2006 Lawyer-to-Lawyer Referral Guide

Los Angeles Lawyer

June 2006 / $4

EARN MCLE CREDIT

Inadvertently Produced Documents
page 33

Royal Treatment

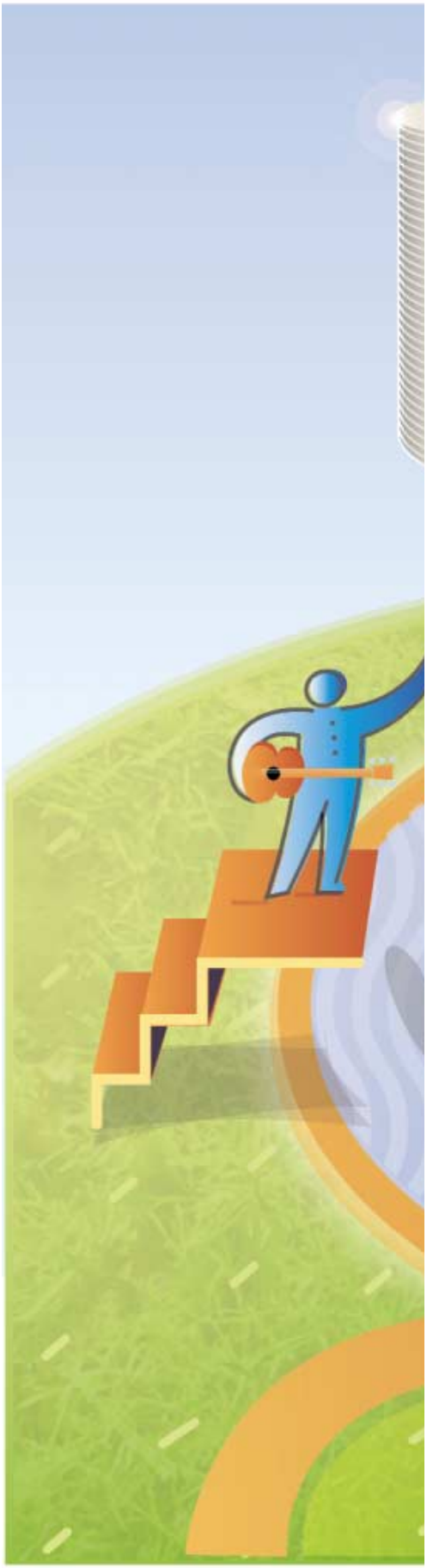
Abhay Khosla and Steven T. Lowe explain the difficulties faced by artists seeking unpaid royalties page 24

PLUS

by
STEVEN T. LOWE & ABHAY KHOSLA

Royal TREATMENT

WHILE MANY LEGAL REMEDIES MAY EXIST TO COLLECT UNPAID MUSIC ROYALTIES, ARTISTS MAY FIND THEMSELVES STYMIED IN THE ABSENCE OF A FIDUCIARY RELATIONSHIP



KEN CORRAL

On May 4, 2004, a two-year investigation by New York State Attorney General Elliot Spitzer into record industry royalty payments ended with a $50 million settlement paid to thousands of artists.[1] Spitzer claimed that major U.S. record companies failed to maintain contact with artists or their estates and, therefore, failed to pay royalties that were due.

Record companies, however, face a difficult accounting challenge to fulfill their royalty obligations, one that has grown more complex as online sales of music have increased. In commenting on the challenge, the chief information officer of Warner Music Group stated: "It's a huge transactional nightmare. The number of contracts is in the thousands, and each one is different. And there is no off-the-shelf software that can scale to what we're talking about. This is tens of millions of transactions a month."[2] While this assessment may be true, the Spitzer settlement confirms, as many recording artists have long suspected, that a complete failure to pay royalties due and owing to artists, producers, and songwriters remains a significant problem.

Artists usually have the right to audit the books and records of the distributor, but this may be insufficient—and litigation may be necessary. Indeed, on December 16, 2005, the Beatles sued the EMI Group and Capitol Records after an audit allegedly revealed an astounding failure to pay royalties of $53 million.[3] Record companies like EMI claim that such disputes are a result of true differences in contractual interpretation.[4] However, critics— including the California Senate Select

Steven T. Lowe is the owner of Lowe Law, a professional law corporation specializing in entertainment and business litigation. Abhay Khosla is an associate with Lowe Law.

Committee on the Entertainment Industry—contend that artists are forced by the record companies to sue so that record companies can settle the lawsuits at a discount.[5] In fact, the committee stated that record company accounting departments appeared to be guilty of, at a minimum, "purposeful neglect."[6]

The committee probably is correct, since California law provides no penalty or other disincentive for underpayment or nonpayment of music royalties. In order to prevail in a lawsuit for royalties, attorneys must understand the different sources of royalties as well as the various causes of action available to an aggrieved recording artist, producer, and songwriter.

Sources of Royalties

Artists are entitled to multiple types of royalties for any composition or sound recording.[7] While the right to receive royalties may vary from contract to contract, the sources of income to creative participants in the music industry fall into the following general categories: artist/producer royalties, mechanical royalties required by the Copyright Act, synchronization fees, master use licensing fees, fees for Internet use, and public performance royalties.[8]

A "sound recording" usually is created by an artist and a producer, and both jointly own the copyright to the work. Typically, the copyright to the sound recording is assigned to a record company in return for an agreement by the record company to pay advances and royalties.[9] Artist and producer royalties generally are computed by a complicated formula based upon the retail price and number of copies sold.[10] However, the artist and producer are not entitled to any royalties until the advances paid to them have been recouped by the record company.[11]

Copyright owners of compositions are entitled to mechanical royalties pursuant to Section 115 of the Copyright Act.[12] This provision allows record companies to record and manufacture records pursuant to a "compulsory license" provided that they pay a royalty to the owner or owners of the copyright in the composition.[13] Under the compulsory license, the mechanical royalty is fixed by law at a flat rate per song per record made and distributed. As of January 1, 2006, the flat rate is 9.1 cents or 1.75 cents per minute of playing time or fraction thereof, whichever is greater.[14]

Under a compulsory license, royalties are due whenever records are considered "made and distributed."[15] However, compulsory licenses rarely are used in practice, as most music publishers and record companies opt to employ "negotiated licenses" and "controlled composition" clauses that require mechanical royalties to be paid for records sold, or paid for and not returned—and only require the payment of royalties at 75 percent of the "statutory rate."[16]

A synchronization license must be obtained from the publisher anytime a musical composition is used in conjunction with an audiovisual work, such as a movie or television show.[17] Customarily, these licenses provide for a one-time fee to include the composition in the work and, sometimes, a royalty for the sale of a DVD or VHS tape of the audiovisual work.

The use of a sound recording in an audiovisual work also requires a master use license from the copyright owner of the sound recording. Usually, master use licenses are obtained directly from the record company that owns the copyright to the sound recording. Master use licensing fees are similar to fees for synchronization licenses. The key difference is that these fees are paid to the owner of the sound recording rather than the owner of the underlying composition.[18] Master use licenses also are required when the sound recording is "sampled" and used in a different sound recording.[19]

Music may be downloaded legally through the Internet. Internet downloads are treated in a similar manner to the sale of a CD—that is, each transaction is divided among the distributor, the songwriters, the producer, the artist, and the label. Artists must be wary of labels that charge for "packaging deductions" despite the fact that Internet downloads quite obviously do not involve any physical packaging.[20]

Compulsory licenses in the Internet context are referred to as "DPD licenses"—DPD being the initials for digital phonorecord deliveries. DPD license fees are paid at the maximum mechanical royalty statutory rate.[21] For recordings produced pursuant to contracts entered after 1995, the law prohibits a controlled composition provision of the artist's contract from discounting the compulsory DPD rate. Therefore, for these recordings, even if there is a controlled composition clause in the contract,[22] a singer-songwriter should receive the maximum statutory rate for downloads.[23]

In addition to Internet downloads, artists should monitor "nonterrestrial" radio. On February 6, 2004, the U.S. Copyright Office designated SoundExchange—a nonprofit organization established in 2003 as a spinoff from the Recording Industry Association of America Inc. (RIAA)—as the sole designated agent to collect and distribute royalties for music transmitted via digital means.[24] These include Internet radio, Internet "Web casts," and the increasingly popular satellite radio services such as XM and Sirius. Because these services are akin to traditional radio, they are considered performances rather than reproductions of the copyrighted work.[25]

Finally, cellular telephone ringtones are an increasingly lucrative area of revenue in the music industry. In the United States, the Harry Fox Agency issues ringtone licenses for its principals, though some publishers prefer to issue the licenses directly to the ringtone providers.[26] Royalties from ringtones typically are the greater of either a fixed amount per download of the song or a percentage of the gross retail receipts.

When music is played on the radio or television, or in nightclubs, live concerts, and retail establishments, the writers and publishers of the composition are entitled to public performance royalties.[27] These royalties are collected by public performance organizations, such as ASCAP and BMI. The way in which these organizations apportion and distribute the moneys they receive for public performances has not been disclosed and remains a mystery.[28]

Underpayment or Nonpayment of Royalties

No California statute explicitly requires a correct and timely payment of music royalties. At the same time, California courts have limited severely the scope of relief and claims available to artists by, among other things, denying artists the ability to pursue causes of action for breach of fiduciary duty in certain situations.

Arguably, an important case in California for artists seeking proper payment of their royalties is *Wolf* v. *Superior Court*.[29] While the *Wolf* case was not an action for the nonpayment of music royalties, its holding might, under analogous circumstances, be applied to that claim. In *Wolf*, writer Gary Wolf pursued a claim against Walt Disney Pictures and Television arising out of the 1988 film *Who Framed Roger Rabbit*. Wolf asserted that Disney underreported revenues (including merchandising) related to the film and failed to pay him his due contingent compensation. One of Wolf's claims was for breach of fiduciary duty. Essentially, Wolf alleged that Disney owed him a fiduciary duty to properly report revenues and pay contingent compensation, such as profit participation. The California Court of Appeal dismissed Wolf's breach of fiduciary duty claim.

The court of appeal held that a contractual right to contingent compensation by itself was not sufficient to create a fiduciary relationship because every contract requires parties to repose trust and confidence in the other to perform. The appellate court also rejected Wolf's contention that revenue-sharing agreements or the right to accountings created fiduciary relationships because the relationship of the parties was akin to a joint venture.[30] In its rejection of this contention, the appellate court analogized that the relationship between royalty recipient and the licensee was similar to a debtor-creditor relation-

ship—a relationship that does not include the existence of a fiduciary relationship.

The *Wolf* decision may be crippling for recording artists. A cause of action for a breach of fiduciary duty may give rise to damages beyond the amounts underpaid, such as general or punitive damages. Without a tort claim, the most an artist can hope to win at trial is simply the amount due. Since record contracts typically do not include provisions for attorney's fees, recording artists usually must settle their claims at a discount, lest they see their royalties disappear or substantially diminish in a blizzard of litigation-related attorney's fees.

There is some hope that *Wolf* will be overturned. In a dissenting opinion in *Wolf*, one of the appellate justices wrote that a fiduciary duty relationship was vital in order to avoid an inherent conflict of interest:

> The opportunity and temptation to cheat are present in the relationship here just as much as in the trustee-beneficiary, partnership, or other traditional fiduciary relationships. Wolf must depend entirely on the honesty and accuracy of Disney in the performance of the accounting function Disney is carrying out for both of them. Every sale of a toy "Roger Rabbit" that Disney fails to include in its report of receipts from exploitation of Wolf's character means less money for Wolf and more profit for Disney. The conflict of interest inherent in this relationship, therefore, is more than apparent. So there appears to be just as great a need to impose a fiduciary duty on the performance of that accounting responsibility in order to discourage Disney "from taking unfair advantage of" its special position as there is for partners who manage a partnership business or for trustees who keep the books for a beneficiary's property interests.[31]

In addition, it is difficult to reconcile *Wolf* with prior case law, in particular those decisions aligned with the longstanding principle that when one party collects moneys for another and has a duty to account for a portion of those proceeds—which is precisely what record companies do—a fiduciary duty exists regarding the party's payment obligations.[32] For example, in *Waverly Productions* v. *RKO General, Inc.*, the California Court of Appeal held that a motion picture distributor that had a written contract with a production company was not a fiduciary "except as to accounting for rentals (proceeds) received from the motion picture."[33] Also, the court of appeal held in *Parsons* v. *Tickner* that assignees of copyrights to songs authored by a recording artist owed duties to the artist's heirs "as fiduciaries of [the artist]."[34]

Wolf has been distinguished in two court decisions, one of which is on review. In *Celador International Ltd.* v. *Walt Disney Company*, the creators of the game show *Who Wants to Be a Millionaire* sued ABC and Buena Vista Television—both subsidiaries of Disney—in federal court for breach of fiduciary duty and other claims.[35] The plaintiffs asserted that a joint venture existed between the plaintiffs and the defendants because the plaintiffs allegedly possessed reversionary rights, merchandising rights, approval rights, and consultation rights concerning the program. The defendants filed a motion to dismiss the claim for breach of fiduciary duty based upon *Wolf*.

The district court sided with the plaintiffs on the grounds that their allegations were sufficient to support the existence of a joint venture or other "confidential" relationship. The district court made this ruling despite a contractual provision between the parties that expressly disclaimed the existence of a joint venture.[36] The *Celador* decision may provide little solace to less established recording artists who, in most cases, will not be able to plead similar rights to support the existence of a joint venture or confidential relationship.

Wolf also was distinguished in a patent case, *City of Hope National Medical Center* v. *Genentech, Inc.*[37] However, in February 2005 the California Supreme Court granted review of the court of appeal's decision and, therefore, the fate of this case is uncertain. The essential issue before the supreme court is whether the contractual relationship between the parties rose to the level of a fiduciary relationship. The appellate court found that the contractual relationship—under which the plaintiff submitted its ideas and research to the defendant, and the defendant was charged with patenting and licensing the ideas—created fiduciary duties that flowed from the defendant to the plaintiff. The court of appeal distinguished *Wolf* on the grounds that literary rights are different than the "secret ideas" the plaintiff transferred to the defendant.[38]

A recent decision in the U.S. District Court in the Eastern District of Pennsylvania suggests a glimmer of hope for artists filing lawsuits in California who wish to plead a cause of action for conversion for the failure to pay royalties. In *Levert* v. *Philadelphia International Records*, members of the O'Jays, a rhythm and blues band, brought a conversion claim against their record company, alleging that they were owed royalties on record contracts dating back to 1972.[39] The defendants filed a motion to dismiss the conversion cause of action, claiming that the failure to pay royalties constituted a debt, and the failure to pay a debt is not conversion. The district court denied the defendants' motion and held that the failure to pay royalties was not analogous to a debt but was actually more similar to a lack of payment by a consignor to a consignee.[40]

The court in *Wolf* characterized the profit-participation arrangement in that case as a debt, but this conclusion was based in part upon a contractual provision stating "nothing herein contained shall be deemed to…create a relationship between [Disney] and [Wolf] other than creditor-debtor."[41] However, in *Cusano* v. *Klein*, a Central District of California court—interpreting New York law—held that a claim for conversion in a case involving an alleged failure to pay royalties could not be maintained if it was "predicated on a mere breach of contract."[42] The additional facts that must be pleaded, at least under New York law, remain unclear. California courts have not

specifically addressed this claim in a factual scenario involving the wrongful withholding of royalties that are due and owing. However, plaintiffs risk dismissal of conversion claims if they are filed prior to an accounting, because conversion requires a specific, identifiable sum to be at issue.[43]

Because punitive damages are potentially available for conversion claims,[44] the *Levert* line of reasoning could be an important development for artists seeking redress for a failure to pay royalties. In addition, attorney's fees are available for a successful conversion claim pursuant to California Civil Code Section 3336. Finally, conversion claims potentially give rise to general damages as well as emotional distress damages.[45]

A breach of contract claim is almost always available when an artist is entitled to royalties pursuant to a record contract.[46] However, most record contracts do not provide for the recovery of attorney's fees or for termination as a result of the underpayment of royalties. In addition, no general or punitive damages are available.

Even when there is no written contract, artists also should be entitled to assert a breach of implied contract claim. In essence, the use of intellectual property implies the obligation to pay for it.[47] Like any breach of contract claim, plaintiffs should be entitled to "expectancy damages"—that is, what they would have received had the contract not been breached. Creative participants also may have a third-party beneficiary claim against the distributor in the absence of a contract.[48]

If there has been a virtual failure of consideration, artists are able to rescind license agreements and pursue copyright infringement claims.[49] However, in *Nolan* v. *Sam Fox Publishing Company*, rescission was denied in a New York case in which 26 percent of the artist's royalties due had been paid.[50]

If the artist or producer has entered into a contract with the record label, copyright infringement claims are an unlikely alternative because some money usually is paid up front as an "advance."[51] Furthermore, recording agreements may contain a clause that provides that in the event of a breach, the artist is limited to its remedies at law and does not have the right to terminate or rescind the contract.[52] Nevertheless, in situations involving a failure to pay mechanical royalties, the Copyright Act provides that copyright owners can revoke mechanical licenses and pursue infringement claims for any subsequent reproduction or distribution of the composition.[53]

If a license to use a copyrighted work is limited in scope, any exploitation of the copyrighted work outside of the prescribed limits also constitutes infringement.[54] For example, in *Frank Music Corporation* v. *Metro-Goldwyn-Mayer, Inc*., a licensee exploited musical compositions pursuant to an ASCAP license for "non-dramatic use" of the compositions.[55] The Ninth Circuit held that the licensee infringed the copyrights to those compositions when it used the compositions in a dramatic work.[56]

Audits and Delayed Discovery

Most record contracts provide for accounting rights. In addition, accounting claims are available as a matter of law when there are complicated accounts and a dispute arises over whether or not money is owed.[57]

Artists who receive incorrect royalty statements may try to pursue causes of action for fraud or deceit, but these causes of action have not found much favor with the courts. In *Cusano*, the court dismissed a fraud cause of action on a motion to dismiss.[58] The case involved one of the songwriters for the band KISS, who claimed that the royalty statements he received were incorrect and thus were fraudulent in their representation of the amount that was due to him. The Central District held that the cause of action for fraud should be dismissed because it merely stated a breach of contractual duties, not the breach of a legal duty independent of the contract.[59] While there is no case directly on point under California law, California courts generally have not allowed fraud causes of action to proceed when the fraud was indistinguishable from the breach of contract.[60]

The failure to pay mechanical royalties, as required by the Copyright Act, is an unlawful practice that may give rise to an unfair competition claim under California Business and Professions Code Section 17200.[61] California courts have consistently interpreted Section 17200 broadly "precisely to enable judicial tribunals to deal with the innumerable 'new schemes which the fertility of man's invention would contrive.'"[62] A successful Section 17200 claim may entitle the prevailing party to attorney's fees.[63]

Often artists are not aware of accounting irregularities until long after they occur. This situation leads to the issue of the statute of limitations as applied to an artist's claims of underpayment or nonpayment of royalties. Record companies have argued that the statute of limitations should run as soon as an incorrect accounting report is released, since it is the artist's responsibility to conduct audits regularly to determine whether any underpayment has occurred.[64] Despite this argument, however, the issue appears to have been resolved. In 2004, the California Court of Appeal in *Weatherly* v. *Universal Music Publishing Group* held that the delayed discovery rule applied to royalty payments in the music industry.[65]

The defendant in *Weatherly* had argued that the statute of limitations had run because the plaintiff could have audited the defendant's books at any time, and if the plaintiff had done so he would have discovered the underpayment more than 20 years prior to filing his lawsuit. The appellate court ruled that because of the misrepresentations in the royalty statements, the plaintiff was not put on notice of his claims—and his discovery was delayed until he conducted an actual audit of the defendant's books and records.[66]

When artists seek legislative solutions to their accounting woes, they can expect to face the recording industry's well-funded lobbying machine. One Web site estimates that the RIAA spends $550,000 every six months on lobbying efforts, and that Universal Music Group alone spends $220,000 every six months for this purpose.[67] It is probably unlikely that artists will be able to persuasively argue their case in the face of that sort of economic power.

For example, in July 2004, Governor Arnold Schwarzenegger signed SB 1034 (Recording Artist Contracts) into law.[68] In its original form, the bill imposed fiduciary duties on record companies regarding their obligation to account for royalties owed to creative participants in the music industry.[69] However, after lobbying from the record companies,[70] the final bill was watered down. Lawmakers excluded the provisions imposing fiduciary duties from the bill. Instead, the compromise version—now codified as California Civil Code Sections 2500 and 2501—provides artists—individually or in groups—with a statutory right to an audit.[71] Section 2501 also codifies the established practice of hiring auditors on a contingency fee basis. The audits must take place within three years after the end of a royalty earnings period under the contract.[72] To date, there are no published or unpublished cases interpreting these statutes.

The statutory right to an audit has some value, particularly if artists take advantage of the provisions allowing for multiple royalty recipients to audit a company's books and records simultaneously under a contingency fee arrangement. The failure to provide relevant records to the auditor (a frequent complaint by artists) might also constitute an unlawful practice pursuant to Business and Professions Code Section 17200. Whether this provides any incentive in the long term for record companies to account correctly and pay royalties remains to be seen.

Until then, recording artists and their counsel should remain vigilant in demanding regular accounting statements, examining those statements, and exercising their audit rights. Unfortunately, this will

not always be enough—and litigation frequently will be the only way for artists to recover their royalties. ■

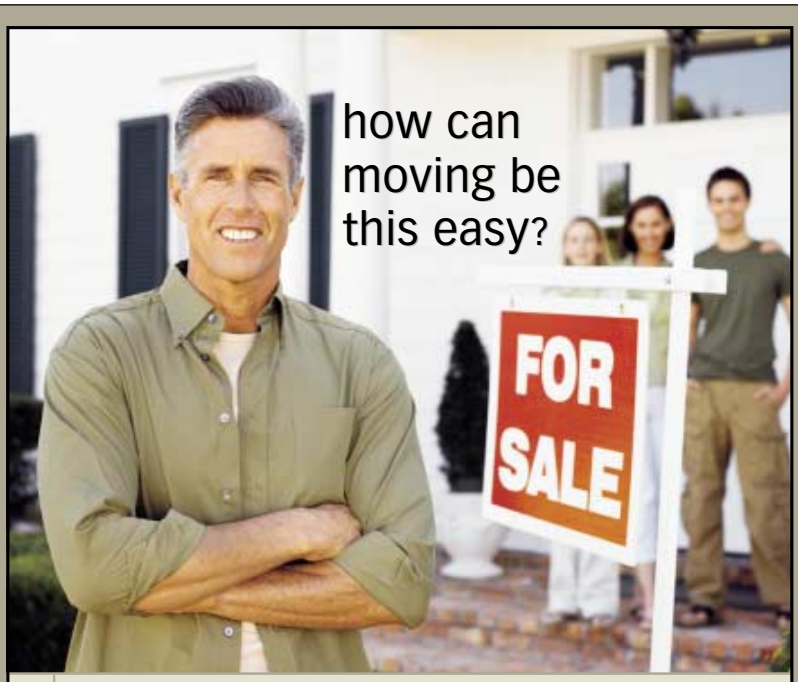
[1] Brian Garrity, *Labels Agree to $50 Million Royalty Payout,* BILLBOARD (May 04, 2004), *available at* http://www.billboard.com/bbcom/news/article_display.jsp?vnu_content_id=1000502611.
[2] Dan Briody, *Music-Industry Foes Join Hands to Accept Royalties,* CIO INSIGHT (Nov. 5, 2005), *available at* http://www.cioinsight.com/print_article2/0,1217,a=165871,00.asp.
[3] Gordon Masson, *Beatles Sue EMI*, VARIETY (Dec. 16, 2005), *available at* http://www.variety.com/article/VR1117934802?categoryid=19&cs=1.
[4] *Id.*
[5] Senator Kevin Murray, Recording Industry Practices (Dec. 3, 2002), *available at* http://democrats.sen.ca.gov/articlefiles/985-Recording Industry Practices.pdf.
[6] *Id.*
[7] The Copyright Act defines "sound recordings" as works that result from the "fixation of a series of musical, spoken, or other sounds." 17 U.S.C. §101 (2006). A composition "consists of music, including any accompanying words" and "may be in the form of a notated copy (for example, sheet music) or in the form of a phonorecord." Copyright Office, Copyright Registration of Musical Compositions and Sound Recordings, Circular 56a, *available at* http://www.copyright.gov/circs/circ56a.pdf. A copyright in the composition is separate and distinct from the copyright in the sound recording.
[8] For a detailed discussion of the different forms of income, *see, e.g.*, Howard Siegel & Linda A. Newmark, *Counseling Clients in the Entertainment Industry 2004*, 782 Practicing Law Institute 855 (2004).
[9] AL KOHN & BOB KOHN, KOHN ON MUSIC LICENSING 420-21 (2002); PETER MULLER, THE MUSIC BUSINESS: A LEGAL PERSPECTIVE 112-16 (1994).
[10] MULLER, *supra* note 9, at 86-91.
[11] KOHN & KOHN, *supra* note 9, at 114-15.
[12] 17 U.S.C. §115 (2005).
[13] *Id.*
[14] U.S. Copyright Office, Mechanical License Royalty Rates, *available at* http://www.copyright.gov/carp/m200a.html.
[15] 17 U.S.C. §115 (2005).
[16] Siegel & Newmark, *supra* note 8, at 878-79.
[17] 6-30 NIMMER ON COPYRIGHT §30.02 (2005).
[18] Linda Pickering & Mauricio F. Paez, *Music on the Internet: How to Minimize Liability Risks While Benefiting from the Use of Music on the Internet*, 55 BUS. LAW 409, 412-18 (1999).
[19] *See, e.g.*, Newton v. Diamond, 349 F. 3d 591 (9th Cir. 2003).
[20] Dina LaPolt, *Taking a Glance at New Media Deals in the Music Industry*, MUSIC BIZ ACADEMY (Aug. 2005), *at* http://www.musicbizacademy.com/articles/dl_newmedia.htm.
[21] *Id.*; 17 U.S.C. §115(c)(3)(2005).
[22] A controlled composition clause is a voluntarily negotiated mechanical license limiting the amount of money the record company is required to remit in mechanical royalties. *See* KOHN & KOHN, *supra* note 9, at 692-96.
[23] 17 U.S.C. §115(c)(3); Derek M. Kroeger, *Applicability of the Digital Performance Right in Sound Recordings Act of 1995*, 6 UCLA ENT. L. REV. 73 (1998).
[24] Digital Performance Right in Sound Recordings and Ephemeral Recordings, 69 Fed. Reg. 5693 (Feb. 6, 2004), *available at* http://www.copyright.gov/fedreg/2004/69fr5693.html. To determine the other sources of royalties that SoundExchange collects for artists, musicians, and the like, *see* http://www

To sign up for our free electronic newsletter

CASE DEVELOPMENTS IN EMPLOYMENT & BUSINESS LAW

visit our web site at
www.socalmediator.com
or call us at
(949) 852-0550

AMC ASHLEY MEDIATION CENTERS



WITH PARAGON'S REAL ESTATE AND MOVING SERVICES, YOU SAVE MONEY, TIME AND EFFORT.

Paragon provides real estate and moving services, at no cost, to LACBA members. Paragon's unique program provides you with a complete package of real estate, rental and moving services — plus real estate rebates* and a free home warranty.

Unlike other services that only offer a list of unknown service providers, Paragon manages a national network of more than 2,000 pre-qualified, real estate agents and move professionals. A knowledgeable Move Services Consultant provides personalized service and coordinates all aspects of your real estate and move experience.

FIND OUT HOW PARAGON CAN HELP YOU.
1-888-509-6087
www.paragonreri.com/lacba
info@paragonreri.com

PARAGON REAL ESTATE RESOURCES, INC.
Official LACBA Member Benefit Provider

*Where allowed by law