

# CALIFORNIA'S RECORDING INDUSTRY ACCOUNTING PRACTICES ACT, SB 1034: NEW AUDITING RIGHTS FOR ARTISTS

By *Lon Sorensen*

As home to both the entertainment industry and an unpredictable political climate, California is fertile land for novel ideas to take root in its state legal code. Nowhere was this phenomenon more evident than at Governor Arnold Schwarzenegger's signing of Senate Bill 1034 ("SB 1034")<sup>1</sup> on July 16, 2004.<sup>2</sup> Officially dubbed The Recording Industry Accounting Practices Act,<sup>3</sup> the bill was a response to the continuing outcry against royalty accounting practices in the music business. Artists had long bemoaned the power exercised by labels through recording contracts that gave the companies near complete control over a musician's royalty statements and financial freedom. By granting recording artists a statutory right to audit their record labels,<sup>4</sup> the law was the first of its kind in the nation and endowed artists with more access to information and greater control over their careers.<sup>5</sup>

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1. 2004 Cal. Legis. Serv. 150 (West). SB 1034 modifies California Civil Code §§ 2500, 2501 and is filed under the heading "Recording Artist Contracts." CAL. CIV. CODE §§ 2500, 2501 (West Supp. 2005). For purposes of this Note, however, I will be using the citation to SB 1034 before it was officially codified into state law.

2. Press Release, Office of the Governor, Legislative Update 7/16/2004 (July 16, 2004), at [http://www.schwarzenegger.com/en/news/uptotheminute/news\\_upto\\_en\\_LegisUpdate12.asp?sec=news&subsec=uptotheminute](http://www.schwarzenegger.com/en/news/uptotheminute/news_upto_en_LegisUpdate12.asp?sec=news&subsec=uptotheminute). Although the governor signed the bill in July 2004, SB 1034 did not take effect until January 1, 2005.

3. *Assembly Committee on Arts, Entertainment, Sports, Tourism, and Internet Media*, 2002-2003 Leg., 1 (Cal. 2003) (presenting a bill analysis for SB 1034), available at [http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1001-1050/sb\\_1034\\_cfa\\_20040607\\_15\\_2304\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1001-1050/sb_1034_cfa_20040607_15_2304_asm_comm.html).

4. 2004 Cal. Legis. Serv. 150 (West).

5. Highlighting the pervasive suspicion held by government officials about the recording industry at the time, the California law was passed almost concurrently with New York State Attorney General Eliot Spitzer's investigations into the industry in New York. In May 2004, Spitzer announced that the five major record labels had signed a pact

The legislation was largely the result of an impassioned state legislator responding to a high-profile issue that had both a personal and professional draw.<sup>6</sup> In 2002, after a cluster of news accounts exposed the myriad of problems surrounding royalty calculations in the music industry, State Senator Kevin Murray (D-Culver City) held a series of Senate hearings to allow both sides of the business—the recording artists and the record labels—to articulate their concerns before lawmakers.<sup>7</sup> What came to light was shocking to those outside of the entertainment world: an industry where artists had little idea where their earnings came from and little control over their financial futures.<sup>8</sup>

While most artists' contracts contained a provision allowing them to audit their record labels' royalty statements, several formidable barriers made that provision historically more cosmetic than substantive. First, throughout the life of the contract, the onus was on the artist to prove that the label was underreporting sales and thereby underpaying royalties.<sup>9</sup> Audits could easily verify suspicions of underpayment, but this was an expensive venture for a new artist and also an unreliable one as the audit was not certain to uncover royalty discrepancies. Costing anywhere from \$10,000 to \$100,000,<sup>10</sup> an audit was also a luxury only established re-couped artists could afford. Furthermore, audits often took several years to complete and the documents available for review were usually contractually limited, a provision that shielded the labels from unwanted scrutiny.<sup>11</sup> Artists that did find instances of royalty underpayment were contractually

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with his office agreeing to pay back royalties totaling \$50 million owed to former recording artists. Though the California law deals with current or future royalties and the New York pact deals with former back royalties, the two actions are significantly similar with their focus on accounting discrepancies and their proximity in time to each other. Jeff Leeds, *Music Giants Pay Back Royalties*, L.A. TIMES, May 4, 2004, at C1.

6. Chuck Philips, *Artists Put Pressure on for Benefits, Pensions*, L.A. TIMES, June 3, 2002, at C1 [hereinafter Philips, *Artists Put Pressure*]; Chuck Philips, *The Nation Auditors Put New Spin on Revolt over Royalties Music*, L.A. TIMES, Feb. 26, 2002, at A15 [hereinafter Philips, *Nation Auditors Spin*].

7. Chuck Philips, *State Senate to Examine Music Firms Royalties: A Second Hearing on Recording Industry Accounting is Planned to Probe Allegations that Artists are Being Cheated*, L.A. TIMES, Aug. 26, 2002, at C1.

8. Chuck Philips, *Music Labels Urged to Revise Royalties: A State Senate Panel Criticizes Record Firms' Accounting and Threatens to Take Action*, L.A. TIMES, Dec. 3, 2002.

9. See Philips, *supra* note 6, at A15.

10. *Record Label Accounting Practices: J. Hearing of the Cal. State Senate Comm. on the Judiciary and State Senate Select Comm. on the Entm't Indus.*, 2001-2002 Leg., 3 (Cal. 2002) [hereinafter *Record Label Accounting Practices Hearing*] (overview by Sen. Martha M. Escutia, Chair).

11. See Philips, *supra* note 6, at A15.

limited to only receiving what should have been paid to them under the terms of the original agreement,<sup>12</sup> leaving the artist at a financial disadvantage since she would personally have to pay for the services of an auditor or attorney. Finally, artists rarely chose to litigate over royalties under a breach-of-contract claim since an amiable relationship was preferred with the company that exercised such control over their careers.<sup>13</sup> Generally, artists just opted for a negotiated settlement to receive their money.<sup>14</sup>

Based on these realities, State Senator Murray proposed potent legislation that established a fiduciary relationship between artist and label and that mandated punitive damages payable by labels in cases of breach. Yet the bill signed into law by the governor in 2004 was a far cry from the original bill envisioned by the senator in 2002. Gone was any language mentioning a fiduciary duty, punitive damages, or an artist's right to be released from a recording contract in cases of royalty underreporting. Instead, the bill established a simple set of statutory auditing rights that attached to every record contract.<sup>15</sup>

This new law is significant not only in its novelty as a section in a state legal code, but also in its measured benefit to artists. At a minimum, the new law will help dissipate artists' suspicion about royalty underreporting in the state of California. And through an enumerated set of basic auditing rights, the law will help balance the scales of power long bemoaned by recording artists. This is all done without the heavy hand of government oversight and the uncertainties of a fiduciary relationship in the music industry setting. Thus, while SB 1034 is more limited in scope than the original bill, it is decidedly more sensible and pragmatic.

But aside from its merits, perhaps SB 1034's greatest impact can best be seen when viewed against the backdrop of other recent developments in the music industry. Accordingly, this Note examines the major changes left in the wake of SB 1034's passage. Part I tracks the history of the recording industry and the recent forces that are posing a challenge to its traditional structure. Part II details the major milestones leading up to the governor's signature on SB 1034, from recent California case law to the acrimonious hearings in the state capitol. Finally, Part III evaluates the lingering questions left by SB 1034's passage, namely (1) how the legislation interfaces with a recent California court ruling that shifted the burden of proof to record labels in litigation surrounding royalty payments; (2) whether the bill has unintended consequences that could toll the death

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12. *Id.*

13. *Record Label Accounting Practices Hearing*, *supra* note 10, at 44.

14. *Id.*

15. *See* 2004 Cal. Legis. Serv. 150 (2004).

knell for an already embattled industry; and (3) how the ominous legislation as originally proposed—which would have thrust a fiduciary duty on record labels and allowed for increased liability—may have prodded the industry toward the desirable path of self-reform. This Note concludes that SB 1034, with its limited approach to accounting reform, is superior to the sweeping law originally proposed by State Senator Murray due to its small but important role in the current evolution of the music industry.

## I. BACKGROUND

### A. Players in the Recording Industry

The cornerstone of the music industry, past and present, is the much-maligned recording artist contract.<sup>16</sup> To recording artists, it is the essential bridge between raw talent and the promised lands of future celebrity. To record labels, it is a proven conduit to the creative resources necessary to run a profitable enterprise. Called the hub around which nearly every aspect of the music industry revolves,<sup>17</sup> the central role of the recording contract has never been disturbed, despite profound technological changes in the world of music. New players and modes of distribution define the current state of the business, but artists are still bound to the terms of a written document that has changed very little since its inception.

#### 1. *Shifting Roles for Artist and Label*

The music recording industry owes its rise to technological innovation.<sup>18</sup> This technology was historically expensive and unavailable for private use, with record companies positioned as the only entities capable of making the significant investment in new machinery to make and record music. These companies invested significant resources in building more recording studios and in developing their artists and repertoire (A&R) departments to scout new talent. This A&R staff was responsible not only for locating talent, but also for writing and arranging the artist's music. Thus, A&R served a vital role in the hegemony exercised by the record labels over nearly every aspect of the music business, from fostering creativity to managing finances.<sup>19</sup>

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16. Lynn Morrow, *The Recording Artist Agreement: Does it Empower or Enslave?*, 3 VAND. J. ENT. L. & PRAC. 40, 42 (2001).

17. ENTERTAINMENT INDUSTRY CONTRACTS § 159.01 (Donald C. Farber ed., 2002).

18. See GEOFFREY P. HULL, THE RECORDING INDUSTRY 17 (2d ed. 2004).

19. See generally RICHARD BUSKIN, INSIDE TRACKS (1999) (compiling firsthand accounts from famous record producers about the evolution of the music business).

However, the 1960s marked the gradual demise of the label's A&R staff as a musical contributor and the ascension of the record producer as a central participant in the creative process.<sup>20</sup> Originally the record companies employed the producer, but as they continued to play a central role in the marking of sound recordings, and as artists wanted more creative control over their music, producers left the employ of record labels to start their own production companies.<sup>21</sup> By the 1970s, producers functioned almost entirely separate from labels, thereby removing the creative aspect of music making from the record companies' control and confining the labels' A&R departments to simply identifying talent and managing the books.<sup>22</sup> This division of labor—with labels focused on finances and artists/producers focused on music—appeared to result in a healthy balance between making music and distributing the finished product.<sup>23</sup> But despite this new construct and the shifting responsibilities of the various players, the one entity that remained unchanged was the recording contract.

The financial success of the industry in the late 1970s attracted outside investment to the labels, beginning a series of mergers that resulted in record companies functioning as one branch of a bureaucratic conglomerate that was largely removed from the idiosyncrasies of the music business.<sup>24</sup> As the record labels became more corporate, the division of labor between artist and label only served to widen the growing gap in philosophies between them. The omnipresent recording contract began to be viewed by artists as a means of corporate control and manipulation—a tool to tie artists to a life of professional indentured servitude.<sup>25</sup>

## 2. *The Contemporary Milieu*

Today, only four major record companies control over 90 percent of the recording contracts.<sup>26</sup> These companies—Universal Music Group, Sony BMG,<sup>27</sup> EMI Record Group, and Warner Music Group—funnel the

20. *Id.* at 49.

21. See M. WILLIAM KRASILOVSKY & SIDNEY SHEL, *THIS BUSINESS OF MUSIC* 37 (8th ed. 2000).

22. *Id.*

23. See Senator Kevin Murray, *Recording Industry Practices*, 24 ENT. L. REP. 4 (2002). This structure aligned with the artists' perception of themselves as creative talent and not as business people.

24. See REEBEE GAROFALO, *ROCKIN' OUT: POPULAR MUSIC IN THE USA 200-02* (2d ed. 2002).

25. Morrow, *supra* note 16, at 41.

26. Murray, *supra* note 23, at 6.

27. Until August 2004, there had been five major record labels dominating music distribution. However, in the fall of 2004, Sony Music Entertainment and Bertelsmann Music Group completed the merger of their operations. This new venture has created the

music industry through the terms of a monolithic contract that has changed little over the past seventy years and has grown to over eighty pages in length.<sup>28</sup>

Adding to the dominance of labels in the industry is their familiarity with the contracting process. Armed with experienced attorneys and oblique contracts, record labels have been able to ensure a deal that guarantees maximum income and considerable leverage for themselves. To labels, this is simple economics since they are corporations that must turn a profit in order to survive.<sup>29</sup> In line with this image, record labels portray themselves as “risk distributors, in the same vein as banks, oil wildcatters, and venture capital companies[,]”<sup>30</sup> who invest in artists they think will be successful despite the fact only a small percentage ever will be. As seen by industry representatives, record labels simply spread risk and hope for a return.<sup>31</sup>

Not surprisingly, artists take an entirely different view of the industry, largely seeing themselves as victims of a detached corporate giant and a hard bottom line. Invoking metaphors of slavery and servitude,<sup>32</sup> they view the record companies as conspiring to keep them perpetually indebted to a plantation that also owns the product of their labor.<sup>33</sup> According to artists, nowhere else is this manipulation more evident than in the royalty accounting scheme established by the record contract. “Of the thousands of royalty compliance audits I’ve conducted over the past 30 years,” reported one prominent accountant for recording artists, “I can recall only one instance where the artist owed money to the company,”<sup>34</sup>

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world’s second-largest music company, just after Universal Music Group, and highlights the state of flux afflicting the traditional music industry establishment. Media Brief, *Sony Corp.: Deal Creating Music Company with Bertelsmann is Completed*, WALL ST. J., Aug. 6, 2004, at B6.

28. Murray, *supra* note 23, at 9.

29. XAVIER M. FRASCOGNA, JR. & H. LEE HETHERINGTON, *THIS BUSINESS OF ARTIST MANAGEMENT* 130 (1997).

30. *Record Label Accounting Practices Hearing*, *supra* note 10, at 71 (statement by Steve Marks, Senior Vice President of Business and Legal Affairs, Recording Industry Association of America (RIAA)).

31. *Id.* For every 100 artists signed, a label can expect to have only five release a hit album. Also, labels commit an average of \$450,000 per contract for advances and production just to launch an artist’s first album. *Id.* at 69.

32. *Id.*

33. *Id.*

34. Philips, *Nation Auditors Spin*, *supra* note 6, at A15 (quoting Wayne Coleman, an accountant whose St. Louis firm has recovered more than \$100 million in unpaid royalties for clients).

directly implying that labels generally always owe royalty money to artists.

## B. Portents of Change

If the history of the music industry is defined by a static recording contract binding together label and artist, then the contemporary music industry is largely defined by forces that put this historical structure in doubt. The current era has witnessed better representation of artists, the rise of digital distribution, and the formation of groups to advocate on behalf of artists—trends that may or may not lead to the eventual marginalization of the recording contract.

The rise of the corporate record label also saw the concomitant ascension of the sophisticated talent lawyer. With an understanding of the labyrinthine record contract and the salient issues affecting an artist, modern talent lawyers ensure the best contracts possible for their clients by matching the sophistication of record label negotiators. As such, labels claim that recording contracts have become increasingly favorable to artists over the years.<sup>35</sup> If an album does gain success, labels are quick to highlight that artists—through their savvy management—almost always renegotiate their contracts for improved financial terms.<sup>36</sup>

Digital distribution and the rise of the home computer have also ushered in profound changes to the business. The online music store is now a staple in music distribution and is fast becoming the preferred means of purchasing music for many consumers.<sup>37</sup> While these online stores are built on the traditional artist-label relationship defined by a recording contract, the ease of this Internet distribution is encouraging some artists to bypass this historical construct altogether.

The Magnificent Union of Digitally Downloading Artists (“MUDDA”) is the most notable group advocating the abandonment of the recording contract. Formed in January 2004 by rock veteran Peter Gabriel, MUDDA strives to completely remove record labels from the music business by letting artists directly sell their music online.<sup>38</sup> It is difficult to

35. *Record Label Accounting Practices Hearing*, *supra* note 10, at 67.

36. *Id.* at 70.

37. Perhaps no other company is more symbolic of this digital revolution than Apple Computer’s iTunes. Steve Jobs, Apple’s prodigious CEO, has explained his vision of the future of music: “[T]he personal computer has become the epicenter of the music-listening experience. People keep their music collections on their computers. They want to burn CDs and to put their music on portable players. Why shop at a record store?” Chuck Philips, *Apple’s Jobs Unveils Song Service*, L.A. TIMES, Apr. 29, 2003, at C1.

38. Associated Press, *Rock Singers Plan Online Venture*, L.A. TIMES, Jan. 27, 2004, at C6; *see also* MUDDA, at <http://www.mudda.org> (last visited Mar. 10, 2005).

predict the ability of MUDDA and other similar groups to change the traditional power structures in the music industry, but the groups' efforts are notable in that they represent the most extreme reaction to the current music industry by envisioning a business model free of labels and recording contracts.

Finally, once loosely affiliated artists are now coming together to combat shared obstacles and present a unified message to the world. Groups like the Recording Artists' Coalition<sup>39</sup> and the Future of Music Coalition<sup>40</sup> have served as rallying points for disparate musicians in search of a collective voice. From lobbying Congress to educating the public to helping mold public opinion, the groups have had measured success in counteracting the powerful and seasoned Recording Industry Association of America (RIAA).

## II. EVOLUTION OF SB 1034

The history of the recording industry formed the foundation for State Senator Murray's eventual legislation in the recording industry. But several pivotal events occurred before the state legislator proposed his sweeping changes to the industry and its players. These events—a decision from a California state court and enhanced media attention surrounding the music business—proved a powerful impetus for the senator to take legislative action.

### A. Impact of *Wolf v. Superior Court*

The ideas that would eventually take shape in SB 1034 owe at least some of their beginnings to a California state court. Kevin Murray, the former talent agent-turned state senator from the Los Angeles area,<sup>41</sup> was troubled by the California Court of Appeal ruling in *Wolf v. Superior Court*,<sup>42</sup> which held there was no fiduciary duty between an author who had assigned his intellectual property rights to a distributor in exchange for contingent compensation from the exploitation of those rights. The dispute in *Wolf* arose when an author transferred the rights to his novel

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39. See Recording Artists' Coalition, at <http://www.recordingartistscoalition.com> (last visited Mar. 10, 2005).

40. See Future of Music Coalition, at <http://www.futureofmusic.org> (last visited Mar. 10, 2005).

41. Senate Democratic Caucus, *Biography of Senator Kevin Murray*, at <http://democrats.sen.ca.gov/templates/SDCTemplate.asp?pg=senbiography&cp=MemberPage&sln=Murray&sdn=26&zrn=Zone> (last visited Feb. 16, 2005).

42. 130 Cal. Rptr. 2d 860 (Ct. App. 2003).

and its cast of characters to the Walt Disney Corporation.<sup>43</sup> In exchange for acquiring these rights, Disney agreed to pay the author a fixed royalty of the receipts it earned from merchandising and other exploitation of the author's characters.<sup>44</sup> The agreement between Disney and the author further stated that Disney was not obliged to perform any of the rights granted to it under the contract and could freely assign or license all of the rights.<sup>45</sup> After Disney developed and co-produced a motion picture based upon Wolf's novel, Disney and the author entered into another agreement that not only confirmed the author's entitlement to the contingent compensation from the original agreement, but also empowered the author with specific audit rights.<sup>46</sup> Each time the author attempted to exercise these rights, however, Disney allegedly refused him access to the pertinent records. In his suit, the author claimed breach of the auditing contract and further accused Disney of underreporting revenues it received in connection with the characters.<sup>47</sup> Pointing to the exclusive control Disney exercised over information concerning the exploitation of the characters and the revenue received therein, the author argued that Disney's conduct not only amounted to a breach of contract, but also to a breach of fiduciary duty.<sup>48</sup>

The *Wolf* court held that the "contractual right to contingent compensation in the control of another has never, by itself, been sufficient to create a fiduciary relationship where one would not otherwise exist."<sup>49</sup> The court also struck down the author's claim that a fiduciary relationship existed because he "reposed 'trust and confidence' in Disney to perform its contractual obligation."<sup>50</sup> While every contract requires one party to place at least some trust and confidence in the other, the court reasoned, by no means does this establish the elements giving rise to a fiduciary duty.<sup>51</sup> Trust imbues every contract with the implied covenant of good faith and fair dealing, but public policy mandates it not create a fiduciary relationship since every contract would thus be prone to the heightened duties sur-

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43. *Id.* at 862-63. The motion picture that was eventually produced by Walt Disney, with Steven Spielberg's Amblin Entertainment, was *Who Framed Roger Rabbit* (1988). *Id.* at 862.

44. *Id.* at 862-63.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 863.

49. *Id.* at 864.

50. *Id.*

51. *Id.*

rounding agency.<sup>52</sup> The court also rebuffed the author's claim that the profit-sharing nature of the agreement gave rise to a fiduciary relationship.<sup>53</sup> Citing the absence of a joint venture between the author and Disney, and the fact that Disney was under no obligation to maximize profits from the author's characters, the court stated that no fiduciary duty existed between the two. "The contract plainly allowed an opportunity for nonmutual profit that is absent in fiduciary relationships."<sup>54</sup>

The court next considered whether the author's contractual auditing rights created a fiduciary duty. The court determined that a relationship is either fiduciary in character or it is not; the remedy sought is irrelevant in defining the nature of the relationship.<sup>55</sup> Therefore, the presence of auditing rights "does itself not convert an arm's length transaction into a fiduciary relationship."<sup>56</sup>

The *Wolf* court did, however, establish an important new presumption for artists suing over royalties in California courts. The author's final argument for a fiduciary duty centered around whether shifting the burden of proof to a party in exclusive control of financial records transformed the contractual relationship into a fiduciary one.<sup>57</sup> The author claimed, and the court agreed, that in contingent compensation cases where essential financial records are in the exclusive control of the defendant who would benefit from any incompleteness, public policy would best be served by shifting the burden of proof onto the defendant. The court ruled, however, that this burden shifting did not create a fiduciary duty since the nature of a contractual relationship is separate and distinct from the burden of proof.<sup>58</sup>

The *Wolf* ruling prompted State Senator Murray to seek legislation that would directly counter the decision by expressly establishing a fiduciary duty between recording artist and record label. Seeing the two entities more as spouses than as business unions,<sup>59</sup> Murray believed a fiduciary duty between the two was not only appropriate, but entirely necessary. He felt a fiduciary relationship was a sure way to prevent opportunism in a situation where the company is often in the position to benefit itself rather than the artist through either negligent recordkeeping or intentional

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52. *Id.*

53. *Id.* at 865.

54. *Id.* at 866.

55. *Id.* at 867.

56. *Id.*

57. *Id.*

58. *Id.* at 868.

59. Murray, *supra* note 23, at 5.

fraud.<sup>60</sup> The salient quality present in each form of fiduciary relationship is a level of profound inequality between the parties,<sup>61</sup> which State Senator Murray reasoned was true of artist-label agreements. A fiduciary duty in the context of recording contracts would be significant in that it would give the artists not only a contractual right, but also an empowering moral right to receive fair and accurate royalty statements.<sup>62</sup> The label would be “duty bound to act with the utmost good faith for the benefit” of the artist<sup>63</sup> and would be required to disclose all relevant information regarding royalties—a potent remedy that would dramatically increase the power of artists vis-à-vis labels.

## B. SB 1034

In addition to *Wolf*, two articles in the *Los Angeles Times* further prodded State Senator Murray to introduce SB 1034. In one story, the paper detailed famous recording artists forced to rely on public assistance or denied a pension and health insurance because record labels underreported their royalty earnings—all outcomes that cost the public money in the form of state services.<sup>64</sup> The second article told how recording artists were forced to sue their labels just to secure a proper accounting of their royalty earnings.<sup>65</sup> Due to this media focus and the problems he perceived stemming from *Wolf*, State Senator Murray organized two hearings in the state capital to galvanize support for possible legislative action. These hearings were jointly chaired by the Senate Judiciary Committee and the Senate

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60. Robert Flannigan, *Commercial Fiduciary Obligation*, 36 ALBERTA L. REV. 905, 906 (1998). Flannigan explains in his article that “[f]iduciary responsibility, like all forms of legal responsibility, is a product of social policy. In the fiduciary context, the operative social norm is the desire to inhibit opportunism.” *Id.*

61. 37 AM. JUR. 2D *Fraud and Deceit* § 32 (2004).

62. RESTATEMENT (SECOND) OF AGENCY § 13 (2004); Murray, *supra* note 23.

63. *Barbara A. v. John G.*, 193 Cal. Rptr. 422, 431 (Ct. App. 1983) (citation omitted).

64. See Philips, *Artists Put Pressure*, *supra* note 6, at C1 (describing how Motown diva Mary Wells was so destitute at the end of her life that the “First Lady of Motown” was forced to check into a charity ward of the country medical hospital to receive treatment).

65. See Philips, *Nation Auditors Spin*, *supra* note 6, at A15 (stating that singer Peggy Lee and 300 other performers obtained a \$4.75-million settlement in a class-action suit that accused their record company of cheating them out of royalties from back to the 1940s and describing recent efforts by the Recording Artists Coalition to raise funds and lobby lawmakers for fairer record contracts).

Select Committee on the Entertainment Industry and set the tone for the eventual legislation authored by the senator.<sup>66</sup>

As originally drafted, SB 1034 proposed sweeping changes to the artist-label relationship. The bedrock of the original bill was a call for a fiduciary duty on recording companies to accurately account for royalties earned under a recording contract.<sup>67</sup> Moreover, the bill empowered artists with a statutory right that existed above and beyond the specific terms of each ad hoc contract to audit the accounting records for their royalties. Finally, the bill stipulated specific remedies for artists in cases of breach of that fiduciary duty: requiring a label to pay an artist's costs of an audit, legal fees, and interest if an audit revealed an underpayment of royalties greater than ten percent; requiring a label to pay an artist three times any amount of underpayment if the amount was greater than ten percent; permitting an artist to rescind her recording contract if the audit revealed an underpayment greater than twenty percent; and submitting any disputes concerning the payment of royalties arising from the audit to binding arbitration.<sup>68</sup>

This proposed legislation would have profoundly transformed the recording industry in California by granting artists unprecedented contractual and remedial power. The current state of the law required an artist who suspected royalty underpayment to bring a lawsuit based on a violation of the duty of good faith and fair dealing—an unappealing and expensive route for most musicians.<sup>69</sup> Because there were no penalties against labels for the negligent underpayment of royalties, damages would generally be limited to expectation damages, or what was originally due under the terms of the contract. California law did provide penalties for the un-

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66. According to Senator Martha Escutia, Chair of the Senate Judiciary Committee, the Judiciary Committee co-chaired the hearings due to reports that past recording artists had to rely on public assistance because they were shortchanged their royalty earnings during their careers. Senator Escutia explained that “if public tax dollars are being spent to support artists who were cheated out of their royalty earnings, we need to shift the burden back to where it belongs: to the record labels that failed to pay the artists their rightful earnings.” *Record Label Accounting Practices Hearing, supra* note 10, at 1 (overview by Sen. Martha M. Escutia, Chair).

67. *Assembly Committee on Arts, Entertainment, Sports, Tourism, and Internet Media*, 2002-2003 Leg., 1 (Cal. 2003) (presenting a bill analysis for SB 1034), available at [http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1001-1050/sb\\_1034\\_cfa\\_20040607\\_152304\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1001-1050/sb_1034_cfa_20040607_152304_asm_comm.html).

68. *Assembly Committee on Arts, Entertainment, Sports, Tourism, and Internet Media*, 2003-2004 Leg., 1-2 (Cal. 2004), available at [http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb\\_1001-1050/sb\\_1034\\_cfa\\_20040607\\_152304\\_asm\\_comm.html](http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1001-1050/sb_1034_cfa_20040607_152304_asm_comm.html).

69. Murray, *supra* note 23, at 6.

derpayment of royalties in cases of outright fraud,<sup>70</sup> but the artist had to prove a specific intent by the record label to fraudulently underpay.<sup>71</sup> Because specific intent was extremely difficult to prove in court and the artist could rarely afford to litigate, the record company was largely perceived as free to act negligently in its royalty accounting without penalty.<sup>72</sup> As stated by one industry accountant:

The [recording] companies play this 'catch-us-if-you-can' game with artist royalties. It's not like they sit down and scheme how to take advantage of everybody. But the systems are designed to impede. They're archaic and the royalty staffs are lean. Only artists with muscle really have the ability to get their money.<sup>73</sup>

Yet State Senator Murray's threatened seismic shift to the recording industry never took place. Whittled away by the legislative process and intense lobbying by the RIAA, SB 1034 as signed by Governor Schwarzenegger was significantly diluted and far less severe—a compromise package palatable to the recording industry conglomerates and legislators leery of government intervention in private contracting. While the bill creates a statutory right for artists to audit royalty statements issued by recording companies, it falls far short of establishing the fiduciary relationship originally advanced by State Senator Murray.<sup>74</sup> Artists may now only audit their labels once a year, and the artist must request this audit within three years after the end of a royalty earnings period as defined by the contract.<sup>75</sup> While artists can choose their own auditor and hire him on a contingency fee basis, they can only audit a particular royalty earnings period once. Auditors can audit a label on behalf of several artists at once, but if impropriety is found, artists are limited to the contractual remedies found in their individual contracts, with no enhanced right to punitive damages.<sup>76</sup> Thus, one of the seminal issues that gave birth to SB 1034—the lack of a fiduciary duty between artist and label as defined in *Wolf*—ultimately failed to appear in the final passage of State Senator Murray's bill.<sup>77</sup>

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70. CAL. CIV. CODE § 3294(a) (West 2004); 23 CAL. JUR. 3D *Damages* § 137.

71. Murray, *supra* note 23, at 7.

72. *Id.*

73. See Philips, *Nation Auditors Spin*, *supra* note 6, at A15 (statement by veteran music accountant Fred Wolinsky of Sherman Oaks, CA).

74. 2004 Cal. Legis. Serv. 150 (West).

75. *Id.*

76. *Id.*

77. Murray, *supra* note 23, at 7.

### III. ANALYSIS

Despite the differences between State Senator Murray's first draft and the bill as passed, SB 1034 provides artists a very tangible tool in their quest for equity in bargaining power and accuracy in royalty payments—audit rights with defined metes and bounds that attach regardless of contractual terms. Furthermore, when viewing the law in the context of recent reform in the industry, the legislation points to a larger shift towards artist information that invariably results in a balanced and more trusting environment in the music business, an environment that would be overwhelmed by the enormous weight of a fiduciary duty as originally envisioned by the senator.

#### A. SB 1034 and *Wolf*: Empowering Artists Both Before and After Litigation

The burden-shifting scheme outlined in *Wolf* empowers artists with information only *after* litigation has commenced, while SB 1034 grants artists the right to audit throughout the normal course of the artist-label relationship. Thus, State Senator Murray's bill is arguably more forward thinking and proactive, assuaging concerns before they grow. *Wolf*'s evidentiary ruling is decidedly more reactive, gaining potency only after the start of formal legal proceedings.

At a cursory glance, the California court of appeal ruling in *Wolf* seemed to affirm the limited the rights of an artist who had assigned her intellectual property to a distributor. With the court refusing to impose a fiduciary duty on a company bound to a contingency compensation agreement with an artist, the distributors of assigned intellectual property rights appeared to score a major victory in the ruling. Record labels were able to maintain the status quo and confine artists' remedies to the terms of the contract and the implied covenant of good faith that included no heightened obligation of disclosure, no moral obligation to accurately account to an artist, and no elevated standard of diligence when managing an artist's royalties,

But the end of the *Wolf* opinion was capped with a brief discussion that quietly reshaped the contours of lawsuits between the two sides. Noting that an artist litigating against a corporate distributor faced an uphill battle without access to the all-important accounting records, the court ruled that the burden of proof in a royalty underpayment claim should be shifted away from the plaintiff artist and on to the defendant distributor:

[I]n contingent compensation and other profit-sharing cases where essential financial records are in the exclusive control of

the defendant who would benefit from any incompleteness, public policy is best served by shifting the burden of proof to the defendant, thereby imposing the risk of any incompleteness in the records on the party obligated to maintain them.<sup>78</sup>

While this shifting of the evidentiary burden does not transform the nature of the parties' relationship from contractual to fiduciary,<sup>79</sup> it is significant nonetheless. By placing the burden on the distributors to open their accounting books and prove that royalties are being paid correctly, the *Wolf* court granted artists a powerful right to access and knowledge. Although not the fiduciary duty State Senator Murray hoped to impose on labels, it is a notable victory for artists and a large step towards bringing transparency to the shrouded world of royalty accounting. Recording artists who now choose to file suit against their label alleging royalty underpayment have the luxury of having the label carry the burden of proof that the artist has been paid her fair share.

But the victory for artists that the *Wolf* ruling represents must be tempered by the practical difficulties of suing record companies. The steps leading up to this point are formidable: the artist must first hire an auditor to ascertain whether royalty underpayment has occurred, retain counsel for a lawsuit against the label, and then file a suit in court. This course of action is not only extremely expensive for an unrecouped artist struggling to break into the music industry, but it is also a hostile action against an entity without which most artists traditionally cannot live. Despite recent trends to the contrary, record labels and recording contracts are still a significant force in the music industry and the primary means by which artists gain a foothold in the business. Pushing a royalty underpayment contention to the point of litigation poisons the well between artist and label and stands as a harbinger of a future bumpy ride together.<sup>80</sup>

But all is not lost, because it appears SB 1034 will serve as a preliminary safety valve by providing an artist with the right to audit *before* filing a lawsuit. State Senator Murray's legislation empowers artists with a discrete set of auditing rights that apply throughout the life of a recording contract and that transcend any stipulated terms in ad hoc negotiations. The bill also removes barriers to hiring an auditor, thus enabling an artist to address royalty concerns before resorting to litigation. Taken together, *Wolf* and SB 1034 vest artists with more rights and more information,

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78. *Wolf v. Superior Court*, 130 Cal. Rptr. 2d 860, 867-68 (Ct. App. 2003).

79. *Id.* at 868.

80. *Record Label Accounting Practices Hearing*, *supra* note 10, at 44 (statement by Mr. Londell McMillan, General Counsel, Artist Empowerment Coalition).

thereby increasing artists' collective knowledge and ensuring that they reap the benefit of their album sales.

## B. Possible Limitations and Ramifications of SB 1034

During the legislative hearings leading up to SB 1034's passage, some state lawmakers expressed open reticence about the effectiveness of a Sacramento-crafted law in the esoteric world of recording contracts. One state senator bluntly admitted that "I truly don't understand any of this."<sup>81</sup> Referring to the recording artists and record labels, he went on to say that

I understand in any business negotiation both sides try to protect themselves, but how do we get in the middle of this and not mess it up so badly, because trust me on this one, if we do get in the middle of this, we will mess it up. That is the nature of the legislative process.<sup>82</sup>

With its skeletal set of mandated auditing rights, it seems unlikely SB 1034 is going to "mess up" too much in the music industry, but it is worth highlighting at least some of its possible side effects, namely the potential for thinner record deals for artists, the flight of labels from California, and lawyer-driven acrimony in the industry.

### 1. *Diminished Record Contracts for New Acts*

With its specific list of accounting rights and its prescribed methods for conducting royalty audits, SB 1034 is likely to bring some degree of healthy transparency to the recording industry. This transparency may come at a cost, however, and that cost could be less generous deals for new recording artists. Facing the financial pressure of online piracy and copyright infringement,<sup>83</sup> record labels are stretched thin in their struggle to maintain the traditional market structure. Being brittle and bruised from their war with technology, record labels could react to elevated auditing responsibilities by simply tightening the noose around new artists' necks and offering them a lower royalty rate that includes more latitude for the label but less for the artist. As recording contracts have been the backbone of the music business and virtually every new artist must go through a recording deal at some point, SB 1034 may signal a more difficult time for emerging talent ahead. New artists often must take what they are offered since they have no track record of musical success and little leverage at the negotiating table. After SB 1034, what they get from a label may be

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81. *Id.* at 45 (statement by Sen. Ray Haynes).

82. *Id.* at 45-46.

83. *Id.* at 3.

more rights to accounting sheets but less money and maneuvering power under the contract.

## 2. *Flight of the Labels from California*

Geography may be another factor limiting the effectiveness of SB 1034. Along with California, New York and Tennessee serve as ground zero for the music industry. SB 1034 may set the stage for the exit of major record labels from California in an effort to escape its requirements. While this scenario seems unlikely given the long-standing history of the recording industry in the Golden State and the significant pool of talent that emerges from the region, it is not outlandish to envision major operations for labels moving entirely to some other jurisdiction more friendly to record companies. This could feasibly be accompanied with the labels inserting a contract provision detailing that this new jurisdiction would be the proper venue for any and all litigation arising under the terms of the contract.

## 3. *A Boon for Lawyers and Accountants*

Finally, aside from recording artists, SB 1034 will make at least two other groups of professionals happy: accountants and lawyers. With the enhanced power to audit and the ability to investigate suspected royalty underpayments, artists will be calling on the services of accountants to do the financial probing—and in instances of gross royalty underpayment, on an attorney to commence litigation against the label to either break the contract or demand payment. Such intrusions by two little-loved professional groups seem likely to deepen the growing divide between artist and label who have historically functioned in a symbiotic relationship. Once compared to a marriage<sup>84</sup> by State Senator Murray, this relationship could be reduced to a hostile war zone defined by legions of lawyers and accountants fighting their counterparts on the other side.

However, when viewed against the backdrop of other recent changes in the industry, it is unlikely SB 1034 will be a cash cow to the legal and accounting worlds or that California will see the en masse migration of record labels from its borders. Rather, the legislation is one part of the much larger evolution that is transforming the industry of music.

## C. **SB 1034 Prodding Industry Self-Reform**

The recording companies voluntarily implemented much of the spirit of the original SB 1034 before its diluted counterpart ever passed—one more sign of increasing pressures on the industry to change. For over two

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84. Murray, *supra* note 23, at 5.

years, State Senator Murray had been threatening to impose change on the recording business through legislative fiat. After the 2002 legislative hearings, the senator sent this warning to record labels in a law review article: "I urge the record companies to consider the structural and accounting changes on their own to avoid legislation that would mandate contract terms, and to engage in discussions with State Legislatures and Congress about enacting those suggestions that require legislative action."<sup>85</sup> While opening the door for self-regulation and organic reform, State Senator Murray also made clear he would not be coy about using the blunt force of legislative action to remedy a pervasive problem in the recording industry.

Three of the label conglomerates moved quickly toward internal self-reform. Bertelsmann Music Group (BMG)<sup>86</sup> was the first to break ranks with industry rivals by proposing a "fairer, more transparent" accounting system for royalty payments.<sup>87</sup> At the end of 2002, BMG announced its sweeping changes to the way it did business with artists: it would simplify royalty computations; reduce the number of pages in a standard recording contract from 100 to 12; introduce a new contract model that would restrict the number of years an artist would be bound to the label while also opening up a new stream of shared revenue; and compute royalties based on the wholesale price of a CD rather than the suggested retail price.<sup>88</sup> As explained by a music industry accountant, "It's exactly what artists are crying out for. In theory, if it became a universal practice, there would be little reason for artists to ever conduct audits."<sup>89</sup>

Feeling both peer pressure from BMG and the threat of legislative action, Universal Music Group, the largest of the record labels, next followed suit. Among other reforms, Universal announced in 2002 that it too would revamp its royalty accounting process by giving artists access to

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85. *Id.* at 9-10.

86. This announcement from BMG came nearly one year before its merger in late 2004 with Sony Music Group. The newly merged label, Sony BMG, is owned equally by the two media giants and it remains to be seen what type of lasting reform will endure in this new corporate structure. See Media Brief, *supra* note 27, at B6.

87. Chuck Philips, *BMG to Roll Out Royalty Plan: The Move Could Help Ease the Controversy Over the Industry's Accounting Practices*, L.A. TIMES, Nov. 20, 2003, at C1.

88. *Id.* Royalties based on wholesale prices or suggested retail prices will likely be the same, but the benefit for artists will be in the form of simplified royalty statements. "For instance, an artist with a 12% royalty based on the suggested retail price of \$17.98 per CD typically earns about \$1—after the company extracts a bevy of deductions. Under BMG's plan, the same artist will receive a 9% royalty based on the wholesale price of \$11.41 per CD, with no deduction, still receiving about \$1." *Id.*

89. *Id.* (statement by Phil Ames, a music industry accountant who has performed countless audits for recording artists).

manufacturing documents that it had previously withheld.<sup>90</sup> Also significant was Universal's plan to double the size of its audit staff to enable the company to be more responsive to royalty inquiries from artists.<sup>91</sup> Finally, in a move to educate artists about industry accounting practices and to alleviate their suspicions, Universal announced it would hold royalty workshops twice a year.<sup>92</sup>

In the most significant accounting reform, Warner Music Group announced in 2003 that not only would it simplify royalty calculations across the board, but it would also subject itself to self-imposed penalties in the advent of royalty underpayment. By promising to pay interest in prime rates to artists on unpaid royalties found in an audit and to reimburse acts for the costs of any audit that revealed royalty underpayment exceeding ten percent,<sup>93</sup> Warner Music became the first and only record company to expose itself to monetary damages for its own negligence.

Exactly what prompted the record labels to voluntarily reform their royalty accounting practices is unknown. Considering the extended length of the law's passage and the high profile senate hearings held in the state capital, SB 1034 packed a media punch that was felt throughout the entertainment industry. State Senator Murray was able to marshal considerable momentum in his call to empower artists by catering to a national media audience with an issue that made headlines but also appealed to people's inner sense of fairness. Whether it was the negative press emanating from the senate hearings about the antiquated practices of the recording industry, or the specter of government oversight manifest through a statute which would have imposed a fiduciary duty, the bill as signed by Governor Schwarzenegger was much more narrow in its approach to industry reform. Receiving the final blessing of the RIAA, the recording artists, and the Sacramento political establishment, SB 1034 was largely able to accomplish the overly ambitious goals of the original bill sans governmental intrusion into private contracting.

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90. Contracts require labels to compensate artists on records sold, not manufactured. Therefore, labels historically only provided artists with records of sales during audits. The fact that the manufacturing records were withheld from auditors caused suspicion among artists who accused labels of selling albums manufactured overseas without accounting for them in royalty statements. See Chuck Philips, *California Universal Music to Redo Royalties: Firm Becomes Second to Respond to Concerns About the Industry's Accounting Practices*, L.A. TIMES, Nov. 28, 2002, at C2.

91. *Id.*

92. *Id.*

93. Chuck Philips, *Warner Rolls Out Royalty Reforms: Record Company Says Move Will Make it Easier for Acts to Determine What They are Owed*, L.A. TIMES, Mar. 20, 2003, at C1.

#### IV. CONCLUSION

By all accounts, the artist-label relationship was ripe for change, and recent events have done much to address a number of glaring problems in the recording industry. Viewed as a whole, these changes have significantly emboldened artists through more information and greater access to documents once held exclusively by the labels. The accounting self-reform enacted by three major record companies alleviates the misinformation and the suspicion an artist may have about proper royalty recording, feasibly removing the need for an audit in the first place. However, if an artist did choose to audit, SB 1034 grants her discrete audit rights and a means to defray the formidable ensuing costs. Finally, if the artist chose to sue for royalty underpayment, the *Wolf* decision places the burden on the record label to prove that the artist was being paid correctly. These recent actions are all incremental but decidedly prudent, as they allow the music industry to organically adapt itself to the expectations of talent and the financial realities facing labels in an uncharted digital age. Legislative actions that would impose artificial relationships and stipulate damages, such as the original bill proposed by State Senator Murray, overreach and threaten to bring enmity, rather than cooperation, to the industry. The music business has adapted to the technical innovations and evolving musical tastes of the last 100 years, and there is every reason to believe that it will continue to do so in the years to come through self-adaptation, minimal government intrusion, and cooperation between artist and label.