The Market for Performance Rights in Sound Recordings: Bargaining in the Shadow of Compulsory Licensing

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EXECUTIVE SUMMARY

The music business is, in some respects, more regulated than most other industries. For instance, most countries essentially impose a compulsory license on the owners of rights to sound recordings, requiring them to license the right to broadcast and publicly play their recordings to all who are willing to pay a standard rate. They cannot refuse to license; they cannot do exclusive deals; and, importantly, they cannot set their own prices.

Under this compulsory licensing regime, the owners of sound recording rights essentially have only the right to receive "equitable remuneration" for the broadcasting and public performance of their recordings. This remuneration only rule results in rates being set by courts, regulators, or legislatures rather than markets.

This institutional arrangement is quite unusual. Society usually leaves price setting to the market for good reasons. Regulators and courts simply cannot set "correct" prices, as they have neither the access to information nor the capacity to process it that millions of market participants do collectively. Moreover, non-market pricing violates important non-economic values such as self-determination and autonomy.

The imposition of remuneration-only rules has profoundly distorted the market for performance licenses for sound recordings. Drawing and applying new insights from the literature on Standard Essential Patents, this article explains the ways in which remuneration-only rules skew bargaining power in favor of licensees, suppress rates, ignore market conditions, and deprive consumers of choice and diversity in the market for music.

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[*] Professor, Southern Illinois University School of Law; President, Institute for IP Research. Thanks to Geneva Network for financial support in the research and preparation of this article. Geneva Network has received funding from a range of public sector, non-governmental and private sector organizations (including the recording industry). The views and conclusions expressed herein are entirely those of the author.

The market distortions created by compulsory licensing include the following:

- Despite music being an essential input to music radio and music dominating the airwaves, performance fees for the use of sound recordings amount to only 1.65% of global commercial radio industry revenue. This suggests that revenues are being shared in a highly inequitable manner.
- Remuneration only rules skew bargaining power dramatically in favor of licensees. The institutional arrangement encourages rational licensees to always refuse to deal and to delay as they benefit economically from doing so. The worst-case scenario for a licensee is that it will eventually be required to pay an equitable price after a period of economically beneficial delay.
- The institutional arrangements tend to bias courts and regulators toward marginal, incremental changes based on existing rates rather than changes in the marketplace.
- The lack of ability to do exclusive deals as is the case in the television industry impairs the music business from adapting to changing technology and consumption patterns. Consumers are the ultimate losers, as fewer new business models fail to emerge and less innovative content is developed.

We make the following recommendations:

- Restore injunctions as a remedy and negotiating tool. At the very least, they should be available in the case of bad faith negotiations and delay.
- Approach rate-setting with the understanding that courts and regulators are unlikely to have enough knowledge to determine the right rate, with awareness that the institutional setting skews bargaining power in favor of the licensee.
- Avoid perpetuating past mistakes by avoiding the use of existing rates as the starting point for setting new rates. It is likely that previous rates did not accurately reflect past market conditions, given skewed bargaining power. Instead, courts and regulators should thoroughly assess current and changing economic conditions.
- Since delay is profitable for licensees, make it less so to rebalance bargaining power and avoid unnecessary litigation. Measures to do so might include:
    - Making new rates retroactive to the date of the first offer from licensor.
    - Awarding a higher interest rate, accounting for the internal rate of return of the licensee.
    - Adding penalties or pre-established damages for bad faith delay.

- More significantly, restructure licenses to allow for exclusivity and windowing in order to promote competition and diversity in business models.
- Consider streaming service royalties as a compelling comparable transaction.

These changes would rebalance a market long-distorted by an extraordinary institutional arrangement that deprives copyright owners of control of their property. If the example of television serves well, the results would likely create more dynamism and diversity in industry business models and content, with consumers the ultimate beneficiaries.

INTRODUCTION

The music business is a surprising exception to the rule that if you want to use something that does not belong to you, you first must get permission and mutually agree to a price to do so. Throughout the world, owners of copyrights in sound recordings cannot stop others from broadcasting or otherwise publicly playing their recordings. The broadcasters, restaurants, bars, and other venues that use sound recordings are free to play them at a price set by government through legislation, regulatory proceedings, or court decisions.

This state of affairs is quite remarkable. Prices for most goods are set in the free market, as a result of individual bargains or impersonal market forces. Typically, those who own property decide who can use it and negotiate the terms of sale and the price paid. When somebody trespasses on these rights, the owner can usually get a court to stop them by issuing an injunction and they may receive damages that are sufficiently high to deter further unauthorized use.

The owners of sound recordings don't have these options in most markets. By law or by consistent practice, courts won't give them injunctions to enforce their right to control public performances. In fact, they do not really have such a right. They merely have the right to remuneration at an equitable rate. Broadcasters and others have a right to play essentially all existing music at a standard rate.

The reason that such a relatively innocuous industry is so heavily regulated is largely the result of path dependence. History, momentum, politics, and legislative lock-in have resulted in the recording industry having far more limited rights than most other industries today. Denying sound recording right owners the ability to set prices and determine who they deal with was a mid-20th Century solution to mid-20th Century concerns. However, it persists because it was locked into legislative frameworks and then validated by international treaties, particularly the Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations of 1961.

Unfortunately, the current regulatory framework was designed for a marketplace that no longer exists. The industry has greatly evolved in the 50 years since, experiencing the advent of commercial FM radio, the consolidation of the broadcast industry in many countries, digitization of sound recordings, the decline of the market for physical copies of recordings, the rise and fall of digital sales of music, and finally the growing dominance of streaming. Nevertheless, mid-20th Century assumptions about market power, industry structure, and technological possibilities continue to govern the recording industry.

Prices for performance rights are set in a variety of ways, but the end-result is the same. In some countries, the royalty is set by law. In others, a regulatory body determines the rate and any later increase. In some, there is first a negotiation for an initial rate or increase. After the negotiations inevitably fail (we explain why failure is inevitable), the licensor must sue its customer, the licensee. At the end of the proceeding, a court will determine an equitable rate. In all cases, the worst a prospective licensee can expect is to be able to continue to use music while paying what a third party says is a fair price – a price it likely will get some say in setting, not through a market negotiation, but through arguments, persuasion, and selectively presented and framed evidence.

The discussion in scholarship, courts, regulatory bodies, and legislatures regarding licensing for performance rights in music often takes remuneration-only rules as a given and proceeds directly to discussing how license fees should be set. Accepting the world the way it is has pragmatic appeal, as this is the way things have been done for many decades, almost universally throughout the world.

However, the unusual nature of this situation and the effect it has on the music business is worth considering. Before deciding how governments ought to divide up the economic "pie" among market participants, one first needs to consider how government intervention changes the very nature of the market and inevitably effects how that pie gets divided. This paper addresses this under-examined and under-theorized issue. We first consider how the inability to control the use of one's property and negotiate prices free of government intervention violates norms regarding property that are well-established and widely held for good reasons. We then examine how remuneration-only rules likely suppress rates for performance licenses for sound recordings by skewing bargaining power drastically against copyright owners, locking in place outdated prices, and failing to account for current market conditions.

Depriving an entire industry of the right to control its property and freely negotiate prices contradicts strong and widely held values and norms regarding property. It frustrates many of the goals and justifications – both economic and non-economic – for the institution of property and the benefits it is expected to confer on individual owners and society. In an ideal world, some all-knowing and neutral central authority might efficiently, fairly and wisely distribute property and set prices. However, no such omniscient authority exists in the real world. Instead, property rights and market pricing are very effective real-world solutions for accomplishing many goals including economic efficiency; fairness; justice, autonomy; self-determination; utility maximization; and more. Property may not yield perfect results by all standards, but the ideal alternative does not exist. Moreover, it may be a first best solution for promoting some of the values that justify the institution of property, such as personal autonomy and self-determination.

Market pricing is particularly efficient because it solves an incredibly difficult knowledge problem. Market prices aggregate and account for a vast amount of information almost "magically," as they are determined by and reflect millions of uncoordinated transactions, made by sellers and buyers, those who are closest to the transaction with the best information as to their own needs and wants. On the supply side, prices account for input costs and opportunity costs of producers among other things. On the demand side, prices account for what buyers can afford vs how much they want or need, and the value provided by the purchase versus substitutes. All this information is reliably revealed impersonally – forced into the open – by people's actions – their revealed preferences.

Property also has a moral dimension. Property rights facilitate freedom and autonomy, as people transact freely, choosing what to do with their labor, property, and resources.

Thus, compulsory licensing for music is more than a curiosity, but, rather, takes something away from the market for music, and the people who participate in it. Courts, legislators, and regulators do not have enough information nor the same incentives to get things right as do market participants, adapting to changing conditions day to day. Market participants and the public lose the benefits of decentralized knowledge and the freedom and autonomy to act on it.

Depriving copyright owners of the ability to get an injunction also tips the scales drastically in favor of licensees. This is an undertheorized issue in the literature on intellectual property licensing generally and copyright licensing specifically, so this paper draws lessons from an area of scholarly and public policy debate that has been actively debated recently: licensing negotiations for Standard Essential Patents or SEPs.

As the owners of rights in sound recordings have long experienced, the owners of SEPs have recently found their bargaining power curtailed. Most courts in most countries are now unwilling to award injunctions to SEP holders. Rates and terms must be "fair reasonable and non-discriminatory" (FRAND).

Scholars have observed that these restrictions on the market for SEP licenses have given rise to a phenomenon known as "holdout." A holdout occurs where a prospective licensee refuses to deal with the licensor, forcing it to go to court. The licensee is not being intransigent to cause difficulty, but rather it is a rational tactic with a payoff that benefits the licensee. The restrictions faced by the licensor – no injunctions and FRAND terms – assure that the licensee's worst-case outcome is that after using the technology for some time, it eventually must pay a "fair" royalty. This institutional framework gives the licensee a great deal of bargaining power, ultimately likely suppressing royalty rates for SEPs.

This paper applies lessons from the scholarship on the effect of no-injunction rules in the SEP setting to the music licensing setting. The situations are similar enough that the insights are revealing. To the extent they differ, the differences likely make copyright owners' bargaining position even worse.

We also consider how the no-injunction rule has limited diversity of business models and competition in the music business.

We conclude that setting license fees for musical performances by means of compulsory licensing is a less fair and efficient way to price music than through market prices. However, this method is likely to persist for reasons of political economy and sheer momentum. If it does persist, considering the asymmetrical nature of the bargain and the vast recent changes in the music marketplace, regulators, legislators, and courts should consider additional information in rate setting proceedings to bring rates more into line with market rates.

The paper proceeds as follows: First, we describe in general terms how governments regulate the licensing of performance rights for sound recordings. Second, we consider why this restriction on property rights is unusual – because it eliminates many of the benefits of granting property rights. Third, and most significantly, we explore how the no-injunction rule and other aspects of the institutional setting dramatically shift bargaining power to copyright licensees, encourage holdout, likely suppress licensing rates below market levels, and limits the ability of the industry to evolve to the benefit of copyright owners, music services, and consumers. We conclude with recommendations for courts and policymakers.

I. BACKGROUND

Market transactions are the norm around the world for most goods and services, except where the music industry is concerned. Here, de jure or de facto compulsory licenses are the dominant form of rate setting for the use of sound recordings (Handke & Towse 2007). This norm is reinforced by Article 12 of the Rome Convention, which establishes "right to equitable remuneration" for broadcasting and publicly performing sound recordings as the baseline standard for protection.

This Section provides a brief overview of the institutional arrangements for licensing sound recordings. We first describe the current situation globally, which is broadly consistent enough to allow for generalizations. We then discuss the original, mid-20th Century rationale for the current institutions and why they have persisted without serious consideration of major changes despite vast changes in technology and market structure.

A. Copyright Protection for Sound Recordings

Table 1 shows the situation throughout the word with respect to copyrights in sound recordings, listing six possibilities (although the reality is even more nuanced). Most countries protect sound recordings against unauthorized copying, except for the handful that don't provide any protection at all listed in Column F. This right enables copyright owners in most countries to control the making of physical and digital copies (CDs, vinyl, and digital downloads) and the inclusion of their recordings in soundtracks for commercials, movies, and TV shows. However, their rights and control over other uses of sound recordings is more limited.

Broadcasting and playing recordings in a public setting is one of the key ways to economically exploit recordings. However, rights owners often have much more limited control of the broadcasting and public performance of their recordings than their copying and distribution.

Some countries don't grant any right to control or get paid for performances or broadcasts. The U.S. is the most notable example (Column E). In the U.S., the owners of sound recordings receive no royalties from terrestrial radio broadcasts or having their songs played in physical venues, although the owners of rights in the musical composition do.[1]

Most countries have laws that expressly limit remedies for the owners of sound recordings to remuneration only for broadcasts and other public performances (Columns B & D). There is some difference among a handful countries as to how they treat licenses to broadcasters (Column B) versus physical venues such as bars, concert venues, and retailers (Column D), making two columns necessary.

Finally, some countries nominally grant exclusive rights, which means that injunctions are theoretically available. Even here, however, rights are more limited than that nominal designation indicates. (Columns A & C). Once again, differences in a handful of countries as to treatment of licenses to broadcasters (Column A) and physical venues (Column C) requires two columns. In these countries, the owners of sound recordings can theoretically control who uses their works and freely negotiate prices, but their rights are in fact much more limited. Generally, exclusive rights are "diluted" in practice by virtue of rules requiring that rights be licensed and managed collectively by Collective Management Organizations (CMOs), and by statutory restrictions that accompany collective licensing of rights, such as making the entire repertory available to all who seek it or by rules requiring mediation rather than injunctions. Moreover, when courts are faced with the possibility of granting an injunction in an exclusive rights country, they may refuse to do so in fact.

Taiwan and South Africa provide two examples of "exclusive rights" regimes converted into de facto remuneration only regimes by rules or court actions. The Taiwanese Copyright Act as amended in 2003, established the Copyright Examination and Mediation Committee to mediate compensation disputes. Rates are thus set by mediation rather than by resort to an injunction. South Africa's Copyright Tribunal ruled against a rate published by a CMO in 2013.[2] The next

[1] Here, it is useful to note that what a casual listener might call a "song" includes two different copyrighted works: A musical composition and a sound recording, each of which may be (and often is) owned by different parties. The distinction becomes clearer when one considers the example of popular standards that have been recorded many times. There is only one musical composition entitled "White Christmas" by Irving Berlin. However, a multitude of recorded versions of "White Christmas" exist. In most countries, playing "White Christmas" on the radio requires two licenses: One from the owner of the copyright in the musical composition. and also a license from the owner of the rights to whichever sound recording version is played.

[2] Foschini Retail Group (Pty) Ltd & Others v South African Music Performance Rights Association [2013] ZAGPPHC 304

year, the Supreme Court of Appeal declared that, absent an agreement between the parties, the Copyright Tribunal has both the authority and an obligation under the South African Copyright Act to determine the appropriate royalty rate.[3]

[3] National Association of Broadcasters v South African Music Performance Rights Association [2014] ZASCA 10

Table 1

BROADCASTING AND PUBLIC PERFORMANCE RIGHTS

January 2016

Nominal exclusive right for broadcasting	Remuneration only right for broadcasting	Nominal exclusive right for public performance (not including other forms of communication to the public)	Remuneration only right for public performance (not including other forms of communication to the public)	Protection for sound recordings but no rights for broadcasting or public performance	No protection for sound recordings at all
Antigua and Barbuda Argentina Bahamas Bangladesh Barbados Belize Bolivia Brazil	Albania Algeria Armenia Australia Austria Azerbaijan Belarus Belgium Benin	Antigua and Barbuda Argentina Bangladesh Barbados Belize Bolivia Brazil Brunei Bulgaria	Albania Algeria Armenia Australia Austria Azerbaijan Belarus Belgium Benin	Afghanistan China[4] Congo Djibouti Gabon Iran Japan[5] Kuwait Macao	Aruba Central African Republic Comoros Cuba Libya Mauritania São Tomé and Príncipe

[4] China - *pending: both rights proposed in a draft bill*

[5] Japan - *broadcasting but not public performance rights*

Brunei Bulgaria Chile Cyprus Czech Republic Egypt Fiji Grenada Guatemala Guyana Hong Kong India Iraq Israel Jordan Kenya Malaysia Mongolia Myanmar New Zealand Namibia Nicaragua Nigeria Oman	Bhutan Bolivia Botswana Burkina Faso Burundi Cambodia Cameroon Canada Chad* Colombia Cote D'ivoire Costa Rica Croatia Denmark Dominica Dominican Republic Ecuador El Salvador Estonia Ethiopia European Union *(Member States*	Chile Cyprus Czech Republic Egypt Fiji Grenada Guatemala Guyana Hong Kong India Iraq Israel Jordan Kenya Malaysia Mongolia Myanmar New Zealand Namibia Nicaragua Nigeria Oman Pakistan Romania	Bhutan Bolivia Botswana Burkina Faso Burundi Cambodia Cameroon Canada Cape Verde Chad* Colombia Cote D'ivoire Costa Rica Croatia Denmark Dominica Dominican Republic Ecuador El Salvador Estonia Ethiopia European Union *(Member States free*	Marshall Islands Micronesia North Korea Qatar Singapore[6] Sudan United States[7] Zimbabwe	Somalia Suriname Turkmenistan Yemen

[6] Singapore - *both rights (as remuneration rights) included in the EU-Singapore FTA which was supposed to enter into force in 2015 but may be delaying due to developments at EU level.*

[7] United States - *with respect to broadcasting, US law grants phonogram producers rights, subject to a statutory licence, only with respect to satellite digital audio services*

Pakistan Portugal* Romania Saint Kitts and Nevis Saint Lucia Saint Vincent and the Grenadines San Marino Sierra Leone Slovakia South Africa Spain Taiwan Thailand Turkey UAE United Kingdom Zambia	*are free to grant stronger protection: exclusive rights)* Finland France Gambia Georgia Germany Ghana Greece Guinea Haiti Honduras Hungary Iceland Indonesia Ireland Italy Jamaica Japan Kazakhstan Korea (South) Kyrgyzstan Laos Latvia Lebanon	Portugal* Saint Kitts and Nevis Saint Lucia Saint Vincent and the Grenadines San Marino Sierra Leone Slovakia South Africa Spain[2] Thailand Turkey UAE United Kingdom Zambia	*to grant stronger protection: exclusive rights)* Finland France Gambia Georgia Germany Ghana Greece Guinea Haiti Honduras Hungary Iceland Indonesia Ireland Italy Jamaica Kazakhstan Korea (South) Kyrgyzstan Laos Latvia Lebanon Lesotho Liechtenstein Lithuania		

	Lesotho Lichtenstein Lithuania Luxembourg Macedonia Madagascar Malawi Maldives Mali Malta Mauritius Mexico Moldova Morocco Mozambique Netherlands, the Niger Norway Panama Paraguay Peru Philippines Poland Russian Federation Rwanda Senegal		Luxembourg Macedonia Madagascar Malawi Maldives Mali Malta Mauritius Mexico Moldova Morocco Mozambique Netherlands, the Niger Norway Panama Paraguay Peru Philippines Poland Russian Federation Rwanda Senegal Serbia Seychelles Slovakia Slovenia Spain*		

	Serbia Seychelles Slovakia Slovenia Spain* Sri Lanka Sweden Switzerland Tajikistan Tanzania Togo Tonga Trinidad & Tobago Uganda Ukraine Uruguay Venezuela Vietnam		Sri Lanka Sweden Switzerland Taiwan Tajikistan Tanzania Togo Tonga Trinidad & Tobago Uganda Ukraine Uruguay Venezuela Vietnam		

***Additional notes for certain countries:**

Chad – Exclusive communication to the public right when sound recordings are used as foreground music,
Portugal – Exclusive rights for phonogram producers only.
Spain – Phonogram producers enjoy both exclusive and remuneration right for broadcasting and public performance.

Source: IFPI; Gervais (2010)

Thus, most countries have remuneration only regimes by law, and a significant number of the rest with "exclusive rights" regimes are de facto remuneration only regimes. In sum, the compulsory license, set by a government entity, is the norm worldwide for licensing of performance rights in sound recordings.

There are three main ways to set royalties: by legislation; by regulatory body; and by court.

A number of jurisdictions utilize regulation to determine compulsory licensing royalty rates for the use of sound recordings. Generally, a copyright act will grant powers to a specific ministry or create an administrative board and provide for the creation of collective management organizations (CMO) to manage the relevant rights, including negotiation, collection, and distribution of royalties. CMOs are highly regulated by statutes, limiting their creation, governance, license prices, membership, distribution, and more (Handke, 2013).

The main method for setting rates, whether by court or administrative tribunal, is judicial estimation. Reasonable remuneration is very difficult for a court to determine at best, as pointed out by the Australian Competition and Consumer Commission (ACCC) in its 2018 draft guidelines for the Australian Copyright Tribunal.[8]

The most common estimation methods used by courts and administrative tribunals are benchmarking and the construction of a hypothetical bargain where there is equal bargaining power between the parties. In rate setting proceedings, authorities listen to arguments from rights holders and their licensees as to the prices to be charged. Under the benchmarking method, the parties may offer evidence of: (1) the existing rate for the licensing of the material as determined by previous negotiations or by previous determinations; (2) rates or tariffs paid for the use of the same copyright material in different uses; (3) rates or tariffs paid for the use of similar copyright material in other jurisdictions; and (4) and/or rates or tariffs paid in comparable, more competitive markets. For the hypothetical negotiation method, the court estimates both the licensee's willingness to pay and the licensor's willingness to supply then calculates the value created by the bargain and dividing it between the licensor and licensee to reach a price.

Finally, this picture is complicated by the recent emergence of streaming services, which are not covered by existing regulations on music licensing. Services such

[8] Draft ACCC Guidelines to assist the Copyright Tribunal in the determination of copyright remuneration, October 2018

as Spotify provide a one-to-one, on demand transmission selected by and transmitted exclusively to the individual listener, rather than a one-to-many broadcast or performance selected by the broadcaster and transmitted to all who can receive or hear it. Since this new form of distribution does not fall under the rules governing broadcasts and public performances, it opened an opportunity for free market negotiations. In the U.S., this freedom to negotiate was recognized by law in the Digital Performance Right in Sound Recordings Act of 1995 (17 U.S.C. 114(j)(4)). In other countries the recognition was largely the result of the international copyright treaties, most notably the 1996 WIPO Performances and Phonograms Treaty (WPPT).

Most significantly, the result of the inapplicability of past regulation has been that interactive streaming services such as Spotify and Apple Music are not covered by remuneration only rules. Copyright owners and streaming services have voluntarily and freely negotiated worldwide licenses for these services. These licenses are the first major blanket licenses for music freely negotiated between private parties. We discuss later in Section III the importance of these transactions for setting a benchmark for market pricing of licenses.

B. The Rationale for Remuneration Only Rules

The dominance of remuneration only rules is a somewhat unusual institutional arrangement that calls out for an explanation. The response is a story of rules established for good reasons but now perpetuated by historical momentum despite change circumstances. Originally, CMOs regulated by remuneration only rules resulted from concerns about economic efficiency and competition. Today, path dependence and political economy sustain them.

1. *The Original Rationale for CMOs and Compulsory Licenses*

The collective management of performance licenses can provide certain efficiencies by reducing transaction costs. (Handke 2013; Handke & Towse 2007; Besen & Kirby 1989). As Landes & Posner state, CMOs can be "efficient market responses to copyright problems caused by high transaction costs. The number of users (radio and television stations, restaurants, hotels, night clubs, movie producers and so on) of copyrighted music is so great that individual negotiations with copyright holders to acquire performance rights are infeasible." (Landes & Posner 2003: 116).

Kobayashi (2015) describes several ways in which CMOs can reduce transaction costs. For copyright owners, a CMO allows them to avoid the cost of negotiating many market transactions. In fact, it allows them to outsource the licensing function entirely. For licensees, a CMO represents a single point of contact for acquiring licensing rights, thus reducing both search costs and negotiation costs. The CMO also provides centralized monitoring of compliance with licenses, collection of licensing fees, and distribution of proceeds.

In the 20th Century and earlier, the case for the benefits of reducing these transaction costs was high. Communications, and thus negotiations, were slower and relatively costlier. Absent centralized, blanket licenses, radio stations and other users would have needed to track which recordings were licensed. This arrangement would have required constantly updating and consulting a paper list to determine which records they could play. Payments were tracked on paper and checks were mailed out, a task that would have become vastly more complex and time consuming if many, independent licensors managed their own rights.

The challenges of the analog era thus made CMOs a compelling solution for copyright owners. The first CMO for songwriters and composers was established in France in 1851, with organizations in other countries following suit over the next several decades. By the time sound recordings became available and copyrights in them were recognized, it was logical to either add them to existing CMOs or create new ones to manage the rights. Most countries expressly or effectively mandated CMOs for licensing performance rights in sound recordings.

While organizing licensors into CMOs was a natural and efficient response to transaction costs at the time, the then-prevalent market conditions raised competition concerns about a disparity of bargaining power in favor of licensors. Licensees, such as radio stations and retailers, were numerous and sometimes small. By the time licensing for performance rights in sound recordings emerged, there was a widespread practice of regulating CMOs for other parts of the industry and setting prices directly or by court resolution of disputes. This practice was solidified in 1928 at the dawn of the commercial radio era when the Berne Convention was amended to give songwriters and composers "the exclusive right of authorizing the communication of their works to the public by radio-diffusion," but also gave national governments the right to regulate the conditions by which rights were granted and provided for a right "equitable remuneration which shall be fixed, failing agreement, by the competent authority." (Berne Convention, Article 11bis, Rome Act, 1928).

Moreover, it was argued that non-exclusive licenses to the entire repertoire benefitted all stakeholders, including consumers. Broadcasters and other licensees were provided negotiation-free flexibility to adapt playlists and formats to consumers' volatile tastes. The recording industry and performers, it was contended, received advertising and exposure. Consumer welfare was enhanced by enabling broad access to music that met a wide variety of preferences.

Once countries began to provide copyright in sound recordings, regulation of the recording industry generally duplicated the existing regime in place for songwriters and composers. Thus, owners of copyright in sound recordings have only a right to equitable remuneration, determined, ultimately or in the first instance, by a court, administrative body, or legislation. The entire repertoire is subject to a non-exclusive, compulsory license. This regime was confirmed by the 1961 Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations, which instituted a similar regime to the Berne Convention. Article 12 of the Rome Convention provides for "equitable remuneration" of copyright owners, as does Article 15 of the WPPT.

2. *Current Rationale for CMOs and Compulsory Licenses: Change and Institutional Momentum*

The fact that the current arrangements were once likely efficient and necessary does not guarantee that they remain so. Nor are they justified simply because they reduce transaction costs. As Kobayashi (2015) points out,

> a complete analysis of [CMOs] cannot end with an accounting of the costs of carrying out market transactions. Rather, this analysis must consider the relative benefits and costs of using a [CMO] rather than market transactions. Moreover, the net benefits of using [CMOs] will likely vary over time and depend upon technological innovation as well as the administrative mechanism used by the [CMO] to set prices in lieu of reliance on market pricing.[9]

Kobayashi contends that technology and the market have changed such that the benefits of CMOs and non-market pricing no longer outweigh the costs: "In the context of the [CMOs], both changes in technology and costs of the mechanism used in lieu of market pricing have arguably lowered or eliminated the net benefits of using these organizations."[10] Kobayashi cites reduced transaction costs from greatly improved technology that allows licensors and licensees to easily monitor and control the music being played. What was once a complex, physical process can now be automated because of digital technology. Kobayashi also observes that there are fewer potential licensees, at least with respect to digital services.

[9] Kobayashi 2015 at 926.

[10] Ibid.

The market structure that once raised competition concerns has also changed greatly, as licensees also enjoy market power. The days when the licensing market consisted of smaller entities with limited bargaining power and asymmetrical information appear to be long gone. Media consolidation has concentrated ownership of radio stations in many major markets. (Centre for Media Pluralism and Media Freedom, 2018). Moreover, broadcasters are often organized into large and powerful trade associations. (Handke 2013). Other licensees such as concert venues have also experienced consolidation in major markets. The ownership of retailers and restaurants is somewhat more consolidated than in the past, and, in any event, they are also represented by trade associations that negotiate on their behalf. The respective bargaining power of licensors and licensees has thus shifted greatly, such that several economists have described the licensing market as a case of bilateral monopoly. (Hollander 1984; Besen and Kirby 1989a; Besen Kirby and Salop 1992; Watt 2000).

Moreover, arguments for non-exclusive licensing are less compelling than they were 50 years ago. As we explain in Section III, the net benefits of non-exclusive, whole repertoire licenses have been reduced or eliminated by new possibilities enabled by technological change. Streaming services provide consumers with greater access to music than ever before, while eroding the arguments for non-exclusivity. The video market illustrates the possibilities denied to the music industry. Netflix, Hulu, HBO and other platforms use exclusive content to differentiate their services, while innovating new technology, business models, and creative works. Consumers have more choices as a result.

While these technological and market changes might invite a re-examination of the current rules and institutions for rate-setting, the current arrangements appear sticky. Arguments largely continue to be about how courts and regulators should set rates rather than whether they should do so at all.

The lack of impetus to change existing rules for music licensing can be explained by the phenomenon of path dependence. Ideally, institutional arrangements would be open to alteration if changing circumstances make them less than ideal. In reality, historical momentum and political economy are powerful forces that can preserve less than optimal institutions. As economic historian Douglass North explained in his Nobel Prize Lecture, "path dependence" is one of the "remarkable regularities of history." (North 1993). North's work explains that institutional arrangements can stubbornly persist along a path linked to the past because of the high transaction costs of changing them. (North 1981). The high transaction costs of change can persuade a rational actor to accept an inefficient or unbalanced system, working to optimize their position within the existing system rather than spend much greater resources trying to change the system. Moreover, to the extent that the institutional arrangement favors one party, that party will expend resources to persuade legislators to maintain it, thus making change more difficult.

Path dependence appears to explain the current institutional arrangement for licensing performance rights in sound recordings as well as anything else. While CMOs, non-exclusive licenses, and rates set by regulators or judges once likely constituted an efficient and reasonable way to set rates, things have changed. The current arrangements still offer some efficiencies, but the net benefits are likely greatly reduced by changes in technology and market structure. Despite these changes, fundamental revisions to existing rules are rarely seriously considered and changes are unlikely to occur soon. For one thing, licensees find the current arrangements to their advantage. As we explain, current arrangements set prices at rates that are likely low compared to the market. Moreover, the rules confer significant bargaining advantages on licensees. Licensees often have political clout sufficient to make it a political challenge to change the status quo. Meanwhile, licensors find it easier to work within familiar arrangements than to engage in costly and uncertain campaigns to change them.

Nevertheless, it is worth first considering just how unusual the current institutional arrangements are compared to most treatment of property rights. We do so before undertaking the more practical task of examining the operation of existing rules and suggesting how they might be re-balanced to allocate bargaining power more equally and better account for a changing market place.

II. DENYING PROPERTY OWNERS THE RIGHT TO CONTROL THE USE OF THEIR PROPERTY AND SETTING PRICES FRUSTRATES THE POLICIES THAT JUSTIFY PROPERTY RIGHTS

The fact that countries almost universally deny the owners of copyrights in sound recordings the right to set their own terms for the use of their recordings is remarkable. With the government setting prices, either by law or fact, and copyright owners required to license their sound recordings to all comers, the market for sound recordings is exceptional. The law typically gives owners of most types of property the right to use that property exclusively, which includes the right to set the terms for allowing others to use it. While there are deviations from this rule in practice, they are exceptional for good reasons.

The ability to control the use of one's property is fundamental to the institution of property and its proper function. (Claeys 2015) Depriving an owner of that control interferes with both economic and non-economic goals that justify the institution of property. First, it is inefficient in that no government decisionmaker can acquire the knowledge to determine the most efficient use of property in a way that even remotely approaches a market. Second, denying an owner the right to control property impairs non-economic values including fairness, autonomy, and self-determination.

A. The Knowledge Problem

A fundamental problem with remuneration-only rules is that the authority setting prices – a court, legislature, or regulatory body – cannot acquire enough information to match the information embodied in market prices. In a market, prices embody the knowledge of vast numbers of participants who have the best information – as they are closest to the transaction – and the greatest incentive to get prices right. Market prices are also dynamic, as they reflect ever-changing market conditions.

By contrast, when a court, legislature, or regulatory body sets prices, it faces a knowledge problem. It inevitably must decide based on limited information about the situation at a particular moment in time. Contrast that situation to market pricing, where many people decide independently how much to ask and how much to pay on a continuous, dynamic basis, based on their own preferences, opportunity costs, and the current state of the world. Each of these people may have limited information about market conditions, but cumulatively they know a great deal. Markets obtain, process and act on information far beyond the capability of individual or decision-making body.

Hayek explained the advantages of market pricing in his seminal work on the use of knowledge in society:

> Fundamentally, in a system in which the knowledge of the relevant facts is dispersed among many people, prices can act to coordinate the separate actions of different people in the same way as subjective values help the individual to coordinate the parts of his plan. It is worth contemplating for a moment a very simple and commonplace instance of the action of the price system to see what precisely it accomplishes.[11]

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[11] Hayek 1945.

As Hayek explains it, the market impersonally, efficiently and continuously processes vast amounts of information in a way that even a theoretical omniscient single decisionmaker might only hope to achieve:

> The whole acts as one market, not because any of its members survey the whole field, but because their limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all. The mere fact that there is one price for any commodity—or rather that local prices are connected in a manner determined by the cost of transport, etc.—brings about the solution which (it is just conceptually possible) might have been arrived at by one single mind possessing all the information which is in fact dispersed among all the people involved in the process.[12]

Non-market price setting must forego all of these advantages, which means that prices will not reflect real world conditions. Moreover, such price-setting is done only on a periodic basis as rates are set by courts, regulators, or legislators at a discrete moment in time. Even if a price is right when first set, it inevitably will fail to reflect changing market conditions.

For music licensing, the knowledge problem means that remuneration only rules set an impossible task for courts and regulators. Although most countries require a "reasonable rate" or "equitable remuneration," there are few effective signposts to indicate what is reasonable or equitable. Market transactions are scarce in music licensing. As Handke and Towse observe, experts find it very hard to determine what is fair, and if experts "find it hard to determine the right price, regulators will hardly find it much easier." (Handke and Towse, 2007). The problem is so difficult that Watt contends that "determining socially optimal prices [for music licenses] would appear to be almost impossible" for regulators. (Watt 2000).

Moreover, rate setting is not helped by the fact that it relies to some degree on information submitted by the parties. Market prices force buyers and sellers to reveal their reservation prices through the process of reaching an agreement or failing to do so. People's actions are the best evidence of what they are willing and able to do. By contrast, in a rate setting proceeding, parties have every reason to obscure reservation prices, and instead will present information in the best light to obtain the most favorable price possible

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[12] Hayek 1945.

In practice, the best that regulators often can do when faced with a request to increase rates for performance licenses is to use the current price as a baseline. They then allow an increase based on the retail price index or some other inflation factor, (Liebowitz 1982), much like an employer might provide a cost of living raise. The difficulty with this technique is that the previous price was unlikely to have fully embodied real past market conditions, and changes in the retail price index, a general measure, may not reflect changes in the music market. In this circumstance, a mandated rate can start in the wrong place and then continue in a straight line that diverges ever more from shifting market conditions.

As a result of the knowledge problem, prices set by government cannot accurately reflect market realities – the parties' costs, needs, wants and opportunities. At best, they reflect a good faith, but theoretical and speculative attempt to approximate a market price, because even the most diligent decisionmaker cannot obtain all the necessary information.

Despite these problems, the disadvantages of remuneration-only rules often receive limited consideration when setting rates for performance rights. It may be because both scholars and regulators are overly familiar and comfortable with such rules. Following the seminal work by Calabresi and Melamed, legal scholars often analyze control of resources as a matter of a choice between property rules and liability rules.[13] (Calabresi & Melamed 1972). In theory, property rules and liability rules can be equally efficient, because, assuming no transaction costs, parties will have the full knowledge and time necessary to reach an efficient bargain. The scholarship thus starts the discussion from a theoretical point where a property rule and liability rule are often potentially equally valid choices by ignoring, for the sake of analysis, the very real knowledge problem.

Practicing lawyers, courts, and regulators are also quite familiar with using liability rules to set the terms of transactions between private parties. For examples, utilities often face universal service obligations, and their rates are often set or approved by governments. The same is often true in industries where competition policy concerns are high. Given the amounts at stake, a great deal of government resources, practical lawyering, expert testimony, and academic scholarship is devoted to these proceedings. Government rate-setting thus looms large as a topic for regulators, lawyers, expert consultants and scholars.

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[13] The distinction derives from remedies – property rules allow the owner of an entitlement to block others from using or impairing a resource, typically by means of an injunction, whereas liability rules allow only for compensation for the impairment of a resource, typically by payment of damages.

Nevertheless, the imposition of a remuneration only rule represents an extraordinary deviation from the norm, notwithstanding the familiarity of liability rules in both economic theory and regulatory proceedings. As Epstein observed, in practice, property rules dominate institutions, and the situations where liability rules are in fact used or appropriate to use are relatively rare. (Epstein 1997). Among other issues, the knowledge problem makes liability rules too costly and inefficient. Outside of a handful of transactions in regulated industries, vanishingly few transactions involve active government involvement in setting terms or prices. The truth of that statement is shown by reflecting on the fact that every day, each individual person or business engages in many transactions, both large and small, governed by property rules, from buying a cup of coffee to acquiring another business.

It might be better for all concerned if those involved in setting rates for music licenses, particularly courts and regulators, were less inured to remuneration only rules and more sensitive to the knowledge problem that they raise. This might encourage them to approach rate setting with greater epistemic modesty. They cannot be sure that they imposed the correct rates in the past or that they will do so in the future. They ought to thus be more willing to consider the bargaining disparities discussed here and to re-examine old baselines in light of new information and changing market conditions.

B. Non-Economic Values

Depriving property owners of their right to control the use of their property interferes with core values that property rights advance. These values include self-determination, autonomy, efficiency, and independence. While there are different justifications for property rights generally and copyright specifically, there is some wide, general agreement as to the importance of these values. (Merges 2011).

Imposing a liability rule forces parties into relationships they may not want for moral, artistic, or business reasons. It denies them with control over how they earn their livelihood and build their careers.

Discussions of rates for sound recordings typically disregard these non-economic considerations, but they are not inconsequential. Artists often express a preference regarding who uses their music. For example, in recent years, there have been frequent objections to the use of music at political events. Admittedly, some of these preferences are impossible to quantify as they require reconciling incommensurable values.

Nevertheless, non-economic values matter for a few reasons. First, they bear on just how extraordinary it is to impose a liability rule on any property owner. They tend to militate against depriving a property owner of control of her property, lest she lose the opportunity for self-determination, autonomy, or other goals that justify and support property rights.

Second, non-economic values tend to support giving the copyright owner the benefit of the doubt when it comes to rate setting. Even if the value of the control that they are surrendering is not easily quantifiable, copyright owners are giving something up that both they and society believe is important.

Third, and perhaps most practically, some of these non-economic values support more robust consideration of certain economic arguments in rate setting. For example, the inability of artists to do exclusive deals on a temporary or long-term basis represents an opportunity cost that could be factored into a license fee. The fact that denying a creator exclusive control also interferes with autonomy and self-determination bolsters the case for attempting to compensate the copyright owner for the loss of this right.

While non-economic values by their nature are not easy to fit into a rate-setting framework, they merit some consideration. Given the exceptional nature of remuneration-only rules, courts and regulators who are determining rates should approach the task with some modesty and regard for the rights of property owners.

III. COMPULSORY LICENSING LIKELY UNDERVALUES LICENSES FOR COMMUNICATING SOUND RECORDINGS TO THE PUBLIC

Remuneration only rules likely undervalue licenses for performance rights. When a liability rule is imposed on a property owner, the ability to bargain for a price changes in several important ways that disadvantage the property owner and make it more likely to receive a lower price than it would in a free market. In the case of licensing of sound recordings, licensees enjoy several strategic advantages that likely systematically suppress resulting licensing rates. Moreover, the inflexibility of rate setting procedures makes it difficult to address new business opportunities and changing benchmarks, thus having systemic effects that impede innovation in business models and creative content.

This Section discusses the ways in which remuneration only rules likely cause performance rights to be undervalued. First, while acknowledging that remuneration only rules make it impossible to determine a market value for licenses, we note some evidence that indicates they likely are undervalued. Second, we describe how the inability of licensors to obtain an injunction confers significant strategic advantages on licensees. Third, we describe how compulsory licensing prevents CMOs and their members from employing alternative business models such as exclusives and windowing that would increase the value of their works. Fourth, we observe that new consumption patterns and comparable transactions have emerged to challenge assumptions on which previous rates were based.

A. Some indications that licensing rates are low

This paper's discussion so far calls for some modesty about speculating as to the "right" price for licenses. Since market transactions for music licenses are still vastly by far the exception, we just cannot say for certain that rates are either too low or too high compared to a theoretical market standard (Liebowitz 2004). Moreover, without agreement on non-market concepts such as "fairness" and the omniscience to determine them, one cannot say whether prices are too low (or high) compared to any subjective standard.

Nevertheless, we have some good indications that rates are probably not too high. For one thing, we can be confident that current rates are not sufficiently high to significantly impair the use of music, given the large percentage of airtime devoted to it on commercial radio.

Table 2 shows the average amount of time devoted to recorded music on commercial radio stations in a sample of mostly European countries.

Table 2. Average Percentage of Airtime Devoted to Music on Commercial Radio:

Bulgaria	74%
Canada	76%
Denmark	40%
Finland	55%
France	68%
Germany	70%
Italy	65%
Latvia	70%
Netherlands	54%
New Zealand	82%
Norway	58%
Spain	76%
Sweden	75%
Switzerland	75%

Source: Data from the International Federation of Phonographic Industries supplied to author, except:
Canada: Paul Audley & Marcel Boyer 2007, 'The "Competitive" Value of Music to Commercial Radio Stations' CIRANO, Scientific Series, 2007s-30, p.13
Germany: Helmut Scherer and Beate Schneider 2011, 'Music on Radio and Television' in Musical Life in Germany: Structure, facts and figures, German Music Council, pp.219-239 at pp.226-227
New Zealand: Phonographic Performances (NZ) Ltd v Radioworks Limited [2010] NZCopyT 1; [2010] NZCOP 1 (19 May 2010)

Table 3 shows the percentage of radio industry revenue captured by stations that program mostly music – more than 30% -- in a sample of largely European countries.

Table 3. Industry Revenue Share of Stations Broadcasting More than 30% Music

Bulgaria	97%
Denmark	100%
Finland	100%
France	73%
Italy	100%
Latvia	100%
New Zealand	81%
Norway	100%
Spain	31%
Sweden	100%
Switzerland	100%

Source: Data from the International Federation of Phonographic Industries supplied to author

Table 2 indicates that radio stations are not avoiding programming music, as they might do if licensing fees were impracticably high. Instead, they are devoting a substantial portion of airtime to playing music. Table 3 shows that the radio stations that do program a substantial amount of airtime (over 30%) generate almost all revenue in most countries.

Taken together, these statistics indicate that the music format is not only viable at current rates, but dominant.

Moreover, while CMOs and their members wish to maximize profits, they cannot do so if licensing rates drive their customers out of business or to use substitute programming. If rates were set too high by law, we might see CMOs offering some version of discounts or rebates to licensees to maintain a sufficient market.[14] (Liebowitz 2004) There is no evidence that such things are happening.

[14] There are reasons that prices could be higher than a market equilibrium price without rebates or discounts emerging. For one thing, the law might prevent it. For another, in other markets where sellers have monopoly power they enjoy supra-competitive prices without resorting to discounts. Still, however, the lack of such tactics indicates that prices are not destructively high.

Indeed, there is some evidence that some national markets could endure higher rates. An econometric study by Sweeting (2013) indicates that if radio stations in the U.S. were required to pay 10% of their revenues as performance fees for sound recordings (they currently pay nothing) would result in the loss of about 11% of music radio stations over 15 years. While one might mourn the loss of any music programming, the most fundamental understanding of economics tells one to expect that a price increase will almost certain reduce demand for good or service. What is telling is that the size of the marginal reduction is estimated to be a relatively small percentage despite a hypothetical increase from 0% to 10%, a rate that is much higher than the global average as set forth in Table 4, or indeed, any other percentage of revenue set forth in Table 4. At least in the framework of the Sweeting study, a higher hypothetical rate than the one set in other countries appears to fall short of a price that would be "too high" for the vast majority of U.S. market participants.

On the other hand, there are good indications that rates are probably too low. To understand why, it helps to establish a baseline. Table 4 shows the percentage of revenue that the commercial radio industry paid as performance fees for sound recordings in a large sample of countries in 2017. Figure 1 presents the same information in a graphic format. Globally, the percentage of commercial radio revenue paid as performance fees is 1.65%.

Table 4. Percentage of Revenue Paid by Commercial Radio Industry as Performance Fees for Sound Recordings in 2017

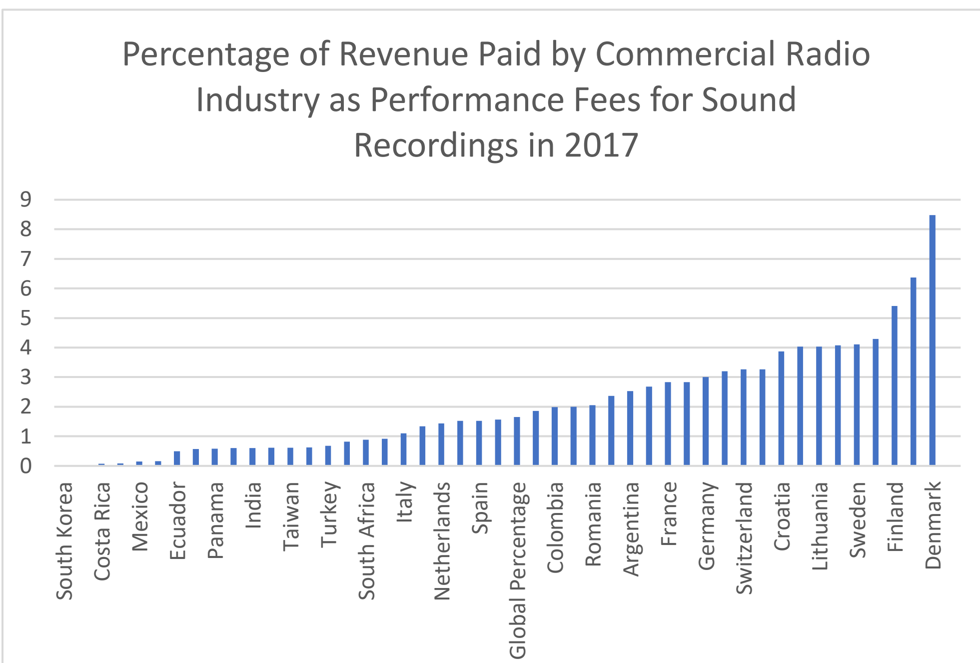
Argentina	2.53
Australia	0.6
Austria	4.08
Belgium	0.16
Brazil	3.27
Canada	1.86
Chile	0.82
Colombia	1.99
Costa Rica	0.07
Croatia	3.87

Czech Republic	2
Denmark	8.48
Ecuador	0.49
Estonia	2.68
Finland	5.41
France	2.83
Germany	3
Global Percentage	1.65
Greece	4.03
Hungary	1.52
India	0.6
Ireland	2.83
Israel	3.2
Italy	1.1
Japan	0.92
Latvia	4.29
Lithuania	4.03
Malaysia	0.62
Mexico	0.15
Netherlands	1.44
New Zealand	2.37
Norway	6.37
Panama	0.58
Peru	0.57
Poland	1.57
Portugal	0.61

Romania	2.05
Slovenia	1.34
South Africa	0.88
South Korea	0.01
Spain	1.52
Sweden	4.11
Switzerland	3.26
Taiwan	0.61
Thailand	0.08
Turkey	0.68
Venezuela	0.01

Source: Data from the International Federation of Phonographic Industries supplied to author

Figure 1:



Previous studies have proposed methodologies for setting rates for licenses. All conclude that rates should command a much higher percentage of revenue than shown by Table 4 and Figure 1. Watt (2010; 2011) bases his models on widely accepted methodologies for determining optimal negotiating outcomes (the Shapley methodology and Nash bargaining). Audley and Boyer (2007) and Boyer (2015) base their methodology on the freely-negotiated prices that radio stations pay for non-musical programming, reasoning that a radio station will choose a programming mix between talk and music in proportions where the marginal contribution to profit or station value is the same (i.e., "where the last minute of talk and the last minute of music brings in the same net advertising revenue."[15]) Boyer (2018) refines the methodology of the 2007 study by also referring to rates for Sirius XM, Pandora, and Spotify. Boyer (2018) estimates that royalties in Canada should constitute 28% of revenue, a percentage much greater than that actually paid. Watt's estimates are more hypothetical, but they range from about 25% to more than 50% of revenue – although actual amounts would depend on several factors.

The key insight that drives these models and justifies their relatively high estimates for rates is that music is an, if not the, essential input to a music radio station. As Watt explains, the licensor "is supplying an essential input to the user's production process, and as such it may be considered reasonable that the copyright holder should earn most of the surplus that is created, since without her input, no surplus at all is created." Watt (2011: 66). Few other businesses could expect to essentially act as a reseller of another's product, even a value-added reseller, and pay the mere 1.65% paid by the global radio industry for the use of sound recordings.

This paper does not purport to offer a methodology for determining the right rate, as Audley, Boyer, and Watt have already made this contribution. However, this paper does offer additional reasons to believe that rates have been set too low and explains the mechanisms through which this outcome occurs in the following discussion.

B. Limitations on Property Rights and Bargaining Power

The owners of copyrights in sound recordings generally cannot block others from broadcasting or otherwise publicly performing their works, as discussed earlier. To the extent that bargaining does occur, it occurs in the shadow of ultimate resolution by a third party, where the prospective licensee has no fear that they will be stopped from using the recordings in the meantime.

[15] Boyer (2018: 6-7).

The unavailability of injunctions in the market for public performance licenses strongly sets bargaining power in favor of licensees, with the potential effect of depressing the price below market values. The effect of the lack of injunctions on prices has been under-studied in academic and practical discussions of the music licensing market. It deserves more consideration.

However, the issue has recently emerged as an important topic of discussion about another form of IPR licensing, the licensing of standard essential patents (SEPs). While the analogy to the music market is not complete, these discussions hold important lessons. There are important similarities between the two situations, and although there are important differences, those differences largely indicate the burdens placed on copyright owners are even harder to justify.

1. *Licensing of SEPs and Performance Rights: Useful Analogies*

Here, we briefly explain the parallels between the SEP setting and copyright licensing to illuminate the relevance of the SEP discussion. The explanation is somewhat simplified for these purposes.

A Standard Essential Patent is a patent that is necessary to implement a technological standard, much like recorded music is necessary to operate a music-format radio station. For example, in the market for mobile communications technology, the LTE standard coordinates how phones and other network components connect to each other. If a manufacturer does not conform to the standard, its equipment almost certainly will not work. Technical standards are set by parties participating in a standard-setting body on a consensus basis. Standards have many components, often vast numbers of them, typically developed and contributed by many parties. In some instances, a contributor has a patent or patents over a component that is designated to be part of a standard. Manufacturers need licenses to such patents to make equipment that implements a standard, thus they are "standard essential patents."

Courts and competition authorities in many countries have denied SEP holders the right to obtain injunctions and to set their own license rates because of concerns about their potential market power and bargaining leverage. Once again, there is a parallel to the restrictions imposed on copyright owners to deny public performance licenses and set their own prices. As concerns emerged about the bargaining power of SEP holders, they either voluntarily made, or were required by standard setting organizations, courts, and regulators to make, commitments to license patents on fair, reasonable and non-discriminatory terms (FRAND). Courts and competition authorities in many countries have denied, by law or in fact, SEP holders the right to obtain injunctions and to determine their own FRAND rates. Similarly, the Rome Convention only guarantees the sound recording right holders a "right to equitable remuneration."[16] It is almost universal that courts or regulators determine the equitable price, either as a matter of course or after the parties fail to reach a bargain. Thus, regulators or courts in most countries deny copyright owners, by law or in fact, the right to set their own "equitable remuneration."

Therefore, both copyright owners and SEP holders face similar restrictions on their ability to set terms and prices on licenses. The restrictions are motivated by similar concerns. And they have a similar impact on the bargaining power of each type of IP owner, with likely suppression of rates below a "fair" or "equitable" price.

2. *Understanding the SEP Debate: Holdup vs Holdout*

The initial concerns that led to limiting the rights of SEP holders emerged from a fear that they would "holdup" potential licensees, but those restrictions have led to a recognition that licensees are now in a position to "holdout" from bargaining in order to suppress the eventual license fee. The holdup concern is that SEP holders might be able to withhold access to an essential component of a standard. (Shapiro 2010). If an implementer has invested in implementing the standard (e.g., it has built its equipment and manufacturing capacity to implement a standard), it stands to lose its entire investment. The implementer then would be in a precarious bargaining position, and the SEP holder might be able to extract licensing fees that exceed the value of its contribution to the standard. A further, theoretical, concern is that such bargaining power held by a number of different SEP holders could lead to "royalty stacking," where the problem is multiplied as each SEP holder gains an excessive royalty, resulting in a "royalty stack" that impairs implementers' incentives and ability to operate or innovate. (Lemley and Shapiro 2007).

It is notable that empirical work has observed that the theoretical fears of holdup and royalty stacking have failed to emerge in the real world. There is some disagreement as to whether that positive outcome is because of measures aiming to mediate SEP holder bargaining power or natural market forces, such as the power of standard setting organizations and the desire of SEP holders to preserve their customer base.

[16] Rome Convention, Article 12.

Importantly for purposes of this discussion, however, a counter-critique has emerged that documents how depriving SEP holders of the ability to obtain injunctions has led to the problem of "holdout." A holdout occurs where a potential licensee "holds out" from taking a license, with the knowledge that its worst-case outcome is that it will be able to use the technology free of charge until ordered to pay what a court determines is a fair price. Scholars have recently considered how "no injunction" rules shift bargaining power in ways that encourage holdout and, that further consequently, suppress license rates.

3. Bargaining in the Shadow of Limited Remedies

The law and economics literature has long observed that parties negotiating a settlement or to set a license rate bargain in the "shadow of the law." (Cooter et al, 1982). The "shadow" that falls over the negotiation is the awareness of the parties as to the likely outcome of a failed negotiation that is resolved by court. The available options as to remedies and what a court is likely to award affect each parties' bargaining leverage and what they are likely to accept as a settlement. Later work has extended and applied these general insights to intellectual property licensing specifically, for example with Schankerman and Scotchmer explaining that rules for determining damages and injunctions profoundly affect the expectations of parties and incentives to develop intellectual property. (Schankerman & Scotchmer 2001).

The type of remedy available can thus greatly advantage one party over another. As discussed earlier, the seminal Calabresi-Melamed framework classifies remedies into property rules and liability rules, according to whether the owner of an entitlement can receive an injunction or damages. In a theoretical world without transaction costs, the type of rule chosen should not affect outcomes. However, in the real world, there are a variety of transaction costs, including the impossibility of obtaining enough information to duplicate market prices and the costs and delays imposed by litigation. Because of these difficulties, the law generally prefers property rules. (Epstein 1997). The possibility of an injunction creates the prospect of the potential licensee being denied use of the asset, which in turn spurs it to bargain to a final price that reflects its actual needs and preferences. By contrast, a liability rule may allow a prospective licensee to plead its case to a court or tribunal, hoping for a better deal or that litigation costs and delays drive the owner to settle for less than it would have obtained under a property rule.

The no-injunction, remuneration only rule found in both SEP litigation and performance royalty setting is a liability rule with particularly one-sided characteristics in favor of the licensee. Concerns about bargaining power and holdup have caused widespread adoption of liability rules for setting rates for these types of licenses. In some instances, adoption of a liability rule does not necessarily dramatically shift bargaining power. For example, the prospect of having to pay a sufficiently large damages award can bring a prospective licensee to the table, as explained by Schankerman and Scotchmer. However, less certain and remunerative rules for damages can deter settlement or the conclusion of a voluntary bargain in the free market. (Schankerman & Scotchmer 2001). The rules applied to SEPs and performance licenses are indeed the less remunerative kind: Courts and agencies generally limit awards to FRAND or equitable compensation, respectively.

Absent the availability of enhanced damages, the combination of difficult or no-injunction rules and a ceiling on the license fee sets an upper limit that makes the prospects of damages less daunting. The worst prospect for a defendant who refuses to bargain is that it will pay a fair price, which will most likely be no more than the licensor's initial offer. Moreover, this will essentially be a deferred payment that occurs at the end of proceedings, after using the IP without interference for some time. (Kattan and Wood 2013).

The shift in bargaining power created by a rule that bars injunctions or makes them unlikely has led many commentators to conclude that a rational prospective licensee will likely forego good faith bargaining.[17] As Kieff & Layne-Farrar argue, weakening injunctive relief cause prospective licensees "to rationally consider the benefits of simply avoiding any up-front offer to take a license on any terms, RAND or not, knowing that on the back end they will not have to face an injunction . . . ."[18] A U.S. competition regulator and antitrust scholar, Federal Trade Commissioner Joshua Wright, explained the incentives at work: "it is well understood that weakening the availability of injunctive relief for infringement . . . may increase the probability of [a strategic refusal to take a license] and weaken any incentives implementers have to engage in good faith negotiations with the patent holder." [19] He went on to explain that without an injunction, "a potential licensee can delay good faith negotiation of a FRAND license, and the patent

[17] (Heiden & Petit 2018); (Langus, et al. 2013); (Ganglmair, et al. 2012); (Sidak 2008) ; (Camesasca et al. 2013); (Epstein et al. 2012); (Kieff & Layne-Farrar 2013); (Wright 2014).
[18] Kieff & Layne-Farrar 2013, 1113
[19] Wright 2014, 807

holder can be forced to accept less than fair market value for the use of the patent."[20]

Some have criticized these commentators for not explaining the mechanism through which IPR license prices are suppressed by weak or no-injunction rules,[21] but a recent paper by Heiden & Petit does so through a theoretical model supported by the results of a sample of interviews with market participants.[22] Heiden & Petit set forth the following model describing the decisions faced by the prospective SEP licensee:

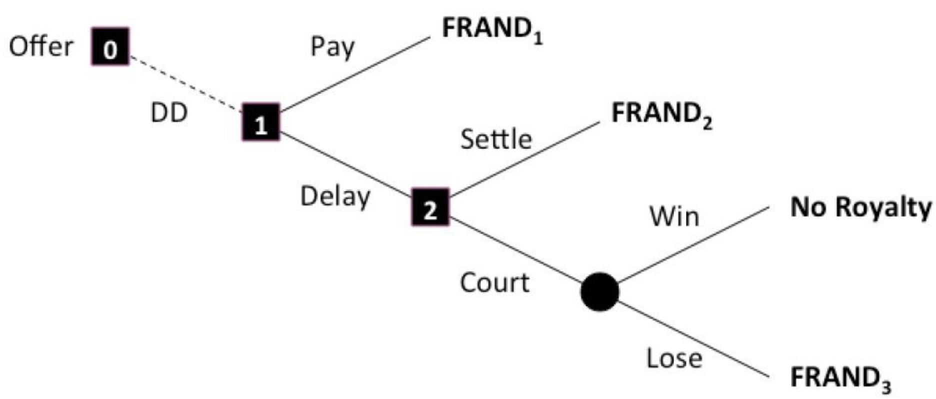


Figure 2.1 Patent trespass decision model

Source: Heiden & Petit 2018

They explain the model as follows:

> The model depicts an initial offer (FRAND1) followed by the decision to accept or delay. If delay is chosen, this strategy continues until a settlement is agreed upon (FRAND2) or a final court decision is adjudicated (FRAND3). When FRAND3 ≤ FRAND2 ≤ FRAND1 is perceived to be true, delay and litigation will be preferred over payment up until the point when the certainty of the outcome (e.g. in relation to court decision) makes settlement a better financial choice than delay.[23]

[20] Wright 2014, 807
[21] Siebrasse 2017, 517.
[22] Heiden & Petit
[23] Id. at __.

As Heiden & Petit explain it, this model shows how strategic refusal to bargain by the prospective licensee results in a lower royalty payment:

> Under this model of behavior, the SEP holder will automatically face a reduction in their initial offer (FRAND1) by the costs associated with delay and litigation as well as the time value of money and the probability of success in court. In essence a potential SEP implementer is indemnified against a FRAND royalty payment up to the amount of these transaction costs. As the difficulty of litigation increases (for example, in jurisdictions where patents are more difficult to enforce), the value of [refusal to bargain] increases.

It is helpful to note that a court is unlikely to award a rate higher than FRAND1. The licensor's opening offer logically sets an upper bound on the possible outcomes, amounting to an admission by the licensor as to a fair and reasonable rate. Therefore, the licensee can expect that if it holds out, its rate at worst will be a time-discounted FRAND1.

Langus, Lipatov & Neven (2013) also provide a formal model in the context of common practices in European courts that specifies the results of bargaining power shifts in SEP licensing negotiations based on differences in various parameters. The first scenario they describe that has relevance to licensing performance rights is as follows:

- The patent is strong. Similarly, the rights of copyright owners are not just strong but virtually unassailable, unlike patents where there is some risk of invalidation.
- The potential impact of an injunction is weakened by protracted litigation. By contrast, in the case of licensing performance rights, the practice is no injunctions, so they are not even available, much less weakened in impact.
- The parties both propose licensing rates in their negotiations before litigation, and one of those rates will prevail.

Under these circumstances, even where an injunction is possible, they predict that the potential license "will sometimes prefer to litigate" particularly "when the prospective licensee has little to fear from being found unwilling, name when the trial takes time (so that the threat of injunctions is less powerful), and when litigation costs are low."[24]

[24] Langus et al at ____.

The authors provide extensive mathematical proofs in the paper, but they explain the intuition as follows: The licensee must compare prospective payoffs from inducing litigation with a low offer or making (or accepting) a high offer. When the rights of the IP owner are strong (as is certainly the case with a copyright owner), then the rate that will avoid litigation is likely to be relatively high because the IP owner has no incentive to voluntarily accept a low rate. If litigation is likely to be protracted (which is often the case, and the licensee can influence that outcome), and an injunction will likely come much later, then the prospective licensee's prospective payoff includes some chance it will achieve its proposed lower rate or, at worst, will be forced to pay IP owner's higher preferred rate, but that payoff will be discounted by the time value of money.

To sum it up, if the licensee takes or makes a high offered rate, it pays that rate for sure, but if it litigates it may pay a lower rate, or, at worst, a higher rate, but later, after using the IP for some time. It is unlikely a court will award more than the licensor's opening offer. In such circumstances, it makes sense for the licensee to holdout, and the bargaining power of the IP owner is weakened.

Langus et al add further circumstances that more closely mirror litigation over performance rights in several countries. Under these circumstances, they find it certain that the licensee will holdout:

- Courts do not award injunctions, but rather set the FRAND rate if the parties are unable to reach agreement. In the case of performance rights, courts or agencies determine equitable remuneration either to conclude litigation or as a matter of regular practice.
- As is common in Europe, courts assess litigation costs on the loser, which is a general circumstance applicable to patent or copyright licensors.

Langus et al (2013) find that these circumstances "always give rise" to holdout by the licensee. The intuition here is that since the licensee does not face an injunction, it has an increased opportunity to obtain a rate lower than the one initially demanded by the licensor. The licensor will not be able to obtain an injunction that forces payment of the higher rate it initially requests, and the court may very well be persuaded to choose a lower rate. The licensee does bear the risk of paying costs in their model, but both parties bear the risk of being assessed litigation costs equally. The worst-case outcome for the licensee is capped at the FRAND rate, which is unlikely to be higher than the licensor's initial request, and which will be discounted by the benefit of litigation-induced delay, so the licensee has much more to gain from litigating than the licensor.

There are a few key differences between the SEP license context and the performance rights context, but they tend to justify giving CMOs more latitude and benefit of the doubt than SEP owners. First, in the SEP context, one concern is that SEP owners might abuse their leverage, using their rights over a small component to claim an outsized royalty. Furthermore, the accumulation of royalty payments to SEP owners securing such royalties might induce a "royalty stack" that could raise consumer prices and suppress incentives to innovate. By contrast, in the market for performance rights, they tend to be licensed by one or two CMOs. The CMO supplies the one or one of two essential inputs into the licensee's service – i.e., the right to perform recorded music for a music format broadcast station. There is little danger of claiming a royalty out of proportion to the value contributed to the licensee's product when the licensor is supplying much of the value of the licensee's product. Moreover, there is virtually no danger of a royalty stack, as the licensor is likely one of two entities granting essential licenses.

Second, the rights of copyright owners are more certain. Patent owners' rights are said to be probabilistic – that is, there is a non-zero chance that a court could invalidate an SEP asserted against a prospective licensee. By contrast, the vast portfolio of copyrights licensed by CMOs is essentially unassailable.

Third, unlike the SEP setting, the licensor is typically trying to increase an already-existing royalty rate rather than establish one for the first time. Thus, the licensor has less to gain by negotiating and litigating, and the licensee even less to lose. For most players in the market, royalty rates have been in place for a long time. The licensee continues to pay the existing rate until it agrees to, or a court or agency sets, a higher rate. In the SEP scenario, a licensor that decides not to pursue a license gets nothing. In the performance rights setting, the licensor will keep getting its existing rate, with its payoff being a possible incremental increase. This lesser payoff and lower stakes make transaction costs a greater obstacle in the performance rights setting, with the unavailability of injunctions an even greater detriment to the licensor's bargaining power.

4. *Applying Lessons from SEP Negotiations to Performance Rights Licensing*

Applying insights from the literature on holdout in the SEP context to licensing performance rights, the bargaining power of copyright owners is similarly impaired by limitations on injunctions and ceilings on royalty rates, but likely to an even greater degree. Just as in SEP licensing, the prospective licensee's worst-case outcome is having to pay a "fair" royalty rate, eventually, at the conclusion of litigation, while it continues to use the music being licensed without interference.

Following Heiden and Pettit's model of SEP bargaining, the decision model for negotiating a performance rights royalty rate increase for the licensee is as follows:

In this model, the licensor makes an initial offer for an ***increased*** royalty (IR1), which is the difference between the new royalty (NR) and the existing royalty (ER). The licensee decides to accept or delay. The licensee can continue to extend negotiations until either an agreement is reached on an increase (IR2) or a court finally sets an increase (IR3). Just as in Heiden and Pettit's original model, when IR3 ≤ IR2 ≤ IR1 "is perceived to be true, delay and litigation will be preferred over payment up until the point when the certainty of the outcome (e.g. in relation to court decision) makes settlement a better financial choice than delay."

As Heiden and Petit explain, the licensor begins the negotiation with an expectation to receive only a discounted percentage of its original proposal. It "will automatically face a reduction in their initial offer [IR1] by the costs associated with delay and litigation as well as the time value of money and the probability of success in court." When faced with a request for a rate increase (IR1), a rational licensee considers:

- The time value of delay (IR1(1+IRR)t – IR1) (where IRR is the internal rate of return on the use of the delayed payment)
- The potential value of a favorable court decision (IR1 – (1-p)IR3);
- The potential value of the licensor giving up (IR2= 0) and
- The potential costs associated with the delay and litigation (c(t)).

As in Langus et al.'s model, the conditions are such that the licensee **always** has the incentive to hold out rather than accepting the offer of a higher rate. The worst-case outcome for the licensee is capped at the difference between a new "equitable" rate and the status quo, discounted by the benefit of delay. The best-case scenario is preservation of the status quo, or, if it argues for a reduction, perhaps even a lower rate.

As a result of these circumstances, the licensee has much greater bargaining power in negotiating against a licensor seeking an increase in performance right rates. The licensor's best-case scenario is that it will eventually begin to receive a higher rate, capped at the level of equitable compensation, but discounted for delay and uncertainty. It faces a licensee that has little reason to compromise, as its potential losses are limited from the start and its gains increase with delay.

5. *The Benefits of Delay to the Licensee*

Since delay is such a powerful strategic tool and motivator for the licensee, it is worth explaining its benefits to the licensee. This issue is invoked by many commentators in the SEP literature, but it is best and most clearly explained by Heiden and Petit. Indeed, the Heiden and Petit study is bolstered by its sample of interviews with market participants, where some prospective licensees admit to intentional strategic delay for its own sake, rather than due to a belief that a license is unwarranted.[25]

As Heiden and Petit explain, even if a court is willing to award compensation for the payments that would have occurred during litigation, i.e., a back payment with interest, the loss to the licensor and the gain to the licensee is more than a mere deferred payment. There are several reasons. One reason is that back payments and/or interest may not be available at all or may only be available from the start of the court filing, as opposed to the period of initial negotiation. In the case of increasing royalty rates, courts and agencies often treat them like an employee's pay raise -- prospective only. Importantly, as Heiden and Petit explain, "interest rates are generally much lower than internal rates of return."[26] They explain that "the delay of payment calculated at the internal rate of return of both the . . . licensor and licensee can be quite substantial for both parties. For example, a licensee that is ordered by a court to pay interest for back payments at a risk-free rate could save over 10% compounded annually over the time of the delay in relation to its actual cost of capital."[27]

A licensor, particularly in the performance rights context, thus can benefit greatly from delay. Every month of delay reduces the impact of a potential rate increase and makes it less valuable to a licensor. The prospect of the cost of delay may deter a licensor from seeking an increase or settling for less of an increase.

It is also notable that licensees have the ability and opportunity to increase delay. Heiden and Petit document a few tactics observed by their respondents: for example, postponing meetings or sending a representative to negotiate without

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[25] They report that "most respondents insist that patent trespass is essentially about seeking to delay the initiation or progression of licensing negotiation with the goal of eliminating or reducing the amount of royalties paid to the SEP holder. Given that licensing negotiations and litigation can take many years, the combination of direct costs and the uncertainty of judicial outcomes favors a strategy of delay on behalf of the SEP implementer in the absence of accessible injunctive relief. "Heiden & Petit at 41.

[26] Ibid at __.

[27] Ibid at __.

settlement authority. In any event, such tactics are familiar from everyday business practice and litigation, and a clever licensee can find innumerable examples to follow and will likely originate a few all its own. Even where a court has the inclination and authority to account for unjustified delay in its final judgment, a party can engage in at least some strategic behavior that is justifiable on its face and unlikely to be sanctioned.

6. *Institutionalized Rate Setting*

One way to avoid at least some of the bargaining power issues described in this Section is through regular, institutionalized review of rates. In some countries, rates for performance licenses are reviewed at regular intervals by a tribunal or agency.

A well-designed and regularly scheduled rate setting proceeding can avoid the issues of delay and consequent disadvantage to the licensor. If rate proceedings have a regular schedule and a set deadline, uncertainty is reduced as is the opportunity for strategic delay. Each party brings its best arguments for a new rate to the tribunal with the expectation of a decision by a certain date. Ideally, such a venue also can also reduce litigation costs by using more streamlined administrative procedures.

This mechanism is still only a second-best solution to the market, however, as it not only institutionalizes rate setting, but, in many ways, also institutionalizes the licensor's bargaining power disadvantage. First, delay is essentially scheduled into the system. A licensor facing changed market conditions cannot act but must wait for the next scheduled rate setting proceeding. (Admittedly, however, freely negotiated contracts often also create the same situation). Second, the licensor still cannot resort to walking away or obtaining an injunction if it is not satisfied with the proposed price. Its best-case scenario is still an "equitable" rate, so its upside is limited, as is the licensee's downside.

Moreover, institutionalized rate-setting is still beset by the issues described below: the strategic value of uncertainty regarding the "right rate," the incremental setting of rates based on past rates rather than current market conditions, and the inability to offer exclusive rights.

C. The Strategic Value of Uncertainty Regarding the "Right" Rate

Nobody really can say with certainty what the "right" rate is for performance licenses. This uncertainty creates strategic opportunities for parties in a negotiation, which may particularly favor licensees, given the bargaining power disparity created by institutional constraints.

The lack of a history of market transactions for performance rights makes rate-setting a very speculative exercise. For many decades, those rates have been set by courts, agencies, and regulatory bodies throughout the world, all of whom faced the limitations imposed by the knowledge problem described in Section II. Courts and regulators must guess at prices with almost no available reference freely-negotiated market transactions, at least until very recently. (Incidentally, those recently-emerged market reference points, the negotiated rates for streaming services, are much higher than any court set rate. We discuss this more below).

Schankerman and Scotchmer point out one difficulty here, as there is an inherent and inevitable logical circularity to attempting to determine reasonable royalties in markets that lack sufficient market transactions. (Schankerman & Scotchmer 1999). In such settings, absent a robust market, royalty rates are affected by damage awards and vice versa. Thus, as Schankerman and Scotchmer point out, the range of possible royalty rates is so wide as to be indeterminate.

Such indeterminacy is reflected in the wide range and diversity of royalty rates for performances set from country to country as described in Table 4.

Strategically, this uncertainty gives the prospective licensee an opportunity to influence the award provided by a court. Langus et al. (2013) show that under their model of SEP negotiation, the prospective licensee can use its offers during negotiation as a "powerful strategic tool" to influence the court. The licensee can calibrate its offers to induce rejection by the licensor, and thus litigation, and resulting delay. But it can also attempt to set its offer such that it appears to be bargaining in good faith but anchors the court's royalty determination by setting a lower bound on the range. Admittedly, this is a lot to accomplish with an offer, but given the licensee's enhanced bargaining power, it has more room to maneuver than the licensor. The licensee benefits from maintaining the status quo, and the unavailability of injunctions and the "equitable" cap on royalties makes it easier for the licensee to set its offer low and wait out resolution of the negotiation and any subsequent litigation.

In the context of performance rights licensing, the licensee has an advantage over the SEP licensees described by Langus et al. In the case of performance licensing, the licensor is almost always seeking a rate increase rather than to establish a license for the first time. By definition, the prior rate is one that was found to be equitable at one point. This fact confers a strategic advantage by providing the licensee greater certainty about the rate that is likely to be a safe lower bound in instances where courts have discretion and are inclined to sanction unreasonable refusal to bargain.

Uncertainty as to the "right rate" further creates an opportunity for the parties to make self-serving arguments in hopes of influencing the decisionmaker. Even where courts and agencies are insulated from raw politics, parties can hope to influence the outcome with exogenous considerations. This point has been observed in the SEP debate, for example Kieff and Layne-Farrar observe that licensees may use "the courts or agencies to obtain better terms and conditions than could be achieved through good faith negotiations." (Kieff & Layne-Farrar 2013: 1114).

A rather prominent and overt example of attempts to politically influence rate-setting has occurred in the U.S., as the streaming service Pandora has repeatedly attempted to use the political process to influence rate setting for its non-interactive streams. For example, in 2007, Pandora founder Tim Westergren urged users to contact their congressional representatives to urge them to overturn a rate set for Pandora by the Copyright Royalty Board. Several years later, Pandora tried again, securing the introduction of proposed legislation specifically crafted to reduce its rates. As one commentator observed, the purpose of "the Internet Radio Fairness Act . . . crafted pretty specifically for Pandora, is to reduce the royalties the company has to pay for the music played on the service."[28] As a commentator observed, "Pandora is effectively asking the government to intervene and reduce its cost structure, helping it remain a viable business because it knows its business model only works while running limited advertising. Why should the U.S. government allow musicians to be harmed simply to help Pandora and its investors generate enhanced returns?"[29] While particularly overt, this an example of the kind of politicking that Hayek cautions will happen when governments set prices.

One might ask, however, whether both sides can engage in special pleading. They can, but the opportunities may not be symmetrical. Licensees include broadcasters, which can communicate directly with listeners, who are also voters. Moreover, the broadcasters in many countries are dispersed across many geographic locations, and, depending on the electoral system, may thus be present

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[28] Eric Savitz, "Pandora Asks Users To Lobby Congress On Royalty Rates," Forbes (September 24, 2012), https://www.forbes.com/sites/ericsavitz/2012/09/24/pandora-asks-users-to-lobby-congress-on-royalty-rates/#6048f1224e38.

[29] Id. quoting BTIG analyst Richard Greenfield.

in many electoral districts represented by many elected officials. While licensors can sometimes bring the "star power" of popular artists to bear on licensing disagreements, the political economy may advantage broadcasters with their broader reach and more direct connection with the public.

D. Competition and a Changing Marketplace

Another reason to believe that royalty rates are likely low relative to freely negotiated rates is that the current rules for rate-setting fail to account for dramatic changes to the music business in recent years. Changing technology has made new business models for delivering entertainment possible. However, non-exclusive, compulsory licenses prevent the music industry from taking full advantage of these changes, in contrast with the less-restricted movie and television industry.

The increasing importance of streaming also has led to changes in the marketplace that have created more competition with traditional broadcasters and provided an example of a freely-negotiated rate much higher than previous rates set by compulsory licenses. This new reference ought to be considered.

1. Non-exclusive licenses, competition, and lost opportunities

The non-exclusive nature of performance licenses likely suppresses royalty rates relative to freely negotiated rates. The inability to obtain an injunction means that licensors cannot choose who gets a license to music, when they get it, or which part of the catalog they can play.

This limitation on control devalues licenses, as licensors have no opportunity to segment their markets, time their delivery, or grant temporary or permanent exclusives to part of their catalog. In other words, in economic terms, they cannot engage in price discrimination. Price discrimination in the market for copyrighted works can benefit both creators and consumers. Creators can maximize revenue, but consumers also may benefit creators are more likely to produce creative products and delivery methods that satisfy a wider variety of preferences.

The current rules for performance rights deprive licensors of the opportunity to do truly exclusive distribution deals, which would engender some competition for licenses. They cannot limit the distribution of high value content to exclusive platforms for limited or indefinite terms. These alternate arrangements would likely lead to higher license fees through the mechanism of competition.

What would a world with at least some exclusive deals in music look like? It is somewhat hard to imagine, given that music licensing has been heavily regulated on a worldwide basis for years. Still, we can see some glimpses of innovation from newer parts of the business that are less comprehensively regulated. Thus, there is some variety among streaming services, such as Apple Music, Spotify, and Tidal, which offer some differences and variety to consumers and to creators. Each has some unique content.

Tidal has exclusive deals with certain artists, supporting higher subscription fees from consumers and higher payments to those artists. However, even when Tidal does exclusive streaming deals, that exclusivity is somewhat illusory and incomplete. Tidal exclusives may not be available on Spotify and other streaming rivals, but they are available on radio and via user uploads to YouTube. This lack of true exclusivity may explain why some Tidal artists have wavered in their commitment to exclusivity.[30]

Movies and television supply a better example of the possibilities allowed by a freer licensing environment. There, content delivery is less regulated, and creators and consumers both reap benefits. For example, studios engage in "windowing," granting exclusivities on a temporary, rolling basis. Thus, a movie may appear first in theaters, and then it may be available exclusively for rental or pay-per-view, and then it might have an exclusive stint on a cable network, such as HBO, or a streaming service such as Netflix. Finally, after some time, it might eventually be licensed more broadly on a non-exclusive basis as part of the general catalog of many platforms, such as Netflix, Hulu, and Prime, and/or broadcast and cable channels.

This sort of sequence of exclusivities increases competition among platforms, thus increasing license fees and maximizing licensor revenue. However, it may also benefit the licensees by providing points of differentiation that drive viewership. It can benefit consumers too, by providing a variety of ways to enjoy content that most suits individual interests. A true fan might enjoy a movie theater experience the first weekend of a release, while a viewer with more casual interest may wait to see a movie on a smaller screen at home. The ability to charge different rates – both for licensing, and, in turn, to the consumer, allow different viewing experiences to exist.

These opportunities appear to have been beneficial to the creators of movies and television. Innovation has blossomed, as both creators and content delivery

[30] See, e.g., Kris Holt, Beyoncé and Jay-Z's Tidal exclusive lasted less than two days, Engadget, (June 18, 2018), https://www.engadget.com/2018/06/18/beyonce-jayz-tidal-album-spotify-apple-music-amazon/.

services are free to experiment with new business models. Moreover, it is widely acknowledged that creativity is flourishing – consumers have more and better choices than ever.

Technology unleashed this competition in the market for movies and TV shows, but it was enabled by the relative absence of interference from the IP and regulatory regime. Once technology advanced enough to enable new platforms and business models, content owners had enough freedom to license them on a competitive basis.

The level of competition and differentiation enjoyed in the TV and film business cannot happen in the music market. The obstacle is not technology, but restrictions on legal rights. There certainly have been dramatic developments in the emergence of streaming, but full competition and a greater diversity of experiments new business models are impaired the licensing regime. The likely losses are an argument against the no-injunction, compulsory license system that exists today. In this respect, the losses are systemic rather than merely systematic. Even if policymakers are unperturbed by systematically suppressed royalties, the effects on the system – the loss of innovation and creative diversity – out to disturb them.

Moreover, the lack of competition and differentiation in the music market, as compared to TV and film, provide another reason to think that rates are likely suppressed below market levels. In a free market, there would be more differentiation among service and competition for licenses. The deal that licensees are currently enjoying from courts and agencies – unlimited access to music catalogs -- would either be unavailable or come at a premium in a free market.

2. *The Growing Importance of Streaming*

The ways in which music fans consume music have rapidly changed over the past 20 years and the music business has dramatically changed as a result. As Figure ___ shows, sales of physical product have declined. Today, streaming is an important and growing source of revenue for the global industry, exceeding sales of physical product as a source of revenue for the first time in 2016.

These changes in the marketplace for music are relevant to rates for performance licenses for two reasons:

(1) The Decreasing Relevance of the Promotional Effect Argument. The fact that consumers increasingly stream music rather than buying it undermines the

longstanding contention that license fees for performances should be discounted to account for their promotional effect on record sales. There has long been a controversy as to whether radio play has a positive or negative effect on music sales. One argument is that it serves as advertising that drives sales, and thus has a promotions effect. A counter-argument is that consumers may have their demand for music wholly or partly satisfied by radio, making them less likely to buy music – a substitution effect. As Watt (2012) observes, the weight of published academic work appears to be on the side of a substitution effect.

Liebowitz (2004, 2007) argues that the substitution effect outweighs any promotions effect. One of Liebowitz's points is that the argument for a promotional effect argument suffers from a logical fallacy, the fallacy of composition. That is, radio play is more likely to affect *which* music a music buyer chooses rather than *whether* somebody becomes a music buyer. The promotions effect thus helps direct interest to particular music instead of generating greater sales overall.

The shift to consumption via streaming services reinforces Liebowitz's point. Consumers are buying less music. Instead, they increasingly obtain music by paying flat monthly subscription fees to stream music from interactive services. At most, a promotional effect from listening to radio directs a consumer to particular music within their unlimited subscription service. Choosing to stream one song over another does nothing to increase overall revenue for the industry. The subscription fee is already paid, and any promotional effect simply shifts the choice of what to stream.

To the extent that there was ever a valid argument that public performance rights should be discounted for promotional effects, changing consumption patterns are undermining it. If a listener hears a new song they like on the radio, they are much less likely to buy it. As Aguiar and Waldfogel have found, and logic indicates, streaming services displace sales of individual tracks, (Aguiar & Waldfogel 2018). When consumers choose to stream one song in preference to another, there is no net gain in revenue to music suppliers.

(2) The Establishment of a Comparable Rate, Established in a Free Market Negotiation. The emergence of streaming has created, for the first time, a significant transaction in the music market that is not governed by a statute, court decision, or regulatory proceeding. Services such as Spotify and Apple Music have freely negotiated their rates with record labels. The results are unprecedented, both in terms of providing a benchmark for the value of music and revealing what a buyer in an unfettered

marketplace is willing to pay for a license when music is the essential input into their service.

Courts and others charged with setting music licensing rates should look to streaming licenses as an essential benchmark. When setting rates or determining damages in IP cases, courts and agencies typically invoke a hypothetical arms-length negotiation to determine what price the parties might have achieved in a marketplace transaction. Evidence of comparable market transactions often serves as evidence of what might have happened in a hypothetical transaction. The problem with rate-setting in the music licensing market has long been that there were few, if any, comparable market transactions. The hypothetical negotiations imagined by courts and regulators to determine royalty rates were truly and entirely hypothetical, until streaming licenses emerged to provide a real benchmark.

Press reports show that Apple and Spotify streaming services pay most of their revenue as royalties. It has been reported that Apple pays 70% of its revenue to music rights owners – 58% to the owners of copyrights in sound recordings and 12% to the owners of copyrights in musical compositions.[31] Spotify reportedly pays a similar proportion, 55% to the owners of sound recordings.[32]

These rates are many times what broadcasters pay for performance rights. As described in Section II (see Table 4), the global percentage of commercial radio revenue paid as performance licenses is 1.65%. Even the highest rates do not exceed 10%.

A couple of caveats are in order. First, the percentages may decline over time, as the services make more money or renegotiate rates. Second, streaming is interactive, and thus essentially, an effective replacement for buying music. Thus, it can be expected to demand and command a higher rate.

Still, it is notable that when streaming services negotiated a rate in the free market for the essential input into their service, that essential input received a significant share of revenue. One expects that negotiating in a free market with other music users – at least the ones for whom music is the essential input to their product –

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[31] Tim Ingham 2016, Spotify is Out of Contract with all Three Major Labels – And Wants to Pay Them Less,
https://www.musicbusinessworldwide.com/spotify-contract-three-major-labels-wants-pay-less/
[32] Lucy England2015, Apple Music Will Pay Artists Way More Than We Previously Thought,
http://www.slate.com/blogs/business_insider/2015/06/16/apple_royalties_apple_music_will_pay_more_than_70_percent_of_monthly_fee.html

would engender significant revenue splits. This result is what Watt (2010; 2011) and Boyer (2018) predict in a market where parties freely negotiate for the use of the essential input to their service.

Courts and agencies should look to these transactions to better understand what a freely negotiated transaction might look like in the performance rights context.

CONCLUSION AND POLICY RECOMMENDATIONS

The remuneration-only rule that dominates licensing negotiations and rate-setting proceedings in the market for sound recordings profoundly distorts the market. The rule is unusual and ignores the many benefits conferred on individuals and society by fully functioning property rights. Among the benefits usurped by this rule are several important non-economic values, but it also makes it impossible to set prices efficiently or fairly. Significantly, it skews bargaining power dramatically in favor of the prospective licensee and impairs the market from adapting to changing technology and consumption patterns.

Therefore, we recommend that legislators, regulators, and courts consider the following changes. Which actor can fix which problem will depend on national laws, but courts and regulators should use such discretion as they have.

- Restore injunctions as a remedy and negotiating tool. At the very least, they should be available in the case of bad faith negotiations and delay.
- Approach rate-setting with modesty as to having enough knowledge to determine the right rate, with awareness that the institutional setting skews bargaining power in favor of the licensee.
- Avoid perpetuating past mistakes by simply using existing rates as the starting point for setting new rates. There is a significant chance that previous rates did not accurately reflect past market conditions, given skewed bargaining power. Instead, courts and regulators should thoroughly assess current and changing economic conditions.
- Since delay is profitable for licensees, make it less so to rebalance bargaining power and avoid unnecessary litigation. Measures to do so might include:
    - Making new rates retroactive to the date of the first offer from licensor.
    - Awarding a higher interest rate, accounting for the internal rate of return of the licensee.
    - Adding penalties or pre-established damages for bad faith delay.
- More significantly, restructure licenses to allow for exclusivity and windowing in order to promote competition and diversity in business models.
- Consider streaming service royalties as a compelling comparable transaction.

Some of these changes may fall into the discretion of a court, many would surely require legislation. They all are worth considering to rebalance a market long-distorted by an extraordinary institutional arrangement that deprives copyright owners of control of their property. If the example of television serves well, the results would likely create more dynamism and diversity in industry business models and content, all to the benefit of consumers.

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