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DePaul Journal of Art, Technology & Intellectual Property Law

Volume 4
Issue 2 *Spring/Summer 1994*

Article 5

The CD Skirmish: Distributors, Artists, and Retailers Do Battle

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THE CD SKIRMISH: DISTRIBUTORS, ARTISTS, AND RETAILERS DO BATTLE

I. INTRODUCTION

A heated battle is being waged across the music industry over the sale of used compact discs ("CDs"). On the one hand, consumers are thrilled with the prospect of paying less money for a product that is so in demand, and retailers are thrilled to provide the product at a reduced cost to consumers while maintaining a healthy profit margin for themselves. On the other hand, compact disc distributors, and more significantly the artists themselves, are up in arms considering the sale of used CDs deprives them of their royalties.

No legislation has been drafted as yet to deal specifically with the resale of CDs, but it may be forthcoming. Industry insiders seem to think legislation may be the only viable solution to the current situation.[1]

But is brand new legislation geared specifically toward CDs really necessary? California enacted its Resale Royalties Act in 1976. The Act provides that an artist maintains an interest in the works of fine art he creates, and gives the artist the right to share in the profits as the works pass from one owner to another.[2] The only other state to take a step in California's direction is New York, which introduced a bill early in 1993 that is nearly identical to California's Act.[3]

This update will examine the growing concern over the sale of used CDs and the differing perspectives of either side of the controversy. Next it will address existing legislation from California and New York to determine if it is applicable to the CD dilemma. Finally, the alternative solutions, legislative or otherwise, will be discussed to determine the best possible way to turn a controversial and inflammatory situation into a situation in which both sides of the equation get at least some of their interests served.

II. THE RETAILERS' VIEWS

From the moment of their introduction 10 years ago, CDs have been touted as the new generation of sound, almost indestructible and offering superior sound quality when compared to vinyl records or cassettes.[4] Therefore, the recording industry reasoned, CDs should sell at a higher price than records or cassettes.[5]

Retailers and consumers alike were quite willing to buy this reasoning . . .

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1. Laurence H. Rudolph, *Seeking a Solution to Used CD's*, Billboard Magazine, Aug. 7, 1993, at 7.

2. CAL. CIV. CODE §986 (WEST 1976).

3. N.Y. ARTS & CULT. AFF. §1641 (McKINNEY 1993).

4. Jane Birnbaum, *Without a Scratch, Used CD's Rise Again*, The New York Times, Sept. 6, 1993, at 35.

5. Birnbaum at 35.

literally. The compact disc market has grown steadily over the past ten years, evidenced by the fact that in 1992 alone four hundred seven million CDs were sold as compared to the fewer than eight hundred thousand CDs' sold in 1982.[6] As CDs are sold at a list price of sixteen dollars and ninety-eight cents, it is clear the sale of CDs was essentially responsible for the record nine billion dollar year the music recording industry enjoyed in 1992; CD sales accounted for fifty-six percent of all sales.[7]

However, the tide seems to be turning. Consumers seem no longer altogether willing to pay around sixteen dollars for a new release.[8] Some retailers have responded to customer complaints about the high price of CDs by introducing used CDs.[9]

Blazing the trail is Wherehouse, a California-based chain with three hundred forty stores in ten Western states, which began selling used CDs in 1992.[10] Wherehouse pays customers six dollars credit or three dollars and sixty cents cash for their used CDs.[11]

Similar systems have cropped up at retail stores all over the country. Stores generally pay from two dollars to four dollars for used CDs, and resell them for seven to ten dollars.[12] Considering retail stores pay manufacturers around ten or eleven dollars for a new CD to resell it for fourteen to sixteen dollars, retailers are pleased with the comparable profit margins they have achieved selling used CDs.[13]

Apparently, consumers are pleased with the availability of used CDs as well. Speculations about just how much money the used CD business is generating led to the estimate of five hundred million dollars in the last year alone.[14]

Ironically, the used CD bonanza has been made possible by manufacturers of CDs themselves by introducing CDs as "virtually indestructible."[15] Unlike vinyl albums and cassettes that deteriorate in quality over time, CDs will continue to have the same impeccable sound quality as long as they are not physically damaged. In addition, thanks to the protection of the "jewel cases" in which CDs are sold, they will also continue to look new over time.[16]

Obviously, offering a high quality product was the intent of the manufacturers and distributors of CDs, but the exploitation of the superior qualities of the CD

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6. Richard Harrington, *Sound and the Fury; the Battle Over Used CD's*, The Washington Post, July 27, 1993, at E5.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. Nicole Peradotto, *Used Market Causes Strife; Companies Angry Over Loss of Royalties*, Lewiston Morning Tribune, July 30, 1993, at 1D.
15. Harrington, *supra* note 6.
16. *Id.*

to allow their resale was never intended.[17]

III. THE DISTRIBUTORS' VIEWS

Responding to the unchecked growth in the used CD business, four of the six major music distributors withdrew millions of dollars in advertising and promotional allowances from retailers who sold used CD's early in the summer of 1993.[18]

The four distribution giants (CEMA (Capitol/EMI labels), Sony Music Distribution (Columbia/Epic), UNI (MCA), and WEA (Warner Bros./Electra/Atlantic)) stated two main reasons for the withdrawal: 1) the sale of used CDs will diminish consumer interest in new releases and 2) the perceived value of new CDs will also diminish.[19]

First, distributors argue, because of the availability of used CDs, consumers are being diverted from spending their money on new releases. Even worse, the prices of used CDs affect the public's "price perception", making them think new CDs are not worth sixteen dollars.[20] At this point in the argument, retailers counter by charging mail order CD clubs, two of the biggest of which are owned by another major distributor (BMG), are the main reason the "price integrity" of CDs has been damaged.[21]

The real crux of the argument for the distributors is the used CD business does not generate royalty payments for songwriters, recording artists, producers, and others who profit from the sale of new products.[22] Michael Green, president of the National Academy of Recording Arts and Sciences, predicts the used CD market could grow to occupy as much as twenty percent of the unit volume over the next 5 years. This loss of income, he says, could "spell disaster for the majority of those in our artistic community who already live perilously close to the edge of financial ruin."[23]

In addition, the loss of profits from the sale of new CDs could mean less new music will be created. A CEMA representative made the statement, "[t]he revenue CEMA derives from these projects [the 5 to 10 percent of projects that make a profit] is used to record many artists who 'never see the light of day'. The profits also go toward music videos, promotion and artist tours."[24]

Throwing his cowboy hat into the fray, country superstar Garth Brooks has brought the used CD dilemma into the public perception. At Brooks' behest, CEMA announced in early August 1993 it would not provide Brooks' latest album, "In Pieces", to retailers who sold used CDs.[25] Within weeks, however,

17. *Id.*
18. Birnbaum, *supra* note 4.
19. Harrington, *supra* note 6.
20. *Id.*
21. *Id.*
22. Birnbaum, *supra* note 4.
23. *Id.*
24. Peradotto, *supra* note 14.
25. Birnbaum, *supra* note 4.

CEMA heeded legal advice and reversed its position.[26] CEMA's attorneys suggested it would be easier to defend accusations of withholding cooperative advertising funds than accusations of withholding actual product, such as Brooks' album.[27]

IV. THE CD SKIRMISH

The distributors may have gotten the first punch in April of 1993 by withdrawing co-operative advertising from any retailer who sold used CDs, but the retailers, headed by Wherehouse, have gotten in a few good punches of their own. Wherehouse embarked on a media blitz Memorial Day Weekend 1993, encouraging consumers to bring in used CDs for cash or credit.[28] It advertised used CDs as "an alternative to rising CD prices" and "a way for new CD owners to build their library at minimal cost."[29]

In addition, on July 19, 1993, Wherehouse filed separate lawsuits in Federal Court against each of the four complaining distributors accusing the distributors of antitrust activity in withholding the advertising money.[30] Following suit, the Independent Music Retailers' Association, comprised of one hundred fifty to two hundred "mom and pop" type music stores, also took on the four distributors over second-hand CDs and filed suit in a federal California court on August 2, 1993.[31]

The complaints alleged three counts. First, the complaint stated the record companies have combined and conspired to unreasonably restrain trade and commerce of used CDs by eliminating advertising and promotional allowances for those retailers who buy and resell CDs. It claimed this agreement between the companies has as its goal to protect the high prices of new CDs from the competition of used CDs, and "thus operates to stabilize prices in violation of the Sherman Act[32] in that it directly involves and affects a term and condition of prices charged by each defendant to its respective customers."[33]

The second count alleged violations of the Robinson-Patman Act[34] because the withholding of advertising and promotional allowances based on whether or not a retailer sells used CDs involves the granting of an allowance for advertising or promotion on terms not proportionally equal to all purchasers.[35] The third count alleges a violation of § 17200 of the California Business and Professions

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26. *Id.*

27. *CEMA Distribution Tries to Limit CA Case to Co-Pay Issue Antitrust: Wherehouse Entertainment v. CEMA*, The Entertainment Litigation Reporter, Sept. 27, 1993.

28. Harrington, *supra* note 6.

29. *Id.*

30. Birnbaum, *supra* note 4.

31. See *supra* note 27.

32. 15 U.S.C. § 1

33. *2 CA Suits Accuse 4 Distributors of Antitrust Violations: Antitrust: Wherehouse Entertainment v. CEMA*, The Entertainment Litigation Reporter, Aug. 23, 1993.

34. 15 U.S.C. § 13

35. *See supra* note 27.

Code, since the conduct described in the first two counts allegedly constitutes an unfair method of competition.[36]

The complaint seeks treble the amount of damages sustained pursuant to § 4 of the Clayton Act (15 U.S.C. § 26); that the alleged conduct of the defendants be enjoined; and that plaintiffs receive attorneys' fees and costs of the suit.[37] As of September 4, 1993, each of the four distributors rescinded its policy and restored advertising money to retailers as long as they do not use the money to promote used CDs.[38]

The agreements between distributors and retailers are typified by CEMA's 4-part agreement with Wherehouse. Cooperative advertising would resume as long as the retail chain: "1) does not sell used CDs that are currently featured in the co-op ads; 2) displays used and new CDs in separate areas of retail stores; 3) does not sell CDs marked for promotional purposes; 4) does not advertise the sale of used CDs with new CDs."[39]

In the midst of accusations and lawsuits, distributors, record companies, and artists continue to seek a way to recover the royalties to which they feel entitled.

V. PROTECTION OF SOUND

Musical compositions were not protected at all until 1831 when Congress first extended federal copyright protection to musical compositions.[40] The copyright holder of a composition had the exclusive authority to sell copies of the musical score. With the advent of machines that had the ability to reproduce the composition mechanically, such as piano rolls and records, Congress saw the need to provide more protection for composers.[41] The Copyright Act of 1909 considered piano rolls and records to be "copies" of the original composition, and could not be manufactured without first making payment to the holder of the copyright.[42] In 1971, Congress amended §5 of the Act to include "sound recordings" within the Act's protection due to technological advances that allowed record piracy.[43]

The Copyright Act of 1976 expanded the protection of sound by attaching proprietary rights to works fixed in a tangible medium.[44] The Act defines a sound recording as the fixation of a series of sounds, other than the sounds accompanying a motion picture or other visual work. Fixation is defined as sound put into a "tangible medium of expression . . . perceived, reproduced, or other-

36. *Id.*

37. *See supra* note 33.

38. Dean Rhodes, *Music Industry Skips Logic in Used CD Sales Debate*, The Phoenix Gazette, Sept. 30, 1993, at E3.

39. Michael Kinsman, *1 Firm Dropped From Used-CD Suit*, The San Diego Union-Tribune, Aug. 28, 1993, at C-1.

40. *Goldstein v. California*, 412 U.S. 546 (1973).

41. *Id.* at 561.

42. *Id.* at 564.

43. *Id.* at 561.

44. Linda Benjamin, *Tuning Up the Copyright Act: Substantial Similarity and Sound Recording Protections*, 73 Minn. L. Rev. 1175, 1177 (1989).

wise communicated for a period of more than transitory duration."[45]

Although music is protected by the Copyright Act by not allowing piracy of the composition, the Act offers no protection against the reselling of the CD once it has been bought. Therefore, writers, producers, musicians, cannot rely on the Copyright Act since §109 of the Act[46] grants copyright holders the right to dictate only the "first sale" of their works.[47] After the first sale, the law allows the owner of a lawfully made copy to dispose of that copy in the way he or she chooses.[48] Hence, reliance on legislative solutions may be necessary.

VI. APPLICATION OF FINE ARTS LEGISLATION TO CDS

One possibility is a legal concept called "droit de suite" which is used primarily in European countries. Under this theory, artists should be entitled to participate in profits derived from the resale of works of art which they have sold or otherwise disposed of.[49]

Droit de suite, which translates to "art proceeds right", or literally "follow-up right", was introduced in France in 1921.[50] The impetus of the right was to make sure a "starving artist" who sold a painting for one hundred dollars would be able to profit from a work that gained in value over time.[51] Simply stated, it is unfair to limit an artist to proceeds from the original transaction, while someone else profits from the artist's work.[52]

The biggest advantage of legislation protecting the resale rights of the artist is artists are encouraged to produce works of fine art, knowing they may someday reap the benefits of their increasing fame.[53]

Only California has enacted legislation granting resale royalties to artists. The law, called the California Resale Royalties Act, requires the payment of a royalty of five percent of the resale price to the artist when the work is resold inside California or by a California resident anywhere outside the state.[54]

Almost identical legislation may be forthcoming in New York. Assembly Bill 1641, introduced in the first regular session of New York's 215th General Assembly, provides the same rights to artists as the California law. Namely, the bill also provides a payment of five percent of the resale price back to the artist.[55]

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45. *Id.* at 1177, *quoting* 17 U.S.C. §102 (1982).

46. 17 U.S.C. §§101-810 (1982).

47. 17 U.S.C. § 109 (1976).

48. Rudolph, *supra* note 1.

49. *Id.*

50. Jay B. Johnson, *Droit de Suite: An Artist Is Entitled to Royalties Even After He's Sold His Soul to the Devil*, 45 Okla. L. Rev. 493 (1992).

51. *Id.* at 493.

52. *Id.* at 505.

53. *Id.* at 509.

54. Rudolph, *supra* note 1.

55. Specifically, the bill provides that any seller of fine art, whether it be a gallery, dealer, broker, or museum must withhold 5% from the sale, locate the artist, and pay the artist. If the artist cannot be found within 90 days, the amount equal to 5% of the resale will be transferred to the Council on the Arts. If the Council is unable to find the artist, and the artist or his estate does not file a petition

Although "droit de suite" legislation has referred only to fine art, there does not seem to be any reason why such legislation cannot be applied to CDs and musical artists. It seems the existing legislation could be tailored to fit the specific needs of the recording industry.[56]

The one obvious difference between works of fine art and CDs is there is only one painting or sculpture, but there are thousands of CDs that constitute the same "work." This would make collection and monitoring of royalties very difficult.[57]

The same problem was faced years ago when radio play of recorded music was first introduced. Music publishers realized the potential for new royalties to be derived from the public performance of their copyrighted compositions.[58] However, they also realized the futility of trying to negotiate individual licenses with individual radio stations for each piece of music. ASCAP and BMI, royalty collection societies, were created to provide licensing for the performance or transmission of the composition and to provide the composer with the royalty payments due.[59]

For "droit de suite" to be feasibly applied to the resale of CDs, a royalty collection society, such as ASCAP or BMI, is needed. Then, similar to the licensing of radio stations, licenses could be granted to retailers engaged in selling used CDs. Cost would be determined based on the volume of the retailer's used CD business. This way, retailers would be forced either to share some of their profits with copyright holders, or choose not to sell used CDs and avoid paying a blanket fee for a license.[60]

Another major difference between droit de suite as applied to fine art and droit de suite as applied to the music industry is some of the beneficiaries of royalty payments in the music industry may hardly be considered "starving art-

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for the money to the Council within 7 years of the date of the sale of the art, the artist's rights are terminated and the money is transferred to the operating fund of the Council.

If the artist or his estate does file a written claim for the money within 7 years of the date of the sale of the work, the Council will pay the artist the money held for him less 10% to be retained by the Council as the cost of administering the money. The withheld 10% will be transferred to the operating fund of the Council.

If the seller of the art fails to pay the artist 5% of the resale value of the work, or fails to transfer the amount to the Council on the Arts, the artist may bring an action for damages within three years after the date of sale, or one year after the discovery of the sale, whichever is longer.

The Bill does not apply to any of the following exceptional situations: to the initial sale of a work of fine art where legal title to the work at the time of the sale is vested in the artist; to the resale of a work of fine art for a price less than $1000; to the resale of the work after the death of such artist; or to the resale of the work in exchange for another work of fine art or for a combination of cash, other property, or other works of art where the fair market value of the property exchanged is less than $1000.

The Bill provides that an "artist" is a person who creates a work of "fine art", which means an original painting, sculpture, or drawing.

56. Rudolph, *supra* note 1.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

ists". Large record companies and some artists (Garth Brooks is a case-in-point) are certainly not needy. However, there is a significant group of artists who would benefit from droit de suite-like legislation: those writers, musicians and producers who have not yet achieved commercial success or financial security. A vital sub-group of the industry, these individuals should not be denied potential royalties which the resale of CDs will surely deny them. If these artists are allowed to have their "cut", they may continue to create new music.

VII. ADDITIONAL SOLUTIONS

Even CEMA's main spokesperson, Russ Bach, admitted "we recognize we will never eliminate the sale of used CDs."[61] So, now that the proverbial "cat is out of the bag", how can artists/distributors and retailers reach a happy medium?

One legislative solution, in addition to "droit de suite," might be the enforcement of limitations on the number of used CDs that may be carried by a retailer. Perhaps a rule of proportions could be formulated to provide for a certain allowable number of used CDs per retailer depending on the number of new CDs it carries and promotes.

Or, perhaps a legislative "time lag" rule could be created providing for a certain time period in which retailers may not resell a CD. This could temper the frustration the artists/distributors experience when a recently released new CD is not bought at full price because the used version is already available for less than half the price.

Certainly the mail order CD clubs are contributing to the resale of CDs. When a consumer can get "8 CDs for a penny" he certainly does not appreciate the cost of a CD, and may even consider the CD somewhat "disposable" in that if he does not like the CD, he can simply resell it, making money where he spent virtually none.[62] In fact, a *Billboard* survey found that some retailers estimate that fifteen to forty percent of used CD stocks came from record clubs.[63] Perhaps distributors need to monitor the mail order CD clubs more closely to make certain new CD's are not becoming used CDs for sale.

Some industry insiders are also predicting a technological push by the recording industry to come up with CDs that cannot be duplicated.[64] When consumers can buy a CD and duplicate it on an audiocassette, the CD can be resold quickly since the consumer already has a copy.

VIII. CONCLUSION

Whatever the solution, it is clear something must be done. Both sides of this dilemma clearly have legitimate interests. Consumers want to keep the cost of CDs down to an affordable level, while retailers want to serve consumer needs

61. Harrington, *supra* note 6.
62. *Id.*
63. *Id.*
64. Birnbaum, *supra* note 4.

and maintain a healthy profit margin. The artists and distributors merely want what they feel is their fair share of the profits. They do not want to be denied their royalties, especially as the consequence might be fewer new artists, and less new music. The artists/distributors merely want to protect their futures.

"Droit de suite" legislation which currently exists only in California, and is pending decision in New York, has as its focus the resale royalties of fine arts, but the same concepts with slight revision certainly seem applicable to the CD dilemma. Actually, any solution which would bring retailers and distributors to a common ground is necessary. Otherwise, the used CD battle may escalate to a full scale war.

Peggy Bachmann