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NEWSLETTER

An Entertainment Industry Organization

CALIFORNIA COPYRIGHT CONFERENCE

The President's Corner

Dan Butler

Welcome back! Hopefully all of our members and friends had a productive and/or relaxing summer.

Tonight, we officially kick off the CCC's 52nd year with our Annual Legal Eagles Update. Moderator and CCC VP David Hirshland (Exec. VP of Bug Music) will head up a terrific panel comprised of David Altschul (Partner at Altschul & Olin), Evan Cohen (Owner of Cohen & Cohen), Ron Gertz (President of Music Reports Inc. and Royalty Logic Inc.), Neville Johnson (Partner at Johnson & Rishwain), and Neil Netanel (UCLA Law Professor in Copyright and International Intellectual Property).

Our learned lawyers will discuss the new Supreme Court decision in *MGM v. Grokster* and cover other controversial music topics, including mechanical licensing reform, a class action lawsuit against the record clubs, and the dispute over how artists should get paid for legal downloads of their music.

I would like to extend my personal thanks to all of our panelists and attendees. On behalf of the CCC Board of Directors, we look forward to enlightening and entertaining you tonight and throughout the coming year.

The Meaning of *Grokster*:

Supreme Court Supports Studios over P2P File Sharing Sevices

Jeremy Geltzer

While summer blockbusters duked it out on theater screens, a different battle played out behind the marble columns of the Supreme Court. In *MGM v. Grokster,* two titans of the communications world went toe-to-toe, as copyright and content owners fought Internet file-sharing technology companies.

In recent years, technological innovators and content owners have balanced in an uneasy equilibrium. New technology, such as peer to peer (P2P) communications have further polarized the camps. P2P software permits users to search, find and transfer files between computers. The system was intended to transfer massive amounts of data quickly; and without centralized control, this information superhighway would avoid bottlenecks. But the emergence of a potential communications utopia didn't make everyone happy. Technological promise came as a threat to content owners. To copyright holders, the unregulated system has spawned a huge black market for music and movies, a high tech tool for infringement and theft on a massive scale.

The *Grokster* case, decided by the Supreme Court in June 2005, posed a deceptively simple but critical question to the world of new technology. In plain terms, the issue was: "when is a manufacturer liable for the actions of its customers?"

Setting the Stage for Innovation: the Betamax Case

To fully understand the legal question posed in the *Grokster* case, the background of earlier skirmishes between the two camps is key. The first major confrontation between technology and copyright proponents came in *Sony v. Universal (1984)*, more commonly referred to as "the *Betamax* case." Here, the studios saw their very existence threatened by the proliferation of home video devices. In a moment of high drama, then-MPAA president Jack Valenti begged Congress to see that, "the VCR is to the American film producer ... as the Boston strangler is to the woman home alone." (See J. Lardner "Fast Forward: Hollywood, the Japanese, and the VCR Wars").

The Supreme Court saw things differently. The Court refused to hold Sony liable for the potentially infringing actions of its customers. The opinion found 'time-shifting' (taping a program off broadcast television to watch it later) a principal non-infringing use, and this point saved Sony. The Supreme Court's ruling supported technological innovators, providing a shield from liability as they brought new products to the marketplace. Thus, the *Betamax* rule created a safe harbor from secondary liability as long as a commercially significant non-infringing use for the product existed.

Peer to Peer Pressure: the Napster Case

For more than 15 years, the *Betamax* standard helped to encourage high tech innovators to develop new methods to use, store, transfer audio-visual and text content, but it was inevitable that the tension between the competing values of technological innovation and copyright holders would need to be redefined.

The *Napster* case brought P2P

technology to the public's attention in 2001. In *A&M v. Napster*, the Ninth Circuit considered whether the P2P service could be held liable for contributory or vicarious infringement. Napster operated a centralized server that permitted user to access infringing materials. Sidestepping the *Betamax* case standard, the court found, that although the technology may be capable of "commercially significant non-infringing use," the file sharing service knew of massive infringement and could have blocked access. Because Napster turned a blind eye, the service was held liable.

Nuts & Bolts, Bits & Bytes: How P2P Works

Despite the promise and press worthiness of P2P technology, it is still mysterious to many people. Numerous versions of P2P software are currently available; Morpheus (see Morpheus.com) permits users to connect to file sharing services such as Kazaa (see Kazaa.com), LimeWire (Limewire.com), eDonkey (edonkey2000.com), and Bit Torrent (bittorrent.com). By downloading free software, users may create decentralized and self-forming communities. Networks are ever-changing as a user signs on or off. Once a user signs on to a network, P2P software permits the user to search, find and transfer files without interference from the service provider. Because Napster's centralized index gave rise to liability, the newer versions of P2P services like Grokster and StreamCast were careful to engineer more pure P2P systems. Once a user downloaded the software, the service played no further role in transactions between peers.

Pure P2P: Grokster at Court

Just as the *Napster* case was reaching a resolution in 2001, a new battle was beginning. In October 2001, motion picture studios, recording companies and class of 27,000 music publishers and songwriters sued for damages and injunction against continuing infringement against Grokster and StreamCast. The Ninth Circuit was once again in the center ring of the conflict between P2P technology and content owners.

Using the same strategy that prevailed in the *Napster* case, the content owner plaintiffs based their case on a theory of secondary liability, contributory and vicarious infringement. Secondary liability is a rare finding because the results can easily become absurd -– should Ford Motors be liable for every bank robbery where the getaway car is a Mustang? Because of this, courts are wary of extending secondary liability. *Contributory infringement*, however, occurs when one party intentionally encourages, induces or aids known infringement. *Vicarious infringement* occurs when the secondary party profits from direct infringement while declining to stop or limit the infringement.

At trial, the Grokster camp relied primarily on the *Betamax* safe harbor. Obviously there were important uses for this developing technology, such as the ease of data transfer. Files could be transferred and retrieved far faster without a centralized system, this provided great benefits in terms of security, cost, and efficiency. The *Betamax* rule required Grokster to demonstrate commercially significant non-infringing use to be sheltered from liability. Grokster demonstrated their service could distribute licensed content with permission from the copyright holder; musicians such as Wilco, Pearl Jam, and Dave Matthews authorized their music and video content for P2P distribution. P2P was also the ideal means of distribution for shareware (free software) and research materials. Project Gutenberg made literary works in the public domain such as Shakespeare's plays, The King James Bible, and the Communist Manifesto available for transfer between peers. Because of the lawful uses and commercial viability of P2P technology, Grokster argued their services should fall within the safe harbor of *Betamax.*

The Ninth Circuit agreed with Grokster's interpretation. While the court's previous analysis found Napster liable based on a centralized structure, the decentralized system used by Grokster and StreamCast was engineered to avoid the same mistake. Although the court recognized that many files exchanged on these P2P networks were in violation of copyright law, the Court argued that the need to support technological innovation saved the P2P services.

The studios challenged this decision and took the battle to the Supreme Court. They argued that P2P technology caused copyright holders and content owners "massive and irreparable harm," as evidenced by Recording Industry Association of America (RIAA) figures reporting steady drops in CD sales over the last five years. The studio also argued that P2P created a "culture of contempt for intellectual property."

The Supreme Court Decides

From all accounts, the *Grokster* oral arguments at the Supreme Court were the hottest tickets in Washington D.C. The Justices deciding the case, however, seemed uniquely unsuited for the job. Few used email. Justice Souter drafted his opinions in pencil on yellow legal notepads. At the oral arguments, the panel seemed hostile to both parties.

The Supreme Court overruled the Ninth Circuit and held for the studios, labels and copyright owners. On its face, the opinion was unanimous; but the Justices were divided into three contingents. Justice Souter's majority opinion tackled the issues clearly and directly. In the opening lines, he wrote: "The question is under what circumstances is the distributor of a product capable of lawful and unlawful use is liable for acts of copyright infringement by third parties using the product. We hold that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties."

While recognizing the need to support innovation, the Court found a powerful argument for imposing liability on Grokster based on the "gigantic number" of infringing downloads. In addition, the Court discerned Grokster's pandering to the market of former Napster users seeking infringing materials. An internal email from a company executive convinced the Court of Grokster's intent: "we have to put this network in place so that when Napster pulls the plug on their free service ... or the if court orders them to shut down ... we will be positioned to capture the flood of their 32 million users that will be actively looking for an alternative."

Rather than relying on theories of contributory or vicarious liability the *Grokster* Court hung its opinion on a theory of *inducement*. According to this standard, "one who distributes a device with the object of promoting its use to infringe copyrights as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties." Internal emails and advertising campaigns satisfied the requirement for illegal purpose and intent. Two facts satisfied the requirement for affirmative steps: First, neither Grokster nor Streamcast attempted to develop filtering tools or other mechanisms to diminish infringing activity; and second, both P2P services made money by selling advertising space on infringing downloads.

Thus, in a departure from the *Betamax* rule, which seemed to favor technology companies, *Grokster* supported content owners who had become more vulnerable in a world of P2P digital transfers. It seems easy to distinguish between a consumer taping a movie or television program for his or her own personal use (as permitted by *Betamax)* and a P2P service user uploading DVDs and CDs to literally millions of other consumers, who would then be able to watch the movie or hear the CD without paying the copyright owner.

Confusions and Conclusions:

While *Grokster* gave a solid victory to motion picture studios, labels, publishers and recording artists, James Nguyen, a partner at Foley & Lardner, recognized the consequences of the decision. At a recent Beverly Hills Bar seminar, Nguyen noted "the Supreme Court left technology companies and their attorneys to pick through a dangerous minefield of legal uncertainties." The stakes are high, with great risk to P2P innovators. Statutory damages for as much as $150,000 per work infringed means that a single iPod filled with infringing songs could give rise to millions of dollars in damages. The Supreme Court's decision in *Grokster* makes it clear that P2P companies are subject to such liability if there is direct proof of intentional inducement of copyright violations. Creative/devious legal engineering of P2P business models, however, will likely insure that such proof will be unavailable.

Will *Grokster* really make a difference? Just as the Grokster service initially found a way to get around *Napster*, new services will undoubtedly adapt to the new legal standards or flaunt them. In many respects, new technologies have already let the horse out of the barn, and *Grokster* may ultimately be seen as a futile attempt to close the door. P2P file sharers will continue to illegally disseminate music and movies over the Internet by the billions of files. Although some feel that the MPAA and RIAA's policy of litigating against infringing users is doomed to failure, copyright owners certainly don't want those organizations to stand by while their property is given away.

Litigation, of course, is only one tactic of the MPAA and RIAA. Many efforts are underway to educate the public that illegal downloading is wrong (e.g., trailer advertisements in movie theaters advising, "You wouldn't shoplift a DVD or CD from a store - Illegal downloading is stealing, too"). Various labels are experimenting with new copy protection on CDs and DVDs with mixed results. The recent explosion of iPod and iTunes store sales, along with ringtones and ringbacks have demonstrated a real market for legal music downloads, with a content explosion poised to hit cellphones in the near future.

Many people believe that labels and studios need to embrace technology instead of fighting it. By losing the *Betamax* case in 1984, studios may have actually benefited. Home video became a reality far quicker than if the studios had been able to keep VCRs out of the marketplace. Home video releases and re-releases have generated a great deal of revenue. Perhaps content owners should learn from *Betamax* and embrace technology and new modes of distribution. Is a P2P department as unthinkable today as a Home Video department was in 1983 before *Betamax*? Developing technology has changed the way we communicate and access information. Like an addiction, greater access has fed a need for even more content. By considering the potential of P2P and other developing technologies, a brave new world of access to content may unfold. Until then, expect more court cases and confusion.

Editor's Note: As we go to press on September 6, 2005, in another victory for copyright owners, Australia's Federal Court yesterday ruled against P2P software Kazaa, finding that Kazaa's managers authorized users to infringe on music copyrights. The Court directed Kazaa to modify their software applications if they want to stay in business, either by (i) including non-optional key-word filter technology in new versions of the software and exerting maximum pressure on existing users to upgrade to the new version; or (ii) restricting their search software to only providing lists of non-copyright infringing works. A separate hearing will be held later to address the music labels' damage claims.

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SECTION 115 REFORM

Ed Arrow

Background

The last of the scheduled statutory mechanical rate increases will take place on January 1, 2006. Typically, rates remain in effect for a period of two years. Therefore, one would expect a ruling from the Copyright Royalty Judges setting a rate schedule commencing January 1, 2008. But, record companies and digital music distribution services, among others, say that the 96 year old U.S. mechanical licensing model is outdated and that Section 115 of the U.S. Copyright Act (the compulsory mechanical licensing provision) should be amended or abolished. In The House of Representatives, the Subcommittee on Courts, the Internet, and Intellectual Property (of the Committee on the Judiciary), has held hearings to determine what changes, if any, need to be made to Section 115 to facilitate the digital distribution of music. Based on statements made by committee members, it appears they would like to devise a simplified licensing model that would permit digital services to license large numbers of songs quickly. A blanket license has been suggested. Members of the committee have also stated that they believe songwriters and publishers are not adequately compensated for the use of their music.

Record Companies

The decline in record sales has hurt record companies more than publishers. Record companies rely almost solely on sales of records for their revenues. Publishers enjoy more diversity in their sources of revenue. Consequently, the record companies' need to exploit new markets is much greater than the publishers'. In order to take advantage of new opportunities, the record companies want to be able to license their recordings, or authorize sales of their recordings, quickly. They are often frustrated knowing that they can quickly license their masters, but they cannot cash in until the licensee has successfully navigated the more complex world of song licensing.

To obtain a mechanical license one must identify all owners of songs for which they intend to obtain licenses. Many owners have authorized The Harry Fox Agency to license on their behalf. This simplifies matters somewhat. But, the Harry Fox Agency only represents approximately 70% of songs in the market. For the other songs record companies must go on the hunt. Additionally, the calculation of rates pursuant to controlled compositions clauses is complex and time consuming. Although the controlled compositions clause is a complexity the record companies impose on themselves, they would argue that it is the only way they can control their mechanical royalty costs.

New recorded music formats such as DVD-Audio, SACD, and DualDiscs have presented record companies with licensing challenges because they contain multiple mixes (e.g. 5.1 and stereo) of each song. Publishers claim that they are entitled to be paid for each mix. Record companies only want to pay one time for each song. Some record companies claim that a compulsory license does not require them to pay for more than one mix. Publishers disagree.

Master use ringtones are a great new revenue generating opportunity for record companies and music publishers. Music publishers have already cashed in on monophonic and polyphonic ringtones, for which music publishers were able to negotiate directly with ringtone providers. In order to simplify and speed up the licensing process, record companies would like to negotiate mastertone deals directly with the mastertone providers, eliminating music publishers from the discussion. To that end, some record companies have taken the position that mastertones are phonorecords (as defined in the Copyright Act) and are therefore subject to compulsory mechanical licensing. If this is true then record companies may license controlled compositions, file compulsory license notices for other compositions, and pay the publishers the statutory mechanical royalty rate. Publishers generally do not agree that mastertones are phonorecords.

In considering the alternatives to the current model, record companies would like to know that the economies of their business are preserved, at least when it comes to the cost of mechanical royalties. They do not want to find themselves suddenly paying substantially more than they are currently paying. Beyond that, they would like to simplify the process of licensing by moving to a blanket license model with payments based on a percentage of revenue – essentially the European mechanical licensing model.

Digital Music Distribution Services

Digital services offering subscription models need to be able to license large numbers of songs quickly. The more recordings a subscription service can offer, the more subscribers they are likely to attract. Once a subscription service identifies the recordings they wish to offer, they must obtain licenses from the owners of those recordings. That could take some time, but it wouldn't be too difficult. It's easy to find out which record company owns each recording. Next, the service must obtain rights to the songs. They can go to The Harry Fox Agency and enter into an agreement with them. They must submit a list of songs to Fox along with the names of the writers, and/or artists, and hope that Fox can match those songs to their database. If a subscription service does not have writer names (as is often the case), or if they have misspelled titles, Fox may not be able to make the match, and the songs would remain unlicensed. This process only covers those songs owned by members of The Harry Fox Agency - approximately 70% of the market. For other songs, the service must try to identify the owners, get their contact information, and attempt to obtain licenses from them individually. The subscription services must also obtain performing rights licenses from ASCAP, BMI, and SESAC.

The digital subscription services want something as close to one stop shopping as possible. Ideally, they would like to be able to go to one party and license the entire bundle of rights they need for the both the recordings and the songs. If they can't get one stop shopping for recordings, they certainly want it for songs.

Music Publishers

Music publishers want a higher mechanical royalty rate. They believe that the current mechanical royalty rate of 8.5 cents per song is far lower than the rate would be if market forces were in play. Because the rate has always been set by statute, no one knows what the true market value of the mechanical royalty is. In 1909 the rate was set at 2 cents. The rate was not increased until 1978, after which it has been increased every two years. If the 1909 2 cent rate had been increased in accordance with the Consumer Price Index, the current rate would be around 40 cents per song. To make matters worse for the publishers, they often receive far less than the 8.5 cent statutory mechanical rate, due to the operation of controlled compositions clauses. Music publishers would consider moving to the European licensing model which is based mechanical royalties on a percentage of the wholesale price of the unit, but with per song floor, to protect against low cost dumping. Publishers would love to see the end of the controlled compositions clause because the controlled compositions clause lowers their royalties and, in some cases, delays their payments.

Recommendations of The Register of Copyrights

In her testimony before the Subcommittee on Courts, the Internet, and, and Intellectual Property, Register of Copyrights, Marybeth Peters, has proposed a "collective licensing structure" in place of the compulsory license. Peters proposes that the performing rights societies (ASCAP, BMI & SESAC) should be transformed into Music Rights Organizations (MRO's) authorized to license mechanical rights as well as performing rights. She proposes that other organizations could also be authorized by copyright holders to provide similar licensing services.

Additionally, she proposes that an MRO would be required to offer a reproduction right to any party seeking a public performance license for a digital transmission. This would effectively bundle the performing, reproduction, and distribution right for on demand streams, satisfying the needs of the subscription services.

Copyright owners would retain the right to circumvent the MRO's by entering into direct licenses. Copyright owners would also be permitted to authorize other entities to license their mechanical rights, except for digital transmissions.

Conclusion

Record companies, digital services, Congress, and the U.S. Copyright Office all want to change the licensing model so that licensing becomes faster and less complicated. Music publishers, while not pushing for a change in the licensing model, are not opposed to change. Music publishers want an increase in mechanical royalty rates. Can all of the players be made happy? Publishers would be happy with a hefty mechanical rate increase. Everyone else would be happy with a simpler licensing model Consequently, Congress may eliminate or amend Section 115 and replace it with either a blanket licensing model, such as exists for performing rights societies, or the appointment of a national mechanical rights licensing collective. Royalties will likely be paid on a percentage basis, with per song minimums. The royalty rate scheme will most likely result in an increase to the mechanical royalties paid to publishers. The MRO's proposed by Marybeth Peters are also a distinct possibility. The only thing that seems to be certain is the need to change.

RECORD CLUB SETTLEMENT IS MOVING FORWARD

David Hirshland

Two years ago, for the second time, a group of writers and publishers brought an action against the two record clubs, Columbia House and BMG Direct, for distributing songs without obtaining mechanical licenses. In the previous action, known as the Wixen case, the clubs prevailed, successfully arguing that (i) they were not financially able to function like record companies and negotiate and obtain licenses and (ii) years of acceptance of royalty payments at 75% of the statutory rate without objection established implied licenses.

Led by class action litigation experts Max Blecher of Blecher & Collins and Neville Johnson of Johnson & Rishwain, plaintiff's team succeeded where the Wixen attorneys failed – pushing the case beyond the summary judgment stage on the twin pillars of a strong infringement claim and certification of the class. Still, they knew quite well that they were faced with an uphill and time consuming battle based primarily on the clubs' strong position and financial wherewithal and consequently agreed to settle the case for terms which have proven controversial in the publishing community. The initial settlement agreement, which was entered into in February, has since been amended due primarily to the objections received by the court.

The major source of contention is the so-called "negative option" component of the settlement, whereby songs and their proposed payment terms are to be posted at least 30 days prior to the release date on a dedicated website for acceptance or rejection by the publishers within 30 days. In the initial settlement agreement there was no floor to the rate but in the amended agreement the rate is no lower than 75% of the prevailing rate as of the date of manufacture. If an objection is filed by each copyright owner within the required time period the clubs have the option of obtaining a compulsory license, negotiating a higher rate with the owner(s) or not releasing the composition.

The settlement also contains an economic element, 6.5 million dollars (split evenly between the clubs) to be distributed to the members of the class which consists of all copyright owners with songs distributed by the clubs since March 20, 1999. From this total amount the clubs may deduct aggregate costs of $320,000 to set up the new "licensing" procedure and maintaining it for the first year. Class members will have the ability to opt out by a date to be set by the court. The target date for Settlement Notices to go out to class members is currently October 11 with a final approval hearing set for December 19.

Assuming the Settlement holds and is approved by the court it appears that the economic positions of the parties will not have changed much but copyright owners will have gained a measure of control over the licensing process.