 act added a compulsory license. This was originally set very low—$8.00 per year per jukebox. After the jukebox royalty was included in the Copyright Arbitration Royalty Panel structure in the 1976 Copyright Act (17 U.S.S. § 116) an arbitration panel increased the amount to $50 per machine. Currently, jukeboxes are subject to a voluntary negotiation backed up by the threat of a royalty arbitration tribunal, 17 U.S.C. § 116 (2003). The emergence of Internet-based "on-demand" jukeboxes sheds light on the undervaluation of musical compositions in the jukebox context. This new generation of jukeboxes is not subject to the threat of a compulsory license. Instead, digital jukebox companies (such as Ecast of San Francisco) enter into individual agreements with the owners of musical composition copyrights. The royalty rates in these agreements are potentially much more flexible than those subject to the one-size-fits-all statutory rate or conventional jukeboxes. And there is evidence now that consumers value songs played on a jukebox much more highly than was traditionally thought. See, for example, Jon Healey, "Paying for Music on Demand," *Los Angeles Times*, September 18, 2003, p. C2. ("Tracks from traditional jukeboxes run 50 cents or less apiece, while Ecast's machines charge up to $2.50.")

35. Joseph Taubman, *In Tune with the Music Business* (New York: Law-Arts, 1980).

36. See generally Al Kohn and Bob Kohn, *Kohn on Music Licensing* (New York: Aspen, 2002): 778.

37. The Harry Fox Agency of New York is the largest "synchronization rights" agent for copyright owners, bringing together the myriad sellers of these rights—typically, music publishing companies—with prospective buyers, typically producers or music coordinators for movie studios and television production companies. See Harvey Rachlin, *The TV and Movie Business: An Encyclopedia of Careers, Technologies, and Practices* 1991 (Nevada City, CA: Harmony Books, 1991), p. 203

38. For example, one industry account states that "Fees for use of a single song in a motion picture range from a few thousand dollars to $50,000 or more." See Rachlin, p. 202. The website of one of the many companies that specializes in clearing such rights provides a vivid description of how markets work in this area:

> Q: Here's the critical question—how much will a synchronization license [the technical name for using copyrighted music in a movie or TV show] cost?
>
> A: That depends on a lot of factors, not least of which is the nature of the music you're looking for. If a client calls us up and blithely announces that they've got $5,000.00 and are looking for a Beatles song, we will gently advise them that those kinds of dollars simply will not buy a Lennon-McCartney tune. Likewise, if we call up the publisher of "Pickle-for-a-Nickel-with-the-Mustard-on-Top" to negotiate a one-week usage on a radio station in the village of Carbuncle, and they grandly declare that they won't take less than $100,000.00 for such a usage, we will firmly inform them that such funds will not be forthcoming.

Available at http://www.patcoresources.com/piece-of-music.htm. For background on the highly competitive "music publishing" industry, which handles deal-making for these rights (as well as others related to music), see http://www.nmpa.org/nmpa. html.

39. In 2001, the Harry Fox Agency—which handles many of the transactions in this area—reported synchronization license revenue of $620 million. See National Music Publishers Association, *2001 Annual Report*, www.nmpa.org/pr/NMPA_Inter national_Survey_12th_Edition.pdf.

40. This section draws on Merges, "Contracting into Liability Rules."

41. Once SoundExchange had been formed, one might suppose that the parties would simply have proceeded to private negotiations without waiting for the CARP panel to reach its decision. It is clear, however, that the looming presence of the CARP prevented almost all private negotiations. Everyone chose to make some "influence expenditures" and wait. See Library of Congress, Copyright Office, "Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings," July 8, 2002.

42. Quoted in Drew Clark, "Sensenbrenner Takes New Approach to Recording Industry," *National Journal Technology Daily*, March 28, 2001.

43. Noel L. Hillman, "Intractable Consent: A

Legislative Solution to the Problem of the Aging Consent Decrees in *United States v. ASCAP* and United States v. BMI," *Fordham Intellectual Property Media and Entertainment Law Journal* 8 (1998): 773.

44. See 17 U.S.C. § 114(e)(1).

45. Again, the example of BMI—formed by large media companies specifically to compete with ASCAP—may be helpful.

46. Note that the Copyright Act exempts SoundExchange and any competitor that may arise from antitrust liability for certain negotiation and price-setting activities. See 17 U.S.C. § 114(e) (2003).

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