# THE WINDING STREAM: ENTITLEMENT THEORIES AND INTELLECTUAL PROPERTY RIGHTS IN EMERGING MEDIA TECHNOLOGIES

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In March of 2007, Congress published updated compulsory royalty rates for webcasters[1] wishing to license rights in sound recordings under the Digital Performance Right in Sound Recordings Act of 1995 (DPRA) and the Digital Millennium Copyright Act (DMCA).[2] Working under its authority as created by the DPRA, the Copyright Royalty Board established per-performance rates through 2010 that radio industry commentators claimed would "wipe out an entire class of business," that of small independent internet radio stations.[3] Early analysis indicated that larger commercial webcasters, such as industry-darling Pandora, would also be unable to sustain profitability.[4]

Two July 2009 announcements drastically altered what had been a bleak landscape for internet radio since March of 2007. In the same month that the D.C. Circuit affirmed the Copyright Royalty Board's ratesetting decision, the Copyright Office announced that SoundExchange, its selected clearinghouse for administering digital sound recording rights, had reached a negotiated agreement with a collection of large and small commercial webcasters on an



1. Webcasting consists of digital delivery of real-time content using "streams" of audio data, which are buffered on the listener's computer and deleted following playback. In its most common form, webcasting is analogous to AM/FM radio broadcasts—the user selects a channel and content is streamed continuously.

2. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380).

3. Daniel McSwain, *Webcast Royalty Rate Decision Announced*, RADIO & INTERNET NEWSL., Mar. 2, 2007, http://www.kurthanson.com/archive/news/030207/index.shtml (internal quotations omitted).

4. *See id.*

alternative set of royalty rates and payment structures through 2015.[5] Some feel that these two developments saved internet radio.[6]

To better evaluate the successes and challenges met by the DPRA/DMCA thus far, it can be helpful to look to entitlement theory. Entitlement theorists, relying on a law and economics theory pioneered by Professor Guido Calabresi and A. Douglas Melamed, classify entitlements as being protected under one of two rules: property rules or liability rules.[7] If an entitlement is protected under a property rule it is an "absolute permission rule" and cannot be used by others without the permission of the owner. Liability rules, in contrast, allow the user of the entitlement to compensate the owner at a later date, often at a value determined by courts.[8] The compulsory license used to protect many intellectual property rights, including the digital performance right for webcasters, exemplifies the liability rule—courts or legislatures determine an amount owed to an entitlement owner ex-post.

Entitlement theorists have, over the past few decades, endeavored to describe the consequences of creating property-rule and liability-rule entitlements in the context of efficient exchange of resources between holders and users of such entitlements. Focusing on various forms of transaction costs associated with these exchanges, debate continues over whether one entitlement form or another is superior or, more subtly, in what situations policymakers may do better to prescribe one rule over another.[9] Two points of view in this debate are particularly useful to understanding the DPRA's compulsory license in these terms. In *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, Professors Ian Ayres and Eric Talley (hereinafter Ayres & Talley) explore the value of liability rule

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5. *See* Intercollegiate Broad. Sys. Inc. v. Copyright Royalty Bd., 571 F.3d 69 (D.C. Cir. 2009) (affirming Copyright Royalty Board's ratesetting decision); Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796, 34,797-98 (July 17, 2009).

6. *See, e.g.*, Posting of MG Siegler to TechCrunch, *Pandora (and Other Internet Radio) Has Officially Been Saved*, http://www.techcrunch.com/2009/07/07/pandora-and-other-internet-radio-has-officially-been-saved/ (July 7, 2009).

7. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106–10 (1972).

8. The government's eminent domain power to take property so long as it pays just compensation is an example of a liability rule. *See id.* at 1092.

9. *See generally* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1(1960). Coase argued that, when transaction costs equal zero, initial property grants do not matter, because parties will bargain with each other to achieve a distribution of property that maximizes value to all parties. As transaction costs come into play, however, initial entitlements become important to allocative efficiency.

entitlements, such as the compulsory license, in facilitating bargaining by forcing parties to the entitlement to exchange information about their relative valuation.[10] In *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, Professor Robert Merges outlines several issues associated with the use of liability rules in intellectual property entitlements and analyzes the birth of collective rights organizations (CROs) such as ASCAP out of the creation of property rule entitlements.[11]

This Note evaluates the structure and history of the digital performance right in the context of non-interactive webcasting[12]—a liability rule entitlement with some property rule-like features—and tests it against the theories of both articles, exploring the information-forcing attributes described by each through the empirical lens of fifteen years of webcasting regulation. Ultimately, it appears from this brief history that the theories each set forth have been borne out to some extent: certain features of the DPRA structure have served to increase information exchange between rights holders and rights users, while other features have limited that exchange and stifled Coasean bargaining, demonstrating that there are some significant issues for policymakers to consider when prescribing liability rules for intellectual property rights (IPRs).

Part I summarizes the theories of Ayres & Talley and Merges, with a focus on implications for IPRs. Part II provides a history of the creation of the digital performance right as it relates to webcasters, from the Digital Performance Right in Sound Recordings Act of 1995 to the Digital Millennium Copyright Act of 1998, recent royalty rate determinations for webcasters under the DPRA and DMCA, and the challenges of arbitration under the willing buyer/willing seller standard of review. Part III evaluates the history of the webcasting proceedings in the context of the theories described in Part I and discusses the specific impact of the webcasting compulsory license on information exchange and efficient bargaining between interested parties.

10. *See* Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995).

11. *See* Robert P. Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CALIF. L. REV. 1293 (1996).

12. To be classified as a non-interactive webcaster, a webcaster must meet several criteria outlined in the DPRA/DMCA, the most important of which is that users must not be able to select upcoming songs to stream. See *infra* Section II.A.1.

# I. ENTITLEMENT THEORIES AND THE DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS

Ayres & Talley present a number of ways in which divided entitlements, such as those created by liability rules, reduce transaction costs towards Coasean bargaining, and also describe several types of transaction costs that may be exacerbated by liability rules.[13] Merges extends this thread, further analyzing efficiency gains and losses for liability and property rules in the IPR context.[14] These articles indicate that neither liability rules nor property rules have a categorically superior effect on efficiency, and proper ex ante allocation critically relies on a refined sense of the specific entitlement and relevant parties to an exchange.

## A. AYRES AND TALLEY: SOLOMONIC BARGAINING AND INFORMATION COSTS

Ayres & Talley's 1995 article is a response to the conventional wisdom at the time that property rules produced more efficient allocative results than liability rules by promoting bargaining. It was argued that property rules were "market-encouraging" and liability rules were "market-mimicking."[15] Their view of liability rule entitlements focuses on the fact that such entitlements create a form of *divided ownership*: the property owner is free to use the property, but other interested parties have a form of call option, allowing them to use the property and pay compensation. "Endowing each bargainer with a share of the underlying entitlement creates the possibility of two different types of Coasean trade: A bargainer might buy the other party's claim, or, alternatively, she might sell her own."[16]

The type of offer the parties make to each other in this circumstance—an owner's offer to pay a potential user not to exercise her call option and pay compensation, for example—serves as an indicator of value not present in a property rule structure, and can induce more bargaining and thus more efficient allocation versus property rule entitlements.[17] Additionally, in the shadow of a liability rule, representations of value by parties are more credible, improving the efficiency of bargaining when compared to property rule allocations.[18] However, Ayres & Talley do point out circumstances in

13. *See* Ayres & Talley, *supra* note 10.
14. *See* Merges, *supra* note 11.
15. *See* Ayres & Talley, *supra* note 10, at 1032.
16. *Id.* at 1030.
17. *Id.* at 1041–43.
18. *Id.* at 1039.

which non-information-based transaction costs can be exacerbated by liability rules, and note the potential negative effect "tailoring" liability rule valuations can have on bargaining in this context.[19]

#### 1. *Liability Rules' Information-Inducing Effects on Bargaining*

Ayres & Talley describe a three-stage game that makes up bargaining under a liability rule, and the results of this game exemplify the information effects absent in a typical two-stage property rule bargain.[20] A typical property rule bargain involves two steps: (1) the interested party makes an offer, and (2) the owner accepts or rejects the offer. Other discussions may surround those two points, but they suffer from the classic challenge of adverse possession as the owner is incentivized to represent its valuation as high as possible, and the buyer to represent its valuation as low as possible.[21]

A divided, liability rule allocation adds an initial step to this game. In the three-stage game, the owner first offers to sell her claim to the property or offers to buy the interested user's call option under the liability rule.[22] The effect of this initial step is to separate the owners into two categories: high valuing and low valuing entitlement holders and to set boundaries on the resulting offers via the liability rule damages amount.[23] "This self-selection . . . can increase the likelihood of an efficient transaction, because it effectively gives the parties less 'room' to misrepresent their private valuations in bargaining."[24] Ayres & Talley demonstrate via a rigorous game theoretical model that the constraints created by this three-stage game will *induce more parties to trade than under a property rule game and increase the joint payoffs to buyers and sellers*.[25] By credibly representing their preferences to potential users, owners deal in the second stage with users who are open to trade at relative valuations closer to Coasean equilibrium.[26]

#### 2. *Tailoring, Impediments to Efficient Information Exchange, and Potential Consequences*

Ayres & Talley make an important qualification regarding the effects of bargaining in the shadow of liability rules, noting that the act of tailoring

19. *Id.* at 1035–36.
20. *Id.* at 1049.
21. *Id.* at 1042.
22. *Id.* at 1049–50.
23. *Id.* at 1055.
24. *Id.*
25. *Id.* at 1058–61.
26. *Id.* at 1044.

liability rule damages to closely reflect the owner's valuation, though initially appealing, can actually damage the information-inducing effects of the liability rule structure.[27] If the damages amount of a liability rule perfectly compensates the owner ("plaintiff" in a potential suit), she is no longer incentivized to represent an interest in bribing the option-holder not to take the property.[28] The game returns to two stages and nonconsensual takings (exercise of options by "defendant") increase, eliminating the information efficiencies and resultant bargaining.[29] This result is particularly significant in the context of compulsory licenses such as the digital performance right, where Congress has put in place proceedings to determine accurately the adequate royalty rate to compensate copyright holders—a perfect example of tailoring damages that makes up the bulk of the discussion below.[30]

Additionally, Ayres & Talley note that "structural impediments to pre-taking negotiations might be so great that the facilitating effects of liability rules . . . are not sufficient to induce any bargaining."[31] Large, amorphous bodies of potential buyers or sellers can make such divided bargaining impossible.[32] Furthermore, if lawmakers misidentify the most efficient owners and users of a given entitlement, a divided entitlement can induce collective-action inefficiency. Inefficient owners may be incentivized only to sell their property and will therefore not credibly represent their interests, as exemplified by the hold-out problems inherent in purchasing adjoining plots of land to build a large development.[33] Furthermore, the model created by Ayres & Talley assumes valuations are uncorrelated. Where one party's representation of valuation can affect that of another party, liability rules may further disincentivize a potential buyer to state credibly her interest, and "thus reduce the potential benefit of Solomonic bargaining."[34]

One of the major consequences of divided entitlements is the potential to induce underinvestment. If an initial owner of a divided entitlement is unsure whether she will achieve full value for her investment, or will instead

27. *Id.* at 1066.

28. *Id.* at 1067.

29. *Id.* at 1068.

30. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24084; *see also infra* Section III.A.

31. Ayers & Talley, *supra* note 10, at 1083.

32. *Id.*

33. *Id.* at 1086. In this example, a single property owner's land is not relatively more valuable than another's, but she is incentivized to wait until she is the last owner to sell, at which point the value of the entire development rests on her sale.

34. *Id.* at 1089.

have the item taken nonconsensually, there may not be sufficient incentive to develop the property.[35] This is a significant concern for lawmakers in the context of intellectual property entitlements, where the goal is balancing incentive to create with public access to technological and creative advances.[36]

### B. MERGES: SUPERIORITY OF PROPERTY RULES WHEN ALLOCATING INTELLECTUAL PROPERTY RIGHTS

In his article, Merges argues for the superiority of property rule entitlements in situations where rights holders encounter each other frequently, such as in IPRs.[37] In so doing, he addresses Ayres & Talley and points to a number of efficiency issues endemic to using liability rule entitlements to protect rights holders in new media.[38] In Merges's IPR-specific theory, liability rule entitlements such as compulsory licenses authorize "rights holders" to receive compensation from "infringers" who wish to use the IPR.[39] Merges discusses two historical examples of property rule IPRs that resulted in the formation of private CROs—ASCAP for musical works and patent pools for related patents—and concludes that strong property rule protection of IPRs, coupled with encouragement of fledgling CROs, can yield a form of collective liability rule protection that offers the same free access for potential infringers as congressional liability rules but better approximates the proper valuation for these rights.[40]

#### 1. *Efficiency Concerns with Liability Rules and IPRs*

Merges identifies several issues with liability rules that seem to produce suboptimal results in the context of IPRs when compared to property rules. He cites historical evidence based on IPRs such as the long-standing mechanical royalty and song "covers".[41] First, the positive information effect proposed by Ayres & Talley falls apart in the IPR context due to the potential for "phantom infringers" to discredit claims by entitlement holders.[42] Also, although liability rules may limit transaction costs in the

35. *Id.* at 1083.

36. *See* BRUCE P. KELLER & JEFFREY P. CUNARD, PRACTISING LAW INSTITUTE, COPYRIGHT LAW § 1:2.1 (2009).

37. *See* Merges, *supra* note 11, at 1297.

38. *Id.* at 1300 ("I argue that the conclusion of some scholars that liability rules best facilitate transactions and bargains is inapplicable in the IPR context . . . .").

39. *See generally id.*

40. *Id.* at 1391.

41. *Id.* at 1308–09.

42. *Id.* at 1305–06.

traditional entitlement context, valuation problems with IPRs require internalization of significantly higher litigation risk as well as the volume of expert analysis required to effectively educate courts in rapidly changing markets.[43]

Merges's argument regarding the potential for "phantom infringers" to disrupt the information-producing results of liability rules is an echo of Ayres & Talley's concern that a high-valuing seller will not wish to bribe all parties with a call option to infringe. Because taking can occur infinitely in the IPR context, liability rule entitlements can spawn phantom infringers. Phantom infringers are parties who will, upon discovering that a rights holder is willing to buy call options from potential infringers under the Ayres & Talley model, represent a false high valuation in order to receive a payout without a credible interest in using the property.[44] Phantom infringers prevent the rights holder from credibly signaling an intent to bribe the potential infringer not to infringe.[45] The positive effects of liability rules to provide a valuation signal in pre-taking bargaining is therefore defeated in the IPR context.

Because a proliferation of phantom infringers prevents a rights holder from representing a valuation higher than the liability rule damage award (or compulsory royalty), it creates a ceiling on valuation, from which parties can only negotiate downward, and this presents significant incentive issues for creators.[46] The valuation ceiling created by this bargaining inefficiency ties into two other concerns expressed by Ayres & Talley: the potential of liability rules to encourage underinvestment and the problems created by tailoring. The valuation ceiling is particularly challenging in the world of copyright and music, where overlapping rights and responses to new technologies (such as webcasting) make it difficult to determine the effects of valuation on creators' incentives. Pricing an IPR liability too low defeats a key copyright goal (encouraging creation[47]), but pricing too high may have the practical impact of destroying distribution models before their benefit to creators and the public can be fully realized. Additionally, phantom infringers have a similar impact as tailoring damage awards on Coasean bargaining, eliminating the incentive of a rights holder to represent higher valuation. The phantom infringer problem is even more significant, though, because it occurs independent of whether the damage award accurately reflects the rights

43. *Id.* at 1317–18.
44. *Id.* at 1305–06.
45. *Id.*
46. *Id.*
47. Keller & Cunard, *supra* note 36, at § 1:2.1.

holder's ideal valuation. As nonconsensual taking increases under a liability rule entitlement that suffers from the problem of phantom infringers, the accuracy of Congress's or the court's damage award becomes increasingly critical to compensate properly creators or rights holders for their creations.

Compulsory licenses in the context of IPRs and developing technologies suffer from at least two transaction costs not typically associated with property rule entitlements of the same rights. First, high administrative costs are associated with arbitration to determine future compulsory royalty rates.[48] "[O]ne component of this cost," Merges states, "would be the expenditures made to influence the judge's valuation decision."[49] Beyond rate-setting administrative decisions, there is a high potential for litigation because IPRs are notoriously difficult to value.[50] As will be discussed below, the administrative costs of compulsory licensing in webcasting have substantially borne out these concerns.

### 2. *Private Collective Rights Organizations and Market-tuned Liability Rules*

In response to these IPR-endemic transaction costs, Merges argues that property rule entitlements can outperform liability rule entitlements when parties engage in a high volume of repeat transactions, doing so through the creation of private CROs.[51] He examines two such institutions—ASCAP for copyrighted musical works and patent pools for related patents—that formed organically out of property rule protections.[52] In Merges's view, CROs create a form of liability rule by contracting with potential infringers. By pooling content and negotiating various "one-size-fits-all" agreements with potential infringers, CROs form a compulsory license of sorts: terms will not necessarily mirror individual negotiation by rights holders and are available to all who wish to deal with the CRO, but they will more closely approximate equilibrium value than legislative or judicial liability rules through repeated negotiation and contracting.[53]

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48. Merges, *supra* note 11, at 1317.

49. *Id.*

50. *Id.* The intangible nature of the rights, combined with uncertainty around the media in which they will be exploited in the future, leads to difficulty in assigning consistent value. For example, a copyright in a musical composition can vary widely in value depending on the popularity of the original artist, current uses of the song, and potential future revenue streams from music sales or performances.

51. *Id.* at 1325–1327.

52. *Id.* at 1328.

53. *Id.*

Private CROs reduce enforcement and administrative transaction costs for individual rights holders, and therefore address many of the concerns with liability rules presented by both articles.[54] To this end, Merges concludes that policymakers should consider strong property rule protections for IPRs in conjunction with efforts to encourage the formation of CROs.[55] These "intermediate forms of collective valuation" are critical to new markets and multimedia, as overlapping licenses become increasingly necessary and the rate of repeat interactions increases.[56]

## II. BACKGROUND AND HISTORY OF THE DIGITAL PERFORMANCE RIGHT IN SOUND RECORDINGS

Since its creation under the Digital Performance Right in Sound Recordings Act (DPRA), the digital performance right in sound recordings has been embroiled in confusion and controversy as the recording industry, broadcasting industry, and digital community struggle for ground amid the tremors of rapidly changing technologies and markets.

### A. THE DPRA/DMCA AND THE DIGITAL PERFORMANCE RIGHT

A response to the emergence of new music consumption technologies and concerns by artists and other copyright holders regarding monetization of these technologies, the DPRA created categories of digital copyright users and established a range of rules under which licenses to digital performance rights would be granted.[57] These categories were immediately challenged as failing specifically to include traditional webcasting, and were ultimately clarified by the DMCA.[58]

#### 1. *Categories of Copyright User Under the DPRA and DMCA*

Four subcategories of digital audio broadcaster arose out of the DPRA and DMCA. An "interactive service" such as Rhapsody, to which users subscribe and through which they are able to select individual songs for immediate streaming, is subject to the rights created by the DPRA in the form of a typical property rule and requires permission from the copyright holder for use. "Non-subscription broadcast transmissions," which occur when terrestrial radio broadcasters stream their broadcasts over the Internet,

54. *See id.* at 1325–27.
55. *Id.* at 1391.
56. *Id.* at 1392.
57. H.R. REP. NO. 104-274, 10 (1995).
58. 17 U.S.C. § 114(d) (2006).

were initially exempt from the DPRA, but were eventually determined by the Copyright Office to fall within it.[59] "Non-interactive online-only transmissions," which encompass traditional webcasting, are subject to a compulsory royalty as determined by the Copyright Office, and is protected by the hybrid property/liability rule that is the subject of the bulk of this Note.[60] In order to qualify for this license, broadcasters must meet strict requirements, including restrictions on the number of songs by one artist that can be played in a three-hour period and that no advance notice be given as to what song will be played.[61] Finally, online-only transmissions that do not meet the strict requirements above, such as those that only play the music of a single artist, are required to obtain licenses directly from copyright owners.[62]

### 2. *The Compulsory Royalty for Webcasters*

The DPRA authorized the Librarian of Congress to convene a Copyright Arbitration Royalty Panel (CARP) composed of three professional arbitrators to recommend royalty rates and terms for the imposition of the compulsory royalty in digital performance rights for webcasters.[63] This task was taken over by the Copyright Royalty Board (CRB), a set of three full-time judges that sit on issues of compulsory royalties in copyright, under the Copyright Royalty and Distribution Act of 2004.[64] Statutory royalty rates are to be set by the conduct of adversarial proceedings, with participants to include broadcasters, copyright holders, or the copyright holders' designated common agent for the administration of the statutory royalty (in this case, SoundExchange, described below).[65] The Copyright Office publishes notice of intent to commence proceedings to determine the statutory royalty rate for a given period of *x* years, and parties have six months to submit negotiated terms of their own before the panel convenes.[66]

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59. Joshua Keesan, Note, *Let It Be? The Challenges of Using Old Definitions for Online Music Practices*, 23 BERKELEY TECH. L.J. 353, 359–60 (2008); *see also* 17 U.S.C. § 114(d) (2006).

60. *See* Digital Millennium Copyright Act, 17 U.S.C. § 114. It was not clear to industry participants whether the DPRA intended to include webcasters in this category. As such, Congress specifically included webcasters under the DMCA.

61. Keesan, *supra* note 59, at 360.

62. *Id.*

63. *See* Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,087.

64. Copyright Royalty and Distribution Act of 2004, Pub. L. No. 108-419, 118 Stat. 2341, 2341.

65. 17 U.S.C. § 114(e)–(f).

66. 17 U.S.C. § 802(b)(3)(B) (2006).

In making its decisions in these proceedings, the CRB is expected to consider several criteria under 17 U.S.C. § 114(f)(2)(B), the most important of these being the willing buyer/willing seller standard.[67] Under that standard, the Copyright Royalty Judges "shall establish rates and terms that most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller."[68]

The Copyright Office convened one CARP in 2001–2002 (*Webcasting I*) and the first CRB in 2006–2007 (*Webcasting II*).[69] Both went through extensive appeals and were ultimately superseded by the Small Webcaster Settlement Act of 2002, and the Webcaster Settlement Acts of 2008 and 2009.[70] They are discussed further below.[71]

#### 3. *SoundExchange as Royalty Clearinghouse*

SoundExchange was established in 2000 by the Recording Industry Association of America (RIAA) to administer and distribute the royalties under the compulsory license of the DPRA and DMCA.[72] The RIAA is an industry group comprised of music labels owning approximately 90 percent of the relevant sound recordings covered by the digital performance right. The Copyright Office acknowledged this agency function in *Webcasting I*.[73] Following *Webcasting I*, in 2003, SoundExchange was spun off from the RIAA into an independent, non-profit organization, with a board comprised

67. 17 U.S.C. § 114(f)(2)(B).

68. *Id.*

69. *See* Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261); Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380).

70. *See* Intercollegiate Broad. Sys. Inc. v. Copyright Royalty Bd., 571 F.3d 69 (D.C. Cir. 2009) (appeal of *Webcasting II*); Beethoven.com v. Librarian of Congress, 394 F.3d 939 (D.C. Cir. 2005) (appeal of *Webcasting I*); *see also generally* Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, § 3, 116 Stat. 2780, 2781 (suspending payment under agency determination in favor of ex-post negotiated agreement); Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796 (July 17, 2009) (same).

71. *See infra* Section II.B.

72. SoundExchange, FAQ, http://soundexchange.com/category/faq/ (last visited Oct. 28, 2009). SoundExchange's activities are analogous to those of the Harry Fox Agency, which manages the mechanical license under 17 U.S.C. § 115 on behalf of music publishers. 17 U.S.C. § 115 (2006).

73. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45,267.

of RIAA members and performer or creator representatives.[74] *Webcasting II* upheld the Copyright Royalty Board's decision to appoint SoundExchange as the sole agent for administering the compulsory royalty, against challenges by Royalty Logic, a competing, for-profit organization.[75]

### B. *WEBCASTING I* AND THE SMALL WEBCASTER SETTLEMENT ACT OF 2002

The first proceedings under the DPRA and DMCA began on November 27, 1998, with the initiation of voluntary negotiations for the first royalty period from 1998–2000.[76] When this schedule proved unworkable for the parties, the Copyright Office consolidated the 1998–2000 rate determination with the 2001–02 determination and hearings began July 30, 2001.[77] Parties included companies and organizations representing both webcasters and copyright holders, although small webcasters were noticeably absent from the proceedings.[78]

#### 1. *CARP and Library of Congress Determinations*

One of the primary points of contention between webcasters and copyright holders, represented by the RIAA, dealt with the collection of royalties on a percentage of revenue versus a per-performance rate. The RIAA argued for per-performance rates as the closest proxy for actual usage and value in the right, while the Digital Media Association (DiMA) proposed an option between a per-performance royalty and a per aggregate tuning hour (ATH) royalty.[79] What small webcasters remained insisted on a percentage of gross revenue model for calculating royalties.[80]

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74. *Id.* One may speculate that this was in response to concerns of anti-competitive conduct by the RIAA via SoundExchange, as alleged in *Webcaster Alliance, Inc. v. RIAA*, No. C 03-3948 WHA, 2004 WL 1465722, *2 (N.D. Cal. Apr. 1, 2004).

75. *See* Intercollegiate Broad. Sys. Inc. v. Copyright Royalty Bd., 571 F.3d 69, 91 (D.C. Cir. 2009).

76. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45,241.

77. *Id.*

78. *See id.* Commentators point out that, in order to participate in a CARP proceeding, a party had to pay a share of the arbitrators' fees, and this excluded many small webcasters from participating. *See, e.g.*, Karen Fessler, Note, *Webcasting Royalty Rates*, 18 BERKELEY TECH. L.J. 399, 415 (2003).

79. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45,241–42. An aggregate tuning hour represents one hour of broadcasting

Relying on a prior agreement reached between the RIAA and Yahoo! before the initiation of proceedings, CARP found that a per-performance rate was appropriate, and the Library of Congress in its review affirmed this determination.[81] However, the Library rejected royalty rates determined by CARP as being arbitrarily high, instead setting rates for commercial webcasting at $0.0007 under § 114 and a fee for ephemeral recordings under § 112 of nine percent of per-performance royalties.[82] CARP also designated SoundExchange as agent for unaffiliated copyright holders, allowing it to collect and distribute royalties for parties to the compulsory license that did not designate other agents.[83]

### 2. *Small Webcaster Settlement Act of 2002 and Copyright Royalty Distribution Reform Act of 2004*

The absence of many small webcasters as participants in the proceeding, coupled with complaints that establishment of a per-performance royalty fee by CARP disadvantaged those webcasters, prompted the Small Webcasters Settlement Act of 2002.[84] Fees under the 2002 CARP decision were suspended for small webcasters and noncommercial webcasters, and Congress provided approximately eighteen months for parties to negotiate an agreement based on a percentage of revenue structure for small webcasters.[85] Furthermore, Congress established that any agreement under this act would not have precedential value under the willing buyer/willing seller standard.[86] Responding to this mandate, parties reached such an agreement on December 24, 2002.[87]

In an effort to renovate the dysfunctional CARP process and its inconsistent results, Congress passed the Copyright Royalty Distribution Reform Act of 2004.[88] The act substituted ad hoc CARP panels for a permanent three-member Copyright Royalty Board; added three months of

to a single user over a single channel. If a stream broadcasts for two hours to two users, it has accumulated four ATH.

80. *Id.*

81. *Id.* at 45,250.

82. *Id.* at 45,255 and 45,272.

83. *Id.* at 45,267.

84. Settlement Act 2002, Pub. L. No. 107-321 at 2780.

85. *Id.* at 2781.

86. *Id.*

87. *See generally* Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 67 Fed. Reg. 78,510 (Dec. 24, 2002).

88. *See generally* Copyright Royalty and Distribution Reform Act of 2004, Pub. L. No. 108-419, 118 Stat. 2341 (2004) (codified as amended in scattered sections of 17 U.S.C.).

board-supervised negotiations prior to initiation of hearings and a twenty-one-day settlement period following discovery; and greatly reduced costs associated with participation.[89] Although many experts argued that substantive reform would benefit the ratesetting process (revision of the willing buyer/willing seller standard, for example), the legislation achieved only procedural reform.[90]

### C. *WEBCASTING II* AND THE WEBCAST SETTLEMENT ACTS OF 2008 AND 2009

The Copyright Royalty Board initiated the second rate-setting process on February 16, 2005, and, following three months of failed negotiations, heard testimony and proposals by experts representing large commercial webcasters and the DiMA, small commercial webcasters, radio broadcasters, and SoundExchange.[91] These proposals once again varied significantly in value and structure.

#### 1. *CRB Decision in* Webcasting II

SoundExchange set forth a proposal with a dual payment structure that demanded the greater of a fixed percentage of broadcast revenue or a per-performance rate multiplied by the number of performances. By contrast, DiMA and several small commercial webcasters were seeking a royalty structure based on a percentage of revenue or on an ATH basis.[92] The CRB refused to apply the percentage of revenue approach, citing a number of issues and stating that such a proxy for per-performance metrics was unnecessary in light of the ability to collect per-performance royalties directly.[93]

Both sides of *Webcasting II* provided their views on which benchmarks were appropriate for determining per-performance royalty rates. The CRB ultimately agreed with SoundExchange's expert that agreements in the market for interactive webcasting covering the digital performance of sound recordings most closely resembled the target market for their ratesetting decision.[94] SoundExchange's expert discounted the rates for interactive

89. *Id.* at 2341.

90. Paul Musser, Note, *The Internet Radio Equality Act: A Needed Substantive Cure for Webcasting Royalty Standards and Congressional Bargaining Chip*, 8 LOY. L. & TECH. ANN. 1, 18 (2009).

91. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,085.

92. *Id.* at 24,091–94.

93. *Id.*

94. *Id.*

webcasting by an "interactivity value" to achieve proposed rates, which the CRB found persuasive.[95] The court rejected benchmarks offered by webcasters, as well as a host of evidence provided by commercial webcasters that buyers and sellers in the market faced a less-competitive market than non-interactive services.[96] Based on this testimony, the CRB decided to adopt SoundExchange's proposed royalty rates for commercial webcasters, as well as an ATH-based royalty for 2006–2008.[97]

### 2. *Webcasters' Appeal in Intercollegiate Broadcasting and the Webcaster Settlement Acts of 2008 and 2009*

In July 2009, nearly all holdings by the CRB were affirmed in *Intercollegiate Broadcast System*, over objections that this would destroy the businesses of small commercial webcasters.[98] The Circuit Court stated, "[t]he Judges are not required to preserve the business of every participant in a market. . . . If small commercial webcasters cannot pay the same rate as other willing buyers and still earn a profit, then the Judges are not required to accommodate them."[99] If *Webcasting II* caused critics to "say goodbye to webcasting," then this statement in *Intercollegiate Broadcast System* was an indicator that they should not expect to see it again.[100]

At the same time as the webcasters' appeal moved through the D.C. Circuit, Congress intervened, much as they had in *Webcasting I*, and passed the Webcaster Settlement Act of 2008, which provided a temporary suspension of fees and permitted a privately negotiated settlement to supplant the arbitrated terms if such an agreement could be made by February 15, 2009.[101] When an agreement had not been reached by the end of Spring 2009, Congress extended the deadline to July 30 through the Webcaster Settlement Act of 2009.[102]

95. *Id.* at 24,092.
96. *Id.* at 24,093.
97. *Id.* at 24,096.
98. *See generally* Intercollegiate Broad. Sys. Inc. v. Copyright Royalty Bd., 571 F.3d 69, (D.C. Cir. 2009).
99. *Id.* at 81.
100. Posting of Mark Cuban to Blog Maverick, Say Goodbye to Webcasting, http://blogmaverick.com/2007/03/05/say-goodbye-to-webcasting/ (Mar. 5, 2007 9:55 PM).
101. Webcaster Settlement Act of 2008, Pub. L. No. 110-435, § 2(5), 122 Stat. 4974, 4975.
102. Webcaster Settlement Act of 2009, Pub. L. No. 111-36, § 2(3), 123 Stat. 1926, 1926.

### 3. *SoundExchange's Negotiated Agreement with Commercial Webcasters*

The Librarian of Congress published the results of those government-supported negotiations on July 17, 2009.[103] Independent negotiations uncovered a higher level of detail in analysis, based on the fact that the private settlement includes additional market subcategories within the commercial webcaster category.

The negotiated agreement contemplates three types of commercial webcaster, distinguishing between large commercial webcasters providing bundled services, large pureplay commercial webcasters, and small commercial webcasters.[104] The royalty rates negotiated under the July agreement are markedly different than those determined by *Webcasting II*. SoundExchange justified these terms by stating:

> We believe the rates the CRB set were appropriate and fair. However, by incorporating an experimental approach whereby artists and copyright holders share in the growth of pureplay services, it gives certain pureplay webcasters the opportunity to flesh out various business models and the creators of music the opportunity to share in the success their recordings generate.[105]

Despite these statements, the rates agreed upon by the parties cast some doubt on the usefulness of the willing buyer/willing seller standard as a means to determine statutory rates. In 2010, for example, the rates to be paid under the negotiated agreement are only fifty-one percent of the CRB-determined royalty. Efforts to reach a mutual accord that maximizes market potential for all parties involved reached a drastically different result than the adversarial proceedings. This is further exemplified by the creation of alternative term structures for pureplay commercial webcasters. [106] However, there is a clear intent on the part of SoundExchange to focus its collaborative efforts on the broadcasters that can do the most to promote its constituents'

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103. Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796 (July 17, 2009).

104. *Id.* at 34,797–98. (defining Affiliates/Bundled Services, Commercial Webcasters, and Small Pureplay Webcasters). Pureplay commercial webcasters are distinct from bundled service providers because bundled service providers broadcast DPRA eligible transmissions as well as non-eligible transmissions as part of a bundled subscription.

105. Press Release, SoundExchange, SoundExchange and "PurePlay" Webcasters Reach Unprecedented Experimental Rate Agreement (July 7, 2009), http://soundexchange.com/2009/07/07/soundexchange-and-"pureplay"-webcasters-reach-unprecedented-experimental-rate-agreement/.

106. Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. at 34,800.

interest, as evidenced by the addition of a $25,000 minimum fee per broadcaster that elects to be bound by the private agreement.[107] This fee offsets the first $25,000 in royalty payments made, and the practical effect is to eliminate from this agreement those small webcasters than can have little to no effect on developing the market.

## III. DISCUSSION

The fifteen-year history of the DPRA provides a rich background against which to test the theories of Ayres & Talley and of Merges. As a liability rule-protected IPR, subject to possible tailoring and phantom infringer issues, the digital performance right in webcasting addresses head-on both articles' concerns with valuation ceilings and their impact on the information efficiencies of divided entitlements. Furthermore, the record of the CRB and *Webcasting I* and *II* demonstrates the impacts on efficient bargaining of other, non information-related transaction costs associated with liability rule entitlements.

As discussed above, the key to realizing the private bargaining efficiencies predicted by Ayres & Talley's liability rule analytics is the exchange of credible information regarding the relative valuations of each party to the divided entitlement.[108] This is captured in the first stage of the three-stage game—the offer by the owner to sell her entitlement or to buy the potential infringer's "call" option to infringe.[109] Both articles, however, note the possibility that certain aspects of a particular liability rule entitlement could destroy the credibility of this information. Either through structural impediments, such as tailored damages, or through the nature of liability rule-protected IPRs and the potential for phantom infringers, an inability to exchange credible information on relative valuation creates a *valuation ceiling* by eliminating entitlement holders' incentives to offer to bribe potential infringers not to infringe.[110] Absent this indicator of whether a holder is high-valuing or low-valuing, the benefits Ayres & Talley calculate for liability rule bargaining versus property rule bargaining are lost.[111]

107. *See id.* at 34,799.
108. *See* Ayres & Talley, *supra* note 10, at 1100.
109. *Id.* at 1049.
110. *See infra* Sections.I.A.1 and I.B.
111. *See* Ayres & Talley, *supra* note 10, at 1068.

### A. TAILORED ROYALTIES AND DPRA

For webcasters, the DPRA represents a liability rule entitlement that seeks to proactively tailor royalties to compensate effectively copyright holders, while simultaneously encouraging pre- and post-hearing private negotiations. Ayres & Talley would argue that efforts to encourage bargaining in the shadow of a liability rule would be ineffective where the entitlement also includes tailored damages.[112] Though this argument is in many ways borne out by the recent history of ratesetting under the DPRA, the proceedings have the potential to force information exchange not currently contemplated by the Ayres & Talley model.

Although some pre-ratesetting bargaining did occur prior to *Webcasting I*, Ayres & Talley's concerns regarding tailoring are particularly well-supported by events following the Small Webcaster Settlement Act of 2002. Though the Act suspended the high rates set by CARP in *Webcasting I*, the signal sent by CARP's decision to rights holders such as SoundExchange was that their arguments for valuation were far more persuasive than those of the webcasters, and therefore they could expect royalty rates approximating that valuation. Armed with this information, SoundExchange had limited incentive to engage in credible exchange of information with webcasters in the negotiating period that followed. If any nonconsensual taking on the part of webcasters would result in payment of a compulsory royalty approximating the value sought by SoundExchange in its proceedings, there is little chance that the organization would bribe webcasters not to infringe, as this would imply it valued the entitlement at significantly more than it argued for in court. Consequently, in the period leading up to *Webcasting II*, the bargaining window opened and closed without an agreement.[113]

Private negotiation induced by the settlement acts of 2002 and 2008–2009 provides another perspective on tailoring in the context of the DPRA. Though the fact that some bargaining did exist in the shadow of these ratesetting decisions is perhaps encouraging, there is little evidence that this bargaining reflects the efficiencies of information exchange contemplated by Ayres & Talley. In this case, the effects of tailoring royalties to match the rates argued for by SoundExchange created a valuation ceiling from which webcasters could only hope to bargain downward. Outcry in the press by webcasters that the rates determined by CARP would succeed only in

112. *Id.* at 1066–68.

113. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,084.

destroying the webcasting business model in its entirety[114] further reduced the credibility of SoundExchange to represent that it valued its entitlement at higher than the royalty amount. Tailoring, in this case, may not have led to an increase in nonconsensual takings, but the bargaining that did occur did not reflect any information-exchange efficiencies over those likely to take place in a property rule context.

Despite the issues with tailoring evident in the DPRA ratesetting structure, the process of adversarial hearings on royalty rates does have the effect of introducing some new, credible information on valuation that would be absent from property rule bargaining. The willing buyer/willing seller analytical framework under which the CRB operates allows parties for both sides, copyright holders and webcasters, to submit proposed benchmarks and economic justification for their recommended royalty structure.[115] Based on those proposals, the CRB selects a structure that best represents what a willing buyer and willing seller would agree to in a hypothetical market without a compulsory license.[116] Because parties must make persuasive arguments for a reasonable royalty rate, they are ultimately providing some information regarding valuation. They are stating what they believe to be a reasonable valuation.

The penalty for providing a structure/rate recommendation that is not credible is evident from the results of *Webcasting I* and *II*.[117] Where webcasters failed to provide a reasonable economic analysis in the eyes of CARP and CRB, that analysis was rejected and the panel adopted the analysis set forth by SoundExchange.[118] The *Webcasting I* and *II* opinions speak very unfavorably of the webcasters' recommendations, and it would seem likely that future proceedings would see a tighter valuation gap between SoundExchange and webcasters as webcasters seek to persuade the CRB. This information regarding a reasonable valuation should serve to narrow the

114. David Hinckley, *Congress Warned of 'Net Royalty Pains*, N.Y. DAILY NEWS, Mar. 28, 2002 at 112, *available at* http://www.nydailynews.com/archives/entertainment/2002/03/28/2002-03-28_congress_warned_of__net_roya.html.

115. Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45,246.

116. *See* 17 U.S.C. § 114(f)(2)(B) (2006).

117. *See generally* Beethoven.com v. Librarian of Congress, 394 F.3d 939 (D.C. Cir. 2005); Intercollegiate Broad. Sys. Inc. v. Copyright Royalty Bd., 571 F.3d 69 (D.C. Cir. 2009).

118. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,098–99; Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45,247.

band of negotiation to within those values. In this, credible information about the relative valuations of both rights holder and infringer might be ascertained, representing greater information exchange than even that predicted by Ayres & Talley.[119]

This information exchange may have been a significant contributor to the enhanced bargaining codified by the settlement acts of 2002 and 2008/2009, but it is unclear whether this factor was outweighed by the significance of Congressional intervention. Although Ayres & Talley's game would imply that, following ratesetting, parties would privately negotiate individual agreements around use of the digital performance right, the Acts encouraged all interested parties to reach a broad agreement that contemplated multiple user types, rates, and payment structures.[120] SoundExchange (and through it the RIAA and primary rights holders) provided some information about its valuation of the webcasting performance right during ratesetting, and agreements were reached in both cases with many categories of webcaster.[121] In this way, Congress's efforts to force private negotiation through the settlement Acts once additional information had been injected into the system both promotes and discredits the significance of this additional information on the bargaining process.

Because Congress required broad private agreement to be reached following the ratesetting decisions, one cannot be certain whether Coasean bargaining would have truly occurred without that mandate. The fact that an agreement could not be reached prior to *Webcasting II* may be evidence that Congressional involvement was more significant than information exchange in encouraging bargaining post-ratesetting, as one would have predicted that the information shared in *Webcasting I* would have improved bargaining in the following proceeding. This fact is not dispositive, however, and speaks to one of the great challenges of this field: with technology advancing so quickly and digital media markets undergoing incredible transformation on a month-to-month basis, the value of information about valuation, particularly where multiple IPRs cover a single work, may be useful only within a narrow band

119. *See* Ayres & Talley, *supra* note 10, at 1043–44. While Ayres & Talley's model predicts increased information exchange on the part of liability rule plaintiffs (rights holders), defendants under the generic liability rule structure do not credibly provide any information beyond that in a property rule. *Id.*

120. *See* Webcaster Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926; Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, 116 Stat. 2780.

121. *See generally* Notification of Agreements Under the Webcaster Settlement Act of 2009, 74 Fed. Reg. 34,796 (July 17, 2009); Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 67 Fed. Reg. 78,510 (Dec. 24, 2002).

of time and within a narrow subsector of the broader market. Nevertheless, the history of the webcasting compulsory license does provide examples of information exchange not found in property rule entitlement structures, and this may be sufficient to induce additional bargaining, where the tailoring aspects of the DPRA diminish the exchange effects theorized by Ayres & Talley in traditional liability rule entitlements. To the extent that more information can have a positive effect on bargaining, there is some evidence that the DPRA produces more information than a property rule structure.

### B. PHANTOM INFRINGERS AND THE DPRA

Similar to Ayres & Talley, Merges expresses concerns about the ability of liability rule entitlements to produce credible information exchange in the face of a valuation ceiling created by structural elements.[122] His article focuses its critique of liability rule entitlements specifically on issues specific to IPRs, and the existence of phantom infringers is one such issue.[123] As discussed above, the ability of an IPR to be used (infringed) an infinite number of times reduces the credibility of any offer by a holder to bribe a potential infringer not to infringe on a liability-rule protected IPR.[124] A phantom infringer may falsely represent a high valuation in order to induce the holder to bribe them not to take, and no holder has the ability to effectively bribe an infinite number of users.[125] Furthermore, the presence of so many potential infringers points to another issue Ayres & Talley note in their article: amorphous bodies of entitlement holders and users can make credible exchange of information difficult.[126] As with tailoring, the inability to indicate credibly valuation on the part of the entitlement holder above that of the damage award eliminates the information exchange benefits Ayres & Talley predict for a liability rule entitlement.

Despite the problems the webcasting compulsory license, as an IPR, has on its face with phantom infringers, there are two ways in which parties in the webcasting space may root out phantom infringers and make indications of high valuation. First, the costs of participating in ratesetting proceedings, coupled with the connection between the proceedings and the pre- and post-proceeding private negotiations serves to separate the honest infringers by forcing interested parties to invest resources in the process. Second, recent efforts by record labels to acquire equity stakes in digital broadcasters, such

122. Merges, *supra* note 11, at 1305–06.
123. *Id.*
124. *Id.*
125. *See id.*
126. Ayres & Talley, *supra* note 10, at 1082–83.

as YouTube, MySpace Music, and Spotify, serves as a model for labels to indicate credibly a valuation above the compulsory royalty rate.[127]

The key aspect of the DPRA royalty proceedings that serves to reduce the theoretical impact of phantom infringers and nebulous infringer pools is the way that Congress has bundled private bargaining with the ratesetting proceedings, creating a window before and after (through the settlement Acts) the proceedings for parties to negotiate a mutual agreement.[128] It is in these proceedings that parties on either side are able to interact with those counterparties representing a credible interest in using the entitlement. Prior to the Copyright Royalty and Distribution Reform Act of 2004, costs associated with ratesetting decisions by CARP were borne by parties to the negotiation.[129] Arbitrators' fees for the 2002 CARP hearing exceeded $1.2 million, and many small webcasters were excluded from the proceedings because of their inability to bear a share of the costs.[130]

Although this fee structure may have overexcluded a number of legitimately interested parties, the general exclusionary effect is clear: it is likely that only parties with such a legitimate interest will invest their own resources into the proceedings.[131] By then, coupling the private negotiations with those proceedings, the parties can easily identify serious users for information exchange, where those who have signed up for arbitration are likely open to negotiation. Even the current CRB ratesetting structure, in which royalty judges are paid federal employees, still requires that parties bear their own costs of the proceedings.[132] Such costs are likely to be high, where, in addition to written statements from the twenty-eight participants and their witnesses, the 2007 CRB judges "heard 48 days of testimony, which filled

127. Andrew Ross Sorkin & Jeff Leeds, *Music Companies Grab a Share of the YouTube Sale*, N.Y. TIMES, October 19, 2006, at C1, *available at* http://www.nytimes.com/2006/10/19/technology/19net.html; Posting of Greg Sandoval to CNET News Blog, As Expected, MySpace Unveils New Music Service, http://news.cnet.com/8301-10784_3-9910344-7.html (Apr. 3, 2008 08:08 PDT); Posting of Michael Arrington to TechCrunch, This is Quite Possibly the Spotify Cap Table, http://www.techcrunch.com/2009/08/07/this-is-quite-possibly-the-spotify-cap-table/ (Aug 7, 2009).

128. *See, e.g.*, Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, 116 Stat. 2780.

129. 17 U.S.C. § 802(c) (2006).

130. Fessler, *supra* note 78, at 415.

131. Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, 116 Stat. 2780, 2780. An outcry by small webcasters following *Webcasting I* prompted the Small Webcaster Settlement Act of 2002. Fessler, *Id.* at 415.

132. *See* 17 U.S.C. §802(c), (e) (2006).

13,288 pages of transcript, and 192 exhibits were admitted. The docket contains 475 entries of pleadings, motions and orders."[133]

No amount of reducing the population of potential infringers at the bargaining stage will be sufficient to eliminate the valuation ceiling created by a lack of credible information exchange unless rights holders have a means to effectively bribe them not to infringe. In the context of IPRs, the concept of a monetary payment to a potential infringer not to infringe is practically meaningless, for reasons described above. As soon as SoundExchange pays one webcaster not to broadcast, a thousand webcasters would no doubt be at their door, prior interest in ratesetting be damned. However, an interesting model has arisen in several digital media contexts (and in one ex-U.S. webcaster) to address this, and may be useful to U.S. webcasters going forward. In the licensing arrangements negotiated by YouTube, MySpace Music, and Spotify, the major record labels have acquired equity interests in those companies, indicating a desire to obtain some of the economic benefit of their licenses beyond royalty rates.[134]

In acquiring these equity interests, the record labels are attempting to capture a portion of the potential profits the companies seek to earn on distribution of licensed content. It follows that they are relying on the assumption that the rights they have licensed to these companies are more valuable than the licenses themselves. Were the rights not, the companies would fail to generate profit, and any equity interest would yield no return.

The licensing agreements for the three companies mentioned above do not appear on their face to include DPRA webcasting royalties.[135] Nevertheless, the agreements stand as an interesting model for "bribing" potential infringers. Under this model, SoundExchange would, upon determination by the CRB of a compulsory royalty rate, offer to purchase from chosen infringers an equity interest in their operations. This upfront payment would not be for infringers not to infringe per se, but rather for SoundExchange to recover some of the economics it sees itself (and through it, rights holders) as giving up through compulsory use by webcasters. The amount paid for an equity interest would be a function of the expected profits foreseen by the operation, itself a function of the value of the content

133. Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,085.

134. *See supra*, note 127.

135. While Spotify is a pureplay webcaster, it does not offer services to U.S. users and therefore does not pay a compulsory royalty under the DPRA/DMCA.

over the royalty rate paid. The greater SoundExchange's relative valuation, the higher the offer for a given equity interest.

Encapsulating the Ayres & Talley "bribe" in an equity interest adds practical significance to an otherwise purely theoretical payment when dealing with IPRs. Potential phantom infringers, those parties with low valuations representing a high valuation in hopes of a payout, are more likely to be seen for their true colors when their books are opened in the context of a potential equity investment. As with the burden of persuasion in ratesetting, this model has the potential to encourage greater information exchange than Ayres & Talley assume in their theory. Both the rights holder and the potential infringer must exchange information on relative valuation: the rights holder through its offer for an equity interest, and the potential infringer through the opening of the books in anticipation of such an investment. Practical issues abound in such a hypothetical, such as liquidity concerns and mechanisms for SoundExchange to distribute proceeds from these investments in light of its legal independence from record labels and artists. The fact that the labels have already attempted to bring the model to bear on distributed digital media, however, provides some hope it might succeed in the context of the DPRA webcasting license.

### C. CORRELATED VALUATION AND THE DPRA

Ayres & Talley briefly discuss the potential challenges to their theory brought about by the potential for correlated valuation between two parties to a liability rule negotiation.[136] In situations where one party's valuation (or their representation of that valuation) impacts that of the other, both may be disincentivized to exchange credible information.[137] While Ayres & Talley note this one type of correlated valuation, two others deserve exploration in the context of the DPRA, where they may have an impact on information exchange. First, the benchmark approach to royalty rate determinations under the CRB creates the possibility of correlation between prior valuation and future compulsory rates. Second, the multi-class structure of the DPRA creates a series of correlated valuations between different types of users. In all three cases, there is the potential for parties to be disincentivized to exchange information or to exchange false information, defeating the potential efficiency advantages of the Ayres & Talley liability rule theory.

136. Ayres & Talley, *supra* note 10, at 1088–89.

137. *Id.* ("When their valuations are correlated, however, a buyer's revelation may also raise the minimum price that the seller is willing to accept. With correlated valuations, then, a buyer may be even more reluctant to reveal her valuation.").

### 1. *Inter-party Correlation*

The potential for inter-party correlation of valuation is evident in the structure of the DPRA ratesetting proceedings in both the pre-arbitration and post-arbitration negotiation windows. In the pre-arbitration window, parties are likely to be reluctant to share credible information about their relative valuations for fear that it will affect the arguments made by their counterparty during the arbitration itself. An indication by webcasters of a high valuation may serve to encourage SoundExchange to push the CRB for a high royalty rate, and vice versa. Post-ratesetting behavior under the DPRA may also lack credibility, where a low-valuing SoundExchange might attempt to induce webcasters into infringing by representing a high valuation.

The argument for correlated valuation between two parties to a liability rule entitlement in the context of digital media is hampered somewhat by the youth of the digital media market. Ayres & Talley suggest that liability rule entitlements, coupled with Coasean bargaining, are best at unlocking idiosyncratic value, or value specific to a particular user.[138] Because participants in the digital media market have a vast array of opinions on its future growth and size, the absence of consensus works against any idea of inter-party correlated valuation.[139] With different approaches to distributing content rising and failing almost daily, the idiosyncrasies of particular methods appear crucial to capturing the value of that content.[140] One party's valuation is therefore unlikely to affect that of another.

### 2. *Temporal Correlation within Webcasting*

The structure of the webcasting royalty rate proceedings is more likely to produce correlated valuation from five-year period to five-year period than between parties, due to the benchmark analytical framework employed by the CRB. In *Webcasting I* and *II*, parties presented their recommended royalty structures in terms of existing benchmarks, from which CARP and CRB

138. *Id.* at 1084.

139. The number of business models attempting to capitalize on webcasting alone (ad-supported, subscription-based, freemium) speaks to varied opinions on its ability to generate large revenues. *See* Fred Wilson, *The Freemium Business Model*, A VC, Mar. 23, 2006, http://www.avc.com/a_vc/2006/03/the_freemium_bu.html.

140. For example, infant MySpace Music recently acquired failed music social network Imeem, only a year after MySpace Music was formed. Eliot Van Buskirk, *MySpace Music Acquires Shuttered Imeem Music Service*, WIRED, Dec. 8, 2009, (Epicenter blog), http://www.wired.com/epicenter/2009/12/myspace-music-acquires-shutters-imeem/.

determined the proper solution.[141] Bargaining in the shadow of upcoming ratesetting proceedings, this format encourages a party to negotiate as harshly as possible, in hopes of solidifying one favorable agreement that it can hold up as its benchmark in arbitration.[142] It minimizes, for example, SoundExchange's incentives to represent anything but a high valuation prior to CRB proceedings. Should it come across a high-valuing webcaster, it can secure a deal that proves a high royalty rate is reasonable for all parties, later on negotiating downward during the post-arbitration period, but from an elevated level.[143]

This behavior surfaced in *Webcasting I*, where CARP threw out twenty-five of the twenty-six agreements the RIAA reached with webcasters prior to arbitration, noting that none of the webcasters in those agreements had anywhere near the resources or expertise of SoundExchange and that it was apparent that SoundExchange had sought out a "sweet spot" and closed only deals that conformed to those rates.[144] Nevertheless, CARP selected the agreement between the RIAA and Yahoo! to serve as the benchmark, despite outcry that even those rates were exorbitant and potentially destructive to the industry.[145] The fear of the benchmark was struck in the hearts of all parties to the webcasting proceedings, and future negotiations under the Small Webcaster Settlement Act of 2002 were statutorily exempted from having precedential value as such.[146] Further, negotiation prior to *Webcasting II* resulted in no additional agreements, and the Webcaster Settlement Acts of 2008 and 2009 exempted any private agreements reached from use as benchmarks once again.[147]

Information exchange to induce bargaining in the shadow of a liability rule suffers when correlation may exist between current and future valuations. The parties to *Webcasting II* were forced to rely on benchmarks outside the commercial webcasting field, shifting the debate to which

141. *See, e.g.*, Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings and Ephemeral Recordings, 67 Fed. Reg. 45,240 (2002) (codified at 37 C.F.R. pt. 261) at 45245; 17 U.S.C. § 114(f)(2)(B) (2006).

142. *See* Fessler, *supra* note 78, at 420.

143. *Id.*

144. *Id.*

145. *See* Hinckley, *supra* note 114.

146. Small Webcaster Settlement Act of 2002, Pub. L. No. 107-321, 116 Stat. 2780, 2782. ("[No] provisions of any agreement entered into pursuant to subparagraph (A) . . . shall be admissible as evidence or otherwise taken into account in any administrative, judicial, or other government proceeding . . .").

147. *See* Webcasters Settlement Act of 2009, Pub. L. No. 111-36, 123 Stat. 1926; Webcaster Settlement Act of 2008, Pub. L. No. 110-435, 122 Stat. 4974.

submarket of digital music distribution could best be modified to approximate that of webcasting.[148] The benchmark analytical framework thus contributes to information-exchange inefficiencies produced by two types of correlation: the temporal valuation correlation discussed here, and the valuation correlation between multiple classes of DPRA users.

### 3. *Valuation Correlation Between Multiple User Classes of a Single Right*

In *Webcasting II*, without a voluntary agreement in non-interactive webcasting to rely on as a benchmark, SoundExchange turned instead to another category of user under the DPRA, the interactive webcaster.[149] The CRB agreed with SoundExchange's recommendation to apply a discount to previous voluntary interactive webcasting licensing agreements in order to determine applicable rates for the compulsory license in non-interactive webcasting.[150] This result is an example of a third type of correlation that can have the effect of reducing credible information exchange, valuation correlation between categories of DPRA/DMCA user.

To summarize briefly an offshoot of entitlement theory, Abraham Bell and Gideon Parchomovsky describe the existence of "pliability rules," entitlements that take on more than one form, not simply one protected by a liability rule or a property rule.[151] One form of these pliability rules is the simultaneous pliability rule, in which entitlement holders hold different types of rights with respect to different users.[152] Bell and Parchomovsky give the example of fair use in copyright, where commercial users are subject to a property rule exclusion but fair users are free to use the right as a liability rule with a payment of zero to the entitlement holder.[153] The digital performance right in sound recordings is such a simultaneous pliability rule, contemplating several types of users and protecting the copyright holder with a number of property rule and liability rule protections against particular types.[154]

Bell and Parchomovsky argue that understanding whether an entitlement is protected by a pliability rule provides entitlement holders with "certainty concerning future changes in the rules protecting their entitlements, and,

148. *See* Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,098.

149. *Id.* at 24,091–92.

150. *See id.* at 24,092.

151. *See* Abraham Bell & Gideon Parchomovsky, *Pliability Rules*, 101 MICH. L. REV. 1 (2002).

152. *Id.* at 49–50.

153. *Id.* at 50–51.

154. *See supra* Section II.A.

therefore, a truer appreciation of the nature of protection they enjoy at present."[155] However, the history of the DPRA and webcasting raises concerns about the potential negative impacts of pliability rules on efficient bargaining and investment in IPRs. Where rights protected from multiple user classes under a pliability rule have correlated values, the potential for uncertainty can both reduce information exchange and induce underinvestment in IPRs.

The argument for reduced information exchange created by correlated valuation among user classes parallels those for the temporal correlation discussed above: where a single agreement can serve as a relevant benchmark for future negotiations or arbitration, rights holders become incentivized to represent their valuation regarding a particular rights use higher, in an effort to close a deal with a high-valuing user. Similarly, if both property rule- and liability rule-protected uses are likely to result in a non-zero license, information made public in a compulsory license ratesetting proceeding such as the CRB, where recommendations by the rights holder are constrained by the burden of persuasion, may be harmful to the holder's property rule-protected interests. This type of correlation, therefore, has the additionally negative impact of calling into question the credibility of the recommendations made by a rights holder such as SoundExchange, despite the burden of persuasion discussed above. This is because the cost of losing a few tenths of a cent in compulsory royalties may not outweigh the benefit of keeping real information regarding valuation private for future property rule negotiations.

The potential for valuation-correlated pliability rules to impact investment in IPRs stems from the possibility that information exchanged in the context of determining a liability rule damage award, or the determination itself, may serve as a benchmark for future property rule negotiations.[156] Bell and Parchomovsky state that "[p]roperty rules are generally thought to encourage greater investment than liability rules, since the entitlement holder may prevent involuntary loss of the object."[157] To the extent that the liability rule aspects of a simultaneous pliability rule drag down the actual value for

155. Bell & Parchomovsky, *supra* note 151, at 27.

156. It has been mentioned above that the converse has already occurred, where a voluntarily negotiated property rule license for interactive webcasters was used as a benchmark for determining the compulsory royalty rate for non-interactive webcasters. *See* Digital Performance Right in Sound Recordings and Ephemeral Recordings, 72 Fed. Reg. 24,084 (May 1, 2007) (codified at 37 C.F.R. pt. 380) at 24,090.

157. Bell & Parchomovsky, *supra* note 151, at 27; *see also* Ayres & Talley, *supra* note 10, at 1032–33.

which a rights holder can negotiate in a property rule license, investment in the IPR will be doubly affected, both by the uncertainty of the liability rule protection and the decreased value received for the property rule protection. To use the digital performance right in sound recordings as an example: if an unfavorably low compulsory royalty rate were ascribed to non-interactive webcasting in the next ratesetting proceeding, an interactive webcaster may expect the next property rule license he negotiates to drop as well. If it does not, and his business becomes less competitive as a result, he may exit or change models, eliminating revenues for rights holders. As such revenues fall, artists are will consequently have less incentive to create new works versus engaging in other revenue-generating activities. Where incentivizing artists to create works is a central goal of copyright, the risks of correlated, simultaneous pliability rules can have an even more damaging effect than independent liability rules.[158]

### D. SOUNDEXCHANGE AND THE DPRA

One aspect of the development of the webcasting compulsory license under the DPRA/DMCA that Ayres & Talley and Merges would both likely applaud is the ascension of SoundExchange as the congressionally mandated sole agent of digital performance rights holders for the administration of the compulsory license. Responding to challenges by other parties seeking to achieve a share of the digital royalty administrator business (namely Royalty Logic in *Webcasting II*), Congress has taken steps to establish SoundExchange as the default agent for rights holders under the DPRA/DMCA.[159] In so doing, they have improved the potential for information exchange and private negotiation by creating a single point of contact for potential infringers. Furthermore, fostering the growth of a CRO with connections to RIAA, Congress has enabled the record labels to better internalize the valuation externalities predicted by the correlated valuation issues.

The main thrust of Merges's article is that CROs, typically born out of property rules, are better able to negotiate market-tuned royalty rates than government bodies.[160] Similarly, Ayres & Talley note that information exchange under liability rules is most likely to produce benefits when entitlements are made to the most efficient holder and negotiating parties are small in number and easily identifiable.[161] By supporting SoundExchange,

158. *See* Keller & Cunard, *supra* note 36.

159. *See, e.g.*, *id.* at 90–91; Notification of Agreement Under the Small Webcaster Settlement Act of 2002, 67 Fed. Reg. 78,510 (Dec. 24, 2002) at 78510.

160. *See* Merges, s*upra* note 11, at 1328.

161. Ayres & Talley, *supra* note 10, at 1083.

itself controlled by a board of both artist and record label representatives,[162] it would appear Congress has properly empowered an agent of the most efficient holders and created essentially a single party on one side of the negotiation. Much as organic CROs such as ASCAP are, in Merges's eyes, able to achieve a more accurate royalty rate through private bargaining than would be possible under a compulsory license, SoundExchange (and through it the RIAA) is able to couple its public arbitration experience with almost fifteen years of private negotiations and deliver similar value to rights holders, where ratesetting by the CRB can only draw on one of those two datasets.[163]

By supporting an RIAA-directed agent in SoundExchange over an independent agent in Royalty Logic, Congress has also maximized the potential for rights holders to internalize some of the externalities outlined above regarding correlated valuation, particularly the simultaneous pliability rule of the broader digital performance right.[164] Were Royalty Logic the default agent authorized to negotiate on behalf of compulsory license rights holders, it would lack visibility into discussions being held by the RIAA with potential users of other digital performance rights. Conversely, the RIAA would be unable to proactively account for any information exchange or actions by Royalty Logic with potential infringers of the compulsory license. In this scenario, it is much more likely that Royalty Logic could do harm to the incentives underlying the simultaneous pliability rule of the DPRA/DMCA than SoundExchange, with its Board connections to the RIAA. Once again, information exchange—even between parties representing the same rights holders—can maximize efficiency.

## IV. CONCLUSION

The history of the digital performance right in webcasting has provided a great deal of data about the practical implications of liability rule entitlements in new media. Testing this record against the theories of Ayres & Talley and Merges, we learn that policymakers must consider the qualifications of Ayres & Talley and the challenges of Merges to the efficiency of liability rules as

162. SoundExchange, Board, http://soundexchange.com/about/people/board/ (last visited Jan. 31, 2010).

163. Further analysis of the discovery documents uncovered during the ratesetting proceeding may establish that this is when a great deal of the private negotiation between proceedings is made public. That being said, SoundExchange will always have more information than the CRB at the commencement of the proceedings, based on private information exchange in the interim period.

164. *See supra* Section III.C.3.

they consider using compulsory licenses and other liability rules to protect new media entitlements. Although liability rules in the IPR context can be shown to promote some Coasean bargaining, the impact of this bargaining on other, correlated rights is unclear and efficiency versus organically grown CROs is untested. However, this context and those described by Merges, show that reducing the number of bargaining parties through CROs can produce some degree of exchange, and such organizations should be supported in both liability rule and property rule entitlement schemes.