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## The Aftermath of Aftermath: The Impact of Digital Music Distribution on the Recording Industry

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## The Aftermath of *Aftermath*: The Impact of Digital Music Distribution on the Recording Industry

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I. INTRODUCTION .....	323
II. BACKGROUND .....	325
A. <i>The Traditional Record Industry: A Brief Overview</i> .....	325
B. <i>The Development of MP3 Technology</i> .....	326
C. <i>Impact of the MP3 on the Traditional Industry</i> .....	327
III. ANALYSIS: <i>F.B.T. PRODUCTIONS V. AFTERMATH RECORDS</i> .....	331
A. <i>Background of the Dispute</i> .....	333
B. <i>The Ninth Circuit Decision</i> .....	334
C. <i>The Allman Brothers Case</i> .....	338
D. <i>Aftermath and the Current State of the Industry</i> .....	340
IV. APPLICATION .....	341
V. CONCLUSION .....	343

### I. INTRODUCTION

As digital technology continues to grow, the business of music, that is, the traditional recording industry dominated by the major labels, is under increased pressure and on the verge of collapse.<sup>1</sup> Throughout the 20th century, record labels controlled consumer access to music by providing artists the necessary capital to make recording and distribution a viable option, in ever-changing mediums.<sup>2</sup> In essence, record labels turned music into a business by recording what was previously only available to a live audi-

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1. *The music industry – From major to minor*, BUSINESS & FINANCE, THE ECONOMIST, (Jan. 10, 2008), <http://www.economist.com/node/10498664>.

2. David Byrne, *David Byrne's Survival Strategies for Emerging Artists – and Megastars*, WIRED MAGAZINE, (Dec. 18, 2007), [http://www.wired.com/entertainment/music/magazine/16-01/ff\\_byrne?currentPage=all](http://www.wired.com/entertainment/music/magazine/16-01/ff_byrne?currentPage=all). See generally Shuman Ghosemajumder, et al., *Digital Music Distribution*, DIGITAL BUSINESS STRATEGY PROFESSIONAL SEMINAR, Mass. Inst. Tech. Sloan School of Management (2002) (discussing the history of recorded music from the gramophone to MP3 technology).

ence, promoting it, and selling it to consumers; labels made music a commodity.<sup>3</sup>

While that business is now struggling in the Digital Age, the music industry itself is prospering as niche music markets continue to sprout, and unique genres appeal to growing, new audiences.<sup>4</sup> Prior to the advent of the traditional industry, characterized by CD-based distribution, music was only available through live performances, and audiences were unable to bring that experience into their homes. Over time, major labels brought music into consumers' homes through various mediums, with the traditional industry relying on CDs. Today, the industry is shifting away from that traditional model as modern consumers share, purchase, and discover new music instantly through the Internet, rather than CDs. In this Digital Age, more independent artists are able to thrive because of decreased market-entry barriers, namely lower costs, fostered by digital music production and distribution.<sup>5</sup>

This article will address the impact the shift from hard-copy recordings to digital music distribution has had on the recording industry. Specifically, it will apply *F.B.T. Productions v. Aftermath Records*,<sup>6</sup> which correctly held that a label's relationship with third-party-digital-music-providers is that of licensor-licensee, to the modern music industry.<sup>7</sup> Based on this holding, record labels need to reconsider their relationships with artists, and create new business models that rely on licensing music, rather than the traditional sale-based distribution model.

The decision in *Aftermath* will lead to increased royalties for artists in the Digital Age. This article will analyze the impact of that decision for the modern music industry by advocating for increased artist royalties in this digital music era. By examining other relevant case law, the fundamental purpose of royalty distributions, and the evolution of the recording industry, this article will emphasize the need for the recording industry to adapt to the changing musical landscape and suggest possible business models.

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3. Byrne, *supra* note 2.

4. See Mike Stanzione, *The Effects of MySpace on the Music Industry*, COLD CLASS COMMUNICATIONS, (2010), <http://coldclasscommunications.blogspot.com/2010/02/effects-of-myspace-on-music-industry.html>; Byrne, *supra* note 2.

5. Byrne, *supra* note 2.

6. 621 F.3d 958, 961 (9th Cir. 2010).

7. *Id.*

## II. BACKGROUND

A. *The Traditional Record Industry: A Brief Overview*

Throughout the 20th century, the recording industry has adapted to multiple technological innovations, changing the manner and medium through which it marketed and sold recorded music.<sup>8</sup> For example, cassette tapes and “8 tracks” competed with vinyl records and turntables until, eventually, the CD (Compact Disc) became the preferred medium among consumers and dominated the marketplace by the late 1980s.<sup>9</sup> Similarly, the industry has dealt with consumers’ widely available access to radio broadcasts, working to ensure that consumers purchase music rather than simply rely on free radio.<sup>10</sup>

When CDs became the primary distribution method, labels changed their business models, requiring high-volume sales to maximize profits.<sup>11</sup> Prior to the ‘80s, record companies grew talents locally by promoting across varied markets through discos, retailers, disc jockeys, and the National Top 40, while catering to divergent musical preferences in many genres.<sup>12</sup> As CDs became the predominant medium for distribution, high-volume sales were necessary to offset the costs of finding, promoting, and developing talent.<sup>13</sup> Thus, labels shifted from localized promotion across multiple genres to simply selling CDs and growing revenues around few, superstar artists.<sup>14</sup> Essentially, labels needed assurance that CDs would be sold and that their investments would be repaid. Therefore, rather than risking a failed investment by funding a “flop” artist in a niche genre, labels focused their resources on popular artists who were certain to sell high-volumes.

As the disco-era came to a close and record sales floundered in the late ‘70s, the industry was revitalized by mega-hit artists, like Madonna and Michael Jackson, who made their “pop” music debuts in the 1980s.<sup>15</sup> When the “pop” music business exploded during the 1980s, record labels, in an effort to lower corporate risk and increase profit predictability, sup-

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8. Ghosemajumder et al., *supra* note 2, at 1–2.

9. *Id.* at 2.

10. Stan J. Liebowitz, *The Elusive Symbiosis: The Impact of Radio On The Record Industry*, 1(1) REV. OF ECON. RES. ON COPYRIGHT ISSUES 93, 94 (2004).

11. See Wolfgang Spahr, *Heavy Revenue: Change to Money-Based Tabulation Method Helps German Chart Rock Harder*, BILLBOARD, Aug. 11, 2007, at 19 (discussing a change in music sales measurement to increase profitability).

12. Ghosemajumder et al., *supra* note 2, at 2–3.

13. Byrne, *supra* note 2.

14. *Id.*

15. The Eighties Club, *The Politics and Pop Culture of the 1980s*, <http://eightiesclub.tripod.com/id207.htm>.

pressed the marketplace by controlling supply and clustering fans around these star performers.<sup>16</sup> The model had become: create a megahit-artist and watch profits from platinum CD sales soar.<sup>17</sup> By the mid 1990s, the industry experienced record-high sales, seeing the largest percentage gain in revenue in seventy-four years.<sup>18</sup>

Prior to MP3 technology, the recording industry was extremely complicated, relying on many players to create a successful artist and generate profits.<sup>19</sup> Historically, only the top fifteen percent of the music industry has been profitable, while the other eighty-five percent operated at a loss, largely due to high market-entry costs.<sup>20</sup> Consequently, major record companies dominated the industry while independent labels and artists found it difficult to enter the market successfully.<sup>21</sup> As a result, artists relied on major music companies, like Sony, Warner Brothers, and Universal, to fund their recording sessions, manufacture, market, and distribute their CDs, and pay the high costs associated with touring.<sup>22</sup>

#### B. *The Development of MP3 Technology*

The Nielsen SoundScan, the predominant music-sales tracking system, projected that digital album purchases would surpass those of physical CDs in 2011.<sup>23</sup> Through the first six months of 2010, digital sales accounted for 27.4% of total music purchasing, an increase of 21.5% from the same mark in 2009.<sup>24</sup> As digital purchases are projected to reach \$17 billion by 2014, the business of making and selling music is still viable; however, “major” labels will need to establish new methods by which they generate revenue and re-evaluate how royalties are distributed in an increasingly digital environment.<sup>25</sup>

After its initial development in the late 1980s, the MP3 has grown in popularity, making it easier for consumers to share, discover, and listen to

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16. Ghosemajumder et al., *supra* note 2, at 2–3.

17. Byrne, *supra* note 2.

18. Ghosemajumder et al., *supra* note 2, at 3.

19. Pedro Ferreira, et al., *Impact of MP3 on the Music Industry*, MANIAC TOOLS.COM, <http://www.maniactools.com/articles/impact-of-mp3-on-the-music-industry.shtml> (last visited Oct. 28, 2010).

20. *Id.*

21. *Id.*

22. Byrne, *supra* note 2 (discussing artist reliance on major labels for the costs discussed above as well as needing labels’ economic resources to ensure the longevity of artists’ careers); Ferreira, *supra* note 1.

23. *Digital sales gains over physical in 2011*, THE INDEPENDENT, (July 8, 2010), <http://www.independent.co.uk/arts-entertainment/music/digital-sales-gains-over-physical-in-2011-2021704.html>.

24. *Id.*

25. *Id.*

new music—both legally and illegally.<sup>26</sup> Over the last decade, the MP3 has increasingly become the preferred medium among consumers, as CD sales have decreased approximately thirteen percent from their peak in 2002.<sup>27</sup> Similarly, the Internet and digital downloads, via stores such as Apple Computer's iTunes, are replacing record stores as sources to purchase music.<sup>28</sup>

### C. Impact of the MP3 on the Traditional Industry

The transition to CD-based distribution required higher sales volumes and forced the industry to restructure its approach to artist development in order to satisfy its volume quotas. The industry shifted from developing talent in a wide range of musical styles to investing heavily in individual artists and creating demand for a particular artist, from a particular genre. Under the traditional model, with labels investing large sums in individual artists, the cost of producing, selling, and promoting a CD was high, leading to the megahit-artist model of the 1980s.

Under the traditional industry, volume pressures and costs associated with artist development led to the royalty-based artist compensation method that still dominates today. After investing in an artist, labels needed assurance that their costs would be repaid, even if the artist failed to attain widespread popularity; thus, the royalty system was developed to pay artists incrementally, insuring that labels would recover their costs first and foremost, before artists were ever paid.

The traditional justification for artists receiving smaller royalties, rather than larger percentages for their work, was that labels were investing substantial sums, often upwards of \$400 thousand, in potentially unsuccessful acts and needed to recover their investments.<sup>29</sup> In the traditional industry, labels had to balance the high costs associated with distributing CDs, such as manufacturing, printing, and shipping.<sup>30</sup> Consequently, la-

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26. Ghosemajumder et. al, *supra* note 2 at 3–4. See generally The Recording Industry Association of America, *2008 Consumer Profile*, [www.riaa.com](http://www.riaa.com).

27. The Recording Industry Association of America, *2008 Consumer Profile*, [www.riaa.com](http://www.riaa.com).

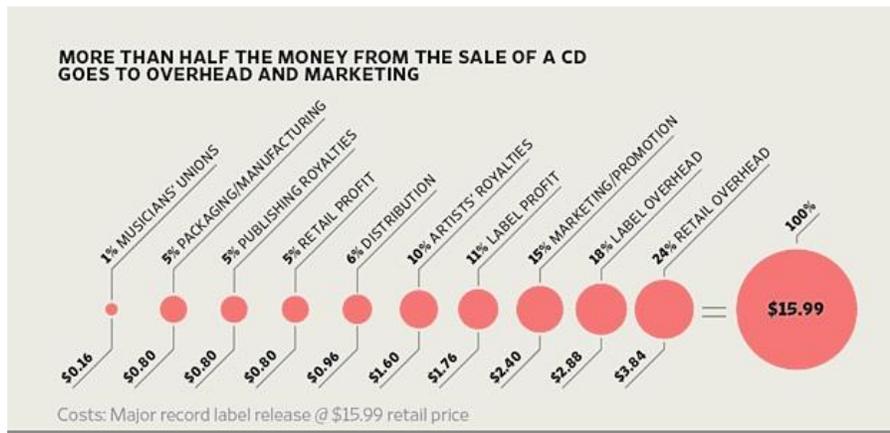
28. *Id.* (finding an approximate fourteen percent decrease in purchases from “record store[s]” and an almost fifty percent decrease in purchases from “other store[s]” from their height in 2004); see also The Nielsen Company, *A Big Music Year for Jackson, Boyle, Swift, Digital Downloads . . . and Vinyl?*, NIELSONWIRE, (Jan. 7, 2010), <http://blog.nielsen.com/nielsenwire/consumer/a-big-music-year-for-jackson-boyle-swift-digital-downloads-and-vinyl/> (citing 2009 music purchases up 2.1% over 2008 sales, largely driven by an 8.3% increase in digital sales of individual tracks and 16.1% increase in digital album sales).

29. See Byrne, *supra* note 1; Nicole M. Richardson & Chandra M. Hayslett, *The rise of independent music: indie labels maximize control*, BLACK ENTERPRISE (Dec. 1, 2007), <http://www.blackenterprise.com/2007/12/01/the-rise-of-independent-music/> (discussing the costs associated with producing and distributing a record and the record label's need to recover those costs).

30. Byrne, *supra* note 2.

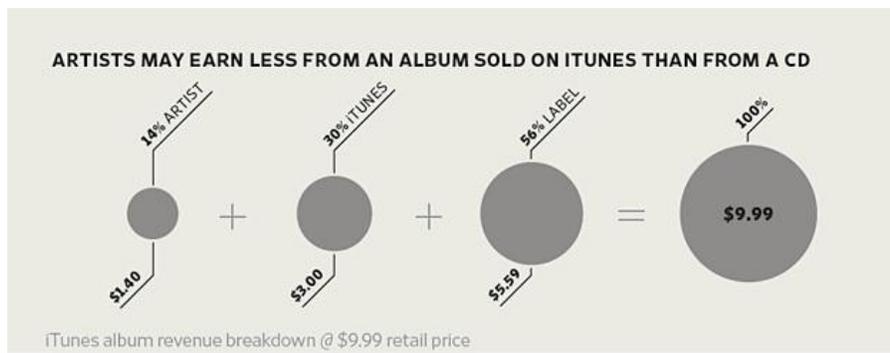
bels set a “break-even” point of minimum-records-sold, below which it was not economically feasible to distribute a record, because labels would not recover their investments.<sup>31</sup> Thus, labels were forced to over-inflate the retail price of a CD and limit artists to those royalties available after the label recovered its cost from production and distribution of the record.<sup>32</sup>

For example, depending on the specific structure of the artist contract in question, a traditional royalty payment for a CD that costs \$15.99, may break down like this:



**Figure 1. Costs Associated With Traditional CD Distribution.**<sup>33</sup>

Conversely, a breakdown of the payments associated with a CD sold as an MP3, which only costs \$9.99, may break down like this:



**Figure 2. Royalty Distribution Under Traditional Recording Contract**<sup>34</sup>

31. *Id.*

32. Ferreira et al., *supra* note 19.

33. Byrne, *supra* note 2.

As the charts above demonstrate, the profits from “record” sales are lower in the Digital Age because of the lower costs required to get those “records” to consumers with digital technology.<sup>35</sup> With digital distribution, it costs less to manufacture an MP3 “record” than it did when CDs dominated the industry. Thus, labels charge consumers less because they have lower costs to recover. However, when consumers are charged less per “record” in the Digital Age, labels earn less profit per unit, making artists’ royalty percentages lower per sale. While labels and artists are earning less from “record” sales in the Digital Age, artists are finding new ways to earn revenues in this digital era.<sup>36</sup>

In this Digital Age, recording costs have decreased significantly as artists are able to record and mix music from home and no longer rely on major label funding to pay for professional recording studios, engineers, and producers.<sup>37</sup> The cost of manufacturing, printing, and shipping CDs, which labels bore in the traditional CD-based traditional industry model, has been largely eliminated in this Digital Age. Today, artists can distribute their songs via the Internet, largely for free, and do not have to buckle to the volume pressures, which characterized the traditional industry.<sup>38</sup> In the traditional industry, creating a successful artist could cost labels upwards of \$1 million after promotion, research and development, and production costs are factored in.<sup>39</sup> Additionally, labels currently invest approximately \$5 billion a year in artists worldwide.<sup>40</sup> By contrast, production and distribution in MP3 format costs only a few hundred to a few thousand dollars, depending on the equipment used.<sup>41</sup> Further, artists can distribute their music through free channels, like YouTube and Facebook, building a fan base without relying on major label funding.

Additionally, the Digital Age has presented artists with opportunities to secure revenue via channels that previously never existed.<sup>42</sup> For example, under the “traditional” model artists earned money from selling CDs,

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34. *Id.*

35. *Id.*

36. Casey, *Breaking Artists, and New Definitions of Success*, FUTURE OF MUSIC COALITION, (Jan. 29, 2010), <http://futureofmusic.org/blog/2010/01/29/breaking-artists-and-new-definitions-success>.

37. Byrne, *supra* note 2; *see, e.g.*, Richardson, *supra* note 29 (indicating costs for professional recordings range from \$10 thousand to \$100 thousand per musical track and renting a recording studio can cost \$1 thousand a day).

38. Richardson, *supra* note 29, at 3.

39. Helienne Lindval, *The record industry fights its corner in the download age*, Music Blog, GUARDIAN.CO.UK (Mar. 12, 2010, 12:07 PM), <http://www.guardian.co.uk/music/musicblog/2010/mar/12/behind-the-music-record-industry-ifpi-report>.

40. *Id.*

41. *See* James Lee Stanley, *How Much Does It Cost to Make A Record?*, DATAMUSICATA (Nov. 28, 2007, 10:19 AM), <http://www.datamusicata.com/journal/2007/11/28/how-much-does-it-cost-to-make-a-record.html>.

42. Casey, *supra* note 36.

live touring, and “public performances” via radio and licensing; however, as new mediums, like video games, ringtones, and streaming music over the Internet continue to develop, artists have more opportunities to spread their work and grow revenues.<sup>43</sup> Further, artists have traditionally earned higher royalty percentages through live performances, rather than album sales. Thus, with lower distribution and publicity costs in the Digital Age, artists can spend their resources on touring and increase their revenues through live performance, despite a decline in hard-copy sales.<sup>44</sup>

From the rise of radio, to different technologies competing to become the preferred means of listening to music among consumers, record labels have faced pressure from various sources, in varying degrees, throughout the evolution of music.<sup>45</sup> However, the music business has, arguably, experienced no greater threat than the development of the MP3, which allows an audio file to be compressed to about one tenth of its original size, making it easier and cheaper to distribute music than ever before.<sup>46</sup>

With CD-based distribution, artists relied on labels to front the costs associated with producing and distributing their music. Thus, labels stood to make the most profit in the CD-dominated, traditional industry model because artists were forced to rely on their well-funded, established distribution channels.<sup>47</sup> Further, with CD-based distribution, consumers had to purchase an entire record, even if they only preferred one or two songs on that record. By contrast, the Digital Age allows consumers to pay considerably less by purchasing their favorite songs individually.<sup>48</sup> Thus, as individual-track-purchasing is increasing in the Digital Age, record labels are seeing less profit from records sold.<sup>49</sup> Given this, it is no surprise that CD costs have decreased, as labels strive to keep the CD viable among consumers, while the MP3 continues to dominate the market.<sup>50</sup>

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43. See *Do music artists fare better in a world with illegal file-sharing*, TIMES LABS BLOG, (Nov. 12, 2009), <http://labs.timesonline.co.uk/blog/2009/11/12/do-music-artists-do-better-in-a-world-with-illegal-file-sharing/>.

44. *Id.*

45. As new methods for listening to music were introduced to the marketplace, consumer purchases were temporarily diverted, leading to decreased sales for major labels. For example, as radio grew in popularity during the 1920s, vinyl record sales decreased. Similarly, as the marketplace was confronted with new mediums (i.e. vinyl to cassette, cassette to CD), older mediums, and overall sales, suffered as consumers transitioned to the new playing devices required by those mediums. Ghosemajumder et al, *supra* note 2, at 1–3.

46. Ghosemajumder et al, *supra* note 2, at 3.

47. See Byrne, *supra* note 2; Ferreira, et al., *supra* note 19.

48. See Michael DeGusta, *The REAL Death Of The Music Industry*, SAI Contributors, BUSINESS INSIDER (Feb. 18, 2011, 12:13 PM), <http://www.businessinsider.com/these-charts-explain-the-real-death-of-the-music-industry-2011-2>.

49. *Id.*

50. The Recording Industry Association of America, *The CD: A Better Value Than Ever*, (Aug. 2007) [www.riaa.com](http://www.riaa.com). See generally Byrne, *supra* note 2; Ferreira, et al., *supra* note 19.

Digital distribution has significantly diminished artists' reliance on major label distribution. In the traditional system, where CDs dominated, artists only earned, on average, less than one dollar for every sixteen-dollar CD sold.<sup>51</sup> While artists were forced to rely on labels when CDs dominated the market; the shift to digital music distribution has diminished that need.<sup>52</sup> Thus, as in the past, where technological changes have forced the industry to change its business model, the shift to digital distribution will have a similar impact as costs are lower and genres continue to fragment. In the digital era, the traditional-industry-justifications for lower artist royalties no longer hold true because labels no longer need to recover the high distribution costs associated with the CD-based model.

As digital distribution continues to grow, the *Aftermath* decision and ever-changing technology demonstrate the recording industry's need to adapt and restructure to stay viable. The Digital Age for music is here, and labels must look to alternative business models to remain influential players in this developing, new industry.

### III. ANALYSIS: *F.B.T. PRODUCTIONS V. AFTERMATH RECORDS*

In a new era for music, where digital sales are the preferred medium among consumers, record labels no longer need to, nor can they realistically, rely on physical album sales to generate revenues.<sup>53</sup> Digital technology has lowered costs for production and distribution of music, allowing artists to operate independently of major label support. Even if artists still sign to a label, digital distribution has eliminated the costs associated with manufacturing a physical CD, meaning lower overhead for labels to incur.<sup>54</sup>

The standard recording contract awards an artist a "royalty" based on a fixed percentage rate of total revenues earned from sales of that artist's work. As discussed above, royalties developed to ensure that labels would recover the costs necessary to promote, manufacture, and distribute an artist's work. Depending on the type of recording contract, artists typically earn anywhere from six percent to eighteen percent, with labels earning between fifty percent and sixty percent, of the revenues from records

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51. Ferreira et al., *supra* note 19.

52. Byrne, *supra* note 2.

53. See *Digital sales gains over physical in 2011*, *supra* note 23 (reporting significantly decreased physical album sales and, thus, generating the industry's need to rely on digital distribution mechanisms to remain profitable).

54. See, e.g., Byrne, *supra* note 2 (showing how decreased market-entry costs, resulting from digital distribution systems, allow independent artists and labels to operate more efficiently by bypassing the costs associated with physical CD distribution); *The music industry—From major to minor*, *supra* note 1 (discussing similar cost decreases for major labels as a result of digital distribution systems).

sold.<sup>55</sup> As *F.B.T. Productions v. Aftermath Records* demonstrates, artists typically receive a higher royalty percentage for records licensed than they do from records sold.

In light of the decreased costs from digital distributions, major labels no longer need to recoup the expenses associated with physical album sales and can, therefore, offer higher royalties for artists. Further, as the discussion below shows, music distribution in the Digital Age seems to be shifting from selling music to licensing it as consumers receive their music differently than they did during the traditional industry era. This shift will trigger the higher royalty percentage rate for artist in most recording contracts. If labels hope to remain a practical option in the Digital Age, they need to reevaluate the royalty percentages they offer artists or risk an increasing number of musicians opting for independent distribution and foregoing the label structure entirely.

The principle contention in *F.B.T. Productions v. Aftermath Records* was whether the defendant-record-label, Aftermath Records, was selling or licensing the musical works of rap artist Eminem. Specifically, the court examined whether Aftermath's relationship with digital distribution services, like Apple's iTunes system, constituted a seller-buyer relationship, or a licensor-licensee relationship.<sup>56</sup> The dispute centered on the percentage amount of royalties owed to F.B.T. under its contract with Aftermath, stemming from the distribution of Eminem's recordings.<sup>57</sup> The parties disagreed on whether the contract's "Records Sold" provision or "Masters Licensed" provision determined the royalty rate for distribution of Eminem's recordings in the form of permanent downloads.<sup>58</sup> At the trial court, after denying F.B.T.'s Motion for Summary Judgment, the jury returned a verdict for Aftermath; however, the Ninth Circuit reversed, finding that the contract's "Masters Licensed" provision unambiguously applied to Aftermath's distributions via third-party digital download platforms.<sup>59</sup>

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55. See EDWARD R. HEARN, *Recording and Distribution Contracts with Independent Labels* 1, 5 (2001) (discussing various royalty percentages for multiple types of recording contracts).

56. *F.B.T. Prods.*, 621 F.3d at 961 (Note: the case involves multiple parties; however, the court referred to them as F.B.T. Productions and Aftermath Records, respectively. Accordingly, this analysis will do the same).

57. *Id.*

58. *Id.*

59. *Id.*

### A. Background of the Dispute

In 1995, Eminem signed an exclusive recording contract with F.B.T, giving it the exclusive rights to his music.<sup>60</sup> Thereafter, in 1998, F.B.T entered an agreement with a larger label, Aftermath, transferring Eminem's exclusive recordings to the defendant, Aftermath.<sup>61</sup> Under that agreement's "Records Sold" provision, F.B.T. is owed "between 12% and 20% of the adjusted retail price of all 'full price records sold in the United States . . . through normal retail channels.'"<sup>62</sup> Alternatively, if Aftermath licenses an Eminem recording, the "Masters Licensed" provision is triggered. That provision specifies that "[n]otwithstanding the foregoing, F.B.T. is to receive 50% of Aftermath's net receipts '[o]n masters licensed by [Aftermath] . . . to others for their manufacture and sale of records or for any other uses.'"<sup>63</sup>

The contract further provides that a "master" is a "recording of sound . . . which is used or useful in the recording, production or manufacture of records."<sup>64</sup> However, as the terms "licensed" and "normal retail channels" are not defined by the contract, the dispute centered on which of these provisions governed Aftermath's distribution of Eminem's recordings via third-party distributors.<sup>65</sup>

In 2002, Aftermath entered an agreement with Apple Computer, Inc. that allowed Eminem's master recordings to be sold through Apple's iTunes store as permanent downloads.<sup>66</sup> Under the agreement, "[p]ermanent downloads are digital copies of recordings that, once downloaded over the Internet, remain on an end-user's computer or other device until deleted."<sup>67</sup> Since 2001, Aftermath had entered into many contracts, like its agreement with Apple, for third-party distributors, including major cell phone networks, to sell Eminem's recordings.<sup>68</sup>

Recording contracts, like that between F.B.T. and Aftermath, often provide for increased royalty percentages based on "escalations."<sup>69</sup> An "escalation" grants higher royalties when "total album sales surpass certain targets."<sup>70</sup> In 2004, F.B.T. and Aftermath amended their contract to in-

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60. *Id.*

61. *Id.*

62. *F.B.T. Prods.*, 621 F.3d at 961.

63. *Id.*

64. *Id.* at 961–62.

65. *See id.* at 961–62, 964–65 (relying on various sections of the Copyright Act and relevant case law to define the term "license" under the agreement in dispute).

66. *Id.* at 962.

67. *Id.*

68. *F.B.T. Prods.*, 621 F.3d at 962.

69. *Id.*

70. *Id.*

clude that “Sales of Albums by way of permanent download shall be treated as [U.S. Normal Retail Channel] Net Sales for the purposes of escalations.”<sup>71</sup> The 2004 amendment indicates that “[e]xcept as specifically modified herein, the Agreement shall be unaffected and remain in full force and effect.”<sup>72</sup> Thus, aside from amending the contract to allow permanent downloads to factor into the escalation calculation, the original agreement, “Records Sold” provision, and “Masters Licensed” provision remained unchanged.<sup>73</sup>

When a 2006 audit revealed that Aftermath had been using the “Records Sold” provision to calculate F.B.T.’s royalties for the sale of Eminem’s music through digital downloads, F.B.T. brought suit.<sup>74</sup> F.B.T. asserted that distributing Eminem’s recordings through digital download constituted a licensing of that recording, thus seeking to have the “Masters Licensed” provision, and the accompanying fifty percent royalty distribution, apply to digital downloads of Eminem’s music.<sup>75</sup> Conversely, Aftermath argued that such downloads were sales of Eminem’s work and, thus, only owed F.B.T. between twelve percent and twenty percent royalties under the “Recordings Sold” provision.<sup>76</sup> After denying both parties’ motions for summary judgment, the jury returned a verdict for Aftermath and this appeal followed.<sup>77</sup>

### B. *The Ninth Circuit Decision*

The central focus of the dispute was whether Aftermath licensed Eminem’s music to third party download providers, like Apple, triggering the “Masters Licensed” provision, rather than the “Records Sold” provision.<sup>78</sup> Aside from arguing that F.B.T. waived its ability to appeal the trial court’s decision, based on procedural failures that are beyond the scope of this note, the thrust of Aftermath’s argument was that the “Records Sold” provision applied to downloads of Eminem’s music.<sup>79</sup> In its motion for summary judgment, Aftermath maintained that because permanent downloads are “records” and digital music providers, like iTunes, are normal retail channels, the “Records Sold” provision should apply to such down-

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71. *Id.* (emphasis added).

72. *Id.*

73. *F.B.T. Prods.*, 621 F.3d at 962.

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *F.B.T. Prods.*, 621 F.3d at 962.

79. *Id.* at 962–63.

loads.<sup>80</sup> In rejecting this argument, however, the Ninth Circuit noted that the agreement also provided that “notwithstanding” the “Records Sold” provision, F.B.T. is to receive a fifty percent royalty rate on “masters licensed by [Aftermath] . . . to others.”<sup>81</sup> The court concluded that, in light of the term “notwithstanding,” if an Eminem master is licensed, F.B.T. would receive a fifty percent royalty, “even if a transaction arguably falls within the scope of the Records Sold provision.”<sup>82</sup>

The court begins by defining “license” as “permission to act,” according to the ordinary definition of the word.<sup>83</sup> Further, it reasoned that where Aftermath, by its own admission, entered into agreements that merely *permitted* third parties to use Eminem’s masters to sell permanent downloads, such permissive uses were licenses.<sup>84</sup>

However, beyond the basic understanding of the word “license,” the court further supported its conclusion that Aftermath’s relationship with third party distributors was that of licensor-licensee by applying federal copyright law. The court first noted the clearly differentiated meanings given to the terms “license” and “sale” under the Copyright Act, highlighting important policy differences distinguishing the two terms, which should govern artists’ rights.<sup>85</sup> Under federal copyright law, the first sale doctrine grants the lawful owner of a particular copy the power to “sell or otherwise dispose of the possession of that copy” without the permission of the copyright owner.<sup>86</sup> Here, that “copy” would refer to a consumer’s purchase of an individual CD, separating physical property from intellectual property. By distinguishing between ownership of the copyright and ownership of a mere copy of the copyrighted expression, the doctrine strikes a balance between the purchaser’s right to make use of his property and the copyright holder’s interest in the underlying intellectual property therein.<sup>87</sup>

Categorizing a transfer of copyright as a license versus a sale is important because a licensee is only permitted to make use of the work under the circumstances specified by the license, while a buyer can take certain actions without express permission.<sup>88</sup> While the first sale doctrine is ex-

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80. *Id.* at 964.

81. *Id.*

82. *Id.*

83. *Id.* (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 1304 (2002)).

84. *F.B.T. Prods.*, 621 F.3d at 964–65.

85. *Id.*

86. 17 U.S.C. § 109(a) (2008).

87. Eurie Hayes Smith IV, *Digital First Sale: Friend or Foe?*, 22 CARDOZO ARTS & ENT. L.J. 853, 854 (2005).

88. See J. THOMAS MCCARTHY, 4 MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 25:41 (4th ed. 2001) (noting that, beyond the power to sell or dispose of a particular copy, a buyer can do

pressly broad in that it exhausts a copyright holder's ability to control a particular copy, intellectual property interests compel limiting a buyer's rights by restricting the doctrine's reach to commercial transactions.<sup>89</sup> In other words, a buyer's property interest in a particular copy is largely outweighed by the copyright owner's interest in the broader right to control the work, thus requiring a buyer to obtain a copyright owner's permission to engage in uses other than resale. By expressly limiting a buyer's power to making second-hand distributions, the first sale doctrine implicitly ensures that the copyright holder retains all other rights granted under the Copyright Act.<sup>90</sup> Thus, the first sale doctrine only relates to particular copies of a work, leaving the copyright holder to prescribe to others any additional uses of its work in the form of a license.<sup>91</sup>

In contrast to a sale, a license is an agreement between the copyright holder and a licensee, allowing the licensee to make certain, specified uses of the copyright holder's work.<sup>92</sup> Various provisions of the Copyright Act define "license." First, § 114(f) of the Copyright Act refers to various uses and authorizations a copyright owner may grant to third parties, such as: allowing subscription services to transmit his sound recordings and make public performances, referring to such permissive uses as "licenses."<sup>93</sup> Further, the court notes that the rights permitted by licenses, unless expressly granted to a third party, are those ordinarily held exclusively by the copyright owner.<sup>94</sup>

Additionally, federal copyright law allows third parties to obtain a "compulsory license" to produce and distribute "phonorecords" of musical works, namely songs, to consumers for private use, provided that such distribution is with the authority of the copyright owner.<sup>95</sup> The ability to obtain a compulsory license is, however, restricted by the uses a licensee may make of the copyrighted work.<sup>96</sup> Implicit in this statutory requirement that compulsory licenses can only be obtained with the express authorization of the copyright holder is the notion that the copyright holder retains all own-

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little without the permission of the copyright holder who otherwise has exclusive rights and control over the intellectual property).

89. See *Quality King Distrib. v. Lanza Research Int'l*, 523 U.S. 135, 152 (1998) (discussing exhaustion of a copyright holder's interests merely as related to distribution of a particular copy of a work after placing the work in the stream of commerce, giving the buyer the right to make future, second-hand sales).

90. *Id.*

91. *F.B.T. Prods.*, 621 F.3d at 965.

92. *Id.*; see 17 U.S.C. § 114(f) (2012).

93. 17 U.S.C. § 114(f) (2012); *F.B.T. Prods.*, 612 F.3d at 965.

94. *F.B.T. Prods.*, 621 F.3d at 965.

95. 2 JOHN GLADSTONE MILLS III ET AL, *PATENT LAW FUNDAMENTALS* § 6:120 (2d ed. 2012).

96. See 17 U.S.C. § 115(a)(1) (2010) (restricting permissible uses of compulsory licenses to "distribute [phonorecords] to the public for private use").

ership rights of the underlying material and merely permits third parties to distribute it.<sup>97</sup> Thus, licensor-copyright-owners retain any rights not granted to the licensee in the license and any licensee rights are merely permitted by the copyright owner.

The court concluded that a transaction is a license where the copyright holder transfers a copy of its material to a third party, yet retains title to the work, limits the permissible uses of the material, and is periodically compensated based on the licensee's use of the material.<sup>98</sup> Where a copyright owner transfers copies of its work to a third party to make certain specified uses, and those uses are expressly limited by the language of the transfer agreement, such permissive uses constitute a license because the transferee holds no copyright interest in the underlying work.<sup>99</sup> When a copyright owner imposes restrictions on how a third party may redistribute or transfer a particular copy of its work, the purchaser of that right is a licensee, not an owner, because an owner has greater alienability with respect to its property than that afforded by a license.<sup>100</sup> To truly own something connotes the ability to make any possible use of it. As illustrated above, an owner of a copy may resell that copy based on the owner's property interest in the tangible good; however, where an owner of a copy simply maintains a property interest in the physical good, any uses beyond reselling are controlled by the licensor-copyright-holder, which retains all other rights in the work. The licensor chooses the rights and uses a licensee is permitted to make.

The parties did not dispute that Aftermath was the copyright holder of Eminem's recordings after it obtained those rights from F.B.T. in exchange for the royalty rates in contention.<sup>101</sup> However, Aftermath's agreements with third party distributors, like Apple, do not constitute a "sale" because those third parties did not receive title to the digital works.<sup>102</sup> At all times, Aftermath retained title and ownership of the digital files, reserving the right to remove the files from Apple, preventing it from distributing the files to consumers, and obtained recurring payments based on download volume via the third party distributors.<sup>103</sup> Because Aftermath retained title

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97. *F.B.T. Prods.*, 621 F.3d at 965 (noting that, despite the authorization to distribute phonorecords, the title to the underlying work remains with the copyright holder).

98. *Id.*

99. *Wall Data, Inc. v. Los Angeles Cnty. Sheriff's Dep't*, 447 F.3d 769, 784–85 (9th Cir. 2006) (discussing licenses under 17 U.S.C. § 117 as relates to authorized use of computer software).

100. *Id.* at 785 (characterizing restraints imposed by the copyright owner on the purchaser's rights under the agreement to denote a license because copyright owners would enjoy greater freedoms in their property).

101. *F.B.T. Prods.*, 621 F.3d at 965.

102. *Id.*

103. *Id.*

to the copyright at all times, its agreements with third parties comported well with the statutory definition of a license: distribution of permanent downloads, in exchange for periodic payments, authorized by the copyright holder.<sup>104</sup> Third party distributors never owned Eminem's work. Rather, Aftermath permitted download providers to make specified uses of copies of Eminem's work, at all times owning and controlling the underlying works.

Further, as § 115 of the Copyright Act expressly recognizes distribution of digital downloads by third-party vendors as a "license," and the contract does not indicate a different definition, Aftermath's relationship with those third parties is that of licensor-licensee.<sup>105</sup>

Despite Aftermath's contention that the "Masters Licensed" provision had, previously, been applied "only to compilation records and incorporation into movies, TV shows, and commercials," its agreement with F.B.T. does not indicate that it intended to restrict the term "license" to such use.<sup>106</sup> Where digital downloads only came to exist between 2001 and 2003, and the contract expressly recognizes Aftermath's right to exploit Eminem's masters in any future technology, the terms of the contract, specifically "license," were intended to evolve with technology.<sup>107</sup> Thus, the court concluded that the trial court erred by denying F.B.T.'s Motion for Summary Judgment as Aftermath merely permitted third parties to use Eminem's masters to sell digital downloads, and reversed the trial court's judgment in favor of Aftermath.<sup>108</sup> The court remanded the issue for further proceedings.<sup>109</sup> As Aftermath's relationship with third-party distributors constitutes a license, F.B.T. is owed fifty percent royalties of Aftermath's profits from those downloads.<sup>110</sup>

### C. *The Allman Brothers Case*

In 2008, a district court in the Southern District of New York decided an issue similar to the dispute in *Aftermath*; however, given its lack of legal analysis, the ruling in *Allman* will not impact future applications of the principles in *Aftermath*.<sup>111</sup> In both *Aftermath* and *Allman*, the court analyzed a record label's relationship with third-party download providers and

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104. 17 U.S.C. § 115(a)(1) (2012); *F.B.T. Prods.*, 621 F.3d at 965.

105. *Id.*

106. *F.B.T. Prods.*, 621 F.3d at 966.

107. *Id.*

108. *Id.* at 967.

109. *Id.*

110. *F.B.T. Prods.*, 621 F.3d at 967.

111. *Allman v. Sony BMG Music Entm't*, No. 06 CV 3252(GBD), 2008 WL 2477465, at \*1 (S.D.N.Y. June 18, 2008).

whether, in light of that relationship, higher royalty percentages were due to artists.<sup>112</sup> However, *Aftermath* marks the first time such an issue has been discussed at the appellate level and, because *Allman* was decided on a procedural issue, *Aftermath* more accurately represents the current state of the industry. Thus, the holding in *Allman* will probably not undermine the decision in *Aftermath*. However, the facts in *Allman*, specifically the contractual language at issue, support the conclusion in *Aftermath* and should serve to reinforce its basic premise: record labels and third party download providers have a licensor-licensee relationship.

As in *Aftermath*, the dispute in *Allman* centered on the royalty percentage owed to plaintiff-songwriters from their defendant-label. The issue was whether plaintiffs were owed fifty percent royalties of the defendant's net licensing proceeds.<sup>113</sup> Plaintiffs sought fifty percent royalties from the revenue earned through sales of plaintiffs' recordings by the defendant-label's licensees, third-party digital download providers.<sup>114</sup> In an unpublished opinion, the court granted defendant's Motion to Dismiss, finding that the contractual language, upon which plaintiffs' claim was premised, did not justify the proposed royalty rate.<sup>115</sup> This case, however, is distinguishable from *Aftermath* in that the court did not conduct sufficient analysis of plaintiffs' claim, dismissing the complaint for plaintiffs' inadequate pleading and ruling based on a purely procedural issue.<sup>116</sup>

In *Allman*, the contract's licensing provision provided that "[i]n respect of any Master Recording leased by [defendant] to others for their distribution of Phonograph Records in the United States, [defendant] will pay [plaintiff] fifty percent (50%) of [defendant's] net receipts from its Licensee."<sup>117</sup> The court concluded that, based on the plaintiffs' failure to demonstrate that the defendant had leased its masters to third-party distributors, the fifty percent royalty rate was inapplicable based on the provision's language.<sup>118</sup> The plaintiffs' failure to allege specific facts showing that their record label "leased" their music constituted an insufficient pleading and the court granted defendant's Motion to Dismiss.<sup>119</sup>

However, aside from the plaintiffs' failure to properly assert their claim, the express language of their recording contract does not require a different result than that reached in *Aftermath*, that record label relation-

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112. *Id.* at \*2.

113. *Id.* at \*1.

114. *Id.*

115. *Id.* at \*2.

116. *Id.* (granting defendant's Motion to Dismiss, pursuant to FED. R. CIV. P. 12(b)(6), for plaintiffs' failure to state a claim upon which relief could be granted).

117. *Allman*, 2008 WL 2477465, at \*1 (emphasis added).

118. *Id.*

119. *Id.* at \*2.

ships with digital download providers are that of licensor-licensee.<sup>120</sup> To the contrary, the contractual language in *Allman* expressly deems a third-party distributor a “licensee,” and, were it not for plaintiffs’ inadequate complaint, the proper result would have been reached.<sup>121</sup>

#### D. *Aftermath and the Current State of the Industry*

By properly applying relevant copyright and case law rules, the Ninth Circuit reached the correct conclusion in *Aftermath*, that third-party distributors are licensees. As licensees, artists deserve higher royalty percentages based on the downloads they provide, rather than the lower percentages earned from sales. On March 21, 2011, the Supreme Court of the United States denied *Aftermath*’s petition for a writ of certiorari, accepting the Ninth Circuit’s decision and cementing the pro-artist shift currently underway in the new, increasingly-digital age of music.<sup>122</sup> Moreover, the Ninth Circuit decision, and subsequent denial of *Aftermath*’s petition, comports well with the trend toward digital distribution in the music industry discussed below.

Digital distribution has decreased the costs associated with producing and distributing music. Where, under the traditional, CD-based music industry, record labels had to withhold payments to artists until they could first recoup expenses, the shift to digital distribution systems, like those examined in *Aftermath*, has largely decreased these costs.<sup>123</sup> Traditionally, labels bore the expense of recording costs because they were simply too high for artists to handle without support.<sup>124</sup> For example, recording costs included a minimum of fifteen thousand dollars to rent a professional studio, plus the cost of an engineer and producer, which could cost up to \$100 thousand per track.<sup>125</sup> However, in the digital age, artists no longer rely on labels to front these costs because records can be made from in-home “studios” using laptop computers.<sup>126</sup>

As discussed above, today’s music consumer purchases music digitally through third-party digital download providers, like those contemplated in *Aftermath*. Whereas, in the past, record labels rarely licensed music to third parties, the *Aftermath* decision makes it clear that licensing is now the

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120. See *F.B.T. Prods.*, 621 F.3d at 965–66.

121. *Allman*, 2008 WL 2477465, at \*1.

122. *Aftermath Records, Inc. v. F.B.T. Prods., LLC*, 621 F.3d 958 (9th Cir. 2010), *petition for cert. filed*, (U.S. Dec. 10, 2010) (No. 10-768) available at <http://www.supremecourt.gov/Search.aspx?FileName=/docketfiles/10-768.htm>.

123. Byrne, *supra* note 2.

124. *Id.*

125. See *id.*; Richardson, *supra* note 29 (citing costs associated with recording records).

126. Byrne, *supra* note 2.

common distribution method for labels.<sup>127</sup> Consumers rely on digital download providers, like Apple, as the sources for their digital music consumption. Thus, labels rely on licensing their music catalogues to download providers for distribution to consumers. In light of *Aftermath*, labels will now need to pay the once-rare fifty percent licensing-royalty rate on a regular basis as they distribute artists' music through digital download. Thus, labels will be paying artists more and earning less if they do not restructure their business model to secure revenue differently than they did in the traditional industry.

Today, artists are able to grow their reputations digitally, without radio airplay or marked retail sales, and earn money from merchandising, licensing songs to video games, commercials, TV shows, ringtones, and through performance royalties from webcasting and satellite radio.<sup>128</sup> Consequently, artists are becoming more self-reliant and leaving major labels to exist independently, affording themselves complete creative control over their works and the resulting economic dividends.<sup>129</sup> Labels must restructure their approach to the industry if they hope to remain a successful enterprise.

#### IV. APPLICATION

In *Aftermath*, the Ninth Circuit properly concluded that *Aftermath*'s relationship with third party download distributors, like Apple's iTunes, constituted a licensor-licensee, rather than seller-buyer, agreement.<sup>130</sup> In light of this holding, and the shift to digital distribution of music in the coming era, record labels will need to reevaluate the royalty percentages they offer artists if they hope to stay viable in an era when many musicians are operating independently of label support.

As discussed above, given the decreased costs associated with music distribution in the digital era, the traditional justifications for withholding payments from artists, and only paying them small royalties, no longer exist. Essentially, with lower distribution costs, labels are no longer taking as large a risk by investing in an artist because they do not need to invest as much. Further, more artists are opting to pursue their careers without signing to a major label; thus, labels will need to make themselves more attrac-

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127. See *F.B.T. Prods.*, 621 F.3d at 965–66.

128. See Byrne, *supra* note 2; Mike McCready, *The Future of the Music Industry*, THE HUFFINGTON POST, Mar. 11, 2009, [http://www.huffingtonpost.com/mike-mccready/the-future-of-the-music-i\\_b\\_173481.html](http://www.huffingtonpost.com/mike-mccready/the-future-of-the-music-i_b_173481.html).

129. See Byrne, *supra* note 2; Richardson, *supra* note 29 (discussing various artists who have left their major label distributors to afford themselves greater freedom).

130. See *supra* Part III. A.

tive by offering higher royalties from music sales. Labels have realized that the profits earned from digital music sales will, likely, never equal those gained from traditional CD distribution.<sup>131</sup> Because consumers have indicated their continued interest in digital music, labels will need to rely less on retail sales and more on other profitable aspects of the industry, like merchandising, licensing, and touring, to remain viable.

As digital becomes the dominant method for music consumption, there are several possible futures for the industry. Based on the *Aftermath* holding, it is clear that if labels continue to move into the Digital Age using old business models, namely, licensing music to third-party platforms for distribution, it will be increasingly expensive for them to operate.<sup>132</sup> Currently, labels base their revenue on selling music to consumers, largely through third-party download providers. Now, in light of *Aftermath*, that model will cost labels a fifty percent royalty rate for any music they license to third-party distributors. This system will not be sustainable in the Digital Age as labels can no longer rely on the sale-based business model in an era characterized by music licensing.

The industry has begun to confront this issue by restructuring artist contracts in several ways. First, many major labels are turning to the “360 Deal” in which all aspects of an artist’s career and works are owned and controlled by the label.<sup>133</sup> This may be beneficial to the labels because they receive a portion of all profits earned by the artist; however, artists may not favor such deals because they lose some creative control and have to share almost every aspect of their career with the label.<sup>134</sup>

A second option, the “Profit-Sharing Deal” allows the artist to retain the master to the recording but shares in the profits with the label.<sup>135</sup> However, the trend in the industry is towards licensing arrangements, like those contemplated by *Aftermath*, because the industry has learned that consumers demand music at no cost, or nearly free, and is moving away from iTunes-like paid downloads and towards free streaming of content.<sup>136</sup> Essentially, data indicates that today’s consumer is less interested in purchasing music and, instead, seeks to listen to music online for free, without ever purchasing the song.<sup>137</sup> Under this system, labels, or the copyright owners, will license the works to third-party distribution services that will offer the music for free to consumers.<sup>138</sup> The service will either be funded by adver-

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131. *The music industry*, *supra* note 1.

132. *See* F.B.T. Prods., LLC, 621 F.3d at 962–63.

133. *Byrne*, *supra* note 2.

134. *Id.*

135. *Id.*

136. *The music industry*, *supra* note 1.

137. *Id.*

138. *McCready*, *supra* note 128.

tisers or through the end consumer's monthly Internet subscription rate.<sup>139</sup> This system is similar to the arrangement at issue in *Aftermath* in that it contemplates a licensor-licensee relationship between the label and third party distributors. Unlike *Aftermath*, however, the third-party distributors will not earn revenue based on paid downloads but, rather, will pay a fee to labels for use of the music and run the risk of securing revenue from various other channels.<sup>140</sup> In this system, artists are paid royalties based on the fee charged to third party distributors for use of their works.<sup>141</sup>

From this free distribution model, another option for labels, which also comports well with the decision in *Aftermath*, is the "License Deal." Here, the artist retains the copyrights and ownership of the master recording, like *Aftermath* did, and licenses the right to exploit that property to a label, for a limited period of time.<sup>142</sup> This arrangement allows both parties to profit from the works created, recover their investments, and will allow labels to profit by licensing songs to third party distributors.

#### V. CONCLUSION

In the digital era of music, major labels have two choices: adapt to the changing trends in consumer preferences and survive or continue to operate under the traditional model and fail. As more artists pursue their careers independent of major label support, the possibility of failure grows. However, even in the digital age, major labels are still attractive for many traditional reasons, like advertising, promotion, and substantial bankrolls. In light of *Aftermath*, and the digital trend in music distribution, it will be up to labels to keep themselves an attractive option for artists. The current label structure, which relies on profits from music sales, will not remain viable in a digital era where music is licensed to third-party distributors. By finding alternative ways to profit from "records" and offering artists higher royalty rates, labels can remain viable, but they must adapt to the changing industry.

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139. *Id.*

140. *Id.*

141. *Id.*

142. Byrne, *supra* note 2.