

The Internet & Digital Downloading Are Changing the Music Industry



Photo: Guy Brown, G H Brown Communications

Entertainment/intellectual property law and music industry panelists: Patricia Lawrence Kolaras, Fernando M. Pinguelo, Brenda Saunders, Patrick Caraher, and Scott Jon Shagin.

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THE DOWNLOADING OF MUSIC USING THE Internet and the use of the World Wide Web to distribute songs to the masses has changed the music business and the recording industry forever. New business models have been created. Studios and artists have begun a conversation about various legal issues, from revenue to intellectual property rights. All parties are planning for the future with the knowledge that things will never be the same.

To this end, the following panel discussion—held at Seton Hall Law School—begins the process of looking at the legal issues that will shape the music business for the foreseeable future. *COMMERCE* magazine called upon experts in the fields of music, law and intellectual property to address this “digital revolution.”

The panelists: Fernando M. Pinguelo, Esq., a partner at Norris McLaughlin & Marcus and Chair of its Entertainment Law Group; Patrick Caraher, manager of business and legal affairs for Sony BMG Music Entertainment; Patricia Lawrence Kolaras, president of the PLK Law Group, P.C.; and Scott Jon Shagin, an entertainment, media and intellectual property lawyer in Hackensack, and an Adjunct Professor of Law at Seton Hall Law School.

Q. *How is downloading music and the Internet impacting the music industry?*

PINGUELO: Thanks to the Information Age, digital piracy continues to grow at exponential rates every day and the public is well aware of its impact on the music industry. According to a study cited by the Recording Industry Association of America, the trade group that represents the U.S. recording industry, global music piracy causes \$12.5 billion of economic losses every year, including the loss of 71,060 U.S. jobs, \$2.7 billion in workers’ earnings, \$422 million in tax revenues, \$291 million in personal income tax, and \$131 million in lost corporate income and production taxes. With staggering numbers like that, there’s no wonder why the music industry has reacted the way it has.

Napster’s launch in 1999 created a new era of digital piracy that precipitated a decline in music sales in an unprecedented way. The music industry’s strategy to combat this new threat initially focused on filing a lawsuit against the most popular online music file-sharing service at the time, Napster. The music industry “won” the battle when Napster was shut down. The victory, however, was short-lived when technology and the entrepreneurial spirit collaborated to develop new tech-

nology that decentralized peer-to-peer file-sharing programs in a new way—one that is much harder to control and that essentially overturns the very laws created to regulate them.

In the aftermath of the piracy market's ability to overcome the short-lived "victory" over Napster, the music industry switched focus from attempts to shut down the companies responsible for facilitating the file-sharing networks to the individual downloaders themselves. The public and pundits widely criticized this shift in strategy as excessive and heavy-handed [suing children and grandmothers doesn't usually bode well from a PR standpoint], but the music industry hoped that the individual lawsuits would act as a deterrent to file-sharing—which it did temporarily. The reality is that these lawsuits do not significantly lower the number of people file-sharing as demonstrated by the fact that file-sharing increased at a higher rate after a short period of time elapsed.

The "get-it-free" culture has spawned beyond the music industry's control. Today, digital technology allows for access to an unlimited reproduction of copyrighted material. The economic-based litigation utilized by the industry is not solving the problems of piracy. Rather than hinder progress, the proper solution is to embrace these technological developments and adapt accordingly. Business tactics and models need to change or else these businesses will fail, leaving the public with less musical variety. These adaptations must balance the needs of the industry with the artists they support and the wishes of the consumers.

Q. *How is the recording industry changing for artists and record labels?*

CARAHER: The digital revolution relegated the halcyon days of platinum CDs and multi-million-dollar record advances to nostalgic reminiscences of those who were in the industry "back then." With the explosion of reality television, digital music players and social networking Websites, perhaps at no point has music been more ubiquitous than today; however, the challenges are equally prevalent. The business paradigms are shifting rapidly and business savvy has never been at a higher premium. Music is becoming a component of a larger digital economy, and it is increasingly commoditized as part of other products and services—making venture agreements and business partnerships more important.

Artists must decide whether to sign with a record label or try to make it on their own. Technology provides decreased cost and increased access to quality recording equipment, making the choice not to sign with a label a viable option. Artists must weigh marketing themselves and keeping a larger share of revenues against availing themselves to marketing opportunities labels can provide through their strategic business partnerships. Independent artists lack the negotiating lever-

age of a major label, thus successful independent artists must rely on their own business acumen and have quality, trustworthy management.

There has been a lot of buzz recently surrounding a new addendum to traditional recording agreements, the so-called "360" deals. Under these agreements, labels agree to pay additional money to artists early in the term of the agreement—and if the artist becomes a celebrity, generating revenue from endorsements, book deals, etc.—the label will share a portion of such revenues as a return on its investment in developing and marketing the artist. The artist's decision becomes whether to take more guaranteed money up front or potentially collect more revenue on the back end (if the artist makes it big; it is similar to the decision to seek a larger advance or be paid a larger royalty).

Record label board rooms are replete with executives who feel 360 deals are instrumental to reviving record labels. While potentially generating new streams of revenue for labels, the importance is often overstated. Historically, periods of mainstream stars emerging from the music industry ebb and flow. High watermarks often coincide with the advent of new technology. Today is a time of unprecedented commoditization of music largely driven by digital technology; in other words, it is high tide. Signing new artists to 360 deals today assumes it will still be high tide two to five years down the road, when the artists may reach celebrity status.

The sexy allure of celebrity has always drawn people to the music industry, but success results from talented artists, good producers and a good business model that distributes the product to consumers in the format they are consuming. Clearly, in a rapidly changing business environment, achieving this is far from simple. It requires foresight and a thorough understanding of the marketplace. Savvy business is rarely sexy, but it is profitable. Ultimately, the labels that survive and thrive will invest in technology nimbly and intelligently, stay on top of the sea changes in the industry and negotiate good deals.

Q. *What legal issues do you see looming that could affect the music download market?*

PINGUELO: I see three trends developing with unclear legal implications. The first trend relates to "audioblogs," also commonly known as MP3 blogs. Basically, an audioblog is a Web site designed to share music reviews of songs that are readily available to be downloaded. Audioblogs usually focus on its creator's particular musical preferences and typically feature obscure songs that "music connoisseurs" can share, critique and promote their common appreciation for music. The music reviews usually post the music tracks, provide information about the artist and the music, and offer commentary from the blogger. As in any Web site that encourages the downloading of digital audio

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recordings, audioblogs raise concerns over copyright infringement and music piracy. Whether audioblogs qualify for a “fair use” defense or other protections remains to be seen. However, audioblogs have largely escaped the wrath of the record industry—at least for the time being.

The second trend relates to the growing popularity of satellite radio. In the 1990s, satellite radio emerged as an alternative to traditional broadcast radio. It provides listeners with commercial-free music, among other programs. The satellite radio industry embraced consumer demand for portable devices that allow consumers to listen to live music and record it in an effortless way that can be played back at any time; and developed the technology to give consumers what they wanted. As suspected, this issue has resulted in litigation by the music industry. Whether satellite radio digital recording devices infringe upon the distribution rights of copyright owners continues to be litigated.

The third trend, one close to home, involves state government attempts to control budget deficits and increase state income by taxing a new category of taxable property, called “digital property.” In 2006, New Jersey became one of the most recent states to try such a tax in the hopes of expanding its sales and use tax base to reflect the shift in consumer spending to electronically accessed

goods. Whether New Jersey’s desired goals are ever realized will depend, in large measure, on how the law is impacted by constitutional obstacles and practical obstacles related to tax collection and market forces.

Q. *How do you see the future of the music industry and the role of technology in the future?*

SHAGIN: The future of music is bright. The future of the music industry is more clouded. Old media companies are struggling to transform archaic business models. Their downbeat outlook is reflected in the value of those companies whose stocks are publicly traded.

Peer-to-peer file sharing and other technologies require the music industry to compete with “free.” A few years ago, industry veterans were demanding for more restrictive copyright laws and claiming that competing with “free” was not possible. Why pay for Coke if all you have to do is turn on the sink and Coke comes out? Except that the Coke was music and the sink was the Internet. This situation of competing with “free” has been called the *pirate’s dilemma*.

Apple has proven that you can compete with “free.” The iPod is an ingenious device that carries massive

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amounts of music and plays it anywhere in an eye-catching gadget. Its business model allows you to acquire music priced by the song, rather than by the CD. Music lovers resented paying for entire CDs to get only one or two songs that they wanted to hear. By pricing songs individually, Apple has made it easier to compete with “free.” Moreover, artists are happy because they get regular royalty checks along with statements that are easily understood. We will see more combinations of low pricing, great technology and “must have” aesthetics.

Technology will continue to improve how music is created, distributed and enjoyed. Digital processing capabilities will increase while the cost of technology falls. The equipment needed to create high quality music is no longer in the exclusive hands of a few recording studios. Musicians today are creating great recordings on equipment in their basements and uploading them to MySpace. Music listening devices will continue to fall in price and increase in features. Soon iPhone and iPod functionalities will converge. Video will also become ubiquitous. There will be more iPod competitors.

Because of lower costs to create and distribute music and the cool devices that allow us to play it anywhere, the barriers to entry have fallen for talented, motivated artists to create music and expose it to mass audiences. Artists are being discovered on the Web, then migrating to deals with major labels on more equitable terms than used to exist. This is one reason why major labels offer the controversial “360 deals” that enable them to participate in the artist’s tour and merchandise revenues in exchange for a higher royalty.

Music labels claim that new technology has enabled the free distribution of music and decimated their business model by flaunting copyright laws. Perhaps, but to those businesses that have mastered the technology and studied how to compete with “free,” the future of the music business has never looked so good.

Q. *What are the problems or challenges that need to be overcome to keep the industry healthy?*

KOLARAS: Frankly speaking, the music industry has not been the healthiest for quite a while. Annual record sales are down 19 percent from last year, 14 percent the year prior and 11 percent the year before that. Apparently, an immediate solution to such declining sales resulted in record companies downsizing to the extent that only four major companies remain. Under these changed circumstances, it’s safe to say that the music industry does not represent what it once did.

This drastic change is due to the evolution of digital music. It has been reported that the annual growth rate of digital music sales will be 23 percent, with \$4.8 billion in revenue in year 2012. Such growth rates are attributable to new software technology like Limewire,

Grokster, and Zune. Also, Napster plays a role in that it provides unlimited music on demand, while Zune offers unlimited MP3 music at 79 cents, 20 cents less than standard downloads. Wi-Fi’s wireless access, on the other hand, eliminates adapters, plugs and connectors altogether, making it extremely convenient to download music anytime and anywhere.

While digital music has made buying music through these sources very convenient, it has simultaneously made piracy very prolific. This is a real problem without a real solution. Although record companies were aware of this phenomenon nearly 10 years ago, the initial reaction was to ignore, and outright refuse to change its business model from mastering music on plastic discs to exploiting music content in a digital fashion. It’s no secret that plastic discs are becoming more obsolete, particularly when some of the new technology fosters a “blind eye” approach to regulating music downloads.

The existence of new technology has forced a new way of doing business and unfortunately, the music industry is suffering a significant loss. Despite the record company’s effort to develop strategic alliances to facilitate digital music deals, the delayed response to the digital craze does not allow time to play catch up. Although iTunes, Rhapsody, Yahoo! and others attempt to regulate downloading, the impact against piracy is slight because of the inability to prevent unauthorized file sharing once the download is purchased legally. As a remedy, the trend of the music industry is shifting toward copy protection technology such as DRM-free music coupled with the impact of social networks that host MP3 music as a means of competing with “free.”

However, record companies are also looking to expand revenue based on artists’ passive participation in movies, television, endorsement deals, and other outside revenue sources—intended to cover the decline in traditional record sales due to the digital downloading explosion. In this instance, record companies will act as a one-stop shop and partner with the artist to generate income from sources outside of record sales. This sort of partnership could serve to be mutually beneficial for both the artist and the record company if structured fairly.

The artist is given the opportunity to utilize the record company’s established relationships in film, television and other entertainment-related industries to enhance brand recognition and ultimately bring overall value to the artist. On the other hand, the record company, after investing millions in developing the name, likeness and overall brand of an unknown artist, can benefit from revenue sources not impacted exclusively by digital downloading. ■

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