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Regulation of Intellectual Property and Contract Structure

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REGULATION OF INTELLECTUAL PROPERTY AND CONTRACT STRUCTURE

A Thesis
Presented to
the Graduate School of
Clemson University

In Partial Fulfillment
of the Requirements for the Degree
Master of Arts
Economics

By
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Accepted by:
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ABSTRACT

This paper seeks to address the newest issue arising between songwriters and their record companies in the music industry which is the underpayment of royalties. This paper will seek to answer if with more and more artists and songwriters suing for compensation due to underpayment of royalties, will artists lose the incentive to create new music and eventually decrease overall production? Clearly defining and regulating intellectual property and the use and efficiency of contracts will be topics for discussion. After testing my hypothesis, some results show no decrease, whereas, other results report some decrease in record company and songwriter incentives and in production. Therefore, in conclusion, the finding is that there is no clear association between underpayment and lack of production.

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INTRODUCTION

This thesis poses the question of whether recent changes in the music industry specifically, the introduction of the digital era through the internet and internet sources, has or will eventually have an effect on the overall production of new music. Also in question, have the record companies' classification of sale royalties and license royalties been or will they become a driving force in the decrease of music production? Sale royalties and license royalties are the two main ways record companies and songwriters receive royalty payment, which is a major source of profit in the music industry. Contracts between music labels, performing rights organizations, songwriters, and artists will be examined. How or if contracts have changed to adjust to the new development and the inclusion of digital music will be examined. As regulations have changed over time to accommodate new outlets of music, contracts have been adjusted to benefit artists and songwriters. These contracts define the terms of compensation for all parties, and other terms that will give songwriters the incentive to create new music.

I argue that when the internet introduced a new outlet for music distribution, contract terms for record companies and songwriters lost their clarity. Determining provisions from royalties became a point of contention and decreased the marginal revenue and marginal benefit of producing new music. I hypothesize that the incentive or motivation for songwriters to produce new music decreases and the overall production of new music decreases over time. After collecting and comparing data on the amount of new music produced by different artists before and after the digital era began, and analyzing a case study, I find that when more emphasis is placed on the definition of a sale royalty and a license royalty in contracts and a songwriter's intellectual rights are clearly defined and are upheld by all parties, incentives and production will not decrease over time.

In recent years, the popularity of the internet has given consumers unlimited access to music through iTunes and other, sources of file sharing. These changes have caused friction between music companies and songwriters, specifically concerning royalties. By definition, a royalty is a payment that is given to a company or an individual that creates a song and owns the rights for the asset to be distributed. Even though there were disputes with songwriters and companies before the digital age, recently more songwriters have sued their record companies over royalties that they believed have not been paid or for not receiving the correct payment from music downloading, ringtones, or other digital music outlets. This paper addresses the differences in intellectual rights for a songwriter's asset, which in this case would be the song and the songwriter's royalties before and after the digital age in the United States. Also addressed will be what changes were made to the system, and how they were interpreted in contracts, to ensure all parties involved get their share of revenue?

The distinction between a sale royalty and a license royalty is very blurred in the music industry. When a songwriter and record company form a contract, they have the option of obtaining revenue by selling a consumer, which is defined as an individual or company purchasing a song from the record company through a sale or a license. The consumer purchasing a copy of a song for entertainment purposes only would be a sale royalty. A license royalty involves a consumer buying a master copy from the record company. These transactions are usually done by radio stations, TV programs, and movie production companies. This entitles the consumer, defined as the individual or company purchasing from the record company, to record, perform, duplicate, redistribute and gain a profit from the song they purchased from the record company. Currently, sale royalties are given to the songwriter and the record company for digital downloading. But, songwriters believe digital purchases should be considered as license royalties because internet companies take masters of songwriters' song recordings and sell copies to individuals for profit. Further discussion of this topic is explained in the analysis.

The government regulates and enforces issues of royalties. Performing right organizations (PROs) monitor and enforce issues of royalties on behalf of songwriters. There are four PROs in the United States: The American Society of Composers, Authors, and Publishers (ASCAP), Broadcast Music Incorporated (BMI), the Sound Exchange, and the Society of European Stage Authors and Composers (SESAC). The United States Copyright Royalty Board, a government service organization, in association with the Library of Congress, executes digital performance rights laws written in 1995. The Copyright Royalty Board maintains and enforces royalty rates that record companies and PROs set. In April 2012, a United States Court declared that the Board would officially be responsible for maintaining and enforcing royalty rates from digital downloads.

Before the evolution of the internet, most revenue came from record sales, sheet music sold, royalties for performing in public, and songs that are used in movies or T.V. The songwriter or the company who creates the song lyrics and registers it with the Library of Congress is considered the owner of the song. The owner has the right to record, distribute, reproduce, alter, or perform the song publicly, live, or through radio, TV, or other means of media. If the owner decides to musically record the song, the songwriter, record company, or a separate artist, can register the song recording with the Library of Congress to become the owner of the song recording copyright, which is different from owning the right to the song lyrics. When someone owns the song recording, usually a record company, then that owner has the right to distribute and publicly perform the song, but not alter the lyrics or melody of the song. Royalties are usually paid through copyright licensing. When the asset holder, who is the owner of the sound recording, gives permission to other parties to use a song they receive payment through licensing. They are paid through sales when the asset holder gives permission to purchase a song only for listening. PROs, as well as, mechanical rights agencies keep track of royalties that needs to be paid. For example, in a diagram given by the ASCAP, PROs monitor various outlets for

how many times a song is played in a period of time, and the money they receive from the those outlets is given to the songwriters in the form of royalties.

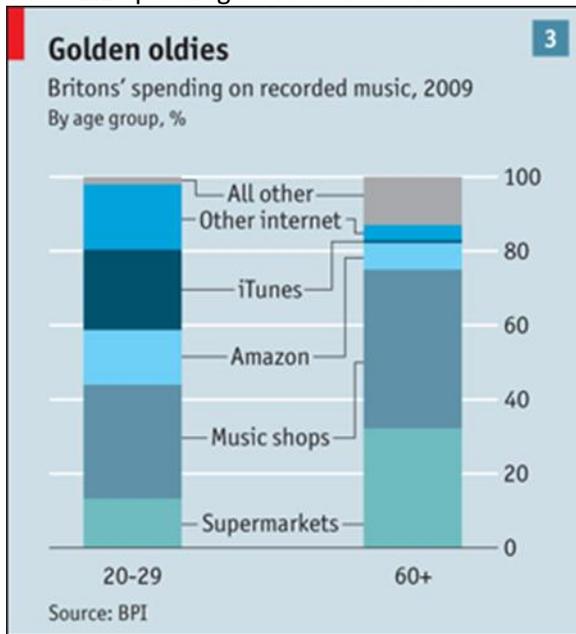
Table 1.1 How PROs keep track of royalties



Source: ASCAP

Because the internet has given consumers other outlets for downloading music, royalties are harder to track so asset holders lose the money they would receive in royalties because of free file sharing websites. Websites including iTunes and Amazon have become popular outlets used by younger consumers to download music, as noted in the chart below.

Table 1.2 Spending on recorded music



Source: The Economist

This table shows that individuals ages 20-29 use iTunes and other internet sources as the primary sources of distributing music, suggesting that over time, the internet would become the main outlet of obtaining music. As the internet becomes a main source for music for all ages, the clarity of contract terms becomes more important for record companies and songwriters. When contract terms are clarified, the record companies and songwriters are able to receive just compensation from digital downloading and the incentives to produce new music will not decrease. In an article written by The Economist magazine, the internet is a huge distribution outlet and could arguably bring a large amount of revenue to record companies and songwriters alike. iTunes and other legal music downloading sites are a major alleviator in recovering unpaid royalties to asset owners, but evidently, the problem still exists due to many reports of songwriters and artists suing over payments. With the infusion of these internet outlets come major concerns for the record companies and for the songwriters taking issue with the selling of their music and making revenue from their music.

The most crucial part to this study is the answers to the question of what constitutes a sale royalty and what constitutes license royalty concerning digital music. Before the creation of digital downloading, the answer was understandable. Physical goods, like CDs that were sold to consumers were sales. Licensing sold the right to record, duplicate, distribute, or perform the song. Now, with digital downloading, record companies sell to digital retailers like iTunes a single master recording, not a license, which those retailers in turn duplicate for customers. The fact that digital retailers duplicate a record makes this transaction have “license like” characteristics.

Volker Lehmann classifies four types of licensing: attribution, noncommercial, no derivatives works, and share alike. The attribution type will essentially give the person a copyright, as long as the person gives the person who actually holds the copyright credit for their work. The noncommercial type will apply to regular consumers, DJs, and artists who want to sample an artist’s work. This type allows people to do the same as people who choose attribution; the only exception is that they must use it for a noncommercial purpose. The no derivative works option allows the consumer to do everything except create a new song from the original work. Lastly, share alike type will allow derivative work to be distributed under the same license as the original work the derivative was taken from. There are other exceptions to these four types including the Sampling License, a Public Domain Dedication, a Founder’s Copyright, a Music Sharing License and a Developing Nations License. After the digital era began to pick up speed, Preston and Rogers write that record companies began to make alliances with social networks to license their music by various artists to be distributed by social networks and record companies preserved the right to have certain copyrighted work removed if they felt it was necessary. These alliances of license agreements have recently have evolved to include new websites such as Vevo, a outlet of You Tube and outlets allowing consumers to gain access to live performances as well as recordings of their favorite songs. This brings about more revenue for the record companies, but not necessarily to the songwriter.

Songwriters receive royalties through sales and licensing of music. Since more rights are granted to the individual or company when purchasing a license, they are required to pay more to obtain a license, meaning the songwriter is paid more licenses sold than sales sold. Licensing royalties are a songwriter's preferred choice of payment since they historically receive more from a license than they do from a sale, no matter which outlet is used. Songwriters believe licensing applies to the internet because of the fact the iTunes and other internet companies similar to iTunes purchase master recordings from record companies to make a profit by selling music to individuals for a profit. If a songwriter feels they are being underpaid for their services, they lose the incentive to create and produce new music, which leads to a decrease in the production and the selection of new music for consumers.

This paper will attempt to present substantial evidence highlighting the issue of royalties in a detailed case study involving Aftermath Records and F.B.T. Productions. F.B.T. Productions contends that the company was underpaid as a result of the revenue from digital downloads being counted as sale royalties rather than license royalties. Aftermath Records contends that Aftermath and F.B.T agreed that downloads would be treated as sales and the two parties would receive sale royalties. This case study gives an example of unclear contract terms leading to problems of royalties and a decrease in incentive to create new music. Other applications are shown to support the hypothesis that contract structure and clear provision of digital royalties will maintain or increase any incentives necessary to promote creativity for new music and production of new music. Empirically, I expect to find that songwriters who decide their contract with their respective record company does not give them the greatest marginal benefit and revenue will decrease the amount of new music they produce over time. The intention is to shed more light on the impact of the digital era and the revenue and copyright practices of record companies, as well as address contract terms in the music industry. Section ii will

give a theoretical framework to this analysis. Section iii will review previous literature, Section iv will give empirical evidence, and Section v will offer an overall conclusion.

THEORETICAL FRAMEWORK

General topics in economics: contract structure, strong property rights, and production are addressed. The purpose of the contract is generally to clearly define property rights. The clearly defined property rights enable all parties to produce and sell efficiently, promote marginal costs and benefits, and create a strong market. Marginal costs and benefits are associated with the creation of sound property rights and contracts.

In theory, there are two parties who are involved in the creation and distribution of an asset. It is assumed that whoever owns the title, owns the all the residuals. There are only two forms of payment, which are a sale or a license. The residual claims to either form are given solely to the record company, the songwriter, or the claims are shared by the two. The residual claims include profit in the form of royalties from purchases, more specifically suited for this thesis, digital purchases. The residual claims and claimants are listed in a contract between all parties involved. The digital world makes it hard for record companies to monitor songwriters or vice versa, and this monitoring process is more expensive.

The issue of defining property rights relates costs associated with establishing, monitoring, and enforcing rights. The internet created a new market essentially for record companies to capitalize and make a large profit. This is because when digital downloading first became available to consumers, websites and programs like Napster invited consumers to easily download songs for cheap or even free of cost. As more and more individuals began to obtain their music over the internet record companies began to seek revenue by setting up their own alliances with iTunes. However, it became extremely difficult, as well as costly to stop websites like Napster who didn't have alliances with the record companies from forming and seizing the opportunity to obtain additional revenue. Enlisting the help of the government alleviated some of the cost of enforcement; however, digital downloading is still listed

as a problem by songwriters. Songwriters believe that since record companies sell master sound recordings to music downloading websites that those purchases should be treated as licenses rather than sales. Now that there is digital downloading, a songwriter's intellectual property, the song, is so easily distributed and accessible to everyone that costs are extremely high for both record companies and songwriters. Restricting access of the songs through government regulation and legal websites like iTunes increases the value of assets and gives songwriters and record companies more incentive to monitor the market and obtain a better profit.

A song and a song recording can be considered nonexclusive resources, as explained by Steven Cheung. Nonexclusive, for the purpose of this paper, means that a song is distributed and is not depleted or doesn't go away as more consumers download the song. He continues that a contract may not even exist implicitly or explicitly with nonexclusive resources. The costs of enforcing policies and making sure the marginal revenue and benefits to all parties are the same will most likely be exceedingly higher than contracts with exclusive resources. This could give some insight as to why songwriters or PROs don't clearly establish or enforce the revenue seeking practices of record companies. Though PROs are established to serve and protect songwriters and their rights, they are not able to pay the marginal costs of continuously enforcing contract terms with record companies.

In the book *Property Rights: Cooperation, Conflict, and Law*, a property rights entrepreneur is a person who sees the marginal benefits of defining and enforcing property rights and is able to reduce marginal costs to receive a larger gain. When new markets open, the marginal benefit of utilizing the market becomes greater. As the property rights entrepreneurs enforce and monitor rights, the marginal cost will eventually decrease by the entrepreneurs' working with the government and forming alliances to decrease costs. Consequently, the party that is able to see all costs and benefits associated with utilizing the market will capitalize on the opportunity. Creators of Napster and iTunes along with record

companies could be considered the property rights entrepreneurs of the internet. As the internet became a tool in the downloading of music, record companies teamed up with music websites to capitalize on the gains of music downloads.

The principal-agent model, an economic model, would be a plausible fit with the property rights theory. An agent’s job is to produce or to serve the principal’s desires. This would be similar to a politician overseeing and protecting the interests of their constituents. There is the possibility of an agent abusing their given power by using other sources and accumulating gains for their own benefit as a politician could be swayed by lobbyists for gains that are not for the good of all constituents. The downside to the principal-agent model, according to Anderson and McChesney, would be that principals “are not residual claimants to the rents they help create”. Consequently, if claimants or principals don’t receive the rents that they create, then they don’t have the incentive to enforce rules for their s agents. Agents then are inclined to act on their own behalf rather than on the behalf of their principal. The solution lies in effectively monitoring agents who supervise the rents created from property rights. If this doesn’t happen, this could result in institutions not being as strong or as efficient as institutions where agents were less corrupt and catered to the needs of the principals. The table is an illustration of the principal-agent model applied to the music industry.

Table 2.1 Principal-agent model in the Music Industry

Principal (Songwriter)	Agent (Record Company)	Enforcer (pro, Government)
Gives or shares their rights of their song with record company Trusts record company to receive residual claims made from song	Responsible for the reproduction, promotion, and distribution of song Pays royalties to songwriter	Government sets royalty rates for record company to pay PROs responsible for tracking what royalties are owed to songwriters Both PROs and government hold record companies accountable for royalties not paid

When the government and PROs effectively enforce and monitor record companies, songwriters and record companies will be able to form strong, clearly defined contracts and maintain the production of new music.

The music industry could also be considered to use a buyout system, a form of the principal-agent model, with the record company and the songwriter. The songwriter (principal) entrusts the record company (agent) to distribute and sell their product and should be confident that the contract will include provisions that ensure that the record company won't make decisions only for their own monetary benefit. As of right now, agents seem to follow the theory of principals and agents. On the other hand, PROs serve as monitors of the agents. Although they essentially don't have superior power over agents, they do have a significant amount of power to defend and assist songwriters ex ante finalizing a contract.

Another model to consider is the model of asset ownership created by Sanford Grossman and Oliver Hart (1986). This model explains "when one firm will desire to acquire the assets of another firm." The contract type, details of the contract, and costs associated with parties in a long term contract relate more closely to the issues of royalties in the music industry and clear uncertainties between licenses and sales. When contract terms are clear, the uncertainties of who gets paid what and how they are paid are clear, so songwriters will not have to worry about losing revenue or benefits and their incentive to create new music will increase. The asset ownership model could give a better understanding of economic issues including who has control over residual rights, the incentives to produce, and if the loss of incentives can eventually decrease production. Theoretical insight to possible changes to a contract's flexibility or rigidity before and after the internet may find that if this new model is applied to the music industry, a contract with clear, detailed terms will more likely be possible for all parties involved (Hart, 2007).

In forming contracts, parties make sure to define and enforce contract terms that will give them the biggest gain, and not necessarily for social benefit. If a contract makes the record company better off concerning profit or incentives than the songwriter or vice versa, and there is an optimal amount of production, then the fact that the other party is worse off or at least no better off doesn't make any difference as long as production is maintained and doesn't decrease. When a party being worse off eventually leads to a less amount of production, then changes or adjustments will probably be made even when the cost of contract is high to better accommodate all parties. There is also the possibility that the opportunity of a large profit could cause post-contractual opportunism (Klein, Crawford, Alchain, 1978). After contracts have been formed and there is a large profit from music downloading, songwriters see it as an opportunity to gain more revenue and a better reputation. Record companies have the opportunity gain more revenue as well by enhancing marketing strategies on the internet.

The record company could be selling digital music as a sale rather than a license in order to receive greater revenue for a songwriter's music. Owners withholding services of a specialized asset to receive a greater share could cause problems in the music industry and in other industries as well. According to Anderson and McChesney, fixing the problem would mean either to "purchase the specialized input outright or be able to monitor its contributions so as to identify opportunistic behavior by the owner." In the music industry, if a songwriter can't monitor the contributions he or she makes in obtaining revenue for digital music, a songwriter has the choice of being the sole owner of the rights to their song recordings choosing not to share their copyright with the record company. The costs, however, of purchasing, promoting, and distributing music can be extremely high for a songwriter. These high costs cause the songwriter to continue their relationship with the record company and renegotiate with the company to receive the maximum benefit.

If contracts have a basic structure, that is terms that specify distribution of income for all parties and the conditions of using and selling resources, then the relationship between the parties involved should be a positive working relationship (Cheung, 1970). If a contract is missing foundations of its structure, then some parties can be worse off over time and may lose the incentive to produce or work with the other parties included in the contract over time. Songwriters who are worse off compared to record companies concerning profit and incentives eventually lose their incentive to create new music and the overall production in the music industry will decline over time.

Focusing solely on digital downloading, in the case of recent lawsuits artists have claimed they have been “underpaid.” They state that publisher (the record company) has been recording digital downloads as sales rather than licensing downloads, which would lead to higher royalties. They claim that when downloading sites like iTunes purchase music from record companies, the websites are given a master copy of songwriters’ music, which is usually done when a company or individual wants to license a songwriter’s music. This becomes a case of establishing a sound contract agreement, where the distinction of royalties and sales are agreed on by all parties, or using a similar method like Towse’s principal agent method. Are there economic models that are better suited, or more efficient in making sure all parties receive their correct amount of royalties for all distributions?

In the derivation of a contract between a record company and a songwriter, the record company usually decides how to pay a songwriter for their services by examining their popularity at that present time, and determining how successful the song in negotiating could be. Economically, the royalty rate setting, and the artist reputation are considered in the marginal cost of production for the record company. More successful artists, successful in this case meaning if an artist sales more than a million songs sold per album, have a better chance and leverage to negotiate price. There is then the probability that the more in royalties an artist gets the less profit the record company will receive. If the record

company is working with a new artist, the incentive for the record company to pay songwriters by licensing and paying songwriters according to the number of sales the song makes is much lower than just paying a lump sum to an artist. When a songwriter becomes more successful and has a reputation of producing highly profitable songs, the record companies' incentive to license will be higher and will be more willing to obtain residual claims for the songwriter. Contracts in the music industry would most likely contain terms that monitor an asset, which in this case would be a song and the residual claims to the asset once it's been produced and distributed. A songwriter could use the buyout method, where the songwriters receive a lump sum for their song and don't receive the residual claims after the song is distributed. The record company can share the copyright of their song with whatever party they choose, which for this paper will be a record company, or a songwriter could even create his or her own record company, which is not explored in this paper.

The danger for a songwriter agreeing to the buyout method might be if a song becomes highly successful, the record company will want the songwriter to keep creating so that they can continue to reap the rewards. However, that incentive to create new music may dwindle if they always receive the same amount of money. Of course, this could be a win win since reputation is a large incentive for artists. If the tables were turned (which is probably unlikely), record companies would lose the incentive to work with songwriters when the songwriters receive the residual claims. Using an optimal contract, the residuals can be shared by both the record company and the songwriter. Having a contract that clearly defines residual claims will give more of a guarantee that songwriters will receive compensation for their creativity and record companies will receive a decent profit that is more than the costs of mass distribution. Even though in most cases of larger, well known record companies, the cost could be considered relatively cheap for record companies, there could be an instance that the economic benefit of producing an artist's album is too low or the marginal benefit is considered to be too high. Most

contracts between the record company and a songwriter do include the costs of packaging and distribution of albums no matter the success of artists.

LITERATURE REVIEW

While most economic research that has been done to explain copyrights theoretically, only few economists explored this literature empirically. Volker Lehmann theoretically wrote how new outlets of technology bring about new ways of production, disregarding what the new outlet might do to the old outlet. He mentions that file sharing websites like Napster became such a threat to record companies because of the large amount of profit the sites were able to take away. They were able to take so much away from the record companies because the websites were able to operate with essentially no transaction costs. This gave the record companies an incentive to enforce rights of distribution to consumers concerning the internet. The record companies claimed that not only were songwriters and artists not being compensated, but the record companies were not receiving a large profit either, and overall music sales fell by 30%. The author then moves on to discuss the cases of various artists and record companies fighting with individual downloaders and websites in the form of lawsuits to protect property. In contradiction to Hardin's Tragedy of the Commons, Lehmann talks about the Tragedy of the Anti-Commons. He touches on the issue that the government has no direct influence on the use and distribution of rights. This can be considered one of the reasons that there are no clear terms in contracts between songwriters and record companies. Lehmann claims that the lack of centralization increases the transaction costs of record companies to distribute, produce, and use copyrights in the music industry. Lehmann says that adjusting current enforcement of copyrights in the music industry doesn't fix the "root" of the problems of enforcement, but rather focus should be given to the design of the copyright laws and adjustments that should be made there. A solution suggested by Lehmann is for the government to create a monopoly in the music industry where the government is easily able to govern and control the music industry's practices. However, Lehmann decides that this would not be the best choice since lobbyists would most likely determine fees given to record companies and artists. He continues that government decision making has a history of changing laws and regulation after new

developments have been introduced, such as a new outlet like the internet. On the other hand, the music industry thrives and capitalizes on adjusting to innovations as they happen. Overall, the author suggests how difficult it is enforcing and finding the copyright law that will create an optimal production, marginal cost, and marginal benefit to consumers wanting to use some type of asset in the music industry.

Seth Ericsson goes into more detail about the creation of iTunes and its impact on the music industry. Ericsson calls iTunes the central download that was the only outlet that supplied music from all labels and became a more acceptable alternative to peer to peer websites like Napster and other file sharing websites. The site's flexible pricing and it being easy to use made it able to lure consumers away from file sharing websites. Generally speaking, this paper speaks to the history of how the recording industry and the innovation of online music were forced to blend together. This paper gives more support of how the internet has become a major outlet for the music industry and the necessity for clearly defined contract terms pertaining to the internet is vital.

Paschal Preston and Jim Rogers speak on the music industry and social networks blending together as well, saying that the record companies "reconfigured core structures," meaning they invested more money and time into the internet instead of their usual avenues of distributing music like T.V. and radio, to accommodate the booming digital world, when they originally produced most of their sales from CDs. They offer insight into how the ownership of property rights plays a part in the music industry re-shaping and they ask the question if sites including iTunes and Napster, have diminished the power of record companies by being a direct source for consumers to connect to artists. Before the digital era began, the music industry used property rights laws as a defense mechanism to combat new technology outlets. The authors also comment that the industry's initial reaction in the early 1990s was to take legal action against these sites since those sites did have a direct effect on their revenue. These

lawsuits are still brought to court. The authors found that in summer 2010, 35,000 individuals were still awaiting their court appearance for downloading and file-sharing offences. Over time, the industry changed to what Preston and Rodgers call a 360^o bundle of rights, where the authors claim the music industry “merged” into a centralized institution, where one entity handles distribution, promotion, sales, etc. on all outlets, which overall makes the artist or songwriter worse off, since they have no choice but to give all their rights to one publisher where before the songwriter had a choice of sharing or giving their rights to different companies to get a better return on their investment. The record companies’ alliances with websites could also be evidence of companies trying to take hold of the market and block new entry. Before the internet, record companies were considered the monopolist in mass distribution. Taking hold of the internet market could make them the monopolist once again in the music industry for mass distribution for new music. In an interview the authors conducted with eight managers in the music industry, each manager agrees that even with the opportunities that are presented with the internet there is no clear confirmation that the internet provides a new clear alternative to distribution of songs and increased sales as well as other outlets like TV and radio. They report that though songwriters could use the internet to distribute their own music, record companies still hold influence and the power to mass distribute a songwriter’s product to all markets in all geographic regions. As far as record companies losing their overall power in the industry, the authors conclude that though the digital world has affected record companies, the crucial need for marketing and mass distribution makes record companies needed and just as powerful in the music industry. The centralization of the music industry will increase the chances that songwriters will lose their incentives to create new music, which could decrease the amount of production of new music for the record companies. Record companies have the comparative advantage of mass publicity and distribution through radio and T.V. Songwriters that don’t rely on record companies would have to go to great costly measures to distribute their music

and most likely wouldn't earn much money or even have the option of earning money through sales or licenses.

Industry experts were also interviewed in Martin Peitz and Patrick Waelbroeck's research on the impact of online distribution in the music industry, as well as other data sources. In the following table supplied by Peitz and Waelbroek, even with the internet in place, radio is still the number one way to influence consumers to buy music and for record companies to receive profit.

Table 3.1 Type of media that influenced US consumers to purchase their last CD (in %)

Radio	75
Friends/Relatives	46
Music Video channel	45
Saw in the store	42
Movie Soundtrack	37
Live performance	29
TV Advertisement	24
Featured in TV Show	23
TV Show Appearance	22
Downloaded MP3	19
internet	17
Magazine/Newspaper	17
internet Radio	15
Record Club	15
Video Game	5

Source: Edison Media Research, June 2003; in percentage of consumers who have purchased a music CD in the past 12 months.

This literature provided Peitz and Waelbroek is different from previous literature for the authors discuss opportunity costs for consumers of using computers to download music rather than purchasing CDs. They do make mention of the decline that online downloading had on the music industry. The individual purchasing the music from the internet will want to minimize their costs by purchasing songs from the internet. Their opportunity costs include the time of actually using the computer to download files, the time it takes to download files, and the threat that an individual can download a "bad" file, whether that is a file not compressed correctly or a file with a virus. Another detail of the paper worth mentioning is that they "infer from the success of Apple's iTunes that digital music downloaded from the

internet will partly replace music sales in the traditional format. In this sense, it would just become another channel through which music is distributed. Instead of selling records through record stores the labels sell downloads through music sites.” According to Peitz and Waelbroek, this shows the big impact of outlets on distribution. They also note how digital sites have become opportunities to sell music to sites and they are counted as sales as opposed to licenses, which affects the revenue and overall incentive of songwriters to produce new music.

All of the literature shows how the internet impacted the music industry and became a major way for record companies to distribute songs and market their artists and for songwriters to make a profit for their songs and to build a reputation. With the internet becoming such a formidable force in the music industry record companies will take more time and money to form alliances and make profits. Therefore, the rights between record companies and songwriters will have to be strong and clearly defined in contracts.

Ruth Towse (2000) touches on the principal-agent model and the buyout system applied to the music industry. She explains that this method of principal-agent is claimed to expose the “trade-off between risk-bearing over the life of copyrighted work, the amount of effort at marketing and maintaining the reputation of the work and the transaction costs inherited in the different payment methods.” The paper goes on to use empirical analysis to determine if paying royalties to the agent provides incentives to create more music. To find the amount of money most artists receive in royalties Towse put together a table shown below. Record collecting societies from the UK, Sweden, and Denmark respectively Musician’s Union, SAMI, and GRAMEX provided Towse with information on how much various artist were paid in royalties and to show the distribution between artists.

Table 3.2 Distribution of Royalties

UK		Sweden		Denmark	
Band of Distributed Income (in pounds)	Percent of Musicians	Band of Distributed Income (in kroner)	Percent of Musicians	Band of Distributed Income (in kroner)	Percent of Musicians
0-90	12	0-249	75	0-249	32
91-200	16	500-999	16	250-999	52
201-500	24	1000-4999	8	1000-2999	9
501-1000	16	5000-9999	1	3000-4999	2
1001-2000	14	10000-49999	1	5000-9999	2
2001-5000	12	50000-99999	Less than 1	10000-19999	1
5001-10000	5	100000 and over	Less than 1	20000-29999	Less than 1
Over 10000	1			30000 and over	Less than 1
Total:	100		100		100

Source: Musician’s Union 1995, SAMI 1994, GRAMEX 1995. Exchange rates in 1995: 5.6 Danish kroner to 1 dollar, 7.3 to 1 ECU and 8.8 to 1 pound; 1.7 dollars to 1 pound

Using data on individuals who received royalties for performing rights in Sweden, Denmark, and the UK, the concluded that though there are few performers that receive a substantial payment in royalties, the majority does not and this in turn does not create an incentive for “creativity.” Towse also concludes that government involvement does not help in increasing incentive or production of new music.

Ivan Pitt (2010) uses data from the ASCAP 2007 annual report to estimate the optimal amount of dollars members in a performing rights organization would want to make assuming every members goal is to maximize income while the popularity of their song is high. Dependent variables for finding the optimal dollar value included the money received from license, T.V., radio, internet, jingles, and the amount of years an artist has been in the music business. Pitt finds that success or the large amount of income that is collected by PROs is skewed, going to a small amount of asset owners because of a song’s current popularity and high frequency in TV, radio, and other outlets. This shows that many songwriters don’t receive a large amount of money even when the popularity of a song is high. Since songwriters

make more money from licensing than sales royalties, songwriters will want record companies to sell their music through licensing, so they can receive the largest amount of profit possible.

APPLICATION

Though the literature work supports this thesis in the sense that record companies have had to change their institutional foundations to include the digital music era, no research has delved into the subject of how record companies classify their profit from digital sales (whether their profit is listed as a sale or license), what the results of their classification do to the songwriters and artists that are influenced by the sales of their product, and if that classification affects overall production.

If a songwriter chooses to sell his property or share the copyright of their song with a record company, monitoring costs will be a factor for the record company to make sure illegal websites or a random downloading will not interfere. The biggest deciding factor in the contract is what makes the asset a sale or an opportunity of a license. The theory of post contractual opportunism could easily be applied in the music industry regarding this issue. The issue of whether an asset is sold by record companies to outlets as a sale or a license could be classified as a record company withholding services to outlets to gain a greater share of profit, since sales of songs will give songwriters a smaller profit than a license will, or vice versa for record companies. Actually fixing the problem is currently proving to be difficult for songwriters. A decent solution is the use of PROs, who do step in to monitor record companies to make sure that songwriters do get their share. This doesn't stop more and more songwriters and artists from suing the record companies to fix this very problem. So what would be the next step? More government action could be a possibility. As of right now, the only government action taken in the form of lawsuits from songwriters for record companies, as well as the United States Copyright Royalty Board. The government's involvement currently involves settling disputes and maintaining current terms of how royalties are set and given to various artists. If the government was to have more involvement of restricting the access of music on the internet or harsher punishment and restriction on people who violate property rights, the value of property rights would increase.

An interesting factor that could change the value of a song particularly in the music industry is the popularity of a song, or the popularity of the artist or songwriter. A newer songwriter holds more uncertainty of creating a highly successful song that will bring in a large amount of revenue. The more popular an artist gets, the more uncertainty decreases, and the more likely all parties involved will gain a bigger profit, and in turn bigger royalties due to the large number of consumers purchasing the song, whether they are TV outlets, radio, movies, individuals purchasing CDs or digital downloading. The opportunity of record companies receiving a bigger profit because of an artist's or songwriter's status will cause the record companies and songwriters to keep a tighter hold on digital downloading: defining and enforcing rights for them and songwriters in contracts, and maintaining incentives.

A songwriter's incentive to create and produce a new song would be fostered on the fact that they are receiving just compensation from record companies receiving their product. The songwriter trusts that the publishers will not abuse their power for their own gain. If a songwriter delves into legal matters with record companies or feel that they can't keep at least their reservation wage, they could lose their incentive to create or distribute new songs for the record companies to publish. When the production of new songs goes down, record companies will begin to make additional adjustments to the core structures and mainly in the rights of songwriters and establishing better definitions of what constitutes a sale and what should be considered licensing in the digital world.

The main applications for defining intellectual property rights and enforcement in this thesis is to explore an actual case that is said to be groundbreaking for all songwriters in the music industry, and will collect data on other cases currently in court and see if there was a significant decrease in production. The theory derived to test a songwriter and his or her relationship with a record company is fairly simple. There is a songwriter and a record company, and the songwriter has a copyright that they choose to share with the record company. The record company will promote, and distribute the song to

all outlets available, including the internet. Assuming both the record company and the songwriter want to maximize profit, the record company will either count the success of the song as a sale or a license, whichever makes them more money. The songwriter will most likely want the company to license the song since most contracts state they will get a larger amount from licensing than sales since licensing will allow an individual reproduce and gain profit from the songwriter's song. As the songwriter becomes more popular among consumers, the record company will continue to record and distribute the songwriter's product and will set out the gain as much revenue as they possibly can. On the other hand, if the songwriter is underpaid, they will lose incentive to produce new music and the production of new music will decrease. This finding will be evidence to show that adjustments to contracts made between the record company and the songwriter to define contract terms concerning intellectual property could be instrumental in maintaining incentive and overall production.

EMPIRICAL ANALYSIS

Data was collected from the United States Ninth Circuit Court of Appeals to give an actual account of contracts, royalties, and the affect they have on overall production. The discography of four artists: Kenny Rogers, Sister Sledge, Al Yankovic, and Public Enemy artist Chuck D is given to evaluate the amount of production before and after each artist sued their respective record companies for underpayment.

In a particular court case, Aftermath Records, a company operated by Universal Music Group (UMG) Recordings, versus F.B.T. Productions, LLC is considered a groundbreaking case concerning this very issue. In a summary given by the United States Court of Appeals in the Ninth Circuit, the plaintiff, F.B.T. Productions, claims that the company received digital royalties as a result of sales rather than as a result of licenses. The contract, originally established in 1995 with record company Aftermath records, songwriters F.B.T. Productions, and the artist who publicly performed F.B.T.'s songs, rap artist Marshall Mathers whose stage name is Eminem, gave all rights to F.B.T. This didn't include digital rights. The courts make it a point to mention the contract agreement stated that F.B.T would receive 50% of all sales from a masters license (the equivalent of a license in this thesis). Masters refers to the recording, yet there was no definition of a license mentioned in the agreement. The agreement also included a provision called records sold (the equivalent of a sale in this thesis), which promised this production company 12%-20% of royalties. From 2001 to 2003, with no change to the contract, UMG Recordings established agreements with Apple Inc. and several cellular phone companies to sell and distribute master recordings through iTunes and ringtones. In 2003, F.B.T and Aftermath Records renewed their contract agreement, which provided the same contract terms of records sold and masters licenses with an increase to the royalty rates, where the percentage of each was not provided. The court's document stated that in 2004 the contract added that "Sales of Albums by way of permanent download shall be treated as net sales for the purposes of escalations," where escalations are "Increases in the royalty rate

when total album sales surpass certain targets.” The sale of digital downloads were obviously mentioned during the new negotiations, but it is unclear what the exact contract terms were. That discrepancy led to F.B.T.’s first case involvement with the courts in 2006, claiming Aftermath was counting digital downloads as their record sales when the two parties supposedly agreed to count them as masters license. Aftermath argued otherwise, stating that the 2004 amendment between the two stated the parties agreed downloads would be treated as sales. The judge declared that “the agreements were reasonably susceptible to either party’s interpretation,” and did not award F.B.T. anything, but awarded Aftermath \$2.4 million dollars in legal fees.

FBT Productions, LLC –w- Aftermath Records
 Summary of Findings
 July 1, 2005 through December 31, 2009

1. Incorrect Royalty Rates	
A. Black Vinyl Rate Reduction	\$ 12,069
B. Black Vinyl Rate Escalations	307
C. Military Sales Escalations	574
D. Litigation Settlements Participation Percentage	386
E. NA	
F. Permanent Digital Downloads	3,810,256
G. Budget Sales – “Curtain Call”	152,374
H. Mid-price/Budget Permanent Downloads	18,906
I. NA	
J. Foreign Licensing	131,749
2. Failure to Report Royalties	
A. Factoring Returns for Free Goods	3,865
B. Excess Record Club Free Goods	8,302
C. Excess Foreign Free Goods	207,357
D. Video Clip Income	
3. Third Party Royalties	
A. “Stan” – “Curtain Call”	130,878
B. Dr. Dre Compact Discs	4,720
C. “Encore”	26,834
D. Foreign Pricing	32,188
E. TV Advertising Costs – Understated Producer Credit	17,371
4. Other	
A. Overstated Costs	40,895
B. Overstated TV Advertising Costs	361,915
C. Aerosmith Sample Allocation	11,165
D. TV Advertising Cost Allocation	28,169
E. Foreign Income Taxes	68,680
F. TV Advertising Costs Reserve – “Relapse”	15,527
G. YouTube Litigation Settlement Income	86,398
H. Legal Hold	2,068,337
I. Dr. Dre Shared Costs	
J. Public Performance	
K. Other Income	
5. Interest on Claims	

In 2009, Hollywood Reporter showed an audit report displaying the difference between sales and licenses sold, according to an audit conducted by the plaintiff, amounts to over \$3,000,000. The New York Times reports, "Unlike physical sales, where the record company manufactures each disc and has incremental costs, when they license to iTunes, all they do is turn over one master," said Richard S. Busch, a lawyer for F.B.T. "It's only fair that the artist should receive 50% of the receipts." F.B.T. appealed the court's decision and went back to court in 2010. The songwriters further argued that the contracts were ambiguous between Aftermath Records, and the courts needed to decide if music downloads followed the guide of "records sold" or "masters license." The courts decided that the revenue Aftermath Records did make from iTunes, were indeed "masters" and were used as if they were licenses and not sales. As a result, the reward of attorney fees for Aftermath Records was reversed and the case was remanded for further proceedings. Aftermath Records tried to overturn the decision by taking the case to the Supreme Court, but the Supreme Court declined to hear the case. As of 2012, F.B.T. Productions has filed a supplemental complaint over permanent downloads that was not mentioned in previous court hearings (previous hearings concerned conditional downloads, music that is purchased for a limited amount of time), which the court has granted. The court has ordered Aftermath to record conditional digital downloads as masters licenses instead of sales, and pay the money F.B.T. claimed the record company owed. The court is now deciding if the record company should pay F.B.T. money for permanent downloads.

This case shows how the ambiguity between sales and licenses in a contract can cause friction between a record company and a songwriter in the case of digital downloading. However, did this lead to a decrease in publishing by F.B.T Productions? Did the lack of clarification hinder the artists associated with Aftermath Records incentives to create or perform music? Or does the record company, in this case Aftermath Records, not distribute or promote as much? Marshall Mathers, recorded his last song with Aftermath Records in 2010 and with F.B.T. in 2009. After 2010, Marshall Mathers departed

from Aftermath and started his own record company and produced their first album in 2012. Although the record was digitally distributed and had little promotion according to the artist website, the album still landed on the Billboard Charts and sold 171,000 copies in its first week. It could be stated that the confusion in contracts didn't lead to a decrease in production or incentives for this songwriter.

Aftermath Records hasn't produced, distributed, or promoted any new music since 2010, and F.B.T Productions hasn't produced any new music 2009, during which time their court case was being heard in court. In this case, the ambiguity of contract terms and residual claims deeply affected record companies as well as the songwriters. As a result of the contract structure, the number of CDs produced after the contract structure was argued in court, decreased considerably compared to the number of CDs produced before the legal issues began. Yet there is no way to tell if the incentive to create new music decreased.

There are some lawsuits in the music world that could be considered as evidence of decreased production. Of all the artists that sued record companies for underpayment, the production before and after the lawsuits against the record company was tracked to compare the changes, if any, in production of new music from each artist. If production before is no different than the production after the lawsuit, or if the production even increases in the market, then there is no need to worry about the underpayment of artists and songwriters from an economic standpoint. However, if there is a decline in production, then some adjustments should be made to clearly define what is considered a sale and what is considered a license to satisfy songwriters while keeping record companies happy with the revenue they bring in. Four artists, Kenny Rogers, Sister Sledge, Al Yankovic, and Chuck D from the group Public Enemy, which filed or settled lawsuits in February 2012 were observed as far as production before and after the lawsuit settled. Every lawsuit was filed by the artist for underpayment of royalties from digital downloading revenue. Each artist was chosen from articles that were found in the same month and year

regarding the same issue of underpayment. The discography of each artist was used to track the production of new music. All discographies were taken from the official website for each artist, with the exception of Sister Sledge, whose website was under construction. Instead the discography was taken from a website focusing on the music history for all artists. The artists are listed in Table 6.

Table 5.1 Observation of Artist Production

Artist/Songwriter	Number of Albums Before Lawsuit	Year of Lawsuit	Number of Albums After the Lawsuit	Production of New Music
Kenny Rogers	49	2012	1	Yes
Chuck D	12	2011	2	Yes
Sister Sledge	16	2012	0	No
Al Yankovic	28	2012	1	Yes

For example, Kenny Rogers has consistently created new music up until 2012, when he filed his lawsuit in court. Since then, he only has one new album produced. It's not clear if production actually decreased from a result of filing lawsuits of underpayment. For this observation, this may be because the span of time between the lawsuit filing and the time this paper is written is extremely short. Another reason is because most of the artists observed are older and have been working in the music industry many years before they filed the lawsuit. For those artists who are currently producing new music despite their lawsuit shows that there are no production issues for record companies and consumers.

There are some issues plaguing these two examples. The first issue being the amount of time that has surpassed to make a comparison between production before and after lawsuits were filed in court. All empirical evidence mentioned are currently ongoing cases. Another issue is the fact that it is not certain if record companies made began to record digital downloads as licenses rather than sales after lawsuits were filed, and how that affects the production. When the cases have been heard and final judgment has been given, it will be easier to compare production.

Another theory would be the case of older artists versus younger or new artists. There are more cases of older artists, who have been creating music for many years, or older meaning they haven't created new music in many years being underpaid from digital royalties. It is said that the case between Aftermath and F.B.T is a crucial case for these artists because if the verdict turns out in F.B.T.'s favor, then older artists could easily begin to renew the contracts they have with record companies to earn more money or even sue the record companies for the money they haven't received from the time they stopped creating new music until now. That begs the question of if there is a pattern of older artists being paid through sale royalties, while newer artists and songwriters are paid through licensing royalties. There is a point that most contract negotiations done before the year 2000 had no need to negotiate terms over digital music. Now that digital music downloading has become such an integral part of the music industry, younger, more current artists automatically include a clause for digital music. So it's very possible that all older artists who negotiated and signed contracts before the year 2000 do not consider digital music provisions, which means they were paid royalties through sales and not licenses. This is why we see the increase in older artists, who haven't renewed contract terms go to court to sue over digital music royalties. This observation gives support to the theory of contract structure and contract terms in the music industry. Another test considered was the theory that the more successful songwriters are; the more likely they are paid through licensing royalties than sale royalties. With a current successful artist, for example, being measured as a songwriter who songs makes more than a million dollars during one particular year, it could give the artist more incentive to influence the contract terms with the record company, to promote their music in concerts, interviews, and other outlets. This gives the record companies more opportunity to make a bigger profit licensing the songwriters profit than outright selling it. Of all the lawsuits presented to the courts, none of the artists would be considered successful in the year they filed their lawsuits, which was either 2011 or 2012. However, finding the data to this theory proved difficult and there is no clear evidence that this is

true. As far as the hypothesis that though laws are adjusted as more outlets become available over time to maintain marginal benefit for songwriters and record companies and maintain production of new music, some applications included in this paper support the hypothesis more than others. For instance, in the case study, contracts between the songwriters and the record company did adjust to accommodate the new outlets of distributing music, and the production of new music of the songwriter and the record company decreased as a result of their ongoing court battle. However, in the applications of older artists and of artists who have sued over royalty underpayment, the production of new music from the artists ranged from minimal to nothing even before the introduction of digital music, and nothing in their contracts with their respective record companies did not include provisions for music downloading through the internet. Therefore the hypothesis that the production decreased due to the contract agreement is not supported.

CONCLUSION

The topic of intellectual property rights in the music industry has no one clear answer and will continue to be an interesting topic over time. Overall, through this analysis, this paper shows the pertinence of contract structure and how clear terms and provisions should be defined to diminish conflict between record companies and songwriters, or any other parties in the music industry. One also learns the importance of royalty setting as it relates to production and the success of all artists, regardless of their success and experience in the industry. The cost of establishing these contracts could be expensive, but the marginal costs of ignoring the making of certain terms clearly defined could prove to be higher for record companies in the form of legal battles with songwriters in the future. Even though the internet has provided great advances as well as setbacks in the music industry, the internet classified as a new distribution outlet for songwriters is still unclear. Record companies still hold major power in distribution and have used the digital world to their advantage for marketing and advertising strategies. From observing the artists in this thesis, production approximately remains the same after lawsuits are settled, so there is not enough evidence to make the claim that production decreases. However, the case between Aftermath Records and F.B.T. Productions noted a change in production for the record company and other companies responsible for production. A variety of artists and cases to examine, may have afforded more variation in the results.

A testable implication could be testing (focusing just on digital sales) if money received from licensing is substantially more than money received from sales of a song. It could show that those copyright holders do have a valid claim that present general contract negotiations concerning the internet isn't profit maximizing for the songwriters. Another test could be to use data from the annual reports of performing rights organizations. Data collection on distribution of royalties collected by all artists, like Ivan Pitt's analysis, using empirical data to find the optimal value that artists would want to receive. Using the data could help the record companies' decision to give out royalties through sales or

licensing practices and could determine the amount of incentives for the songwriter. Also, looking at the production of music or the amount of digital recordings produced, a conclusion can be made if contracts need to be adjusted to fit the new digital era. Using the data from the annual reports, reports of royalties, sales, and money received from licenses could be used to test effects the theory of asset ownership implications of ex ante and ex post decisions in contracts. Even finding the financial reports of specific artists' revenue on exactly what songs the artists received in sales royalties and what the artist received in license royalties. Data could also be collected of the production of songwriters who are currently in court for underpayment of royalties and compare their production with a songwriter who is not in any lawsuit. Comparing the differences in production between a songwriter in court and a songwriter who is not would show how production is affected by ambiguous contracts and royalty underpayment. This data would be a starting point to develop an improved model of contracts in the music industry that fits more closely with a particular economic model.

This research has presented a new perspective on intellectual property and the enforcement of contract terms in the music industry. The biggest problem that drew many artists to court to sue record companies was the fact that most digital downloading revenue was listed by record companies as sales rather than licenses, which in turn gives artists a greater payment in royalties. This paper attempted to observe the change in production before and after lawsuits was filed in court by a different range of artists. Though none of the lawsuits that have been heard in court to date have reached a final judgment by a judge, the cases show how difficult it is to have clear contract terms between record companies and songwriters in the case of digital downloading. The production of new songs from both sides has been affected comparing the amount of new music produced before their lawsuits and the music produced as their cases are being heard.

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