

3-22-2010

The Rental Epidemic of The Twenty-First Century: A Look at How Netflix and Redbox Are Damaging The Hollywood Film Industry and How To Stop It

Ryan Sullivan

Loyola Law School Los Angeles, ryanesullivan@lls.edu

Follow this and additional works at: <https://digitalcommons.lmu.edu/elr>



Part of the [Law Commons](#)

Recommended Citation

Ryan Sullivan, *The Rental Epidemic of The Twenty-First Century: A Look at How Netflix and Redbox Are Damaging The Hollywood Film Industry and How To Stop It*, 30 Loy. L.A. Ent. L. Rev. 327 (2010).
Available at: <https://digitalcommons.lmu.edu/elr/vol30/iss2/4>

This Notes and Comments is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Entertainment Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact digitalcommons@lmu.edu.

THE RENTAL EPIDEMIC OF THE TWENTY-FIRST CENTURY: A LOOK AT HOW NETFLIX AND REDBOX ARE DAMAGING THE HEALTH OF THE HOLLYWOOD FILM INDUSTRY AND HOW TO STOP IT

I. INTRODUCTION¹

The Hollywood film industry is hurting. DVD sales, which account for up to seventy percent of a film's profits,² are slumping dramatically.³ This is a serious problem for the film industry because many films only start to turn a profit when people buy the DVDs.⁴ Since last year, DVD sales have fallen over thirteen percent⁵ and are expected to account for just over half of the overall film industry revenue by 2013.⁶ This will cause the

1. This Comment uses the phrase "Netflix and Redbox" to generally refer to the emerging commercial DVD rental industry. Netflix is an example of a DVD mail rental subscription service. Netflix sends the DVDs directly to the subscriber's mailbox, and the person returns the DVD by mailing it back in a prepaid envelope. Redbox is an example of a DVD rental kiosk company, where people can rent and return a DVD from the same kiosk for a per night rental fee. Netflix and Redbox are the leaders of their respective niches in the commercial DVD rental industry. Also, this Comment will only briefly discuss Blockbuster. Blockbuster does not generally use the First Sale Doctrine to operate, because Blockbuster has negotiated revenue-sharing contracts with most movie studios.

2. Ronald Grover, *Hollywood Ponders a Post-DVD Future*, BUSINESSWEEK, Mar. 2, 2009, at 56.

3. Ronald Grover & Olga Kharif, *Hollywood vs. Redbox*, BUSINESSWEEK, Aug. 24, 2009, at 38.

4. John Horn, *DVD Sales Figures Turn Every Film Into a Mystery*, L.A. TIMES, Apr. 17, 2005, at A1 ("Even a box-office blockbuster may reach profit only when it arrives on DVD shelves because movies have become so expensive to produce and market."); Edward Jay Epstein, *Hollywood's Profits, Demystified*, SLATE, Aug. 8, 2005, <http://www.slate.com/id/2124078/> ("Nowadays, in the new Hollywood, the world box office is a money loser.").

5. Marc Graser & Marcy Magiera, *H'w'd Red Alert: Biz Grapples with DVD Kiosk Boom*, DAILY VARIETY, Aug. 26, 2009, at 1.

6. *Analysis—Hollywood Warming to Internet as DVDs Begin to Fade*, CNNMONEY.COM, Sept. 30, 2009, http://money.cnn.com/news/newsfeeds/articles/reuters/MTFH16729_2009-10-01_00-17-23_N30253574.htm.

film industry to potentially lose billions of dollars in revenue.⁷ However, the effects are already being felt. Major studios are funding fewer movies⁸ and delaying releases for completed films, including ones that have Oscar potential.⁹ Furthermore, one former major studio is currently being forced to put itself up on the auction block.¹⁰ Overall, American film companies will release forty percent fewer movies between September and December this year compared to last.¹¹ Consequently, there are fewer jobs available.¹²

However, people have not stopped watching movies. Rather than buying movies, many people are renting them.¹³ In the first half of 2009, consumer spending on rentals grew over eight percent.¹⁴ While the Hollywood studios are suffering, Netflix and Redbox are seeing their profits flourish, growing twenty percent and 110 percent respectively in the second quarter of 2009.¹⁵ While the rental industry's revenue is growing substantially, the companies that actually make the product are seeing their revenues plummet.¹⁶

One of the reasons why such a perverse outcome exists is because of the First Sale Doctrine.¹⁷ This doctrine states that once a person buys a copyrighted item from the owner, the seller no longer has the right to prevent the buyer from reselling it, giving it away, or lending it out.¹⁸ Libraries, eBay, Craigslist, and many other companies use this doctrine to

7. David B. Wilkerson, *Studios Feel Pinch of Slowing DVD Sales, Rise in Rentals*, MARKETWATCH, Sept. 22, 2009, <http://www.marketwatch.com/story/studios-hurt-as-dvd-sales-fall-and-rentals-grow-2009-09-22/> [hereinafter *Studios Feel Pinch*].

8. See Brooks Barnes, *MGM, Ousting Its C.E.O., Hires Turnaround Expert*, N.Y. TIMES, Aug. 19, 2009, at B4 (discussing MGM studios' declining movie production).

9. Nikki Finke, *Shocker! Paramount Moves Scorsese's 'Shutter Island' to February 19, 2010*, DEADLINE HOLLYWOOD, Aug. 21, 2009, <http://www.deadline.com/hollywood/shocker-paramount-moving-scorsesedicaprios-shutter-island-to-february-2010/>.

10. Dave McNary, *MGM Officially on the Block*, VARIETY, Nov. 13, 2009, <http://www.variety.com/article/VR1118011324.html>.

11. Michael Cieply, *Oscar Race May Heat Up At Festival In Toronto*, N. Y. TIMES, Sept. 1, 2009, at C1.

12. Gina Keating, *Disney to Produce Fewer Movies, Cut 650 Jobs*, REDORBIT, July 19, 2006, http://www.redorbit.com/news/business/578257/disney_to_produce_fewer_movies_cut_650_jobs/index.html.

13. Graser & Magiera, *supra* note 5.

14. *Id.*

15. Ben Fritz, *Warner Delays Rentals*, L.A. TIMES, Aug. 14, 2009, at B3.

16. Graser & Magiera, *supra* note 5.

17. 17 U.S.C. § 109 (2006).

18. JULIE E. COHEN, LYDIA PALLAS LOREN, RUTH L. OKEDIJI & MAUREEN A. O'ROURKE, COPYRIGHT IN A GLOBAL INFORMATION ECONOMY 374 (Aspen Publishers 2d ed. 2006).

operate their businesses.¹⁹ Unfortunately for the film industry, Netflix and Redbox are using this doctrine to their own commercial advantage. In some instances, Netflix and Redbox have negotiated revenue-sharing or similar types of agreements with studios.²⁰ But when negotiations fail, Netflix and Redbox go to a store, buy the DVD for twenty dollars, and then rent the disc to their customers.²¹ Netflix has only reached agreements with half of the Hollywood studios,²² which means that a significant amount of Netflix's discs are bought and rented under the protection of the First Sale Doctrine.²³

Seeing their revenues vanish, some studios are trying to stand up to Redbox²⁴ and, more recently, to Netflix.²⁵ Twentieth Century Fox (Fox), Warner Brothers Studios (Warner Bros.), and Universal Studios (Universal) are refusing to sell Redbox any DVDs through their wholesalers until at least twenty-eight days after the DVDs have been released to the general public (a "sales-only window").²⁶ In early 2010, Warner Bros. and Netflix came to a mutual agreement that will similarly delay the studio's newly released DVDs from reaching Netflix customers for twenty-eight days.²⁷ Other studios may soon follow suit.²⁸

However, this plan to salvage the film industry's main revenue stream will probably not work because Netflix and Redbox can still buy a DVD at a retail store and rent it to their customers.²⁹ In fact, Redbox may soon sign a deal with Best Buy, Wal-Mart, or Target to buy discounted DVDs to stock its vending machines if it cannot purchase the newly released DVDs

19. *Id.*

20. Patrick Goldstein, *If You Can't Beat Redbox, Join It*, L.A. TIMES, Aug. 18, 2009, at D1 ("Sony and maverick indie Lionsgate, recently agreed to long-term distribution deals with Redbox, netting the studios hundreds of millions in revenues in exchange for guaranteeing Redbox a free flow of DVD product."); Danny King, *Physical: Company's CFO Praises Blockbuster's Store Closure Strategy*, VIDEO BUS., Sept. 16, 2009, <http://www.videobusiness.com/article/CA6697417.html> ("Netflix's revenue-sharing agreements with movie studios account for about half of the DVDs the U.S. leader in movie-rentals via mail ships to its subscribers.").

21. See Ryan Nakashima, *Studios Not Yet Sure How to Handle \$1-A-Day Rentals*, SAN JOSE MERCURY NEWS, Aug. 8, 2009, at 2C.

22. King, *supra* note 20.

23. See generally *Brilliance Audio, Inc. v. Haight's Cross Commc'ns*, 474 F.3d 365, 373 (6th Cir. 2007).

24. Goldstein, *supra* note 20.

25. Carl DiOrio, *WB, Netflix Hit Pause*, HOLLYWOOD REP., Jan. 7, 2010, at 1.

26. Goldstein, *supra* note 20.

27. DiOrio, *supra* note 25.

28. Adam Satariano, *Netflix, Studios Discussing 'Sale-Only' for DVDs*, BLOOMBERG.COM, Oct. 23, 2009, <http://www.bloomberg.com/apps/news?pid=20601110&sid=a6wj6dbUGsRg>.

29. See generally COHEN ET AL., *supra* note 18, at 374.

directly from the studio.³⁰ It is hard to imagine that the First Sale Doctrine was created to allow for such a situation. Furthermore, there are inconsistent rental policies across the industry that could undermine the sales-only windows.³¹ If the studios' sales-only window applies only to Redbox (like the policies implemented by Fox and Universal), people can rent the DVD from Netflix;³² if the sales-only window applies to both Netflix and Redbox (like the policy implemented by Warner Bros.), people can rent the DVD from Blockbuster.³³ Absent a consistent national rental policy, people can still rent DVDs from another rental company the day it is released.³⁴ Consequently, Congress must act to stop the commercial DVD rental business from distorting and abusing the First Sale Doctrine.

Part II of this Comment discusses the background of the First Sale Doctrine and the history of the rental industry. Part III examines the current exceptions to the First Sale Doctrine in the U.S. and the reasons why the exceptions are necessary. Part IV reviews European Copyright law, which bars a business from renting out a cinematic work without the permission of the copyright holder.³⁵ Finally, Part V proposes an important exception to the Copyright Act barring major commercial companies from renting out DVDs unless they share the revenue with the copyright holder.

30. *Ahead of the Bell: Redbox Rental Dispute*, THESTREET.COM, Oct. 12, 2009, <http://www.cdn.thestreet.com/story/10610096/1/ahead-of-the-bell-redbox-rental-dispute.html> [hereinafter *Ahead of the Bell*].

31. See Goldstein, *supra* note 20 (discussing how Sony and Lionsgate have agreed to sell DVDs to Redbox as soon as the DVD hits the market); King, *supra* note 20 (discussing how Netflix has revenue-sharing agreements with many studios, which allow them to get the DVDs as soon as the DVD is sold on the open market). *Contra* Goldstein, *supra* note 20 (discussing how some studios are waiting 28 days before they sell their DVDs to Redbox); DiOrio, *supra* note 25 (discussing how Warner Bros. and Netflix agreed to wait twenty-eight days after a DVD hits the market before Netflix starts renting it to its customers).

32. See Goldstein, *supra* note 20. The current practices by Twentieth Century Fox and Universal Studios target only Redbox. Consequently, a consumer can go to any other video rental store and rent the DVD. *Id.*

33. See DiOrio, *supra* note 25 (discussing how Warner Brothers and Netflix have agreed to delay new-release discs reaching Netflix for twenty-eight days).

34. See Goldstein, *supra* note 20; DiOrio, *supra* note 25.

35. GUY TRITTON ET AL., *INTELLECTUAL PROPERTY IN EUROPE* 501 (Thomson 3d ed. 2008). See Council Directive 92/100/EEC, 1992 O.J. (L.346) 61 (EC).

II. BACKGROUND OF THE FIRST SALE DOCTRINE AND THE HISTORY OF THE RENTAL INDUSTRY

A. *The Creation of the First Sale Doctrine*

The intellectual property clause of the U.S. Constitution allows Congress to give copyright owners limited monopolies over their work in order “[t]o promote the Progress of Science and useful Arts.”³⁶ By recognizing this limited but exclusive right, copyright law gives an economic incentive to people who create and disseminate ideas.³⁷ The U.S. Supreme Court has held: “The economic philosophy behind the clause . . . is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare”³⁸ The ultimate aim is to stimulate creative works for the public good, and this is done by securing a fair return for the author’s work.³⁹

However, the courts have sometimes held that in order to promote creative works for the public good, it is necessary to limit copyright holders’ rights.⁴⁰ In *Bobbs-Merrill Company v. Straus*, the Supreme Court heard a case that dealt with the book, “The Castaway.”⁴¹ The publishers put a notice in the book stating that anyone reselling the book must sell it for one dollar, the same price as a new book.⁴² After buying the books from a wholesale dealer, the defendants ignored the notice and resold the book for eighty-nine cents per copy.⁴³ The publishers filed suit.⁴⁴ The Court ultimately decided that “the copyright statutes, while protecting the owner of the copyright in his right to multiply and sell his production, do not create the right to impose, by notice . . . a limitation at which the book shall be sold at retail by future purchasers, with whom there is no privity of contract.”⁴⁵ In another case, the Court further explained its rationale:

The limited monopoly created by copyright law is needed to promote the creation of new works and ensure that the creator is properly compensated for this effort. Once a copyright holder

36. U.S. CONST. art. I, § 8, cl. 8.

37. *Harper & Row Publishers, Inc. v. Nation Enters.*, 471 U.S. 539, 558 (1985).

38. *Mazer v. Stein*, 347 U.S. 201, 219 (1954).

39. *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975).

40. See *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908).

41. *Id.* at 341.

42. *Id.* at 342.

43. *Id.* at 341.

44. *Id.*

45. *Id.* at 350.

has consented to distribution of a copy of that work, this monopoly is no longer needed because the owner has received the desired compensation for that copy.⁴⁶

The Court's limitation on the copyright holder's distribution right is based on the principle that a person is entitled to only the full value—no more, no less—of the copyrighted work upon its disposition.⁴⁷

The Court's opinion was later dubbed "The First Sale Doctrine," and Congress codified this holding in the 1909⁴⁸ and 1976 Copyright Acts.⁴⁹ These acts neither expanded nor diminished the power of the doctrine.⁵⁰

B. *The History and Evolution of the Rental Industry*

Although home video technology was invented in 1956, the average consumer could not afford home video until the mid-1970s when Sony's Betamax and JVC's VHS were released.⁵¹ In November 1977, Fox became the first studio to provide movies on home video.⁵² The videos were intended for private use only, and cost \$49.95.⁵³ However, just a month later, the first video rental store was opened in West Los Angeles.⁵⁴ George Atkinson bought these Fox titles for \$3.00 over cost to rent them out to the community.⁵⁵ To rent a video, people had to buy a membership, either \$50 for an annual membership or \$100 for a lifetime membership, and pay \$10 per day to rent a video.⁵⁶ Although it was expensive, renting videos gained in popularity and caught the attention of the movie studios.⁵⁷ Atkinson was quickly threatened with a lawsuit for renting these videos to

46. *Brilliance Audio, Inc. v. Haights Cross Commc'ns*, 474 F.3d 365, 373 (6th Cir. 2007).

47. *Parfums Givenchy, Inc. v. C & C Beauty Sales, Inc.*, 832 F.Supp. 1378, 1389 (C.D. Cal. 1993).

48. Nancy B. Lewson, *The Videocassette Rental Controversy: The Future State of the Law*, 30 COPR. SOC. U.S.A. 1, 5 (1982); The Copyright Act of 1909 § 27, 35 Stat. 1075 (current version at 17 U.S.C. § 109 (2008)).

49. Lewson, *supra* note 48, at 5 (1982); The Copyright Act of 1976, 17 U.S.C. § 109 (1976).

50. Lewson, *supra* note 48, at 5 (1982); 17 U.S.C. § 109.

51. Sylvie Castonguay, *50 Years of the Video Cassette Recorder*, 6 WIPO MAGAZINE, Nov. 2006, at 9.

52. The Entertainment Merchant Association, *A History of Home Video and Video Game Retailing*, http://entmerch.org/industry_history.html [hereinafter *History of Home Video*] (last visited Feb. 7, 2010).

53. *Id.*

54. *Id.*; Dennis McLellan, *George Atkinson, 69; Pioneer in the Movie Video Rental Industry*, L.A. TIMES, Mar. 12, 2005, at B17.

55. McLellan, *supra* note 54, at B17; *History of Home Video*, *supra* note 52.

56. *History of Home Video*, *supra* note 52.

57. *Id.*

the public, but it was soon determined that the video rental industry is protected under the First Sale Doctrine.⁵⁸

The film industry soon saw the video rental industry as a major threat to its business.⁵⁹ The President of the Motion Picture Association of America, Jack Valenti, famously stated before Congress, "I say to you that the VCR is to the American film producer and the American public as the Boston strangler is to the woman home alone."⁶⁰ From 1982 to 1983, the film industry tried to push through Congress an exception to the First Sale Doctrine, which would prevent video stores from renting out movies without the copyright holder's permission.⁶¹ These efforts ultimately failed, and the video rental industry was here to stay.⁶²

Since the studios had to find a way to stay profitable and compete with this emerging technology, they decided to come up with a "rental price" scheme in the early 1980s.⁶³ The studio would initially release its video for a very high price—approximately \$100—and the typical buyer would be a video rental business.⁶⁴ Five or six months later, the price would drop to approximately twenty dollars, after which the typical buyers would be "end-users."⁶⁵ The video rental industry was a huge success for the film studios.⁶⁶ Within ten years of VHS and Betamax players being released to the public, combined video sales and rentals eclipsed total box office revenue.⁶⁷ Shortly thereafter, video rental revenues exceeded box office receipts for the first time and continue to do so today.⁶⁸

In the late 1990s, the DVD was introduced in the U.S. and became "the most rapidly adopted consumer electronics product in history."⁶⁹ Beginning in 2004, people started to rent more DVDs than VHS tapes.⁷⁰

A dramatic difference in the evolution between the DVD and VHS

58. *Id.*

59. Castonguay, *supra* note 51.

60. *Id.*

61. *History of Home Video*, *supra* note 52.

62. *Id.*

63. JULIE HOLLAND MORTIMER, PRICE DISCRIMINATION, COPYRIGHT LAW, AND TECHNOLOGICAL INNOVATION: EVIDENCE FROM THE INTRODUCTION OF DVD'S 2 (2006), <http://mortimer.fas.harvard.edu/06dvd1117.pdf> [hereinafter PRICE DISCRIMINATION].

64. *Id.*

65. *Id.*

66. *History of Home Video*, *supra* note 52.

67. *Id.* ("Rental revenue in 1986 was \$3.37 billion and sales revenue that year was \$1.01 billion, for a total of \$4.38 billion. Theatrical box office was \$3.78 billion in 1986.")

68. *Id.*

69. *Id.*

70. *Id.*

formats is that the linear rental pricing formula was never adopted for DVDs.⁷¹ The linear rental pricing formula was important during the VHS era because it helped recoup some of the losses when people would rent videos instead of buying them.⁷² However, this advantage has since dissipated because studios now release DVDs for one low price, and have not shown any signs of implementing a linear rental pricing formula.⁷³ With DVD sales already dropping significantly, implementing such a formula could have catastrophic consequences for the film industry.⁷⁴

Today, the two most popular DVD rental services, behind only Blockbuster, are Netflix and Redbox.⁷⁵ Netflix and Redbox have been around since 1998 and 2002, respectively, but their popularity has exploded during the past few years.⁷⁶ Netflix is an example of a DVD mail rental subscription service.⁷⁷ Netflix sends the DVDs directly to the subscriber's mailbox, and the subscriber returns the DVD by mailing it back in a prepaid envelope.⁷⁸ Today, Netflix has more than ten million subscribers.⁷⁹

Redbox is an example of an automatic rental kiosk where people can rent DVDs for a daily fee.⁸⁰ Each kiosk holds approximately 630 DVDs.⁸¹ Originally placed in McDonald's restaurants, Redbox kiosks today can be found in restaurants and grocery stores across the country.⁸² Presently, there are over 19,000 Redbox kiosks that rent out over 575 million DVDs.⁸³

71. PRICE DISCRIMINATION, *supra* note 63, at 2.

72. *Id.*

73. *Id.*

74. Grover & Kharif, *supra* note 3, at 38.

75. In the first quarter of 2009, Redbox's revenue was \$154 million, while Netflix's revenue was \$394 million. *Redbox's Vending Machines Are Giving Netflix Competition*, N.Y. TIMES, June 22, 2009, at B4. In the second quarter of 2009, Blockbuster's revenue from rentals was \$789.2 million. *Blockbuster's Loss Exceeds Forecast*, N.Y. TIMES, Aug. 14, 2009, at B4.

76. Press Kit, Redbox, The History of Redbox 1, <http://redboxpressroom.com/factsheets/TheHistoryofRedbox.pdf> [hereinafter History of Redbox] (last visited Nov. 30, 2009); *History of Home Video*, *supra* note 52.

77. Press Kit, Netflix, Consumer Press Kit 2 (2009), http://cdn.netflix.com/us/pdf/Consumer_Press_Kit.pdf [hereinafter Netflix Press Kit].

78. *Id.*

79. *Id.* at 5.

80. History of Redbox, *supra* note 76, at 1.

81. Press Kit, Redbox, Redbox Fact Sheet 1, <http://redboxpressroom.com/factsheets/RedboxFactSheet.pdf> (last visited Feb. 4, 2010).

82. History of Redbox, *supra* note 76, at 1.

83. *Id.*; Redbox, Redbox Press Room, <http://redboxpressroom.com/> [hereinafter Redbox Press Room] (last visited Nov. 30, 2009).

III. EXCEPTIONS TO THE FIRST SALE DOCTRINE

A. The Record Rental Amendment of 1984

The first successful attempt to amend the First Sale Doctrine by the entertainment industry came in 1984.⁸⁴ During that time, the record industry was facing a serious piracy problem.⁸⁵ Instead of buying a phonorecord, people were renting music records and copying them onto blank tapes.⁸⁶ While Congress debated the Record Rental Amendment, there were about 200 commercial record rental stores renting phonorecords for one dollar a day.⁸⁷ Congress also noted: "Frequently, blank audio cassette tapes [were] sold in the same establishment. One such establishment advertised, 'Never, ever buy another record.'"⁸⁸

The record industry proved to Congress that there was a direct link between commercial renting and the illegal copying of a record.⁸⁹ The record industry convinced Congress that the "commercial record rental and duplication may directly and adversely affect the ability of copyright holders to exercise their reproduction and distribution rights under the Copyright Act."⁹⁰ As a result, Congress passed the Record Rental Amendment of 1984, which generally prohibits the owner of a phonorecord from renting it for commercial advantage to the public.⁹¹ By pointing to a real and significant threat to its survival, the record industry succeeded in obtaining an exception to the First Sale Doctrine.⁹²

It is important to note that Congress limited this exception to people who tried to obtain a direct or indirect commercial advantage by renting a phonorecord to the public.⁹³ This exception does not prohibit the rental, lease, or lending of phonorecords by libraries that are not-for-profit.⁹⁴

84. See Record Rental Amendment of 1984, Pub. L. No. 98-450, 98 Stat. 1727 (1984).

85. MARSHALL A. LEAFFER, UNDERSTANDING COPYRIGHT LAW 323 (Matthew Bender & Co. 4th ed. 2005).

86. *Id.*

87. H.R. REP. No. 98-987, at 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2898, 2899.

88. *Id.*

89. *Id.*

90. *Id.*

91. Record Rental Amendment of 1984, Pub. L. No. 98-450, 98 Stat. 1727 (1984).

92. LEAFFER, *supra* note 85, at 324.

93. *Id.* at 323; Record Rental Amendment of 1984, Pub. L. No. 98-450, 98 Stat. 1727 (1984).

94. LEAFFER, *supra* note 85, at 323.

B. The Computer Software Rental Amendments Act of 1990

Unlike the situation the record industry faced, the computer software industry effectively persuaded Congress to preemptively act against a threat to its industry.⁹⁵ Although there was some renting of computer software, the threat of piracy and the purpose of renting computer software convinced Congress to act.⁹⁶ Congress recognized that, unlike entertainment products such as phonorecords, software is a utilitarian product.⁹⁷ "Short term rental of software is, under most circumstances, inconsistent with the purposes for which software is intended."⁹⁸ For example, the Microsoft Office program is intended to be used long-term on a consistent basis, instead of being rented out every time a person needs to write a paper.⁹⁹ Furthermore, "[r]ental of software will, most likely, encourage unauthorized copying, *deprive copyright owners of a return on investment, and thereby discourage creation of new products.*"¹⁰⁰ An organized computer software rental industry would have threatened the software industry's economic health.¹⁰¹

Thus, Congress passed the Computer Software Rental Amendments Act of 1990, which generally bars a software owner from renting out computer software to the public for direct or indirect commercial advantage.¹⁰² As with the phonorecord exception, this exception does not prohibit the rental, lease, or lending of computer programs by libraries that are not-for-profit.¹⁰³

C. California Resale Royalty Act

Although the California Resale Royalty Act is not a true exception to the First Sale Doctrine, California passed this interesting state law that

95. *Id.* at 324.

96. *Id.*

97. H.R. REP. NO. 101-735, at 8 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6935, 6939.

98. *Id.*

99. LEAFFER, *supra* note 85, at 324.

100. H.R. REP. NO. 101-735, at 8, *reprinted in* 1990 U.S.C.C.A.N. 6935, 6939 (*emphasis added*).

101. 136 CONG. REC. S17, 577 (daily ed. Oct. 27, 1990) (statement of Sen. Hatch) *available at* <http://thomas.loc.gov> (follow "Congressional Record" hyperlink; then select Congress "101"; enter date "10/27/90" through "10/27/90" and select "search"; then open "Judicial Improvement Act" document hyperlink).

102. H.R. REP. NO. 101-735, at 8, *reprinted in* 1990 U.S.C.C.A.N. 6935, 6939; LEAFFER, *supra* note 85, at 324.

103. COHEN ET AL., *supra* note 18, at 372.

contradicts the First Sale Doctrine's principles.¹⁰⁴ The California Resale Royalty Act applies to fine art works and entitles an artist to a royalty payment of five percent upon the resale of his or her copyrighted work if the resale is for \$1,000 or more.¹⁰⁵

While California is the only state that recognizes the resale royalty right, other countries do have similar laws.¹⁰⁶ In fact, *droit de suite*, or the resale royalty right, is a European concept,¹⁰⁷ which the European Union (EU) requires all members to respect.¹⁰⁸

There are several benefits to a resale royalty act.¹⁰⁹ The most popular rationale is that profits from a resale give an artist added incentive to produce more works of fine art.¹¹⁰ Because creators of fine art are generally at a disadvantage compared to other authors and composers who can sell many copies of their copyrighted works, these laws help remedy this disparity by allowing a fine artist to collect multiple times from one piece of work.¹¹¹ Also, "allowing the purchaser to reap all the benefit of the increased value of the work is a form of unjust enrichment that comes at the expense of the original artist."¹¹²

Despite these benefits, the California Resale Royalty Act has been severely criticized in the U.S. and abroad.¹¹³ One common criticism is that it benefits too few artists and hurts the California market.¹¹⁴ Because this act only applies to sales in California or by California residents, people avoid buying art in the California art market.¹¹⁵ Also, "[i]t is clear the California Resale Royalty Act has been ignored and brushed under the carpet by all those in the California legal and art market."¹¹⁶ This is

104. CAL. CIV. CODE § 986 (2009).

105. *Id.*

106. California Arts Council, California Resale Royalty Act, <http://www.cac.ca.gov/resaleroyaltyact/resaleroyaltyact.php> (last visited Nov. 30, 2009).

107. LEAFFER, *supra* note 85, at 328.

108. Council Directive 2001/84, 2001 O.J. (L 272) 35.

109. See generally Gary Pulsinelli, *Harry Potter and the Re(order) of the Artists: Are We Muggles or Goblins?*, 87 OR. L. REV. 1101, 1115–17 (2008).

110. Elliott C. Alderman, *Resale Royalties in the United States for Fine Visual Artists: An Alien Concept*, 40 J. COPYRIGHT SOC'Y U.S.A. 265, 272–73 (1992) ("One can argue that the potential for increased remuneration is a potent incentive for further creation.").

111. Pulsinelli, *supra* note 109, at 1115.

112. *Id.* at 1116.

113. See Mara Grumbo, Note, *Accepting Droit de Suite as an Equal and Fair Measure Under Intellectual Property Law and Contemplation of Its Implementation in the United States Post Passage of the EU Directive*, 30 HASTINGS COMM. & ENT. L.J. 357, 371 (2008).

114. LEAFFER, *supra* note 85, at 329.

115. *Id.*

116. Grumbo, *supra* note 113, at 371.

because enforcement of the California law is incredibly difficult.¹¹⁷ The law requires the seller to withhold the royalty, find the artist, and send the artist the proceeds.¹¹⁸ There is no central collection agency to administer the system, so the only way to enforce the statute is through lawsuits from the artists.¹¹⁹ Therefore, the artists are required to follow every art sale in California to see if one of their copyrighted works was sold and then sue the gallery owners to recover any unpaid royalties.¹²⁰ This makes enforcement impractical and impossible.¹²¹

The situation is starkly different in the European Union. The EU's *droit de suite* law¹²² has been much more successful.¹²³ The first significant difference between the EU law and the California Law is the existence of a dedicated collection society.¹²⁴ Art dealers pay the royalty directly to the dedicated collection society, and that agency enforces compliance with the law.¹²⁵ The second significant difference is that, so far, the law has only applied to auctions.¹²⁶ While the law technically covers most sales by art dealers, implementation and enforcement of the law has focused on auctions.¹²⁷ Although not perfect, applying this law exclusively to auctions still covers a considerable amount of art sales, and makes it significantly easier to enforce.¹²⁸ Payment is the responsibility of the auctioneer instead of the seller, and auctions are easier to regulate than private art sales.¹²⁹

Droit de suite laws are important to the present discussion because these laws emphasize the viewpoint that the original copyright owner's economic and moral rights sometimes need to be recognized for the public good.¹³⁰ Unlike the current First Sale Doctrine exceptions, the purpose for

117. Michael B. Reddy, *The Droit de Suite: Why American Fine Artists Should Have the Right to a Resale Royalty*, 15 LOY. L.A. ENT. L. REV. 509, 523 (1995).

118. *Id.*

119. Eliza Hall, *The French Exception: Why The Resale Royalty Works in France and Why It Matters To the U.S.*, 1 J. INT'L MEDIA & ENT. L. 321, 331 (2007).

120. *Id.*

121. *Id.*

122. Council Directive 2001/84, 2001 O.J. (L 272) 35.

123. Hall, *supra* note 119, at 331.

124. *Id.*

125. *Id.* at 332.

126. *Id.* at 325 (noting that the EU Directive is relatively new and enforcement has been focused on auctions thus far).

127. *Id.* at 332.

128. Hall, *supra* note 119, at 325.

129. *Id.* at 332.

130. See Grumbo, *supra* note 113, at 371.

adopting a *droit de suite* law was not to curtail the threat of art piracy.¹³¹ Rather, these *droit de suite* laws are designed to economically and morally promote the public good.¹³² The party that pays the additional compensation is the party who is actually profiting from the copyright owner's work.¹³³ These laws address the issue that artwork may be under produced if the artist can only receive profits from the original sale.¹³⁴ Without an economic incentive, significant harm can be done to the public good because there will be less creative artwork for the public to enjoy.¹³⁵ Like the intellectual property clause in the U.S. Constitution, these incentive-based laws help promote the progress of the useful arts.¹³⁶

IV. THE EUROPEAN UNION'S "RENTAL RIGHT DIRECTIVE"

The European Union (EU) has passed an exception to its copyright law similar to the one this Comment will later propose.¹³⁷ Since 1994, the EU's "Rental Right Directive" (Directive) established the exclusive right for the copyright owner to authorize or prohibit the rental, lease, or lending of her cinematic work.¹³⁸

In adopting this legislation, the European community stated that there was a legitimate economic justification to recognize the right to proceeds from a rental.¹³⁹ Additionally, with the threat of piracy, the Directive notes that rental revenues of copyrighted works play an important role in offsetting the loss of income.¹⁴⁰ The Directive finally states that this law is needed to continue the economic and cultural development of the EU.¹⁴¹

European copyright scholars have lauded the Directive.¹⁴² Supporters

131. See generally Hall, *supra* note 119, at 324.

132. *Id.* at 324 (commenting that the purpose of a *droit de suite* law is typically to benefit starving artists and to give them a greater economic incentive to produce works of art).

133. Grumbo, *supra* note 113, at 367 (noting that it is the obligation of the seller to pay the royalty due to the copyright owner).

134. COHEN ET AL., *supra* note 18, at 414.

135. See *id.*

136. U.S. CONST. art. I, § 8, cl. 8.

137. See *infra* Part V.D; Roberto Garza Barbosa, *Revisiting International Copyright Law*, 8 BARRY L. REV. 43, 92 (2007).

138. TRITTON ET AL., *supra* note 35, at 501; see also Council Directive 92/100/EEC, 1992 O.J. (L 346) 61.

139. TRITTON ET AL., *supra* note 35, at 500; see also Council Directive 92/100/EEC, 1992 O.J. (L 346) 61.

140. TRITTON ET AL., *supra* note 35, at 500.

141. Barbosa, *supra* note 137, at 92.

142. I DAVID T. KEELING, *INTELLECTUAL PROPERTY RIGHTS IN EU LAW* 281 (Oxford 2003).

argue “that even the most devoted film buff rarely watches a film more than once or twice.”¹⁴³ Supporters also note that, as in the U.S., the revenue from rentals could be the most profitable part of the market.¹⁴⁴ Logically, more films will be made if the copyright owners expect a reasonable return on their investment.¹⁴⁵ Because of this, these supporters argue that it is in everyone’s interest to allow the copyright owner to receive some money when the copyrighted work is rented.¹⁴⁶

Even when rental companies have to comply with the Directive, the DVD rental industry can still be sustainable and profitable.¹⁴⁷ LOVEFiLM, a European counterpart to Netflix, has over one million subscribers and has expanded from England to four other European countries.¹⁴⁸ Despite the enormous amount of money it costs to start an online DVD rental business, LOVEFiLM began to turn a profit within three years of its creation.¹⁴⁹

V. THE CURRENT STATE OF THE FILM INDUSTRY AND THE SOLUTION TO FIX IT

A. The Film Industry is Suffering

Unlike the early 1980s when the first attempt to pass a video rental exception to the First Sale Doctrine failed,¹⁵⁰ the landscape of the entertainment industry has substantially changed.¹⁵¹ According to Rentrak, in the first half of 2009, U.S. consumer spending on DVDs fell 13.5%.¹⁵²

143. *Id.*

144. *Id.*; see generally Grover, *supra* note 2.

145. See *Mazer v. Stein*, 347 U.S. 201, 219 (1954) (“[E]ncouragement of individual effort by personal gain is the best way to advance public welfare . . .”).

146. KEELING, *supra* note 142, at 281.

147. See Helia Ebrahimi, *BBC Fiasco Helps LoveFilm Turn a Profit*, THIS IS MONEY, Nov. 8, 2008, http://www.thisismoney.co.uk/news/article.html?in_article_id=456774.

148. LOVEFiLM International, What We’re About, <http://www.lovefilm.com/corporate/about.html> (last visited Nov. 30, 2009).

149. Ebrahimi, *supra* note 147.

150. See generally COHEN ET AL., *supra* note 18, at 372.

151. In the early 1980s, the studios feared the new technology and thought it was going to significantly harm the industry. Castonguay, *supra* note 51, at 9–10. Today, the movie industry has embraced the video rental market and substantially depends on it to turn a profit on many of its films. Horn, *supra* note 4 (“Even a box-office blockbuster may reach profit only when it arrives on DVD shelves because movies have become so expensive to produce and market.”); Epstein, *supra* note 4 (“Nowadays, in the new Hollywood, the world box office is a money loser.”).

152. Graser & Magiera, *supra* note 5, at 1.

Adams Media Research conservatively predicts that DVD sales will drop by 9% this year.¹⁵³ A significant amount of revenue is being lost because physical home entertainment video currently accounts for 70% of film profits.¹⁵⁴ This means that there are, potentially, billions of dollars at stake.¹⁵⁵

Specifically, many film studios are struggling to stay solvent or, at the very least, are delaying films in the hope that the economy will rebound.¹⁵⁶ MGM-UA has only released one film in 2009, but faces \$300 million in annual loan interest payments and a \$1 billion loan payment in June 2011.¹⁵⁷ Facing these enormous payments, MGM-UA has decided to entertain bids to buy out part or all of the company.¹⁵⁸ Additionally, some films' release dates are being delayed, partly due to home video sales.¹⁵⁹ According to one studio source, "[g]iven where the DVD business is in 2009, our only hope is the economy and the retail business rebounds in 2010 because the hardest hit segment has been movies that play to an older adult audience."¹⁶⁰

During the VHS era, the commercial video rental market was extremely profitable for the film studios industry.¹⁶¹ This was because the film studios had developed a linear rental pricing structure to account for the lost revenue due to video rentals, and had revenue-sharing agreements with the major rental retailers.¹⁶² However, there is no such linear rental pricing structure in place today.¹⁶³ It is also more common for rental companies to not have any rental agreement with the studios and instead use the protection of the First Sale Doctrine to operate.¹⁶⁴ At least 39% of Redbox's rental revenue comes from studios with which it does not have a

153. Grover & Kharif, *supra* note 3, at 38.

154. Grover, *supra* note 2, at 56.

155. See generally David B. Wilkerson, *Battles with Redbox, Netflix Underscore Shift as Consumers Buy Less, Rent More*, MARKETWATCH, Sept. 22, 2009, <http://www.marketwatch.com/story/studios-hurt-as-dvd-sales-fall-and-rentals-grow-2009-09-22>.

156. See generally Barnes, *supra* note 8; Finke, *supra* note 9.

157. Barnes, *supra* note 8.

158. McNary, *supra* note 10.

159. See Finke, *supra* note 9.

160. *Id.*

161. James J. Jozefowicz, Jason M. Kelley & Stephanie M. Brewer, *New Release: An Empirical Analysis of VHS/DVD Rental Success*, ATL. ECON. J., June 2008, <http://www.entrepreneur.com/tradejournals/article/181301267.html>.

162. PRICE DISCRIMINATION, *supra* note 63, at 2; *History of Home Video*, *supra* note 52.

163. PRICE DISCRIMINATION, *supra* note 63, at 2 ("With the introduction of the DVD format, studios have almost exclusively adopted sell-through pricing . . .").

164. See generally *Ahead of the Bell*, *supra* note 30.

rental agreement,¹⁶⁵ while Netflix's revenue-sharing agreements roughly account for half of the company's revenue.¹⁶⁶

Lately, Hollywood studios tried a "sell-through" model, which focuses on having the consumer buy the DVD.¹⁶⁷ The downside to this model is that these DVDs are available to video rental stores for a very cheap price.¹⁶⁸ In order to make up for the lost revenue due to video rentals, more people need to buy DVDs.¹⁶⁹ Unfortunately for Hollywood, this is not happening now as all trends indicate that more people are opting to rent movies instead of purchasing DVDs.¹⁷⁰

Since the trend of declining DVD sales has been going on for the past five years,¹⁷¹ retail stores are starting to lose faith in the product, which will exacerbate the problem.¹⁷² For example, Best Buy Company and Borders Group Inc. are allocating less physical space in their stores to DVDs.¹⁷³ In stores that had been opened for at least a year, Borders Group saw DVD sales drop 48% compared to the same period in 2008.¹⁷⁴ Once comprising 23% of its sales, Borders Group now says that DVD sales represent just 8% of its sales.¹⁷⁵ It will be much harder for DVD sales to rebound if there are physically fewer DVDs being sold in the stores.¹⁷⁶

During these tough economic times, more people are choosing to rent movies rather than spend more money to purchase them.¹⁷⁷ "In the first half of [2009], U.S. consumer spending on DVD and Blu-ray rentals rose 8.3%."¹⁷⁸ During this time period, DVD sales fell to \$5.4 billion, while rental revenue grew to \$3.4 billion.¹⁷⁹ In the second quarter of 2009, Redbox's revenue grew 110%, and Netflix's revenue grew 20%.¹⁸⁰ By

165. *Id.*

166. King, *supra* note 20.

167. JUDSON COPLAN, DIAGNOSING THE DVD DISAPPOINTMENT: A LIFE CYCLE VIEW 6 (2006) <http://w4.stern.nyu.edu/glucksman/docs/Coplan.pdf>.

168. See generally PRICE DISCRIMINATION, *supra* note 63, at 2.

169. *The Green Mile* was originally released on VHS for \$107.95 and on DVD for \$24.95. Although there may be different costs in producing and shipping a VHS and DVD, the studios were making a lot more money per film sold on VHS as compared to DVD. *Id.*

170. Graser & Magiera, *supra* note 5.

171. COPLAN, *supra* note 167, at 2.

172. *Studios Feel Pinch*, *supra* note 7.

173. *Id.*

174. *Id.*

175. See *id.*

176. See generally *id.* (noting how retailers have lost faith in DVDs).

177. See *id.*; Graser & Magiera, *supra* note 5.

178. Graser & Magiera, *supra* note 5.

179. *Studios Feel Pinch*, *supra* note 7.

180. Fritz, *supra* note 15.

2013, an industry analyst predicted that Netflix's revenue will grow by 42% to \$3.1 billion and that kiosk revenue will increase by more than 200% to \$1.5 billion.¹⁸¹ In cases where the rental company does not have a rental agreement with the studio, a one-time purchase of \$20 for a DVD yields a \$12 per disc profit on average, not including business costs and selling the discs to consumers or wholesalers.¹⁸² Considering that Redbox has over 575 million DVDs in over 19,000 kiosks across the US,¹⁸³ the profits add up very quickly for Redbox.¹⁸⁴

Mitch Lowe, CEO of Redbox, has tried to argue that "[t]he relationship between rentals and DVD sell-through remains complementary, not cannibalistic."¹⁸⁵ He also claims that, "[a]ccording to customer research, a majority of Redbox renters report their typical DVD purchase is the result of having previously rented and enjoyed the title."¹⁸⁶ However, these findings do not negate the fact that DVD sales are plummeting while the rental business continues to flourish.¹⁸⁷ President Chase Carey of News Corp., the parent company of Fox, complained that its DVD "product rent at a dollar is grossly undervalued."¹⁸⁸ Likewise, John Marmaduke points out that retailers "simply cannot give away products that cost hundreds of millions of dollars to produce. . . . Once the main product of an industry is artificially devalued, the negative economic impacts will ripple throughout the industry, impacting the workers and businesses that rely on the overall industry."¹⁸⁹

In particular, studios are having a very difficult time deciding which movies to produce because DVD sales play such an important role in the decision-making process.¹⁹⁰ Just a few years ago, studios could expect

181. Randall Stross, *When the Price Is Right, the Future Can Wait*, N.Y. TIMES, July 12, 2009, at B3.

182. David Lieberman, *Video Kiosks Have Rivals Seeing Red*, USA TODAY, Aug. 12, 2009, at 3B ("Redbox pays about \$18 for a DVD and rents it about 15 times at an average of \$2 per transaction. The company sells half of the used DVDs back to wholesalers for as much as \$4 per disc, and sells about 3% directly to consumers for about \$7. It destroys most of the rest.").

183. History of Redbox, *supra* note 76, at 1; Redbox Press Room, *supra* note 83.

184. *See generally* Graser & Magiera, *supra* note 5, at 1.

185. Mitch Lowe, *Redbox Chief: 'We Are an Engine for Industry Growth'*, THE WRAP, Oct. 2, 2009, <http://thewrap.com/blog-entry/redbox-ceo-we-are-engine-industry-growth-8165>.

186. *Id.*

187. Graser & Magiera, *supra* note 5, at 1. *See generally* Lieberman, *supra* note 182.

188. Lieberman, *supra* note 182.

189. *Redbox Roulette: Gambling with the Industry's Future*, THE WRAP, Oct. 7, 2009, <http://www.thewrap.com/blog-entry/redbox-roulette-gambling-industrys-future-8360> [hereinafter *Redbox Roulette*].

190. Susanne Ault, *DVD Payoff Formulas Are Tricky to Predict*, WEEKLY VARIETY, Sept. 7, 2009, at 7.

DVDs to generate eighty-five cents for every dollar a film grossed at the box office.¹⁹¹ However, since 2008, this number has dropped substantially, as DVD titles have generated only seventy cents per box office dollar.¹⁹² Playing it safe, studios are producing a substantially smaller amount of films each year.¹⁹³ Studios will now have to factor into their formula the likelihood that the film is going to be rented instead of purchased.¹⁹⁴ Over the summer, distributors were baffled as to why “Paul Blart: Mall Cop” was selling so slowly off the shelves.¹⁹⁵ Yet right around the same time, newspapers were noting how “Paul Blart: Mall Cop” was Redbox’s “record-holding rental title.”¹⁹⁶ In significant numbers, people decided to rent that movie for one dollar rather than purchase it for twenty dollars.¹⁹⁷

B. The DVD Rental Business is Being Unjustly Enriched at the Expense of the Studios

The current landscape of the industry is perverse.¹⁹⁸ The studios, which actually create the copyrighted work, are seeing their revenues vanish¹⁹⁹ and are trying to come up with new strategies to stay viable as they produce fewer movies each year.²⁰⁰ However, the rental business which disseminates the copyrighted work, in many cases without fairly compensating the original copyright owner, continues to thrive and expand.²⁰¹

As stated earlier, the primary objective of the intellectual property clause in the U.S. Constitution is to benefit the public by promoting the production of original works, and this is done by compensating the authors.²⁰² In *Fox Film Corp. v. Doval*, the Supreme Court held that “the sole interest of the United States and the primary object in conferring the monopoly lie in the general benefits derived by the public from the labors

191. *Id.*

192. *Id.*

193. Cieply, *supra* note 11.

194. Compare *id.* (discussing how “Paul Blart: Mall Cop” did not sell as many copies as expected), with Stross, *supra* note 181 (noting how “Paul Blart: Mall Cop” was Redbox’s most popular rental).

195. Ault, *supra* note 190.

196. Stross, *supra* note 181.

197. Graser & Magiera, *supra* note 5.

198. *Id.*

199. *Id.*

200. Cieply, *supra* note 11.

201. See generally Graser & Magiera, *supra* note 5.

202. Craig W. Dallan, *The Problem with Congress and Copyright Law: Forgetting the Past and Ignoring the Public Interest*, 44 SANTA CLARA L. REV. 365, 430 (2004).

of authors.”²⁰³ Later, in *Twentieth Century Music Corp. v. Aiken*, the Supreme Court affirmed its reasoning by stating: “Creative work is to be encouraged and rewarded, but private motivation must ultimately serve the cause of promoting broad public availability of literature, music, and the other arts.”²⁰⁴ The Court further explained in *Sony Corp. v. Universal City Studios, Inc.* that the First Sale Doctrine “is intended to motivate the creative activity of authors and inventors by the provision of a special reward, and to allow the public access to the products of their genius after the limited period of exclusive control has expired.”²⁰⁵

For decades, the rental industry and the studios enjoyed a complimentary relationship; both were able to thrive and grow together.²⁰⁶ This relationship thrived because of the linear rental pricing scheme and revenue-sharing agreements that existed between the studios and rental companies.²⁰⁷ The linear rental pricing scheme enabled studios to cover the lost revenue from rentals up front by charging a very high initial price.²⁰⁸ For retail outlets like Blockbuster that did not want to pay this high price, studios entered into revenue-sharing agreements under which the studios sold the videos to the rental company at a lower price in return for a share of its revenue.²⁰⁹ In the end, the rental companies had two choices: (1) purchase the video at a high price offered to the general public; or (2) purchase the video directly from the studio’s distributor at a lower price and enter into a revenue-sharing agreement.²¹⁰ Both options resulted in a mutually beneficial solution in which studios recovered their lost video-sale income from the video rental industry, while video rental companies benefitted from decreased video sales.²¹¹

This complimentary relationship no longer exists today.²¹² There is no linear rental pricing scheme.²¹³ Today, consumers are able to buy DVDs at a reasonable price as soon as the DVD becomes available on the

203. *Fox Film Corp. v. Doyal*, 286 U.S. 123, 127 (1932).

204. *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975).

205. *Sony Corp. v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984).

206. JULIE HOLLAND MORTIMER, VERTICAL CONTRACTS IN THE VIDEO RENTAL INDUSTRY 4–5 (2006), <http://mortimer.fas.harvard.edu/06jmp1201.pdf> [hereinafter VERTICAL CONTRACTS].

207. See generally Jozefowicz et al., *supra* note 161.

208. PRICE DISCRIMINATION, *supra* note 63, at 1308.

209. VERTICAL CONTRACTS, *supra* note 206, at 4–5.

210. *Id.*

211. See *History of Home Video*, *supra* note 52 (noting how both the studios and video rental stores, Blockbuster in particular, grew together and made hundreds of millions of dollars in revenue).

212. See generally Graser & Magiera, *supra* note 5.

213. PRICE DISCRIMINATION, *supra* note 63, at 1308.

market; due to price discrimination laws, rental companies can also purchase the DVD at the same price.²¹⁴ Accordingly, rental companies have two different options today than they did a decade ago: (1) purchase DVDs at the low sale price offered to the general public;²¹⁵ or (2) purchase the DVD directly from the studio's distributors at a slightly lower price and share the revenue with the film studios.²¹⁶ It is no mystery why Netflix and Redbox chose to purchase DVDs at a low price instead of sharing its revenues with the studios.

Under the First Sale Doctrine, rental companies can generate a significant amount of revenue from potential DVD buyers without giving just compensation to the studios.²¹⁷ Because the First Sale Doctrine creates this situation, it undermines the rationale of the intellectual property clause in the U.S. Constitution.²¹⁸ Since consumers rent DVDs more frequently than they purchase them, studios are losing a significant portion of their revenue.²¹⁹ In many instances, rental companies do not adequately compensate the studios for their diminished profits beyond the initial purchase price.²²⁰ Consequently, fewer films are being financed and produced.²²¹ This, in turn, results in thousands of lost jobs.²²² Furthermore, the First Sale Doctrine is stifling the creative activity of authors.²²³ Rather than incentivizing studios to generate creative works of art—which the Supreme Court has recognized “is the best way to advance public welfare”²²⁴—the First Sale Doctrine is causing the studios to produce fewer films.²²⁵

214. Glynn S. Lunney, Jr., *Copyright's Price Discrimination Panacea*, 21 HARV. J.L. & TECH. 387, 401 (Spring 2008).

215. *Id.*

216. *See* King, *supra* note 20.

217. *See* Brilliance Audio, Inc. v. Haight Cross Commc'ns, 474 F.3d 365, 373 (6th Cir. 2007).

218. U.S. CONST. art. I, § 8, cl. 8.

219. *Ahead of the Bell*, *supra* note 30.

220. *See* Graser & Magiera, *supra* note 5.

221. Cieply, *supra* note 11.

222. Lord of the Rings—New Zealand, New Zealand Tourism Guide, <http://www.tourism.net.nz/lord-of-the-rings.html> (noting, for example, that over 2,000 people were employed during production of the Lord of the Rings movies).

223. Video rental companies are using the First Sale Doctrine to withhold just compensation from the movie studios. Because the studios are being deprived of this revenue, they are producing fewer films. *See* Cieply, *supra* note 11.

224. *Mazer v. Stein*, 347 U.S. 201, 219 (1954).

225. Cieply, *supra* note 11.

C. Congress Needs to Take Action

Congress must rectify this problem, as the current situation is unsustainable.²²⁶ Some studios have entered into profit-sharing agreements with various rental companies,²²⁷ while other studios have prohibited their distributors from selling newly released DVDs to rental companies for a specified amount of time.²²⁸ Wanting full access to newly released DVDs, Redbox has sued the studios that are restricting its access to the distributors.²²⁹ This has created an uneven legal landscape where some studios receive compensation from some video rental businesses, but not from others.²³⁰ Because studios are not being justly compensated for all their creative works, they are producing significantly fewer movies, which, in turn, reduces the available job opportunities.²³¹ The end result: the public good is suffering greatly.²³²

Much like fine artists, film studios are no longer justly compensated for their work.²³³ Film studios rely on income from both box office receipts and DVD sales because many movies only become profitable when consumers buy the DVD.²³⁴ Accordingly, if DVD sales continue to plummet, film studios will produce fewer films because they will no longer be able to rely on DVD sales to make the movies profitable.²³⁵ Congress needs to pass a law—similar to a *droit de suite* law²³⁶—that will promote the public good by requiring additional compensation to the copyright owner. This law will put more money in the studios' pockets to produce

226. See generally Barnes, *supra* note 8; Finke, *supra* note 9.

227. See King, *supra* note 20.

228. Goldstein, *supra* note 20.

229. See Samantha Clark & Marcy Magiera, *Redbox Sues Fox on DVDs*, DAILY VARIETY, Aug. 13, 2009.

230. E.g., Goldstein, *supra* note 20 (discussing how some studios are waiting 28 days before they sell their DVDs to Redbox); DiOrio, *supra* note 25 (discussing how Warner Bros. and Netflix agreed to wait 28 days after a DVD hits the market before Netflix starts renting them to their customers).

231. Cieply, *supra* note 11.

232. The author concludes that the public is significantly harmed because there are fewer movies to enjoy and less jobs available to people. See *id.*

233. Lieberman, *supra* note 182; *Redbox Roulette*, *supra* note 189.

234. Horn, *supra* note 4 ("Even a box-office blockbuster may reach profit only when it arrives on DVD shelves because movies have become so expensive to produce and market."); Epstein, *supra* note 4 ("Nowadays, in the new Hollywood, the world box office is a money loser.").

235. Ault, *supra* note 190.

236. E.g. CAL. CIV. CODE § 986 (2009); Council Directive 92/100/EEC, 1992 O.J. (L 346) 61 (EC).

more films, which in turn promotes the public good.²³⁷ Like a *droit de suite* law, the party that should pay the additional compensation is the party that actually profits from the copyright owner's work—the rental companies.²³⁸

The current landscape of the film industry is very different than what it was in the early 1980s when the first video rental amendment failed in Congress.²³⁹ In the early 1980s, there were many unknowns about the emerging rental industry, particularly its potential effect on the film studios.²⁴⁰ The studios were unable to convince Congress that the rental industry would damage their business.²⁴¹ Moreover, the film industry still had viable non-legislative options.²⁴² Film studios eventually raised the initial price of a video to about \$100, which made the price prohibitively high, such that only rental companies bought the video.²⁴³ This price increase enabled film studios to recover the lost revenue in sales that resulted from people renting movies instead of buying them.²⁴⁴

The linear rental pricing model is an unsustainable business model today.²⁴⁵ In fact, under that model, the DVD sales business, which is already suffering greatly, could be irreparably harmed.²⁴⁶ If the studios used the same formula as they did in the early 1980s to calculate a price that accounts for lost DVD sales to rentals, the initial price for a DVD could be as high as \$225.²⁴⁷ At that price, many consumers, other than

237. See *Mazer v. Stein*, 347 U.S. 201, 219 (1954).

238. See, e.g., CAL. CIV. CODE § 986; Council Directive 92/100/EEC, 1992 O.J. (L 346) 61 (EC).

239. See generally PRICE DISCRIMINATION, *supra* note 63, at 1308 (noting that in the 1980s the studios set up a linear rental pricing scheme, while the studios are now setting a low sell-thru price as soon as the DVD hits the market).

240. See generally Castonguay, *supra* note 51, at 9. Specifically, the MPAA was worried that this new technology would destroy the industry. Unbeknownst to it, the studios would ultimately benefit greatly from this new technology. Jozefowicz et al., *supra* note 161.

241. See generally COHEN ET AL., *supra* note 18, at 372.

242. See generally PRICE DISCRIMINATION, *supra* note 63, at 1310–11 (discussing the linear rental pricing option).

243. *Id.*

244. See generally Jozefowicz et al., *supra* note 161.

245. As DVD sales continue falling, consumers still do not want to pay for a DVD at the current price. Graser & Magiera, *supra* note 5. Also, higher prices could lead to an increase in piracy, and “a sell-through pricing strategy is aimed at discouraging piracy.” PRICE DISCRIMINATION, *supra* note 63, at 1308.

246. *Id.*

247. This number was calculated by the consumer price index inflation calculator. In 1982, \$100 would roughly equate to \$225 in 2009. Inflation Calculator, <http://data.bls.gov/cgi-bin/cpicalc.pl> (last visited Mar. 31, 2010).

video rental companies, would be unwilling to pay for a DVD.²⁴⁸ Furthermore, by making a creative work only available to a certain group of people—even if there were enough rental copies to satisfy everyone's needs—this option would run afoul of the U.S. Constitution.²⁴⁹

Moreover, today's technology makes movie-pirating easy.²⁵⁰ A simple Google search can help any novice find a movie online within seconds.²⁵¹ Nevertheless, film piracy has not crippled the industry.²⁵² When consumers are given a choice between content provided by the studio and pirated content, most people prefer the legitimate studio option.²⁵³ For example, Hulu, a joint online venture between several Hollywood studios, streams television shows and movies.²⁵⁴ This online service became enormously popular and successful because the available content was free and high quality.²⁵⁵ The only inconvenience viewers experience is the occasional commercial break, which most people do not mind.²⁵⁶ Compared to the poor quality of bootleg films, consumers choose higher quality, legal content available at Hulu.²⁵⁷

However, if a linear rental pricing formula is reintroduced, many significant problems can arise.²⁵⁸ Under a linear rental pricing scheme, the consumer will have the following choices: (1) purchase an overpriced DVD; (2) wait for the film to become available through a rental company (which can be a while if demand is high); or (3) watch a lower quality, bootleg version of the film online for free. If these were the options available to consumers, it is not a stretch to assume that more people would

248. If a significant amount of people are unwilling to pay for a DVD at the current price, it would only be logical that the same amount of people, if not more, would be unwilling to pay for DVDs at a higher price. See Graser & Magiera, *supra* note 5.

249. See generally *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975); U.S. CONST. art. I, § 8, cl. 8.

250. Eriq Gardner, *Paramount Antipiracy Speech Pirated*, HOLLYWOOD REP., ESQ., Sept. 23, 2009, <http://www.thresq.com/2009/09/paramount-filessharing.html>.

251. For example, a person can go to Google and type in a search with the words "Avatar" "online" "movie" and "free" and several sites appear that a person can either download the movie or watch the movie streaming online.

252. See generally Ben Drawbaugh, *Hollywood Still Doesn't Understand Why People Pirate Content*, ENGADGET HD, Feb. 27, 2009, <http://hd.engadget.com/2009/02/27/hollywood-still-doesnt-understand-why-people-pirate-content/>.

253. *Id.*

254. Hulu, About, <http://www.hulu.com/about> (last visited April 4, 2010).

255. Frank Rose, *Hulu, a Victim of Its Own Success?* WIRED.COM, May 12, 2009, <http://www.wired.com/epicenter/2009/05/hulu-victim-success/>.

256. See generally *id.*

257. *Id.*; Drawbaugh, *supra* note 252.

258. As previously noted, the threat of piracy always looms in the background. See generally PRICE DISCRIMINATION, *supra* note 63, at 1308.

pirate films, which in turn could create a deadly piracy problem for the studios.²⁵⁹

The situation the film industry now faces is similar to that which the computer software industry faced in the 1990s.²⁶⁰ Due to the First Sale Doctrine, film studios are producing fewer movies.²⁶¹ In order to produce more movies, the studios will have to raise DVD prices to account for the revenue lost to rentals.²⁶² However, due to the likely exponential increase in piracy, even if the studios wanted to raise DVD prices, they would be unable to do so.²⁶³ This is exactly like the situation Congress tried to prevent when it passed the Computer Software Rental Amendments Act.²⁶⁴ This option would “encourage unauthorized copying, depriv[ing] copyright owners of a return on [their] investment, and thereby discourag[ing] creation of new products.”²⁶⁵

Without congressional action, the film industry only has a few options available.²⁶⁶ The film studios can maintain the status quo and allow DVD rental companies—that do not enter into revenue-sharing agreements—to siphon off their profits without justly compensating the studios.²⁶⁷ This option will result in studios producing fewer movies, which is already occurring.²⁶⁸ Some studios are trying to prevent rental companies from obtaining copies of their movies,²⁶⁹ thereby spurring lawsuits from the DVD rental industry.²⁷⁰ However, the First Sale Doctrine prevents the studios from putting restrictions on how the consumer uses the DVD once that DVD is purchased.²⁷¹ Further yet, the film studios can raise the initial DVD price to an exceptionally high price to account for lost sales replaced

259. *See generally id.*

260. *See generally* LEAFFER, *supra* note 85, at 324.

261. Cieply, *supra* note 11.

262. By increasing the price of a DVD and going back to the linear rental pricing system in place during the 1990s, studios would be able to partially recover losses due to video rentals. *See* PRICE DISCRIMINATION, *supra* note 63, at 1308.

263. *See id.*

264. LEAFFER, *supra* note 85, at 324.

265. H.R. REP. NO. 101-735, at 8 (1990), *reprinted in* 1990 U.S.C.C.A.N. 6935, 6939.

266. Many studios are not yet sure how exactly they are going to handle the current situation. Lieberman, *supra* note 182.

267. *Id.*; Redbox Roulette, *supra* note 189.

268. Cieply, *supra* note 11.

269. Goldstein, *supra* note 20.

270. Clark & Magiera, *supra* note 229.

271. Nakashima, *supra* note 21; Olga Kharif, *Wal-Mart, Target Put Squeeze on Redbox*, BUSINESSWEEK, Feb. 2, 2010, http://www.businessweek.com/technology/content/feb2010/tc2010022_125668.htm.

by rentals.²⁷² As explained, this could cause an exponential increase in piracy.²⁷³

D. Proposal: The Film Rental Exception

Congress should pass a film rental exception to the First Sale Doctrine. Under this proposal, a company would be barred from renting out a DVD for direct or indirect commercial advantage without compensating the copyright owner.²⁷⁴ This exception would mirror the EU's regulation; however, this model should be modified to adapt to the current situation confronting the U.S. film industry.²⁷⁵

In order to best promote the sciences and useful arts, this proposed law should not be exactly like Europe's Rental Right Directive, which bans video rentals without the copyright owner's permission.²⁷⁶ Instead, this exception should generally ban video rentals that fail to justly compensate the original copyright owner.²⁷⁷ This suggestion closely mirrors California's Resale Royalty Act, which allows the transactions to proceed as long as the original copyright owner is appropriately compensated.²⁷⁸ During congressional hearings on this exception, Congress should determine what just compensation for the studios would be. It could be set at five percent of the total revenue of the product, as with the California Resale Royalty Act,²⁷⁹ or some other percentage that Congress deems appropriate.

The film studios are being hurt financially—many by major rental companies, such as Netflix and Redbox, with whom they do not have a rental agreement in place.²⁸⁰ However, the studios that do have rental

272. This option would be similar to the one the film industry had in place during the 1990's. PRICE DISCRIMINATION, *supra* note 63, at 1308.

273. *Id.* at 1309.

274. *E.g.*, CAL. CIV. CODE § 986 (2009); Council Directive 2001/84, 2001 O.J. (L 272) 32, 34.

275. The situation between Europe's landscape in late 1999 and the US landscape in 2010 is starkly different. Most notably, Redbox and Netflix have become established businesses, which should neither be shut down nor at the mercy of the studios until a revenue-sharing agreement is negotiated. *See* History of Redbox, *supra* note 76, at 1; Netflix Press Kit, *supra* note 77, at 2.

276. TRITTON ET AL., *supra* note 35, at 501. *See* Council Directive 92/100/EEC, 1992 O.J. (L 346) 61, 62 (EC).

277. Otherwise, Netflix and Redbox would have to shut down operations until they negotiated an agreement with the studios. This proposal allows Netflix and Redbox to stay in business, while ensuring the studios receive just compensation.

278. California Arts Council, *supra* note 106.

279. *Id.*

280. Netflix and Redbox have millions of customers and earn millions of dollars in revenue compared to local mom and pop shops that lack the requisite nationwide customer base. *See*

agreements with these companies are seeing economic advantages.²⁸¹ In fact, some of these revenue-sharing agreements are netting hundreds of millions of dollars in revenue for the studios.²⁸² Without these agreements in place, the rental companies would logically hold onto this revenue.²⁸³ Because the problem lies in the absence of a revenue-sharing agreement, the law should honor all agreements between the studios and rental companies. This law should create a default, minimal plan in place, unless the two parties can come to an agreement.

The law should also set a minimum amount of revenue that the rental company has to generate before it is governed by this new law. The purpose of this provision would be two-fold. First, it would make the law easier to enforce by limiting the number of parties to identify.²⁸⁴ Second, it would promote the public good by creating a greater economic incentive to film studios to produce more movies, thus increasing the availability of films.²⁸⁵ In turn, it would likely create more job opportunities. Larger rental companies are better suited to compensate the studios because these rental companies can spread the higher costs over a wider base of customers, thus minimizing the cost increases.²⁸⁶ However, if this law is to be applied to every business, small rental shops may be forced to increase prices possibly to a point that most consumers would be unwilling to pay.²⁸⁷ These small businesses may have to close down, because consumers would likely resort to a cheaper option, such as Netflix or Redbox.²⁸⁸ This would not benefit the public good and would go against what this constitutional clause seeks to accomplish.²⁸⁹

History of Redbox, *supra* note 76, at 1; Netflix Press Kit, *supra* note 77, at 2.

281. Goldstein, *supra* note 20.

282. *Id.*

283. See *Parfums Givenchy, Inc. v. C & C Beauty Sales, Inc.*, 832 F. Supp. 1378, 1389 (C.D. Cal. 1993).

284. By having fewer companies to expect payment from, the studios can easily check from a short list whether a rental company has paid them or not. One of the reasons why the EU's *droit de suite* law has been very effective is that it only applies to auctions. All the energy that it takes to enforce the law is thus focused on one manageable area. Hall, *supra* note 119, at 331.

285. See generally *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975) (discussing that stimulating creative works is done by securing a fair return for the author's work).

286. Rich Greifner, *Why We Like Big Moats*, YAHOO! FINANCE, Jan. 20, 2010, <http://uk.finance.yahoo.com/news/why-we-like-big-moats-foolcoulk-cd0188c18462.html> (noting that "bigger companies can offer products at a lower cost than smaller ones can" because they "can spread [their] operational costs across a wide store base" and therefore "undercut [their] competitors on price and still turn a tidy profit").

287. See e.g., *id.*

288. See generally *id.*

289. U.S. CONST. art. I, § 8, cl. 8 ("To promote the Progress of Science and useful

VI. CONCLUSION

The film industry is at a crucial pass. Studios may potentially lose billions of dollars due to slumping DVD sales.²⁹⁰ Furthermore, studios are producing fewer movies.²⁹¹ The film industry is trying to correct the situation itself, but it simply cannot.²⁹² The film industry cannot charge one price to an individual consumer and a higher price to a business because the practice would violate price discrimination laws.²⁹³ It would be unreasonable to charge a higher initial price for DVDs because it would likely have fatal consequences to DVD sales and encourage people to obtain the copyrighted work through other means, such as piracy.²⁹⁴ Preventing the studios' distributors from selling DVDs to the rental industry would only minimally affect the current situation because the rental industry could still purchase the exact same product from a local Wal-Mart or Best Buy.²⁹⁵ Furthermore, the rental industry would likely sue the studios that try to prevent it from purchasing those DVDs.²⁹⁶

The rental industry is abusing the First Sale Doctrine as technology advances.²⁹⁷ Rental companies profit from the film industry's product,²⁹⁸ which contributes to the film industry's financial problems.²⁹⁹ As a result, the studios produce fewer creative works.³⁰⁰ The film industry depends on the revenue generated from DVD sales to create more jobs by producing

Arts . . .").

290. *Studios Feel Pinch*, *supra* note 7.

291. Cieply, *supra* note 11.

292. *See generally* Goldstein, *supra* note 20; DiOrio, *supra* note 25, at 1.

293. VERTICAL CONTRACTS, *supra* note 206, at 5.

294. DVD sales are falling and people already do not want to pay for a DVD, at the current price. Graser & Magiera, *supra* note 5. Also, higher prices could lead to an increase in piracy, and "a sell-through pricing strategy is aimed at discouraging piracy." PRICE DISCRIMINATION, *supra* note 63, at 1309.

295. *Ahead of the Bell*, *supra* note 30. Recently, Wal-Mart and Target limited the amount of DVDs a customer can buy at anytime, which makes it harder for Redbox to stock up on DVDs by purchasing them at a retail store. However, it is not impossible because the employee can just go to a store that does not have such a policy, like Best Buy, or return to the store several times throughout the day and buy the maximum amount of DVDs allowed. Kharif, *supra* note 271.

296. Clark & Magiera, *supra* note 229.

297. The First Sale Doctrine is being used by the video rental companies to withhold just compensation from the movie studios. Because the studios are being deprived of this revenue, they are producing fewer films. *See generally* *Ahead of the Bell*, *supra* note 30; Graser & Magiera, *supra* note 5, at 1; Cieply, *supra* note 11.

298. Graser & Magiera, *supra* note 5.

299. *Id.*

300. Cieply, *supra* note 11.

more films.³⁰¹ The First Sale Doctrine, originally created to limit the author from getting more than what she deserves,³⁰² now causes the film industry to receive less than it deserves.³⁰³ Worse still, this current application of the First Sale Doctrine directly conflicts with the intellectual property clause of the U.S. Constitution.³⁰⁴ Rather than stimulating the creative arts, it is indirectly causing the film studios to release fewer films.³⁰⁵ In order “[t]o promote the Progress of Science and useful Arts,”³⁰⁶ Congress must take action and pass a film rental exception to the First Sale Doctrine.

Ryan Sullivan *

301. Horn, *supra* note 4 (“Even a box-office blockbuster may reach profit only when it arrives on DVD shelves because movies have become so expensive to produce and market.”); Epstein, *supra* note 4 (“Nowadays, in the new Hollywood, the world box office is a money loser.”).

302. *Brilliance Audio, Inc. v. Hights Cross Commc'ns*, 474 F. 3d 365, 373 (6th Cir. 2007).

303. *See* Lieberman, *supra* note 182.

304. *See generally* *Twentieth Century Music Corp. v. Aiken*, 422 U.S. 151, 156 (1975); U.S. CONST. art. I, § 8, cl. 8.

305. Cieply, *supra* note 11.

306. U.S. CONST. art. I, § 8, cl. 8.

* J.D. Candidate, Loyola Law School, Los Angeles, 2011; B.A., The George Washington University, 2008. I would like to thank Professor Aaron Caplan for his incredible comments and revisions, and Chief Production Editor Sharoni Finkelstein for working tirelessly on this Comment. Additionally, I would like to thank the members of the Loyola of Los Angeles Entertainment Law Review, especially Ryan Mowry. Finally, I would like to thank Paul Marmaro, Stanley Addison Freeman, and Michael Salad for being continuous sources of inspiration.