



# THE MUSIC INDUSTRY AS A CASE STUDY FOR ENABLING DISRUPTIVE INNOVATION IN CONSOLIDATED MARKETS

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## INTRODUCTION

Disruptive innovation is a term of art coined by Harvard Professor Clayton Christensen in his book *The Innovator's Dilemma*.<sup>2</sup> The term has been used for innovations that establish new markets by finding new customers or transform existing markets by introducing simplicity, convenience, accessibility, and affordability.<sup>3</sup> Disruptive innovations will eventually disrupt the existing market and value network and displace the previous technology.

Disruptive innovation is important because it marks the creation of a significant amount of value for the general public. This is what differentiates disruptive innovations from other kinds of innovations. The invention of the automobile was revolutionary, but it wasn't disruptive. The disruptive innovation in automobile technology

was when Ford lowered the cost of the automobile through the use of mass production. This made the Model T affordable to the general public. It was the innovation in affordability of automobiles that completely changed the transportation industry.

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DISRUPTIVE INNOVATION IS TYPICALLY MARKED BY A TRANSFER OF CONTROL TO CONSUMERS, AN INCREASE IN AFFORDABILITY, AN INCREASE IN CHOICE, MAKING A TECHNOLOGY MORE ACCESSIBLE, OR GIVING CONSUMERS A VOICE.

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The creation of an affordable car is but one example of how disruptive innovation benefits consumers. Disruptive innovation is typically marked by a transfer of control to consumers, an increase in affordability, an increase in choice, making a technology more accessible, or giving consumers a voice. Disruptive technologies offered by businesses like Skype, Craigslist, Google, eBay, Amazon, Uber, and Twitter have some or all of these characteristics.

However, how does disruptive innovation occur in a consolidated market where entrenched market participants have control over vital inputs? In these markets a disruptive innovator must deal with market participants in order to provide a product or service. These market participants may be displaced or inconvenienced by the disruptive innovator's activities. In essence, the disruptive innovator must ask permission to enter a market from entities that may not wish them to enter. The result is that these industries are characterized by stagnation. At best, they experience small, incremental sustaining innovation; consumers receive none of the benefits resulting from transformational advances that disruptive technologies bring about.

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<sup>2</sup> Clayton Christensen, *The Innovator's Dilemma: The Revolutionary Book That Will Change the Way You Do Business* (1st ed. 1997).

<sup>3</sup> For further discussion of disruptive innovation both in common usage and as originally proposed, see Matt Schruers, A Working Definition of Disruptive Innovation, Project DisCo (Oct. 2, 2012), <http://www.project-disco.org/competition/a-working-definition-of-disruptive-innovation/>.

This is especially true in entertainment industries because of the way inputs are governed by intellectual property laws. Intellectual property laws incentivize creativity and invention by artists and inventors, but the resulting transaction costs add a substantial layer of legal complexity that can make it difficult, if not impossible, for new entrants to obtain vital inputs. Entire “middlemen” industries have arisen to collect and manage copyright licensing and to license and distribute content to consumers. When these industries are consolidated, there is often very little motivation for established participants to deal with new entrants. This makes it difficult for these industries to have disruptive innovation because such innovation often comes from new entrants.

The sports industry is a prime example of a consolidated industry that is hostile to disruptive innovation. In sports, leagues or committees are often formed in order to manage the events and license intellectual property rights.<sup>4</sup> These leagues or committees can license rights to as many or as few downstream content distributors as they wish. Often, there are only a few of these distributors that obtain licenses. NBC has exclusive rights to broadcast the Olympics both online and via television until 2032.<sup>5</sup> The NFL only licenses television broadcast rights to four large networks—CBS, Fox, ESPN, and NBC—and its own network—the NFL Network.<sup>6</sup> These established relationships leave little room for disruptive innovators to enter the market. This can be seen in how little sports content is available outside of a subscription for television service.

The industry for video entertainment stands in contrast to the sports industry. The video entertainment industry does not have any central organization controlling intellectual property rights and licensing of content. The internet has also removed the barriers to distribution that previously created power in large television networks in choosing which content is available for consumers. As a result, while specific content might be tightly controlled by a creator or distributor through licensing deals, there are fewer barriers to gaining access to content in general. This has created a number of disruptive new services—from niche to mainstream—that provide video content to consumers. Services like YouTube allow users to generate and monetize their own content. Services like DramaFever and Crunchyroll translate, subtitle, and stream foreign content to English speaking audiences. Netflix revolutionized direct to consumer streaming of online video content and now produces its own award winning content.

The music industry stands somewhere between these industries. On the one hand, rights in music are predominantly controlled by a select few large companies—especially for musical compositions.<sup>7</sup> On the other hand, government consent decrees dating to 1941 have established ground rules that provide access to these musical works. These decrees have helped to restrain collusion by music publishers, enabling the introduction of disruptive new music services like Spotify, YouTube, iTunes, Google Play Music All Access, and Pandora.

This paper analyzes how government oversight has enabled disruptive innovation in the consolidated music industry. First, the paper provides background on the legal and competitive framework that governs the music industry. Second, the paper examines disruptive innovation by internet radio services and how the consent decrees enabled their entry. Third, the paper discusses a specific case of pushback by established members of the industry against the consent decrees and Pandora in particular. Finally, the paper identifies the key successes and failures in the ability of the consent decrees to enable these new forms of innovation.

<sup>4</sup> Although these leagues or committees are often composed of many competitors, some degree of coordination is necessary for the product of sports to be available at all. *National Collegiate Athletic Assn. v. Board of Regents of Univ. of Okla.*, 468 U.S. 85, 101 (1984). Antitrust law may exempt some instances of collective decision making for this reason, even if the result of that collective decision-making is a lack of meaningful competition. *Id.* But cf. *American Needle, Inc. v. National Football League*, 130 S. Ct. 2201, 2216-17 (2010) (refusing to recognize antitrust immunity on the basis of the single entity exception to § 1 of the Sherman Act).

<sup>5</sup> Joshua Brustein, *NBC Is Betting \$7.65 Billion That It Knows What TV Will Look Like in 2032*, *Bloomberg Business* (May 8, 2014), <http://www.bloomberg.com/bw/articles/2014-05-08/nbc-is-betting-7-dot-65-billion-that-it-knows-what-tv-will-look-like-in-2032>.

<sup>6</sup> The NFL also allows satellite television service DirecTV to sell games pay-per-view.

<sup>7</sup> As described in the next section, the music to which we listen generally involves two separate copyrights, one in the so-called musical composition (the notes and lyrics written by the composer and/or lyricist) and a different one in the so-called sound recording (the recording artist's recorded version of the musical composition). While every sound recording involves a musical composition, not every musical composition gets embodied in a sound recording.

## THE MUSIC INDUSTRY'S LEGAL REGIME

Music copyright is complex. The music we hear on the radio, for example, implicates two separate copyrights, one held by the songwriter, and the other by the recording artists who record a performance of the song. The songwriter receives a copyright for the musical work or “composition,” which includes the notes and lyrics for a song. The performers of the sound recording receive a separate copyright for that recording. For example, Whitney Houston’s recording of “I Will Always Love You” is one of the best-selling singles of all time,<sup>8</sup> even though the song was written by Dolly Parton.<sup>9</sup>

Songwriters typically assign their rights to a music publisher, like Sony/ATV Music Publishing (“Sony”), who takes over the responsibility for licensing and enforcing the rights to the song. A public performance license is necessary when a musical work is played, streamed, or broadcast to a public audience.<sup>10</sup> Internet radio services need a public performance license for the musical work and a license for the sound recording, while on-demand music services need those licenses as well as a so-called “mechanical” license.<sup>11</sup> The primary method for licensing the public performance rights for musical works is through a Performing Rights Organization (“PRO”).

There are three leading PROs in the United States: The American Society of Composers, Authors and Publishers (“ASCAP”), Broadcast Music, Inc. (“BMI”), and the Society of European Stage Authors and Composers (“SESAC”). When ASCAP and BMI receive a royalty fee they deduct an administrative fee and then distribute 50% to the music publisher and 50% directly to the songwriter(s). SESAC operates for profit and retains an undisclosed amount of the royalty.

The PROs primarily license performance rights through what is known as a blanket license. A blanket license enables “the music user to perform any or all of” the songs in the PROs repertory “as much or as little as they like.”<sup>12</sup> The music user then pays the PRO a fee based on the agreed upon terms of the blanket license. These blanket licenses offered by the PROs cover the following number of works: ASCAP—over 9 million;<sup>13</sup> BMI—over 8.5 million;<sup>14</sup> and SESAC—over 400,000.<sup>15</sup> All licensing by ASCAP and BMI is governed by consent decrees originally entered into in 1941 that resulted from criminal antitrust proceedings brought by the Department of Justice in 1940 alleging, *inter alia*, illegal price fixing and restraint of trade. ASCAP’s consent decree was last amended in 2001 and BMI’s was last amended in 1994. SESAC is not governed by a consent decree but is the subject of two recent private antitrust actions.<sup>16</sup>

In 1979, thirty-eight years after the original consent decrees, the broadcast television industry challenged the blanket license as *per se* illegal price fixing under the antitrust laws.<sup>17</sup> The Supreme Court found that the blanket license “involves ‘price fixing’ in the literal sense” but that “[l]iteralness is overly simplistic and often overbroad.”<sup>18</sup>

<sup>8</sup> See List of best-selling singles, Wikipedia, [https://en.wikipedia.org/wiki/List\\_of\\_best-selling\\_singles](https://en.wikipedia.org/wiki/List_of_best-selling_singles).

<sup>9</sup> Dolly Parton’s own version of “I Will Always Love You” reached Number One on the Billboard country music charts on two separate occasions. See I Will Always Love You, Wikipedia, [https://en.wikipedia.org/wiki/I\\_Will\\_Always\\_Love\\_You](https://en.wikipedia.org/wiki/I_Will_Always_Love_You).

<sup>10</sup> 17 U.S.C. § 101 defines a public performance as “(1) to perform or display it at a place open to the public or at any place where a substantial number of persons outside of a normal circle of a family and its social acquaintances is gathered; or (2) to transmit or otherwise communicate a performance or display of the work to a place specified by clause (1) or to the public, by means of any device or process, whether the members of the public capable of receiving the performance or display receive it in the same place or in separate places and at the same time or at different times.”

<sup>11</sup> A “mechanical” license refers to a license to reproduce the musical composition; that is, to make a copy of the song, for example, on a listener’s mobile device to enable offline listening.

<sup>12</sup> Common Music Licensing Terms, ASCAP, <http://www.ascap.com/licensing/termsdefined.aspx>.

<sup>13</sup> 2013 Annual Report, ASCAP, <http://www.ascap.com/~media/files/pdf/about/annual-reports/2013-annual-report.pdf>.

<sup>14</sup> About, BMI, <http://www.bmi.com/about>.

<sup>15</sup> About Us, SESAC, <http://www.sesac.com/About/About.aspx>.

<sup>16</sup> Meredith Corporation et al v. Sesac, LLC et al, No. 09-9177 (S.D.N.Y. filed Nov. 4, 2009); Radio Music License Committee, Inc. v. SESAC, INC. et al, No. 12-5807 (E.D. Penn. Filed Oct. 11, 2012).

<sup>17</sup> Broadcast Music, Inc. v. Columbia Broadcasting System, Inc., 441 U.S. 1 (1979).

<sup>18</sup> *Id.* at 8-9.

The Supreme Court ultimately decided that the blanket license was not a *per se* violation in part because “[a] middleman with a blanket license was an obvious necessity if the thousands of individual negotiations, a virtual impossibility, were to be avoided.”<sup>19</sup> The Supreme Court also believed that the blanket license served to reduce costs by reducing the number of total transactions and obviating the need for monitoring.<sup>20</sup> The Supreme Court also referenced the existence of government oversight from the consent decrees as having some effect on their decision.<sup>21</sup>

## HOW THE CONSENT DECREES ENABLED THE INTERNET RADIO REVOLUTION

Streaming technology has created a revolution in online music. On-demand music services like Spotify, Rdio, Last.FM, and Google Play Music All Access, and internet radio services like iHeartRadio and Pandora compete for listeners by offering them new options in how they can consume music. Of these, the most popular is Pandora.<sup>22</sup> Pandora leverages modern technologies as well as its own work on the Music Genome Project in order to create personalized radio stations for its users.<sup>23</sup> Users can create up to 100 radio stations based on a seed song, artist or genre.<sup>24</sup> Pandora then uses its database to find songs that have musical similarities to that seed and then generates a playlist.<sup>25</sup> The playlist is streamed to the user’s device and can be further refined by the user using an up or down rating system for each individual song.

Pandora’s service to consumers is a combination of two technologies: 1) the technology to stream music to individual consumers; and 2) the technology to accurately select songs a user is likely to enjoy. Pandora has been an innovation leader in pioneering this second technology through its Music Genome Project.<sup>26</sup> The Music Genome Project is a system that analyzes individual songs based on up to 450 distinct musical characteristics.<sup>27</sup> This analysis is done by trained music analysts.<sup>28</sup> Analysts must have “a firm grounding in music theory, including familiarity with a wide range of styles and sounds.”<sup>29</sup> The project is over ten years old.<sup>30</sup>

Most other internet radio services also have their own system for personalizing music playlists to their consumers. These song selection systems have significant value over terrestrial radio because they can generate custom song lists based on each user’s preference. Terrestrial radio broadcasts its music to a general audience and therefore must create their playlists to appeal to a general audience. In contrast, a service like Pandora is able to play a wider variety of songs and over 80% of the songs it plays are not played on terrestrial radio.<sup>31</sup> The technology that powers companies like Pandora gives consumers a more personalized experience than terrestrial radio and exposes them to more music that they may like.

This feature also benefits artists because not only are they getting more exposure than terrestrial radio can provide, their music is also targeted directly at the consumers most likely to buy their albums. Pandora conducted a study on

<sup>19</sup> *Id.* at 20.

<sup>20</sup> *Id.* at 21.

<sup>21</sup> *Id.* at 13.

<sup>22</sup> The category of internet radio excludes music on demand services like Spotify and Google Play Music All Access. Internet radio services do not allow listeners to choose what specific music will be played.

<sup>23</sup> About Pandora, Pandora, <https://www.pandora.com/about>.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> The Music Genome Project method for matching songs from a database to listener preferences is patented. U.S. Patent No. 7,003,515.

<sup>27</sup> About The Music Genome Project, Pandora, <https://www.pandora.com/about/mgp>.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> Jon Healey, Pandora holds out olive branch of data to musicians, LA Times (Oct. 22, 2014), <http://www.latimes.com/business/technology/la-fi-tn-pandora-offers-help-to-musicians-20141021-story.html>

the effects that plays on its service has on music sales and found a positive correlation. The study compared sales in regions where songs were available to Pandora listeners and regions where the songs weren't available. The study concluded that there was an average increase in sales by 2.31% for new music and 2.66% for catalog music.<sup>32</sup> This effect increased with the number of plays.<sup>33</sup>

Unfortunately, internet radio services would never exist if they could not obtain the necessary intellectual property rights to play music. This would normally be challenging in an industry that is highly consolidated and perhaps uninterested in disruptive innovation. However, the consent decrees that govern the two largest PROs—ASCAP and BMI—create mechanisms for any entity to license performance rights at a reasonable rate.

Both consent decrees require the PROs to license their music repertory to any party requesting a license. A licensee is deemed to be licensed upon submitting a license request to ASCAP or BMI.<sup>34</sup> This prevents the PROs from using their monopoly power to prevent music users (*i.e.*, licensees) from doing business in order to extort higher rates or prevent them from exercising their legal rights. Both consent decrees require the PROs to license the performance rates at a reasonable rate.<sup>35</sup> If the licensee and PRO can't agree on what rate is reasonable, then a special rate court in the Southern District of New York will determine a reasonable rate that is binding on the parties.<sup>36</sup> ASCAP and BMI each have their own specially designated rate court. These rate courts provide protection to music users from the monopoly power held by the PROs. The rate courts have the power to set interim fees when one or both parties elect to have the rate court determine a reasonable rate.<sup>37</sup> Both consent decrees prevent the PROs from discriminating in price among similarly situated licensees.<sup>38</sup> This keeps the PROs from picking winners and losers and enables greater competition among music user competitors.

It is undoubtable that these consent decrees have facilitated entry by disruptive innovators. New internet music services can obtain the performance rights to musical works controlled by ASCAP and BMI simply by submitting an application. Internet music services are guaranteed a reasonable rate that is the same as other similarly situated music services. Internet music services also have the option of asking a rate court to set a reasonable rate if one cannot be agreed upon. In fact, Pandora has elected to pursue such a right and was protected from anticompetitive activities by the respective rate courts.

## THE ESTABLISHMENT STRIKES BACK

The best way to measure the success of the consent decrees is how the decrees manage the exercise of monopoly power in the attempt to raise prices. Litigation between Pandora and ASCAP and BMI has developed an extensive record on this issue.

The music industry is highly concentrated. As has been previously stated, three PROs license the vast majority of performance rights for musical works in the U.S.—ASCAP, BMI, and SESAC. ASCAP and BMI license a majority of these rights with control of over 9 million and 8.5 million songs respectively. In addition, the industry of music publishers that own and administer these songs is also highly concentrated. Sony and Universal Music Publishing Group

<sup>32</sup> Glenn Peoples, New Study from Pandora Touts the 'Pandora Effect' on Music Sales, *Billboard* (Nov. 18, 2014), <http://www.billboard.com/articles/business/6319937/pandora-study-calculate-promotional-effect-music-sales>.

<sup>33</sup> *Id.*

<sup>34</sup> ASCAP Second Amended Final Judgment (June 11, 2001), available at <http://www.justice.gov/atr/cases/f307300/307388.pdf>; BMI Amended Final Judgment (November 18, 1994), available at <http://www.justice.gov/atr/cases/f307400/307413.pdf>.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

("UMPG") control over half of the music publishing market with estimated market shares of 29.4% and 22.6% in 2013 respectively.<sup>39</sup> In some cases, companies with large market shares can take advantage of their market power to demand higher prices than would be experienced in a competitive market.<sup>40</sup> This problem is exacerbated where, as in the music industry, the information goods being licensed are not freely substitutable. Prospective licensees are compelled to deal with all sellers in the marketplace in order to field a product desirable to users. That is, an online music service that declined to deal with Sony and UMPG, and thus only offered consumers 50% of commercially produced songs, is unlikely to be a viable product.

When a handful of companies control a market of this nature, it is easier to form and enforce formal or informal cartels. This also makes it easier to discover and punish companies that "cheat" on the cartel by competing on prices or terms they agreed not to compete on. Cartels can also restrict access to vital information in industries where information is necessary in order to properly establish bargaining positions. This creates problems when a company needs to contract with a cartel member but lacks the information to properly value the goods and services, to identify the goods and services being exchanged, or to determine whether the goods and services are even necessary for the company's operation. The ASCAP and BMI consent decrees were formed to protect music users in response to government challenges to the competitive problems found in the music industry.

The actions of the two largest music publishers, Sony and UMPG, and their coordination with each other and ASCAP and BMI demonstrate how the consent decrees can be used to preserve competition.<sup>41</sup> At the end of 2012 Sony began planning to withdraw from ASCAP the ability to license its performance rights only in regard to digital music services, which it termed "New Media."<sup>42</sup> This partial withdrawal<sup>43</sup> took effect January 1, 2013.<sup>44</sup> Pandora was concerned about the Sony withdrawal and its languishing rate discussions with ASCAP, and so it filed a rate court petition on November 5, 2012. This rate court filing angered some companies in the ASCAP community. UMPG's Chairman and CEO Zach Horowitz, for example, threatened Pandora's outside law firm for representing the company in litigation.<sup>45</sup>

Horowitz also wrote to ASCAP's then-CEO John LoFrumento to give the following advice on negotiating with Pandora:

*My take: [Pandora's outside counsel] and Pandora are scared. They just want to settle with ASCAP and settle fast. Be strong. Time is on your side. Pandora is now under intense pressure to settle with ASCAP. They have to put this behind them. You can really push Pandora and get a much better settlement as a result. They are reeling. They will pay more, a lot more than they originally intended, to do that.*<sup>46</sup>

Horowitz forwarded this email to his competitors at Sony and BMG Music Publishing, as well as the music industry trade group National Music Publishers Association. Horowitz called Pandora's outside counsel again to apply pressure, reporting to LoFrumento that they have "been spending hours on fallout from their repping Pandora.

<sup>39</sup> UMG and WMG see gains in recorded-music market share in 2013, while Sony/ATV dominates music publishing. See Music & Copyright's Blog (May 6, 2014), <https://musicandcopyright.wordpress.com/2014/05/06/umg-and-wmg-see-gains-in-recorded-music-market-share-in-2013-while-sonyatv-dominates-music-publishing/#more-1166>. These market share estimates are "share-weighted," meaning the market share is reduced to reflect where a publisher may control less than 100% of a musical work, which is a very common occurrence. That is, a share-weighted market share figure may considerably understate the percentage of the music publishing market for which a publisher controls some portion of a work.

<sup>40</sup> The FTC has previously settled charges with five record companies, including Sony and Universal Music, for minimum advertised price policies that were alleged to cost consumers as much as \$480 million. Part of the FTC's complaint alleged that these policies were "facilitating practices" that increase the risk of collusion. Press Release, Record Companies Settle FTC Charges of Restraining Competition in CD Music Market, F.T.C. (May 10, 2000), available at <https://www.ftc.gov/news-events/press-releases/2000/05/record-companies-settle-ftc-charges-restraining-com-petition-cd>.

<sup>41</sup> See, e.g., Del Bryant, BMI on Rights Withdrawal: An Open Letter to the Music Industry, Billboard (Feb. 12, 2013), <http://www.billboard.com/biz/articles/news/legal-and-management/1538785/bmi-on-rights-withdrawal-an-open-letter-to-the-music> (stating that BMI intends to use the higher rates from music publisher agreements to get higher rates for all songwriters).

<sup>42</sup> *In re Pandora Media, Inc.*, 6 F. Supp. 3d 317, 340 (S.D.N.Y. 2014).

<sup>43</sup> Partial withdrawal is when a music publisher removes the right of a PRO to license music to only a certain category of music users. Here, the partial withdrawals concern removing the right of a PRO to license to so-called New Media, but PROs can still license to any other type of music user.

<sup>44</sup> *In re Pandora Media, Inc.*, 6 F. Supp. 3d at 341.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

They are embarrassed. [Pandora's counsel] said they will withdraw from repping Pandora in the next few weeks if the [rate court litigation with ASCAP] doesn't settle."<sup>47</sup> Pandora and ASCAP could not ultimately reach a settlement. This was primarily due to the pressure Sony and UMPG applied to ASCAP.<sup>48</sup>

Sony had significant power in 2012 due to a merger between Sony and EMI, which were the second and fourth largest music publishers.<sup>49</sup> Despite already having this significant power, Sony sought to further unbalance its direct negotiations with Pandora by refusing to give Pandora a list of the songs in its repertoire.<sup>50</sup> Sony also refused to give ASCAP permission to release this list to Pandora, leaving Pandora without a way to remove Sony's songs from its service if a deal could not be reached by the January 1, 2013 deadline.<sup>51</sup> This created a substantial threat to Pandora continuing its business. If Pandora accidentally played any song owned by Sony it faced statutory damages of up to \$150,000 *per* infringement.<sup>52</sup> With Sony owning roughly 30% of the music publishing market, Pandora faced a situation where it likely could not afford to continue doing business if it did not reach an agreement. Indeed, Sony began its negotiations with the veiled threat "[i]t's not our intention to shut down Pandora."<sup>53</sup> Pandora ultimately agreed to a rate that was 25% over the prevailing rate.<sup>54</sup>

After the deal was concluded, and despite the existence of a confidentiality agreement, Sony leaked the key terms of the agreement.<sup>55</sup> This is because Pandora would soon have to negotiate with Sony's competitor UMPG. UMPG began its own partial withdrawal effective July 1, 2013. UMPG began negotiations with Pandora with the same implicit threat—"we want Pandora to survive."<sup>56</sup> UMPG was also confident that they knew the material terms of the Sony deal. UMPG's Horowitz repeatedly asked his Pandora contact how they got Sony to accept such a low payment.<sup>57</sup> Pandora asked UMPG for a song list so that it could take down UMPG's songs if a deal could not be reached. UMPG ultimately provided a list, but only under terms that would not enable Pandora to use it to remove the songs.<sup>58</sup> UMPG would not budge from a 7.5% rate even though Pandora's competitor iHeartRadio had received a 1.70% rate.<sup>59</sup> Pandora ultimately agreed to the 7.5% rate subject to contingencies concerning the rate court proceedings and determination of whether it could be licensed at the 1.70% rate due to its acquisition of KXMZ-FM.<sup>60</sup>

The activities by Sony and UMPG are significant not only because of their use of market power and lack of transparency to obtain substantial royalty increases, but also because they sought to use these new rates as benchmarks in the rate court proceedings. The ASCAP and BMI rate courts would have to determine if partial withdrawals are allowed under the consent decrees and whether the rates obtained were valid benchmarks.

The rate courts handled the partial withdrawals in dramatically different manners. The ASCAP court found that the ASCAP Second Amended Final Judgment banned partial withdrawal.<sup>61</sup> Therefore, Sony and UMPG's attempts at partial withdrawal were held to be inoperative.<sup>62</sup> The BMI rate court agreed that the consent decree banned partial withdrawal, but instead held that withdrawal was effective as to all BMI licensees.<sup>63</sup>

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 342.

<sup>49</sup> *Id.* at 342-43.

<sup>50</sup> *Id.* at 344-45.

<sup>51</sup> *Id.* at 345.

<sup>52</sup> See 17 U.S.C. § 504(c)(2).

<sup>53</sup> *In re Pandora Media, Inc.*, 6 F. Supp. 3d at 343.

<sup>54</sup> *Id.* at 346.

<sup>55</sup> See *Id.* at 346-47.

<sup>56</sup> *Id.* at 348.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 349.

<sup>59</sup> *Id.* at 349-50.

<sup>60</sup> *Id.* at 350.

<sup>61</sup> *Id.* at 350-51.

<sup>62</sup> *Id.*

<sup>63</sup> *Broadcast Music, Inc. v. Pandora Media, Inc.*, 109 U.S.P.Q.2d 1964, 2013 WL 6697788 (S.D.N.Y. 2013).

ASCAP rate court judge Denise Cote commented on the high degree of coordination among competitors in obtaining the high rates from Pandora.<sup>64</sup> Judge Cote stated that “Sony and UMPG justified their withdrawal of new media rights from ASCAP by promising to create higher benchmarks for a Pandora-ASCAP license and purposefully set out to do just that.”<sup>65</sup> Judge Cote also commented on how Sony and UMPG interfered with Pandora’s negotiations with ASCAP and how “Sony made sure that UMPG learned of all of the critical terms of the Sony-Pandora license.”<sup>66</sup> Judge Cote noted that “ASCAP, Sony, and UMPG did not act as if they were competitors with each other in their negotiations with Pandora. Because their interests were aligned against Pandora, and they coordinated their activities with respect to Pandora, the very considerable market power that each of them holds individually was magnified.”<sup>67</sup>

## THE SUCCESSES AND FAILURES OF THE CONSENT DECREES

The lessons from these events are significant now that the Department of Justice (“DOJ”) is considering amending the ASCAP and BMI consent decrees.<sup>68</sup> This provides an excellent opportunity to review the successes and failures of the consent decrees. Because the decrees have been essential to enabling innovative new internet music services, any changes should be pro-innovation or at the very least innovation-neutral. Therefore, the appropriate focus should not be on whether royalty rates exceed some arbitrary amount, but whether the licensing process enables new entry and fosters competition to the extent possible in the market.

The Sony and UMPG attempts at partial withdrawal have highlighted the need for transparency in song ownership. Both companies were able to wield significant negotiating leverage due to the threat of statutory damages for copyright infringement. This threat distorts the real market value of performance rights licenses and is not the result of fair competition. Amending the consent decrees to add transparency of song ownership would completely negate this threat. A music publisher asking for too high of a rate would then face the potential of having their songs removed from a service altogether.

Full transparency in song ownership can create other benefits as well. For example, internet music services would be able to assess which music publishers’ songs provide the most value to their services. Transparency could enable a music service to approach various music publishers to put together a package of songs that might appeal to a particular subset of the music listening marketplace.

The DOJ is also considering whether the consent decrees should allow for partial withdrawal.<sup>69</sup> Partial withdrawal would allow music publishers to withdraw from the PROs the rights to license their songs to a specific group of music users. All other music users would be able to continue to license the music publisher’s songs through the PROs, but the group of music users the withdrawal effects would have to license directly with the music publisher. As discussed above, both rate courts that examined the previous attempts at partial withdrawal have ruled that the consent decrees only allow an all-in-or-out approach. That is if the music publisher attempts a partial withdrawal it will either be ineffective or it would apply to every music user, not just the music users the music publisher intends to withdraw from.

While partial withdrawal is not inherently anticompetitive, the manner in which Sony and UMPG attempted partial withdrawal is. Both Sony and UMPG withdrew from the PROs in such a way that Pandora could not refuse its offer. This is because Pandora was already operating under blanket licenses from the PROs that covered all songs from all

<sup>64</sup> In re Pandora Media, Inc., 6 F. Supp. 3d at 357-58.

<sup>65</sup> Id. at 357.

<sup>66</sup> Id.

<sup>67</sup> Id. at 357-58.

<sup>68</sup> ASCAP BMI Antitrust Consent Decree Review, Department of Justice, <http://www.justice.gov/atr/cases/ascap-bmi-decree-review.html>.

<sup>69</sup> In re Pandora Media, Inc., 6 F. Supp. 3d at 357-58.



music publishers. Pandora would have to accurately identify all songs owned by Sony and UMPG and remove them from their services in order to avoid copyright infringement. Each instance of copyright infringement risks high statutory damages, therefore mistakes are not an option. Both Sony and UMPG refused to give Pandora the information it needed in order to successfully remove their songs, creating a huge risk for Pandora to continue operations. The result was a situation where the music publisher could dictate the terms of the agreement not due to strength of their products, but because of their high market power and control of vital information. This is exactly the kind of behavior that consent decrees are meant to protect against and the current consent decrees did in fact bar this behavior.

Some of these described problems with partial withdrawal would be addressed if there was adequate transparency. However, whether or not to partially withdraw would still be completely up to the music publishers. This means that partial withdrawal will only occur when music publishers feel they can get a better deal outside of the PROs. This one-sided right will only put upward pressure on performance right prices as there is no counterbalancing source of downward pressure. Therefore, partial withdrawal does not actually increase competition and will probably harm it.

In order for partial withdrawal to increase competition there must also be a counterbalancing right on the music user side. Under the current regime, the lack of transparency of song ownership makes it virtually impossible for a music user to determine which music publisher owns which rights. Further complicating this issue is that music publishers can own and administer a fraction of a song. This means that a music user can't realistically demand lower rates from a music publisher under the threat of removing their songs from its service. Furthermore, the opacity of how the PROs internally make their distribution calculations means that it is possible that even if a music user removed a music publisher's songs from its service that music publisher could still be paid. The only way to balance the upward price pressures of partial withdrawal is to correct these information asymmetries so that music users can also withdraw from using a music publisher's songs. This would create competitive pressure on both sides—music publishers that believe their works to be more valuable than the ASCAP rate can withdraw and music services that believe that a music publisher's works are less valuable than the ASCAP rate can also withdraw.

Finally, there should be some fact finding to determine whether the category ASCAP and BMI defines as New Media is a proper category of similarly situated licensees. As discussed above, both consent decrees forbid ASCAP and BMI from discriminating among similarly situated licensees. The increase in new digital services that compete with established products and services necessitates some determination of how the term "similarly situated" applies to them. For example, internet radio services compete with and are substitutes for terrestrial radio, but they are not substitutes for physical or digital music sales.<sup>70</sup> It may be that internet radio services are most similarly situated with terrestrial radio licensees. Other New Media services that are substitutes for music sales, like Spotify, may not be similarly situated at all.

## CONCLUSION

The music industry is an important example of how government oversight can enable disruptive competition in consolidated industries. The consent decrees originally formed with ASCAP and BMI in 1941, before computers were even developed, have enabled the entry of innovative new internet music services. Although it has been necessary to amend these decrees from time to time, it is important to keep rules in place that enable new entrants and innovation. Actions by Sony and UMPG have shown that those aspects of the consent decrees are still vital to this day. Any further changes to the consent decrees should keep in place conditions that allow for disruptive innovation due to the benefits it creates for consumers and the new forms of competition that it brings.

<sup>70</sup> This is evidenced by the Pandora study discussed above.