NEW YORK UNIVERSITY
LAW REVIEW

VOLUME 89 OCTOBER 2014 NUMBER 4

ARTICLES

PENALTY DEFAULT LICENSES: A CASE FOR UNCERTAINTY

KRISTELIA A. GARCÍA*

Research on the statutory license for certain types of copyright-protected content has revealed an unlikely symbiosis between uncertainty and efficiency. Contrary to received wisdom, which tells us that in order to increase efficiency, we must increase stability, this Article suggests that uncertainty can actually be used to increase efficiency in the marketplace. In the music industry, the battle over terrestrial performance rights—that is, the right of a copyright holder to collect royalties for plays of a sound recording on terrestrial radio—has raged for decades. In June 2012, in a deal that circumvented the statutory license for sound recordings for the first time ever, broadcasting giant Clear Channel granted an elusive terrestrial performance right to a small, independent record label named Big Machine and agreed to pay royalties where no such legal obligation exists. This result not only improves upon many of the statutory license's inefficiencies but is also the opposite of what we would expect given both the tumultuous history surrounding the rights at issue and the respective parties' bargaining positions. It suggests an

 Associate Professor at the University of Colorado Law School; Director, Silicon Flatirons Center for Law, Technology, and Entrepreneurship. The author would like to thank the following people for their especially generous and helpful contributions: Michael Abramowicz, Ian Ayres, Robert Brauneis, Stephen Carter, Peter DiCola, Margot Kaminski, F. Scott Kieff, Alvin Klevorick, Mark Lemley, Daniel Markovits, Viva Moffat, Jonathan Nash, Lisa Larrimore Ouellette, Matthew Sag, Alex Stein, Rebecca Tushnet, Urska Velikonja, and Alexander Volokh, as well as the participants in the Seventh WIPO Advanced Research Forum on Intellectual Property Rights, the 2013 Searle Center Research Roundtable on the Law and Economics of Digital Markets, and the 2013 Intellectual Property Scholars' Conference for their helpful insights, Jodi LeBolt for her invaluable research assistance, and the editors of the *New York University Law Review*, especially Ian Bausback and Steve Hsieh, for their thoughtful insights and tireless efforts toward improving the piece. Finally, this Article is dedicated to the charming city of Munich, without whose cafes and coffee shops it never would have been written. Accolades and compliments, and criticism couched as such, are welcome at kristelia@colorado.edu.

underexplored mechanism at play: uncertainty. Using the statutory license for sound recordings and the Clear Channel–Big Machine deal to motivate the analysis, this Article argues that bounded uncertainty—such as uncertainty about the future legal status of terrestrial performance rights and uncertainty about future digital business models—converts a statutory license into a "penalty default license." Just as penalty default rules encourage more efficient information exchange between asymmetrical parties, penalty default licenses encourage more efficient licensing among otherwise divergent parties by motivating them to circumvent an inefficient statutory license in favor of private ordering. While not without its drawbacks, which previous work identified and ameliorated, private ordering improves upon the statutory approach, resulting in greater efficiency not only for the parties involved but for society overall. Recognition of the role that uncertainty plays in converting an inefficient statutory license into a penalty default license that improves market efficiency while mitigating inequality has implications beyond the statutory licensing context. It suggests a revision in the way we view the relationship between uncertainty and efficiency. Specifically, it shows that when coupled with a penalty default, uncertainty can bring greater efficiency to the marketplace by encouraging private ordering—with its tailored terms and responsiveness to rapid legal and technological change—while mitigating concerns about inequality and gamesmanship.

Introduction

A recent spate of private broadcasting deals has circumvented the statutory license for sound recordings[1] for the first time ever and created a new, private intellectual property right that does not exist under the current copyright laws: the terrestrial performance right.[2] These deals offer unique insight into both the potential gains and the potential drawbacks of private ordering[3] in the shadow of a statutory regime. They also reveal an unlikely symbiosis between uncertainty and efficiency that runs contrary to the received wisdom that efficiency is borne of stability.

It may surprise the reader to learn that his or her favorite recording artists are not paid when one of their songs is played on a terrestrial radio station in the United States. This fact has certainly surprised (and angered) recording artists and copyright holders,[4] who for the last two decades have fought for a so-called "terrestrial performance royalty" only to be shut down repeatedly by the broadcaster lobby.[5] When the issue was last before Congress in 2009,

---

[1] 17 U.S.C. § 114 (2012). The statutory license for sound recordings, like other statutory licenses for copyright-protected content, operates as an "open offer" that may be "accepted" by any prospective licensee willing to pay the statutory rate and comply with the statutory terms. As discussed in Part I, many of these statutory licenses for copyright-protected content are administered by collective rights organizations (CROs), which function as collective bargaining entities that typically set and enforce a going rate for individual or blanket licensing of content. *See, e.g.*, *About*, SoundExchange, http://www.soundexchange.com/about/ (last visited Sept. 9, 2014) (describing one such CRO, SoundExchange, as an "independent nonprofit performance rights organization that collects and distributes digital performance royalties to featured artists and copyright holders").

[2] A terrestrial performance right entitles the copyright holder to be paid for public performance of a sound recording on terrestrial radio. Terrestrial (or "analog") radio refers to traditional FM/AM radio and also includes hybrid digital (HD) radio. It is distinct from Internet (or "webcast") radio services like Pandora and satellite radio providers like SiriusXM.

[3] For the purposes of this Article, "private ordering" refers specifically to the government-induced variety of private ordering around a penalty default license. This form of private ordering is distinct from conventional private ordering in a free market insofar as the former operates with the explicit comfort of a safety net, while the latter refers to private negotiation in an efficient marketplace. However, they share common efficiency gains, challenges, and drawbacks.

[4] The recording artist and the copyright holder are rarely the same party. Most recording artists assign their copyrights to an intermediary record label (and likewise, most songwriters assign their copyrights to an intermediary music publisher), which explains why deals like that between Clear Channel and Big Machine can have pros for the copyright holder and cons for the artist. *See infra* Part II.B.2.b (discussing the denial of statutory royalties distribution to artists as a result of circumventing § 114).

[5] Broadcasters have always resisted a terrestrial performance right for sound recordings on the basis that their programming provides a valuable promotional service to artists and record labels and, as such, they should not have to pay royalties. The fact that digital broadcasters—of whom the same could be said—are nonetheless subject to

Dennis Wharton, then–executive vice president of media relations for the National Association of Broadcasters (NAB), called the Performance Rights Act[6] "the biggest threat to radio in 50 years."[7]

Notwithstanding this sentiment, in June 2012 media conglomerate and content licensee Clear Channel Communications, Inc. (Clear Channel) granted the elusive terrestrial performance right to independent record label and content licensor Big Machine Label Group (Big Machine) in a private deal that circumvented § 114, the statutory license for sound recordings, and SoundExchange, the collective rights organization (CRO) charged with collecting and administering royalties under the statutory license.[8] In other words, one of the nation's largest broadcasting companies agreed to pay Taylor Swift a share of its advertising revenues *where it had no legal obligation to do so*.[9] Many copycat deals followed in short order.[10]

---

performance royalties serves as but one example of unresolved inconsistencies in this area of the law.

6 H.R. 848, 111th Cong. (2009). The Act would have established a terrestrial performance royalty. *Id.*

7 Kristina Sherry, *Radio Stations Step Up Battle Against Performance Rights Act*, L.A. TIMES (July 3, 2009), http://articles.latimes.com/2009/jul/03/business/fi-ct-radio3. "For more than 80 years, commercial stations have aired songs without paying royalties to musicians, but a bill making its way through Congress would change that." *Id.*

8 Ed Christman, *Clear Channel, Big Machine Strike Deal to Pay Sound-Recording Performance Royalties to Label, Artists*, BILLBOARDBIZ (June 5, 2012, 7:00 AM), http://www.billboard.biz/bbbiz/industry/legal-and-management/exclusive-clear-channel-big-machine-strike-1007226762.story. SoundExchange is the sole CRO charged with collection and administration of digital performance royalties for sound recordings. *See About*, *supra* note 1 ("SoundExchange is *the* independent nonprofit performance rights organization that collects and distributes digital performance royalties to featured artists and copyright holders.").

9 This grant of a terrestrial performance right is significant not only because Clear Channel had no legal obligation to pay it but also due to the fact that "[t]errestrial radio still accounts for 98% of U.S. radio's music advertising revenue." Dan Rys, *Clear Channel Inks Second Radio Royalties Label Deal, This Time With Glassnote*, BILLBOARDBIZ (Sept. 27, 2012, 1:41 PM), http://www.billboard.biz/bbbiz/industry/radio/clear-channel-inks-second-radio-royalties-1007962302.story.

10 *See, e.g.*, Ben Sisario, *Clear Channel-Warner Music Deal Rewrites the Rules on Royalties*, N.Y. TIMES, Sept. 13, 2013, at B1 (describing the Clear Channel–Warner Music Group deal); Priscilla Kim, *Clear Channel Signs Another Direct Deal with Indie Label*, DIGITAL MUSIC NEWS (July 25, 2013), http://www.digitalmusicnews.com/permalink/2013/07/25/clearchannelinnovativeleisure (citing a deal between Clear Channel and Innovative Entertainment as "one of many similar deals with other labels, including agreements with Big Machine Label Group, Glassnote Entertainment Group, Dualtone, Fearless Records, and more"); Glenn Peoples, *Big Machine Label Group Signs Terrestrial Royalties Deal with Entercom*, BILLBOARDBIZ (Sept. 20, 2012, 10:12 AM), http://www.billboard.biz/bbbiz/industry/record-labels/big-machine-label-group-signs-terrestrial-1007954192.story (describing the Big Machine–Entercom deal); Rys, *supra* note 9 (describing the Clear Channel–Glassnote deal). Clear Channel is reportedly approaching more labels. Helienne Lindvall, *Should Labels Bypass SoundExchange and Enter into Direct Deals with Clear*

Powerful licensees are circumventing the statutory license to grant less powerful licensors new, meaningful intellectual property rights and are thereby incurring payment obligations where no legal obligation exists. This is significant both for its departure from the historical deadlock around terrestrial performance rights and because it runs counter to the parties' respective bargaining positions, suggesting an unexplored mechanism at work: uncertainty.[11] An inefficient statutory license, coupled with uncertainty about the future legal status of terrestrial performance rights and future digital business models, is providing a powerful impetus for circumvention of the statutory license through private dealmaking.

In previous work, I identified an emerging phenomenon in which parties operating under a nonmandatory statutory license were circumventing the license and instead engaging in private ordering.[12] This brand of private ordering—which I termed "private copyright reform"[13]—brings efficiency advantages vis-à-vis the statutory license, but it also presents potential distributive justice concerns.[14] Having addressed those concerns by suggesting two relatively straightforward statutory amendments,[15] I return in this Article to an exploration of the efficiency advantages of private ordering for certain types of copyright-protected content.

This investigation reveals uncertainty as an unexpected tool for improving efficiency. When coupled with a penalty default, uncertainty can bring greater efficiency to the marketplace by encouraging private ordering, which allows for tailored terms and responsiveness to rapid legal and technological change. While scholars have recognized the behavior-influencing properties of uncertainty,[16] these observations have not identified uncertainty as a means of

---

Channel?, Digital Music News (May 3, 2013), http://www.digitalmusicnews.com/permalink/2013/05/03/bypass.

[11] This Article uses a lay understanding of the word "uncertainty"—i.e., lack of confidence as to the outcome—as opposed to the economic definition in which the probability of outcomes cannot be estimated.

[12] Kristelia A. García, *Private Copyright Reform*, 20 Mich. Telecomm. & Tech. L. Rev. 1 (2013).

[13] *Id.* at 3.

[14] *See id.* at 29–37 (discussing these implications).

[15] An amendment making the § 114(g)(2) distribution inalienable would ameliorate concerns about artists being cut out of deals to which they are not a party, while the addition of a more robust disclosure requirement for rates presented to the Copyright Royalty Board would reduce concerns about market misrepresentations. *Id.* at 32–37.

[16] *See, e.g.*, Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 Stan. L. Rev. 1471, 1518–19 (1998) (discussing, inter alia, the tendency of individuals to underestimate the likelihood of uncertain events in the field of behavioral economics); Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. Risk & Uncertainty 297, 297 (1992)

improving efficiency. Many industries suffer from market inefficiency, and the copyright-protected content industries—music, film, television, and publishing—are no exception. Using the recording industry as a case study in the inefficiencies of a statutory licensing regime, this Article shows how players in a notoriously unstable industry are incentivized to make their own efficiency by circumventing § 114, a de facto penalty default license.

The term "penalty default license," introduced here to describe the use of bounded uncertainty[17] to induce private ordering, borrows its name and function from the parallel concept of "penalty default rules." First introduced by Professors Ian Ayres and Robert Gertner,[18] penalty default rules are unpalatable fallback options in contract law that kick in unless the parties negotiate their own terms. Such rules induce more knowledgeable parties to "reveal information by contracting around the default penalty."[19] Similarly, the bounded uncertainty of penalty default licenses encourages more efficient deal making among otherwise unequal parties by motivating them to circumvent an inefficient statutory license in favor of private ordering and the resulting efficiency gains that come from tailored rates and terms.

The fact that parties in the music industry are circumventing the relevant statutory license and CRO in favor of private ordering—not a costless endeavor—signals inefficiency in the statutory regime. While not without drawbacks, private ordering improves upon the conventional approach. Unlike the statutory license, private ordering allows for a predictable outcome tailored to the contemplated content and use. Just as penalty default rules can encourage more efficient information exchange between asymmetrical parties,[20] penalty default

(extending a critical view of utility theory as the dominant model of individual decision making under uncertainty in the field of social psychology).

17 "Bounded uncertainty" means a limited, controlled quantity of uncertainty, such as uncertainty about the future state of the law or uncertainty over a future statutory rate, as opposed to complete chaos, which could have precisely the opposite effect on efficiency. In this Article, "uncertainty" refers to bounded uncertainty.

18 Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 91 (1989).

19 *Id.* at 94. In other words, where a default rule results in an undesirable outcome for Party A (possessor of information unknown to Party B), Party A may be incentivized to negotiate around the default, thereby revealing his information publicly—not only to Party B but also to the legislature, which can use that information to draft better rules, default and otherwise.

20 *See id.* at 91 (introducing the concept of "penalty defaults" as "designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer").

licenses can encourage more efficient licensing among otherwise divergent parties.

Ultimately, this Article has two overarching goals: First, to propose that the statutory licensing regime for certain types of copyright-protected content can be made more efficient with penalty default licenses, and second, to suggest that uncertainty can lead to greater market efficiency by converting a default into a penalty default. Where much of the literature focuses on increasing stability and minimizing uncertainty to improve efficiency,[21] this Article makes the contrary case: To increase efficiency, legislators may utilize uncertainty to encourage private ordering under a statutory license. Awareness of the role uncertainty plays in increasing market efficiency in the statutory licensing context allows for more refined consideration of uncertainty generally, as well as its potential application in other areas of the law. Considerable amounts of time, money, and effort are spent chasing the elusive goal of stability.[22] The argument presented here—that uncertainty coupled with a penalty default might actually increase efficiency—provides a more cost-effective and attainable solution to the problem of market inefficiency.

Part I summarizes the rich literature on defaults and intellectual property rights that motivates the analysis and forms the basis for the subsequent case study. Part II analyzes the Clear Channel–Big Machine deal to show how inefficiencies in § 114 have both led to, and

---

21 *See, e.g.*, Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. CIN. L. REV. 127, 132 (2012) ("By reducing . . . uncertainty faced by parties in a transaction . . . earnouts can improve pricing efficiency."); William P. Johnson, *The Hierarchy That Wasn't There: Elevating "Usage" to Its Rightful Position for Contracts Governed by the CISG*, 32 NW. J. INT'L L. & BUS. 263, 268 (2012) ("As a consequence of [Uniform Commercial Code] bias, U.S. courts have utterly failed to recognize the different approach required by the [United Nations Convention on Contracts for the International Sales of Goods], leaving businesspersons engaging in international sales transactions with unnecessary and undesirable uncertainty regarding the terms of their sales contracts. That uncertainty increases transaction costs and undermines efficiency."). In the intellectual property context, see, for example, Ben Depoorter, *Technology and Uncertainty: The Shaping Effect on Copyright Law*, 157 U. PA. L. REV. 1831, 1862 (2009). In the context of adapting copyright rules to changes in technology, Professor Depoorter asks, "What initiatives can one undertake to *reduce* uncertainty and delay?" *Id.* at 1862 (emphasis added).

22 For example, legislators, industry players, and scholars have for years debated a statutory license for music sampling without success. *See, e.g.*, Robert M. Vrana, Note, *The Remix Artist's Catch-22: A Proposal for Compulsory Licensing for Transformative, Sampling-Based Music*, 68 WASH. & LEE L. REV. 811, 814 (2011) (arguing for a compulsory licensing scheme for musical recordings); George Howard, *Should There Be a Compulsory License for Derivative Works?*, TUNECORE BLOG (Apr. 17, 2013), http://blog.tunecore.com/2013/04/should-there-be-a-compulsory-license-for-derivative-works.html (proposing a compulsory license for derivative works).

yet do not fully explain, the recent circumvention deals. Specifically, it demonstrates that private ordering brings predictability, flexibility, and cooperation to a historically unstable and contentious industry, while also acknowledging the potentially unsavory impetuses motivating the parties, including a desire to influence the eventual statutory rate to the detriment of competitors. It concludes by asking why, given that the statutory license has always been inefficient, § 114 has not previously been circumvented, a question that the rest of the Article attempts to answer. Part III discusses the various challenges to circumvention, possible approaches for overcoming those challenges, and the potential drawbacks of circumvention. It ultimately proposes utilizing uncertainty as a sufficiently strong impetus for circumvention. Part IV makes the case for coupling uncertainty and penalty defaults in the market context, arguing that together they can induce private ordering to increase efficiency, while at the same time mitigating concerns about gamesmanship commonly associated with private ordering.[23] The Article concludes by demonstrating how this would apply in the highly controversial sampling context.

I
Theoretical Foundation

Contract doctrine recognizes rules as either immutable or default. Immutable rules, so named for their inalienability, are typically implemented where lawmakers seek to protect either parties to a contract or nonparties outside the contract.[24] Default rules minimize

23 There is often marked disparity in bargaining power between the parties involved in the licensing of sound recordings. Larger, more powerful parties may take advantage of their privileged positions in order to game the system—whether by unduly influencing industry custom or by striking influential deals that disadvantage competitors who are unable to match terms. These and other forms of gamesmanship are discussed in Part II.B.2.b.

24 *See* Ayres & Gertner, *supra* note 18, at 87 ("The legal rules of contracts and corporations can be divided into two distinct classes. The larger class consists of 'default' rules that parties can contract around by prior agreement, while the smaller, but important, class consists of 'immutable' rules that parties cannot change by contractual agreement."). Termination rights for sound recordings, 17 U.S.C. § 203 (2012), are an example of an immutable rule established to protect a party—in this case, recording artists—perceived as vulnerable relative to the record label. Section 203 allows an artist to terminate a grant of copyright thirty-five years after the date of execution of the grant. Congress established § 203 as an immutable rule in an effort to "safeguard[ ] authors against unremunerative transfers" and to specifically address "the unequal bargaining position of authors, resulting in part from the impossibility of determining a work's value until it has been exploited." H.R. Rep. No. 94-1476, at 124 (1976).This right cannot be waived and survives even in the face of an agreement to the contrary. 17 U.S.C. § 203(a)(5) ("Termination of the grant may be effected notwithstanding any agreement to the contrary . . . .").

transaction costs by mimicking what the parties would have wanted.[25] In this way, parties to a contract are spared the costs associated with private negotiation, while still achieving their desired outcome. Penalty default rules set a default that parties would not want in an effort to encourage them to contract around the default and set their own (more efficient) terms.[26]

As a form of contract, statutory licenses fall into these same two categories. Mandatory compulsory licenses—like § 111 for broadcast cable and § 119 for satellite television—are immutable. Circumventable compulsory licenses—like § 114 for sound recordings and § 115 for musical compositions—are defaults. A default license that is unpalatable to both parties, such as § 114, is a penalty default. Just as penalty default rules can encourage more efficient outcomes by encouraging information exchange among otherwise unequal parties, so too can penalty default licenses facilitate greater efficiency by encouraging opt-out and private ordering. This assumes the existence of a property right—in this case, an intellectual property right—and borrows from both the liability and property-rights schools of thought regarding the most efficient means of licensing that right.

Under a liability rights regime, content owners are compensated ex post (usually in accordance with a statutory rate) and any prospective licensee willing and able to pay the statutory rate may

---

While outside the scope of this Article, the protections intended by termination rights might be better served by conversion to a default. If termination rights were established as a default instead of an immutable rule, recording artists less concerned with future earnings than with current earnings would be able to "sell" the right as part of contract negotiations. In addition to the moral rights argument—i.e., that the artist, not Congress, is in the best position to decide what is best for him—there is also great value in this kind of signaling, particularly in the creative industries where the inherent creativity risk is difficult to hedge. *See, e.g.*, Ricard Gil & Pablo T. Spiller, *The Organizational Implications of Creativity: The U.S. Film Industry in Mid-XXth Century* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 13253, 2007), *available at* http://www.nber.org/papers/w13253 ("Creativity . . . generates particular informational asymmetries between creative talent and management . . . .").

[25] Ayres & Gertner, *supra* note 18, at 115–16 (discussing the "mimic-the-market" approach to default rules). Two commonly recognized categories of defaults are tailored and untailored: A tailored default aims to give the parties precisely what they would have contracted for, while an untailored default simply aims for a standard that most parties would have contracted for. *See, e.g.*, Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 4 (1993) ("Untailored ('off-the-rack') defaults are rule-like because they are contingent on fewer variables, while tailored defaults are standard-like because they are contingent on more variables concerning the attributes or conduct of the particular contracting parties.").

[26] Ayres & Gertner, *supra* note 18, at 91. Ayres and Gertner see penalty default rules as useful for filling contractual gaps that can result from information asymmetry and strategic behavior by contracting parties. *Id.* They conclude that "a penalty default should be used if it results in valuable information revelation with low transaction costs." *Id.* at 128.

procure a license under standard terms.[27] A property rights regime, in contrast, requires ex ante negotiation and agreement between licensee and licensor.[28] A penalty default license blends the two regimes by setting an unpalatable ex post rate[29] (a liability rule) to force more efficient ex ante negotiation (a property rule). In other words, the penalty default licensing regime proposed by this Article uses an unpalatable liability rule to encourage the substitution of a more efficient property rule.

Ronald Coase demonstrated that so long as property rights are well established and transaction costs are negligible, their initial allocation does not matter because the parties will negotiate among themselves to reach the maximally efficient allocation.[30] Fittingly, Coase developed his famous theory while working on the problem of radio frequency regulation.[31] In 1959, when Coase was conducting his research, all radio stations could use the same tuning frequencies, thereby potentially interfering with each other's broadcasts.[32] Coase determined that so long as property rights in those frequencies were well defined (regardless of to whom those property rights were assigned), the radio station that most highly valued broadcasting on the frequency at issue would have an incentive to negotiate with (i.e., pay) the interfering station(s) to stop using that same frequency.[33] In other words, in the absence of transaction costs, the individual radio stations would negotiate among themselves to reach the optimally efficient allocation of rights. The station with more to gain from the uninterrupted use of a frequency would pay for its exclusive use, while the station with more to gain from selling its use of the frequency

---

27 *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972) (defining liability rules).

28 *See id.* (defining property rules); Robert P. Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CALIF. L. REV. 1293, 1302 (1996) (discussing property rules and liability rules in the context of CROs).

29 To avoid gamesmanship, this rate must be unpalatable to both parties, though not necessarily equally so. Thus, even though a more established party may be better able to sustain rate uncertainty than a start-up, unpalatability is unpalatability. Both parties simply need to have something to gain through private negotiation, even if those gains are disparate. That unpalatability can stem from a variety of factors—in this case, uncertainty about the future state of the law.

30 *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) ("It is always possible to modify by transactions on the market the initial legal delimitation of rights. And, of course, if such market transactions are costless, such a rearrangement of rights will always take place if it would lead to an increase in the value of production.").

31 *See* R.H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1 (1959) (exploring the Federal Communications Commission's regulation of broadcasting).

32 *Id.* at 5 (discussing the "chaos in broadcasting" resulting from this practice).

33 *Id.* at 25.

would acquiesce and accept payment, making both parties better off. The debate over how to best allocate these property rights has led to a rich literature on liability versus property rules.

The liability-rule school of thought calls for ex post payment, usually via a statutory license that ensures access to content for all prospective licensees willing to pay the statutory rate. In their seminal work on property rights, Professors Guido Calabresi and A. Douglas Melamed establish a preference for liability rules as the most efficient means of collective valuation in intellectual property.[34] This collective valuation, as determined by a court or legislative body, is embodied in a statutory license[35] and is intended to minimize transaction costs. Indeed, compulsory licensing occurs in industries such as sound recordings and cable broadcasting in which individual negotiation with numerous, disparate rights holders would be both time and cost prohibitive. Compulsory licensing in these industries allows for efficient en masse licensing of content and subsequent scalability of service where individual transactions are not practicable.[36] In their work on bargaining and rights allocation, Professors Ian Ayres and Eric Talley suggest that liability rules can encourage more efficient contracting.[37] They also posit that ambiguity can induce cooperation.[38] The Clear Channel–Big Machine case study provides a real-world example of this type of cooperation.[39]

The property-rule school of thought requires ex ante negotiation, often in the form of a blanket license issued by a CRO like the American Society of Composers and Publishers (ASCAP) or Broadcast Music, Inc. (BMI). In his work on CROs, Professor Robert Merges champions the position that property rules are more efficient than liability rules for the licensing of intellectual property because rights holders can and will contract those rights away when it is

[34] *See* Calabresi & Melamed, *supra* note 27, at 1110 ("[T]he collective valuation involved in liability rules readily lends itself to promoting distributional goals.").

[35] In some industries, such as music publishing, a collective valuation may alternatively be established by a CRO, such as the American Society of Composers and Publishers (ASCAP).

[36] Part II.B.1 questions whether the bulk licensing justification for compulsory licensing is losing ground in the new digital age.

[37] *See* Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1033 (1995) ("[L]iability rules may induce both *more contracting* and *more efficient contracting* than property rules.").

[38] *See id.* at 1035 (using economic modeling to show "how ambiguity can induce bargainers to act more cooperatively").

[39] *See infra* Part II (detailing the benefits for both Clear Channel and Big Machine in circumventing § 114 and the traditional deal structure).

efficient to do so, thereby avoiding "transactional bottleneck[s]."[40] In response to Calabresi and Melamed's case for liability rules, Merges counters, inter alia, that a property rights regime is preferable insofar as it is more likely to lead to the formation of CROs.[41] Merges explains that in the absence of a compulsory licensing regime, an industry can and will minimize costs[42] and increase efficiency by setting up CROs to assign a collective valuation.[43] He thus recommends a property rule approach for industries such as content licensing where parties engage in repeat interaction.[44]

Interestingly, the establishment and administration of a collective valuation by a CRO in an industry like digital music licensing—whose inception came after the establishment of the statutory license, such that there is not and never has been a real market for it—is effectively a liability-rule regime, except that the rate is set by the relevant CRO instead of by statute.

Despite popular acceptance of CROs as useful for concentrating bargaining power and setting a collective valuation,[45] CROs fare no better than statutory licenses at differentiating among individual valuations. Merges recommends the establishment of CROs as a means of "expert tailoring,"[46] but while a CRO such as ASCAP dedicated to the licensing of musical compositions may be able to tailor a rate specific to that genre of content, its blanket licenses do

---

[40] Merges, *supra* note 28, at 1295. In a recent article, Professor Mark Lemley questions the import of this conclusion by pointing out that intellectual property rights owners can and do contract around liability rules just as easily. Mark A. Lemley, *Contracting Around Liability Rules*, 100 CALIF. L. REV. 463, 464–65 (2012) ("True, parties can contract around inefficient property rules in IP cases. But . . . they can—and do—contract around inefficient liability rules as well."). The case for penalty default licenses, as presented in this Article, provides proof of exactly that. In support of his argument, Lemley cites, among other examples, the formation of SoundExchange, the CRO governing the collection and administration of digital performance rights for sound recordings: "It was the creation of a legal [digital performance] right, not the creation of a property rule to enforce that right, that drove the founding of collective rights organizations to administer public performance rights." *Id.* at 478.

[41] Merges, *supra* note 28, at 1295.

[42] *See id.* at 1302–03 ("It is the high transaction costs associated with the initial entitlements that lead the parties to establish the [CRO]—an organization that then dramatically lowers the costs of exchanging the rights.").

[43] *See id.* at 1296 ("What separates private CROs from compulsory licensing schemes is that the former have proven to be more flexible over time.").

[44] *See id.* at 1297 ("[P]roperty rule entitlements may be superior in other situations where right holders encounter each other frequently.").

[45] *See id.* at 1294 (noting that CROs "promulgate rules and procedures for placing a monetary value on members' property rights" and thereby "conserve on transaction costs either by making it easier to identify and locate rightholders, or by creating the occasion for repeat-play, reciprocal bargaining").

[46] *See id.* at 1295 (citing "expert tailoring" as one distinct advantage of CROs).

nothing in the way of recognizing different values for the individual pieces of music in its catalog. The tailoring performed by CROs is too broad to be "expert" in any meaningful sense because it frequently encompasses entire genres (e.g., sound recordings, musical compositions, and films) without regard to specific pieces of content contained within these genres.[47]

As to whether CROs are efficient at setting "market rates," there is insufficient data to make that determination. Until very recently CROs like ASCAP prevented development of an actual market for the licensing of musical compositions.[48] To the extent opt-out indicates CRO failure, however, one need look no further than the recent broadcaster deals, all of which explicitly circumvented Sound Exchange.[49] And at the beginning of the year, the nation's largest music publisher (Sony/ATV) announced that it would henceforth handle all of its content licensing in private deals, on a case-by-case basis, thereby withdrawing all of its content from ASCAP.[50]

Merges blames the popularity of the statutory license in intellectual property on the high cost of transacting multiple deals with multiple partners and argues that the same economy can be more flexibly accomplished through CROs.[51] Recent private content deals cut against this argument, however. Like Merges, I believe that statutory licenses lack the requisite flexibility to best serve intellectual property licensing in the new digital age. Unlike Merges, however, I believe CROs share that defect[52] and thus argue that the inflexibility

---

[47] In the CROs' defense, it may be the case that tailoring is not worth it in the collective. Future work will more fully examine the evolving role and questionable efficiency of CROs.

[48] Until the recent attempts at CRO circumvention, almost all music publishing licensing was done through CROs so that there was no private market from which to cull a market rate.

[49] *See supra* notes 8–10 and accompanying text.

[50] Sony/ATV's withdrawal paid off. On January 17, 2013, they signed a direct licensing deal with Pandora for a digital performance rate twenty-five percent higher than ASCAP's going rate. *See, e.g.*, *Sony/ATV Negotiates 25% Royalty Increase from Pandora: Report*, BILLBOARDBIZ (Jan. 17, 2013, 8:01 AM), http://www.billboard.com/biz/articles/news/publishing/1510421/sonyatv-negotiates-25-royalty-increase-from-pandora-report (describing Sony/ATV's negotiation with Pandora for a higher rate than earned under ASCAP). This advantage appears to have ended, however. Shortly after Sony/ATV's withdrawal, Pandora sued ASCAP to enforce its five-year blanket license, which included (at the time of signing) all rights to the Sony/ATV repertoire. On September 17, 2013, the court held for Pandora, denying content owners the right to parcel digital (or "new media") from other rights. *In re* Pandora Media, Inc., No. 12 Civ. 8035, 2013 WL 5211927, at *30 (S.D.N.Y. Sept. 17, 2013).

[51] *See* Merges, *supra* note 28 (making the case for CROs in intellectual property).

[52] A full discussion of CROs' legal and economic shortcomings and whether they might be fixed (e.g., by the institution of mandatory participation) or ought to be scrapped altogether will be addressed in future work. Until then, interested readers should see Ivan

(and, by extension, uncertainty) of statutory licenses is precisely why they should be kept—to encourage a truly flexible and efficient valuation process through private ordering. This Article makes the case that more, not less, compulsory licensing can actually increase efficiency in intellectual property licensing, so long as it has been converted into a penalty default license via uncertainty.[53]

While ultimately favoring a property-rule regime, this Article departs from the received wisdom regarding the choice of rate-setting entities. Unlike Merges's argument in favor of CROs as the optimal means of establishing value in an intellectual property rights regime,[54] this Article argues that, while not perfect, private ordering offers a more efficient, flexible, and responsive valuation option. As the penalty default license approach involves a statutory license, it necessarily invokes government action. Professors Peter DiCola and Matthew Sag recognize the government as a third party in intellectual property rights licensing: "We seek to augment the two-player conception of [content licensing as between content owners and technology companies] and to supplement the property-rights framework with a detailed analysis of the government institutions that create, monitor, and enforce property rights."[55] Indeed, in the context of the Clear Channel–Big Machine deal and its progeny, the government's "threat" of a statutory terrestrial performance right has encouraged private licensing and greater market efficiency.

Examples abound of uncertainty's influence on decisionmaking behavior, and the idea has been widely acknowledged in other literatures.[56] The idea that defaults can influence behavior for the

---

Reidel's work suggesting that the blanket licenses of performing rights organizations (PROs), a specialized type of CRO in the music publishing industry, might not only be inefficient, but even illegal from an antitrust perspective. *See* Ivan Reidel, *The Taylor Swift Paradox: Superstardom, Excessive Advertising and Blanket Licenses*, 7 N.Y.U. J.L. & BUS. 731, 737 (2011) (declaring blanket licenses to be "illegal restraints of trade" and calling for urgent reform of DOJ enforcement practices).

53 This Article focuses on penalty default licensing but recognizes that, to the extent CROs share statutory licenses' tendency toward inflexibility and nonresponsiveness, they too serve as an unpalatable fallback option and their proliferation could also function to encourage more, and more efficient, private ordering (so long as they are not mandatory).

54 *See* Merges, *supra* note 28, at 1295 (citing "two distinct advantages of CROs: expert tailoring and reduced political economy problems").

55 Peter DiCola & Matthew Sag, *An Information-Gathering Approach to Copyright Policy*, 34 CARDOZO L. REV. 173, 176 (2012).

56 *See, e.g.*, *supra* note 16 (recognizing the behavior-influencing properties of uncertainty). In the enforcement context, for example, uncertainty has been associated with higher compliance rates. Of course, an optimally efficient solution would be a one hundred percent enforcement rate and imposition of an appropriate fine. But society settles for less than one hundred percent enforcement—in the context of speeding, for example—because enforcement is costly. *See generally* William M. Landes & Richard A.

better is also well established in the legal literature. Professors Cass Sunstein and Richard Thaler popularized this principle in their influential work on libertarian paternalism, suggesting that "[w]hat [people] choose is strongly influenced by details of the context in which they make their choice, for example default rules . . . ."[57] The Clear Channel–Big Machine deal and its progeny extend this analysis by showing that uncertainty, when coupled with a penalty default, can not only influence behavior but also improve efficiency in the marketplace.

Unlike libertarian paternalism, which assumes that people will stick to the default and consequently focuses on choosing the *best* default, penalty default licenses assume that uncertainty can encourage circumvention. This view focuses on selecting an *unpalatable* default. Both approaches aim to produce a welfare-maximizing result. Penalty default licenses recognize that uncertainty has the same efficiency-promoting effect on market behavior as it does on individual behavior. Just as risk-averse individuals can be motivated to make better decisions when faced with an unpalatable alternative, so too can contracting entities be encouraged to negotiate more efficient deal terms to avoid an unpalatable default. In the statutory licensing context, uncertainty converts the statutory license into a penalty default license. The default nature of the license helps to encourage risk-averse players to engage in private ordering. This is

---

Posner, *An Economic Analysis of Copyright Law*, 18 J. LEGAL STUD. 325, 332–33, 349–59 (1989) (discussing the enforcement costs in the copyright context).

Uncertainty's effect on choice is also seen in the collective action context. For example, on January 13, 1950, the Soviet Union announced its boycott of the U.N. Security Council in response to the defeat of a Soviet proposal to expel the Nationalist Chinese representative. This resulted in the absence of a Soviet delegate from the first ever U.N. vote on military action. At that meeting, the Security Council voted to send troops to South Korea in retaliation for the North Korean attack there. *See Jan 13, 1950: Soviets Boycott United Nations Security Council*, HISTORY, http://www.history.com/this-day-in-history/soviets-boycott-united-nations-security-council (last visited Sept. 9, 2014). Had they attended, the Soviets could have blocked the action with their absolute veto, but they missed the opportunity, teaching the world a valuable lesson: It is better to join the group than to suffer the uncertainties of being bound by collective action anyway, only without any say. There is also the concern of appearing disagreeable to the collective agenda, especially where group practices might eventually become industry norms (or, in the Soviet example, accepted as customary international law).

[57] Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1161 (2003); *see also* Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2044 (2012) (advocating a kind of libertarian paternalism that uses altering rules—i.e. rules that establish the necessary and sufficient conditions for displacing a default—"to encourage contracting parties to choose the default or nondefault options that they jointly prefer"). This Article argues for the use of penalty default rules to encourage the parties to choose a mutually agreeable nondefault option.

wholly consistent with prospect theory, which holds that people make decisions based on valuations of the potential losses and gains.[58]

The application of behavioral economics to law, and especially to the market for intellectual property, has occasionally been criticized as contrived and overly hypothetical: "A significant concern for the behavioral law and economics policy agenda is that biases documented in experimental settings may not prove robust when exposed to market institutions."[59] Unlike the "laboratory" findings lamented by Professor Joshua Wright and Judge Douglas Ginsburg, however, the Clear Channel–Big Machine deal and its successors offer a real-world, practical application of behavioral economics in the marketplace and in copyright law in particular. Section 114 and the recent broadcast deals demonstrate the efficiency-enhancing value of bounded uncertainty in the market. Not only does this uncertainty work to overcome the tendency of defaults toward stickiness, it also mitigates concerns about inequality and gamesmanship by serving as an unpalatable fallback for *both* licensees and licensors.

In the case of § 114, the impetus for private action comes from uncertainty about the future state of the law and future digital business models. This uncertainty is "bounded" in the sense that while neither licensees nor licensors know exactly when a statutory terrestrial performance right will be granted (or what its eventual royalty rate will be), there are a few known parameters that differentiate it from unbounded uncertainty. For example, the parties know that the statutory terrestrial performance right will most likely

---

[58] The seminal paper discussing this phenomenon is Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

[59] Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1044 (2012) ("Indeed . . . many . . . of the behaviorists' findings are fragile and disappear when exposed to market discipline . . . ."). Professor Wright and Judge Ginsburg reference, among others and by way of example, the experiment conducted by Professors Christopher Buccafusco and Christopher Sprigman (who, it should be mentioned, make no claim of its application to the marketplace). *Id.* at 1042 n.34. In their experiment, Buccafusco and Sprigman tested the existence of the endowment effect in intellectual property. Using mostly undergraduate students at the University of Virginia, the professors paid them for half an hour of study at a computer lab in which the subjects wrote haikus and were asked to select among options with varying levels of monetary value and ownership. *See* Christopher Buccafusco & Christopher Sprigman, *Valuing Intellectual Property: An Experiment*, 96 CORNELL L. REV. 1, 17–25 (2010) (describing their experiment). Specifically, Wright and Ginsburg allege that "profit motive, which create[s] incentives for participants to specialize and to learn to reduce their errors," is "not present in the laboratory." Wright & Ginsburg, *supra*, 1044–45. Profit motive is, however, present in the Clear Channel–Big Machine case study presented in Part II.C.

come to exist[60] and that, when it does, it will most likely be established in the form of a statutory license (i.e., a fallback option) that will be collected and administered by a CRO.[61] They may not know how long it will take digital services to surpass terrestrial services as the radio format of choice, but they know that this will happen eventually.[62] The next Part describes the history and general terms of the Clear Channel–Big Machine deal to demonstrate the efficiency-enhancing benefits of private ordering induced by bounded uncertainty.

II
The Present: Circumventing Inefficiency

By virtue of its inherent flexibility and personalization, private ordering improves on the inefficiencies of the statutory license in several ways. First, it allows for a negotiated rate tailored specifically to the content and use in question, which may better align incentives between the parties. In addition, a privately negotiated deal can be repeatedly amended in response to technological developments and changing consumer preferences in real time. This allows for greater experimentation in business models, potentially bringing better services to market. Finally, private deal making takes market valuations into account, resulting in more accurate pricing for consumers and better alignment of licensors' incentive to create with licensees' incentive to invest.

Yet if private ordering is more efficient than statutory licensing, why was the Clear Channel–Big Machine deal the first one to circumvent § 114? Why might a party stick with an inefficient default? The exploration of these questions begins with a brief look at the history of terrestrial performance rights and an examination of how statutory licensing works.

A. Terrestrial Performance Rights and Statutory Licensing

Before turning to the Clear Channel–Big Machine deal, a brief overview of the controversy surrounding terrestrial performance rights is necessary to appreciate its import. Music is protected by two

---

60 *Infra* notes 172–75 and accompanying text.

61 *See* Chris Castle, *Guest Post: Meet the Free Market Royalty Act, an Elegant Solution to Some Complex Issues*, Billboardbiz (Oct. 1, 2013, 12:43 PM), http://www.billboard.com/biz/articles/news/legal-and-management/5740706/guest-post-meet-the-free-market-royalty-act-an (discussing the Act as "a logical step in SoundExchange's evolution to authorize it to issue blanket licenses, continue to collect and pay royalties and to audit licensees").

62 *See infra* notes 121–23 and accompanying text (noting the decline of terrestrial radio and the rapid growth of digital radio).

distinct copyrights: one on the underlying musical composition[63] (the "mechanical" right) and one on the aural representation of that composition[64] (the "master" right). The latter covers sound recordings—popularly termed "songs" or "tracks"—and is governed by the statutory license in § 114. Generally, recording artists and songwriters assign their copyrights to intermediary record labels and music publishers, respectively, who then license and collect royalties on those works.

An exclusive right of public performance derives from these mechanical and master rights.[65] It entitles copyright holders to statutory royalties when their sound recordings or compositions are played publicly.[66] For compositions, the performance right attaches both digitally (e.g., Internet radio) and terrestrially (e.g., traditional broadcast radio). For sound recordings, however, the performance right only attaches digitally (not terrestrially). A spin of Taylor Swift's *We Are Never Ever Getting Back Together*[67] on a local broadcast radio station, therefore, would require that a performance royalty be paid to the owner(s) of the mechanical copyright (songwriters Taylor Swift, Max Martin, and Shellback, in accordance with their respective publishing deals, and Sony/ATV)[68] but not to the owner(s) of the sound recording (Taylor Swift and Big Machine). A spin of the same track on an Internet radio station like Pandora, however, would require that performance royalties be paid to both copyright holders.[69]

If all of this strikes the reader as unduly complicated, the reader is in good company. Proponents on both sides of the issue agree on only one thing: The system stinks. Inequality between digital and terrestrial performance royalties for sound recordings has long been a point of contention. Broadcasters have traditionally resisted a performance right for sound recordings on the basis that radio programming provides a valuable promotional service to artists and

---

63 17 U.S.C. § 102(a)(2) (2012).

64 17 U.S.C. § 102(a)(7).

65 *See* 17 U.S.C. § 106(4) (2012) (affording the copyright owner the exclusive right, "in the case of . . . musical . . . works, . . . to perform the copyrighted work publicly"); § 106(6) (affording the copyright owner the exclusive right, "in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission").

66 17 U.S.C. §§ 114(d)(2), 115 (2012).

67 TAYLOR SWIFT, *We Are Never Ever Getting Back Together*, *on* RED (Big Machine Records 2012).

68 *Id.*

69 Note that a spin of the same track on a preexisting satellite radio station like SiriusXM would also require royalties be paid to both, but at a significantly lower rate for the sound recording (whereas the composition rate would remain the same). *See* 17 U.S.C. § 114(d)(2) (setting forth differential treatment for preexisting services).

record labels, and, as such, they should not have to pay for plays.[70] Music publishers and songwriters, worried that a performance right for sound recordings would cut into their performance royalties for compositions, sided with broadcasters to successfully block a performance right for sound recordings from the Copyright Act of 1976.[71] It was nearly twenty years later before a performance right for sound recordings was finally instituted, and even then only for digital (not terrestrial) broadcast.[72]

The debate over terrestrial performance rights does not appear to have lost any steam. In a March 2013 speech at Columbia University, Register of Copyrights Maria Pallante called for "a more complete right of public performance for sound recordings."[73] Meanwhile, NAB insists that "NAB and broadcasters have been, and continue to be, *unalterably opposed* to the Performance Rights Act since it was first introduced in 2007."[74] In the midst of this ongoing debate, Representative Mel Watt introduced the latest iteration of a terrestrial performance rights act (the unfortunately titled "Free Market Royalty Act"[75]) on September 30, 2013. As discussed further in Part III.A,

---

[70] For an example of a payola story, see *New Settlement in Payola Probe*, ABC NEWS (May 11, 2006, 1:15 PM), http://abcnews.go.com/blogs/headlines/2006/05/new_settlement_/, which quotes then–New York State Attorney General Eliot Spitzer as finding that "UMG has illegally provided radio stations with financial benefits to obtain airplay and boost the chart position of its songs." Interestingly, empirical analysis does not support the entrenched notion that airtime is something worth paying for. Recent statistical analysis finds no determinative evidence that radio play boosts record sales. *See, e.g.*, Stan J. Liebowitz, *The Elusive Symbiosis: The Impact of Radio on the Record Industry*, 1 REV. ECON. RES. ON COPYRIGHT ISSUES 93, 118 (2004) ("The evidence from this empirical examination indicates that, contrary to common beliefs, radio broadcast does not enhance the market for sound recordings."). Furthermore, the broadcasters' position is notably weakened by the payment of performance royalties by digital radio stations, which provide similar promotional value. In fact, a convincing argument might be made that digital radio—with its ability to track listener behavior—has the potential to bring even more such value in the form of user metrics.

[71] *See, e.g.*, John R. Kettle III, *Dancing to the Beat of a Different Drummer: Global Harmonization—And the Need for Congress to Get in Step with a Full Public Performance Right for Sound Recordings*, 12 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 1041, 1053 (2002) ("Joining the NAB's position against a full public performance right for sound recordings are songwriters, music publishers, and performing rights societies. They claim it is the songwriter and music publisher who will lose a substantial portion of income.").

[72] Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (codified as amended in sections of 17 U.S.C. §§ 106, 114).

[73] Maria A. Pallante, Register of Copyrights of the U.S. & Dir. of the U.S. Copyright Office, The Next Great Copyright Act, Twenty-Sixth Horace S. Manges Lecture at Columbia Law School (Mar. 4, 2013), *in* 36 COLUM. J.L. & ARTS 315, 324 (2013).

[74] NAT'L ASS'N OF BROADCASTERS, THE PERFORMANCE RIGHTS ACT PUTS LOCAL JOBS AT RISK (2011) (emphasis added), *available at* http://www.nab.org/documents/advocacy/performanceTax/PerformanceTaxIssueSheet0911.pdf.

[75] H.R. 3219, 113th Cong. (2013); *see also* 159 CONG. REC. E1404–05 (daily ed. Sept. 30, 2013) (statement of Rep. Watt) [hereinafter Rep. Watt's Statement] (calling the Free

never before has the threat of a statutory terrestrial performance royalty been so imminent. When deemed credible, "the *threat of legislation in and of itself*, rather than legislation, plays a remarkable role in controlling behavior, in setting underlying incentives, in maintaining social order, and in inducing change and effecting social policy."[76] The effect of such legislative uncertainty can be seen at play in the Clear Channel–Big Machine deal, along with the inefficiencies of statutory licensing.

Statutory, or compulsory, licenses[77] constitute open offers that allow for the use of certain types of copyright-protected content without requiring permission from, or agreement with, the rights holder.[78] In most cases, a statutory rate and standard terms of use are set and available to all licensees willing and able to comply. This system ensures access to content for all comers regardless of size, market share, or bargaining power. It reduces the potential for anticompetitive behavior by both licensors, who would otherwise be able to demand exorbitant rates or withhold content from competitors, and licensees, who might otherwise outbid smaller players in such a way as to cut them out of the market altogether. In the absence of a statutory licensing regime, smaller, less powerful licensees could be denied access to a licensor's intellectual property.

Accordingly, this Article does not advocate for elimination of the statutory license, despite its inefficiencies. Indeed, as will be shown, inefficiencies can provide the impetus for parties to engage in private ordering. The rest of this Part considers the inefficiencies that motivated the parties in the Clear Channel–Big Machine deal to circumvent § 114.

B. Taylor Swift: A Case Study

In June 2012, media conglomerate and content licensee Clear Channel entered into a private licensing deal with independent record

---

Market Royalty Act "an agreement that would end the years of waiting for fair pay for airplay").

[76] Guy Halfteck, *Legislative Threats*, 61 STAN. L. REV. 629, 635 (2008).

[77] Although the terms "statutory" and "compulsory" are often used interchangeably to refer to the various statutory licenses governing the licensing of intellectual property, there is a linguistic distinction worth mentioning. In general use, compulsory is understood as a synonym for "mandatory." 17 U.S.C. § 111, the statutory license for broadcast cable, is an example of a compulsory license in the mandatory sense of the word—all licensees and licensors are obligated to operate under it. Section 114, in contrast, is compulsory only insofar as a licensor cannot refuse to license to any prospective licensee willing and able to pay the statutory rate. Parties are not required to operate under § 114, however, and instead may opt to circumvent the license altogether in favor of private ordering.

[78] *See, e.g.*, 17 U.S.C. § 111 (2012) (broadcast cable); *id.* § 114 (sound recordings); *id.* § 115 (musical compositions); *id.* § 119 (satellite television).

label and content licensor Big Machine, granting it the hotly contested terrestrial performance right. It did so by circumventing § 114, another unprecedented move. Under the terms of the deal, both digital and terrestrial performance royalties are paid directly from Clear Channel to Big Machine, thereby circumventing SoundExchange's role as a CRO.[79] This arrangement saves the parties money on two fronts: (1) SoundExchange's administrative fee, and (2) the direct-to-artist payment requirement under § 114(g)(2).[80]

The Clear Channel–Big Machine deal makes for an interesting case study not only because it establishes an obligation to pay that seems to run contrary to the parties' respective bargaining positions, but because it departs from the traditional broadcaster position on terrestrial performance rights. As CBS President and CEO Les Moonves commented to the press shortly after the announcement of the Clear Channel–Big Machine deal: "The idea that we have to pay [record labels] to put their music on our radio stations is absurd."[81] This statement echoes the NAB's response to the announcement of the deal: "NAB remains steadfastly opposed to a government-mandated performance tax on local radio stations . . . ."[82]

In exchange for this unprecedented creation of a terrestrial performance royalty for sound recordings, the parties agreed on a lower digital performance royalty than provided for in the statutory license. Both royalties replace the statutory license's fixed, per-play rate with a rate set as a share of advertising revenues. While the terms of the deal lower Big Machine's share of the pie by reducing the digital performance royalty vis-à-vis the statutory rate, they also substantially enlarge the size of the pie by giving Big Machine access to all of Clear Channel's terrestrial advertising revenues.[83]

---

[79] *See, e.g.*, Christman, *supra* note 8 ("[S]ince the deal is a negotiated rate, payments will bypass SoundExchange and be made directly to the label . . . .").

[80] Section 114(g)(2) lays out a distribution scheme for royalties collected under the statute. This scheme includes payment of a portion of royalties directly to artists, which can be avoided by circumventing the statute altogether. *See infra* Part II.B.2.a (outlining how private ordering improves upon the statutory license).

[81] Ben Sisario, *Taylor Swift's Record Label Continues Its Online-Offline Royalties Experiment*, N.Y. TIMES (Sept. 20, 2012, 1:59 PM), http://mediadecoder.blogs.nytimes.com/2012/09/20/taylor-swifts-record-label-continues-its-online-offline-royalties-experiment/; *accord* AM. TELEVISION ALLIANCE, FOR BROADCASTERS, FLIP-FLOPS NEVER GO OUT OF SEASON (2013), *available at* http://www.americantelevisionalliance.org/wp-content/uploads/2013/05/ATVA_FactSheet_Flip_Flop_v9.pdf.

[82] Ed Christman, *NAB, Recording Academy Weigh In on Clear Channel–Big Machine Royalty Deal*, BILLBOARDBIZ (June 5, 2012, 5:16 PM), http://www.billboard.com/biz/articles/news/1094626/nab-recording-academy-weigh-in-on-clear-channel-big-machine-royalty-deal.

[83] *See* Luiz Buff & Nicholas Spanos, *Clear Channel's Giant Step*, MUSIC BUS. J., July 2012, at 6, *available at* http://www.thembj.org/wp/wp-content/uploads/2012/07/MBJ-July-

Clear Channel is a large company employing more than 20,000 people[84] and reporting $1.63 billion in revenue for the quarter ending June 30, 2014.[85] Big Machine, in contrast, is a small, independent record label. As of this writing, the label had all of six recording artists on its roster.[86] The fact that the market-dominant Clear Channel has agreed to pay Big Machine—a relative little guy—for content use that does not trigger a legal payment obligation suggests that the concern over the imbalance of power between licensees and licensors is overblown. Since the signing of the Clear Channel–Big Machine deal in June 2012, a series of similar agreements between these and other licensees and licensors has been completed.[87]

Why are these deals taking place notwithstanding significant differences in bargaining power? Several selfish motivations have been suggested—the opportunity to set a market rate, the disadvantage to competitors, the intent to signal a threat to larger partners—but they are only part of the story. As discussed in the next Part, uncertainty about the future state of terrestrial performance rights and future digital business models is unfavorable for both licensee and licensor, thereby leveling the playing field in a way that has heretofore gone unrecognized. Unlike the statutory license, the Clear Channel–Big Machine deal offers a stable, predictable outcome tailored to the covered content and its contemplated use.

The Clear Channel–Big Machine deal can thus be framed as both a business deal motivated by efficiency concerns and a shrewd preemptive move prompted by anticompetitive motivations. Both explanations are correct and both hinge upon uncertainty about the future legal status of terrestrial performance rights and future digital business models.

First, the efficiency explanation: Spurred by an inefficient statutory license, Clear Channel and Big Machine circumvented § 114 and created a new, private intellectual property right—the terrestrial performance right—that better serves their needs and the demands of their consumers in the new, digital environment. Dozens of copycat deals have followed, bringing predictability and cooperation to a historically unstable and contentious industry while correcting many

2012-Final.pdf (describing the deal as a "free market solution" that may ultimately set a "new standard for royalty payments on broadcast radio").

84 *Investor FAQ*, CLEARCHANNEL, http://www.clearchannel.com/Investors/Pages/FAQ.aspx (last visited Sept. 9, 2014).

85 Clear Channel Commc'ns, Inc., Quarterly Report (Form 10-Q) (July 23, 2014).

86 *See Big Machine Records*, BIG MACHINE LABEL GROUP, http://www.bigmachinelabelgroup.com/label/big_machine_records (last visited Sept. 9, 2014).

87 *See supra* note 10 (citing sources discussing three such deals).

of the inefficiencies of the extant, one-size-fits-all statutory regime. These parties are thus making their own efficiency through private ordering.

Next, the self-interested explanation: Though the statutory terrestrial performance right does not currently exist, it very likely will soon,[88] and the eventual statutory rate and terms are uncertain. By being "first to market" with a valuation, Clear Channel stands to have its private rate adopted industry-wide—both informally, via industry norms stemming from repetition of the rate in subsequent deals, and formally, via mandatory adoption by the Copyright Royalty Board (CRB)[89] in the absence of an alternate rate.[90] This would not only ensure an acceptable rate for Clear Channel but could impose hardship on competitors who value their digital businesses differently. The same might be said of Big Machine, who could secure preferential treatment for its artists at the expense of its competitors.[91]

Moreover, terrestrial radio is on the decline, while digital radio is on the rise.[92] It thus makes more sense for Clear Channel to give on the former, in return for better terms on the latter. It is especially interesting that Clear Channel completed its first such deal with Big Machine,[93] given the label's status as an independent record label distributed through a major label.[94] Clear Channel was almost

---

[88] *See infra* notes 172–75 and accompanying text.

[89] The CRB holds hearings every five years to set the statutory royalty rates under §§ 114 and 115 for the subsequent five-year period. 17 U.S.C. § 804(b)(1) (2012) ("Any change in royalty rates made under this chapter . . . may be reconsidered in the year 2015, and each fifth calendar year thereafter . . . .").

[90] In the case of sound recordings, a value presented to the CRB as representative of the market rate is adopted if, after publication in the Federal Register with a call for comments, there are no effective objections. *See* 17 U.S.C. §§ 801–803 (2012) (outlining the authority and qualifications of Copyright Royalty Judges). In a 2009 rate-setting proceeding concerning digital phonorecord delivery, for example, the rate court said, "[W]e have no choice but to adopt [the private valuation] as the basis for the necessary statutory rates and terms applicable to the corresponding licensed activities. . . . The statute [17 U.S.C. §§ 801–803] provides that the settlement is an adjustment of rates and terms by the parties that we *must* adopt." Mechanical and Digital Phonorecord Delivery Rate Determination Proceeding, 74 Fed. Reg. 4510, 4515 (Jan. 26, 2009).

[91] For example, Big Machine might be able to secure one of Clear Channel's billboard properties to promote a new Taylor Swift album, or may be able to lock her into the headlining position on Clear Channel's iHeart Radio Music Festival, thereby denying these opportunities to other artists.

[92] Digital advertising revenues are projected to increase by more than double digits between 2014 and 2021, while Internet-only radio is expected to nearly quadruple. *See* SNL KAGAN, ECONOMICS OF INTERNET MUSIC AND RADIO 8, 13 (2011).

[93] Clear Channel has subsequently completed comparable deals with Glassnote, DashGo, rpm Entertainment, Robbins Entertainment, Naxos, and Entertainment One Music, among others. *See supra* note 10.

[94] Big Machine is currently distributed by Universal Music Group Distribution, a wholly owned subsidiary of Universal Music Group, one of the three remaining major

certainly aware that word of this deal would get back to the major labels, perhaps serving as a not-so-subtle threat to sign on or be left behind.[95]

Under both explanations—efficiency and self-interest—the parties' motivation to circumvent § 114 stems from the statutory license's inefficiencies and the potential to achieve better results through private agreement.

1. *Statutory Inefficiency*

Section 114 is unnecessarily complicated and inefficient. It is inefficient because parties who circumvent the statutory license and negotiate private terms fare better than they would under the license. And when this circumvention takes place under a penalty default license, such as § 114, they fare better without making parties who continue to operate under the statutory license worse off.[96]

As a statutory license for copyright-protected content, § 114 sets a statutory rate for a specified time period, after which the rate is subject to change.[97] The CRB is tasked with determining and adjusting "reasonable terms and rates of royalty payments."[98] The statutory rate for digital performance royalties for sound recordings

---

labels in the United States. *See Overview*, UNIVERSAL MUSIC GROUP, http://www.universalmusic.com/company (last visited Sept. 9, 2014) (referencing Big Machine's distribution deal).

[95] This approach—testing the waters with a smaller, unthreatening partner before attempting a deal with larger, more powerful partners—is also strategic. It is interesting for its divergence from the traditional music licensing deal wherein digital music services approach major labels directly first, allowing smaller labels to fall into line once those terms have been set. The music services appear to have realized that they have more to gain in negotiations with a less entrenched and powerful partner. And the strategy worked: On September 12, 2013, a little more than a year after the Clear Channel–Big Machine deal, Clear Channel and Warner Music Group, one of the three remaining major label groups, announced a similar deal creating a terrestrial performance right. *See* Sisario, *supra* note 10 (describing the deal between Clear Channel and Warner Music Group). This bandwagon effect raises yet another concern: As more and more players opt into private deals, the value of those deals is diminished. What about the Big Machine artists who have given up their direct royalty payments in anticipation of getting special promotional treatment from Clear Channel, only to now find that the full roster of Warner artists has joined the fray? And now that the full Warner roster is on board, how valuable is it for another label to join up? How many artists can Clear Channel offer promotional value to before the privilege loses its value?

[96] As detailed in Part III.B.1–2, the continuing existence of the statutory license, however inherently inefficient, serves as an access point for those parties unable or unwilling to command a private deal in the marketplace.

[97] *See* 17 U.S.C. § 114(f)(2)(B)–(C) (2012) (describing criteria to be used by the Copyright Royalty Judges to establish rates).

[98] 17 U.S.C. § 801(b)(1) (2012).

adjusts annually and is set in five-year blocks by the CRB.[99] While originally intended to allow for responsiveness to ongoing technological change, a royalty rate scheduled to change annually has done nothing to lend stability or predictability to an industry already in turmoil.

If a fluctuating statutory rate were not enough to put parties operating under § 114 on edge, the CRB also applies different rate-setting standards to different types of content delivery services. The rate for services existing at the inception of the statutory license—aptly named "pre-existing services"—is set under § 801(b)(1) of the Copyright Act of 1976 (the 801(b) standard).[100] For all services originating after the inception of the statutory license, the rate is set under a standard intended (ironically) to emulate fair market value by looking at what a willing buyer and a willing seller would agree to in a hypothetical marketplace (the "willing buyer, willing seller" standard).[101] Under this standard, Internet radio providers like Pandora currently pay more than fifty percent of their revenues in digital performance royalties.[102] The irony lies in the fact that there is not, and never has been, a "market" for digital radio because that business model has operated under the statutory license since its inception. The § 801(b) standard, on the other hand, currently yields royalty rates approaching eight percent of revenues for satellite and

---

[99] *See* 17 U.S.C. § 804(b)(1) (2012) (outlining the process by which royalty rates change).

[100] The § 801(b) standard considers four factors when setting a rate: (1) maximization of availability of creative works to the public; (2) fair return to the copyright owner and fair income to the copyright user; (3) relative and technological contribution, capital investment, cost and risk; and (4) minimization of disruptive impact on the industries involved. 17 U.S.C. § 801(b)(1).

[101] Section 114(f)(2)(B) defines the "willing buyer, willing seller" standard as follows:

> In determining such rates and terms, the Copyright Royalty Judges shall base their decision on economic, competitive and programming information presented by the parties, including—(i) whether use of the service may substitute for or may promote the sales of phonorecords or otherwise may interfere with or may enhance the sound recording copyright owner's other streams of revenue from its sound recordings; and (ii) the relative roles of the copyright owner and the transmitting entity in the copyrighted work and the service made available to the public with respect to relative creative contribution, technological contribution, capital investment, cost, and risk. In establishing such rates and terms, the Copyright Royalty Judges may consider the rates and terms for comparable types of digital audio transmission services and comparable circumstances under voluntary license agreements . . . .

17 U.S.C. § 114(f)(2)(B).

[102] *See, e.g.*, Eric Savitz, *Musicians Oppose Bill to Cut Royalties Paid by Pandora*, FORBES (Nov. 14, 2012, 2:57 PM), http://www.forbes.com/sites/ericsavitz/2012/11/14/musicians-oppose-bill-to-cut-royalties-paid-by-pandora/ ("In 2011, Pandora paid over 50% of [its] revenues in performance royalties . . . .").

cable audio providers like SiriusXM and Music Choice, roughly one-sixth of the rate under the "willing buyer, willing seller" standard.[103] This six-fold disparity between rates increases the overall inefficiency of § 114, not least of all for its propensity to lead to legislation and litigation.[104]

As with other statutory licenses for copyright-protected content, § 114 also lacks the ability to differentiate between market valuations on a per-user, or a per-product, basis.[105] Instead, it sets a rate

---

[103] *See, e.g.*, David Oxenford, *Copyright Royalty Board Oral Argument on SiriusXM SoundExchange Royalties—A View of the Application of the 801(b) Standard Proposed for Internet Radio*, BROAD. L. BLOG (Oct. 25, 2012), http://www.broadcastlawblog.com/2012/10/articles/copyright-royalty-board-oral-argument-on-sirius-xm-soundexchange-royalties-a-view-of-the-application-of-the-801b-standard-proposed-for-internet-radio/ (discussing the debate between SiriusXM and SoundExchange over whether the rate should increase or decrease from "the 8% of revenue that the service now pays").

[104] The marked inequality in rate-setting standards under § 114 has led to the drafting and introduction of several pieces of legislation, most recently the Internet Radio Fairness Act of 2012, H.R. 6480, 112th Cong. (2012), and, in response, the Interim Fairness in Radio Starts Today Act of 2012. For a discussion draft of the Interim Act, see H.R. __, 112th Cong. (2012), *available at* http://nadler.house.gov/sites/nadler.house.gov/files/documents/NADLER_153_xml.pdf. In the midst of these legislative proposals, SiriusXM has filed a lawsuit alleging that interference from SoundExchange has prevented it from engaging in direct negotiation with the major record labels. Complaint, Sirius XM Radio Inc. v. SoundExchange, Inc., No. 12-CV-2259 (S.D.N.Y. Mar. 27, 2012). In a suit recently filed in New York federal court, Pandora has sued ASCAP for setting mechanical royalty rates that are alleged to be "ill-suited and not reasonable." Petition of Pandora Media, Inc. for the Determination of Reasonable License Fees at 3, *In re* Pandora Media, Inc., No. 12 Civ. 8035 (S.D.N.Y. Nov. 5, 2012). Pandora followed that suit with another challenging the right of ASCAP members to withdraw "New Media" rights from ASCAP's blanket license. *In re* Pandora Media, Inc., No. 12 Civ. 8035, 2013 WL 5211927, at *13–19 (S.D.N.Y. Sept. 17, 2013) (granting Pandora's motion for summary judgment concerning ASCAP publisher withdrawals of New Media licensing rights).

[105] The use of product differentiation is prevalent among licensees in the streaming music space, who frequently offer two or more tiers of service: There is an introductory "freemium" tier that is, as the name suggests, free (usually ad supported) and generally constrained by certain limitations on capacity and functionality. There is also a "premium" offering with increased capacity (e.g., unlimited streaming) and functionality (e.g., offline listening). *See, e.g.*, UPGRADE, SPOTIFY, https://www.spotify.com/us/premium (last visited Sept. 9, 2014) (describing free and premium tiers). This is classic product differentiation—licensees are charging different prices based on differences in quality. A licensor may well be willing to charge less for content used under a freemium tier (to help encourage new subscribers to check out a licensee's service) in exchange for collecting a higher fee for content used under a premium tier (i.e., upon conversion of those new subscribers to the upgraded tier). Licensees and licensors thus work cooperatively to build their respective businesses, while sharing both the risk and the reward. Section 114 applies only to noninteractive streaming—also known as "passive listening," in that the user is unable to request a particular song and can only request a particular genre or tracks that sound like a particular song or artist—which leaves all interactive licensing to the private sector. *See* 17 U.S.C. § 114(d)(2)(A)(i) (exempting interactive services from the statutory license). There, services routinely charge different rates for different content and types of use. *See, e.g.*, SPOTIFY, *supra*. One problem presented by this practice in the interactive sector—but avoidable on the noninteractive side due to the presence of a statutory license that acts as a

regardless of the product, the licensee, or the use.[106] By design, a conventional statutory license provides a one-size-fits-all rate that is differentiated, when at all, by licensee type,[107] but not by the content's market value (product differentiation) or the type of use (price differentiation). Price differentiation (sometimes referred to as "price discrimination") allows licensors to charge different prices to different licensees for the same product.[108] Product differentiation, on the other hand, allows a licensor to charge different prices for different products.[109] The lack of price and product differentiation under a statutory license can result in artificial pricing that neither reflects nor responds to the market or consumer preferences. This effect may result in misallocation, where some consumers would be willing to pay more, or could negotiate to pay less, for a particular piece or use of content. It may also reduce incentives for the creation and production of content that satisfies consumer demand.

In addition to inhibiting the ability to differentiate according to the content's market value, a statutory rate—even one that distinguishes between different licensee service types—is unable to

---

default—is the so-called "pump and dump." Given the unpredictable nature of the digital music space and the deterioration of traditional record label revenues, most content licensors in the space require very large advances up front. *See, e.g.*, Michael Arrington, *Confirmed: MySpace to Launch New Music Joint Venture with Big Labels*, TECHCRUNCH (Apr. 2, 2008), http://techcrunch.com/2008/04/02/myspace-to-launch-new-music-joint-venture-with-big-labels/ (describing the distribution of monies to equity-holding copyright owners). Scores of fledgling digital music ventures have allegedly folded as a result of this practice, prompting a backlash against major label licensing as coercive. *See, e.g.*, Paul Resnikoff, *Robertson: Major Label Licensing Will Kill Your Startup . . .*, DIGITAL MUSIC NEWS (Sept. 12, 2011), http://web.archive.org/web/20120502090744/http://digitalmusicnews.com/stories/091211robertson (calling the odds of making money on a major label deal "pretty close to zero"); Paul Resnikoff, *So Turntable.fm Just Got Its Label Licenses. R.I.P. Turntable.fm?*, DIGITAL MUSIC NEWS (Mar. 13, 2012), http://web.archive.org/web/20120315165730/http://www.digitalmusicnews.com/permalink/2012/120312turntable (discussing digital start-up Turntable.fm's struggle with indifferent and disinterested content licensors).

106 Nor is differentiation accomplished by the blanket licenses of CROs. *See supra* Part I (explaining how CROs do no better at recognizing market valuations). For an interesting read on how failure to allow for value differentiation from one song to another leads to higher-than-desired advertising levels, see Reidel, *supra* note 52.

107 In setting the statutory royalty rate for digital performance of sound recordings, for instance, § 114 differentiates between interactive and noninteractive services. 17 U.S.C. § 114(d)(2)(A)(i). To determine the applicable rate-setting standard, to take another example, it differentiates between services that predate and those that postdate the statutory license. 17 U.S.C. § 114(d)(2)(B).

108 *See, e.g.*, LOUIS PHLIPS, THE ECONOMICS OF PRICE DISCRIMINATION 5 (1983) ("There is price discrimination when the same commodity is sold at different prices to different consumers.").

109 KENNETH D. GEORGE, CAROLINE JOLL & E.L. LYNK, INDUSTRIAL ORGANISATION: COMPETITION, GROWTH AND STRUCTURAL CHANGE 214 (Routledge 4th ed. 1992) (1971) ("[I]n a market characterised by product differentiation[,] the firms . . . choose the number and quality of products to produce . . . as well as determine prices.").

accommodate new technologies and business models in a timely fashion. As a result, § 114 is unable to respond to rapid technological change and the new business models such change brings. The CRB rate-setting procedure, for example, is governed by 17 U.S.C. § 804(b), which outlines a specific and extensive notice-and-comment period.[110] For this reason, the rate-setting process is statutorily scheduled to begin a full two years prior to the expiration of the current rate schedule.[111] This timeframe makes it difficult, if not impossible, for the statutory rate to respond to market changes efficiently.

Fluctuating rates, varying rate-setting standards, inflexibility, and lack of differentiation discourage new entrants, potentially lowering competition and increasing costs while simultaneously decreasing the quality and quantity of offerings (as well as access to content). These inefficiencies negatively impact not only the parties operating under the statutory license but also overall welfare. Statutory licensing rates in the music industry have long been a focal point of lobbying efforts by the recording and broadcasting industries,[112] and the Free Market Royalty Act has been no exception.[113] There has also been no shortage of litigation with satellite radio service SiriusXM suing SoundExchange[114] and Internet radio provider Pandora suing ASCAP.[115] As both legislation and litigation are, to a large extent, publicly subsidized—in that U.S. federal and state court systems, as well as congressional salaries, are funded with taxpayer dollars—a regime that encourages these activities decreases overall social welfare.[116]

---

110 *See* 17 U.S.C. § 804(b) (2012) (outlining in detail how royalty rates are adjusted).

111 *See id.* (describing the timing of rate-setting proceedings as two years out).

112 *See generally* Kimberly L. Craft, *The Webcasting Music Revolution Is Ready to Begin, as Soon as We Figure Out the Copyright Law: The Story of the Music Industry at War with Itself*, 24 HASTINGS COMM. & ENT. L.J. 1 (2001) (describing the long and continuing story of lobbying around statutory licensing rates in the music industry).

113 *See, e.g.*, *Clients Lobbying on H.R. 3219: Free Market Royalty Act*, OPENSECRETS, http://www.opensecrets.org/lobby/billsum.php?id=hr3219-113 (listing origanizations that have registered to lobby on the Free Market Royalty Act).

114 *See* SiriusXM Radio Inc. v. SoundExchange, Inc., No. 12-CV-2259 (S.D.N.Y. Mar. 27, 2012) (alleging that interference from SoundExchange has prevented SiriusXM from negotiating directly with the major record labels).

115 *See* Petition of Pandora Media, Inc. for the Determination of Reasonable License Fees, *supra* note 104, at 3 (alleging the setting of "ill-suited and not reasonable" mechanical royalty rates).

116 This Article takes a position in favor of a terrestrial performance right insofar as it comports with copyright's goal of incentivizing creation. A different but reasonable position might suggest elimination of the digital performance right as an alternative means of eliminating the disparity.

The bureaucratic nature of statutory amendment denies § 114 the requisite flexibility to quickly bring these new services to market in real time, thereby delaying (and in some cases denying) consumers the benefit of new and potentially preferable means of accessing the licensed content.[117] In the span of time required for a rate adjustment proceeding to be noticed, held, ruled upon, and enacted, a new technology can come and go (or come and stay) and—due to the nonexistence of a statutory rate for that particular type of new service—establish an industry norm that is not easy to change and may not comply with legislative goals.[118]

Finally, the per-play structure of the statutory rate misaligns incentives between licensees and licensors, who are put at odds over how much content to use: more, from the content owners' perspective since they earn royalties on a per-use basis, or less, from the perspective of broadcasters and other services that pay for each use of that content. Without cooperation between parties whose businesses are interdependent, both businesses and consumers lose out on potential synergies.

2. *Private Efficiency*

Meanwhile, private ordering improves upon the unpalatability of the statutory license in several ways: (1) by improving cooperation between otherwise divergent parties, (2) by establishing a more predictable and stable royalty rate, (3) by allowing for rapid accommodation of new technology and business models, and (4) by differentiating among valuations for different content and uses. Using the Clear Channel–Big Machine deal as a case study, this section identifies the efficiency gains resulting from the circumvention of § 114. It also challenges the legitimacy of these gains to the extent they are neither enjoyed by nonparties nor shared by society overall.

---

[117] *See, e.g.*, Rob Frieden, *Wither Convergence: Legal, Regulatory, and Trade Opportunism in Telecommunications*, 18 SANTA CLARA COMPUTER & HIGH TECH. L.J. 171, 179 (2002) ("'[R]egulatory lag' [is] becom[ing] a more common occurrence. A significant period of time may run before regulations reflect changes in technological and marketplace circumstances. During such periods of delayed adjustment, the regulatory process may favor one competitor over others."). Peer-to-peer technology is a perfect example of market exclusion due to regulatory lag: The illegal file-sharing service Napster had perfected MP3 download technology as early as 1999, but it was not until four years later that the law caught up with the technology to bring a legal version of digital downloads to market. *See, e.g.*, Ben Sisario, *Rhapsody to Acquire Napster in Deal with Best Buy*, N.Y. TIMES (Oct. 3, 2011, 3:55 PM), http://mediadecoder.blogs.nytimes.com/2011/10/03/rhapsody-to-acquire-napster-in-deal-with-best-buy/.

[118] For a fuller critique of the influence of custom on intellectual property law, see, for example, Jennifer E. Rothman, *The Questionable Use of Custom in Intellectual Property*, 93 VA. L. REV. 1899 (2007).

a. Gains

A statutory per-play rate, such as that contained in § 114, misaligns incentives between licensees and licensors. In the case of sound recordings, record labels want as much airtime as possible to promote their artists and boost album sales, while a per-play royalty encourages broadcasters to minimize costs by playing as little music as possible.[119] In contrast, a rate set as a share of revenues—such as that established in the Clear Channel–Big Machine deal—encourages more plays, which in turn induces more listeners, leading to a higher per-ad rate since advertisers will pay more for ads they believe will reach a larger audience.[120] More plays also mean more promotion for the record labels, who are encouraged to offer broadcasters more (and perhaps exclusive) content, which further attracts advertisers, and so on.

Private ordering also accomplishes another important goal where the statutory license fails: It fosters a mutually cooperative relationship between parties whose businesses are interdependent. Terrestrial radio may be in decline,[121] but digital radio is growing quickly. Advertising revenues stemming from digital radio are expected to grow from $713 million in 2011 to $1.55 billion in 2021 or from 1.5% of broadcaster revenues in 2007 to over 7% by the end of 2021.[122] Internet-only radio is forecasted to grow even faster from a current market cap of roughly $293 million to over $1 billion by the end of 2021.[123] A traditional terrestrial broadcaster like Clear Channel looking to expand into digital radio would be best served by cooperative relationships with digital content owners—relationships

[119] As Clear Channel CEO Robert Pittman put it:

> I don't want to try and guess how much advertising I can sell—and if it's not coming in fast enough, can I slow down the song plays? Or should I do an interview show, or do more talk radio and news and sports, or maybe do more pre-1972 music programming? That's just a bad way to run—and even more importantly, try and build—a business. It encourages us to try and play as little music as possible.

Christman, *supra* note 8.

[120] There is a trade-off, as each additional play reduces the time available for running paid advertising. The key in this model is to charge more for less (i.e., to charge more per ad, but run fewer ads).

[121] *See, e.g.*, Richard Siklos, *Changing Its Tune*, N.Y. TIMES, Sept. 15, 2006, at C1 ("[T]he prospects of radio companies have dimmed significantly since the late 1990's . . . . Radio revenue growth has stagnated and the number of listeners is dropping. The amount of time people tune into radio over the course of a week has fallen by 14 percent over the last decade . . . .").

[122] SNL KAGAN, *supra* note 92, at 2.

[123] *Id.*

that may afford them early and exclusive content with which they can attract both advertisers and listeners.

Content licensors like Big Machine are also eager to expand their revenue opportunities. This is a challenging time for these copyright holders. Advances in technology and changes in consumer behavior have decimated traditional recording industry business models,[124] forcing record labels to seek revenues in greener pastures—namely, radio, which is often still credited with encouraging record sales.[125] A cooperative relationship with broadcasters may ensure both better product placement and more opportunities to share in the anticipated growth of digital radio. A revenue share also sets up a cooperative partnership in which the parties share both the risks and the rewards. This marks a significant departure from (and improvement on) the industry's standard digital model that consists of an equity requirement,[126] an exorbitant advance for the licensor with no consequence or responsibility for the fate of the licensee.[127]

The direct payment from Clear Channel to Big Machine also obviates the need for a CRO. In addition to saving on administrative costs, the parties get to control distribution of the royalties.[128] Sony/ ATV's withdrawal from ASCAP, discussed below in Part III.C.3, is another recent example of circumvention that suggests this shift is not an isolated rejection of the CRO model, adding further support to the claim that the CRO model may not meet the needs of licensors and licensees in a digital world.[129]

---

[124] While the medium has evolved (from 8-tracks to vinyl to cassette tapes to CDs), the traditional music business model of selling bundled, recorded music has stayed the same. The digital revolution changed that by allowing for unbundling, or the purchase of individual tracks for less than the cost of a full album.

[125] *See, e.g.*, Kristin Thomson, *Does Radio Airplay Matter?*, ARTIST REVENUE STREAMS (May 7, 2012), http://money.futureofmusic.org/does-radio-airplay-matter/ (compiling data which suggests, inter alia, that "[f]or some musicians, [radio] airplay is perceived as a major driver of record sales and other revenue streams").

[126] *See, e.g.*, Arrington, *supra* note 105 (describing the distribution of monies to equity-holding copyright owners).

[127] *See, e.g.*, Resnikoff, *supra* note 105 (discussing digital start-up Turntable.fm's struggle with indifferent and disinterested content licensors).

[128] For further discussion of the distributive justice concerns potentially arising from this and proposed solutions, see García, *supra* note 12, at 29–37, and *infra* Part II.B.2.b.

[129] *See* Ben Sisario, *Apple's Plans for Internet Radio Run Up Against Big Music Publisher*, N.Y. TIMES (Sept. 28, 2012, 7:29 PM), http://mediadecoder.blogs.nytimes.com/2012/09/28/apples-plans-for-internet-radio-come-up-against-big-music-publisher/ ("EMI already withdrew its digital rights from Ascap, and Sony/ATV will follow suit with the rest of its catalog, effective Jan 1[, 2013]."); *see also supra* note 104 (discussing the recent ruling of *In re* Pandora Media, Inc., No. 12 Civ. 8035, 2013 WL 5211927 (S.D.N.Y. Sept. 17, 2013), which may work to stem the proliferation of ASCAP withdrawals).

As discussed above in Part II.B.1, the statutory rate set under § 114 suffers from fluctuating rates, different rates for different licensee types, and multiple rate-setting standards. This result is largely unacceptable from a business perspective. In the words of Clear Channel CEO Robert Pittman, "What we are really trying to do is come up with a predictable model."[130] Section 114's rate uncertainty denies Clear Channel a stable, predictable basis on which to sell its new digital business model to shareholders.

By applying different rate-setting standards, § 114 also denies prospective licensees the security of knowing they are paying the right rate. Even under the "willing buyer, willing seller" standard, not all services will fall neatly into one of the enumerated categories of service, especially at the current pace of technological development. Such is the downside of setting different rates for different types of licensees without the ability to easily and effectively add new types. Prospective licensees must simply choose the closest category fit and hope they are not challenged (and found owing) later. In addition, there is no assurance that a rate set this year will remain in effect for the duration of the licensee's contemplated use. In most cases, it will not.[131] Nor do the parties have any assurance that pending legislation or litigation affecting the statutory rate will not pass or be decided during the contemplated license duration. For Clear Channel and Big Machine, private ordering avoids this unpredictability altogether and allows them a stable platform on which to build their respective businesses.

With regard to accommodation of new technology and business models, statutory licenses simply cannot be amended fast enough to keep up. Adjustment and modification of private terms, on the other hand, is generally much easier to facilitate. In theory, CROs can accommodate such change, but in practice they do not.[132] Privately determined valuations are considerably more responsive than the statutory regime in addressing the frequent and relentless advances in

---

130 Christman, *supra* note 8.

131 Statutory rates fluctuate annually and are set in five-year increments. *See supra* Part II.B.1 (explaining the rate-setting procedure under 17 U.S.C. § 801).

132 ASCAP, for example, adjusts its blanket license rate annually using the Consumer Price Index instead of responding to market changes and technological developments. *See, e.g.*, ASCAP, BLANKET CONCERT AND RECITAL (BCON): 2013 RATE SCHEDULE 1, *available at* http://www.ascap.com/~/media/files/pdf/licensing/report-forms/concert/blanketconcert.pdf ("The annual license rate under Schedule II, and the minimum annual fee for each calendar year . . . shall be the license fee for the preceding calendar year, adjusted in accordance with the increase in the Consumer Price Index - All Urban Consumers (CPI-U) between the preceding October and the next preceding October . . . .").

technology inherent in the content industries. This is because, relatively speaking, private valuations are easily and cheaply revised. If Clear Channel wants to run a trial of a new product, it need simply negotiate a rate and term with Big Machine, who now has every incentive to cooperate for the good of the new venture.

Finally, all parties under a statutory license pay the same rate and operate under the same terms, regardless of the particular content and the circumstances of its use. Under § 114, therefore, in a result the author can only term sacrilege, a stream of Bob Dylan's *Love Sick*[133] earns the same digital performance royalty as a stream of PSY's *Gangnam Style*.[134] Even (resentfully) putting aside the subjectivity of musical taste, § 114 does not (and cannot) reflect the market value of the individual pieces of content that it governs given that the statutory rate is one-size-fits-all.[135] In addition, since the digital performance license for sound recordings was established simultaneously with the creation of streaming music services, a real market for streaming cannot be said to exist, much less one that differentiates among content and uses. As a result, even where the CRB is charged with taking market valuations into account in its adjustment of rates, it in fact has no such valuations to consider.

Private ordering, on the other hand, allows for tailoring terms to fit the contemplated content and use, thereby alleviating concerns presented by the one-size-fits-all nature of a statutory licensing regime. In this way, private ordering supports the creation and dissemination of the best (i.e., most valuable) content, as determined by the market, thereby producing more desirable outcomes insofar as the parties are (at least in theory) constrained by the discipline of a competitive market.

As part of their private deal, Big Machine, for instance, might wish to charge Clear Channel one price for a spin of Taylor Swift's *We Are Never Ever Getting Back Together* on its iHeart radio service as part of a broader Taylor Swift campaign that includes an exclusive prestream of her new album, while charging CBS a different price to

---

133 BOB DYLAN, *Love Sick*, *on* TIME OUT OF MIND (Columbia Records 1997).

134 PSY, *Gangnam Style*, *on* PSY 6 (SIX RULES), PART 1 (Universal Republic Records 2012).

135 Taste in music may not be as subjective as it seems at first blush. Section 114's failure to account for valuation differences stands in stark contrast to industry practice outside of the statutory license. iTunes, for example, prices different songs differently, according to their respective market valuations. This pricing comes from the record labels. Mike Masnik, *As Rumored, Apple Gives Record Labels Variable iTunes Pricing in Exchange for Ditching DRM*, TECHDIRT (Jan. 6, 2009, 10:41 AM), http://www.techdirt.com/articles/20090106/1039003297.shtml. Thus, a song that music listeners *in the aggregate* are willing to pay more for will sell for $1.29, others for $0.99, and still others for $0.69. *Id.*

simply serve a single stream of the track to one of its digital radio listeners upon request. The ability to price differentiate does not afford Big Machine control over the price Clear Channel or CBS ultimately charges its consumers, thereby raising no additional antitrust concerns.[136]

Unlike price differentiation, which alters the price paid by different consumers for the same product, product differentiation allows for differences in quality to be accompanied by differences in price. In the Clear Channel–Big Machine example, this allows Big Machine to charge more for Taylor Swift's tried-and-proven brand of radio-friendly pop, while offering a reduced price for up-and-coming artists as a means of inducing licensees to give them airplay. Likewise, Big Machine may be willing to accept a lower digital rate in exchange for valuable metrics around listener behavior.

To this point, I have described the various efficiency gains enjoyed by the parties to a private deal circumventing § 114.[137] Do these efficiencies extend to nonparties? To overall welfare? The answer is both yes and no. Listeners benefit from greater access to content, technology, and business models. Artists may benefit from increased exposure and promotional opportunities. Technology companies may find it easier to experiment with new services. Moreover, to the extent private valuations like Clear Channel and Big Machine's become an industry norm, thereby diminishing reliance on the statutory license, society may also benefit from a decrease in the social cost of legislation and litigation around rate setting.[138]

---

136 The usual antitrust concerns surrounding price differentiation still exist, however. In a free market, price differentiation can allow a licensor to favor one licensee over another by overcharging the less favored licensee, or even refusing to license, thereby potentially running the affected licensee out of business. The parties could also agree to a most-favored-nations clause, in which contracting parties agree to offer one another the same terms agreed to with any other parties. In our example, these concerns are obviated by the fact that the statutory license serves as a backup so that no licensee can be denied access to content, nor have his rate increased beyond the statutory rate. To the extent a licensee operating under the statutory license may not enjoy the special pricing that may result from private ordering, this is no different than the status quo, wherein larger licensees (like Clear Channel) have an advantage over smaller licensees when it comes to inducing a licensor to circumvent the statutory license.

137 Of course, all of these efficiency gains could be deemed happy coincidence for parties whose motivations in striking a private deal find root in rent-seeking behavior. By this explanation, private parties might circumvent the statutory license even where the resulting terms are not per se more efficient (and perhaps even less so) in order to take advantage of some rent or other to be had. In the Clear Channel–Big Machine case, this rent seeking might include the fifty percent increase on take-home royalties resulting from a circumvention of § 114(g)(2). *See infra* Part II.B.2.b (discussing the drawbacks of private ordering).

138 That said, industry-driven customs focused on decreasing litigation are not always socially optimal. *See, e.g.*, Rothman, *supra* note 118, at 1952 ("[I]ncorporating [risk-averse

On the other hand, smaller players may find themselves forced to operate under a private valuation scheme ill suited to their business model and without the means to negotiate otherwise. Artists and songwriters may lose out on royalties that they were guaranteed under the statutory license. In this sense, the parties are improving their own positions to the potential detriment of others—making the overall efficiency question somewhat more ambiguous. The next section describes in greater detail some of the potential drawbacks of private ordering.

b. Drawbacks

Despite its efficiency advantages, private ordering presents several potential drawbacks, all of which illustrate the inherent problem of social justice in the contract context. I have written elsewhere on the potential distributive justice issues that private ordering under a statutory license can raise and summarize them only briefly here.[139] One distributive justice concern is the potential to legally bind nonparties. When parties circumvent § 114, they not only circumvent the statutory royalty rate, but the entire section. This includes § 114(g)(2), which mandates that royalties be paid directly to third-party songwriters, recording artists, musicians, and vocalists (all of whom are assumed to have assigned away their copyrights to an intermediary).[140] Since monies collected under privately negotiated deals are not subject to this statutory distribution, parties to a private deal are able to reduce (and even eliminate) royalties paid to these third parties. The loss of this income can have a significant and

customs] greatly expands infringement findings under trademark, copyright, patent, and publicity laws, while narrowing defenses to such infringements. Industry practices establish a highly restrictive IP regime—one in which virtually nothing is free and no use is a fair one.").

[139] For a more in-depth analysis of these issues, see García, *supra* note 12, at 27–28. The brevity of treatment on distributive justice concerns should not be taken as commentary on their import—rather, for the purposes of this Article's argument in favor of more private ordering, I assume that these concerns have been ameliorated by the solutions previously proposed.

[140] Section 114(g)(2) directs that 50% of royalties collected under the statute be paid directly to the artists themselves: 50% of receipts shall be paid to the copyright owner (where the copyright owner is not the artist); 2.5% of receipts shall be deposited in an escrow account for distribution to nonfeatured musicians; 2.5% of receipts shall be deposited in an escrow account for nonfeatured vocalists; and 45% of receipts shall be paid to the featured recording artist on the sound recording. The legislative history indicates that this was an intentional move on the part of Congress to protect and provide for artists who might otherwise be taken advantage of by intermediaries. *See* H.R. Rep. No. 104-274, at 23–24 (1995) (noting that the provision was intended "to ensure that a fair share of the digital sound recording performance royalties goes to performers according to the terms of their contracts").

immediate financial impact on recording artists and songwriters, as well as a long-term impact on creative output.

A statutory amendment requiring parties who circumvent the statutory license to still adhere to such statutory distribution schemes would obviate the potential for disenfranchisement of nonparties. It would make the legal entitlement of creators to royalties an inalienable right.[141]

Private ordering can also raise concerns about the misrepresentation of market rates in industries that have operated under a statutory license since their inception, such as webcasting. Because there is no real market for these industries, they are especially susceptible to the imposition of privately determined valuations as market rates. In the case of webcasting rates under § 114, for example, private values are frequently adopted by the industry—either formally through the CRB's rate-setting procedure or informally through evolving industry norms.[142] Awareness of this tendency almost certainly influenced the completion of the Clear Channel–Big Machine deal. As first to market, the parties get to set the baseline rate that subsequent copycat deals will likely adopt, which can lead to the establishment of an industry norm or custom.[143] They can also present their private value to the CRB as the market rate. If there is no competing value to challenge theirs, the parties may thus be able to set the statutory rate privately.[144]

---

141 *But see* García, *supra* note 12, at 31–34 (discussing the drawbacks of inalienability).

142 *See id.* at 28 (explaining that in the absence of a market rate, a private valuation can gain industry acceptance to the point of becoming not only the de facto "market" rate, but may even be adopted as the statutory rate in the absence of a competing value).

143 In addition to the critique offered by Professor Jennifer Rothman in the intellectual property context, *see supra* note 118, the influence of custom on law has been questioned in other contexts as well. *See, e.g.*, Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 CHI. L. REV. 710 (1999) (criticizing the incorporation of commercial customs into Article 2 of the Uniform Commercial Code).

144 For example, digital music service DMX presented to the CRB the rate it reached privately with music publisher Sony/ATV in 2007 and had it adopted. *See, e.g.*, Broad. Music, Inc. v. DMX Inc., 683 F.3d 32, 35 (2d Cir. 2012) (affirming the district court's adoption of DMX's proposed rates over those presented by ASCAP and BMI); Steve Gordon, *DMX vs. BMI Demonstrates that Digital Services May Use Direct Licensing to Reduce Their Payments to the PROs but the Decision May Be Reversed on Appeal*, FUTURE MUSIC BUS. (July 12, 2011), http://www.futureofthemusicbusiness.biz/2011/07/dmx-vs-bmi-demonstrates-that-digital.html (discussing DMX's successful rate reduction campaign based on the Sony/ATV direct deal campaign and asking "how can 550 direct licenses," the number held by Sony/ATV, "be a benchmark for the true value of the PROs' blanket licenses when those 550 licenses represent, in probability, only a tiny fraction of songs represented by the PROs"). DMX did not, however, disclose the $2.7 million advance that accompanied the rate it reached privately with Sony/ATV. *See* Brief of Petitioner-Appellant BMI at 20–21, *Broad. Music*, 683 F.3d 32 (No. 10-3429) ("When DMX solicited

One way to alleviate the potential for rate misrepresentation is through a statutory amendment requiring full disclosure of the terms and conditions surrounding a privately determined valuation.[145] The language of such an amendment would require complete and accurate disclosure of the circumstances and conditions surrounding a private valuation presented to the CRB. These disclosures could be filed and made publicly available, much like a securities filing. While such a statutory amendment would not completely obviate concerns about misguided industry norms—since those can develop independent of statutory adoption—and would undoubtedly invite objections around proprietary business information, these privacy concerns could be addressed in much the same way as they are in the securities filing context. The disclosure requirement would at least make gamesmanship of this sort more difficult by publicizing the relevant deal terms surrounding establishment of a private rate.

Finally, as previously discussed with regard to CROs, penalty default licenses may also suffer from adverse selection. For example, Clear Channel may find it worthwhile to engage in private ordering only for high-value artists and labels but not others. This leaves the smaller players to the statutory license, potentially pushing all of the "junk" (i.e., lower value) content there, leaving it less funded (since it is collecting fewer membership fees and royalty shares) and less efficient for those left to operate under it (since its blanket license is inherently less valuable with larger members' content removed). This concern, the subject of future work, is particularly complicated and difficult to resolve, even with elimination of the collective. It is not clear whether smaller, weaker parties are disadvantaged more when going at it alone or when operating under a diminished collective. In the meantime, the modest statutory amendments suggested in this Part may work at least to ameliorate this impact by encouraging fair rate setting, resulting in greater overall efficiency for the more powerful parties without leaving weaker nonparties operating under the statutory license worse off.[146]

Beyond these distributive justice concerns, private ordering also raises inefficiency concerns. For a penalty default license to bring about greater efficiency than a statutory license, the private ordering

---

direct licenses from smaller music publishers, it never told them about the advances it had committed to pay Sony. . . . It nonetheless sought to induce publishers to enter into direct licenses that did not include those substantial payments by assuring them they would be treated the same as a sophisticated major publisher who had accepted the same deal." (emphasis omitted)).

145 García, *supra* note 12, at 35–37.

146 *Id.* at 38.

that a penalty default encourages must itself be efficient. This is not always the case—incomplete information, irrationality, asymmetry in bargaining positions, industry circumstances, rent-seeking behavior, and other externalities can all result in inefficient deal terms. The good news is that such inefficiency is generally not sustainable. Parties who strike inefficient deals will typically revise them or, at the very least, not renew them. Even rent-seeking deals are curbed when the rents run out.[147] In addition, *efficient* deals tend to proliferate—such as the copycat deals that followed the Clear Channel–Big Machine deal—thereby establishing and enforcing more efficient industry norms (and crowding out less efficient deals, including rent-seeking ones).[148] The systematic purging of inefficient private deal terms may take time, however, and there is always the possibility that an inefficient valuation will acquire industry norm status despite its shortcomings. In addition, early-stage private dealmaking tends to be concentrated among the larger, more powerful players in an industry because they are both influential enough to induce bargaining and financially secure enough to tolerate greater risk. As a result, a rate deemed desirable by large, powerful parties may be imposed upon smaller, less powerful parties who do not share the same valuation, thereby exacerbating existing inequalities.[149]

The most cited efficiency drawback to private ordering is transaction costs.[150] Individual negotiations require time, money, and other resources. For this reason, collective valuation in the form of statutory licensing and CROs has traditionally been the preferred regime in industries engaged in en masse licensing. Section 114, for example, was specifically enacted (like most statutory licenses) to facilitate trade in music licensing, an industry in which individual negotiation has historically been deemed either time or resource

[147] *See, e.g.*, E.C. Pasour, Jr., *Rent Seeking: Some Conceptual Problems and Implications*, *in* 1 THE REVIEW OF AUSTRIAN ECONOMICS 123, 127 (Murray N. Rothbard ed., 1987) (noting that the gains from rent-seeking can be "completely dissipated through competitive rent-seeking activity").

[148] As this section makes clear, what is good for one party may not be good for another. It is unlikely, for example, that Big Machine's competitors were made better off by the deal it struck with Clear Channel. But the economic efficiency question here is: Are they made worse off? Not surprisingly, the answer is "maybe." This Article seeks to raise awareness of this possible divergence between party and nonparty welfare.

[149] *See generally* Rothman, *supra* note 118, at 1949 ("[M]any of the prevalent customs are not developed with private parties' preferred allocations of rights in mind—much less the optimal societal allocation of rights.").

[150] For an example in the context of content licensing, see Brett M. Frischmann & Mark A. Lemley, *Spillovers*, 107 COLUM. L. REV. 257, 287 (2007) ("[W]hen transaction costs are prohibitive, an efficient deal will not be struck . . . .").

prohibitive (or both).[151] Statutory licenses alleviate these transaction costs by eliminating the need to engage in private deal making.

This bulk approach to licensing was useful for digital music services when they were competing for bragging rights to "the largest online catalogue of free music in the world."[152] It is unclear, however, whether (or to what extent) this rationale applies in today's market, where it is commonly recognized that most users do not want *more* content, but rather *more convenient* or *more readily accessible* content. In other words, "[m]any consumers will say they want everything, but actually don't."[153] To the extent amassing a fully comprehensive catalog of content is no longer necessary, or even desirable to start and grow a digital music service, the promise of easy en masse licensing loses its appeal. Instead, today's services are focused on "curating an ultimately limited selection,"[154] a task best accomplished through private ordering.

A temporal variation on the efficiency concern asks whether certain of the advantages enjoyed by the parties will be diminished if private ordering becomes the norm, as opposed to the exception. To demonstrate, Big Machine may enjoy preferential placement of its artists' songs on Clear Channel–owned radio stations as a result of their private deal.[155] Yet Warner has now signed a similar deal with Clear Channel.[156] If most record labels come to strike similar deals with Clear Channel, how valuable will this benefit be to Big Machine

151 *See, e.g.*, Merges, *supra* note 28, at 1378 ("A compulsory licensing scheme represents a real shortcut: it eliminates the need for private institution-building—a costly and time-consuming process."); Reidel, *supra* note 52, at 770 ("The strongest argument for blanket licenses was then and remains today the capacity of these licenses to deliver large savings in transaction costs.").

152 Press Release, MySpace, MySpace Gains Over 1 Million Registrations with New Music Player (Feb. 13, 2012), *available at* https://myspace.com/pressroom/pressreleases/2012/11/21/myspace-gains-over-1-million-registrations-with-new-music-player; *see also* Andrew Hampp, *Exclusive: MySpace Launches New Music Player, Search Function, Facebook Integration*, BILLBOARDBIZ (Dec. 19, 2011, 8:17 AM), http://www.billboard.com/biz/articles/news/1157474/exclusive-myspace-launches-new-music-player-search-function-facebook ("[T]he size of MySpace's catalog is what [MySpace's parent company] Specific's looking to tout the most.").

153 Paul Resnikoff, *If Only People Cared About 'Comprehensive Catalogs' and Millions of Songs. . .*, DIGITAL MUSIC NEWS (May 14, 2013), http://staging.digitalmusicnews.com/permalink/2013/05/14/care; *see also, e.g.*, Portia Krebs, *Digital Music Sales Soaring, Thanks to Streaming and Downloads*, USTELECOM (Sept. 18, 2012), http://www.ustelecom.org/blog/digital-music-sales-soaring-thanks-streaming-and-downloads (comparing Spotify's sixteen million songs to Pandora's one million songs and noting that "Pandora argues it's quality, not quantity, that distinguishes their collection").

154 Resnikoff, *supra* note 153.

155 The perceived value of that preferential placement may well have motivated Big Machine to accept a lower digital royalty rate.

156 Sisario, *supra* note 10.

(or any of the labels)? In other words, how does replication affect a private deal's value and, by extension, its efficiency? It remains to be seen, but two things are possible, and perhaps even likely. First, proliferation may lead to efficient industry norms that benefit all players (assuming penalty default licenses are used to mitigate gamesmanship). Second, even if some reduction of value were to occur, the parties would not be worse off than they are under the statutory license, which remains available as a fallback option.

Despite these potential efficiency and distributive justice concerns, private ordering still provides a marked improvement over the inefficiencies of § 114. Yet the Clear Channel–Big Machine deal was the first to circumvent this long-standing statutory licensing regime. The next section examines the challenges to circumventing a statutory license through private ordering.

III
The Past: Defaulting into Inefficiency

The inefficiencies of § 114 described above are not new. Indeed, it is safe to say they have existed since the statute's inception. Even so, the statutory license was not circumvented until the Clear Channel–Big Machine deal. So why did no one circumvent it before? And why are some parties still not doing so now? This Part considers some of the reasons parties may continue to operate under a regime that does not best serve their needs.

A. Challenges to Circumvention

For all of its efficiency benefits, private ordering in the shadow of a statutory license faces some formidable challenges. The most obvious obstacle to circumventing certain statutory licenses is a legal prohibition against doing so. Although § 114 explicitly contemplates an opt-out for licensors and licensees of sound recordings,[157] not all statutory licenses give parties this authorization. Cable broadcast and satellite television, for example, are obligated to operate under their respective statutes,[158] which do not permit private ordering. However,

---

[157] It authorizes "copyright owners of sound recordings and any entities performing sound recordings" to alternatively "negotiate and agree upon the royalty rates and license terms and conditions for the performance of such sound recordings and the proportionate division of fees paid among copyright owners, and may designate common agents on a nonexclusive basis to negotiate, agree to, pay, or receive payments." 17 U.S.C. § 114(e)(1) (2012).

[158] *See* 17 U.S.C. § 111 (2012) (governing broadcast cable); *id.* § 119 (governing satellite television).

the legal barrier explanation does not explain parties' reluctance to circumvent § 114.

A better explanation in the case of § 114 might be inequality in bargaining power. It can be difficult for a smaller, less powerful licensor to muster the time and energy required for a direct deal with a more powerful licensee. This inequality may even lead to adverse selection in the statutory license as larger, more powerful licensees opt out, potentially leaving smaller parties with a less effective system.[159] Yet inequality existed between Clear Channel and Big Machine and they managed to overcome it.

Another challenge to circumventing certain statutory licenses stems from their default nature. One thing the competing law and economics literature on defaults seems to agree on is that defaults have a propensity to be "sticky"—that is, parties operating under a default regime tend to stick with the default. The sources of this reluctance are varied. One view suggests that contracting parties tend to view defaults as endowments and claims that there is a prevailing preference for that which is perceived as the status quo.[160] No one wants to give up something they have a right to, nor do they want to lose something that others (especially competitors) are getting. Parties are thus likely to prefer a default that they perceive as representative of the status quo, regardless of its inefficiency. To overcome this resistance, the incentive must be sufficiently strong: "[P]arties will not contract around a default contract term when it would only be *marginally* efficient for them to do so . . . . They are, however, likely to contract around the default term when doing so would be *overwhelmingly* efficient . . . ."[161] Professor Daniel Kahneman has explained the preference for defaults as one of convenience—it may simply be easier not to endure the cognitive strain of making an alternative decision.[162]

Another view suggests that parties may stick with a default in order to signal (or *not* signal) something about themselves.[163] The

---

159 This loss in efficacy, as mentioned in Part II.B.2.b, results from both less monies being collected in the form of membership fees and royalty shares and from a less robust catalog that lowers the value of a blanket license.

160 *See* Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 675 (1998) ("[Parties might] fail to contract around inefficient defaults when their preference for maintaining the status quo relative to alternative states swamps their preference for the alternative contract term relative to the default term.").

161 *Id.* at 666.

162 *See* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 348 (2011) (discussing the stronger emotions that result from deviating from the default option).

163 *See, e.g.*, Kathryn E. Spier, *Incomplete Contracts and Signalling*, 23 RAND J. ECON. 432, 432 (1992) (finding that, among other reasons for contractual incompleteness, "an

classic example of this is the professional athlete who refrains from asking for an injury clause so as to avoid sending a signal (whether true or not) of his propensity for injury, thereby lowering his contractual leverage.[164] In turn, the default of "no injury clause" in professional athlete contracts grows stickier the less frequently it is circumvented. Similar arguments have been made in the context of social norms and relational contract theory. Under this view, a party may be reluctant to opt out of a default for fear that doing so may make him appear "less reliable or more contentious" than similarly situated parties.[165]

These theories converge to create a self-reinforcing norm against default circumvention. Conversely, it follows that where opting out is viewed as normal, a default may lose its stickiness. In their work in this area, Professors Omri Ben-Shahar and John Pottow have determined that "the more common it becomes to propose opting out of a particular term, the less reason there will be for the recipient of the proposal to be suspicious, and so the norm against private tailoring should weaken."[166] In other words, the frequency with which an opt-out is seen in a given market or industry can likewise have a self-reinforcing or self-perpetuating quality, thereby reducing the suspicion associated with a party's request for private ordering. In the *Betamax* case, for example, Sony sought to support their new time-shifting recording technology by citing that "representatives of professional baseball, football, basketball, and hockey testified that they had no objection to the recording of their televised events for home use."[167] They secured sign-off from the National Hockey League, then Major League Baseball, the National Basketball Association, and finally the National Football League.[168] Each

individual may refrain from including a particular clause in a contract in order to signal his type").

164 *Id.* at 433.

165 Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 72 (1993). This rationale can be extended to contract pricing as well. A party may not seek a specific performance clause, for instance, where it would "excite suspicion (and a high price)." Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 388 (1990).

166 Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 667–68 (2006).

167 Sony Corp. of Am. v. Universal City Studios, Inc. (*Betamax*), 464 U.S. 417 (1984).

168 *Id.* at 424.

approval made it less risky for the other organizations to participate.[169]

The Clear Channel–Big Machine deal also provides an excellent example of this bandwagon principle. Despite the decades-long existence of a statutory authorization for circumventing § 114, no one wanted to lose the statutory royalty to which they were legally entitled, or the legal right to not pay royalties on terrestrial plays, and so the default grew sticky. However, once the first circumvention was completed, similar deals followed in short order.[170]

Ben-Shahar and Pottow suggest that "harsh enough penalty defaults can overcome the stickiness effect, and once that effect is overcome, the increased prevalence of deviation will, in and of itself, attenuate the stickiness of the default rule even further."[171] In the case of the Clear Channel–Big Machine deal, uncertainty about the establishment of a statutory terrestrial performance right acted as a harsh enough penalty to overcome even an ingrained resistance to circumvention. As discussed in Part I, the threat of a statutory terrestrial performance right has persisted for decades, but never in so concrete and imminent a form as now. On September 25, 2013, following through on promises made over the last year, Representative Mel Watt introduced the Free Market Royalty Act.[172] It would amend 17 U.S.C. § 106(6) to grant a terrestrial performance right to sound recording copyright holders.[173]

Unlike previous iterations of a performance rights act, this one comes in the midst of industry-wide support for what the Copyright Office is calling the "next great copyright act."[174] Adding to the credibility of this latest legislative threat, Clear Channel's defection from the broadcaster lobby not only weakens the NAB's traditional position that broadcasters should not have to pay a performance right, since Clear Channel has openly agreed to do so, but also puts a significant dent in the organization's lobbying coffers.[175]

---

169 For a discussion of technology diffusion and the bandwagon effect, see Gianvito Lanzolla & Fernando F. Suarez, *Closing the Technology Adoption-Use Divide: The Role of Contiguous User Bandwagon*, 38 J. MGMT. 836 (2012).

170 *See supra* note 10 (listing sources discussing similar deals).

171 Ben-Shahar & Pottow, *supra* note 166, at 669 (citing Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 800–01 (1995)).

172 H.R. 3219, 113th Cong. (2013); *see also* Rep. Watt's Statement, *supra* note 75 (discussing the Free Market Royalty Act).

173 Rep. Watt's Statement, *supra* note 75.

174 Pallante, *supra* note 73, at 315.

175 As noted by Recording Academy President Neil Portnow: "Congress has shown a sincere interest in solving this problem, and with Clear Channel's recognition of the

The emerging prevalence of copycat deals following the Clear Channel–Big Machine deal suggests something further as well: The penalty of being the odd person out bolsters the punitive nature of the default (turning it, in effect, into a penalty default). As more and more record labels sign on to the Clear Channel deal in order to secure terrestrial performance rights for their artists, a record label that refrains—perhaps because its business model cannot support a lower-than-statutory digital rate—may lose its artists to another label. In other words, industry norms can be defaults, too. Building on this, the next section considers three possible approaches for overcoming stickiness.

B. Overcoming Stickiness

The Clear Channel–Big Machine deal and its progeny demonstrate the ability of parties to overcome inequality in bargaining power and the tendency of defaults toward stickiness. As such private ordering can improve on the statutory license, the question is then how best to encourage more of it. This section outlines a few possible approaches to overcoming inequality and stickiness.

1. The Regulatory Inaction Approach

A regulatory inaction (or free market) approach would do away with the statutory license and any extant CROs altogether.[176] In the absence of a statutory license, parties would be forced into private ordering to secure a license. This approach saves administrative costs associated with the establishment and maintenance of a statutory licensing regime. Moreover, the private ordering that results may bring all of the aforementioned efficiency benefits—increased cooperation, rate predictability and suitability, flexibility in response to technological change, and value differentiation—but only for those parties who are in a position to bargain for it. Those without the

---

terrestrial performance right, continued opposition by the NAB will now ring hollow on Capitol Hill." Christman, *supra* note 82.

[176] Alternatively, free market advocates might argue for doing away with just the statutory license and then allowing either existing CROs to remain in place or new CROs to take shape. In addition to the arguments against CROs' efficiency presented in Part I, this would not truly comport with a free market approach, as CROs are simply another form of government intervention. This is especially true in the case of PROs, where both ASCAP and BMI (the largest two in the industry) operate under consent decrees. *See, e.g.*, United States v. Am. Soc'y of Composers, No. 41-1395 (WCC), 2001 WL 1589999 (S.D.N.Y. June 11, 2001) (renewing ASCAP's consent decree). Only by eliminating both the statutory license and CROs are parties forced to engage in private ordering to secure a license.

requisite size or market power to attract a direct deal may be left without the ability to secure a license at all.

In other words, the free market approach increases efficiency by increasing private ordering but only as to those parties with the ability and wherewithal to participate. Without the access guaranteed by the statutory license, smaller, less powerful parties will be further disadvantaged vis-à-vis larger parties with greater bargaining power. They may not be able to secure equally favorable rates, if they are even able to secure rights at all. A licensor planning to enter the licensee market, for instance, could effectively deny access to potential competitors altogether.

In a situation where an established artist like Taylor Swift is in a position to negotiate for preferential treatment, but not a relative unknown like Joe Schmo,[177] free market advocates might respond that Joe Schmo is in no worse of a position in this context than he would be under the current statutory regime.[178] The same might be said for local radio station WXYZ.[179] To the extent WXYZ is unable to reach the same terms with Big Machine that Clear Channel has, this is arguably no different than Clear Channel getting an exclusive interview with Taylor Swift as part of a larger marketing package with which WXYZ is unable to compete.

The issue of access, however, raises different concerns. In a scenario where the statutory license, however inefficient, is left in place, WXYZ is at least *guaranteed* access to content that enables it to attempt to compete in the market. Eliminating this guaranteed access reduces competition, which can result in fewer innovations, fewer service options, and ultimately higher prices for consumers. For this reason, the regulatory inaction approach is not optimal.

2. *The Regulatory Action Approach*

A regulatory action approach might seek to either fix or improve upon the extant statutory license without removing it altogether. An optimistic attempt to fix the statute is not practicable, however, as most of the inefficiencies associated with statutory licenses are inherent and therefore cannot be effectively remedied without

---

[177] Joe Schmo is a fictional recording artist and any resemblance to an actual recording artist is entirely coincidental.

[178] This is not to suggest, however, that the copyright laws—with their constitutional mandate to promote creation and innovation—do not protect or improve the situation of Joe Schmo. It merely suggests that, in economic terms, Joe Schmo is not made worse off in this scenario.

[179] WXYZ is also a fictional entity for illustrative purposes only and bears no relation to any existing radio station.

dismantling the function of the license itself. For instance, the primary purpose of a statutory license is to reduce transaction costs associated with multiple negotiations by setting a fixed rate and terms for all prospective licensees.[180] As such, a statutory license cannot set different rates for different content or uses in response to market valuations. This would, by definition, require observation of pricing behavior in an actual market—a practice precluded in large part by the existence of the statutory license itself, which results in the absence of an actual market. CROs fare no better since, at best, they set a blanket rate to cover all content in a given catalog.

Likewise, the fix for a fluctuating rate is replacing it with a static one. While this might resolve the unpredictability problem, it would substitute a different deficiency: lack of suitability. Without the ability to adapt to evolving technologies and business models, a permanent statutory rate would quickly fail to serve the needs of licensees and licensors, especially in the fast-moving digital context.

The fix for divergent rate-setting standards is to set a single standard applicable across the board. Recently proposed (and failed) legislation to this end,[181] shows that the only thing further apart than the rate-setting standards themselves are the opposing positions on such standards taken by industry interests.

Finally, inflexibility and inability to respond in a timely manner to changes in technology and business models stem from the legislative process itself. Changes to statutes require amendments to be drafted, presented, and approved. This process takes time. The statutory rate-setting process is not, and cannot be made, sufficiently nimble to keep pace with the speed of technological development.[182]

The inherent inefficiencies of the existing statutory regime cannot be fixed if the statutory license is to retain its function. Its continued functionality is especially important for those parties who depend on the statutory license for access to content. It does not follow, however, that the statutory licensing regime cannot be improved despite its inherent inefficiencies.

A more attainable, improvement-focused variation on the regulatory action approach would be to leave the current statutory

---

[180] *See, e.g.*, Merges, *supra* note 28, at 1295 (arguing that legislatively mandated licensing reduces transaction costs by eliminating or reducing haggling and implementing schemes that often come with built-in administrative support).

[181] These include the Internet Radio Fairness Act of 2012, H.R. 6480, 112th Cong. (2012), and the Interim Fairness in Radio Starting Today Act of 2012, H.R. __, 112th Cong. (2012), *available at* http://nadler.house.gov/sites/nadler.house.gov/files/documents/NADLER_153_xml.pdf;. *See also supra* Part II.B.1.

[182] *See infra* notes 197–210 and accompanying text (discussing this issue in the context of recent webcast legislation).

licensing regime in place, thereby continuing to afford access to all comers, but with modifications (as opposed to fixes) that encourage private ordering. There are several ways to accomplish this. One approach would be to leave the statute in place but add an affirmative penalty for noncircumvention, perhaps in the form of a fine or tax that applies whenever a party refuses to deal privately with another party who presents a deal in good faith. However, in addition to the potential subjectivity of a good-faith determination in this context, the problem with this approach is that the parties left to function under the statutory license—a group that might predictably include those smaller and less powerful players who are unable to secure direct deals—will only be further disadvantaged vis-à-vis those parties in a position to circumvent for a better deal.

Alternatively, in a variation on the theme, the statutory license could be left in place, but with an added incentive—perhaps in the form of a tax break or lump sum payment—granted to parties who circumvent the statutory license. However, in addition to the public costs of such a program, this approach still disadvantages smaller, weaker parties who are unable to attract a private deal vis-à-vis those who are able to claim the reward for doing so.

Both of these approaches present anticompetitive concerns insofar as they further disadvantage weaker parties vis-à-vis stronger ones. A balanced approach—the one used by penalty default licenses—leaves the statutory license in place and uses existing uncertainty to incentivize both parties toward circumvention and private ordering, while also minimizing concerns about gamesmanship.

C. *The Role of Uncertainty*

One way to induce circumvention would involve setting a punitive statutory rate that favors one party or the other (e.g., a very low statutory rate to favor licensees or a very high statutory rate to favor licensors).[183] Even assuming equal bargaining power—an aspirational assumption at best—an overly punitive rate could have the unintended consequence of entrenching the favored party in the statutory license. To the extent a statutory license is intended to guarantee access to all comers, an overly punitive rate for licensees could prove prohibitively high for smaller players with less bargaining power and effectively limit, or even eliminate, access to content for

[183] Another conceivable arrangement might include the imposition of a punitively high rate (i.e., disfavoring the licensee) that is partly channeled to a charity, for instance, so that it does not necessarily favor the licensor.

those parties. At the very least, such a regime leaves open the possibility of gamesmanship by setting the parties on an unequal playing field.

Unlike a punitive rate, an *uncertain* rate is unpalatable to *both* parties,[184] making it an effective means of encouraging circumvention without exacerbating concerns about gamesmanship.[185] Where most of the literature on efficiency advocates increasing stability,[186] this Article makes the contrary case: To increase efficiency in statutory licensing, legislators should use bounded uncertainty as a means of encouraging private ordering. By presenting both parties with an uncertain ex post result, uncertainty encourages more ex ante private ordering. Bounded uncertainty also increases parties' incentives to circumvent an inefficient penalty default license for fear of ending up worse off. Concededly, uncertainty has existed in the music industry for decades without bringing efficiency gains. The next section explains why this uncertainty has not prompted private ordering until now.

1. *Uncertainty Then and Now*

Among the statutory licenses for certain types of copyright-protected content, the statutory license for sound recordings enjoys the dubious distinction of an especially contentious and unstable evolution. The history of royalties for Internet radio began when the Digital Performance Right in Sound Recordings Act of 1995 (DPRSRA)[187] granted the owners of copyrights on sound recordings a limited right to control *digital* performance of their recordings.[188] Prior to this, only the owner of a copyright on the musical composition underlying a sound recording enjoyed this right.[189]

As with subsequent legislation aimed at governing royalties for sound recordings, the DPRSRA's effectiveness was limited by its

---

[184] This assumes equal risk tolerance, the most likely scenario in a case such as this one where the parties are participating in the same industry and facing the same market conditions.

[185] This might suggest "uncertain" (as opposed to "penalty") default licenses as a more accurate description. As in the case of penalty default rules, however, it is precisely this uncertainty that makes the default license a penalty default.

[186] *Supra* note 21.

[187] Pub. L. No. 104-39, 109 Stat. 336 (codified as amended in scattered sections of 17 U.S.C. §§ 106, 114–115); *see* 72 Fed. Reg. 24,084, 24,086 (May 1, 2007) (discussing the DPRSRA).

[188] *See* 17 U.S.C. § 106(6) (2012) (granting an exclusive right, "in the case of sound recordings, to perform the copyrighted work publicly by means of a *digital* audio transmission" (emphasis added)).

[189] *See* discussion *supra* Part II.A (discussing the history of statutory licensing for sound recordings).

inability to predict the future—specifically, the evolution of ad-supported Internet services. The DPRSRA exempted "nonsubscription" digital audio transmissions from the statutory license.[190] In other words, Internet radio services whose users paid a subscription fee had to pay a compulsory performance royalty, whereas Internet radio services whose users watched ads in lieu of subscribing were exempt from paying royalties. The DPRSRA's successor, the Digital Millennium Copyright Act (DMCA),[191] attempted to correct this oversight by revising the definition of exempt services but ended up compounding confusion by leaving unanswered the question of whether interactive services fell under the revised definition. When petitions to the Copyright Office asking for clarification of this issue were declined,[192] licensors and licensees were forced to either work it out—i.e., come to a private agreement on terms—or face arbitration under the newly established Copyright Arbitration Royalty Panel (CARP) tasked with determining and adjusting "reasonable terms and rates of royalty payments."[193]

The first in a series of such arbitrations, known as Webcasting I, resulted in a CARP ruling[194] that set rates for the period from 1998 through 2002.[195] These rates were immediately deemed unworkable by the industry.[196] In response, the Library of Congress arbitrarily

---

190 17 U.S.C. § 114(d)(1)(A) (2012).

191 Pub. L. No. 105-304, 112 Stat. 2860 (1998) (codified as amended in sections of 17 U.S.C.).

192 After the passage of the DMCA left the status of interactive services uncertain, webcasters asked the Copyright Office for a ruling that a service is not interactive "merely by virtue of offering the consumer some degree of influence over the streamed programming." Petition of the Digital Media Association (DiMA) for Rulemaking, Section 114 Definition of Interactive Service, Docket No. RM 2000-4 (Copyright Office Apr. 17, 2000), *available at* http://www.copyright.gov/carp/DiMApetition.pdf. This request was denied: "In light of the rapidly changing business models emerging in today's digital marketplace, no rule can accurately draw the line demarcating the limits between an interactive service and a noninteractive service." Public Performance of Sound Recordings: Definition of a Service, 65 Fed. Reg. 77,330, 77,332 (Copyright Office Dec. 11, 2000) (denial of petition for rulemaking) (codified at 37 C.F.R. § 201).

193 17 U.S.C. § 801(b)(1) (2012).

194 Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings, No. 2000-9 (Copyright Office Feb. 20, 2002), *available at* http://www.copyright.gov/carp/webcasting_rates.pdf.

195 Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240, 45,266 (Copyright Office July 8, 2002) (final rule) (codified at 37 C.F.R. § 261).

196 *See, e.g.*, *Online Radio Plans 'Silent' Protest of Fees*, HOUS. CHRON., May 1, 2002, at 3B (noting webcasters' claim that the proposed royalty rates would put them out of business); *see also* David Ho, *Royalty Rates for Internet Radio Rejected*, WASH. POST, May 22, 2002, at E2 (reporting more claims that royalty rates would force webcasters to shut down).

halved the rate set by CARP,[197] to no better reception.[198] Congress's response, the Copyright Royalty and Distribution Reform Act of 2004 (CRDRA), replaced CARP with three Copyright Royalty Judges acting collectively as the CRB.[199] Unfortunately, subsequent rate-setting procedures under the CRB proved no more effective at predicting the technological future. The rate-setting process known as Webcasting II increased the webcasting royalty rate and added a $500 minimum administrative fee "per channel or station."[200] While this cost was reasonable for the average terrestrial broadcaster, which typically has only one radio station, it was an enormous burden to Internet radio services such as Pandora, which allow their users to create an unlimited number of stations. The Webcaster Settlement Act of 2008[201] came about in direct response to this and effectively authorized SoundExchange to negotiate alternate fee agreements with webcasters adversely affected by Webcasting II.[202] The Webcaster Settlement Act of 2009,[203] commonly known as the "PurePlay Settlement,"[204] extended the time allotted for these agreements to be reached.[205] Its terms, which set different rates for different sized webcasters and for different business models, expire in 2015,[206] thereby doing little to improve the pervasive rate uncertainty surrounding performance royalties.

---

197 The Copyright Office reduced the CARP-determined royalty rate of $0.14 per play to $0.07 per play. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. at 45,243.

198 *See, e.g.*, Christopher Stern, *Curtain Call for Webcasts?: Some Decry Order to Pay Royalties to Musicians*, WASH. POST, June 21, 2002, at E1 (discussing continued concern from webcasters postadjustment).

199 17 U.S.C. §§ 801–805 (2012).

200 Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084, 24,097 (Copyright Royalty Bd. May 1, 2007) (final rule) (codified at 37 C.F.R. § 380) (setting digital performance rates).

201 Pub. L. No. 110-435, 122 Stat. 4974 (2008).

202 *See* H.R. Rep. No. 110-941 (2009) (citing as the legislation's impetus "the substantial controversy concerning a June 2007 Copyright Office Royalty Board decision").

203 Pub. L. No. 111-36, 123 Stat. 1926.

204 The term "Pureplay" refers to a commercial webcaster whose revenues are earned primarily through webcasting. *See* Pureplay Webcaster, SOUNDEXCHANGE, http://www.soundexchange.com/service-provider/commercial-webcaster/pureplay-webcaster/ (last visited Sept. 9, 2014). The statutory rates and terms for this category of webcaster are described at 74 Fed. Reg. 34,796–802 (July 17, 2009).

205 *See* 154 Cong. Rec. S10186-02 (daily ed. Sept. 30, 2008) (statement of Sen. Leahy) ("The bill simply extends the time . . . during which the parties can negotiate their own rates, even after the CRB proceeding, and will permit any deal that is negotiated by that time to bind the interested parties.").

206 Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796, 34,799, app. art. 4.2(b)(i) (Copyright Office July 17, 2009).

Given this tumultuous background, it is reasonable to ask why rate uncertainty concerning the future state of the law is prompting private action now, as in the Clear Channel–Big Machine deal, but did not prompt such activity earlier. Why have parties only now begun to circumvent § 114, rather than in 2005 when Internet radio services like Pandora were saddled with unreasonable and disproportionate per-station fees? The answer is one of both timing and degree. First, terrestrial performance rights are the last unknown in sound recording royalties, one that can be avoided altogether by beating the CRB to the punch with a privately established valuation.[207] Parties may not have made the leap to circumvention initially because they had faith, however naïve, in the then-newly established CRB rate-setting process.[208] Having learned the hard way that things do not always go their way when left to the CRB, parties today may be more willing to give private ordering a go. This is especially so where legislation seems imminent and they have no other means to insure against loss as a result of any change in their legal rights.[209]

Second, as a circumventable statutory license, § 114 is effectively a default, which, as discussed above, tends to be sticky. Uncertainty can provide a much-needed push to force an initial break with the perceived status quo. Moreover, in addition to uncertainty about the future legal status of terrestrial performance rights, digital technology provided yet another push in this case. Changes in digital technology have led to increased incentives for cooperation between licensees and licensors, who now find their fates increasingly interdependent. For example, the ability of a digital music streaming service to attract new customers depends, in large part, upon the content that it is able to license from the music labels. The music labels' streaming revenues, in turn, depend significantly upon the service's ability to attract and retain paying customers.

The evolution in digital technology has also led to changes in consumer preferences and expectations, shifting the emphasis from

---

[207] *See supra* notes 51–52 and accompanying text (describing the power of uncertainty and how the threat of government regulation has encouraged private licensing and greater market efficiency).

[208] The CRB was established in 2004 by the Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-419, 118 Stat. 2341 (codified in relevant part at 17 U.S.C. § 114(f)).

[209] While protection against economic change is readily available, there is currently no means of purchasing private insurance against future legal changes, and it has been suggested that this void might be filled by government-provided "transition relief." Jonathan S. Masur & Jonathan Remy Nash, *The Institutional Dynamics of Transition Relief*, 85 N.Y.U. L. Rev. 391, 435 (2010) (finding "the moribund private market for regulatory insurance . . . unlikely to provide a satisfactory solution" and suggesting that instead "the government might provide meaningful transition relief").

terrestrial radio to digital radio (in the case of broadcasters) and from physical CDs to digital MP3s and streams (in the case of record labels). With the number of terrestrial listeners declining each year,[210] it is now more important than ever for a broadcaster to build a digital business. Likewise, with album sales in a steady and undeniable decline,[211] record labels are more eager than ever for alternate sources of revenue.

It helps too that, unlike previous incarnations,[212] the current uncertainty surrounding terrestrial performance rights is a *bounded* uncertainty limited to rate, as opposed to a rampant uncertainty about everything from exemption status to the application of administrative fees. At the same time, there has been a notable shift in consumer preference from terrestrial to digital radio that continues to grow with improvements in technology and service offerings.[213] This creates uncertainty about future digital business models. In other words, there is now both more to lose and more to gain.

Furthermore, the most recent collective webcasting agreement, the PurePlay Settlement, can be viewed as a type of "semiprivate" ordering—a "first draft" of sorts for the private ordering around terrestrial performance rights that is emerging as a natural extension of this inclination to avoid an unknown rate in favor of a negotiated one. The PurePlay Settlement was the industry's last chance to privately negotiate a digital performance rate and, with the missteps of Webcasting I & II looming large in the collective memory, a deal

---

210 *See, e.g.*, Laura Santhanam et al., *Audio: Digital Drives Listener Experience*, *in* PEW RESEARCH CTR., THE STATE OF THE NEWS MEDIA 2013 (2013), *available at* http://stateofthemedia.org/2013/audio-digital-drives-listener-experience ("Financially, the picture does not bode well for traditional radio . . . . Online-only and satellite radio, on the other hand, had better years than in the past, with more positive long-term forecasts. And new legislation under consideration by Congress could be an added windfall to many online-only stations."); *Streaming Music Is Gaining on Traditional Radio Among Younger Music Listeners*, NPD GROUP (Apr. 2, 2013), https://www.npd.com/wps/portal/npd/us/news/press-releases/streaming-music-is-gaining-on-traditional-radio-among-younger-music-listeners/ (noting that, for the fourth quarter of 2012, "[a]s Internet-radio listening rose among [the 13 to 35 age group], listening to AM/FM radio . . . declined 2 percentage points").

211 *See, e.g.*, Ed Christman, *U.S. Album Sales Hit Historic Lows*, BILLBOARDBIZ (Aug. 2, 2013, 7:44 AM), http://www.billboard.com/biz/articles/news/digital-and-mobile/5631721/us-album-sales-hit-historic-lows ("U.S. album sales have hit new historic lows . . . .").

212 *See* discussion *supra* Part III.C.1 (discussing the rampant uncertainty surrounding previous incarnations).

213 *See, e.g.*, *supra* note 210 (observing an increase in Internet radio listening and concurrent decrease in traditional radio listening). In recognition of the increasingly central role that its digital radio service, iHeartRadio, plays in the Clear Channel business, the company recently announced plans to change its name to iHeart Media. Ben Sisario, *Clear Channel Renames Itself iHeartMedia in Nod to Digital*, N.Y. TIMES, Sept. 16, 2014, http://www.nytimes.com/2014/09/17/business/media/embracing-digital-brand-clear-channel-renames-itself-iheartmedia.html.

was eventually reached with the specific aim of avoiding the imposition of a rate set by the CRB.[214]

The same can be said in the case of terrestrial performance rights, where the Free Market Royalty Act, a reincarnation of the Performance Rights Act of 2009 that would have set a statutory terrestrial performance royalty, was introduced by Representative Mel Watt on September 25, 2013.[215] Private ordering around terrestrial performance rights is the industry's chance to get the deal it wants, or at least a deal it can tolerate, before a statutory rate is set.[216] Absent the threat of an imminent and unknown terrestrial performance right, however, and "[k]nowing that they could continue to operate and rely on arbitration, neither [webcasters nor the recording industry] had particularly strong incentives to reach a voluntary agreement."[217] The key to using uncertainty to improve efficiency is thus one of degree. The brand of rampant uncertainty seen in Webcasting I & II breeds mistrust and industry instability. On the other hand, bounded uncertainty—such as uncertainty about the future legal status of terrestrial performance rights and uncertainty about future digital business models—can be used to ameliorate such instability. The next section will show how uncertainty minimizes one of the largest concerns around private ordering: gamesmanship.

2. *The Uncertainty Advantage*

While this Article presents a case for bounded uncertainty, such uncertainty does not guarantee efficiency.[218] Although the level of uncertainty need not be equal for both parties, uncertainty that only affects one party or affects one party too disproportionately can result in inefficiency and gamesmanship. Penalty default licenses mitigate

---

214 *See* Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926 (giving the parties a thirty-day extension); Jeff Leeds, *Reprieve on Royalty Increase Being Pursued for Internet Radio*, N.Y. Times, July 14, 2007, *available at* http://www.nytimes.com/2007/07/14/business/14music.html ("[T]he reprieve [referring to the stay] came as federal lawmakers had begun discussing legislation that would enact reduced fees [referring to the CRB-determined rate].").

215 H.R. 3219, 113th Cong. (2013); *see also* Rep. Watt's Statement, *supra* note 75 (discussing the Free Market Royalty Act). Particularly in light of the title of the legislation (the Free *Market* Royalty Act), it should be kept in mind that the only "market" rate that exists for terrestrial performance is Clear Channel's.

216 The idea that government action can encourage, and even facilitate, private licensing has been proposed by Professors Peter DiCola and Matthew Sag. *See* DiCola & Sag, *supra* note 55, at 242 (citing the Clear Channel–Big Machine deal as an example of "the way that government involvement can spur private negotiations toward a solution").

217 *Id.* at 227.

218 As discussed, the key to using uncertainty to increase efficiency is one of degree. *Supra* Part III.C.1.

this brand of gamesmanship by introducing uncertainty in a way that affects *both* parties. In the case of Clear Channel and Big Machine, for example, both parties are risk averse and gain from removing themselves from the uncertainty surrounding a future, unknown terrestrial performance rate.

Through the use of bounded uncertainty, penalty default licenses work to bring licensees and licensors to the bargaining table without exacerbating existing inequalities. A privately determined rate will not establish an industry norm unless it serves the needs of a majority of the participants. In the case of a penalty default license, those who are not served by it will still have the statutory rate to fall back on and so are in no worse a position than under the status quo,[219] as they retain guaranteed access to content. Proliferation of more efficient private deals has the added benefit of reducing the transaction costs associated with private ordering by establishing a template which may require only minor tweaking from deal to deal. This may allow even smaller, less powerful parties to eventually enjoy the same efficiency gains as larger, more powerful players.

The Clear Channel–Big Machine deal raises concerns about yet another form of gamesmanship: rights accretion. In his work on intellectual property rights, Professor James Gibson suggests that risk aversion can lead to unnecessary rights creation where parties, uncertain about whether or not a particular license is required for a particular use, seek unnecessary licenses until the procurement of those licenses becomes an industry norm.[220] Gibson identifies "[u]ncertainty regarding the reach of intellectual property entitlements" as a key factor leading to unnecessary licensing and thus rights accretion for copyright owners.[221]

The establishment of a terrestrial performance right in the deal between Clear Channel and Big Machine might at first glance seem to present an example of this. Big Machine is being paid for an intellectual property right to which it is not legally entitled, and the

[219] To be sure, the adverse selection concerns discussed in Part II.B.2.b apply, but they are inherent in any nonmandatory statutory licensing regime and do not compromise access (although they may, in the long run, compromise the *quality* of that access). Making the statutory license compulsory is the only way to completely avoid this brand of adverse selection. The question of whether the overall gains resulting from elimination of adverse selection concerns outweigh the efficiency losses resulting from the elimination of private ordering—or whether some other solution might be preferable—is left for future work.

[220] *See* James Gibson, *Risk Aversion and Rights Accretion in Intellectual Property Law*, 116 YALE L.J. 882, 884 (2007) (discussing how the combination of "doctrinal gray areas and . . . the risk aversion that pervades key copyright industries" results in "a practice of securing copyright licenses even when none is needed").

[221] *Id.* at 942.

convention is rapidly spreading in the industry.[222] Closer inspection, however, reveals an important distinction: There is no uncertainty regarding the nonexistence of a terrestrial performance right. It is, in fact, precisely its *certain* nonexistence that makes it such a valuable bargaining tool.[223]

While uncertainty has been shown to correct for gamesmanship stemming from inequality in bargaining power by presenting an unpalatable option to both licensees and licensors, it is less capable of addressing concerns about gamesmanship stemming from private action's influence on industry norms and customs. Still, there are steps that can be taken to help ameliorate some of these concerns. First, a statutory requirement of full disclosure surrounding a private valuation may help alleviate misrepresentation of so-called "market" rates.[224] In addition, Professor Jennifer Rothman has proposed consideration of several factors in determining the legitimacy of a custom in intellectual property. These include "the certainty of the custom, the motivation for the custom, the representativeness of the custom, how the custom is applied (both for what proposition and against whom), and the implications of the custom's adoption."[225] Application of these factors to a proposed "market" rate for terrestrial performance royalties might also help alleviate the potential for the gaming of industry norms. For example, recognition of the strategic motivations behind the Clear Channel–Big Machine deal, in particular the desire to influence the future statutory rate to the disadvantage of differently situated competitors, cuts against the legitimacy of their private rate as a "market" rate. Demonstration of broad proliferation of the deal terms, on the other hand, supports the case for the private rate's adoption. On balance, the application of Rothman's factors may help ensure that a private rate is not mistaken for an industry norm.

---

[222] For further reading on the copycat deals signed since the announcement of the original Clear Channel–Big Machine deal, see *supra* note 10 and accompanying text.

[223] That said, rights accretion may occur where uncertainty impacts one party more strongly than another (a scenario deemed otherwise acceptable). *See supra* note 220 (noting that rights accretion does not necessarily leave the affected party worse off). While outside the scope of this Article, future work on adverse selection will attempt to address this concern.

[224] *See* García, *supra* note 12, at 35–37; *see also supra* Part II.B.2.b (suggesting a statutory amendment to require full disclosure of terms and circumstances surrounding presentation of an alleged "market" rate).

[225] Rothman, *supra* note 118, at 1967–68.

3. Sources of Uncertainty

This Article has focused on uncertainty about the future state of the law and future digital business models, but there are many possible sources of uncertainty. As technological development is both constant and unpredictable, technology itself frequently perpetuates uncertainty in various industries.[226] In addition to changing business models and consumer preferences, "technological innovation affects social norms," which, like defaults, tend to be sticky.[227] Peer-to-peer file sharing demonstrates the magnitude of this effect: By the time the DMCA was passed in 1995, societal norms around file sharing were already firmly entrenched, thereby challenging the law's ability to effectively regulate that type of behavior.[228]

Government intervention can also introduce uncertainty. Such intervention can be indirect, as in the case of CROs, where the government permits their formation and then approves their operation within designated parameters (such as a consent decree). Once formed, licensors are not guaranteed a fixed rate, much less a portion of a blanket license. Royalty accounting under PROs like ASCAP and BMI is notoriously poor, not to mention subject to a complicated pooling calculation that often leaves smaller licensors unpaid.[229] Moreover, licensees are not even guaranteed the content for which they bargain. For example, Sony/ATV's withdrawal from ASCAP makes the latter's catalog inherently less valuable and requires licensees to expend additional time and money to directly license that content.[230] Government intervention can also be direct,

---

226 *See* Depoorter, *supra* note 21, at 1836 ("[T]echnology, by creating an environment of rapid and unpredictable change, establishes two major conditions that have a profound effect on copyright law: legal delay and legal uncertainty."); DiCola & Sag, *supra* note 55, at 180 ("[T]he arrival of new technology almost invariably creates legal uncertainty, market instability, or both . . . . New technologies . . . expose uncertainties and inadequacies in the existing legal regime.").

227 Depoorter, *supra* note 21, at 1837.

228 *See, e.g.*, Christopher Jensen, Note, *The More Things Change, the More They Stay the Same: Copyright, Digital Technology, and Social Norms*, 56 STAN. L. REV. 531, 564 (2003) (pointing out the DMCA's unintended effect of "widen[ing] the existing gap between copyright law and copyright norms, further weakening the law's norm-reinforcing function").

229 *See, e.g.*, Mike Masnick, *How ASCAP Takes Money From Successful Indie Artists and Gives It to Giant Rock Stars*, TECHDIRT (Mar. 26, 2012, 9:25 AM), http://www.techdirt.com/articles/20120323/18055718229/how-ascap-takes-money-successful-indie-artists-gives-it-to-giant-rock-stars.shtml (describing the "unfair practices of collections societies").

230 One such licensee, Pandora, has sued. *See* Paul Resnikoff, *Pandora Is Now Suing ASCAP to Lower Songwriter Royalties . . .*, DIGITAL MUSIC NEWS (Nov. 6, 2012), http://www.digitalmusicnews.com/permalink/2012/11/06/ascap (discussing Pandora's lawsuit against ASCAP over performance royalties). In a recent decision, the Southern District of New York held for Pandora, finding "Pandora is correct that 'works' means musical

such as with the issuance of patents of uncertain scope. Penalty default licenses exemplify yet another type of direct government intervention, one which "might be able to facilitate, hasten, or otherwise encourage a licensing deal."[231]

The implementation of standards, as opposed to rules, is another means of using uncertainty, insofar as they require interpretation and circumstantial application, and their consequences, if any, are only realized ex post.[232] The doctrine of unconscionability in contract law, which deems unenforceable contracts found to be "unconscionable" at the time of formation, is an example of a standard.[233]

The literature on rules versus standards tends to focus on when lawmakers should implement one or the other.[234] Professor Ian Ayres has noted that this debate focuses on immutable rules, as opposed to default rules, since it "has largely ignored how the choice between rules and standards is affected by the ability of private parties to contract around the law."[235] In the default context, standards can be circumvented just as rules can and may induce greater levels of opt-out on behalf of risk-averse parties who would prefer to contract privately for a more certain result. Standards also better accommodate evolving technologies in the digital space.[236]

In the case of § 114, unpalatability comes not only from rate uncertainty but also, interestingly, from excessive rate specificity. Section 114 sets royalty rates for specific types of digital service providers.[237] An example of this is Apple's new iRadio service. Proffered license terms suggest that its business model does not fit

---

compositions and not rights with respect to those compositions." *In re* Pandora Media, Inc., No. 12 Civ. 8035, 2013 WL 5211927, at *6 (S.D.N.Y. Sept. 17, 2013).

231 DiCola & Sag, *supra* note 55, at 173.

232 *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 605 (1992) (noting that "individuals tend to be less well informed concerning standards" and that, relative to rules, standards "can better take advantage of information available only *ex post*").

233 *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) (discussing the doctrine of unconscionability and standards by which to assess contracts for unconscionability).

234 *See, e.g.*, Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 257 (1974) ("This article discusses the conditions under which greater specificity or greater generality is the efficient choice and makes a preliminary effort to appraise the efficiency of the choices actually made by the legal process."); Kaplow, *supra* note 232, at 621 ("This Article provides an economic analysis of rules and standards, focusing on the extent to which the law should be given content before individuals act (rules), rather than waiting until afterward (standards).").

235 Ayres, *supra* note 25, at 2.

236 *See, e.g.*, Depoorter, *supra* note 21, at 1863 ("To some degree, the unpredictable nature of technology simply necessitates open-ended standards in copyright law.").

237 17 U.S.C. § 114(d)(2), (f)(1)–(2) (2012).

§ 114's definition of a webcaster, such that the company is instead engaging in private dealmaking directly with rights holders.[238]

While not without its faults, one of the reasons private ordering often proves more efficient than statutory licensing is because ex ante negotiation is cheaper than ex post litigation. Penalty default licenses represent an optimal use of bounded uncertainty via government intervention in the form of legislative threat.[239] Unlike uncertainty stemming from technological development or changes in consumer behavior, for example, uncertainty about the future state of the law is generally a one-shot concern with plenty of lead time,[240] thereby justifying the expense of avoiding it.

IV
Uncertainty Reconsidered

A. A Statutory Default

As discussed, a penalty default license is a circumventable statutory license imbued with sufficient bounded uncertainty to make it unpalatable to both licensors and licensees, such that they are encouraged to circumvent the default and engage in private ordering. This produces efficiency gains, while also minimizing gamesmanship. Section 114's statutory license for sound recordings exemplifies this brand of government-induced private ordering.[241]

Section 114 contains an explicit authorization to circumvent.[242] This authorization eliminates the legal, and most challenging, barrier to private ordering. Section 114 also sets no cumbersome requirements to qualify for circumvention or language that a party must include to signal an intent to circumvent, thereby lowering

---

[238] For a discussion of the deal terms being offered by Apple to labels, see, for example, Hannah Karp & Jessica E. Lessin, *Apple Spells Out iTunes Radio Terms*, Wall St. J. (June 26, 2013, 7:50 PM), http://blogs.wsj.com/digits/2013/06/26/apple-spells-out-itunes-radio-terms-for-record-labels/. Interestingly, the terms offered also demonstrate the power of industry norms, as the proposed rate calculation already reflects the Clear Channel–Big Machine revenue share model: "Apple intends to pay royalties to labels based on a blend of how many times listeners hear their songs and how much advertising Apple sells." *Id.*

[239] For more on the functioning of legislative threats, see generally Halfteck, *supra* note 76.

[240] Congress will often hold multiple hearings well in advance of a vote on a particular piece of legislation. Once that legislation is passed, however, so too is the time for attempting to influence the resulting law.

[241] Professors Peter DiCola and Matthew Sag cite other examples of private action brought about by government intervention, including blanket license agreements under ASCAP and BMI and takedown notice and compliance procedures under the DMCA. DiCola & Sag, *supra* note 55, at 182–83.

[242] *See* 17 U.S.C. § 114(e)(1), (f)(3) (providing an explicit opt-out for licensors and licensees of sound recordings).

transaction costs further and working to alleviate the propensity of default stickiness.

As demonstrated by the Clear Channel–Big Machine deal, § 114 suffers inefficiencies that are readily improved upon by private ordering. These inefficiencies form the basis of the statutory license's unpalatability and give rise to its "penalty" default nature. Parties who circumvent § 114 may enjoy a predictable rate tailored to specific content and use, one not subject to the determinations of a rate court or the whims of pending legislation or litigation. It is also one that parties can cheaply and readily modify to accommodate new technologies, business models, and consumer preferences.

Finally, § 114 suffers from rate fluctuation and variation in rate-setting standards. By affecting both licensees and licensors, this rate uncertainty mitigates the tendency toward stickiness and minimizes the potential for the type of anticompetitive gamesmanship and opportunism that are born of notable discrepancies in bargaining power. Significantly, the use of existing uncertainty does not constitute the intentional making of "bad law." To the contrary, this Article advocates leaving in place the "best" statutory license possible,[243] then using controlled amounts of uncertainty to encourage greater efficiency via private ordering. Using § 114 as a model, legislators can improve efficiency in the statutory license for certain types of copyright-protected content, while guaranteeing access and mitigating the potential for gamesmanship by converting statutory licenses into penalty default licenses through the use of bounded uncertainty.

B. The Importance of Defaults

This section seeks to illustrate the importance of coupling uncertainty with a penalty default. It uses as an example one of the uncertainty types found in the Clear Channel–Big Machine case study: legislative uncertainty. One contemporary example of this brand of uncertainty is the state-versus-local-law preemption debate taking place in California, a state that has enacted laws permitting the operation of medical marijuana dispensaries. The California Supreme Court recently determined that those state laws do not trump local bans on medical marijuana dispensaries.[244] In cities without such bans, medical marijuana clinics are now uncertain whether or when local

[243] Future work will consider the adverse selection effects that opt-out has on the statutory license and those licensees and licensors left to its purview. For the purposes of this Article, it suffices to keep the existence of adverse selection in mind.

[244] *See* City of Riverside v. Inland Empire Patients Health & Wellness Ctr., Inc., 300 P.3d 494, 512 (Cal. 2013) (holding that California state law legalizing the sale and use of

law may preempt their legal status, potentially shuttering their businesses and forcing them to forfeit their investments. As a result of this legislative uncertainty, the number of clinics operating in those cities may be smaller than an efficient market would optimally support. This is because prospective, risk-averse clinic operators may opt out of starting up new businesses in the face of uncertainty about whether they might be shut down in the future by the passage of local legislation barring their existence. Thus, in the absence of a fallback or default option, uncertainty about the future state of local marijuana legislation may lead to market inefficiency.

A similar effect can be seen in the ongoing immigration debate. The federal Deferred Action for Childhood Arrivals (DACA) program, launched by the Obama administration as a stop-gap measure until Congress passes immigration reform, defers deportation for undocumented immigrants between the ages of fifteen and thirty who came to the United States as children and who are either currently in school or have graduated from high school.[245] However, this has not prevented states like Arizona from denying deferred-action recipients the right to obtain a driver's license or to benefit from paying in-state tuition.[246] Despite the passage of an immigration reform bill by the Senate in June 2013,[247] resistance from the House of Representatives has left the situation uncertain.[248] DACA students in Arizona, for example, may opt not to enroll in college for fear that the state's denial of tuition benefits might not be federally overruled, leaving them with a larger-than-expected, and possibly larger-than-manageable, tuition bill. Again, without a default to turn to, uncertainty about the future state of immigration reform can lead to inefficiency.

In both of these examples, uncertainty about the future state of the law has predictably led to inefficiency in the absence of a default or fallback option. If a medical marijuana clinic in California is shut down by a future local law, its proprietor has no recourse. There is no "security blanket" in the form of a default, such as that provided for

---

medical marijuana does not preempt the authority of California cities and counties to allow, restrict, limit, or entirely exclude medical marijuana dispensaries).

245 Daniel Gonzalez, *A Year Later, Immigrants Face DREAM Act's Limits*, USA TODAY (Aug. 13, 2013, 11:32 PM), http://www.usatoday.com/story/news/nation/2013/08/13/a-year-later-immigrants-face-deferred-action-programs-limits/2651235/.

246 *See id.* (discussing Arizona's restrictions for DACA recipients).

247 *See, e.g.*, Ashley Parker & Jonathan Martin, *Senate, 68 to 32, Passes Overhaul for Immigration*, N.Y. TIMES, June 28, 2013, at A1.

248 *See id.* (noting "firm House resistance to the Senate bill").

sound recordings by the § 114 statutory license.[249] As a result, each of these examples represents a suboptimal outcome stemming from *unbounded* uncertainty.[250]

In behavioral economic terms, uncertainty encourages efficiency because individuals tend to be risk averse. They want predictable outcomes, and they want to avoid loss. For this reason, people tend to purchase insurance, wear seatbelts, vaccinate their children, and go for annual medical exams—all results that, when acted upon, maximize overall social welfare. As such, individuals can generally be pushed toward more efficient outcomes as a result of a desire to avoid an unpalatable alternative. As demonstrated in the next section, penalty default licenses like § 114 show that the same effect is achieved in the market context so long as there is both bounded uncertainty *and* an unpalatable fallback.

C. Bounded Uncertainty

The so-called "negative IP space"[251] provides several examples of the efficiency-enhancing effects of bounded uncertainty coupled with an unpalatable fallback. Despite the fact that tattoos are a form of visual art, they exist in a legal gray area by nature of their unique medium. While tattoos, or at least their line drawings,[252] are most likely protected by copyright, so few infringement suits have been brought[253] that there is uncertainty about the contours of both the current and future state of the law. Are tattoos currently protected? If

---

249 Though it might sound odd, the fact that § 114 serves as an unpalatable default does not preempt it from also serving as a security blanket. In the Clear Channel–Big Machine case study, the statutory license's inherent inefficiencies make it unpalatable enough to induce the parties to the bargaining table. But its existence allows the parties to experiment with a one-off deal without having to commit to the terms vis-à-vis all business partners.

250 Richard Craswell and John Calfee have suggested that a small amount of uncertainty (i.e., "bounded" uncertainty) is most likely to lead to overcompliance, while broad uncertainty (i.e., "unbounded" uncertainty) is more likely to lead to undercompliance. Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 280 (1986).

251 Kal Raustiala & Christopher Sprigman, *The Piracy Paradox: Innovation and Intellectual Property in Fashion Design*, 92 VA. L. REV. 1687, 1764 (2006) (defining the term "negative space" in the intellectual property context to describe areas without adequate intellectual property protection).

252 While some templatized tattoos—generally referred to as "stock" or "flash" designs—are drawn directly on the skin, most custom tattoos are first drawn on paper and then transferred to the skin. The paper drawing is referred to as the "line drawing" because it contains only the outline of the design. The tattoo artist fills in the shading, color, etc., freehand directly on the skin. Aaron Perzanowski, *Tattoos & IP Norms*, 98 MINN. L. REV. 511, 526 (2013).

253 *See id.* at 530 ("Copyright suits between tattooers and their clients, or suits between two tattooers, are virtually non-existent.").

so, when? And will they be in the future? This uncertainty has led to the establishment of private rules that have come to operate as efficient industry norms.[254] A party who is unhappy with a result under the private norm regime has the murky copyright protection to fall back on, but the scant case law demonstrates that this rarely happens.

The same uncertainty can be seen in stand-up comedy, an industry that enjoys only marginal and largely ineffective copyright protection. In the face of this uncertain protection, comedians (like tattoo artists) have developed a system of norms that efficiently governs behavior in the industry.[255] These efficient private norms function precisely because of the "threat" of alternatively leaving it to the mercy of the unpredictable (i.e., unpalatable) copyright coverage for the genre.

Most recently, copyright enforcement is benefiting from the use of uncertainty coupled with a default. Uncertainty about the future of antipiracy legislation, coupled with the highly unpalatable DMCA notice-and-takedown regime (i.e., the penalty default), promises to play an important role in the future of copyright enforcement. On July 15, 2013, the U.S. Intellectual Property Enforcement Coordinator, Victoria Espinel,[256] announced the Copyright Office's support for private efforts to fight piracy, counterfeiting, and other forms of copyright infringement.[257] To date, legislative efforts on this front have proven ineffective and more effective results are being achieved

---

[254] *See id.* at 591 (describing multiple purposes of the norms developed by tattooers, including "protect[ing] both the relationship between tattooer and client and the underlying assertion of personal sovereignty the tattoo represents," "preserv[ing] tradition by encouraging the use of flash designs," "encourag[ing] innovation by protecting custom designs from copying," and "giv[ing] tattooers valuable tools for cultivating market demand for their services"); *see also* Kal Raustiala & Christopher Sprigman, *Flesh, Ink and the Law*, L.A. TIMES, Oct. 6, 2013, at A.31, *available at* http://www.latimes.com/opinion/commentary/la-oe-raustiala-tattoo-copyright-20131006,0,3026228.story ("[I]f there's little doubt that tattoo artists are entitled to copyright, it is far from clear what rights that should give them over their creations.").

[255] *See* Dotan Oliar & Christopher Sprigman, *There's No Free Laugh (Anymore): The Emergence of Intellectual Property Norms and the Transformation of Stand-Up Comedy*, 94 VA. L. REV. 1787, 1790 (2008) ("[I]n stand-up comedy, social norms substitute for intellectual property law.").

[256] On August 13, 2013, Espinel stepped down to assume the reins at software industry trade group BSA . Tony Romm, *Former White House IP Adviser Victoria Espinel to Lead BSA*, POLITICO (Aug. 28, 2013, 7:02 PM), http://www.politico.com/story/2013/08/victoria-espinel-bsa-96015.html.

[257] According to Espinel: "The Administration strongly supports voluntary efforts by the private sector to reduce infringement and we welcome the initiative brought forward by the companies to establish industry-wide standards to combat online piracy and counterfeiting by reducing financial incentives associated with infringement." Victoria Espinel, *Coming Together to Combat Online Piracy and Counterfeiting*, OFF. MGMT. &

by private efforts, such as the Interactive Advertising Bureau's (IAB) guidelines for digital advertising in the marketplace.[258] That proposal, supported by technology companies such as Microsoft and Google, seeks to cut off funding to known pirate sites by prohibiting the sale of advertising inventory to sites known to "engag[e] in, promot[e] or facilitat[e] illegal or legally questionable activities such as . . . online pirating . . . as governed by United States Federal law."[259] The IAB press release accompanying the proposal claims the guidelines provide "brand safety assurances to advertisers that their ads will not appear next to inappropriate content, including pirated intellectual property."[260]

Unlike the highly criticized Stop Online Piracy Act (SOPA), which had similar aims,[261] and unlike the DMCA, which has caused more problems than it has fixed,[262] this private approach promises greater efficiency. The University of Southern California's Annenberg Innovation Lab "do[es] not believe that government regulation alone is the answer to the Piracy problem, but rather that the self-regulation of major sectors like the online advertising industry could make it harder for the 'Kim Dotcom's' of the world to unfairly exploit

BUDGET (July 15, 2013, 8:33 AM), http://www.whitehouse.gov/blog/2013/07/15/coming-together-combat-online-piracy-and-counterfeiting.

258 *See* INTERACTIVE ADVER. BUREAU, QUALITY ASSURANCE GUIDELINES 2.0 (2013), *available at* http://www.iab.net/media/file/QualityAssuranceGuidelines7252013.pdf (establishing guidelines that promote transparency in digital advertising transactions).

259 *Id.* at 28.

260 Press Release, Interactive Adver. Bureau, IAB Releases Quality Assurance Guidelines 2.0 (July 25, 2013), *available at* http://www.iab.net/about_the_iab/recent_press_releases/press_release_archive/press_release/pr-072513.

261 *See* H.R. 3261, 112th Cong. (2011) (defining the aims of SOPA as, inter alia, "promot[ing] prosperity, creativity, entrepreneurship, and innovation by combating the theft of U.S. property"). For a summary of the free speech critiques against the bill, see, for example, Trevor Timm, *How PIPA and SOPA Violate White House Principles Supporting Free Speech and Innovation*, ELEC. FRONTIER FOUND. (Jan. 6, 2012), https://www.eff.org/deeplinks/2012/01/how-pipa-and-sopa-violate-white-house-principles-supporting-free-speech.

262 For a recent sampling of the many examples of DMCA abuse, see, for example, Mike Masnick, *DMCA Copyright Takedowns to Google Increased 10x in Just the Past Six Months*, TECHDIRT (Dec. 12, 2012, 10:00 AM), https://www.techdirt.com/articles/20121211/16152021352/dmca-copyright-takedowns-to-google-increased-10x-just-past-six-months.shtml (citing the number of DMCA takedowns received by Google in a single week as 2.5 million and pointing to the "abuses of the DMCA process" highlighted by Google's Transparency Report); Mike Masnick, *Microsoft Uses DMCA to Block Many Links to Competing Open Office*, TECHDIRT (Aug. 15, 2013, 7:33 AM), http://www.techdirt.com/articles/20130814/17501024181/microsoft-uses-dmca-to-block-many-links-to-competing-open-office.shtml (calling Microsoft's use of the DMCA takedown process to remove competitors' links "flat out censorship" and "abusing a legal process").

artists."[263] To that end, the Lab issues a monthly "Advertising Transparency Report" that tracks the companies whose advertising funds pirate site operation, along with a sampling of brands whose products are featured on those sites.[264] These brands include such prominent names as LG, Verizon, and Visa.[265] According to director Jonathan Taplin, this private effort asks, "Where is the money in this business?"—an inquiry that has exposed companies like Google and Yahoo!, which have consequently "changed their behavior quite rapidly."[266]

In the face of uncertainty about the future state of antipiracy legislation, technology companies and content owners alike are encouraged to engage in private ordering for more efficient results. Copyright holders and technology companies today are uncertain whether any new or additional antipiracy measures will be passed and, if so, when that will be or what they might look like. Rather than wait around for another SOPA or DMCA—i.e., the unpalatable fallback option—parties are incentivized to engage in private negotiation for more efficient, tailored terms. In addition, larger parties like Google are encouraged to act early so as to set a baseline and encourage the development of an industry norm that works for them.

Outside the copyright context, uncertainty in the form of indeterminate patent validity has been suggested as potentially "induc[ing] a limited amount of infringement that enhances social welfare without reducing (or without substantially reducing) the profitability of the patentee."[267] The protection of the patent laws, however uncertain in scope, serves as a fallback that allows for private action—in this case, limited amounts of infringement—to result in greater overall efficiency. Should the level of infringement exceed that which a patent holder deems "limited," he has a recourse. The same is

---

263 USC Annenberg Innovation Lab, *Online Advertising Transparency Report*, http://www.annenberglab.com/projects/ad-piracy-report-0 (last visited Sept. 9, 2014) (quoting monthly report).

264 *See* USC ANNENBERG INNOVATION LAB, ADVERTISING TRANSPARENCY REPORT (5th ed. 2013), *available at* http://www.annenberglab.com/sites/default/files/uploads/USCAnnenbergLab_AdReport_May2013.pdf (listing the "top ten advertising networks on illicit file sharing sites" and providing a sample of "major brands whose ads have appeared on file-sharing sites").

265 *Id.*

266 *Ad Transparency Report Focuses on Piracy Sites*, USC NEWS (Apr. 19, 2013), http://news.usc.edu/#!/article/49582/ad-transparency-report-focuses-on-piracy-sites/.

267 Ian Ayres & Paul Klemperer, *Limiting Patentees' Market Power Without Reducing Innovation Incentives: The Perverse Benefits of Uncertainty and Non-Injunctive Remedies*, 97 MICH. L. REV. 985, 986–87 (1999) ("Limited amounts of infringement combined with increased patent duration . . . can substantially reduce the distortionary ex post effects of *supra*-competitive pricing without reducing the patentee's ex ante incentives to innovate.").

true for the prospective patent infringer. The patent's validity is indeterminate, so that he at least has a fallback argument that its scope was unclear.

Expanding the concept still further, plea bargaining in criminal cases provides another example of uncertainty's ability to encourage more efficient private dealmaking.[268] The uncertainty in these cases comes not only from uncertainty about the likelihood of conviction, but also other prosecutorial variables (such as witnesses). In her work on prosecutorial screening, for example, Professor Celesta Albonetti finds that a decrease in uncertainty surrounding the credibility and likelihood of cooperation of a witness is correlated with an increase in continued prosecution. In other words, increased stability leads to a less efficient outcome: trial.[269]

These examples involve uncertainty, but the uncertainty is bounded by the existence of minimal legal protection that serves as a penalty default. Unlike the DACA student in Arizona who is without an alternative legal recourse when her application for a driver's license is denied, a tattoo artist whose designs are copied at least has the option, albeit unpalatable, to sue should the industry's system of social norms fail to protect his work.[270]

Companies, like individuals, are risk averse. The existence of a fallback option, even a poor one, allows them to take a chance on private negotiation. This is the case because the parties know they have an alternative should the deal not work out. Moreover, the fallback allows them the freedom of dabbling in individual deals with only one partner or a handful of them, affording valuable feedback on which terms work and which ones do not without committing the time and effort required to negotiate individually with all comers. If the

---

268 "Efficient" here simply means that rational parties have saved resources and reached a mutual agreement. There is valid debate regarding whether this makes the conclusion reached "better," or even desirable, for the accused or for society. *See, e.g.*, Timothy Lynch, *The Case Against Plea Bargaining*, REG., Fall 2003, at 24 ("It is true that plea bargaining speeds the caseload disposition, but it does so in an unconsitutional manner.").

269 *See* Celesta A. Albonetti, *Criminality, Prosecutorial Screening, and Uncertainty: Toward a Theory of Discretionary Decision Making in Felony Case Processings*, 24 CRIMINOLOGY 623, 623 (1986) (arguing that decreased uncertainty in case information increases the probability of continuing prosecution).

270 An interesting counterexample is presented by the illegal drug trade, which also faces uncertainty about the future state of the law *without* a legal default option and yet has similarly used private agreements to establish efficient social norms. *See* STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING 89–114 (2005) (discussing the economic organization of drug gangs in inner cities). In the words of Levitt and Dubner, "a crack gang works pretty much like the standard capitalist enterprise." *Id.* at 103. While outside the scope of the current Article, there may be additional incentivizing effects stemming from potential penalties that go beyond the financial, such as prison time.

private terms prove functional and an industry norm begins to take shape—as in the case of the Clear Channel–Big Machine deal—it can then be extended to the larger, more comprehensive partners and eventually reflected in the underlying legal regime.

Conclusion

When coupled with a penalty default, uncertainty can bring greater efficiency to the marketplace by encouraging private ordering, which allows for tailored terms and responsiveness to rapid technological change. This is great news in the music sampling context, where for years scholars, legislators, and industry players have been debating a statutory license.[271] This Article suggests that a penalty default license for samples, coupled with existing uncertainty about the future state of protections for derivative works, might alleviate efficiency concerns by encouraging more and better private negotiation.[272]

This prescription is particularly timely given the imminent rewrite of "the next great copyright act,"[273] and may find application outside the United States as well. In the European Union, for example, there has been a recent push for single-market licensing of intellectual property rights.[274] Copyright territoriality has largely thwarted this

[271] *See, e.g.*, Ed Christman, *Proposal for Compulsory Remix License Has Foes in Steven Tyler and Attorney Dina LaPolt*, Billboard (Feb. 10, 2014, 1:24 PM), http://www.billboard.com/biz/articles/news/legal-and-management/5901155/proposal-for-compulsory-remix-license-has-foes-in (describing Aerosmith and other artists' letters to the Patent and Trademark office opposing compulsory licenses.

Joshua Crum, Comment, *The Day the (Digital) Music Died:* Bridgeport*, Sampling Infringement, and a Proposed Middle Ground*, 2008 BYU L. Rev. 943 (2008) (suggesting a failure of the copyright laws to adequately address digital sampling and arguing for a compulsory sampling license); Ryan C. Grelecki, Comment, *Can Law and Economics Bring the Funk . . . or Efficiency?: A Law and Economics Analysis of Digital Sampling*, 33 Fla. St. U. L. Rev. 297, 328 (2005) (considering, inter alia, compulsory licensing as a possible solution to the digital sampling problem).

[272] This is markedly different from the current state of affairs, where content owners do not have to license their content to anyone or may license only to licensees of their choosing at whatever price they wish. *See* Howard, *supra* note 22 ("Any time an artist desires to sample a work . . . the artist must negotiate with the rights holders, and the rights holders can set whatever terms they want (or just deny the request all together)."). Unsuccessful licensees have no alternative recourse for access should their licensing efforts fail. Introduction of a penalty default license, however, would guarantee licensees that access, while motivating content owners to play ball.

[273] *The Register's Call for Updates to U.S. Copyright Law: Hearing Before the Subcomm. on Courts, Intellectual Prop. & the Internet of the H. Comm. on the Judiciary*, 113th Cong. 48 (2013) (statement of Maria A. Pallante, Register of Copyrights, U.S. Copyright Office); *see* discussion *supra* Part III.A.

[274] *See, e.g.*, Press Release, European Comm'n, Copyright: Commission Proposes Easier Music Licensing in the Single Market (July 11, 2012), *available at* http://europa.eu/rapid/press-release_IP-12-772_en.htm (describing the European Union's Single Market music

initiative,[275] whereas private ordering has resolved it. In November 2012, for example, Google accomplished something the European Union has thus far been unable to: The company struck a private, multiterritory agreement with thirty-five European countries.[276]

Acknowledgment of the role uncertainty and penalty defaults play in increasing effectiveness in the market for statutory licensing and in copyright enforcement is only the beginning. A better understanding of uncertainty as a tool for efficiency has application in any industry facing change as a result of rapid technological growth, evolving consumer preferences, or ambiguity about the future state of the law.

---

licensing proposition); Frances Robinson, *EU Aims to Ease Music-Licensing Rules*, WALL ST. J. (July 11, 2012, 12:51 PM), http://online.wsj.com/article/SB10001424052702303919504577520721438682072.html.

[275] Regardless of how wide or narrow the net of harmonization would be cast over the laws of the Member States, and how rigorous the European legislature would comply with its self-imposed principles of 'better lawmaking', this could never remove the ultimate barrier to market integration: the territorial nature of nationally defined copyright and related rights. Territoriality is the Achilles' heel of the acquis.

MIREILLE VAN EECHOUD ET AL., HARMONIZING EUROPEAN COPYRIGHT LAW: THE CHALLENGES OF BETTER LAWMAKING 307 (2009), *available at* http://www.ivir.nl/publications/eechoud/Harmonizing_European_Copyright_Law_chap9.pdf.

[276] *See, e.g.*, Darrell Etherington, *Google Strikes Licensing Deal with European Music Publishers, Gains Access to 5.5M Tracks Across 35 Countries*, TECHCRUNCH (Nov. 19, 2012), http://techcrunch.com/2012/11/19/google-strikes-licensing-deal-with-european-music-publishers-gains-access-to-5-5m-tracks-across-35-countries/.