“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

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1. Introduction.

The music industry has traditionally relied on a business model that consists of selling physical and digital records (“Old Model”).

The impact of the development of the new digital technology has changed the market’s patterns lowering costs and further has jeopardized the former business structure. Concretely, certain intermediaries of the business are deemed to be unnecessary for the purposes of marketing music and thus its existence has to be either justified or disregarded.

This paper does not seek to provide a new business model but to evidence that certain aspects of the Old Model are needed to be reassessed because some of them are likely to be inefficient.

Thus, this paper seeks to describe and explain, in the context described above, the relationship between the music bands and its intermediaries in a context determined by the new technologies, and to analyze and assess the desirable terms, if any, to bind artists to the intermediaries in the Internet-based marketplace.

2. The “revolution” of the new technologies in the Internet-based marketplace and its economic implications.

2.1. The impact of the new technologies in the music business.

According to The Economist, in 2006 EMI invited some teenagers into its headquarters in London to talk to some managers about their listening habits. When the meeting finished, an EMI’s representative thanked them for their comments and offered them, for free, several CDs. None of the teens took any of them. Instead, they just walked away. “That was the moment we realized the game was completely up,” said a person who was there.¹

This simple but no less suggestive anecdote is not an isolated example of the process that the industry of music has been undergoing in the past decades. Certainly, it

¹ See http://www.economist.com/node/10498664
“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

has dramatically changed due to the implementation, improvement and development of new technologies that not only have altered the music business patterns (specially, related to recorded music) but also have challenged the very way of understanding commerce and intellectual property rights.

Hence, the very existence of some of the legal institutions created upon the traditional conception of the intellectual property law, i.e. Copyright law, now has to be somewhat justified on both legal and economic basis, if possible, and moreover be adapted to this new reality.

The technological innovations have come to, among other things, suggest new ways of trading rights. Songs are now easily and cheaply recorded and, further, digitally distributed, digital downloading in the Internet having become the most common way of purchasing music for users.\(^2\)

The most important improvement of these technologies is the digitalization of contents, i.e. MP3 formats and the like.

Digitalization of contents has lowered costs,\(^3\) simplified the process of distributing records, fostered commerce and, what it is the most important fact, raised questions about the very role of the intermediaries in the business.\(^4\)

In other words, record companies and physical distributors somehow now have to explain why artists need to get into a deal and distribute records through them. This very inquiry suggests that the Old Model is obsolete.

\(^2\) See LINDEY, Alexander and LANDAU, Michael, Lindey on Entertainment, Publishing and Arts. Agreements and the Law. Volume IV, Third Edition, 8-56 and 9-8. As of the end of July 2005, Apple’s iTunes\(^8\) had sold over 500,000,000 music files. Moreover, according to Joshua P. Friedlander (RIAA Vice President) digital downloads in 2011 total $2.6 billion, up 17% from the prior year, having the digital music shown that can be a model for the music industry going forward. See more information available and up-to-date in www.riaa.com.
\(^3\) Furthermore, it is claimed that the cost of reproducing and distributing music is almost zero due to the combination of digital formats, the Internet, and e-commerce utilities. See Henry H. Perritt, Jr., Music Markets and Mythologies, 9 J. Marshall Rev. Intell. Prop. L. 831, 836 (2010).
\(^4\) The problem the major labels face is that the intermediation activities they have organized their bureaucracies to perform have become obsolete because of new technologies. See Henry H. Perritt, Jr., Music Markets and Mythologies, 9 J. Marshall Rev. Intell. Prop. L. 831, 834 (2010).
Moreover, the impact of the digitalization process is wide. As downloading music through iTunes or Spotify and the like has become the rule for most of the consumers of recorded music, traditional distributors and retailers are disappearing.\textsuperscript{5} The ones who are not -very few of them, certainly-, have just been trying to survive by selling any other products rather than recorded music, and therefore becoming less and less competitive.

Obviously, the digitalization of contents implies that CDs do not represent a profitable way to record, produce and distribute recorded music (and, therefore, for record companies to make profits) anymore.

In fact, digitalization of contents has been caused huge losses for record companies\textsuperscript{6} not only because it directly competes in sales with CDs, but also due to the losses resulting from copyright infringements and because of the fact that new players in the scene (the so –called Internet-based intermediaries) are performing some of the record companies’ functions.

At this respect, it is worth noting that most of the record companies have not taken substantial actions yet as regards their business plans even though they have already assumed that the market changed as well as consumption patterns.

On the contrary, they are just trying to minimize their losses by sharing as much as they can from the artists’ revenues,\textsuperscript{7} spending large amounts of money monitoring rights

\textsuperscript{5} See Ryan S. Henriquez, Facing the Music on the Internet: Identifying Divergent Strategies for Different Segments of the Music Industry in Approaching Digital Distribution, 7 UCLA Ent. L. Rev. 57, 131 (1999). Also, another good confirmation of this is the announcement made by HMV, British’s biggest brick-and-mortar music shop, on January 15, 2012, that it was putting itself into administration. See http://www.economist.com/blogs/schumpeter/2013/01/hmv-and-music-business?zid=292&ah=165a5788f0b726c1b1374d8e1ea285.


\textsuperscript{7} See PASSMAN, Donald S. All you need to know about the music business, Eighth Edition, page 97. Moreover, as Matthew Reynolds claims, labels have been trying to find alternate ways to get more bang for the buck from their artists by pressuring them to give up more rights. Traditional recording agreements are quickly being replaced by what are known as “360” deals. See Matthew Reynolds, Why Music Should Be Socialized, 10 Vand. J. Ent. & Tech. L. 505, 508 (2008).
violations (up to now, with some success and certain perverse incentives)⁸ and trying to deal with the new players and artists so that to not lose more share in the pie.

Naturally, the impact of these innovations has caused record companies to undergo a deeply cost-cutting process. This means three things.

First, that there are fewer jobs for executives in record companies⁹ and, further, that those unemployed executives are likely to set up their own independent record companies increasing competition in that area.

Secondly, the major record labels are not promoting new artists anymore since it has become too risky to do so—from the very financial meaning of the term-. Instead, they are likely to promote and enter into deals only with big artists that are able to guarantee a reasonable return.

Last but not least, business concentration (mergers and acquisitions between the major record companies) might be the natural approach for the major record labels to face downside.¹⁰

On the other hand, musicians cannot rely anymore on selling records as a source of income as well. However, most of them never did;¹¹ the royalty rate on a standard record

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⁸ The Recording Industry Association of America (“RIAA”), has filed some 20,000 lawsuits, most against individuals engaged in file sharing and further most of the suits do not go to trial because the RIAA employs contract collection agencies that threaten the defendants with ruin unless they “settle” for $8,000 to $10,000, depending on the apparent wealth and income of the defendant. The courts have been sluggish in punishing such abusive practices. See Henry H. Perritt, Jr., Music Markets and Mythologies, 9 J. Marshall Rev. Intell. Prop. L. 831, 833 (2010).

⁹ For instance, UMG cut staff members back in October last year following the EMI merger. Music Week sources close to the company said that cuts affected around 40 employees in the US. See http://www.musicweek.com/news/read/emi- layoffs-reported-in-the-us/053075.

¹⁰ According to Wikipedia, from 1988 to 1998 there were six major companies (Warner Music Group, EMI, Sony Music, BMG Music, Universal Music Group, and Polygram); from 1998 to 2004 there were five (Polygram was absorbed by Universal Music Group); from 2004 to 2008, there were four (BMG absorbed into Sony), and from 2012, there are just three (Universal Music Group, Sony Music Entertainment, and Warner Music Group, being EMI absorbed into Universal Music Group -recorded music- and into Sony Music Publishing -publishing-). See https://en.wikipedia.org/wiki/Record_label.

deal is roughly between 9-12% on every (physical) album sold\textsuperscript{12} and, further, it is common for artists to wind up owing money to the record label for un-recouped recording and promotion costs.\textsuperscript{13}

This does not mean that recorded music is no longer a good source of income; it just simply suggests that recorded music has yield to new ways of making revenues.

Furthermore, consumers are demanding more recorded music due to the fact that now they generally listen to music in portable devices (iPods and the like)\textsuperscript{14}, and much more music is now available for them because there are a lot of new bands that actually are able to record songs and make them available to users on the Internet without having to spend a considerable amount of money in doing so.

From an economic standpoint, these events mean that the cost of producing and distributing recorded music has lowered substantially. Anyone now is able to record a song and distributed it through the Internet. That is exactly what is happening; there are more artists in the market; therefore, the supply of recorded music increased and since consumers are getting music easily and at a low cost they demand more of it.

Matthew Reynolds has pointed this fact out clearly: “People have changed. They no longer connect to music and artists the way they used to. They eat up music in gulps and handfuls, consuming it more than ever before. They want to buy in bulk, and that calls for lower prices. Keeping in mind that we are competing with “free” pirated music, cheaper will have to be the answer. Let us add two final parts to the framework: [...] People want a lot of music; and [...] People are not willing to pay what they used to for music.”\textsuperscript{15}

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These economic changes rely on a simple fact. Technology (mainly, digital contents) has eliminated the barriers to entry formerly imposed by record companies, increasing the number of competitors in the market. There are more artists (and therefore more recorded music), more independent record companies and more consumers. The music business market has lowered costs and further has spread and those are good news for any economy.

Nevertheless, the increase of the number of competitors (artists) in the market does not encompass the fact that consumers actually purchase all the recorded music that is now produced and offered. The picture is not as simple as that. There is actually an important factor to bear in mind when considering the whole phenomenon: the search costs imposed by the new market, which blurs efficiency.

The market is actually flooded by new artists and consumers so now it has become very difficult for them to find each other in it. Whereas the picture suggests that former intermediaries (record companies and physical distributors and retailers) are not required anymore, it is also important point out the fact that are functions needed to be performed, in particular the one related to the abovementioned search costs. Someone has to perform the “matchmaking” function that the record companies usually provided, among other functions.

Finally, as to the relationship between consumers and music bands, needless to say that it has changed as well. Consumers and musicians have come to find each other (or, in other more accurate words, the market has gathered them) in a more personalized way through the Internet.

By challenging the role of the former intermediaries the new technologies also unmasked certain inefficiencies the music business has been bearing all of these years, representing a remarkable opportunity to change some old habits.

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“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

Up to now, the technological impact of the digitalization of contents is wide. And it also has a name: the “peer-to-peer” technology.

2.2 The “Peer-to-peer” technology.

As mentioned above, the reason why music business changed is directly connected to the technological innovations applied to the music market.

The most remarkable software innovation, as far as it is here concerned, is the peer-to-peer (“P2P”) technology. P2P represents perfectly well the very concept of this technological revolution: a huge cooperative agreement between consumers over the Internet.

According to Wikipedia, P2P is a system which is used to share resources between users over the Internet and that has a remarkable characteristic: it works without a central server, so the computers interacting are both consumers and suppliers of such resources at the same time. 18

P2P neither has the “client” nor “server” notions, but only equal nodes that simultaneously act as client to the others nodes on the Internet, and therefore, differs substantially from the client-server model where communication is to a central server. 19

As regards the abovementioned resources “the owner of each computer on a P2P network would set aside a portion of its resources—such as processing power, disk storage, or network bandwidth—to be made directly available to other network participants, without the need for central coordination by servers or stable hosts”. 20

In other words, the very function of P2P is allowing “users to download media files such as music, movies, and games using a P2P software client that searches for other connected computers”. 21

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19 See http://en.wikipedia.org/wiki/Peer-to-peer
“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

This technology appeared in 1999 with Napster and further it had been developed with other different systems, such as Kazaa and Gnutella, now extinct. The paradigmatic software nowadays is BitTorrent, a system designed by Bram Cohen in 2001, which its main purpose is to facilitate the distribution of large files. However, the difference between systems as Kazza and Gnutella and fully distributed P2P systems is that it is not centralized (as Napster was) and does not lack of scalability of the protocol (as Gnutella).22

Facts speak for themselves. As of January 9, 2012, BitTorrent’s clients have grown to over 150 million worldwide (monthly active users) and its technologies are used by hundreds of millions of people around the world and currently drive between 20% and 40% of global Internet traffic.23

This, of course, has direct implications for the music industry and the distribution of recorded music. In that global Internet traffic there is a lot of recorded music, copyright infringement, and users willing to pay for music.

What is important to point out about P2P is that this technology has changed the way of distributing music and there is no way back to the old model, that is, selling and distributing records physically.

P2P’s revolution is not in the technology used. It is in the main idea that encompasses the technology itself. It adds value on a free exchange process increasing social welfare by sharing resources under an unwritten cooperative agreement between users.

The ones who are responsible for leading the music industry will have to redesign its business model pursuant to this new paradigm or otherwise will no longer survive.

Whereas the new technologies are deem to be an economic improvement since they provide cost-effective resources to the business and foster competition, they also imply legal and economic challenges.

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22 See Peter Biddle, Paul England, Marcus Peinado, and Bryan Willmam, The Darknet and the Future of Content Distribution.
23 http://www.bittorrent.com/intl/es/company/about/ces_2012_150m_users
2.3. **Challenges of the new technologies.**

The effects of the digitalization of contents suggest three challenges:

(i) Understanding that a new profitable and competitive market exist and it has to be developed;

(ii) Rethinking the former legal structures related to intellectual property, mainly copyright law; and

(iii) Re-adapting the relationships among the players of the business.

First, it must be understood that the very concept of property has developed and changed. Thus, the source of income in the music business should be found in another paths rather than sales of records.

Second, copyright law probably will not hold on to this new path leaded by economic change and will disappear, at least as regards recorded music. 24

Furthermore, copyright is actually unenforceable 25 and, moreover, too costly to be applied. Nevertheless, the old business model tries to hold; for instance, the compulsory license was recently expanded to now include digital audio deliveries, as well as sales of hard copies. 26 It might be deemed this it is not enough but undesirable. Policies like the adopted are just provisional solutions that do not solve the problem that represents sharing of contents over the Internet.

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25 Moreover, “Copyright protection for recorded music at the consumer level has become essentially unenforceable. Digital recording technologies make it possible to produce perfect copies of recorded music cheaply and quickly. Compression algorithms embedded in software known as “codecs” produce relatively small files that can be distributed in a few seconds via the Internet”. See Henry H. Perritt, Jr., *Music Markets and Mythologies*, 9 J. Marshall Rev. Intell. Prop. L. 831, 838 (2010).

“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

As suggested by Thomas F. Cooter, “policymakers also need to consider which institutions will best oversee intermediaries, in light of the institutions' own abilities to process information and avoid capture; these institutions may include markets, government, private actors, and entities formed by private actors.”

Third, as the business model needs to be adapted to this new scenario, the relationships between the different actors in the market have to be reassessed, in particular, the one existing between musicians and its intermediaries.

As the next sections describe, this relationship—that arises from the Old Model—implies several costs that are necessary to be lowered in order to achieve efficiency; the technological impact represents a great opportunity to minimize inefficiencies that the music business has been bearing from the very beginning of its existence.

Moreover, these inefficiencies exist no matter which the intermediary is; either a traditional record label or a so-called the Internet-based intermediary. Certainly, the Internet-based intermediaries provide technologies that lower costs (in particular, search costs) but they also provide a structure that, as the old model did, is costly.

The Old Model not only has become obsolete but it also has traditionally been inefficient.

3. How the music business works.

3.1. The music industry structure and the old model: Who is who in the music industry.

In order to assess the desirable terms to bind music bands and their intermediaries it is previously necessary to understand how the recorded music industry has been structured as of these days, as well as who the parties that are involved.

The different players in the music business are:

(i) Artists;
(ii) Producers and mixers;

Generally, provided that marketing songs to a considerable audience is desired, an artist has to enter into a record deal with a record company. A record company intermediates between the artist and the purchaser of records, either physical or digital records. The following sections of this paper explain how.

The reason why an artist requires an intermediary is simple: it is too costly for the artist to perform the functions required to market a record by itself (and the lack of experience in doing business it is deemed as a cost as well).

Also, an artist needs, and in most of the cases wants, time to create art, not to set up a structure to i.e., advertise records.

For such purpose, an artist has two types of record companies in the business to enter into a record deal with; either a major record company or an independent record company.

Major record companies are large companies that own record labels and are organized in divisions depending on the company’s corporate practices. Moreover, as suggested by Allison Klein, “most large record companies are actually huge conglomerates that own a variety of subsidiary record labels” and “often, the subsidiary labels are each mini-companies operating under the umbrella of the larger corporation.”

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29 See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, page 65. As the author mentions, the divisions of a major record company are: A&R, Promotion, Marketing, New Media, Production, Product Management, Finance, International, Business Affairs/Legal and sales. The important aspect of these divisions is the enormous organizing costs implied.

Furthermore, there are three major record labels in the market that further, as of 2012 and according to Nielson SoundScan’s report, controlled the 88.5% of the music business, as follows:

(i) **Universal Music Group**: 39.19%;
(ii) **Sony Music Entertainment**: 30.25%;
(iii) **Warner Music Group**: 19.15%; and
(iv) **Independent labels**: 11.4%. 31

As the description reflects, the recorded music business is highly concentrated in a very few players. Moreover, that very fact suggests who generally fix prices and has the bargaining power in the negotiation of a record deal 32 with the artist and, at the end of the day, who is the one who run the business.

Economically, under certain assumptions, it might be claimed that the music industry structure consists of an oligopoly. The gist of the argument would be that the major record labels, as pointed out below, controls the supply of physical recorded music by selecting certain artists and thus impose a limitation on the exchange of such recorded music. 33

Moreover, this sort of selection 34 of artists does not only represent a barrier to entry, but it is also akin to decide what type of music should a consumer listen. Record companies not only select artists, they also discipline the market, by imposing several

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32 Moreover, as the industry is very concentrated, it is likely for some of these companies to have antitrust issues. For instance, in 2007 EMI was acquired by Terra Firma, a company that defaulted on a $5.4 billion loan in 2011 and had to turn over ownership of EMI to its lender, Citigroup. In 2012 Universal Music Group bought EMI for $1.9 billion and several disinvestments (60% of EMI’s European assets, and a third of its assets globally) were required to be made in order to comply with European antitrust requirements. See [http://www.economist.com/blogs/schumpeter/2012/09/universal-music-and-emi?zid=292&ah=165a5788fdb0726c01b1374d8e1ea285](http://www.economist.com/blogs/schumpeter/2012/09/universal-music-and-emi?zid=292&ah=165a5788fdb0726c01b1374d8e1ea285). See also Henry H. Perritt, Jr., *Music Markets and Mythologies*, 9 J. Marshall Rev. Intell. Prop. L. 831, 833 (2010).

33 Nevertheless, some sort of concerted action among these companies must be alleged and further proved, pursuant to Section 1 of the Sherman Act.

34 See Henry H. Perritt, Jr., *Music Markets and Mythologies*, 9 J. Marshall Rev. Intell. Prop. L. 831, 834 (2010). Moreover, as claimed by the author, it is important to point out that the selection of artists also allows the major labels to save the search costs.
requirements to artists on the delivery of records and flood consumers’ minds with viral advertisement.\textsuperscript{35}

An oligopoly has primarily two effects: (i) the demand curve is not the demand curve of music industry but is the demand curve of these companies; and (ii) these companies are likely to set the price of recorded music, which moreover is the price that maximizes the oligopoly’s profits.\textsuperscript{36}

Obviously, the existence of an oligopoly is not desire since it implies welfare losses due to the lack of offer of products and rising of prices, and furthermore, under conditions of oligopoly these companies are likely to capture a portion of consumers’ surplus.\textsuperscript{37}

To sum up the idea, the major record companies promoted what they consider to be a marketable artist and leave behind several artists from different backgrounds provided they do not fulfill that requirement, imposing a limitation on the production and distribution of music.

Getting back to the players in the industry, in respect to the independents record companies, there are two types of them: (i) the major-distributed independent; and (ii) the so-called “true” independent.\textsuperscript{38}

The major-distributed independent is an entity that is likely to make a deal with a major label to perform all functions except recording the records, and the product is distributed either on the independent’s own label or through a record company’s label.\textsuperscript{39}

In turn, a “true” independent is an entity not own by a major record label that distributes the products with an “independent” distributor.\textsuperscript{40}

\textsuperscript{35} Otherwise, it would be impossible to explain how an annoying song like “My Humps” (from Black Eyed Peas) sold 2,203,000 downloads and earned a double platinum certification by the Recording Industry Association of America (RIAA) for master tone sales. See http://en.wikipedia.org/wiki/My_Humps#cite_note-riaa-25


\textsuperscript{38} See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, 66.

\textsuperscript{39} See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, 66.

\textsuperscript{40} It’s remarkable that, as Donald Passman points out, the most of the big independent distributors are owned by major labels (RED is owned by Sony, Caroline is owed by EMI, ADA is owned by Warner and Fontana by Universal). See PASSMAN, Donald S. All you need to know about the music business”. Eighth Edition, 67.
Nonetheless, either the artist enters into a deal with a major record label, a major-distributed independent or with a “true” independent the standard functions that a record label is supposed to provide to an artist are, according to Patrick Burkart and Tom McCourt, the following:

(i) Recruiting artists;
(ii) Providing capital to cover recording costs (among other costs);
(iii) Managing the recording process;
(iv) Manufacturing, promoting and advertising of CDs;
(v) Distributing records;
(vi) Performing revenue and royalty accounting functions; and
(vii) Enforcing copyright.  

In the abovementioned scenario, record companies (specifically, major record companies) also performs the role of being the gatekeepers of the market, since in most of the cases an artist has to get into a record deal with a major record label in order to gain market presence and to have capital allocated. In spite of the fact that digital distribution of records has evidenced that manufacture and distribution of physical records is unnecessary these days, an artist still needs money to set up the advertisement of records and promote its music.

It is true that the artist might get a deal with an independent record company but the likelihood of selling records and get known by the public would be substantially reduced, since the market presence of an independent record company is not as wide as the major labels.

For now it is important to remark two facts related to the major record labels: (i) they limit the production of music; and (ii) they hold a substantially different interest rather than the artist’s in the business.

The latter is moreover reflected in certain aspects of the business. If an artist wants to market a song, he or she has to enter into an agreement with a record company by

\[41\text{ See Patrick Burkart and Tom McCourt, Digital Music Wars, Ownership and Control of the Celestial Jukebox, 18-19.}\]
means of which the artist receives a certain amount of money to cover the recording costs and once he or she gets the songs recorded delivered them to the record company, also giving up control of the records and income from different sources.

Furthermore, if the artist’s genre is a mainstream one such as rock or pop, it has better to get a record deal with a major record label if the artist wants to achieve success because the record labels are the only players who have the structure and the capital to promote an artist in a wide market.

Of course, an artist can play songs for his family and friends, record a demo and distribute it, and play in bars; it depends on the artist motives. The problem is that if the artist wants to have a huge market presence it is necessary to get access to capital and that is what record companies primarily offer.

It is possible for an artist to build a considerable fan base and promote its music through the iTunes, YouTube or Amazon or any other physical or digital retailer but faces a huge problem that is the capital requirements: recording, promoting and distributing of a record, even over the Internet, costs money, not as much as the past decades, but costs money in the end. The recording costs vary pursuant to the type of intermediary. In a standard record deal with a major label the recording costs typically run from $80,000 to $150,000; in self-produced work a few thousand dollars.

Assuming that an artist wants to get into a record deal, still there are two intermediaries more in the chain involved in the business and that further have a share: the physical distributors and retailers.

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42 Record labels are not even involved in the recording process.
43 See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, 69.
44 An interesting alternative is given by TuneCore and The Orchard. Tune Core puts artists’ music on iTunes, Amazon, Spotify and many other digital stores, collects the revenues and give the artists 100% of the money from their music sales along with detailed streaming and sales reports. See http://www.tunecore.com. The Orchard distributes not only music (physical and digital) but videos and films; and takes a percentage of the sales. See http://www.theorchard.com/music-distribution.
After the artist signs a record deal, the record company enters into an agreement with a distributor, whose main functions are basically aimed by selling copies of the records, both physical and digital versions, to the retailers. For example, if an artist signs a record deal with Columbia or RCA Records, the company who would distribute the record would be Sony.46

In this regard, it is important to point out that the major companies’ records are distributed by major distributors exclusively, that are the ones who coordinate the distribution either digitally or physically, in the latter case getting the records from the manufacture plants to the retailers.

Moreover, the distributors coordinate the distribution and deliver of the records to the retailers as well as store records in warehouses, make shipments, undergo inventory controls, and so on.

Finally, the retailers sell the records to the consumers. The retailers are the so-called “brick-and-mortar” record stores, the so-called “big-box retailers”, such as Walmart, Target and Best Buy, and the online retailers, such as iTunes and Amazon. Through these commercial channels consumers purchase recorded music.

By the time the records arrives to the retailer, the major record label had set up the structure to advertise, promote and market those records so as to generate the necessary revenues to initially cover the costs (which basically is the amount of money given to the artist as an “advance”) and then generate profits for the record label and, sometimes, for the artist (which is called “royalty”).47

46 See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, 66.
47 See PASSMAN, Donald S. All you need to know about the music business”. Eighth Edition, 85.
In a nutshell, the proceeds resulting from a record sale generally are divided among four players: the artist, the producer and mixer, the record company, the distributor and the retailer.

This business structure is not only set up in the sole interest of the major record labels but it is also inefficient since it provides opposed interests between the artists and its intermediaries, either the intermediaries are the traditional ones (major record labels and independents record companies), or the new intermediaries (Internet-based intermediaries).

Moreover, the structure of the business has been designed primarily for the sale and purchase of physical recorded music, an obsolete structure that not only assumes per se that consumers actually go to stores to buy records but also requires large amounts of capital in order to be maintained: to transport goods in the market place a company has to consider warehousing, shipment, inventory controls, sales force, financial controls and the like, and that requires a lot of working capital.

The transaction costs of the physical intermediation has an impact on the company’s rate of return which means that someone would have to pay for it, either the artist or the consumer.

In light of the functions listed above, the record companies basically act as both an investor and a manager of the artists’ works; they paid for studio time, mixed and mastered records, set up the advertising, promoted the songs and provided money to the artist, in order to accomplish the project.

The role of the record companies was of a fundamental importance in the past decades. But, as previously mentioned, it represented a problem for a lot of artists, as they had either to have a very marketable song to sell or a very smart agent (which costs money) to get a record deal.

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48 For the sake of clarity, the analysis of the proceeds resulting from the copyright issues is excluded.
49 According to D. Passman, nowadays, most recording agreements are structured as funds i.e., an amount of money that includes the recording costs and amounts payable to the artist as an advance. See PASSMAN, Donald S. All you need to know about the music business. Eighth Edition, 93.
“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

Physical distributors and retailers’ functions have irremediably been lost. Distributors neither need a warehouse to store inventory nor deliver physical CDs (and burden any of the costs whatsoever associated with it). Now music is easily distributed digitally and it is, as previously mentioned, generally listened in portable devices and in streaming channels over the Internet. This represents an increase of the consumers’ welfare but also a huge loss for the record labels. The gist of the loss of the record labels consists of its organizational costs. Record labels can actually sell records digitally but the revenue of digital sales does not cover its costs, as the business model based on CDs sales did. 50

The incorporation of new technologies simplified the process for making music and some of these functions were swept away by the Internet-based intermediaries, leaving the record companies with the solely function of acting as a mere capital aggregators, performers of advertising campaigns and promotion functions 51 and holders of a discouraging balance: an enormous and inefficient structure that cannot burden its costs preventing record companies of being competitive.

It might be concluded that due to the technological impact some of the traditional intermediaries in the business are not necessary anymore and, therefore, conclude that as a result of having fewer players in the game the share for the remaining ones would be bigger and further consumers would be better-off since music is cheaper. And just then, where one most felt it was right, it would be wrong.

Why does an artist need a record company? Basically, they need them to finance the project and to perform advertisement campaigns. So, why do not they enter into a loan agreement with a bank and with a service agreement with a media agency? It is because no one of the other capital aggregators would assume the risk. Therefore, the market provides a negative externality that it is not likely to be internalized.

"Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace"

The problem with the music business is the diverse incentives the parties hold as a result of entering into a contract, whether such intermediary is a major record label such as Sony, or a digital distributor such as iTunes. It is true that the new intermediaries have come to lower costs because they make distribution cheap and easy and perform the matchmaking functions, but it is also true that they carry the same problem as the intermediaries of the Old Model; that is, they have a diverse interest in the business.

A preliminary conclusion might be drawn. The existence of an intermediary imposes certain costs. Hence, it is necessary to determine what legally an intermediary is and its incentives.

3.2 The legal nature of an intermediary.

As evidenced from Section 3.1, the music industry, as structured as of today, holds a peculiar characteristic: it involves several parties.

This phenomenon exists due to how the ownership interest on songs and records is allocated among the players and, further, the different sources of income and costs that the trading of rights generates. The ownership interest is set forth in the Copyright Act and it is exclusively in the side of the major record labels.\(^5\)

Furthermore, within the wide variety of players in the business there are many intermediaries involved with between the music bands and consumers of music.

It is necessary to bear in mind that not all the players are intermediaries in the business, and, further, not all the intermediaries are important for the purposes of this analysis.

For instance, the performing rights organizations are intermediaries in the music business but are completely irrelevant for the purposes herein considered, since the relationship entered into between the parties, i.e. songwriter and a publisher, does not involve in any event whatsoever a consumer of recorded music.

Thus, many aspects of the music business are important but not all of them will be considered. The main purpose of this paper is to analyze the relationship existing between the entities acting as intermediaries between the music bands and the consumers of recorded music so to suggest a desirable term to bind the bands with the new intermediaries.

In order to accomplish such purpose, it is necessary to determine first what an intermediary is, then whether this intermediary is necessary in the new market and, finally, how the relationship between the music bands and the intermediaries might be structured so as to intent to suggest a basis for a profitable business model that pursue efficiency by lowering costs, fostering competition, and increasing social welfare.

An intermediary is a “mediator” (noun), or the act of “acting between two persons” (adjective) and, in the case of the music business, for a consideration. When referring to an intermediary in this paper this paper is referring to the person, whether natural or legal entity, that mediates and further acts between the artist and the consumer for the purposes of selling records to the latter.

This “acting” is performed nowadays by the record companies, distributors, and retailers, in any case either physically or digitally. These companies intermediate between artists and consumers.

In addition, intermediation is supposed to add value to an exchange process, or otherwise it would not exist. Furthermore, an intermediary is supposed to reduce transaction costs.

An intermediary is often treated as tantamount to an agent. In fact, the Organization for Economic Co-operation and Development (OECD) defines intermediation as “the process by which a firm, acting as the agent of an individual or another firm, leverages its middleman position to foster communication with other agents in the

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marketplace that will lead to transactions and exchanges that create economic and/or social value.”55

There are many reasons that explain why an intermediary appears in this business, but it might be useful to recall two of them, that are distinctive: musicians’ lack of knowledge on how to run the business (fundamentally, advertising and promotion) and the difficulties in accessing to capital. This is the factual basis that justifies its mere existence and the reason why an agreement between the parties is entered into.

From a legal perspective, it might be claimed, as the OECD does, that an intermediary is actually an agent.

An agency relationship is defined by Restatement of the Law (Third) Agency. Pursuant to Section 1.01 of such Restatement: “Agency is the fiduciary relationship that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”

Therefore, a principal-agent relationship exists upon fulfillment of three requirements: (i) agreement or assent between both principal and agent; (ii) benefit for the principal; and (iii) control exercised by the principal over the agent.

In the relationship between an artist and an intermediary, where the artist is the principal and the intermediary is the agent, it is likely to have the former two requirements fulfilled but not often the latter. The “control” element has to be analyzed in a case-by-case basis in order to be determined, since it depends in its entire existence on the provisions of the eventual agreement, if any.

Anyway, considering the fact that the record companies are the ones which hold the bargaining power in the negotiations it is highly unlikely a principal-agent relationship to be assessed since the record companies impose the terms of the contract pursuant to its very own interests.

“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

Therefore, an agreement between the artist and the intermediary does not necessarily involve a principal-agent relationship and, therefore, it consists of a mere agreement.

Why is important to assess the legal nature of the relationship? It is because of the incentives that arise from such relationship. If it is likely to have a principal-agent relationship between the parties the interests between them will be better-off aligned than in a mere agreement and thus there would be no need to consider how the relationship should be structured because the law would have already imposed the conducts due (and presumably desirable) between the parties, especially considering the fiduciary duties due from the agent to the principal.\(^{56}\)

Notwithstanding the foregoing, since the principal-agent relationship is contingent on the existence of control exercised by the principal and, moreover, the relationship between the parties consists of a mere agreement, generally written in favor of the record companies, it is likely that certain costs arise under it.

These costs are transaction costs that result from the negotiation of contracts between the parties, from search costs, from performing of duties imposed by those contracts and from monitoring and enforcing certain obligations.

As mentioned, the music business holds a peculiar characteristic, it involves several parties. This also has a lot to do with the transaction costs, because it increases them. In a two-part negotiation the link to connect both parties is one; if another party is added the link increases form one to three; and if another party is further added the links that connect the parties increase from three to four, and so on. This argument is sustained by Posner, who precisely claimed that adding a party to a transaction increases the costs of transacting exponentially: “The formula for the number of links require to connect up all the members of an n-member set is n(n-1)/2 […]. If all the costs of the more complicated transaction were borne by the parties, it would hardly be a matter of social concern. But

\(^{56}\) There are costs arising from a principle-agent relationship, certainly, but they are likely to be minimized.
some of the costs are borne by the taxpayers who support the court system, and the
courts are not enthusiastic about this [...]". 57

All of these costs have, naturally, a direct impact either on the price of recorded
music, raising it, or on artist’s revenue, lowering it. An intermediary, in this scenario, i.e., a
world of contracts, does not add value whatsoever; it actually destroys it because increase
costs exponentially. As Section 4 describes, these costs are reflected in any record deal
entered into by the artist and the record company.

The preliminary conclusion would be that the very existence of an intermediary as
described in the music business implies costs that moreover should be avoided. These
costs arise because the intermediary has a distinctive and different interest rather than
the artist in the business; whereas the artist wants to make a living with its music a record
company wants to maximize its shareholders’ welfare; managers have to somehow
 guarantee a return to attract capital or otherwise the company would face financial
distress.

The new Internet-based intermediaries not only perform better the functions hold
by the record companies and physical distributors, but reduce the price of recorded music
due to the implementation of digital technologies. However they bear the same costs
since they hold the same role as the former intermediaries.

4. The costs of negotiating contracts.


Artists and record companies hold different interests that, moreover, are not
aligned. Music bands basically pretend to make art with their music, and profit-seeking is
not necessarily the principal motive in doing so, whereas in a record company such motive
is mandatory since it is a fiduciary duty imposed by law to the managers who run those
companies.

As mentioned, the mere fact that those interests are not aligned encompasses
transactional costs that, from a legal standpoint, might be avoided.

57 Frandsen v. Jensen-Sundquist Agency, Inc. 802 F.2d 941 (7th Cir. 1986).
Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace

The parties have to come to terms in a wide variety of issues when entering into a contract, and unless the music bands do not care at all about what the record agreement sets forth, they will try to negotiate the best terms they can.

The terms included in a standard agreement between both parties shows this trade-off of the parties’ interests and the costs resulting from it. Therefore, in order to support this idea, I will list and briefly explain some of them, as follows:

a) **Term:**

Often the agreement sets forth that the term of the contract is either the time needed to record one album or one year, and generally an option to renew for additional periods of one year each (generally up to 5 years or so) is granted in favor of the record companies.

This means that the company is committed to record one album (called “firm” album) and may request, at its sole discretion, the artist to record one or more albums (called “option” albums). Furthermore, it must be considered the contract term has unquestionable relevancy since the agreement always imposes exclusivity to the artist in favor of the record company.

Most of the artists try to avoid the inclusion of these options since they limit the scope of its business and authorize the record companies to get out of the deal if the artist is not a success. Thus, these kinds of options are included in the sole benefit of the record companies.

Any option in a market has a value. In the case of the artists’ record deals, its value consists of the opportunity cost (meaning the value of entering into another record deal with another record company). Nevertheless, record companies do not pay for such costs.

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58 See PASSMAN, Donald S. All you need to know about the music business”. Eighth Edition, 104.
59 Also, the agreements often provides that even if the company fails to timely exercise the option, the company shall nevertheless have the right to exercise that option unless the artist provides written notice to the company that the option has not been exercised and the company then fails to exercise the option within ten (10) business days after its receipt of that notice. As clearly this clause suggests, it is very difficult for the artist to get out of the deal once entered.
options. The best deal an artist might get is to introduce an escalation to its royalties, but it would be highly unlikely to exclude them from the agreement. The basic compensation to the artist does not represent payment for the options because the record company cannot know beforehand whether the artist would worth the advance (and thus to know if they should exercise the option for more albums) and therefore would not pay for an option that is uncertain to be exercised in the future.

b) **Delivery:**

Artists have to deliver to the record companies, within the term provided thereof, the recordings.

When defining “deliver”, it is often stated that it includes -among other several other requirements- the master recordings in a production-ready format consistent with the company’s requirements, “commercially” and “technically” satisfactory to the company for its manufacture and sale of records.

This provision implies that the record company always decides whether to accept the recordings or not. Of course, it directly depends on the extension of the delivery requirements assumed by the artist in the agreement. The standards may vary from time to time; if it is a “commercially satisfactory” standard (the company only has to take the recordings it believes will sell) or a “technically satisfactory” standard (a recording that, as the very word suggests, is technically satisfactory, so the company cannot request for changes).

The reason why the companies request control on the recordings is somehow reasonable. They are supposed to know what the consumers like and try to adapt the product as much as possible to those preferences. But that also generates transaction costs. If companies do not like the recordings, they request the artist to record it again according to whichever the requirements are to be fulfilled, at the artist’s sole expense.

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60 See PASSMAN, Donald S. *All you need to know about the music business*. Eighth Edition, 106.

61 See PASSMAN, Donald S. *All you need to know about the music business*. Eighth Edition, page 110, 111.
c) **Advances:**

The advances are the principal function performed by record companies. Under a record agreement the record company commits to pay a certain sum of money to the artist that is supposed to be used by the artist to cover recording costs and the like.\(^{62}\)

The advances are commonly treated as a prepayment of royalties due to the artist. Moreover, the record company keeps the artist’s proceeds until the total amount given to the artist is covered (commonly known as “recoupment”).\(^{63}\) In other words, the artist will not receive any royalty at all until the record company has recouped all the advances made, and what is more important, the company is likely to recoup most of its costs from the artist’s share.

Notwithstanding the foregoing, this provision is commonly justified on the ground that the company bears all the risk when allocating capital to artists. This is not in fact totally true. By the time the parties entered into a record deal the possibility for the artist to fail in selling records has been already appraised by the record company. In fact, if the company is committed to provide any advance at all is simply because it has a high level of certainty that the artist will succeed in selling records. Otherwise, it would allocate those funds in another band.

d) **Reserves:**

The agreement usually sets forth a right in favor of the record companies that is called “reserves”. As the physical recordings are sold on an entire returnable basis, the company holds an amount of the artist’s royalties until they do know if the recordings are effectively sold. So, even if the artist is entitled to receive any royalty for a record deal it has to discount, at least until liquidation, the reserves due to the record company. This

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\(^{62}\) When the advance includes the recording costs it is called “fund”.

\(^{63}\) See PASSMAN, Donald S. *All you need to know about the music business*. Eighth Edition, 83.
means that the artist is not paid and moreover it is not compensated for the time he or she could not use those funds.64

d)  **Artwork and packaging:**

   All artwork is generally produced or controlled by the record company’s in-house artwork department.

   Also, the agreement usually provides that any amounts incurred by the record company in excess of the applicable artwork budget or in excess of the company’s then-current standard packaging costs shall be the artist’s responsibility.

e)  **Copyright:**

   As mentioned in paragraph (b), the artist has to deliver recordings along with many other rights.

   Moreover, the artist has to deliver all necessary licenses, permissions and clearances as well as the all mechanical licenses for each musical composition embodied in the master recording in favor of the record company.

   Furthermore, it is provided that the masters shall, for purposes of copyright law be deemed a “work made for hire” for the company by the artist, and all other persons rendering services in connection with the masters and the company has the right to obtain registration of the copyright (and all renewals and extensions) in each master, in the company’s name, as the owner and author thereof.65

   By entering into the agreement, the company has the exclusive, perpetual and worldwide right to manufacture, sell, distribute, advertise, license, publicly perform and exploit the music records.

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64 See PASSMAN, Donald S. *All you need to know about the music business*. Eighth Edition, 102.

65 If any masters are deemed not to be “works made for hire,” the agreement is likely to constitute an irrevocable transfer to the record company of ownership of copyright (and all renewals and extensions) in those masters.
“Desirable terms to bind bands to new kinds of intermediaries in the Internet-based marketplace”

The sections of a standard record deal described above show that the record company has an entirely different interest rather than the artist and that there are costs resulting from the control exercised by the record company.

No matter whom the artist is, the record company wants to get as much as possible from the artist’s share (and this desire has become more aggressive in the current business’ downfall), and artist does not necessarily want to sell its music as a commodity.

This is structure, i.e. an agreement between the parties, is inefficient. Record companies, as any company, have a fiduciary duty towards to the shareholders to maximize the company’s profits and, therefore, they need to comply with their own capital requirements (specifically, with a specific rate of return).

The incentives between the parties are badly aligned and because of that there are substantial transaction costs arising from the relationship.

Furthermore, the new Internet-based intermediaries do not solve the problem; they just represent a temporarily change of figures. It is true that now is more easily to record songs and distribute them through online retailers but it is also true that the new intermediaries have the same problem as the old model: their very own interest.

Also, it is important to bear in mind the fact that currently these new intermediaries deal directly with the record companies (and not directly with artists) in order to distribute records through the Internet so the contract terms reviewed above are likely to appear.

As long as the interests between the parties are not somewhat aligned, the business structure would be inefficient and either artists or consumer will bear all the costs resulting from the agreement and from the relationship arising under it.

Therefore, what is necessary is to determine whether any other way is possible to bind artists with its intermediaries. But first, we need to analyze who these new intermediaries are and what they add to the business.

The OECD claims that the main functions of Internet intermediaries are: (i) to provide infrastructure; (ii) to collect, organize and evaluate dispersed information;
(iii) to facilitate social communication and information exchange; (iv) to aggregate supply and demand; (v) to facilitate market processes; (vi) to provide trust; and (vii) to take into account the needs of both buyers/users and sellers/advertisers.66

These functions are well and better performed by the new Internet-based intermediaries rather than by the record companies and physical distributors and retailers. Undoubtedly, the Internet-based intermediaries add value to the process. Still, as anticipated above, there are certain transaction costs arising from any agreement entered into an artist and an intermediary. It is necessary to figure out how to minimize such costs, if possible, and the first question to answer is whether an artist needs an intermediary at all.

4.2. Are the intermediaries needed?

The digitalization of contents has come to lower costs of producing and distributing music records and created a healthy environment for the Internet-based intermediaries to offer its services. This implies two effects.

First, those independent record companies are getting more opportunities in the market and becoming more relevant in the business, and so are the indie artists. As noted previously, the major record labels are focusing on the artists that are able to enter into big record deals that guarantee a desirable return. However, the issue is that as the independent record companies are becoming more important they are highly likely to reflect some, if not all, of the terms described in the record deals with the artists.

Anyway, we concluded that whether dealing with a major record label or independent record company, there are transactional costs resulting from entering into an agreement between music bands and the intermediaries.

Second, there are new intermediaries in the business. Artists do not necessary require a major distributor and physical retailer to market a record since the new players on the Internet-based marketplace offer a cost-effective way of performing some of the

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functions formerly hold by traditional intermediaries. Artists, by entering into an agreement with these new intermediaries, are able to distribute their records over the Internet.

The question is, does an artist need a record company at all? Moreover, does an artist need an intermediary at all? To answer these questions it must take into account the short run and the long run.

In the short run, an artist needs an intermediary, either a record company and an Internet-based distributor, or both.67

The only reason why a record company exists nowadays is simply because record companies are the only ones who allocate capital for the production of records and have the structure to promote them. As soon as the market provides an alternative way for getting capital allocated, record companies will disappear.

Moreover, as soon as artists get access to the technology used to perform the “matchmaking” function and the advertisement on the Internet, they will do it by themselves, and probably the Internet-based intermediaries would allot their business in other field rather than music.

In the short run, until new ways of financing records show up, artists do need record companies. But why an artist does not record its songs and just distribute them through the online channels splitting the income only with the digital retailer? Is there any problem with that structure? There are many, indeed.

As I mentioned before, the genre matters a lot. If the artist’s genre is the so-called “mainstream” it is likely to require a lot of capital for the recordings and to set up a huge advertisement structure to promote the record, and the Internet-based intermediaries do not finance projects, do not have the expertise for promoting (as an artist needs to) and it is very difficult to get access to capital in the market.

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Secondly, if the artist is a so-called independent, it has a huge problem: every single indie artist is doing the same thing. There are thousands of independent artists trying to get their music known through the Internet and to sell records. As the costs lowered, the supply increased having the market become more overcrowded and therefore competitive. Artists need someone who dedicates time to promote records and to perform the matchmaking function. And record companies do that very well.

Third, the most forceful reason is a factual one: new intermediaries deal directly with the record companies and not with the artists. In order to get a deal with any of the Internet-based intermediaries nowadays the artist need to get into a deal with a record company.

The new intermediaries have already provided for a solution to the search costs’ issue but do not solve the problem of having costly agreements that someone would have to pay. The problem with the new technologies is that even though they have lowered costs by reducing the cost of recording and distributing music, and also solved the search cost problem, the business is still requiring a contract model because the market does not provide a solution for the financial and advertisement requirements of the artists. In the short run the business must face the inefficiencies resulting from agreements.

To conclude, in the short run there are transaction costs arising from the very existence of an intermediary in the relationship between the artist and the consumers that the new technologies cannot prevent.

In the long run an intermediary should not exist. The following Section V explains why.

5. Desirable terms to bind bands to new kinds of intermediaries.

So far it has been identified distinct costs resulting from entering into an agreement between the music bands and its intermediaries, whether the intermediary is a traditional one, or an Internet-based one.

In the so-called traditional model -basically, a contract model- the interests between the music bands and its intermediaries are not by any means aligned and,
therefore, there are transactional costs resulting from the negotiation and execution of the agreement that increases the price level of the output and is further burden by the parties.

In this scheme, there are two distinct costs, as follows: (i) negotiation costs in entering into contracts and performing the duties arising thereof; and (ii) cost of capital.

On the other hand, in spite of the fact that the cost of producing recorded music has substantially lowered, from a general standpoint music bands still need to get capital allocated to finance the production of music and to promote and advertise their music, both elements that musicians lack and cannot get access to from other source than record companies.

Therefore, it is suggested that these costs are likely to be burden by the parties and consumers in the short run, since the lack of alternatives that the market provides to finance projects in the music business.

Moreover, as mentioned, in the long run the intermediaries should not exist at all. By stating that it is assumed that there is an efficient way of structuring the business; a business model without contracts that promotes music as an art instead of music as a commodity, with simple ways of trading rights, with new capital aggregators, and focused primarily on artists.

The proposal would be that single entities - firms, such as corporation or a limited liability companies- owned by different music bands should manage all the rights on songs and recordings, finance projects, set up the advertisement structure, and further deal directly with consumers.

According to this approach, the intermediaries must be eliminated so as to eliminate the transaction costs pointed out above and to increase the revenues for the artists.

Furthermore, music bands should be shareholders and/or members, as the case may be, of the company, and therefore be entitled to, pro rata or as the negotiation process would result, the ownership of the company’s equity. The benefit of having
different music bands as shareholders is that the firm might achieve benefits from the economies of scale.

Moreover, these legal entities should be managed by ex-managers and officers of the major record labels so that the company might take advantage of the expertise and know-how to be provided by them. Thus, a new labor market will blossom.

The principal and obvious benefit of having a company is the limitation of personal responsibility of the members. As it has been recognized, the “law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability.”

Notwithstanding the foregoing (the most intuitive reason), there is an important element that a legal entity might provide to the business. The existence of a legal entity allows the parties to save certain costs that otherwise, in a relationship arising under a mere contract, are likely to be borne.

Nowadays, the relationship between the music bands and its intermediaries and the transactions resulting therefrom are likely to be governed by market conditions. This market conditions impose costs such as the ones resulting from the negotiation of contracts between the music bands and the intermediaries that are further reflected in the price of recorded music, increasing the price of the output.

According to Ronald Coase’s theory explained in its work “Nature of the Firm”, a firm might avoid these costs under certain circumstances.

Coase proposed to define a firm from a realistic point of view and thus somehow challenging the idea of an economic system under no control, working by itself, considering, paraphrasing Sir Arthur Salter, a system where: “supply is adjusted to demand, and production to consumption, by a process that is automatic, elastic and responsive”.

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Moreover, his idea assumes that in a system coordinated by the “price mechanism”, where direction of resource relies upon the market and production is coordinated through the market, there are certain costs arising from it.

Within a firm, these market transactions are substituted by a person (“entrepreneur”), who directs production and therefore those costs are saved.

It is costly to organize the business through contracts, as our case suggests. When a music band enters into a contract with an intermediary the relevant prices are unknown (or, what is the same, fixed by record companies without any basis whatsoever).

Moreover, a purchaser of recorded music is paying more of what the record music worth or an artist is getting fewer revenues that the ones deserved.

These costs, as repeatedly mentioned, arise from having to negotiate contracts. Parties have to come into terms to get into a deal and that certainly represent inefficiencies that are pass through to prices of recorded music.

As Coase suggested, these costs can be reduced but never be eliminated at all:

“Again, in certain markets, e.g., produce exchanges, a technique is devised for minimizing these contract costs; but they are not eliminated. It is true that contracts are not eliminated when there is a firm but they are greatly reduced.”

The gist of music business is songs. An artist needs a person who supplies a service that basically fulfills two requirements: (i) allocates capital; and (ii) manages the business. An artist might do so within a firm, not using the market.

Coase claimed that “when the direction of resources (within the limits of the contract) becomes dependent on the buyer in this way, that relationship which I term a "firm" may be obtained”. That is exactly the case. As the direction of the resources depends on the artists it is more efficient to structure the relationship with the

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intermediaries through a firm. When artists allow some authority to direct their resources certain transactional costs are saved.

6. **Conclusion: Re-thinking of the music business and property rights.**

The proposal that Section 5 states it has to be considered just as simple suggestion and, therefore, must not be deemed as a unique solution to the challenges posed by the new technologies in the music business.

These challenges are very difficult to sort out. The evidence is that any solution has not come up from the very market for entrepreneurs, artists, and consumers.

Notwithstanding the foregoing, in order to approach to consider the problem it must be established what the purpose of music is.

Music is art. As such, it is an expression of the human spirit and of its capability of creativity and freedom. Therefore, law has anything to do with it at any respect whatsoever. It is a market issue that the market and its actors have to deal with exclusively.

Regulations imposed by the Government, particularly Copyright, not only have proven to be unenforceable but to be utterly inefficient as they represent an immense burden for the entire society.

This burden consists of costs. First, the costs of the lawsuits to be brought up to enforce rights. Secondly, the costs of monitoring the market in order to assess infringements and take actions against them. Third, the cost of the governmental bureaucrats.

It is claimed that Copyright seeks to “promote literary and artistic creativity by protecting, for a limited time, what the U.S. Constitution broadly calls the writing of authors”. Copyright does not protect art. Conversely, Copyright protects a particular way of doing business with recorded music for a few major record labels. Copyright neither promotes creativity nor foster competition. Such legal protection, if any, constitutes a

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monopoly on ideas. In the matter of fact, it might be claimed that Copyright prevents originality and transforms music into a commodity and spiritual experience into a mere consumption matter.

Provided musicians are able to make a living with its art, no matter what the source of income is, generally they want to spread their work and perform their songs for an audience.

Sharing is something natural and distinctive in human being and, further, it is the essence of any art.

That could be an interesting and challenging beginning to start thinking of a new business model for the music business.

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