

Recent Court Decision Highlights Importance of Drafting Licenses With an Eye Toward Possible Technological Developments and Their Effect on the Marketplace in the Future

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The Supreme Court recently declined to hear an appeal of a Ninth Circuit decision holding that music distributed through Apple's iTunes and other digital-music services qualified as a "license" rather than a "sale." As a result, the artists who entered into these agreements were entitled to the much higher royalty rate specified for "licenses" rather than the lower royalty rate for "sales." See *Aftermath Records v. F.B.T. Prods. LLC*, No. 10-768 (March 21, 2011). Because contract interpretation focuses heavily on the specific language used in specific contracts, the Ninth Circuit decision may not carry broad precedential weight across the entire music industry. This decision could, however, greatly affect the interpretation of similarly worded contracts, as courts attempt to apply language written for the sale of records and compact discs to transactions in the digital marketplace.

Indeed, shortly after the Supreme Court declined to review the Ninth Circuit's decision, a class-action suit was filed against the publishing house Universal Music Group in the District Court for Northern District of California seeking back royalties for digital downloads. As the digital-download market continues to grow at the expense of sales of physical albums, courts will likely again be asked to determine royalty rates in the digital marketplace by interpreting contract language that was drafted with an eye toward an earlier marketplace. These cases serve as a reminder of the importance of drafting contracts with an eye towards the future.

Background

Popular rap artist Eminem had granted exclusive rights to his recordings to F.B.T. Productions ("F.B.T."), who in turn transferred those rights to distributor Aftermath Records ("Aftermath"). Years later, as digital downloads gained popularity, Aftermath's parent company entered into an agreement to distribute Eminem's songs through Apple's iTunes as permanent downloads, which remain on an end-user's computer or other device until deletion. Aftermath also entered into agreements with major cell-phone carriers to sell Eminem's songs as ringtones.

The central issue in *F.B.T. Productions* arose from two different provisions in the agreement between F.B.T. and Aftermath: the "Records Sold" provision and the "Masters Licensed" provision. Under the Records Sold provision, Aftermath owes F.B.T. between 12% and 20% of the adjusted retail price of all "full price records sold in the United States . . . through normal retail channels." Under the Masters Licensed provision, "[n]otwithstanding the foregoing," Aftermath owes F.B.T. 50% of its net receipts "[o]n masters licensed by us . . . to others for their manufacture and sale of records or for any other uses." When calculating the royalties owed to F.B.T. for the sales of Eminem's songs as permanent downloads and ringtones, Aftermath applied the Records Sold provision, determining it owed F.B.T. the lower royalty rate.

F.B.T. sued, arguing that the Masters Licensed provision applied to the downloads and ringtones, thereby entitling F.B.T. to a 50% royalty rate. In response, Aftermath argued that the Records Sold provision applied because permanent downloads and ringtones are records, and iTunes and other digital music providers are normal retail channels. At trial, the jury returned a verdict in favor of Aftermath.

The F.B.T. Productions Decision

In *F.B.T. Productions, LLC v. Aftermath Records*¹, Nos. 09-55817, -56069 (Sept. 3, 2010), the Ninth Circuit reversed the jury verdict, finding that, based on the language in the agreement, the permanent downloads and ringtones were sold as "licenses," thus entitling F.B.T. to the higher royalty rate. The Ninth Circuit noted that the agreement between F.B.T. and Aftermath provides that "notwithstanding" the Records Sold provision, F.B.T. is entitled to a 50% royalty on "masters licensed by [Aftermath] . . . to others for their manufacture and sale of records or for any other uses."

The Ninth Circuit explained that the parties' use of the word "notwithstanding" indicates that even if a transaction arguably falls within the scope of the Records Sold provision, F.B.T. receives a 50% royalty if Aftermath licenses an Eminem master to a third party for "any" use. Thus, the Masters Licensed provision explicitly applies to masters that are licensed to third parties for the manufacture of records "or for any other uses," "notwithstanding" the Records Sold provision. Accordingly, to determine whether the Masters Licensed provision applies, the court had to analyze (1) whether the transactions between Aftermath and the third parties were "licenses" and (2) whether the permanent downloads and ringtones were "masters."

At trial, Aftermath did not dispute that it entered into agreements that permitted iTunes, cell-phone carriers, and other third parties to use its sound recordings to produce and sell permanent downloads and ringtones. Applying the ordinary meaning of license—"permission to act"—the Ninth Circuit found that these agreements qualified as "licenses."

This conclusion, the Ninth Circuit explained, finds support in federal copyright law, where "license" and "sale" have specific meanings. Under the Copyright Act, a "sale" may either be a transfer in title of an individual copy of a work, or a sale of all exclusive intellectual-property rights in a work. The Ninth Circuit reasoned that Aftermath owned the copyrights to the recordings at issue and did not "sell" anything to the third-party distributors, who never obtained title to the digital files.

Instead, Aftermath retained ownership of the files, reserved the right to regain possession of the files at any time, and obtained recurring benefits in the form of payments based on the volume of downloads. In similar situations—i.e., where a copyright owner transfers a copy of copyrighted material, retains title, limits the uses of the material, and is compensated periodically based on the transferee's exploitation of the material—the transaction is deemed a "license."

Specifically, such a license authorizes a third party to engage in behavior that would otherwise be the exclusive right of the copyright owner, who does not transfer title in those rights. The Ninth Circuit determined that under this definition, Aftermath's agreements with

the third-party distributors were licenses to use the Eminem master recordings to create and distribute permanent downloads and ringtones in exchange for periodic payments based on the volume of downloads, without any transfer of title.

The Ninth Circuit also held that the sound recordings constituted "masters" under the agreement. The contract at issue specifically defined a "master" as a "recording of sound . . . which is used or useful in the recording, production or manufacture of records." Since the recordings that Aftermath supplied to the third-party distributors were "used or useful" in producing the permanent downloads and ringtones, those sound recordings were "masters." Finding that the Masters Licensed provision applied, the Ninth Circuit therefore held that F.B.T. was entitled to a 50% royalty under the plain terms of the agreement.

Strategy and Conclusion

1. **Draft contracts with an eye towards the future.** One of the most important and also most difficult aspects of agreement drafting is attempting to anticipate how technology may change in the future and how that will affect the parties' rights and obligations under an agreement. While it is impossible to achieve complete certainty when planning for the future, licensing professionals should work with the business and technical people in their organization to try to draft contracts with an eye towards future technologies and how those future technologies may affect the marketplace in the future and the underlying deal between the parties.
2. **Update contracts drafted for an earlier business model.** If the agreements between your business and distributors or other parties determines royalty rates or other key provisions based on outdated terminology, update your agreements with the other parties before conflict arises. Countless industries have undergone sea changes in the last few years, particularly those media-based markets affected by digitization. Even outside those specific markets, verify that your current agreements employ terminology that applies to your current business model.
3. **Consider how existing catch-all provisions might apply to current market conditions.** If your existing agreements contain catch-all provisions, consider how a court might construe those provisions in light of new developments within your industry. What once may have been an infrequently applicable catch-all provision may have morphed into a controlling provision of the agreement because of fundamental but unforeseen changes in the market.

Endnotes

¹ The *F.B.T. Productions* decision: <http://www.ca9.uscourts.gov/datastore/opinions/2010/09/03/09-55817.pdf>.

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