

WEBCASTING ROYALTY RATES

By Karen Fessler

The emergence of the Internet has been both a blessing and a curse for the recording industry. While this far-reaching medium offers record companies an unprecedented opportunity to reach more consumers around the globe, it also threatens the very control that the industry exercises over its sound recordings and may undercut traditional record sales.¹ The passage of two key pieces of legislation in the past decade—the Digital Performance in Sound Recordings Act of 1995 (DPSRA)² and the Digital Millennium Copyright Act of 1998 (DMCA)³—has significantly helped the recording industry to control the distribution of its sound recordings over the Internet.

The legislation has meanwhile created conflict between record companies and webcasters,⁴ the Internet radio services that transmit copyrighted music over the Web. While the legislation grants record companies the exclusive right to the digital performance of their recordings, it also creates a compulsory licensing regime, which gives eligible webcasters the automatic right to transmit music in exchange for payments of royalties to record companies. This Note focuses on the process of determining webcasting royalties, which has become a source of discord.

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1. U.S. music sales declined 4 percent to \$13.7 billion in 2001 from \$14.3 billion in 2000, according to the Recording Industry Association of America, which represents U.S. record labels. *Recording Industry Announces 2001 Year-End Shipments*, at http://www.riaa.com/News_Story.cfm?id=491 (last visited Feb. 3, 2003). For the first six months of 2002, music sales declined 6.7 percent to \$5.53 billion from \$5.93 billion for the first six months of 2001. *RIAA Releases Mid-Year Snapshot of Music Industry*, at http://www.riaa.com/News_Story.cfm?id=552 (Aug. 26, 2002).

2. Digital Performance Right in Sound Recordings Act of 1995, Pub. L. No. 104-39, 109 Stat. 336 (1995) (codified as amended in scattered sections of 17 U.S.C.).

3. Digital Millennium Copyright Act of 1998, Pub. L. No. 105-304, 112 Stat. 2860 (1998) (codified as amended in scattered sections of 17 U.S.C.).

4. For the purposes of this Note, webcasting refers to noninteractive, nonsubscription streaming of audio on the Internet. Webcasts may consist of retransmissions of over-the-air broadcasts or of Internet-only services. Webcasters employ a technology known as “streaming,” in which packets of digitized transmissions are sent to individual recipients, who use software that reassembles the packets and plays them back immediately.

Record companies and webcasters unsuccessfully attempted to reach an industry-wide agreement on royalty rates under the statutory license.⁵ After negotiations broke down, the Library of Congress (“LOC”)⁶ convened a Copyright Arbitration Royalty Panel (“CARP”), which issued a royalty rate recommendation in February 2002.⁷ However, the LOC ultimately rejected this recommendation and issued its own order in July 2002 establishing rates.⁸ Both record companies and webcasters contested the rate determination.⁹

This Note addresses the shortcomings of the royalty rate determination process; in particular, it examines the workings of the CARP and the hypothetical marketplace standard that it and the LOC used to determine the royalty rates. This Note will proceed in two parts. Part I.A considers the public performance right as it emerged in the DPSRA and DMCA as an important context and background to the webcasting royalty dispute. Part I.B examines how CARP and LOC determine royalty rates. Part II analyzes the divergent interests of webcasters, record companies and the public, and discusses the failings of the CARP rate-setting process. Part II argues that the standard is unworkable and that the CARP distorts the very market that it seeks to replicate, resulting in royalty determinations that undermine the balance that copyright law strives to maintain between fostering innovation and providing fair compensation to copyright holders to

5. See Bob Tedeschi, *Web Radio Awaits a Ruling on Royalties They Must Pay Recording Companies to Stream Music*, N.Y. TIMES, Feb. 18, 2002, at C5; see also Digital Performance Rights in Sound Recordings and Ephemeral Recordings, 66 Fed. Reg. 38,324 (July 23, 2001).

6. The Library of Congress oversees the U.S. Copyright Office, which administers Copyright Arbitration Royalty Panels. These panels meet for limited times to adjust rates and distribute royalties. 17 U.S.C. § 801(b) (2000).

7. In the Matter of Rate Setting for Digital Performance Right in Sound Recordings and Ephemeral Recordings, Report of the Copyright Arbitration Panel, available at http://www.copyright.gov/carp/webcasting_rates.pdf [hereinafter CARP Report].

8. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, Final Rule, 67 Fed. Reg. 45,240 (July 8, 2002) (codified at 37 C.F.R. pt. 261) [hereinafter LOC Report].

9. In December 2002, President Bush approved legislation allowing small webcasters to pay lower royalty rates than the ones set by the LOC. The legislation, known as the Small Webcaster Settlement Act (“SWSA”), authorizes the music industry’s principal royalty collector, SoundExchange, to negotiate binding royalty contracts with small webcasters. Pub. L. No. 107-321, 116 Stat. 2780 (2002) (to be codified at 17 U.S.C. §§ 112, 144). Pursuant to the SWSA, SoundExchange, and a coalition of webcasters negotiated a royalty agreement for small commercial webcasters that allows these webcasters to pay the negotiated fees instead of the fees determined by the LOC. 67 Fed. Reg. 78,510.

promote the development of the webcasting medium.¹⁰ It emphasizes that the CARP discourages meaningful voluntary negotiations between parties and that the standard that CARP uses to set rates is inadequate.

I. BACKGROUND

A. Public Performance Rights in Sound Recordings

Recorded songs, whether on a compact disk or a cassette tape, typically consist of two separate copyrightable works: the “musical work,” the series of notes and lyrics that a composer creates, and the “sound recording,” the actual sound of a performance of those notes and lyrics that is fixed onto a CD or cassette.¹¹

This distinction is important in the context of the copyright law: copyright owners hold a bundle of five exclusive rights specified in § 106 of the 1976 Copyright Act: the rights to reproduce, distribute, perform publicly, create derivatives, and display their work.¹² However, these rights are limited for holders of copyrights in sound recordings, typically record companies, who generally do not have the exclusive right to publicly perform their works.¹³ Therefore, when a song is played on the radio, the composer of the song—the holder of the musical work copyright—receives a royalty payment from the radio station,¹⁴ while the record company—the holder of the sound recording copyright—receives nothing.¹⁵

10. In this balance, fair compensation to creators is secondary to the public benefit. *Twentieth Century Corp. v. Aiken*, 422 U.S. 151, 156 (1975) (stating that the law “reflects a balance of competing claims upon the public interest: Creative work is to be encouraged and rewarded, but private motivation must ultimately serve the cause of promoting broad public availability of literature, music, and the other arts”).

11. See 1 MELVILLE B. NIMMER & DAVID NIMMER, *NIMMER ON COPYRIGHT* § 2.10[A] (2002); see also R. Anthony Reese, *Copyright and Internet Music Transmissions: Existing Law, Major Controversies, Possible Solutions*, 55 U. MIAMI L. REV. 237, 240-41 (2001).

12. 17 U.S.C. § 106 (2000).

13. See *id.* at § 106(4) (“[I]n the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works, [the copyright owner has the exclusive right] to perform the copyrighted work publicly.”); see also NIMMER, *supra* note 11, at § 8.14[A] (2002) (“[T]his excludes from the performance right only pictorial, graphic and sculptural works, and sound recordings.”).

14. Payments to composers are collected and distributed by three principal agencies: American Society of Composers, Authors and Publishers (“ASCAP”), Broadcast Music Inc. (“BMI”), and SESAC, Inc. The societies consist of copyright owners who grant the societies the nonexclusive right to license public performances of their musical works. The societies, in turn, grant blanket licenses to such entities as radio, television stations,

Congress did not address this anomaly until the 1990s when the Internet began to emerge as a viable distribution medium and the digital transmission of songs became widespread. In the past decade, Congress has made two amendments to the 1976 Copyright Act—the DPSRA and DMCA—granting record companies a limited right over the public performance of their sound recordings, thus allowing them to collect royalties when their sound recordings are transmitted through digital media.¹⁶ Both the DPSRA and DMCA were explicitly designed to stimulate the development of new Internet distribution methods and thereby facilitate the delivery of sound recordings to consumers.¹⁷ Congress also sought to ensure that copyright owners would be able to receive fair compensation as new digital technologies emerged.¹⁸ The amendments established a compulsory licensing regime for the transmission of digital sound recordings on the Internet. The compulsory license enables eligible webcasters to automatically obtain a license to transmit sound recordings, easing their burden of having to locate and negotiate individual license agreements with each record company that holds the sound recording copyright to each song transmitted.¹⁹

nightclubs and restaurants, meaning these entities can perform any work in the societies' repertoire. See AL KOHN & BOB KOHN, *KOHN ON MUSIC LICENSING* 1307 (3d ed. 2002).

15. Radio broadcasters were able to exclude payments for sound recordings from the Copyright Act because the broadcasting industry has a powerful lobby on Capitol Hill through the National Association of Broadcasters. See MERGES ET. AL., *INTELLECTUAL PROPERTY IN THE NEW TECHNOLOGICAL AGE* 480 (2d ed. 2000); KOHN & KOHN, *supra* note 14, at 1296-97 (explaining that music publishers and songwriters also resisted a public performance right for sound recordings because they feared that broadcasters would have less money to pay for the performance of their songs if broadcasters were forced to pay royalties to record companies as well).

16. See 17 U.S.C. § 106(6) (2000).

17. See S. REP. NO. 104-128, at 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 356, 361 ("These new digital transmission technologies may permit consumers to enjoy performances of a broader range of higher-quality recordings than has ever before been possible Such systems could increase the selection of recordings available to consumers, and make it more convenient for consumers to acquire authorized phonorecords.").

18. See *id.* at 10 ("The purpose of [the DPSRA] is to ensure that performing artists, record companies and others whose livelihood depends upon effective copyright protection for sound recordings, will be protected as new technologies affect the ways in which their creative works are used.").

19. The other compulsory licenses under the 1976 Copyright Act cover cable and satellite transmissions of television programs under 17 U.S.C. §§ 111, 119, 122; phonorecords under § 115; coin-operated phonorecord players or jukeboxes under § 116; and noncommercial broadcasts under § 118.

1. *Digital Performance Right in Sound Recordings Act*

The DPSRA created a three-tiered system under which different kinds of Internet services receive varying exposure to the performance right:²⁰

(1) "Exempt transmissions" consist of nonsubscription digital audio transmissions which, like analog radio broadcasts, are exempt from the digital performance right, meaning recording artists and producers do not have a right to control these transmissions and demand compensation;²¹ (2) non-exempt transmissions subject to the compulsory license consist of noninteractive subscription digital transmissions;²² (3) non-exempt transmissions that are not eligible for the compulsory license consist of on-demand interactive digital transmissions,²³ sometimes referred to as the "Celestial jukebox."²⁴ Sound recording copyright holders have full control over Celestial jukebox transmissions, meaning those wishing to digitally transmit music interactively must seek licenses from the copyright holders.²⁵

The public performance right granted by the DPSRA is narrow and contains many exceptions.²⁶ For example, it only applies to sound recordings transmitted "by means of a digital audio transmission,"²⁷ which exempts analog AM and FM broadcasts, or other public performances that do not involve a transmission, such as playing CDs as background music

20. See Jane C. Ginsburg, *Copyright Legislation for the "Digital Millennium,"* 23 COLUM.-VLA J.L. & ARTS 137, 167 (1999) ("The structure of the amendments addressed a spectrum of digital performances, from those resembling traditional radio broadcasts, to the 'celestial jukebox' model of music on demand.").

21. See 17 U.S.C. § 114(d)(1) (1994 & Supp. II 1996).

22. See *id.* § 114(d)(2).

23. See *id.* § 114(d)(3).

24. See PAUL GOLDSTEIN, *COPYRIGHT'S HIGHWAY: FROM GUTENBERG TO THE CELESTIAL JUKEBOX* 199 (1995) (describing future interactive technology as "a technology-packed satellite orbiting thousands of miles above Earth, awaiting subscriber's order—like a nickel in the old jukebox, and the punch of a button-to connect him to any number of selections from a vast storehouse via a home or office receiver . . .").

25. See Reese, *supra* note 11, at 346-47.

26. The DPSRA was narrowly crafted to address concerns about the impact that certain kinds of subscription and interactive audio services might have on record sales. The limitations are geared toward preventing subscription services from cutting too deeply into sales of pre-recorded music. S. REP. NO. 104-128, at 15 (1995), *reprinted in* 1995 U.S.C.C.A.N. 356, 362. The limitations are imposed in 17 U.S.C. § 114(d)-(j) (2000). For a description and analysis of the DPSRA, see David Wittenstein & M. Lorraine Ford, *The Webcasting Wars*, 2 J. INTERNET L. 1, 4 (1999).

27. See 17 U.S.C. § 106(6) (2000) (stating that the copyright owner has the exclusive right "in the case of sound recordings, to perform the copyrighted work publicly by means of a digital audio transmission").

in a restaurant.²⁸ The Act also covers only audio performances and does not cover the audio portion of audiovisual works such as movies.²⁹ Services not meeting the eligibility requirements must negotiate voluntary licenses with record companies, which are free to refuse to license their works.³⁰

Webcasts, as noninteractive, nonsubscription transmissions, apparently fall outside of both the sound recording copyright holder's right of control and the obligation to obtain a compulsory or voluntarily negotiated license under the DPSRA framework.³¹ The absence of webcasts from the express language of the act became a point of contention in the dialogue between the record industry and webcasters. Webcasters argued that as nonsubscription transmission services, they were similar to traditional radio broadcasters, and therefore were exempt from public performance obligations under the first category of transmissions specified in the DPSRA. The recording industry, on the other hand, argued that webcasters were subject to the public performance right, and that record companies could therefore control the right to the performances and receive compensation.³² With this debate brewing, the recording industry began to lobby for further revision to the Copyright Act to account for webcast transmissions.³³

28. RALPH S. BROWN & ROBERT C. DENICOLA, COPYRIGHT: UNFAIR COMPETITION, AND RELATED TOPICS BEARING ON THE PROTECTION OF WORKS OF AUTHORSHIP 332-33 (8th ed. 2002) (1958); *cf.* 17 U.S.C. § 106(4) (2000) (“[I]n the case of . . . musical . . . works . . . [the copyright holder has the exclusive right] to perform the copyrighted work publicly . . .”).

29. BROWN & DENICOLA, *supra* note 28, at 332-33; 17 U.S.C. § 114(j)(5) (2000).

30. For background on how compulsory licensing functions, see J. THOMAS MCCARTHY, MCCARTHY'S DESK ENCYCLOPEDIA OF INTELLECTUAL PROPERTY 66-69 (1995). *See also* Robert Cassler, *Copyright Compulsory Licenses—Are They Coming or Going*, 37 J. COPYRIGHT SOC'Y 231 (1990) (describing various compulsory licenses, and the legal, philosophical, economic, and political factors contributing to the creation or elimination of these licenses).

31. For background on the DPSRA's omission of webcasts, see Ginsburg, *supra* note 20, at 167 (stating that the DPSRA's “expansion of the sound recording copyright turn[ed] out to have omitted a principal form of Internet exploitation of sound recordings: audio ‘streaming’ or ‘webcasting’ of recorded performances”).

32. *See* KOHN & KOHN *supra* note 14, at 1300-01; 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, 12-13 (2001) (describing how the recording industry “[felt] the rug pulled out from under it” after digital broadcasters successfully argued that they were not liable for royalties because they were not covered by the DPSRA).

33. *See* Craft, *supra* note 32, at 12-13.

2. *Digital Millennium Copyright Act*

Congress responded to the uncertainty with the passage of the Digital Millennium Copyright Act,³⁴ which established a compulsory license for eligible nonsubscription transmissions: noninteractive, nonsubscription digital audio transmissions, or webcasts.³⁵ The DMCA retains the three-tiered structure of the DPSRA, but limits the category of transmissions that are exempted. Whereas the previous law exempted all services that were neither subscription nor interactive, the DMCA subjects some services to mandatory licensing, even if they are nonsubscription. Broadcasters who simultaneously transmit their over-the-air signal on the Internet are also subject to the compulsory license.³⁶

The DMCA subjects all digital transmissions, subscription or not, to the compulsory license. To be eligible for the statutory license under § 114 of the Copyright Act, a webcaster must meet several criteria that are designed to ensure that webcasts do not facilitate the displacement of record sales by making it easy for users to substitute listening to the Internet transmissions for record purchases.³⁷ Among these requirements, web-

34. The DMCA was mainly intended to implement the World Intellectual Property Organization (WIPO) Copyright Treaty and WIPO Performances and Phonograms Treaty, which were both concluded on Dec. 20, 1996 in Geneva, Switzerland. KOHN & KOHN, *supra* note 14, at 1299.

35. The DMCA requires a compulsory license for entities that fall into one of three categories: (1) subscription digital audio transmissions; (2) eligible nonsubscription transmissions; and (3) pre-existing satellite digital audio radio transmissions. 17 U.S.C. § 114(d)(2) (2000). Webcasters fall under the second category. See David Nimmer, *Ignoring the Public, Part I: On the Absurd Complexity of the Digital Audio Transmission Right*, 7 U.C.L.A. ENT. L. REV. 189, 238 (2000) (“[A]n ‘Internet radio station’ that transmits music for its entertainment value qualifies [for a statutory license].”).

36. The RIAA and broadcasters have disagreed over whether the retransmission of broadcasters’ signals on the Internet is exempt from the digital performance right. However, the Copyright Office ruled that these transmissions are subject to the statutory license of § 114(d)(2). Public Performance of Sound Recordings: Definition of a Service, 65 Fed. Reg. 77,292, 77,293 (Dec. 11, 2000) (codified at 37 C.F.R. § 201.35). A federal district court upheld this determination in *Bonneville Int’l v. Peters*, 153 F. Supp. 2d 763 (E.D.P.A. 2001). As of this writing, the U.S. Copyright Office rejected an application by broadcasters for a stay of its ruling. See *In re Public Performance of Sound Recordings: Definition of a Service, Order* (Oct. 10, 2002) available at <http://www.copyright.gov/carp/stay-amfm.pdf>. For an analysis of the applicability of the public performance right to terrestrial broadcasters, see Raffi Zerounian, *Intellectual Property: Bonneville International v. Peters*, 17 BERKELEY TECH. L.J. 47 (2002).

37. See HOUSE JUDICIARY COMM., 105th CONG., SECTION-BY-SECTION ANALYSIS OF H.R. 2281 52 (Comm. Print 1998) (“Recording artists and record companies were particularly concerned that certain types of programming, without certain limitations, might harm recording artists and record companies In order to address some of these con-

casters must only offer noninteractive programming, or programming that is not on-demand or personalized.³⁸ Webcasters also are subject to a “sound recording performance complement,” which limits webcasters to playing no more than three selections from a given phonorecord in a three-hour period.³⁹ Moreover, webcasters must not publish an advance program schedule or make announcements of upcoming songs to be transmitted,⁴⁰ and must not make musical programming available in archival forms that can facilitate copying.⁴¹ If webcasters do not meet these requirements, they fall outside of the scope of the compulsory license provision, and must obtain licenses from each of the copyright owners of the sound recordings that they want to transmit.⁴² Failure to do so puts the webcasters at risk of infringement liability. Webcasters wishing to operate under the compulsory license must first notify the sound recording copyright owners by filing an “Initial Notice” with the Copyright Office.⁴³

The DMCA specifies that webcasters may receive an automatic license to those copyrighted works either at a voluntarily negotiated rate⁴⁴ or at a rate determined by the Copyright Office through a CARP.⁴⁵ Such a rate retroactively to October 1998, the date of the Act’s passage, should be ap-

cerns expressed by recording artists and record companies, the new statutory license is conditioned on certain programming limitations . . .”).

38. 17 U.S.C. § 114(d)(2)(A)(i) (2000).

39. *Id.* § 114(d)(2)(C)(i), (j)(13).

40. *Id.* § 114(d)(2)(C)(ii).

41. *Id.* § 114(d)(2)(C)(iii).

42. *See* KOHN & KOHN, *supra* note 14, at 1336.

43. Regulations governing the Initial Notice are codified at 37 C.F.R. § 201.35 (2000). The Copyright Office has published a suggested form of the Initial Notice at <http://www.loc.gov/copyright/licensing/notice.pdf> (last visited March 2, 2003).

44. Webcasters can negotiate either with individual copyright owners or with SoundExchange, a division of the RIAA.

45. 17 U.S.C. §§ 801-802 (2000). The CARP is an ad hoc panel of three arbitrators from the private sector, who meet to adjust royalty rates and terms of payment. CARPs are typically installed when opposing parties are unable to negotiate an agreement. The panel makes recommendations to the LOC on the appropriate rates, and on how and when royalty payments should be made. The LOC then has 90 days to adopt, reject or modify the recommendation, subject to judicial review. The CARP system was created by the 1993 Copyright Royalty Tribunal Reform Act, which abolished the previous rate-setting commission known as the Copyright Royalty Tribunal. *See* NIMMER, *supra* note 11, at § 7.27 (2002). All parties who plan to participate in the hearing must file a notice of their intention and must file written direct cases with the Copyright Office and the other parties. 37 C.F.R. § 251.43 (1997). At the hearings, parties can make opening statements, summarize their cases, raise objections to evidence, and conduct direct and cross-examinations. *See* D. Alan Rudlin & Douglas W. Kenyon, 4 BUS. & COM. LITIG. FED. CTS. § 65.16 (1998).

plied until December 31, 2000.⁴⁶ The procedure is then repeated every two years as the webcasting industry develops, though it can be extended by agreement between the parties.⁴⁷

Under the DMCA, two main royalty rates are to be established for webcasters: one for the actual digital audio transmissions;⁴⁸ the other for so-called ephemeral recordings.⁴⁹ The statutory scheme for establishing the terms and rates for both the ephemeral and public performance licenses is the same.⁵⁰ Although not a licensing agency, the Recording Industry Association of America ("RIAA"), which represents U.S. record labels, was designated as the entity to negotiate, collect, and distribute royalties for all of its member record labels.⁵¹ The RIAA, in turn, created a subsidiary known as SoundExchange to carry out those tasks.⁵²

B. CARP and LOC

Pursuant to the DMCA, the Copyright Office gave record companies, represented by the RIAA, and webcasters, the opportunity to negotiate royalty rates independently.⁵³ Although the parties negotiated a total of twenty-six private agreements, they were unable to reach an industry-wide agreement.⁵⁴ The Copyright Office, therefore, convened a CARP to re-

46. 17 U.S.C. § 114(f)(2)(A)-(B) (2000).

47. *Id.* § 114(f)(2)(C).

48. *Id.* § 114.

49. *Id.* § 112. The "ephemeral license" allows a transmitting organization to make a copy of a sound recording for the purpose of transmitting it to the public. *Id.* While the language of § 112(e) suggests that webcasters can make only a single ephemeral recording, in actuality, they may be allowed to produce more to the extent that "the terms and conditions of the statutory license allow for more" reproductions to be made. *Id.* Webcasters subject to the statutory ephemeral license must meet several conditions, including that the recording is retained and used solely by the webcaster that made it and that the webcaster destroy it within six months unless preserved exclusively for purposes of archival preservation. *Id.*

50. See 17 U.S.C. §§ 112(e), 114 (f)(2)(B) (2000).

51. See CARP Report, *supra* note 7, at 4.

52. SoundExchange represents more than 320 record companies and their 2,400 labels. The agency does not compete with ASCAP, BMI and SESAC, which collect performance royalties for the musical work, the songwriters, composers and music publishers. SoundExchange does not collect royalties for interactive performances of sound recordings, digital downloads, or traditional radio and television. For further information on SoundExchange, see <http://www.soundexchange.com>.

53. 17 U.S.C. §§ 112(e)(4), 114(f)(2)(A)-(B) (2000). The purpose of the voluntary negotiation period is to create an industry-wide agreement concerning royalty terms and rates.

54. LOC Report, *supra* note 8, at 45,241. The Act subordinated the rates determined through arbitration to the licensing agreements voluntarily negotiated, meaning the arbitration binds only those parties who do not reach an agreement. See Nimmer, *supra* note

solve the issue and determine the appropriate rates,⁵⁵ subject to review by the Librarian of Congress.⁵⁶

I. CARP Procedure

Sections 112(e)(4) and 114(f)(2)(B) require that CARP determine the royalty rates for both the digital performance and ephemeral licenses based on a standard that reflects what would have been negotiated in the marketplace between a “willing buyer” and a “willing seller.”⁵⁷ In setting the rates, CARP must also take into account such factors as the effect of the use of sound recordings on the sale of phonorecords, and the relative contributions made by both industries in bringing these works to the public.⁵⁸

CARP held six months of hearings during which the RIAA requested that CARP set a statutory rate at 0.4 cents per stream or 15 percent of each webcaster’s gross revenue for business to consumer webcasts.⁵⁹ It also requested a minimum fee of \$5,000 to apply to all webcasters. For the ephemeral license, the RIAA requested a rate of 10 percent of the webcaster’s performance royalty.⁶⁰ Webcasters, in contrast, requested that the rate be 0.014 cents per performance or 0.21 cents per hour.⁶¹ Webcasters did not propose an additional fee for the ephemeral license, and requested a minimum fee of \$250 per year.⁶²

CARP issued its report on February 20, 2002, recommending a two-tiered royalty rate of 0.14 cents per song, per listener, for Internet-only

35, at 219 (“In this way, it is hoped that industry-wide agreement will emerge, thus obviating the need for arbitration panels.”).

55. 37 C.F.R. §§ 251.2, 251.64 (2002); 17 U.S.C. § 803(a)(1) (2000). The Office initially set a schedule for the CARP proceeding to determine rates for the first license period covering October 28, 1998 to December 31, 2000. However, this schedule proved unworkable. While the office met to determine a new schedule, it also commenced the six-month negotiation period for the second license period, covering January 1, 2001 to December 31, 2002. Ultimately, the Office consolidated these two proceedings into a single proceeding in which one CARP would set rates and terms for the two license periods for both the webcasting license and the ephemeral recording license. Parties to the CARP proceeding included the RIAA, the National Association of Broadcasters, and webcasters such as bet.com, listen.com, Live365.com and NetRadio Corp.

56. 17 U.S.C. §§ 801-802 (2000).

57. See 17 U.S.C. §§ 112(e)(4), 114 (f)(2)(B) (2000). This standard will be explored in greater detail *infra* in Part II.C.

58. *Id.*

59. LOC Report, *supra* note 8, at 45,241.

60. *Id.* at 45,242.

61. *Id.*

62. *Id.*

webcasts, and .07 cents per song, per listener for radio retransmissions on the Internet.⁶³ Therefore, for every 1,000 people who use their computers to listen to a song broadcast on the Internet, the webcaster would have to pay 70 cents per song, if it is a terrestrial radio station, or \$1.40, if it is an Internet-only webcaster. CARP based these rates largely on a royalty agreement reached in July 2000 between Yahoo! Inc. and the RIAA [hereinafter "RIAA-Yahoo! Agreement"], which CARP determined best represented the marketplace rate for webcasting.⁶⁴ In doing so, it disregarded twenty-five other agreements that were reached between the RIAA and other, smaller webcasters during the voluntary negotiation period.⁶⁵ CARP determined that these agreements should be ignored, in part, because the RIAA was in a superior bargaining position. Also, CARP felt the RIAA was able to extract super-competitive rates based upon its market power and sophistication in negotiation and the urgent need of some licensees to enter into agreements.⁶⁶

2. *The Library of Congress's Review*

The Librarian of Congress is empowered by the Copyright Royalty Tribunal Reform Act of 1993⁶⁷ to review CARP's decisions.⁶⁸ The Act directs the Librarian to either accept CARP's decision or reject it, and substitute his own determination if the "Librarian finds that the determination is arbitrary or contrary to the applicable provisions of this title."⁶⁹ The Librarian's decision can then be appealed to the D.C. Circuit Court of Appeals.⁷⁰

On June 20, 2002, the Librarian rejected CARP's proposed rates after determining that CARP misinterpreted some parts of the RIAA-Yahoo! Agreement.⁷¹ The Librarian concluded that one of the most significant errors made by CARP was its assumption that the parties must have agreed that radio retransmissions, as opposed to Internet-only transmissions, have

63. See CARP Report, *supra* note 7, at 77.

64. *Id.* at 65-67, 70.

65. *Id.* at 51-54.

66. *Id.*

67. Copyright Royalty Tribunal Reform Act of 1993, Pub. L. No. 103-198, 107 Stat. 2304 (1993) (codified in scattered sections of 17 U.S.C.).

68. 17 U.S.C. § 802(f) (2000).

69. 17 U.S.C. § 802(f) (2000).

70. *Id.* § 802(g). The Copyright Act's standard for judicial review of royalty rates established by the LOC is exceptionally deferential, requiring the court to uphold a royalty award if the Librarian has offered a facially plausible explanation for it in terms of the evidence. *RIAA v. Librarian of Congress*, 176 F.3d 528 (D.C. Cir. 1999).

71. LOC Report, *supra* note 8, at 45,252. While the LOC issued its decision on June 20, 2002, it did not publish its final determination until July 8, 2002.

a large promotional impact on sales of records, and that this impact explained the decision in the RIAA-Yahoo! Agreement to set a higher rate for Internet-only transmissions than radio retransmissions.⁷² The Librarian concluded that this assumption was arbitrary and unsupported.⁷³

The Librarian eliminated the two-tiered royalty structure, which had been based on the alleged faulty promotional value assumption, and set a rate of .07 cents per performance for both types of transmissions.⁷⁴ It also set the ephemeral license rate at 8.8 percent of the performance royalties to be paid⁷⁵ and set a minimum fee of \$500, which is designed in part to cover the administrative costs of administering the license.⁷⁶ To put these rates in perspective, webcasters who transmit fifteen songs to an audience that averages 25,000 listeners would have to pay record companies a fee of \$262.50. This figure has the potential of reaching into the millions of dollars over time as the transmissions or performances add up. This amount is in addition to the license fee that webcasters already must pay to the copyright owner of the musical work.

In setting these rates, the Librarian rejected proposals by both webcasters and broadcasters to provide them with an option to pay a rate based on a percentage of their revenues, rather than a per-performance rate.⁷⁷ The Librarian reasoned that the per-performance approach is more directly tied to the right of public performance being licensed, and that it would be difficult to identify the relevant revenue base against which to apply the percentage because webcasters' business models differed greatly.⁷⁸ Furthermore, because webcasters generate little revenue, copyright owners would receive little compensation from a rate based on a percentage of

72. *Id.* at 45,251.

73. *Id.* at 45,252.

74. *Id.* at 45,243. The Librarian also set rates for noncommercial broadcasters, such as college radio stations, as defined in 17 U.S.C. § 118(g) for Internet-only transmissions. It set these rates for these services at 0.02 cents, reflecting a downward adjustment from the 0.05 cents proposed by the CARP. *Id.*

75. *Id.* The Librarian reasoned that it should reject the CARP's ephemeral license rate because CARP took into account some of the twenty-six voluntary agreements negotiated between the parties in determining this rate, after having decided earlier not to consider twenty-five of twenty-six in setting the main performance right rate. The Librarian concluded that "it was arbitrary for the Panel to use these same rejected licenses to set the Ephemeral License Fee." *Id.*

76. *Id.* at 45262.

77. *Id.* at 45249-50. The traditional licensors of blanket performance licenses in the music industry—ASCAP, BMI and SESAC—all offer licenses based on a percentage of revenue.

78. *Id.*

revenue.⁷⁹ The Librarian established September 1, 2002 as the effective date of the rates, and payments became due on October 20, 2002.⁸⁰ The rates were applicable for the time period beginning October 28, 1998 (the effective date of the DMCA), and ending Dec. 31, 2002.⁸¹

II. DISCUSSION

Analysis of the manner in which the CARP and LOC determined webcasting royalty rates is critical because that rate-setting process will serve as a precedent for future royalty negotiations. Part A evaluates what is at stake for record companies and webcasters in the royalty rate dispute, and argues that webcasting is an important medium whose development should be encouraged, especially in light of the recent consolidation of the terrestrial radio broadcasting industry. Part B discusses the shortcomings of the CARP procedure and various proposals to reform it. One area of concern is the so-called “willing buyer/willing seller” standard on which CARP and LOC based their rate determination. Part C argues that the existence of CARP and the compulsory licensing regime distorts the very market that the CARP and LOC try to mirror in determining the rates, and suggests that the “willing buyer/willing seller” standard creates a one-size-fits-all approach to ratesetting that is in conflict with the varying business models of webcasters. In doing so, Part C evaluates whether the current procedure for determining the compulsory licensing rate that applies to webcasters complies with the principles and objectives of the copyright laws.⁸²

A. The Stakes are High for Record Labels, Webcasters, and the Public

The Librarian’s royalty determination has been criticized on all sides of the debate. Both webcasters and the RIAA have contended that CARP

79. *Id.* at 45249. LOC stated that “the statute does not require the CARP to offer alternative fee structures Clearly, it cannot be arbitrary for the Panel to choose not to deviate from the longstanding practice of establishing only one rate schedule for a license.” *Id.* at 45250-51.

80. *Id.* at 45271. Payments were postponed while Congress worked to pass the Small Webcaster Settlement Act of 2002. *See supra* note 9 and accompanying text.

81. *Id.* at 45266. After December 31, 2002 future royalties must either be negotiated by the parties or set by the same CARP process.

82. *See* R. Anthony Reese, *Copyright and Internet Music Transmissions: Existing Law, Major Controversies, Possible Solutions*, 55 U. MIAMI L. REV. 237, 238 (2001) (“Copyright law in the digital era should attempt to facilitate the development of legitimate dissemination of music over the Internet because this promises to significantly increase public access to copyrighted music.”).

and LOC were misguided in basing their rate determination on a single agreement between the RIAA and Yahoo!.⁸³ Webcasters have decried the order, arguing that it will bankrupt them.⁸⁴ With little in the way of revenue,⁸⁵ webcasters fear that they will have to close their operations in lieu of paying the high royalty rates, putting an end to the promise of webcasting and closing a key outlet for many performing artists who receive little or no airtime on broadcast radio.⁸⁶ The threat of large royalty payments and the uncertainty over copyright liability has already left its mark on the webcasting industry: the number of radio stations transmitting signals online has declined 31 percent to 3,940 as of September 2002, as compared to a high of 5,710 in 2001.⁸⁷

The shrinking webcasting industry has potentially serious public interest implications. Webcasting has the ability to provide listeners with much greater music variety than over-the-air broadcasts, which are limited by a finite amount of radio spectrum.⁸⁸ Diversity in programming is more im-

83. See LOC Report, *supra* note 8, at 45,245, 45,251-53.

84. See Christopher Stern, *Curtain Call for Webcasts? Some Decry Order to Pay Royalties to Musicians*, WASHINGTON POST, June 21, 2002, at E01; see also Stacy Cowley, *Will Music Ever Play?*, PCWORLD.COM, at <http://cssvc.pcworld.com/serve.com/computing/cis/article/0,aid,102516,00.asp> (last visited March 2, 2003); Joe D'Angela, *Will Lower Royalty Rates Save Online Radio?*, MTV.COM, at <http://www.mtv.com/news/articles/1455363/20020621/index.jhtml> (June 21, 2002). Please note that the recently passed Small Webcaster Settlement Act has tempered the concern of many small webcasters. See *supra* note 9 and accompanying text.

85. Webcasters contend that while audience sizes are growing, they are still too small to attract significant advertising. See, e.g., Bob Tedeschi, *Web Radio Awaits a Ruling on Royalties They Must Pay Recording Companies to Stream Music*, N.Y. TIMES, Feb. 18, 2002, at C5.

86. See *Copyright Royalties: Where is the Right Spot on the Dial for Webcasting?: Hearing Before the Senate Comm. on the Judiciary*, 107th Cong. (2002) (testimony by Jonathan Potter of the Digital Media Association), available at <http://www.digmedia.org/webcasting/JPTestimony.pdf>. To be sure, courts have historically upheld rates established through the arbitration process, even when users have argued that the rates would cause them to go out of business. See, e.g., *Nat'l Cable Television Ass'n v. CRT*, 724 F.2d 176 (D.C. Cir. 1983) (holding that rates set at fair market value were proper even though cable operators contended that the rates were prohibitively high and would cause them to terminate transmission of the distant signals at issue).

87. See Press Release, BRS Media's Web-Radio Reports a Steep Decline in the Number of Stations Webcasting, brs media inc. (Sept. 12, 2002), available at <http://www.brsmedia.fm/press020912.html>.

88. See Press Release, Copyright Royalties: Where is the Right Spot on the Dial for Webcasting?, Future of Music Coalition (May 15, 2002), available at <http://www.futureofmusic.org/news/senatejudiciarywebcasting.cfm> ("[I]ndividuals can create and launch a webcasting station with just a handful of affordable resources; access to band-

portant than ever, given the rapid consolidation that has swept the radio broadcasting industry since the passage of the Telecommunications Act of 1996.⁸⁹ To the extent that format innovation and programming diversity benefits the public, high royalty rates may undermine that goal by forcing webcasters to divert available funds away from internal investment, or even leading some broadcasters to end their operations altogether. Moreover, a weakening of the webcasting medium could have economic consequences for record companies. A recent study shows that consumers who use streaming media bought more than 1.5 times the number of CDs in the past year than the average American,⁹⁰ indicating that the Internet provides promotional value to record sales.

While record companies acknowledge the benefits of webcasting,⁹¹ they contend that the rates set by the Librarian are too low and do not reflect the fair market value of their music, resulting in record companies effectively subsidizing webcasters.⁹² The RIAA argues that paying for

width, some computers, software and a little bit of know-how. They don't need signal towers, or satellite dishes, or even an office to start webcasting.”).

89. There are varying reports on the effect of the Telecommunications Act on radio diversity. One study concludes that the industry is now dominated by ten companies that control two-thirds of both listeners and revenue nationwide, and that in almost every local market, four or fewer firms control at least seventy percent of the market share. See Press Release, Commercial Radio Station Ownership Consolidation Shown to Harm Artist and the Public, Says FMC Study, Future of Music Coalition (Nov. 18, 2002), available at <http://www.futureofmusic.org/news/Pradiostudy.cfm>. A Federal Communications Commission study indicates that between 1996 and 2001, the average measure of diversity for the study's nationwide sample increased by 0.74 percent. The study also found a decrease of 2.4 percent in the diversity of songs within the same format across local markets, but an increase of 11.48 percent in the diversity of songs within the same format within each local market. See George Williams, et. al., *Radio Market Structure and Music Diversity*, at http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-226838A18.doc (last visited March 2, 2003).

90. See Christopher Saunders, *Study: 20 % of U.S. Feels Web is 'Essential'*, INTERNETNEWS.COM, at <http://www.internetnews.com/IAR/article.php/1457991> (Sept. 6, 2002).

91. *Copyright Royalties: Where is the Right Spot on the Dial for Webcasting?: Hearing Before the Senate Comm. on the Judiciary*, 107th Cong. (2002) (testimony of Hilary Rosen, Chairman and CEO of the RIAA) (“[Webcasting] has energized music lovers and fans If webcasters don't succeed artists and record companies stand to lose an important new revenue stream.”), available at http://judiciary.senate.gov/testimony.cfm?id=258&wit_id=518.

92. *Id.* (“No one would suggest that webcasters' hardware vendors, bandwidth providers or employees be forced by Congress to give webcasters rebates, below market prices or agree to accept a percentage of a webcaster's revenue to help preserve the webcast industry, even though the webcasters typically spend more on those components of

music is simply another cost of doing business, much like buying bandwidth, and that if webcasters' business models cannot support these fees, they should not be operating.⁹³ Record companies expect and demand an economic return on their investments, and argue that receiving fair compensation for the transmission of their sound recordings online is especially critical given the 4 percent decline in music sales to \$13.7 billion in 2001, which has resulted in part from diminished consumer spending reflecting a weakened economy.⁹⁴ Moreover, they contend that webcasts do not promote record sales, but instead cost the music industry in lost CD sales and increased piracy of their copyrighted songs.⁹⁵

Therefore, the stakes are high for both webcasters and record companies, in the determination of an appropriate royalty rate. Part B contends that the CARP and LOC rate-setting process does not adequately address either side's interests.

B. Shortcomings of the CARP Process

1. *Costs and Lack of Predictability*

The structure and operation of the CARP system has been the source of much frustration among participating parties. Many of these parties have called for reform, arguing that it is inefficient and often produces unfair results.⁹⁶ One of the biggest flaws cited by participants is its expense, which can be prohibitive for small webcasters: participants bear not only their own legal fees, but also the cost of the proceeding itself, especially the expensive evidentiary hearing.⁹⁷ The hearing generates various expenses such as attorney fees, expert witness fees, arbitrator fees, and

their business than they currently earn in revenues. There is no reason artists and record labels should be treated any differently and forced to subsidize webcasters.”)

93. *Id.*

94. *See supra* note 1.

95. The major labels have historically relied on the high margins generated by the sale of physical music products and they have been reluctant to make their products available through digital distribution until they have protected their works. *See* Matthew Fagin et al., *Beyond Napster: Using Antitrust Law to Advance and Enhance Online Music Distribution*, 8 B.U. J. SCI. & TECH. 451, 490-91 (2002).

96. *See Copyright Arbitration Royalty Panel (CARP) Structure and Process: Hearing Before the Subcomm on Courts, the Internet and Intell. Prop.*, 107th Cong. (2002) [hereinafter CARP Structure and Process Hearing], available at <http://www.house.gov/judiciary/80194.pdf>.

97. 17 U.S.C. §§ 114(f)(2)(A), 802(c) (2000). For criticism on the expense of the proceeding, see *CARP Structure and Process Hearing*, *supra* note 96, at 21 (written statement of Robert A. Garrett).

Copyright Office fees.⁹⁸ Many potential participants in CARP were forced to withdraw from the process because of the requirement that they pay a share of the arbitrators' fees,⁹⁹ which exceeded \$1.2 million.¹⁰⁰ Some critics of the process have argued that because small webcasters could not afford those fees, the process to set a rate mostly included representatives of relatively large companies whose interests are not necessarily aligned with those of the small independent webcasters.¹⁰¹

Moreover, webcasters who were not a party in the CARP proceeding were unable to submit comments to the LOC as part of that body's review of the CARP determination, on the theory that they did not have standing.¹⁰² This decision makes the CARP procedure problematic; since CARP proceedings are adversarial in nature, it is essential that all interested parties be represented so the panel would have a complete evidentiary record on which to base its decision.

Many critics have also found fault with the discovery process used for CARP proceedings, which do not follow the discovery rules of the Federal Rules of Civil Procedure.¹⁰³ Parties are not allowed to take depositions, or submit requests for admission and interrogatories.¹⁰⁴ Critics argue that this "deprives the parties of the opportunity, prior to trial cross-examination, to test the assertions made by their opponents."¹⁰⁵

98. *Id.* at 15. During the webcasting CARP proceeding, 75 witnesses offered testimony over a period of about 40 days, generating 15,000 pages of transcript and thousands of pages of exhibits. *See House Panel Considers Ways to Improve System for Compulsory Copyright Royalties*, 64 PAT., TRADEMARK & COPYRIGHT J. 171. In past CARP proceedings, arbitrator costs alone far exceeded the amount of royalties at issue. For example, the costs of arbitrators in the 1992-1994 Digital Audio Recording Technology proceeding amounted to more than \$12,000, more than one thousand times the royalty award that resulted from the proceeding. *Id.* at 12. Arbitrators typically receive \$200 to \$400 an hour in compensation for their work. *Id.* at 35.

99. 17 U.S.C. § 802(c) (2000) ("In ratemaking proceedings, the parties to the proceedings shall bear the entire cost thereof in such manner and proportion as the arbitration panels shall direct.").

100. *See* Paige Albinak, *Carp is Thrown Back*, BROADCASTING & CABLE, May 27, 2002, at 14.

101. *See Library of Congress Decision Setting Performance Royalty Rates for Use of Music on the Internet Condemned by United Group of Webcasters*, at <http://www.voiceofwebcasters.com/Webcasterscongressionalletter.pdf> (July 3, 2002).

102. 37 C.F.R. § 251.55(a) (2002).

103. *See, e.g.*, CARP Structure and Process Hearing, *supra* note 96, at 25 (statement of R. Bruce Rich).

104. *Id.*

105. *Id.*

In addition to cost concerns and a meager discovery process, critics also contend that the ad hoc nature of the CARP proceedings threatens the stability and predictability of rulings by preventing the development of institutional expertise that can be applied to subsequent hearings.¹⁰⁶ With a new panel convened for every proceeding, consistency is difficult to achieve because each arbitrator lacks the perspective and familiarity with the issues that could otherwise have been acquired through repeated exposure to similar rate proceedings.¹⁰⁷ The difficulty of finding arbitrators who have expertise with the relevant issues and law¹⁰⁸ has contributed to the LOC's decision to overturn a majority of prior CARP recommendations.¹⁰⁹

2. *Proposals for Reform*

Calls for CARP reform are not new.¹¹⁰ Most recently, in June 2002, the House of Representatives' Committee on the Judiciary convened a hearing before the Subcommittee on Courts, the Internet and Intellectual Property, to discuss CARP.¹¹¹ Various proposals emerged from the hearing. Some of the proposals addressed internal changes to the structure of CARP itself and its procedures. Among these was one to eliminate or restrict CARP evidentiary hearings, and instead to have CARPs make their determinations on the basis of written submissions as a way to reduce the cost of the proceeding.¹¹² Another suggestion was to replace the ad hoc panels with a permanent group of administrative law judges who would have their own staff, with expertise in the applicable law and technology

106. *Id.* at 35 (prepared statement of Marybeth Peters, Register of Copyrights) ("The decisions they make are for the purpose of deciding that one case and not for establishing lasting precedent."); *id.* at 51 (prepared statement of Rep. Rick Boucher (D-Va)) ("Starting with a new arbitrator panel each time will lead to inconsistent judgments and a constant process of reinventing the wheel.").

107. *Id.* at 139 (letter from the Motion Picture Association of America).

108. *Id.* at 35 (prepared statement of Marybeth Peters) ("We have found it very difficult to find arbitrators that have any familiarity with copyright law, let alone the complex statutory licenses [This puts] a considerable burden upon the Register [of Copyrights] and the Librarian to correct errors and oversights made by CARPs").

109. *Id.* at 31 ("Of the 10 CARP reports which the Librarian has reviewed, only three have been accepted.").

110. For example, in 1998, Howard Coble, chairman of the House Subcommittee on Courts, the Internet and Intellectual Property, introduced a bill called the "Copyright Compulsory License Improvement Act," to establish a Copyright Royalty Adjudication Board consisting of one full-time chief administrative judge and two to four part-time judges with expertise in the businesses of the affected industries. H.R. 3210, 105th Cong. (1998).

111. *See* CARP Structure and Process Hearing, *supra* note 96.

112. *Id.* at 15, 21 (testimony and written statement of Robert A. Garrett).

and in conducting adjudicatory proceedings.¹¹³ This would help ensure continuity with past proceedings and consistency in the decisionmaking.

Other proposals focused on turning outside of the CARP framework. Among these were suggestions to transfer the functions of CARP to a federal district court on the theory that rate determinations require such skills as knowledge of macroeconomics, antitrust, the ability to assimilate data and analyze complex statistics and to make judgments such as the credibility of witnesses, which are skills better suited to judges.¹¹⁴ Determining royalty rates in a court is not without precedent. The so-called ASCAP and BMI “rate court” in the Federal District Court for the Southern District of New York, for example, makes rate determinations when parties are not able to reach agreement with ASCAP and BMI.¹¹⁵ Additionally, 17 U.S.C. § 513 allows individual proprietors of certain businesses to resolve rate disputes with performing rights societies before a district court in the federal circuit in which they operate.¹¹⁶ Short of this, some critics have recommended that appeals of the CARP’s decisions bypass the LOC, and be made directly to the D.C. Circuit Court of Appeals.¹¹⁷ Rather than encouraging compromise and industry-wide negotiation, the current system generates additional disagreement and conflict by providing as many as three adversarial forums to which frustrated parties may turn—the CARP, LOC, and Court of Appeals.

While these proposals deserve attention, a more fundamental problem may be overlooked: voluntary negotiations and settlements in royalty disputes are preferable to government intervention because they give the parties more control, and the very existence of CARP discourages such negotiations.

C. The Willing Buyer/Willing Seller Standard

In the absence of a voluntary royalty rate agreement between the parties, the Copyright Act requires that the CARP and LOC determine rates based on the rate that would have been negotiated in a hypothetical mar-

113. See, e.g., *id.* at 36 (testimony of Marybeth Peters).

114. *Id.* at 23, 28 (testimony and written statement of R. Bruce Rich) (“particularized copyright expertise, even if it did repose in the CARP panels, which it doesn’t, is not as important as other skill sets”).

115. For background on ASCAP and the rate court, see Simon H. Rifkind, *Music Copyrights and Antitrust: A Turbulent Courtship*, 4 CARDOZO ARTS & ENT. L.J. 1, 10 (1985).

116. 17 U.S.C. § 513 (2000).

117. See CARP Structure and Process Hearing, *supra* note 96, at 28 (testimony of Michael J. Remington).

ketplace.¹¹⁸ The CARP concluded that this determination was best based on a review of actual marketplace agreements, even though the statute does not require that it take these agreements into account.¹¹⁹

This standard, however, proved unworkable in the webcasting CARP proceeding, in part because it implied that there was a functioning market that could be relied upon to set a fair price for all participants, when no such market existed. Moreover, the standard created a one-size-fits-all approach to setting rates, effectively exposing all webcasters, from large diversified companies such as Yahoo! to smaller start-ups such as college and hobbyist webcasters, to the same rate structure. This became especially problematic because the rate was structured on a per performance basis, instead of a percentage of revenue basis, which would be more fair to webcasters of varying sizes and revenue bases because their payments would be more proportional to the revenue generated from their webcasts.¹²⁰ Moreover, CARP and LOC effectively set industry-wide rates based on the single RIAA-Yahoo! Agreement; Yahoo!, a multi-billion dollar company whose webcasts have consisted largely of radio retransmis-

118. The rates and terms must represent what:

(4) . . . would have been negotiated in the marketplace between a willing buyer and a willing seller. In determining such rates and terms, the [CARP] shall base its decision on economic, competitive and programming information presented by the parties, including—

(A) 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

(B) 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 [CARP] 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. § 112(e)(4) (2000).

119. CARP Report, *supra* note 7, at 43; *see also* 17 U.S.C. §§ 112(e)(4), 114(f)(2)(B) (2000).

120. This point has been made moot for some webcasters. Some small webcasters now have the ability to pay royalties based on a percentage of their revenue or expenses under the agreement reached in December 2002 between small webcasters and SoundExchange. *See supra* note 9 and accompanying text. Small webcasters who are eligible and decide to accept the terms of the agreement will be subject to the rates and terms of the agreement instead of the per performance rates established by the LOC. Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 67 Fed. Reg. 78,510 (Dec. 24, 2002).

sions, can hardly be said to represent the interests of all small, Internet-only webcasters.¹²¹

1. *CARP Discourages Meaningful Negotiations*

The willing buyer/willing seller standard fails because the existence of CARP may significantly influence the behavior of the parties during the voluntary negotiation period, which thereby affects the hypothetical market that CARP seeks to replicate. The availability of CARP to step in and set rates provides a fallback for the parties, creating a disincentive for meaningful negotiations, and inhibiting the development of marketplace solutions or even an approximation of a true market that CARP can later use to set a royalty.¹²² Given that the CARP's goal is to set rates reflecting the market, its very existence undermines its ability to carry out that objective.

Parties subject to a compulsory licensing regime face conflicting influences. These influences include on the one hand, pressure not to enter negotiations, and on the other hand, pressure on the parties who do enter negotiations to demand unreasonable terms.

The parties may be dissuaded from entering voluntary negotiations in the first place if they believe they can limit their transaction costs by foregoing the negotiations and securing favorable rates through the CARP process. This becomes problematic, however, when the CARP process itself creates its own significant transaction costs, which the parties can avoid by simply not taking part in the CARP process.¹²³ That only twenty-six webcasters voluntarily struck agreements with the RIAA during the six-month negotiation period highlights the fact that the existence of CARP was a disincentive for meaningful negotiations.¹²⁴ In fact, the LOC concluded that most webcasters chose not to enter into voluntary negotia-

121. Internet-only transmissions, as opposed to terrestrial radio retransmissions, account for only 10 percent of Yahoo!'s webcasting business. *See* LOC Report, *supra* note 8, at 45,252. In fact, David Mandelbrot, who was Yahoo!'s representative in its negotiations with the RIAA, has stated that in negotiating an agreement with the RIAA, "the radio retransmission fee was a much more significant factor to us [T]he Internet-only rate was not of great concern to us at that time [O]ur interest was in doing what was best for our business and our business model." CARP Structure and Process Hearing, *supra* note 96, at 133-34 (prepared statement of David Mandelbrot).

122. *See* LOC Report, *supra* note 8, at 45,245. ("For the most part, webcasters chose not to enter into negotiations for voluntary agreements, knowing that they could continue to operate and wait for the CARP to establish a rate.")

123. *See* Albiniak, *supra* note 100.

124. *See* CARP Report, *supra* note 7, at 51-54.

tions knowing they could wait for CARP to establish rates that they hoped would be low, which impeded serious negotiations in the marketplace.¹²⁵

If parties do choose to negotiate, they may believe that it is to their advantage to negotiate firmly, and demand unreasonable terms, in the hopes that at least one opposing party will cave, allowing it to secure agreements on those terms. If a party is able to reach even just one agreement containing terms in its favor, it knows that that agreement may serve as a guide or benchmark for CARP's subsequent efforts to construct a hypothetical market on which to base the royalty rate applicable to all remaining licensees. This creates the potential for that party to gain an industry-wide rate that to some degree reflects that one favorable agreement.

The CARP itself recognized that those parties entering negotiations may have had objectives other than trying to reach reasonable agreements with reasonable rates. The CARP report describes how the RIAA tried to negotiate deals with webcasters that would set a high benchmark to serve as precedent in the event that CARP was later convened.¹²⁶ The RIAA determined a "sweet spot" and then closed only those deals that conformed to it.¹²⁷ As a result, CARP disregarded most of these voluntarily negotiated agreements because "they establish[ed], at best, the high end of the rate range that some services (with special circumstances) might pay."¹²⁸ Instead, the CARP relied on the RIAA-Yahoo! Agreement as a starting point for determining rates because it concluded that that agreement was of a different character: Yahoo!, of all the parties that reached agreements, was "the only one with resources, sophistication and market power comparable to that of RIAA," meaning its agreement was the only one to "reflect a truly arms-length bargaining process on a level playing field"¹²⁹

However, CARP's conclusion that the RIAA-Yahoo! Agreement did not fall prey to the same influences that had tainted the twenty-five other agreements is unconvincing. Since the RIAA-Yahoo! Agreement was also negotiated in the shadow of CARP, it is likely that it, too, is not truly reflective of the kinds of negotiations that would have occurred in an open

125. LOC Report, *supra* note 8, at 45,245.

126. CARP Report, *supra* note 7, at 48-51.

127. *Id.*

128. *Id.* at 51. The CARP found other reasons to disregard most of the agreements including that many of them were with webcasters who were not likely to endure in the market, while others were with webcasters who required an immediate license and could not wait for the CARP, which gave them less bargaining power. *Id.*

129. *Id.* at 60-61.

market, but instead reflects the influence the parties believed their agreement would later have on the CARP.¹³⁰

In sum, when one considers both of these conflicting influences on the behavior of the parties to the negotiations, it becomes clear that reliance on the willing buyer/willing seller standard is not ideal. The standard permits CARP to turn to marketplace agreements in fabricating its hypothetical willing buyer and seller, when these agreements themselves are the product of influences that would not exist absent the CARP, therefore not reflecting agreements that would have been reached in a normal, free-flowing marketplace.

2. *Changing the Rate-Setting Process*

The rate-setting process must be structured in a way that will give parties greater incentive to negotiate voluntarily and in good faith, and to turn to a CARP only as a last resort. Encouraging parties to negotiate a rate, instead of allowing one to be set by law, has many advantages. These include allowing parties to settle on rates that best accommodate their own particular business models and circumstances, which helps them better control their individual destinies, rather than forcing them to pay a rate determined in part by the arguments of their competitors before an arbitration panel.

Providing strong incentives for meaningful negotiations may perhaps be accomplished by forcing those parties, who fail to agree to reasonable royalty offers made during the voluntary negotiation period, to bear a larger share of the costs for the subsequent CARP hearing.¹³¹ Parties may have an incentive to make concessions in their rate negotiations if they know that they can limit their costs for the subsequent CARP hearing that

130. In fact, Yahoo! agreed to an artificially high royalty rate in an effort to avoid a percentage-of-revenue rate that would have been beneficial to smaller, low-revenue webcasters, according to Mark Cuban, founder of Broadcast.com, a webcaster that was acquired by Yahoo! in 1999. While Cuban was no longer with the company at the time of the negotiations, he wrote in an e-mail that the "Yahoo! deal I worked on, if it resembles the deal the CARP ruling was built on, was designed so that there would be less competition, and so that small webcasters who needed to live off of a 'percentage-of-revenue' to survive, couldn't." Paul Maloney & Kurt Hanson, *Cuaban Says Yahoo!'s RIAA Deal was Designed to Stifle Competition*, available at <http://www.kurthanson.com/archive/news/062402/index.asp> (last visited Feb. 22, 2003).

131. This solution closely mirrors Rule 68 of the Federal Rules of Civil Procedure, which provides in part that where a party defending a claim makes an offer of settlement that is rejected by an adverse party, and where the judgment finally obtained by the adverse party is not more favorable than the settlement offer, then the adverse party must pay the costs incurred by the offering party after the making of the offer. FED. R. CIV. P. 68.

would result if their offer is rejected, assuming their offer ultimately turns out to be more favorable to the other party than CARP's rate determination. This may provide a strong incentive for parties to both make and accept good faith royalty offers.

3. *Uniform Standard and the Element of Fairness*

The validity of the willing buyer/willing seller standard is brought into question by the fact that the Copyright Act establishes different rate-setting standards for each of the compulsory licenses. These other standards require that CARP balance the interests of the participants and make the element of "fairness" more explicit in the analysis. For example, the standard under § 801(b), which applies to digital music distribution services other than webcasters¹³² and to public performances of nondramatic works by coin-operated phonorecord players,¹³³ calls for a royalty rate that will, among other things, "afford the copyright owner a fair return for his creative work and the copyright user a fair income under existing economic conditions,"¹³⁴ and be minimally disruptive of the industries involved.¹³⁵

Congress should consider adjusting the webcasting standard to harmonize it with these comparable standards.¹³⁶ The standard applied to webcasters should more explicitly take into account the idea of fairness and the effect of its rates on the viability of the services. This would be an acknowledgement of the fact that compulsory licenses are a kind of subsidy used to make possible and spur the development of nascent industries.¹³⁷ This might also further the copyright law's objectives of taking into account the public interest, and weighing the public benefit of accessing works of art over protection to the creator.¹³⁸

132. 17 U.S.C. § 114(f)(1)(B) (2000).

133. *Id.* § 116.

134. *Id.* § 801(b)(1)(B) (2000).

135. *Id.* § 801(b)(1)(D) (2000).

136. For similar criticisms about the standard, see CARP Structure and Process Hearing, *supra* note 96, at 50-1 (prepared statement of Rep. Rick Boucher (D-Va)); *Copyright Royalties: Where is the Right Spot on the Dial for Webcasting?: Hearing Before the Senate Comm. on the Judiciary*, 107th Cong. 16 (2002) (testimony by Jonathan Potter of the Digital Media Association), available at <http://www.digmedia.org/webcasting/JPTestimony.pdf>.

137. See MCCARTHY, *supra* note 30, at 66-69.

138. The U.S. Supreme Court has instructed that "the Copyright Act must be construed in light of" its basic purpose of "promoting broad public availability of literature, music, and the other arts." *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975).

III. CONCLUSION

The marked discord created by the royalty rate process and determination of the CARP and LOC serves to underscore the fact that the current compulsory licensing regime applicable to webcasters is in need of an overhaul. The CARP process generates too many costs and inefficiencies for the participants. Moreover, the willing buyer/willing seller standard implies that there is always a functioning market that can be relied upon to set a fair price for all participants, but this standard proved unworkable in the webcasting context. The very existence of a CARP, which influences the conduct of the parties in the negotiations, undermines the efficacy of the standard by discouraging parties from entering into meaningful negotiations, at the same time that it gives an incentive, to the parties that negotiate, to demand unreasonable terms. As a result, the standard should be modified, and stronger incentives should be provided to induce the parties to negotiate, and to view the CARP procedure only as a last resort.

