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Accounting Accountability: Should Record Labels Have a Fiduciary Duty to Report Accurate Royalties to Recording Artists

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NOTES & COMMENTS

ACCOUNTING ACCOUNTABILITY: SHOULD RECORD LABELS HAVE A FIDUCIARY DUTY TO REPORT ACCURATE ROYALTIES TO RECORDING ARTISTS?

> *"The record business is in rough enough shape that something might actually change . . . . If things weren't so uncertain, so bleak and in such disarray, the industry would be immovable, even with a gun to its head. If there was ever a set of circumstances that could lead to artists making inroads, it's now."*[1]

I. INTRODUCTION

On June 25, 2002, a Los Angeles judge approved a $4.75 million settlement in a class-action suit brought by the late singer Peggy Lee.[2] Before her death, Peggy Lee led the suit against Decca Records, accusing the record label of using questionable accounting practices to cheat artists out of their royalties for more than four decades.[3] Other members of the class, most of whom are now dead, include the estates of those considered to be among the greatest musical performers of all time—Louis Armstrong, Billie Holiday, Patsy Cline, Ella Fitzgerald, Bill Haley, Mary Martin, and Pearl Bailey.[4] The lawsuit represented more than 300 artists, all of whom recorded for Decca Records before January 1, 1962.[5] Vivendi Universal, the largest record company of the world's music conglomerates, who

1. Edna Gunderson, *Rights Issue Rocks the Music World*, U.S.A. TODAY, Sept. 16, 2002, at 1D (statement by *Blender* magazine editor Craig Marks).

2. *See Judge Clears Music Royalties Settlement*, L.A. TIMES, June 26, 2002, at B11 [hereinafter *Music Royalties*].

3. *See* Ann O'Neil, *Peggy Lee Class-Action Suit Settlement Stalled*, L.A. TIMES, May 8, 2002, at C3.

4. *See Music Royalties*, *supra* note 2.

5. *Peggy Lee*, CITY NEWS SERVICE, June 25, 2002, LEXIS, News & Business, News, News Group File, All.

acquired Decca Records,[6] settled the class-action suit without admitting any wrongdoing.[7]

More recently, a 1960s group, the Ronettes, won a similar judgment for unpaid royalties.[8] Most known for their song *Be My Baby*, which was re-popularized by the 1987 motion picture release *Dirty Dancing*, the Ronettes alleged that a 1963 agreement with Philles Records did not give the record company the right to license master recordings to the motion picture or to third parties for production and distribution of compilation albums.[9] While Philles Records earned considerable income from such licensing and sales, no royalties were paid to the Ronettes.[10] The court held that the Ronettes were entitled to payment of royalties.[11]

In June 2002, members of the Dixie Chicks settled their suit against Sony.[12] They alleged Sony had underreported sales figures and overcharged for record company services, resulting in the underpayment of more than $4 million in royalties.[13] The case settled for an approximate $20 million signing advance, of which the Dixie Chicks must recoup $15 million in record sales to Sony before collecting any future royalties.[14]

Still, there are other casualties in the record label accounting war. Rock singer Meat Loaf was paid approximately $10 million by his record company in exchange for dropping his royalty suit, after estimating that his record company owed him more than $14 million in underpaid royalties.[15]

6. In 1958, MCA acquired a portion of Universal Studios' back lot. Tim Carvell, *The Entertainers: They Found Profit in a Nation of Pleasure Seekers*, FORTUNE, Oct. 25, 1999, at 272, 276. In 1962, after a series of federal antitrust inquisitions, MCA acquired all of Universal and its then-parent, Decca Records. *Id.*; *see also* Dave McNary, *Foes Eye Feds in SAG/ATA War*, DAILY VARIETY, Apr. 5, 2002, at 1. In 1991, Matsushita Electric Industrial Co., Ltd., acquired MCA, which was subsequently sold to Seagram in 1995 for $5.7 billion. *See* Robert Keefe, *Tropicana Goes Big-League*, ST. PETERSBURG TIMES, Oct. 28, 1996, at B10. In 2000, Vivendi, a former water utility, acquired Universal from Seagram, creating Vivendi Universal—the world's largest global media and entertainment powerhouse. *Vivendi Confirms $10.3B Takeover of USA Networks*, THE RECORD (Kitchener, Cambridge, and Waterloo, Ontario, Canada), Dec. 18, 2001, at C12, *available at* LEXIS, News & Business, News, News Group File, All.

7. *Record Label Accounting Practices: J. Hearing of the Cal. State S. Comm. on the Judiciary and State S. Select Comm. on the Entm't Indus.*, 2001–2002 Leg. 1 (July 23, 2002) [hereinafter *Record Label Accounting Practices I*] (overview by Sen. Martha M. Escutia, Chair).

8. *See* Greenfield v. Philles Records, 780 N.E.2d 166 (N.Y. 2002).

9. *See id.* at 168–69.

10. *See id.* at 169.

11. *Id.* at 173.

12. *See Record Label Accounting Practices I*, *supra* note 7, at 2 n.2 (overview by Sen. Martha M. Escutia).

13. *See id.*

14. *Id.*

15. Chuck Philips, *Auditors Put New Spin on Revolt over Royalties*, L.A. TIMES, Feb. 26, 2002, at A15 [hereinafter *Revolt over Royalties*].

Many other musicians, including Tom Petty, Don Henley, John Fogerty, Tom Waits, and Merle Haggard also claim to have been underpaid royalties by their record labels.[16]

The current onslaught of suits against record labels is by no means a new phenomenon. In 1979, the members of the Beatles sued Capitol Records, charging breach of contract and fraud.[17] The Beatles claimed they were not paid all the royalties due for records sold in the United States.[18] The suit accused Capitol Records of a "pervasive practice of lining their own pockets at the expense of [the Beatles] through improper and fraudulent accounting practices,"[19] and subsequently, for withholding royalties on as many as nineteen million records.[20] The case was dismissed, but the Beatles appealed, and the New York State Supreme Court upheld the appeal in 1988.[21] At that time, the Beatles' attorney, Leonard Marks, stated, "[t]he Beatles do not enjoy litigation, and would much prefer to avoid it, but there are some situations where it really is the only thing to do."[22]

Although the court dismissed the Beatles' accounting claims,[23] the court found that a fiduciary relationship existed independent of contractual relations between the Beatles and Capitol Records.[24] The court held that there was sufficient evidence to support the Beatles' claim that "an injury separate and distinct from the breach of contract [was] committed and [was] actionable as a tort."[25] As this Comment will illustrate, this case set a precedent for the music industry.

Most recently, soul singer Sam Moore and others, including the estates of Mary Wells,[26] and Curtis Mayfield,[27] settled a class-action

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16. *Id.*

17. *See* Apple Records, Inc. v. Capitol Records, Inc., 529 N.Y.S.2d 279, 280 (N.Y. App. Div. 1988).

18. *See id.*

19. Steve James, *Beatles Hold Out for Capitol Punishment*, ORANGE COUNTY REG., June 1, 1988, at L3 [hereinafter *Capitol Punishment*].

20. *See Apple Records*, 529 N.Y.S.2d at 283.

21. *See id.* at 284; *see also Capitol Punishment*, *supra* note 19.

22. *Capitol Punishment*, *supra* note 19.

23. *See Apple Records*, 529 N.Y.S.2d at 281, 284. "A similar suit the Beatles brought against EMI in Britain in 1984 resulted in a $4 million judgment against the record company" for accounting errors—not wrongdoing. Steve James, *Court Musicians*, CHI. TRIB., June 6, 1988, § 5, at 3.

24. *See Apple Records*, 529 N.Y.S.2d at 283.

25. *Id.*

26. Singer Mary Wells was "once one of Motown's biggest stars." *See* Sue Zeidler, *Sam Moore Has Union Singing Different Tune over Health Benefits*, ORLANDO SENTINEL TRIB., Dec. 7, 2002, at E11. In 1992, she died of throat cancer, in need of medical support, destitute, and

lawsuit against their union's pension division for $8.4 million.[28] Moore originally filed the suit in 1993, alleging that his record label did not accurately report royalty earnings to the American Federation of Television and Radio Artists ("AFTRA") Health and Retirement Funds.[29] Further, the suit accused AFTRA's pension division of neglecting to keep track of record label contributions to artists' pension accounts.[30]

For years, recording artists have questioned record label accounting practices.[31] It is one of the greatest issues in the ongoing debate over recording artists' rights.[32] Lawmakers are becoming more concerned with a system that artists and recording industry representatives are calling "dysfunction[al]."[33]

Many performers and musicians believe record companies use unfair accounting tricks to reduce their artist royalties, and subsequently, their healthcare and pension benefits.[34] These artists claim record companies should have a fiduciary duty to report royalty statements accurately because currently there is no *real* penalty if the record companies do not.[35] If an artist audits a record company and discovers unpaid royalties, many recording contracts only require the record company to pay what the artist is actually owed, if the record company is found at fault.[36] Without a fiduciary duty imposed on record company accounting, the current system effectively creates "a disincentive for record labels to fully report" royalty

living in a charity ward. *Id.*

27. In 1999, singer/songwriter Curtis Mayfield died without medical benefits, after being paralyzed in 1990 by a piece of lighting equipment that fell on him during a concert. *Today in Music: A Look Back At Pop Music*, UPI, Dec. 26, 2002, LEXIS, News & Business, News, News Group File, All.

28. Chuck Philips, *Singers, Union Find Harmony*, L.A. TIMES, Dec. 5, 2002, at C1 [hereinafter *Singers, Union Find Harmony*].

29. *Id.*

30. *Id.*; *see* discussion *infra* Part II.D.

31. *See generally* Connie Chang, *Can't Record Labels And Recording Artists All Just Get Along?: The Debate Over California Labor Code § 2855 and its Impact On The Music Industry*, 12 DEPAUL-LCA J. ART & ENT. L. & POL'Y 13 (2002) (discussing the history of relationships between recording artists and their record labels).

32. *See* Chuck Philips, *State Senate to Examine Music Firms*, L.A. TIMES, Aug. 26, 2002, at C1 [hereinafter *State Senate*].

33. Sen. Kevin Murray, *Recording Industry Practices Hearing Summary*, *at* http://democrats.sen.ca.gov/servlet/gov.ca.senate.democrats.pub.members.memDisplaySpotlightFeature?District=sd26&ID=2344.html (last visited Feb. 8, 2003) [hereinafter Murray].

34. *State Senate*, *supra* note 32.

35. *See* Murray, *supra* note 33.

36. Jonathan Cohen, *Label's Accounting Practices Under Fire* (Jul. 24, 2002), *at* http://www.billboard.com/billboard/daily/article_display.jsp?vnu_content_id=1553308.

earnings to recording artists.[37] According to accountant Wayne Coleman, whose St. Louis firm has recovered millions of dollars in unpaid royalties for recording artists, "[r]ecord companies use questionable accounting tactics and contractual provisions to get away with unconscionable things. . . . Of the thousands of royalty compliance audits I've conducted over the past 30 years, I can recall only one instance where the artist owed money to the company."[38]

Proper royalty accounting has a direct bearing on a recording artist's profitability.[39] It determines whether an artist will make money or owe money to the record label.[40] The record label must recoup all money it has advanced to a recording artist before the artist is paid any money—known as an artist royalty—for the recording.[41] Recording artists usually see their royalty earnings twice a year, in a statement where their earnings are added up and then deducted from the total cost owed to the record label.[42] The result is an unrecouped or recouped balance.[43]

In addition, proper royalty accounting has a direct and significant effect on the relationship and leverage between artists and their record company during the recording contract term and any subsequent renegotiation of the contract.[44] To the extent that an artist is unrecouped, the record company has an economic hold on the artist, and vice versa.[45]

Finally, proper royalty accounting is important to the artist's qualification status for healthcare and pension benefits.[46] When the artist's earnings reach a certain level, the artist is eligible for benefits under the AFTRA Health and Retirement Fund.[47] If the record company does not

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37. *Id*; *see generally* discussion *infra* Part II.C (defining the purpose and problems of the auditing process under current industry standards).

38. *Revolt over Royalties*, *supra* note 15.

39. *See Record Label Accounting Practices I*, *supra* note 7, at 2 (overview by Sen. Martha M. Escutia).

40. *Id.*

41. DONALD S. PASSMAN, ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS 100 (2000).

42. *See id.* at 100, 164.

43. *See id.* at 100; *see also Record Label Accounting Practices I*, *supra* note 7, at 2 (overview by Sen. Martha M. Escutia).

44. *See Record Label Accounting Practices I*, *supra* note 7, at 2–3 (overview by Sen. Martha M. Escutia).

45. *See id.*

46. *See State Senate*, *supra* note 32; *see also* discussion *infra* Part II.D.

47. *See generally* Employee Retirement Income Security Act of 1974, 29 U.S.C.A. §§ 1001–1461 (discussing the rights of employees and their beneficiaries to receive health and pension benefits); *see also* discussion, *infra* Part II.D (describing the AFTRA Code and health and pension benefits currently required under the Code).

report accurate earnings, an artist may not become eligible.

In sum, improper royalty accounting significantly impacts recording artists. Aside from the simple underpayment, it can put an artist in an unrecouped position for longer periods of time; it can affect the leverage between artists and record companies;[48] and it can deprive or reduce the amount of healthcare and pension benefits owed to recording artists in their later years.[49]

Vivendi Universal ("Universal"), Sony Music Group ("Sony"), Bertelsmann Music Group ("BMG"), EMI, and AOL Time Warner ("Warner Group") are the world's five major music conglomerates ("Big Five").[50] These conglomerates control more than 90% of the American music market,[51] and claim they pay artists "accurate royalties based on time-honored industry accounting practices."[52] The Recording Industry Association of America ("RIAA"), a Washington trade group that represents the Big Five, says that artists are paid in accordance with their contracts.[53] Nevada accountant Phil Ames, who has been performing royalty audits for thirty years, agrees.[54] "Most of the problems we detect are contractually permissible . . . . All of these artificial deductions are embedded in the contract."[55]

The key phrase is "artificial deductions." Because current record industry accounting systems are so complex and include so many deductions that have little to do with actual costs and expenses, improper royalty accounting has become part of the norm.[56] Although the labels admit that their accounting systems are not free of error, they maintain that the errors discovered during audits are unintentional and accidental, and on occasion, they have negotiated settlements with important artists, "simply to keep [them] happy."[57]

On September 24, 2002, the California State Senate Committee on Judiciary and the Senate Select Committee on the Entertainment Industry held a joint hearing in Los Angeles on record label accounting

48. *See Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia).

49. *See State Senate*, *supra* note 32.

50. *Revolt over Royalties*, supra note 15.

51. Chang, *supra* note 31, at 15.

52. *Revolt over Royalties*, *supra* note 15.

53. *State Senate*, *supra* note 32.

54. *Revolt over Royalties*, *supra* note 15.

55. *Id.*

56. *See* discussion *infra* Part II.

57. *Revolt over Royalties*, *supra* note 15.

practices[58]—the second of two hearings concerning accounting issues.[59] Lawmakers are concerned about these issues because of recent news stories about famous recording artists becoming reliant upon public assistance,[60] after being denied health benefits or pensions because their royalty incomes from record sales were underreported, and having to sue their record labels for proper accounting of their royalty earnings.[61] California State Senator Martha Escutia states:

> I am very alarmed by the recent stories in the press about past recording artists having to rely on public assistance or being denied pension benefits because they may have been shortchanged on their royalty earnings during their careers. Recording artists should not have to sue for what is rightfully theirs . . . . If public taxpayer funds are being used to support artists who were cheated out of their royalty earnings, then we need to shift that burden back to where it belongs, to the record companies that failed to pay the artists their rightful earnings.[62]

Over the years, the relationship between artists and record companies has grown contentious regarding the issue of accounting practices. Because record companies and recording artists have not been able to reach a real accommodation through "marketplace negotiations,"[63] California State Senator Kevin Murray[64] hopes to introduce a bill that would penalize record labels that purposely underpay artist royalties.[65] California legislators are trying to learn and understand industry accounting practices.[66] They are currently reviewing recording artist contracts, and

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58. *Record Label Accounting Practices: J. Hearing of the Cal. State S. Comm. on the Judiciary and State S. Select Comm. on the Entm't Indus.*, 2001–2002 Leg. 1 (Sept. 24, 2002) [hereinafter *Record Label Accounting Practices II*] (overview of Sen. Martha M. Escutia, Chair).

59. Murray, *supra* note 33.

60. *See Record Label Accounting Practices II*, *supra* note 58, at 3 (overview by Sen. Martha M. Escutia); *see also* text accompanying notes 26–27; *see also* note 28.

61. *Revolt over Royalties*, *supra* note 15.

62. Press release, Sen. Kevin Murray, State Senate Committees to Review Accounting Practices of Record Companies (Jul. 8, 2002), *at* http://democrats.sen.ca.gov/servlet/gov.ca.senate.democrats.pub.members.memDisplayPressRoom [hereinafter *Press Release*].

63. *See* Bill Holland, *Lawmakers, Others Try To Push Royalty Bill Through*, BILLBOARD, Nov. 2, 2002, at 6.

64. California State Senator Kevin Murray is a Democrat Representative serving the 26th District. *See California State Senate Website*, *at* http://www.sen.ca.gov/~newsen/senators/senators.htp (last visited Jan. 5, 2003).

65. *Revolt over Royalties*, *supra* note 15.

66. Philips, *State Senate Probing Record Companies*, L.A. TIMES, July 3, 2002, at C4 [hereinafter *Probing*]. California lawmakers are interested in recording industry practices because of RIAA lobbying of the California State Legislature, which initially led to an exception to California's Seven-Year Rule in 1987, and the 2000 "Work Made For Hire Amendment,"

probing recording artist allegations that record companies "consistently cheat them out of royalty payments."[67] California lawmakers, versed in recording artists' rights believe that should Senator Murray put forth a bill, the Senate will likely approve it.[68] However, after a "spate of corporate mergers," record companies—owned by some of the largest conglomerates in the world—appear to be "preparing for a giant political fight."[69]

Royalty accounting is a very complex issue. At the September 24 hearing, California State Senator Jim Battin[70] expressed this sentiment when he warned record labels and recording artists to be wary of legislative solutions to resolve the problems of "an industry whose inner workings are a mystery to most."[71] Senator Battin continued to urge both record labels and recording artists to educate the public and the Legislature about recording industry accounting practices, so as to avoid legislatively-imposed solutions, which in turn do not satisfy the needs and goals of either party, furthering a situation where no one is happy.[72]

In the spirit of Senator Battin's statement, this Comment has five sections that discuss artist rights with relation to record label accounting practices, including Part I—the introduction. To effectively analyze recording industry accounting practices, it is imperative that the reader understand the actual royalty accounting process. Thus, Part II details current recording industry accounting standards, including definitions for terms of art such as "packaging deductions," "free goods," "returns," "reserves," and so on. Part II also gives an overview of the auditing process for those artists who are contractually allowed to audit their record company. For readers familiar with recording industry practices in general, Part II is merely a review of terms already known; for those unfamiliar, Part II is vital to understanding the accounting process. Finally, Part II examines the AFTRA Code and its relation to royalty accounting. Part III provides a legal definition of a fiduciary duty—when it exists, and when it does not— through the examination of existing case law. Part IV proposes a new royalty structure and an overhaul of current recording industry

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which was overturned, largely due to recording artist lobbying in Washington, D.C. *See* Murray, *supra* note 33.

67. *Probing, supra* note 66.

68. Chuck Philips and Dan Morain, *Measure on Music Contracts Planned*, L.A. TIMES, Oct. 19, 2001, at C1.

69. *Id.*

70. California Senator Jim Battin is a Republican Representative serving the 37th District. *See California State Senate Website, at* http://www.sen.ca.gov/~newsen/senators/senators.htp (last visited Jan. 5, 2003).

71. Murray, *supra* note 33.

72. *Id.*

accounting procedures. Ultimately, Part V concludes that a fiduciary duty should be imposed on record labels to report accurate royalties to recording artists.

II. THE CURRENT SYSTEM

A royalty is defined as "[a] share of the proceeds from the sale or performance of a work paid to the author or composer; [a] payment to an inventor or proprietor for the right to use his invention or services."[73] In the recording industry, a record company pays what is called an artist royalty to the recording artist.[74] Currently, the average artist royalty is between 12% and 16% of the suggested retail selling price.[75] Some major artists, i.e., "superstars," are able to command a rate between 18% and 21%.[76] This royalty is based on how many records are sold, not how many are manufactured.[77]

A. Calculating the Artist Royalty

Historically, the American recording industry has never used an easy standard for computing artist royalties.[78] In the United States, all artist royalties are based on record sales.[79] Most record companies calculate artist royalties using either a suggested retail list price or a "wholesale-based system."[80] Neither method is necessarily better than the other, nor is the decision to use one method over the other anything more than an arbitrary decision that each record company makes.

1. Suggested Retail List Price ("SRLP")

The SRLP is an approximation of the price that the retailer, i.e., record store, receives from the customer.[81] An artist's royalty is stated as a

73. WEBSTER'S II NEW RIVERSIDE DICTIONARY 607 (1984).

74. *See* PASSMAN, *supra* note 41, at 89–91.

75. *See id.* at 108; *see also* discussion *infra* Part II.A.1.

76. *See* PASSMAN, *supra* note 41, at 108. *But see also* Lynn Morrow, *The Recording Artist Agreement: Does It Empower or Enslave?*, 3 VAND. J. ENT. L. & PRAC. 40, 45 (2001).

77. PASSMAN, *supra* note 41, at 90.

78. *Id.*

79. *See* Morrow, *supra* note 76, at 45.

80. *Record Label Accounting Practices I*, *supra* note 7, at 5 (statement of Jeffrey Light, attorney, Myman, Abell, Fineman, Greenspan & Light and adjunct professor of law, Southwestern Law School).

81. PASSMAN, *supra* note 41, at 90. *See Record Label Accounting Practices I*, *supra* note 7, at 5 (statement of Jeffrey Light).

percentage of the SRLP, such as 12% of $18.98.[82] Because the artist royalty is based on a percentage of the SRLP and not on the actual retail price, essentially, it has nothing to do with the price a consumer buys the CD for in a local record store.[83] For instance, although the current industry standard SRLP is $18.98, many retailers have a CD selling price for much less. It is beneficial to an artist and a record company to be paid on a higher SRLP, but the whole premise of an SRLP artist royalty is based on a completely artificial figure.[84]

2. Wholesale-Based System

Under this system, the artist's royalty is based on a published wholesale price. Again, this rate bears little relation to the price for which the major wholesalers like Best Buy or Tower Records are buying the CDs.[85] Discounts, trade allowances, and advertising issues make the calculation itself, a complex procedure.[86] The wholesale royalty rate is approximately twice the applicable retail rate, subject to other adjustments and deductions.[87] For instance, a 12% royalty based on the SRLP is roughly equivalent to a wholesale rate of 22%.[88]

B. Artist Royalty Deductions

Additionally, whether a record company uses wholesale or SRLP calculations, the record company deducts numerous other items before paying an artist any royalties.[89] Although these deductions do not reflect actual costs to the record company, they are "traditional elements" of the record industry, which is the only reason these costs remain "embedded in royalty computations."[90] Still, there are expenses that record companies do not deduct from the "royalty stream."[91] For instance, record companies usually absorb at least a portion of marketing and distribution expenses.[92]

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82. PASSMAN, *supra* note 41, at 90.

83. *Id.*

84. *Record Label Accounting Practices I*, *supra* note 7, at 4 (statement of Jeffrey Light).

85. *Id.*

86. *Id.* at 5.

87. Morrow, *supra* note 76, at 45.

88. *Id.*

89. *See Record Label Accounting Practices I*, *supra* note 7, at 5 (statement of Jeffrey Light); *see also* Morrow, *supra* note 76, at 45.

90. *See* Morrow, *supra* note 76, at 45.

91. *See* Robert C. Schlegel, *What Is the Value of an Artist's Recordings?*, FAIRSHARE: THE MATRIMONIAL LAW MONTHLY, Oct. 1994, at 20.

92. *See id.*

Certainly, recording artists and their attorneys are aware of these contractual deductions and how they affect artist royalties;[93] however this Comment does not address that issue. Here, the underlying issue is the recording industry's complex accounting system and the errors that occur within that system. Because these errors seemingly occur more often than not, accountability needs to be determined. The following discussion of record industry accounting terms of art exemplifies the confusion and difficulty associated with the current royalty system.

1. Packaging Deductions

Record companies always take out deductions for packaging expenses, called "packaging deductions."[94] In theory, the deduction is taken out to reimburse the record company for the cost of making the CD package.[95] In reality, the packaging deduction is an arbitrary charge—usually for much more than an actual package costs to make.[96] It is an artificial way for a record company to lower an artist's royalty[97] and raise the record company's profit potential.

The result of deducting the packaging charge from the artist's percentage of an SRLP[98] is called "the base price" or "royalty base."[99] The standard packaging deduction for a CD is 25% of the SRLP.[100] Therefore, if an artist has a 12% royalty[101] on a CD with a SRLP of $18.98, then the artist's royalty base is $14.24 and the artist's royalty per unit is $1.71.[102]

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93. *See Record Label Accounting Practices I*, *supra* note 7, at 5 (statement of Jeffrey Light).

94. *See id.*; *see also* PASSMAN, *supra* note 41, at 90.

95. PASSMAN, *supra* note 41, at 90–91.

96. *See* Morrow, *supra* note 76, at 46.

97. PASSMAN, *supra* note 41, at 91.

98. This Comment will calculate artist royalties based on the SRLP system, as it is the most commonly used system within the recording industry. *Id.* at 90.

99. *See id.* at 91.

100. *Id.*

101. The average artist's royalty is between 12% and 16%. *Id.* at 108. Some major artists are able to command a rate between 18% and 21%. *See id. But see also* Morrow, *supra* note 76. This royalty includes any producer royalty or mixer royalty. *See generally* PASSMAN, *supra* note 41, at 132 (discussing producer deals and their effect on the artist's royalty). For instance, if an artist receives a 12% royalty, and the producer has a 3% royalty, the producer receives one-quarter of the artist's earnings and usually is paid from record one—without having to recoup—unlike the artist's account. *Id.* at 137.

102. Whether or not an artist actually takes home the earnings depends upon whether the artist's royalty account is recouped or not recouped. *See generally* PASSMAN, *supra* note 41, at 100 (discussing basic concepts of advances and recoupment).

Suggested Retail List Price of CD	$18.98	
Packaging Deduction (25% of $18.98)	x75%	(-4.74)
Royalty base	$14.24	
Royalty percentage	x12%	
Artist royalty (per unit)[103]	$1.71	

In other words, using *only* the calculations discussed thus far, for every CD that is sold, $1.71 is applied to the artist's royalty account.[104] However, packaging deductions are not the only extra costs applied to the royalty rate that an artist receives.[105] Record companies have a number of other expenditures that they require the artist to recoup.[106]

2. Free Goods

Without understanding the definition of "free goods," one could easily confuse the term with promotional CDs. Free goods do not include promotional CDs[107] and these goods are not free. Essentially, free goods allow a record label to give a retailer more goods for fewer dollars.[108] Record companies determined that selling one hundred records at 85¢ each was the same as selling eighty-five records for $1.00 each—throwing in fifteen "free" copies to the retailer for every eighty-five purchased.[109] By raising the price on eighty-five records and giving away fifteen free records, the record labels save money because they no longer have to pay artist royalties on fifteen records out of every one hundred records sold.[110] Artists are only paid for sold records, not free goods.[111] Record companies can deduct up to 25% for free goods.[112] If asked, most companies will not

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103. Two years ago, the standard SRLP was $16.98. Using the same calculation as above, the packaging deduction (at 25%) would be $4.25 and the artist's royalty (at 12% of $12.74) would be $1.53. Thus, in this example, including the income the record company receives for the packaging deduction, the increase in SRLP from $16.98 to $18.98 increases the profit of the record company by $1.82 per CD, while the artist receives a mere increase of 18¢. *See generally* discussion *infra* Part IV (arguing record companies should lower their prices to make CDs more accessible to the modern consumer. Raising prices benefits the record company far more than the recording artist.).

104. *See* text accompanying *supra* note 102; *see also* PASSMAN, *supra* note 41, at 100 (discussing basic concepts of advances and recoupment).

105. *See* discussion *infra* Part II.B and *supra* notes 89–92.

106. *Id.*

107. *See* discussion *infra* Part II.B.3.

108. *See* PASSMAN, *supra* note 41, at 92.

109. *See id.*

110. *Id.*

111. *Id.*

112. *Record Label Accounting Practices II*, *supra* note 58, at 6 (overview by Sen. Martha M. Escutia).

agree to eliminate free goods from the recording contract, but they will agree to some sort of limitation.[113]

There are two types of free goods: "phony free goods" and "real free goods."[114] Phony free goods—described above—are referred to as normal distributor free goods.[115] Essentially, they are what they seem—"nothing more than a cute way of discounting the purchase price."[116] Real free goods are different. Also known as "special campaign free goods," they are sold at an extremely discounted price.[117] Sometimes, to get stores to stock more of the product, a record label will give away 5% to 10% of all records shipped to encourage the dealer to buy the record, "which they invariably do, since the dealers make bigger profits when they sell [the product]."[118] Because these free goods actually cost the record company money, they bear no royalties to the artist.[119] Today, about half of the record companies use phony free goods, while all of the record companies use real free goods.[120]

3. Promotional Copies

Promotional copies ("promos") are different from free goods. Promos are records that are "given away for promotion . . . don't go to retailers . . . and are marked 'not for sale.'"[121] However, these records can end up being sold as used goods at local record stores for low prices, and because these promos are not legally for sale, the artist sees no royalty.[122]

113. Morrow, *supra* note 76, at 46.

114. *See* PASSMAN, *supra* note 41, at 92–94.

115. *See id.* at 92.

116. *Id.*

117. *Id.* at 94.

118. *Id.*

119. PASSMAN, *supra* note 41, at 94.

120. *Id.* at 93–94.

121. *Id.* at 94.

122. *Id.* at 95. In theory, a record company retains ownership over its promotional products so that any resale of that product is illegal. Technically, a record company can demand return of a promo CD, but that does not seem to stop used-record stores from selling promos or their consumers from buying them at discounted prices. *Id.*

4. Returns

Unlike the movie business, where "sold" means sold,[123] in the music industry, records are sold with a return privilege.[124] Effectively, a return privilege means that if Tower Records buys one hundred CDs from a record company and cannot sell them to consumers, then Tower Records can pack up the CDs, send them back to the record company, and receive a full refund.[125] Some record companies have created caps, or penalties, so that only a percentage of records can be returned, but, in any case, records can be returned.[126]

In their book, *Exploding: The Highs, Hits, Hype, Heroes, and Hustlers of the Warner Music Group*,[127] Stan Cornyn and Paul Scanlon describe the Warner Group's return process as a two-day procedure from the time the CDs are "in the door" at the return plant to the time they are "ready to resell" at full price.[128] In their example, which depicts the Warner Group's National Returns Center ("Returns Center") in Chicago, in the early 1990s, Cornyn and Scanlon explain that the Returns Center's computers keep track of every box of albums that is returned before it reaches the loading dock.[129] Each CD has a return authorization that is supplied from each record label branch.[130] Cartons of CDs come into the Return Center on pallets.[131] Then the pallets are taken to a Holding Area where employees open the boxes, which contain various CDs.[132] The CDs are immediately identified as recyclable (meaning re-sellable)[133] or not, scanned in by their bar codes, and then rolled down a conveyor belt where

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123. The movie industry has had its fair share of accounting abuses. However, within the motion picture business, it is generally accepted that "we can actually track how much money the studio is receiving; and whether they are giving a fair share of that money to the artist or not giving a fair share of that money to the producer is something we can argue about, but at least we know how much money has come in the door." *See Record Label Accounting Practices I*, *supra* note 7, at 5 (statement of Jeffrey Light).

124. Richard C. Wolfe, *Negotiating and Litigating Music Royalties*, 69 FLA. B.J. 56, 56 (1995).

125. PASSMAN, *supra* note 41, at 95.

126. *Id.*

127. STAN CORNYN ET. AL., EXPLODING: THE HIGHS, HITS, HYPE, HEROES, AND HUSTLERS OF THE WARNER MUSIC GROUP (2002).

128. *Id.* at 386.

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. CORNYN ET. AL., *supra* note 127, at 386–87. The returns identified as not re-sellable are ground to dust by hand. *Id.*

a pair of spinning wheels burn the shrink wrap off the CD without harming the plastic jewel case.[134] "Rubber fingers"[135] pull the shrink wrap away from the CD, and a vacuum sucks up the waste.[136] Then, the CDs are rescanned and moved onto "one of ten different aisles," where machines affix new promotional labels, such as "The New Studio Album," "Featuring the hit song," or "Special CD Saver," and so on.[137]

At the conclusion of this process, the returned CDs are ready for resale at full price.[138] Whether the artist earns royalties on these returns is based on whether or not the artist is paid on the record companies' reserves.[139] To calculate "net sales," normally a recording contract allows a record company to deduct returned units, as well as a percentage of shipped units that may be returned.[140] The artist is then paid a royalty on the net sales, not actual sales.[141]

5. Reserves

Reserves go hand in hand with returns. They are "probably the most manipulated royalty item on the royalty statement and in the royalty provisions."[142] Because retailers can return records, a record label will hold back a percentage of the artist's earnings to account for what might be returned.[143] The record label will eventually pay the recording artist for the difference, but the reserves account for any potential returns.[144] Because most record companies cannot ascertain the exact number of returns, the concept of holding back reserves is very common.[145]

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134. *Id.* at 386.

135. In this context, a "rubber finger" is a mechanical device used to help remove the shrink-wrap from a CD. *See id.* (discussing the returns procedure at one of the Warner Group's return centers).

136. *Id.*

137. *Id.*

138. CORNYN ET. AL., *supra* note 127, at 386.

139. Wolfe, *supra* note 124, at 56; *see also* discussion *infra* Part II.B.5.

140. Wolfe, *supra* note 124, at 56.

141. *Id.*; *see also* discussion *supra* Part II.A.

142. *See Record Label Accounting Practices I*, *supra* note 7, at 123 (statement of Fred Wolinsky, CPA, Wolinsky, Becker & Hurewitz, LLP).

143. *See* Wolfe, *supra* note 124, at 56.

144. *See* PASSMAN, *supra* note 41, at 96.

145. *See* Wolfe, *supra* note 124, at 56 (discussing bases for royalties and the concept of reserves and returns).

Once the record label determines that sales are final, the artist is paid on the reserves that were held back.[146] For example, if a record label ships 100,000 CDs, they may claim 35% as reserves.[147] This means the record company only pays an artist for 65,000 CDs, holding back the payment on 35,000 units, which are called "reserves against the returns."[148] Once the record label can tell that the CDs have sold, which is usually within two years from the time the CDs are shipped, they will liquidate the reserves and pay the artist royalties then due.[149] However, if the CDs are returned and not sold, the reserves are never paid to the artist because they are not sales, and artists only earn royalties for records sold.[150]

Arguably, in most contracts, the language regarding reserves is vague and general.[151] For example, a typical contract may read: "A record company is entitled to maintain reasonable reserves, based on anticipated returns."[152] It is possible to end up with a prolific artist selling millions of units, with their record company regularly withholding 35%[153] every royalty period.[154] Under those circumstances, withholding 35% is not reasonable, particularly if "you can show that the rate of return is less than 10%."[155]

The issue of reserves is not that it is a deduction, but instead that it defers recording artist income.[156] In testimony before a California State Senate Committee, entertainment attorney and professor of law Jeffrey Light said, referring to SoundScan (an actual point of sale monitoring system):

> I can't tell you how many times I have seen on a theoretical million seller, where the company will ship a million units, and I will see SoundScan reports indicating that 900,000 of them have been sold, and the record company still says, 'We're going to take a 350,000 unit

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146. *See* PASSMAN, *supra* note 41, at 96.

147. *Id.*

148. *Id.*; *see also Record Label Accounting Practices I*, *supra* note 7, at 11 (statement of Jeffrey Light). Three of the Big Five use a dollar basis, and the other two use a unit basis to calculate returns; the net effect of both is roughly the same.

149. *See* PASSMAN, *supra* note 41, at 96.

150. *Id.*

151. *See Record Label Accounting Practices I*, *supra* note 7, at 123 (statement of Fred Wolinsky).

152. *Id.*

153. Current recording agreements typically stipulate a record company may maintain reserves up to 35%. *Id.*

154. *Id.*

155. *Id.*

156. Wolfe, *supra* note 124, at 56.

> reserve because the contract says that we can do this,' even though that is an inherently unreasonable position, since we know that not more than 100,000 of those records are going to be returned. They've already been sold to the consumer, taken home, unwrapped, and played.[157]

Records that are held in reserves must eventually be liquidated to prevent the record company from taking "artificial deductions" unfairly from the recording artist's royalties.[158]

6. Net Sales Percentage

In the early days, because actual phonograph records were often warped or damaged in transit, many record labels held back 10% of net sales to cover the costs of replacing broken records—also known as breakage costs.[159] Now, CDs do not break easily and are inexpensive to make.[160] However, some companies still hold back an additional 10% to 15%, paying only 85% to 90% of net sales to cover breakage costs.[161] This is just another way to reduce the artists' royalty and raise the record company's profit potential.[162]

7. Music Video Costs

Record companies use music videos as promotional tools to generate CD sales.[163] Normally, artists are contractually required to reimburse record companies "for at least half of the cost of each promotional video."[164] Yet, record companies enter into agreements with video channels, such as MTV, where the record company ends up receiving millions of dollars in payments and other benefits that are never disclosed to the artist.[165] Many artists and their attorneys claim this scheme, which requires artists to recoup at least one-half of the expenses while the record company also gleans income from video channels, is nothing more than a

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157. *See Record Label Accounting Practices I*, *supra* note 7, at 11 (statement of Jeffrey Light).

158. Wolfe, *supra* note 124, at 56.

159. *See* Telephone Interview with Randall Wixen, Wixen Music Publishing, Inc., Los Angeles, Cal. (Jan. 5, 2003) [hereinafter Wixen Interview]; *see also* PASSMAN, *supra* note 41, at 97.

160. Based on the author's own experience. *See* Morrow, *supra* note 76, at 46.

161. *See* Morrow, *supra* note 76, at 46.

162. *See* PASSMAN, *supra* note 41, at 97.

163. *Id.* at 153; *see also State Senate*, *supra* note 32.

164. *State Senate*, *supra* note 32.

165. *Id.*

form of "double dipping."[166]

Many managers and attorneys believe that record companies should share the income with the artist[167] because the artist is required to share the expense of creating the video with the record company.[168] Record companies disagree. They argue that artists and attorneys are aware of the agreements record companies make with video channels as per the artists' contractual negotiations.[169] In addition, they argue that the fees record companies receive from the video channels are not profits, but are used to defray costs and investments of video productions for the artists.[170] Also, record companies claim videos are a form of marketing, and thus should be treated like marketing costs, which can be up to 50% recoupable from recording artists' royalty accounts.[171]

8. Record Club Pacts and Third-Party Licenses

Record club ("the Clubs") agreements are also on the list of hidden costs that affect artists' royalties. "Record clubs are mail-order 'clubs' in which you join by agreeing to buy a given number of records."[172] Originally, the Clubs were created to sell records to people through the mail in rural areas where there were no music outlets.[173] Before newer distribution outlets such as Amazon.com, Best Buy, and Wal-Mart accounted for such a large portion of retail sales, the Clubs helped "spark" record sales.[174]

Years ago, because record labels used the Clubs to increase sales, the record labels began to insert clauses into their contracts that required artists to accept significantly reduced royalty rates for units sold through the Clubs.[175] Today, almost every record contract says that the income from exploitation of records through the Clubs is split fifty-fifty between the record company and the artist because the record company is not actually

166. *See id.*

167. *Id.*

168. Usually a recording artist is charged 50% of the expenses involved in creating the music video. The 50% charged to the account is recouped at the artist's royalty rate. *See Record Label Accounting Practices I*, *supra* note 7, at 122 (statement of Fred Wolinsky).

169. *State Senate*, *supra* note 32.

170. *Id.*

171. *See Record Label Accounting Practices I*, *supra* note 7, at 63 (statement of Steve Marenberg, attorney, Irell & Manella, and outside counsel for RIAA).

172. PASSMAN, *supra* note 41, at 185.

173. *State Senate*, *supra* note 32.

174. *Id.*

175. *Id.*

selling records.[176] Essentially, the record company licenses the Clubs to make the records.[177] The Clubs get the license and manufacture the records—millions of records—that they sell, bearing their logo and name.[178] Because it is a license and not a sale, the artist usually gets a percentage of the negotiated license fee instead of a royalty on sold units.[179] At the most, Club royalties are "half of the [artist's] top-line royalty rate, but not more than 50% of the [record label's] net licensing receipts," which is the amount of money that the record company receives from the Clubs for licensing the record.[180]

Artists complain that record labels provide very little information about their agreements with the Clubs, including whether or not the record label has acquired one of the Clubs through a business merger.[181] This makes it very difficult for artists to determine during an audit how many CDs were manufactured by the Clubs.[182] As a result, artists usually earn very little from Club agreements with their record labels.[183]

9. Foreign Royalty Calculations

Foreign royalty calculations vary from territory to territory.[184] In recent years, large music conglomerates, such as the Big Five, have swallowed up smaller music labels and foreign distributors as well.[185] If a United States record label has ownership interest in a foreign distributor, then most likely, the artist royalty will be higher than the artist royalty in other territories.[186] Many artists and their attorneys maintain that record companies use various accounting tricks to reduce foreign royalty payments to their artists by as much as half.[187] In a few recent lawsuits, record companies would not disclose the exact terms of their

176. *See Record Label Accounting Practices I*, *supra* note 7, at 92 (statement of Don Engel, attorney, Engel & Engel).

177. *See id.*

178. *Id.*

179. *See id.* at 92 (statement of Sen. Kevin Murray, Member of the S. Select Comm. on the Entm't Indus.).

180. PASSMAN, *supra* note 41, at 185.

181. Telephone Interview with Charles Sussman, partner, Gudvi, Sussman, and Oppenheim, Nashville, Tenn. (Nov. 18, 2002) [hereinafter Sussman Interview].

182. *State Senate*, *supra* note 32.

183. *Id.*

184. *See generally*, PASSMAN, *supra* note 41, at 169–70 (discussing foreign royalty rates).

185. *State Senate*, *supra* note 32.

186. *See* PASSMAN, *supra* note 41, at 169.

187. *State Senate*, *supra* note 32.

manufacturing and distribution agreements overseas.[188] In one breath, record labels say they pay fair royalties on music sold in foreign territories, yet in the same breath record labels also say, "it is impossible to generalize how overseas royalties are computed."[189]

For purposes of trying to understand the basics of foreign royalty calculations, most royalties from foreign territories are sorted into three categories: Canada, Majors, and Rest of World.[190]

a. Canada

Normally, Canadian royalties are calculated at 85% of the artist's United States basic rate.[191] For instance, if in the United States an artist would receive a 12% royalty,[192] then in Canada the royalty would be 85% of 12%.[193]

United States Royalty Rate	12%
	x85%
Canadian Royalty Rate	10.2%

b. Majors

Majors are those territories that have significant markets for recorded music such as Japan, the United Kingdom, Germany, France, Holland, Italy, and Australia.[194] In these territories, the foreign royalty is typically 60% to 75% of the United States basic rate.[195] Thus, where one has a 12% artist royalty in the United States, the royalty will be 60% to 75% of 12% in a major territory.[196]

United States Royalty Rate	12%
	x60%
Major Territory Royalty	7.2%

188. *Id.*

189. *Id.*

190. *See* PASSMAN, *supra* note 41, at 169–70.

191. *Id.* at 169.

192. *See* discussion *supra* Part II & *supra* note 101.

193. *See* PASSMAN, *supra* note 41, at 169.

194. *Id.*; *see also* Wixen Interview, *supra* note 159.

195. PASSMAN, *supra* note 41, at 169.

196. *See id.*

c. Rest of World ("ROW")

All of the remaining territories are lumped into one category called the ROW. The royalty for these areas is approximately 50% to 60% of the United States basic rate.[197] Therefore, where there is a 12% artist royalty in the United States, the foreign royalty in a ROW territory is approximately 50% to 60% of 12%.[198]

United States Royalty Rate	12%
	x50%
ROW Royalty Rate	6%

10. The Royalty Statement

Besides those described above, there are many other deductions that are included on a recording artist's royalty statement,[199] but those issues go beyond the scope of this Comment. Based on everything this Comment has discussed thus far, a typical royalty statement might reflect the following calculations:

Suggested Retail List Price of CD	$18.98	
Packaging Deduction (25% of $18.98)	x75%	(-4.74)
Phony Free Goods (15%)	x85%	(-2.15)
Real Free Goods (5%)	x95%	(-0.60)
Net Sales Percentage (5%)	x95%	(-0.57)
Artist Royalty Base	$10.92	
Artist Royalty	x12%	
Artist earning before Reserves	$1.31	
Less Reserves (35%)[200]	x65%	(-0.46)
Artist earning on single CD unit[201]	$0.85	

197. *Id.* at 170.

198. *See id.*

199. *See* discussion *supra* Part II.B; *see also* sources cited *supra* notes 89–92.

200. The reserves are eventually paid to the artist to the extent that there are not returns. *See* discussion *supra* Parts II.B.4–5.

201. Artists' earnings are applied to their artist royalty account. *See* discussion *supra* note 104.

C. The Audit

In the 1970s, record labels began to insert restrictive audit provisions into their contracts with recording artists.[202] Today, contractual provisions allow most recording artists to audit the financial records of their record company.[203]

1. The Process

In a phone interview,[204] Charles Sussman of Gudvi, Sussman, and Oppenheim, an accounting firm with offices in Los Angeles and Nashville, described the auditing process as follows: First, a recording artist's attorney sends a letter via certified mail to the record label requesting an audit based on the specific contractual provisions of their agreement that allow the recording artist to perform the audit. The letter specifies the time period that the artist would like to audit, which may be subject to contractual limitation,[205] and informs the record label of the auditor who has been selected to conduct the audit.

Generally, the record label has an auditing department of one or two people with whom the auditors deal. The auditor contacts the auditing department to determine the next available opportunity to perform an audit. Normally, a record label only allows one audit at a time. The audit itself[206] can take anywhere from one to four weeks. In an effort to defend the accuracy of royalty accounting procedures, record labels may claim they have only had seven audits in any given year. However, the record label decides how many audits it wants to grant a year, so even if one hundred artists requested an audit, the label may only physically allow seven audits to be performed.

Approximately six weeks in advance of the scheduled audit, an auditor prepares a request letter of all of the documents, such as catalogs, price lists, sales reports, non-royalty reports, third-party payments, licensing agreements, and licensing statements that the auditor hopes to

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202. *Revolt over Royalties*, *supra* note 15.

203. *Id.*

204. Sussman Interview, *supra* note 181.

205. Wixen Interview, *supra* note 159.

206. "The audit itself," means the portion of the audit that actually takes place when the auditor physically goes to the record company's office and begins to audit the royalty statements. This does not refer to the entire auditing process which includes scheduling, conducting the audit, and the potential negotiation of an audit settlement. *See* discussion *infra* Part II.C.2.

examine during the audit.[207]

When an auditor arrives at the record label, the auditor sits down with the auditing staff and learns the record label's accounting system. Then, the process begins, and the auditor begins to re-tabulate the information as provided through the requested documents, in order to determine that it was accounted properly and as per the contractual recording agreement. Once concluded, the auditor prepares a report to submit to the recording artist and the artist's counsel, who, in turn, submits the report to the record label. There are a number of interpretation issues that affect an audit, such as how the contract is worded and what the parties intended it to mean at the time the contract was agreed upon. These interpretation issues are beyond the scope of this Comment.

Once the report has been submitted, the record label and the recording artist's attorney begin to negotiate what has or has not been paid improperly. Once there is agreement about the physical numbers of each area of the audit, then the parties begin to discuss settlement terms. The record label's and recording artist's attorneys sit down together to reach a final amount on which to settle. The settled amount is never fair market value—meaning the artist never sees what is actually owed.[208]

2. The Problem

Typically, contracts now give recording artists a window of up to three years to initiate an audit following the release of a record.[209] The process is "extremely time consuming and expensive."[210] The entire audit process can take a minimum of two years to complete, provided that the auditor receives all accounting and sales figures in a timely manner.[211] A typical audit costs $50,000.[212] However, the cost can range anywhere between $10,000 and $100,000.[213]

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207. Auditors must closely examine royalty escalations based on sales because these calculations are often incompatible with their computer programs. Sussman Interview, *supra* note 181. In fact, most, if not all, of the Majors have to manually insert these escalations into their computer programs. Thus, room for error is very large. *Id.*; *see also* discussion *infra* Part IV.A.

208. Sussman Interview, *supra* note 181.

209. *Revolt over Royalties*, *supra* note 15.

210. Jeffrey S. Geibelson, *Business Managers*, *in* 8 ENTERTAINMENT INDUSTRY CONTRACTS § 148.01 (Samuel J. Fox et. al. eds., 2002).

211. *See Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia).

212. *Revolt over Royalties*, *supra* note 15.

213. See *Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia).

Although audits are technically allowed, contracts often place many restrictions on the auditing process.[214] Considered to be an industry standard, most record labels prohibit artists from auditing manufacturing and distribution documents,[215] both of which are crucial for determining accurate numbers of how many CDs are sold, given away, bartered for radio airplay or discounted to the Clubs.[216] Further restrictions imposed by record labels prevent auditors from performing more than one audit at a time at a record label, which means recording artists cannot share the costs of an audit.[217] Unrecouped artists are hard pressed to be in a financial position to perform an audit.[218] And for those artists that do not or cannot push for an audit, the current system of "underreporting royalties" merely adds to a record label's profits.[219]

Outside auditors acknowledge that some royalty claims submitted to record companies following an audit are inflated.[220] But, they also argue that most record companies treat their recording artists unfairly, and often, record companies are unwilling to provide access to all of their financial records.[221] In fact, auditors accuse all of the Big Five of trying to delay audits by "refusing to turn over proper documents."[222] All of the Big Five deny the allegations.[223]

It is not uncommon to uncover around 10% to 30% of underpaid royalties in an audit.[224] But, once an artist performs an audit, getting the record label to pay is another story.[225] Musician Tom Petty routinely

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214. *Revolt over Royalties*, *supra* note 15.

215. Universal recently announced it will now allow auditors to review manufacturing records. Bill Holland, *Most Labels Mum on Royalty Reform*, BILLBOARD, Dec. 14, 2002, at 3. The Warner Group also announced that it will begin to provide access to auditors to all manufacturing records. Chuck Philips, *Warner Rolls Out Royalty Reforms*, L.A. TIMES, Mar. 20, 2003, at C1.

216. *Revolt over Royalties*, *supra* note 15.

217. *Id.*

218. *See Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia). For 98% of recording artists, there is no such thing as negotiating power with the record company. *Record Label Accounting Practices I*, *supra* note 7, at 130 (statement of Fred Wolinsky). Ninety-eight percent of artists are voiceless. *Id.* (statement of Sen. Jim Battin, member of the S. Select Comm. on the Entm't. Indus.).

219. *See Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia).

220. *Revolt over Royalties*, *supra* note 15.

221. *Id.*

222. *Id*

223. *Id.*

224. *Id.*; *see also* Murray, *supra* note 33 (discussing the audit process and royalty accounting).

225. *Revolt over Royalties*, *supra* note 15.

performs audits on his record company.[226] "I personally have turned up millions of dollars missing [in royalties]—money that I would not have been paid without an audit."[227]

"The company holds my money for five years and I pay an auditor to collect it," said Merle Haggard, in a recent interview.[228] "[My auditor] catches them cheating me out of hundreds of thousands of dollars and then the company offers to pay me half of what they owe—with no interest."[229]

Fred Wolinsky, an accountant from Sherman Oaks, California, says the recording industry's accounting systems are designed to impede the recording artist.[230] The systems are archaic and record company royalty departments are short on qualified staff employees.[231] He says, "[t]he companies play this 'catch-us-if-you-can' game with artist royalties . . . only artists with muscle really have the ability to get their money."[232] If Wolinsky's assertion is true, that record companies continuously underreport earnings and overcharge record company costs to artists' royalty accounts, then recording artists are left with the incredible burden and expense of pursuing an audit that ultimately shows the underreporting and overcharging.[233]

D. The AFTRA Code[234] and Its Relation to Artist Royalties

AFTRA is a union that represents singers and several other categories of entertainers, including actors and musicians.[235] In the mid-1950s, AFTRA entered into a collective bargaining agreement with major record

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.* Arguably, record companies should be responsible for paying interest, especially when royalty underpayment occurs over and over again.

230. *Revolt over Royalties*, *supra* note 15.

231. *Id.*

232. *Id.*; *see* discussion *supra* note 218; *see also Record Label Accounting Practices I*, *supra* note 7, at 2 (overview by Sen. Martha M. Escutia).

233. *Record Label Accounting Practices I*, *supra* note 7, at 3 (overview by Sen. Martha M. Escutia).

234. The AFTRA National Code of Fair Practice for Sound Recordings was created in the early 1950s to protect union artists "who work at scale and overscale, and who appear as both royalty and non-royalty artists." *AFTRA's Sound Recordings Code at a Glance*, *at* http://www.aftra.com/resources/negotiations2002/soundglance.html (last updated May 20, 2002) [hereinafter *AFTRA's Sound Recordings Code*]. The AFTRA Code covers sound recordings on CD, cassettes, vinyl, all music formats, books on tape, cast albums, and virtually any sound recording that uses vocal performance. *Id.*

235. *See* Moore v. Am. Fed'n of Television and Radio Artists, 216 F.3d 1236, 1238 (11th Cir. 2000); *see also AFTRA's Sound Recordings Code*, *supra* note 234.

companies called the Phono Code.[236]

In 1959, in order to provide health benefits for singers, AFTRA and the record companies entered into an Agreement and Declaration of Trust ("the Trust Agreement").[237] The Trust Agreement created two funds: a health and retirement fund and twenty trusteeships—ten of which are chosen by the record companies and ten of which are held by individuals chosen by AFTRA.[238] Under the Trust Agreement, the trusteeships have "full authority to determine the form, nature, and amount of benefits" to be paid to those represented by AFTRA.[239]

At the time of writing, under the Trust Agreement and Phono Code, members of AFTRA are eligible for health benefits if their earnings equal at least $7,500 within a twelve-month period for an individual, or at least $15,000 to cover a family.[240] Artist earnings are based on a percentage of the gross income they have earned.[241] This gross amount is not strictly limited to recording income; it also includes television income, and any other income covered by the AFTRA contract.[242]

Basically, signatory[243] record companies are required to pay 9% of a recording artist's earnings to the AFTRA Health and Pension Fund ("Fund"), with an annual cap around $120,000.[244] For instance, if an artist earns $100,000 in income that is applied to the artist's royalty account, the artist's earnings for the year are $100,000 and the record company is required to contribute 9%—a total of $9,000—to the Fund for the artist's health benefits. The record company's contribution is based on gross earnings, which means the record company must contribute to the Fund regardless of whether a recording artist is recouped or unrecouped.[245]

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236. *See Moore*, 216 F.3d at 1238–39. The Phono Code is now called the AFTRA National Code of Fair Practice for Sound Recordings. *AFTRA's Sound Recordings Code*, *supra* note 234.

237. *Moore*, 216 F.3d at 1239. *See AFTRA's Sound Recordings Code*, *supra* note 234. Only record companies that were "signatories" of AFTRA were affected by the agreement.

238. *Moore*, 216 F.3d at 1239.

239. *Id.*

240. *Record Label Accounting Practices I*, *supra* note 7, at 32 (statement of Fred Wilhelms, attorney and former national director of the AFTRA health & retirement funds).

241. *See id.*

242. *Id.*; *see also* note 234.

243. A signatory is an entity that is signed and is therefore bound by the AFTRA Phono Code. Telephone Interview with Ann Chaitovitz, National Director of Sound Recordings, AFTRA, Washington, D.C. (Nov. 15, 2002) [hereinafter Chaitovitz Interview]. Every major record company is a signatory to AFTRA. There are currently 1200 AFTRA signatories. *Id.*

244. *Id.* As a result of the pension arm of AFTRA's recent settlement with recording artists, AFTRA is considering raising the contributions required by record labels from the current 9% to 10%. *Singers, Union Find Harmony*, *supra* note 28.

245. Chaitovitz Interview, *supra* note 243.

When a record company signs a new recording artist, under the Phono Code, signatory companies must make a minimum initial contribution to the Fund to ensure that the artist qualifies for health insurance for the first year of the recording contract.[246] Following the first year, recording artists must qualify based on their gross earnings, whether or not paid.[247] Policy dictates that recording artists should be eligible for health benefits within the first contractual year with a record company, so that they can continue to record and create music and remain in good health.[248]

For those artists who are able to conduct an audit and determine that a record company owes them royalty earnings, the record company must then make a contribution to the Fund, based on the recovered dollars.[249] Those contributions are applied to the year in which the miscalculation took place.[250]

The RIAA argues that one of the reasons contributions to the Fund were mistakenly underpaid or not paid at all is because of underlying ambiguities within the Phono Code itself.[251] In 1995, the Phono Code was amended to eliminate many ambiguities and the RIAA claims there have been very few problems since then.[252] Whatever the case, it is clear that improper royalty accounting is directly related to record company contributions to the Fund, which directly impacts recording artists' health and pension benefits. It is also clear that the entire royalty statement and accounting process can be categorized as confusing for most, at the very least.

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246. *Id.*

247. *Id.*; *see also AFTRA's Sound Recordings Code*, *supra* note 234.

248. *Record Label Accounting Practices I*, *supra* note 7, at 38 (statement of Fred Wilhelms).

249. Chaitovitz Interview, *supra* note 243.

250. *Id.*

251. *Record Label Accounting Practices I*, *supra* note 7, at 81 (statement of Steve Marenberg).

252. *Id.*

III. THE LAW AND HOW IT APPLIES TO CURRENT CASES

The royalty accounting dispute begins with the recording contract between the artist and the record company, and the royalty terms of that contract.[253] Typically, a recording contract spells out the artist's royalty rate for record sales, royalty deductions,[254] and any recoupment and cross-collateralization clauses,[255] which require reimbursement of advances to the record label before the artist is paid royalty earnings.[256] The ways the contracts themselves are written provide for ambiguity.[257] Sometimes, determining what the contract actually means involves legal issues of contract interpretation.[258] Ultimately, these legal issues are beyond the scope of this Comment, but knowledge that they exist is important to the discussion of fiduciary duty.[259]

A. Where the Contract Is Silent or Ambiguous

1. Contract Interpretation

Contract interpretation is the process of determining the meaning of "written or spoken words" that make up a contract.[260] The purpose of

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253. *Id.*

254. *See generally* discussion *supra* Parts II.A–B (describing various royalty deductions embedded in the royalty statement).

255. Collateral is defined as meaning "[o]f or being property used as security for the performance of an obligation." WEBSTER'S II NEW RIVERSIDE DICTIONARY 139 (1984). Essentially, a "cross-collateralization" clause means that if a record company pays advances to a recording artist, the record company can "cross-collateralize" its right to recover those advances from an unrelated income stream. In theory, while an artist may have earned enough income to be "recouped" on Album #1, the artist's royalty statement may show an unrecouped balance because Album #1 and Album #2 are subject to a cross-collateralization clause. *See generally* PASSMAN, *supra* note 41, at 103–04 (discussing cross-collateralization clauses and how they apply to royalty calculations). For example, if an artist releases two albums on any given record label, instead of having two album accounts that recoup separately with their own income, the albums are combined such that any income made by the artist is applied to both accounts equally. *Id.*

256. *Record Label Accounting Practices I*, *supra* note 7, at 2 (overview by Sen. Martha M. Escutia). For instance, if a record label advances $1 million to $2 million to fund and market a recording artist, the recording artist can "literally sell millions of records and not receive a single dime in royalties because of deductions and recoupment clauses." *Id.*

257. *Record Label Accounting Practices I*, *supra* note 7, 4 (statement of Jeffrey Light).

258. *Id.*

259. *See* discussion *infra* Part III.B.

260. 17A AM. JUR. 2D *Contracts* § 336 (1991).

contract interpretation is to ascertain the likely intent of the parties.[261] Thus, the rules of contract interpretation must be flexible.[262] A contract should be viewed prospectively, in the same manner in which the parties did at the time of execution.[263] In addition, a contract should be enforced as the parties made and understood it.

The primary goal of contract interpretation in California is to "identify and give effect to the expressed mutual intention of the parties."[264] Essentially, any contractual language that is explicitly clear must govern the contract's interpretation.[265] Although the majority of California courts do not follow the "plain meaning rule,"[266] priority is often placed on the contract writing in hopes of avoiding ambiguity.[267] A contract is unambiguous if its language has "a definite and precise meaning," and "there is no reasonable basis for a difference of opinion."[268] Once a writing is completely integrated, it represents the entire contract between the parties.[269] Therefore, extrinsic evidence seemingly becomes irrelevant because it is not part of the writing.[270] However, in cases of ambiguity, some courts may consider extrinsic evidence of the parties' intent.[271]

2. Contract Ambiguity in the Recording Industry

Common law contract rules still govern the interpretation of agreements between recording artists and record companies.[272] As stated above, the precept of contract interpretation is that agreements are

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261. CAL. CIV. CODE § 1636 (West 2001); Harry G. Prince, *Contract Interpretation in California: Plain Meaning, Parol Evidence and Use of the "Just Result" Principle*, 31 LOY. L.A. L. REV. 557, 561 (1998).

262. 17A AM. JUR. 2D *Contracts* § 336.

263. *Id.*

264. Prince, *supra* note 261, at 569.

265. *See* CAL. CIV. CODE § 1636.

266. The plain meaning rule approach to contract interpretation is based on the concept of looking solely to the writing, if one exists, to determine the meaning of the contact terms. Prince, *supra* note 261, at 568.

267. *Id.* at 569.

268. Breed v. Ins. Co. of N. Am., 385 N.E.2d 1280, 1282 (N.Y. 1978).

269. Prince, *supra* note 261, at 570.

270. *Id.*

271. For example, in California, the extrinsic evidence test of admissibility is "whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible." Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., Inc., 442 P.2d 641, 644 (Cal. 1968).

272. Greenfield v. Philles Records, 780 N.E.2d 166, 170 (N.Y. 2002).

construed in accord with the parties' intent.[273] Therefore, a written agreement that is clear and unambiguous on its face must be enforced based on the plain meaning of the agreement.[274]

According to RIAA Senior Vice President of Business and Legal Affairs Steve Marks, many contracts within the recording industry purposefully leave some ambiguities because "[the parties are] not able to reach an agreement on a specific point, but they want to get the deal done."[275]

In almost every audit, recording artists find something has been underpaid or underreported.[276] Many times, the dispute of royalties is based on interpretive differences of the recording contract.[277] For instance, in the case of reserves, "most recording contracts simply allow for the taking of 'reasonable' reserves."[278] What is reasonable? In these situations, "established polic[ies] and industry custom[s]" influence the interpretation of the contract.[279]. For those artists unable to perform an audit, what is reasonable is left undefined and unexamined. The recording industry would benefit from creating some "generally accepted accounting principles" to deal with these standard contract clauses.[280]

B. The Law of Fiduciary[281] Duties

Under contract law, in the absence of special circumstances, no fiduciary relationship exists as a matter of law.[282] It is not entirely clear when fiduciary duties arise out of contractual relationships, but it is clear that additional factors are necessary to convert a conventional business relationship into one that is fiduciary.[283]

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273. *See* Slatt v. Slatt, 477 N.E.2d 1099, 1100 (N.Y. 1985).

274. *Id.*

275. *See generally Record Label Accounting Practices I, supra* note 7, at 78 (statement of Steve Marks, senior vice president of business & legal affairs for the RIAA).

276. *See generally* discussion *supra* Parts I & II.C (explaining the elements of an audit, its purpose, and result).

277. *See Record Label Accounting Practices I, supra* note 7, at 76 (statement of Sen. Kevin Murray).

278. Wolfe, *supra* note 124, at 56.

279. *Id.*

280. *Record Label Accounting Practices I, supra* note 7, at 77 (statement of Sen. Kevin Murray).

281. A fiduciary is "relating to or involving the holding of something in trust; held in trust; a fiduciary agent: trustee." WEBSTER'S II NEW RIVERSIDE DICTIONARY 259 (1984).

282. Carter v. The Goodman Group Music Publ'rs, 848 F. Supp. 438, 445 (S.D.N.Y. 1994).

283. *See generally* Reuben H. Donnelley Corp. v. Mark I. Mktg. Corp., 893 F. Supp. 285, 289 (S.D.N.Y. 1995) (discussing required relationship factors for a fiduciary duty to exist).

1. The Definition

Broadly stated, a fiduciary relationship is a relationship founded on confidence and trust by "one person in the integrity and fidelity of another."[284] In "appropriate circumstances," this type of relationship could "exist . . . between close friends,"[285] or when prior "business dealings" have created such "confidence."[286] When two parties have a fiduciary relationship, transactions between them are scrutinized with extreme vigilance, and clear evidence is required that the transaction was understood, and that there was no fraud, mistake, or undue influence. "Where those relations exist there must be clear proof of the integrity and fairness of the transaction, or any instrument thus obtained will be set aside, or held as invalid between the parties."[287]

Fiduciary duties also apply to the principal-agent relationship.[288] Agency is defined as "a fiduciary relationship by which a party confides to another the management of some business to be transacted in the former's name or on his or her account, and by which such assumes to do the business and render an account of it."[289] The existence of an agency relationship is dependent on the consent that the agents will act on principals' behalf and subject to their control.[290]

When an "agent" agrees to act on behalf of a person, a fiduciary duty is created in favor of that person.[291] The trust and reliance principles inherent in a fiduciary duty require agents to conduct their business "in a manner beyond reproach."[292] Fiduciaries are held to the highest standards of loyalty, fairness, honesty, and good faith.[293] Responsibilities of a fiduciary include: the duty to act only for the benefit of the principal;[294] to

284. Michelson v. Hamada, 36 Cal. Rptr. 2d 343, 349 (Ct. App. 1994); *see also* Pierce v. Lyman, 3 Cal. Rptr. 2d 236, 240 (Ct. App. 1991); Mellencamp v. Riva Music, Ltd., 698 F. Supp 1154, 1156 (S.D.N.Y. 1988).

285. *See Apple Records*, 529 N.Y.S.2d at 283; *see also* Cody v. Gallow, 214 N.Y.S.2d 127, 129 (Sup. Ct. 1961).

286. *Apple Records*, 529 N.Y.S.2d at 283; Levine v. Chussid, 221 N.Y.S.2d 311, 314 (Sup. Ct. 1961).

287. Gordon v. Bialystoker Center & Bikur Cholim, Inc., 385 N.E.2d 285, 288 (N.Y. 1978).

288. Hal I. Gilenson, *Badlands: Artist-Personal Manager Conflicts of Interest in the Music Industry*, 9 CARDOZO ARTS & ENT. L.J. 501, 519 (1991).

289. 3 AM. JUR. 2D *Agency* § 1 (2002).

290. *See id.* "An agent is one who represents another, called a principal, in dealings with third persons." CAL. CIV. CODE § 2295 (West 2002).

291. *See* Gilenson, *supra* note 288.

292. *Id.* at 520.

293. *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

294. RESTATEMENT (SECOND) OF AGENCY § 387 (1958).

act only in the principal's name;[295] to keep and render accounts of all money received;[296] and to account in a timely manner upon reasonable demand by the principal.[297] An agent who has received money for the principal has a duty to keep the money safe until remitted to the principal.[298] In addition, unless circumstances make it "impracticable or inequitable," the principal has a right to make a "reasonable inspection" of all accounting books, original data entries, and paperwork kept and used by the agent to conduct the principal's affairs.[299]

Accordingly, courts have found that a fiduciary duty exists between a recording artist and his or her personal manager.[300] Likewise, English courts determined long ago that music publishers are per se fiduciaries.[301] However, American courts have refused to recognize a fiduciary duty between recording artists and their record companies.

2. Fiduciary Duties and the Recording Industry

American courts have routinely dismissed fiduciary duty claims between a recording artist and record company.[302] For example, in *Cooper v. Sony Records International*,[303] members of the music group Third World claimed they had a fiduciary relationship with Sony.[304] Third World

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295. *Id.* § 398 cmt. a. "An agent who receives money on account of the principal cannot properly place it to his own credit in a bank, where it may be subject to a set-off or lien by the bank, or so mingle it with his own that there may be difficulty in tracing it." *Id.* § 398 cmt. b, illus. 1.

296. RESTATEMENT (SECOND) OF AGENCY § 382 (1958).

297. *Id.* § 382 cmt. b.

298. *Id.* § 427.

299. *Id.* § 382 cmt. b.

300. *See* Gilenson, *supra* note 288. Recording artists hire managers to promote and develop their career because the manager has "special knowledge and experience" in the recording industry, which the manager will use on the artist's behalf. *Id.* But ultimately, the artist has the authority to "ratify the manager's decisions." *Id.*

301. *See* Michael I. Yanover & Harvey G. Kotler, *Artist/Management Agreements and the English Music Trilogy: Another British Invasion?*, 9 LOY. L.A. ENT. L.J. 211, 222-23 (1989). More so than in the United States, English courts traditionally provide dissatisfied artists with alternatives to challenge contractual agreements. *Id.* at 232. In addition, English courts have allowed artists to raise the "presumption of undue influence" if the artist was forced to sign a "take it or leave it" contract. *Id.* Generally speaking, English courts more so than United States courts have applied more "general rules of law to ensure against unscrupulous and oppressive conduct with respect to the exploitation of artists' skill." *Id.* While decisions from English courts lack "clear definition," they are unique to American courts and worth noting. *Id.*

302. *See* Cooper v. Sony Records Int'l, No. 00 Civ. 233, 2001 U.S. Dist. LEXIS 16436 (S.D.N.Y. Oct. 15, 2001).

303. *Id.*

304. *Id.* at *17–*18.

entered into a contract to create master recordings for Sony, which Sony was to commercially exploit all over the world.[305] Third World claimed "that the relationship with Sony was one of trust and confidence whereby Sony assumed exclusive control over the Masters" and promised to share a percentage of proceeds from the commercial exploitation.[306] Third World asserted that Sony continued to commercially exploit their work without paying royalties.[307] Nevertheless, the court held, "in the absence of special circumstances, no fiduciary relationship exist[ed]."[308] The *Cooper* court distinguished its case from *Apple Records, Inc. v. Capitol Records, Inc.;* because Cooper did not assert the existence of a "special relationship beyond that which normally exists between contracting parties in an arms-length transaction."[309]

In a counter-claim against Sony, members of the Dixie Chicks attempted to distinguish their case from *Cooper,* asserting that their six-year relationship with Sony was a long and enduring relationship, in which they placed "trust and confidence."[310] The court dismissed the counterclaim because there was insufficient evidence to create a fiduciary duty "in the absence of a special relationship."[311] The fact that Sony was responsible for accounting and "collecting royalties" was not enough.[312]

In *Carter v. Goodman Group Music Publishers,*[313] the estates of the late composers Calvin Carter, Sr., and James Bracken claimed their music publishing companies breached their fiduciary duties by not properly accounting or paying royalties to the composers.[314] The court relied on the decision of *Rodgers v. Roulette Records, Inc.,*[315] which found royalty agreements are solely contractual in nature and thus, create no fiduciary relationship.[316] The *Carter* court concluded as a matter of law that no fiduciary relationship exists between a music publisher and composers.[317]

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305. *Id.* at *3.

306. *Id.* at *18.

307. *Id.* at *5.

308. *Cooper,* 2001 U.S. Dist. LEXIS 16436, at *18.

309. *Id.* at *19 & n.10.

310. Sony Music Entm't. v. Robison, No. 01 Civ. 6415, 2002 U.S. Dist. LEXIS 3100, at *10 (S.D.N.Y. Feb. 25, 2002).

311. *Id.*

312. *Id.* at *9.

313. 848 F. Supp. 438 (S.D.N.Y. 1994).

314. *See id.* at 445.

315. 677 F. Supp. 731 (S.D.N.Y. 1988).

316. *Id.* at 739.

317. *See Carter,* 848 F. Supp. at 445.

In the late 1980s, recording artist John Mellencamp sued his publishing company, Riva Music, for underreporting royalties due, failing to provide royalty statements in a timely manner, and failing to promote his songs to their best effort.[318] He claimed that, by virtue of his publishing agreements with Riva, they became fiduciaries for his interest.[319] The court dismissed Mellencamp's claims, stating they were based solely on professional conduct and did not present any "specific conduct or circumstances upon which trust elements [were] implicated."[320]

The Big Five consistently argue that it is impossible to maintain a fiduciary duty to any one artist because there are artist priorities, conflicts with release dates, and competition within the label for artists' releases in different quarters.[321] And, traditionally, it has been difficult for recording artists to establish that a fiduciary duty exists with their record company.[322] However, establishing that a fiduciary relationship exists has important consequences because breach of the duty can result in punitive damages, rescission of contract, and reversion of copyright to the recording artist.[323]

If the courts or legislators are not willing to go so far to as to find that a fiduciary relationship exists between a record company and its recording artists, perhaps they can do something else. As an example, in *Tran v. Farmers Group, Inc.*,[324] the California Court of Appeal alternatively decided that, although there were no "specific circumstances upon which trust elements [were implicated]," heightened duties should be imposed on the insurer because of its contractual relationship with the insured.[325] As a general rule, courts have held that the insurer-insured relationship is not a fiduciary one in the same sense as an attorney-client or trustee-

318. *Mellencamp*, 698 F. Supp at 1156.

319. *Id.*

320. *Id.* at 1160. The court gave Mellencamp the option to "repair his pleadings" within twenty days because the original complaint did not effectively show existence of a fiduciary relationship.

321. *See generally* Murray, *supra* note 33 (discussing whether or not to impose a fiduciary duty); *see also* discussion *supra* Part III.B.1.

322. *See generally* discussion *infra* Part III.B.2 (referring to discussion of cases where court found no fiduciary relationship existed).

323. *See* Leonard M. Mark & Jane G. Stevens, *Publisher-Fiduciary Issue Gets an Airing*, ENT. L. & FIN., Jan. 1989, at 1; *see also Michelson*, 36 Cal. Rptr. 2d at 350; Stokes v. Henson, 265 Cal. Rptr. 836, 843 (Ct. App. 1990). Damages for breach of fiduciary duty are controlled by traditional tort recovery in general. CAL. CIV. CODE § 3333 (West 1997). In California, punitive damages can only be awarded if the court finds that the tortious conduct constituted malice, oppression, or fraud. *Id.* § 3294.

324. 128 Cal. Rptr. 2d 728 (Ct. App. 2002).

325. *Id.* at 735.

beneficiary.[326] However, the insurer-insured contractual relationship is characterized by "unequal bargaining power," where the insured must depend on the good faith and performance of the insurer.[327] In *Tran*, this characteristic led the court to impose "special and heightened" duties.[328] Although the "special" duties resemble those owed by fiduciaries, the duties did not arise because the insurer is a fiduciary, but because of the "unique nature of the insurance contract."[329]

Just because courts have held a record company and recording artists do not have a "true 'fiduciary relationship,'" does not necessarily mean their relationship is not characterized by "unequal bargaining power."[330] Nor does it mean that "special" and "heightened" duties should not be imposed on record labels. In the recording industry, record labels control all of the recording artist's royalty account information, whether recouped or not recouped.[331] Recording artists are 100% reliant on the record label to provide them with proper accounting and, if the record label does not do so, both the financial burden and the burden of proof are on the recording artist to determine what has been underreported.[332] Because artists must rely on "good faith and performance," record companies should have a "special and heightened" responsibility and duty to diligently account to artists their earnings or their unrecouped balances in a totally accurate and responsible manner.[333] Even if the record company is not a fiduciary in the same sense as an attorney-client or trustee-beneficiary, the underlying contractual relationship with a recording artist is "unique [in] nature,"[334] and therefore, some heightened duty is owed.

A record company acts in a recording artist's name when it licenses that artist's music to any given entity, or when the label promotes and markets that artist's new release. The record label keeps and renders accounts of all monies received on behalf of the recording artist's project. Generally, the record company accounts to the recording artist twice a year—in a timely fashion—as governed by recording industry standards.[335]

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326. *Id.* California courts have long refrained from characterizing the insurer-insured relationship as a fiduciary one. *Id.*

327. *Id.*

328. *Id.*

329. *Id.*; Vu v. Prudential Prop. & Cas. Ins. Co., 33 P.3d 487, 492 (Cal. 2001).

330. *Tran*, 128 Cal. Rptr. 2d at 735.

331. *Record Label Accounting Practices I*, *supra* note 7, at 112 (statement of Don Engel).

332. *Id.*

333. *Id.*

334. *See Tran*, 128 Cal. Rptr. 2d at 735.

335. *See generally* PASSMAN, *supra* note 41, at 164 (discussing the industry standards for receipt of accountings).

Also, a record company is required to keep the artist's earnings "safe" until remitted to the recording artist.[336] In addition, a recording artist has the right to audit the books of the record company, should his or her contract provide for that allowance.[337]

The lack of a tort remedy is the difference between a record company's mere contractual duties to account to a recording artist and that of a fiduciary.[338] The importance of a tort remedy is its effectiveness in creating deterrence.[339] While a contractual claim against a record company can be pursued by a recording artist under a breach of contract theory for underpaid royalties, the end result is not effective because without the possibility of punitive damages, the record company probably will not be deterred from making the same error repeatedly in the future.[340]

3. The Lack of an Effective Remedy

The lack of an effective remedy for royalty underpayment is of great concern to recording artist representatives as well as the California State Legislature.[341] Senator Martha Escutia argues, "If artists are not being properly paid their royalty earnings, [then] that is a breach of contract for which the artist should have an *effective* remedy."[342]

In almost every recording contract, there is an audit clause that essentially says, "[I]f I audit you and you owe me money, the most that you'll ever have to pay me is what you owe me."[343] Effectively, this is an incentive to underpay recording artists. Without a tort remedy, there is no real damage done to the record company, and there is seemingly no deterrence or punishment. Although a recording artist may in fact bring a bad faith claim against a record company, for which there may be a tort remedy, the reality is that recording contracts create disincentives for artists

336. *See generally* Murray, *supra* note 33 (describing fiduciary relationships and a record company's sole control over sales and accounting data).

337. *See* discussion *supra* Part II.C.

338. *See generally Michelson*, 36 Cal. Rptr. 2d at 357 ("The purpose in awarding punitive damages is to punish . . . and thereby deter . . . wrongful acts."). "Punitive damages constitute a windfall." Dumas v. Stocker, 262 Cal. Rptr. 311, 314 (Ct. App. 1989). A fiduciary duty should be imposed, making tort remedies available to the recording artist, so that record companies are effectively penalized for inaccurate royalty accounting, and, so they are effectively deterred from accounting inaccurately in the future.

339. *See Michelson*, 36 Cal. Rptr. 2d at 357; *see also supra* note 338.

340. *See* discussion *supra* note 338.

341. *See Record Label Accounting Practices I*, *supra* note 7, at 1 (statement of Sen. Martha Escutia).

342. *Id.* (emphasis added).

343. *Id.* at 14 (statement of Sen. Kevin Murray).

to bring suit[344] because the contracts themselves are ambiguous, and the interpretation of certain provisions can be difficult.[345]

As a matter of policy, record companies will not agree to any clause that provides for attorneys' fees to the winning side of a lawsuit.[346] While this sounds fairly innocent, in an industry "in which it is almost inevitable that the record company is in a better financial position to bear the cost of a lawsuit . . . that is a powerful disincentive against the artist bringing litigation in order to enforce his or her rights."[347] Under the current system, there is no incentive to make sure royalty accounting is done properly, and there is no penalty for doing it improperly.[348] This lack of deterrence to record companies creates a profit bearing strategy to underreport royalties.

Proper royalty accounting directly impacts recording artists as they are forced to rely on a record company's accounting data.[349] In 1993, members of The Kingsmen, most known for their 1960s hit *Louie Louie*, filed suit against their record company and its assignees for licensing The Kingsmen's master recordings without providing any accountings or paying royalties.[350] The court concluded that failure to pay royalties was a material breach of contract "sufficient to justify rescission" of The Kingsmen's original contracts.[351] The Kingsmen were also awarded attorneys' fees, costs and expenses, and ownership of the master recordings.[352]

In *Forgione v. Crimson Records, Inc.*,[353] former band members of the Soul Survivors[354] asserted a breach of contract claim against their record

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344. *See id.* (statement of Jeffrey Light).

345. See discussion *supra* Part III.A.2.

346. *See Record Label Accounting Practices I, supra* note 7, at 14 (statement of Jeffrey Light).

347. *Id.*

348. Murray, *supra* note 33.

349. *See id.*

350. Peterson v. Highland Music, Inc., No. CV 93-4672, 1997 U.S. Dist. LEXIS 23181, at *2 (C.D. Cal. Apr. 9, 1997).

351. *Id.* at *4.

352. *Id.* at *4, *19. Following the decision, the record companies involved were held in contempt of court for refusing to turn over the master recordings and continuing to license the song *Louie Louie* to a variety of entities, including Funrise Toy Corporation, which designed a plastic toy jukebox that played the song, as well as to the Carsey-Werner Company, which used the song in its television program *3rd Rock from the Sun*. *See id.* at *6–*7.

353. No. 89-4772, 1990 U.S. Dist. LEXIS 17420 (E.D. Pa. Dec. 21, 1990).

354. The Soul Survivors were a 1960s rock band. In 1967, they recorded their first song, *Expressway to Your Heart*. Within a few months of its release as a single, the Soul Survivors had sold over one million copies. *Id.* at *1, *5.

company and its assignees for nonpayment of royalties.[355] In this case, a new company acquired the ownership rights of the Soul Survivors masters, and at some point, all of the Soul Survivors album sales documents from 1967 were lost or destroyed.[356] There was no backup of any kind, "no general ledger, no accounts payable ledger, and no sales invoices."[357] The Soul Survivors had no choice but to accept the nonpayment of royalties because they had no access to the status of their royalty accounts.[358] Although no fiduciary duty was found, the court concluded that the record company's assignees incurred a contractual duty to account and pay artist royalties.[359] The plaintiffs were clearly owed royalties and the defendants had not paid them.[360]

In *Grossman v. Handprints*,[361] the plaintiff agreed to sell all of its stock to the defendant for an agreed price.[362] "The contract of the sale . . . provided that the [defendant]-purchasers would give the [plaintiff]-seller a promissory note . . . payable in installments."[363] The plaintiff alleged that "in flagrant violation of the terms of the contract between the parties the defendants . . . collected mone[y] belonging to the plaintiff . . . and . . . directed customers to disregard prior obligations and to pay only new invoices submitted by the defendant."[364] The plaintiff requested an accounting, which the court summarily denied.[365] The court reasoned that "the right to an accounting rests upon a trust or fiduciary relationship or, under a joint venture agreement whereby the seller . . . participate[s] in losses as well as profits, or, where special circumstances are present warranting equitable relief in the interest of justice."[366] Here, the plaintiff did not plead that a fiduciary relationship existed, nor did the plaintiff plead "any special circumstances justifying the equitable relief of an accounting."[367]

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355. *See id.* at *1

356. *Id.* at *7, *10

357. *Id.* at *11.

358. *See id.*

359. *Forgione*, 1990 U.S. Dist. LEXIS 17420, at *14–*15.

360. *Id.* The plaintiffs were not entitled to full recovery because of a statute of limitations bar, but they did receive prejudgment interest along with net royalties due since 1985. *See id.* at *21–*23.

361. Grossman v. Handprints-N.J., Inc., 455 N.Y.S.2d. 852 (N.Y. App. Div. 1982).

362. *Id.* at 853.

363. *Id.*

364. *Id.* at 858.

365. *Id.*

366. *Id.* at 858.

367. *Grossman*, 455 N.Y.S.2d at 858.

If the right and duty to account "rests upon a trust or fiduciary relationship," then the duty to account for artist royalties should be a fiduciary one. Under the current system there is no effective remedy for recording artists if their record company fails to pay accurate royalties. Even though almost all record contracts explicitly state that "this is not a joint venture or partnership,"[368] the royalty accounting process itself creates a joint venture between the record company and its recording artist because the company, as the seller, participates in the losses as well as the profits.

IV. PROPOSALS FOR AN OVERHAUL

It is a tough time for major record companies.[369] Album sales are down approximately 20% from what they were in 2000, and the recording industry is facing the largest retail downfall "since the Great Depression."[370] As the industry suffers its worst economic decline in decades, record labels "are under intense pressure to satisfy their shareholders with quarterly profits."[371] Recently, the Big Five and the three largest music retailers[372] settled a major class-action price fixing suit with forty States for allegedly participating in "minimum advertised pricing," an industry practice which artificially inflates the price of CDs.[373] According to the Big Five, during the 1990s, large retailers sold CDs below cost as a "loss leader" in order to attract consumers who would purchase items.[374] Allegedly, in violation of both federal and state antitrust laws, with "minimum advertised pricing," "the labels subsidized advertising for those retailers who agreed not to sell CDs below a certain price."[375] Without admitting fault,[376] the Big Five have agreed to compensate consumers for the overpayment of CDs from 1995 to 2000. As such, they will pay more than $143 million in cash and free CDs, i.e., "free goods"—at the expense

368. Wixen Interview, *supra* note 159.

369. *See* Jann S. Wenner, *Why the Record Industry Is in Trouble*, ROLLING STONE, Sept. 19, 2002, at 40.

370. *Id.*

371. Greg Kot, *Music: Artists Challenge Record Industry's Business Model*, ST. PAUL PIONEER PRESS, Mar. 3, 2002, at 1E.

372. The three largest music retailers are Musicland Stores Corp., Trans World Entertainment Corp., and Tower Records. *CD Price-Fixing Suit Settled*, NEWSDAY (N.Y.), Oct. 1, 2002, at A8 [hereinafter *Suit Settled*].

373. *Id.*

374. *Id.*

375. *Id.*

376. *Id.* The world's largest record company, Universal, believes such advertising policies are legal, and merely settled to avoid the cost of lengthy litigation. *Id.*

of their recording artists' royalties.[377]

Some argue that record labels are merely raising CD prices, and spending much time blaming artists, Internet downloading, and music fans as the cause of their troubles, instead of thinking of creative ways to market artists and CDs to increase revenues.[378] These artist representatives claim it is the record industry's unwillingness to change that is the obvious cause of these problems.[379] These representatives reason that the industry is "too willing to put out albums with only two or three good songs" rather than effectively developing and exposing new artists, and the industry insists on keeping CD prices too high.[380]

Rolling Stone editor Jann Wenner writes that "if the labels continue to blame the public for their own mistakes, rather than lowering prices and finding ways to effectively deliver music online, then music fans will grow even more alienated than they already are. And then, by comparison, the current sales slump will look like a boom."[381] Senator Kevin Murray agrees: "[A]s the music business reinvents a business model . . . it needs the artists on whom the industry is built to be its partner in creating the business model."[382] In order for this redefinition to begin, artists have to feel comfortable that they are receiving fair and accurate accountings.[383] Thus, the time may be right for a complete system overhaul.

It is time for the California Legislature to begin regulating the industry because the recording industry itself has failed to police its own practices and the way it conducts business.[384] If recording artists' recent efforts succeed, "they could fundamentally alter the economics" of the entire recording industry.[385] The balance of power needs to be shifted away

377. *Suit Settled*, *supra* note 372; *see also* discussion *supra* Part II.B.2. The companies "will pay $67.4 million in cash" and will "distribute $75.7 million worth of CDs to public entities and nonprofit organizations" such as schools and libraries. *Suit Settled*, *supra* note 372. Also, they have all agreed to stop using such industry policies. *Id.*

378. Wenner, *supra* note 369. Record labels continue "their futile efforts" to shut down digital technological advances, such as "Internet file-sharing sites," instead of embracing the Internet age. *Id.*

379. *Id.*

380. *Id.*

381. *Id.*

382. *Press Release*, *supra* note 62.

383. *Id.*

384. *See* Daniel B. Wood, *Musicians take on record companies*, CHRISTIAN SCIENCE MONITOR, Apr. 24, 2001, at 1.

385. *Id.* Drew Borst, an analyst at Sanford C. Bernstein & Co., a New York based firm that follows and analyzes the entertainment industry, says, "These activities have the joint potential to change the way the music business conducts itself. . . . This may be just the changing tide that the creative side has long awaited." *Id.*; *see also* Gunderson, *supra* note 1 (statement by *Blender*

from record labels—those who package and distribute music, in favor of the artists—those creating the music.[386]

A. Make Contracts Easier to Understand

"American musicians have [long] lamented their treatment at the hands of record [labels]."[387] Many artists feel they are left with few options: give up their rights at an early age or face the risk of never being signed.[388] There is no reason that a recording contract needs to be thirty pages or more. In fact, some attorneys, known to the author, have been able to cut the agreement down to four-to-six pages.

Music executives maintain that "artists voluntarily sign 'industry standard' recording agreements."[389] Therefore, because many records are unprofitable, contracts are structured such that record labels receive a windfall from the few profitable albums they release each year.[390] The record label recoups all advances and other costs from the recording artist's royalties before paying the recording artist.[391] Then, while the artist (through the current industry method of recoupment) essentially pays to create a successful album, the record company owns the master, has the option of demanding other albums, cross-collateralizing advances from any other albums, "and taking profits off of the top," with the advance being another deduction from the artist's royalty account.[392] Generally, recording artists are left with little or no compensation in return.[393]

With the current practice of recoupment, the contract is not easy to understand, particularly the royalty statement.[394] No other industry has this type of concept as its basis for business.[395] In the recording industry, even when accounting is accurate, there is no way of knowing it. Further, if the

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magazine editor Craig Marks).

386. *See* Chuck Philips, *Shaking Up and Turning Around EMI*, L.A. TIMES, Oct. 7, 2002, at C1 [hereinafter *Shaking Up*].

387. Wood, *supra* note 384.

388. *Id.*

389. Chuck Philips, *Seeking a More Perfect Union: Recording Artists Band Together to Protect Their Assets*, THE RECORD (Bergen County, N.J.), Apr. 3, 2001 [hereinafter *Seeking a More Perfect Union*].

390. *Id.*

391. *See* Joseph B. Anderson, *The Work Made for Hire Doctrine and California Recording Contracts: A Recipe for Disaster*, 17 HASTINGS COMM. & ENT. L.J. 587, 590–92 (1994).

392. *See id.* at 590–91.

393. *See generally id.* at 591 (discussing recording agreements, royalties, and compensation).

394. *See* Chaitovitz Interview, *supra* note 243.

395. *Id.*

recording artist is one of the 95% of those whose project has financially "failed," and thus is unable to bear the cost of an audit, there is no effective remedy available for that artist.[396] Even if artists have the resources to explore other legal alternatives and are able to sue their record company, the record company will not be deterred from accounting improperly in the future.[397] Figuratively speaking, the recording industry is the only industry in the world where the bank provides a loan, one pays off the loan, but the bank still owns the house.[398]

Contracts must be clearly written. Currently, contracts keep artists tied throughout their career by terms and restrictions that are dictated by the recording industry.[399] Entertainment attorney Peter Paterno said, "Record labels operate on the premise that because they take such a large financial risk and have such a low rate of success that they have the right to maximize their return when they do score a hit. So the terms are stacked against the artist."[400]

Entertainment law is fraught with conflicts of interest because of the interlocking web of relationships inherent in entertainment contracts involving personal managers, producers, record companies, and distributors.[401] At one time, an entertainment lawyer was able to be adversarial to a record label because there were a lot of different record labels.[402] If the recording artist was talented, the lawyer was able to land a deal at a different label.[403] Nowadays, with fewer and fewer major labels, being adversarial to one major label can hurt a lawyer's career.[404] For this reason alone, many artists and their personal representatives will use one

396. *See* text accompanying *supra* note 218. Even successful artists are affected. *See, e.g.*, Jeff Leeds, *Contract Dispute Greets New Head of Sony*, L.A. TIMES, Feb. 7, 2003, at C1 (discussing recent suit brought by Incubus against Sony for release of contract). "Under current standard industry practices, Sony Music has been handsomely rewarded financially during this period while the members of Incubus have received very little compensation from their creative and professional efforts . . . The core question . . . is whether Incubus 'is entitled to share fairly in the fruits of their labor.'" *Id.* (quoting Incubus manager Steve Rennie). Considered a successful group, worldwide, Incubus has sold an estimated seven million records. *Id.*

397. *See* discussion *supra* Part III.B.3.

398. Wixen Interview, *supra* note 159.

399. Chuck Philips, *Courtney Love Seeks to Rock Record Labels' Contract Policy*, L.A. TIMES, Feb. 28, 2001, at A1 [hereinafter *Courtney Love*] (quoting Peter Paterno, entertainment attorney).

400. *Id.*

401. *See generally* Leonard M. Marks & Robert P. Mulvey, *Ethical Aspects of Entertainment Law Practice*, COUNSELING CLIENTS IN THE ENTERTAINMENT INDUSTRY 605, 619–20 (PLI 1993) (discussing conflicts of interest within the recording industry).

402. *Id.* at 620.

403. *Id.*

404. *Id.*

attorney for transactional purposes to maintain good relations with their record label, and another attorney for any litigation or potential disputes between the artist and the record label.[405] Paterno continues, "As an artist's representative, you wish there was something you could do to change that [the system], but you can't. In this market, there are only five companies, and they all behave exactly the same."[406]

"The recoupment method is so ambiguous, so complex, and so replete with subjectivity that the only real solution is a complete overhaul of the royalty accounting system."[407] Royalty computation should be based on records manufactured.[408] For instance, if one hundred CDs are manufactured, and thirty have shipped, the artist can determine that there are seventy unaccounted for CDs. The RIAA argues that recording artists would still complain, "Where did all these go? You gave away too many free."[409] However, all of these calculations would be clearly and specifically written into the contract. An artist would contract with the record company to determine the percentage of manufactured CDs that could be used for free goods, promotional goods, reserves, and, specifically, how many CDs could be licensed to the Clubs[410] for their distribution. Further, the basic agreement can be modified to match the nature of a project's campaign—although the underlying agreement is contractual, it should remain flexible. If an artist or artist's manager and the record company agree to service a specified amount of radio stations or promotional outlets because the project's campaign warrants it, then an agreement can be made to increase the percentage of units allowed for promos. Likewise, if an artist or artist's representative and the record company agree to provide retailers with free goods because the project's campaign warrants it, then an agreement can be made to increase the percentage of units allowed for free goods (both phony and real), and so on.

Packaging costs should be based on what it actually costs to make a package, and artists should only be charged for those costs. If an artist decides to make a CD with custom artwork, the artist can pay for the added expense. Likewise, if an artist uses a standard package, which costs less

405. *See* Wixen Interview, *supra* note 159.

406. *Courtney Love*, *supra* note 399.

407. Gunderson, *supra* note 1 (statement by Greg Hessinger, national executive director of AFTRA). BMG says it is going to reduce its recording contract from 100 pages to 12 pages in an effort to restructure the system. Chuck Philips, *BMG to Roll Out Royalty Plan*, LA TIMES, Nov. 20, 2002, at C1 [hereinafter *BMG Royalty Plan*].

408. *See Record Label Accounting Practices I*, *supra* note 7, at 83–84 (statement of Sen. Jim Battin).

409. *Id.* at 84 (statement of Steve Marenberg).

410. *See* discussion *supra* Part II.B.8.

than the standard 25% packaging deduction,[411] the recording artist's royalty should not be arbitrarily reduced.

The recording contract should provide a mechanism to determine whether returned records are royalty-bearing or free goods.[412] In addition, "all reserves should be liquidated . . . as soon as the return period expires."[413] The return period should be a standard time—no more than six months.[414]

Also, record companies should be required to provide foreign license agreements, general ledgers to verify sales reports, and data in electronic form, all of which is currently available, and all of which are currently not disclosed by record companies.[415]

With the above proposals, the accounting system becomes transparent. Because auditors already have to manually input figures such as royalty escalations on sales, as such figures often do not sit well with [record company] computers[416] and current accounting systems, the need to create a new accounting system appears practical and warranted.

Under a new system, as proposed above, a typical royalty statement might look like the following:

SRLP	$13.98
Standard CD Package[417]	-1.10
Royalty Base	$12.88
Artist Royalty (12%)	x12%
Artist Earnings	$1.55 per unit[418]

411. *See* discussion *supra* Part II.B.1.

412. Wolfe, *supra* note 124, at 57.

413. *Id.* at 56.

414. *Id.*

415. *See Record Label Accounting Practices I*, *supra* note 7, at 125 (statement of Fred Wolinsky).

416. *See* discussion *supra* Part II.C.1; *see also* Sussman Interview, *supra* note 181.

417. An average cost to manufacture 1,000 CDs is around $1.10 per unit. As the CD numbers increase, the standard cost decreases. When dealing with the Big Five, an initial order for a recording artist's debut CD could be as much as 100,000 units. Currently, record companies deduct up to $4.75 per unit from the artists to offset packaging costs. *See* discussion *supra* Part II.B.1.

418. For the above calculation, the author used $13.98 as the SRLP, proposing that CDs under a new structure be priced for a modern consumer. With an SRLP of $13.98, retailers could actually sell CDs to consumers for $10.00 or less. Recently, BMG announced a new royalty structure. *See BMG Royalty Plan*, *supra* note 407. BMG's example uses a 12% royalty based on an SRLP of $17.98. *Id.* It still takes a 25% packaging deduction, and 2.4 points for "technology deduction," which creates an "effective royalty of 9.6%." *Id.* Then, a 20% deduction is taken out for free goods, identified as "free CDs given to retailers." *Id.* These are not promos, but rather phony free goods. *See* discussion Part II.B.2. The free good deduction leaves the artist with $1.03 per-unit royalty. *BMG Royalty Plan*, *supra* note 407. However, the recording artist still

For every unit sold, a set amount is applied to the artist's royalty account. For every 100,000 units manufactured, a percentage of CDs should be contractually set aside for free goods, promos and the Clubs. But for the remaining CDs, the artist will be paid $1.55 for every single unit sold.

Tracking sales is no longer a problem. For instance, if 10,000 of every 100,000 manufactured CDs are set aside for the Clubs (or if the Clubs are designated to manufacture 10,000 units), then the record company must provide the Clubs' actual sales figures or return figures for the licensed or manufactured 10,000 units. Under this system, royalty earnings are always measured as an objective number.

B. Establish a Fiduciary Duty to Report Accurate Royalties to Artists

The State of California has a history of trying to protect employees, artists, and performers.[419] Unlike recording artists, other California citizens have a reasonable opportunity to receive fair compensation for their services.[420] While it is true that recording artists have gained more power over their work,[421] they "do not receive an equitable share of the enormous profit they create."[422] The "industry has systematically used unfair contracts and the specter of protracted litigation and damages[423] . . . to prevent artists from gaining fair payments for their creative efforts."[424]

The legislature should consider the record companies' duty to account properly and honestly as a fiduciary one.[425] When artists hand over a recording to a record company, they repose trust and confidence in that record company to exploit their creative work in the best interests of the company and themselves. A duty should be imposed on record companies to properly report royalty earnings to their recording artists.

has no way to account for how many CDs actually are given away as free goods, promos, or licensed to the Clubs. *See id.* This calculation still provides no transparency. *See id.*

419. *See Record Label Accounting Practices I*, *supra* note 7, at 112 (statement of Don Engel).

420. *See* Anderson, *supra* note 391, at 600.

421. *Id.* at 589–90.

422. A. Barry Cappello & Troy A. Thielemann, *Challenging the Practices of the Recording Industry*, 25 L.A. LAW. 14 (May 2002).

423. *Id.*

424. *Id.*

425. *See Record Label Accounting Practices I*, *supra* note 7, at 112 (statement of Don Engel).

In the event that record companies and their recording artists fail to reach an agreement, legislation should be introduced to impose heightened scrutiny on the royalty accounting practices of record companies.[426] Further, the legislation should allow recording artists the opportunity to seek punitive damages for "intentional and systemic misrepresentation or royalty withholding."[427] Perhaps an independent accounting board or agency should be created to oversee the recording business and record companies' accounting practices and procedures.[428] This board should be provided with disciplinary powers, and should encourage alternatives to litigation such as mediation and arbitration.[429]

While record companies say "[t]he industry has existed in this fashion for many, many, many years, and we're losing money on over 90 percent of the recordings that we distribute, and this is the only way that we can really get by," this logic does not hold up under any level of scrutiny.[430] The music business is a risk-intensive business, but that does not mean the record companies have a right to shift that burden solely onto the recording artists' shoulders.[431]

"We have managed to create a business that focuses on selling records that do 5 million to 10 million [dollars in] sales, at the expense of almost everything else," said former President and CEO of London-Sire Records, Peter Koepke.[432] That is why "the big record companies are complete and utter nonsense, a thing of the past. [We are] keeping them around because [they have] always been around. But [they are] fast becoming relics."[433]

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426. *See id.* § 7 (written testimony of Londell McMillan, attorney, and counsel for the Artist Empowerment Coalition).

427. *Id.*

428. *Id.*

429. *Id.*

430. *See Record Label Accounting Practices I*, *supra* note 7, at 139 (statement of Greg Hessinger).

431. *See id.*

432. Greg Kot, V. Dion Haynes & Joshua Klein, *You Say You Want A Revolution*, CHI. TRIB., Feb. 24, 2002, at 1, *available at* http://proquest.umi.com/pqdweb?TS=1-423...2&Dtp=1&Did=000000109654617&Mtd=1&Fmt.

433. *Id.* *See generally* CORNYN ET. AL., *supra* note 127, at 448 (discussing the transformation of the business caring about music to growth potential and corporate debt). "There was a time when everyone in the business would sit around and talk enthusiastically about all the great music being made, no matter what label it was on . . . John Lennon . . . Curtis Mayfield . . . Velvet Underground . . . Joni Mitchell. Today all anyone talks about are growth projections." *Id.*

Under the auspice of recoupment, recording artists pay to have their records promoted and marketed.[434] Recording artists want a major record deal because it exposes them to mass audiences.[435] Now, many artists are realizing it is possible to make more money by independently manufacturing and selling records without being tied to a record label, especially when that label has no duty to report accurate royalties.[436]

As MTV and commercial radio are narrowing to accommodate only the most promoted and most expensive music from the labels, recording artists are turning to independent ventures or agreements where they can participate in the entire process.[437] There is a growing network of independent artists who sell less records but consistently make "modest profits" that allow them to continue to produce and record their music.[438] These artists may be the future.

V. CONCLUSION

The recording industry needs standards that require labels to fully disclose accounting practices to recording artists and possible legislation that would penalize record labels that underpay artist royalties. By imposing a fiduciary duty on record labels to report accurate royalties to recording artists, the onus is on the record company to account properly. Currently, there are absolutely no ramifications, other than to simply settle for less than fair-market value, if royalties are underreported. In addition, financially successful artists are the only recording artists that are practically afforded the auditing remedy, regardless of their contractual agreements with the record label.[439] This creates serious detriment not only to recording artists' earnings, but also to their ability to be eligible for health and pension benefits.[440]

AFTRA director Greg Hessinger claims that "[t]he music industry's current accounting system is sorely lacking in transparency . . . . And until the labels recognize that artists have an inherent right to be given a clear

434. *See* Kot, Haynes & Klein, *supra* note 432.

435. *See id.*

436. *Id.*

437. *See id.*

438. *Id.*

439. *See supra* note 218 and accompanying text. Even financially successful artists may be deterred from bringing suit against their record companies so as not to be excluded from future projects or opportunities. *See id.* Perhaps recording artists should focus on increasing their contractual power through the use of their union and collective bargaining agreements with the record labels.

440. *See* discussion *supra* Part II.D.

accounting of what they are owed, people will continue to have the perception that they are being cheated."[441] More importantly, record companies need to understand that artists cannot be treated any longer as though they have no say about their finances.[442] This is not about rich artists who want to make an extra penny here and there.[443] It is about a dysfunctional system that needs real correction. As such, the only solution to effectively create deterrence and terminate the long-standing industry practice of cheating artists out of money they rightfully deserve is to impose a fiduciary duty on record companies to account accurate royalties to their recording artists.

*Corrina Cree Clover**

441. *See State Senate*, *supra* note 32 (statement by Greg Hessinger).

442. *See Press Release*, *supra* note 62. As EMI's Recorded Music division Chairman Alain Levy stated, "There is more pain to come, but the music industry will survive." *Shaking*, *supra* note 386.

443. *See supra* note 218 and accompanying text.

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