

## **On the Brink of Change: An Examination of the Music Industry's Business Practices**

**by Brian Mencher**

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“The current royalty system is incredibly opaque and difficult to unravel and audit, and I think that clearly disadvantages artists.”

-Michael Smellie; BMG Chief Operating Officer

Over the past few years, the combined parties that make up the music industry have faced one common obstacle - prevention of online music piracy. Lawsuits were filed, lobbying efforts were made, and innovative strategies were implemented to halt music thievery. The industry, however, has yet to recover from the impact of unlawful online music sharing. And now, as the music industry continues to battle online piracy, its internal business practices are being called into question by the most visible members of the industry - performing artists.

On July 23, 2002, the California Senate Judiciary Committee and the Select Committee on the Entertainment Industry began a series of hearings examining the music industry's accounting practices. Performing artists, along with the Recording Artists Coalition [RAC], alleged widespread accounts of royalty underpayments at the hands of the record labels. The performing artists' right to audit their record companies has been the only available means to confirm royalty underpayments. Only the most successful performing artists, however, can afford an audit since record labels insist on a highly restrictive auditing provision. In many cases, the cost of the audit exceeds the amount of underpayment due. And, even if the label is found at fault, by contract, the performing artists are only entitled to the underpayment. These business practices have led to a fuller legislative examination of industry-wide standards, namely the accounting process and antiquated contractual provisions.<sup>1</sup>

This article will explore the record labels' auditing processes in light of their general business practices. The purpose of this article is twofold. First, it will identify the underlying reasons for why audits are becoming commonplace in the music business. And second, the

article will examine the practical application of auditing. Ultimately, this article calls for changes in the general business practice of the music industry aimed to decrease the need for audits, along with adoption of a more balanced auditing provision for times when one may be needed.

Section II of this article introduces the arguments surrounding allegations of misleading accounting practices by the music industry. Section III examines the application and limitations of auditing a record label. In section IV, this article correlates decisions to audit with the record labels' confusing accounting practices identified in section II. Finally, section V outlines potential legislative action and recently announced changes by two of the five major record labels. This section will also set forth changes necessary to simplify the industry's accounting practices, while offering suggestions for a more balanced auditing provision.

## **II. Challenging the Labels' Business Practices**

Over the course of three hearings before the California Senate Judiciary Committee and the Select Committee on the Entertainment Industry, numerous claims were made against the accounting practices of the music industry. Leading the debate, State Senator Kevin Murray found that "in almost every case" an independent audit verified record company underpayments.<sup>2</sup> While some artist representatives claimed label accounting practices to be "intentionally fraudulent,"<sup>3</sup> others, including Senator Murray, only found evidence of purposeful neglect. Regardless of the labels' intentions, substantiated accounts of royalty underpayments have been verified.<sup>4</sup>

A third argument surrounding allegations of misleading accounting practices accredits the complexity of the music business, albeit purposefully complex. That is, royalty underpayments occur due to confusing and antiquated recording contracts. And audit requests are sometimes

made by performing artists because of the uncertainty created by these contractual provisions. Contracts generally exceed 100 pages.

#### *A. Royalty Calculations<sup>5</sup>*

A standard recording contract provides a royalty percentage based on suggested retail list price [SRLP] of the album, an estimated amount the record label assumes retailers will charge. Thus, if a compact disc's SRLP is set at \$15.00 and the royalty percentage is 10%, the performing artist should receive a \$1.50 royalty per compact disc sold. This calculation, however, fails to account for a number of deductions and payment schemes required by the record labels.

Most recording contracts include a packaging deduction of 25% off the SRLP. For compact discs and other "new technologies" this percentage also reflects the money invested in developing such new technologies. In essence, the label only pays 10% on \$11.25. The standard contract also deducts a certain percentage for "free goods" - an amount of compact discs claimed to be distributed as promotional items.

The royalty computation becomes further complicated by varying royalty rates for other parts of the world, royalty escalations for reaching certain sales plateaus, and royalty reserves held by the record labels in case of returned goods. Well known music lawyer Donald Passman asks, "Confused? I suspect that's the idea."<sup>6</sup> And once the royalty rate is determined, the royalties earned are generally never the royalties paid. Royalties earned must first be applied toward money paid to performing artists (an advance) and expenses made by the record label on their behalf. By contract, these costs are recoupable.

#### *B. Recoupable Expenses<sup>7</sup>*

Before an artist receives royalty payments, the artist must earn enough money to cover the advance and expenses deemed recoupable. An advance can range from \$10,000 to in excess of \$1,000,000 dollars. Recording and video production costs, as well as touring support and marketing expenditures, including the controversial practice of paying for independent promotion, are all expenses recoupable by the record labels. The additional recoupment mechanism of cross collateralization further clutters the royalty payment scheme. Cross collateralization allows the record label to recoup the costs of prior albums based on royalty earnings of current and future albums.

### *C. Royalty Payments*

This brief overview of royalty calculations and recoupable expenses illustrates the difficulties of determining correct royalty payments. While record labels are in no position to excuse underpayment due to the complexity of the system, these business practices, especially the contingencies of royalty reserves and cross collateralization, make accurate payments difficult. That being said, the burden should be on the labels to make accurate royalty payments. When they fail to fully compensate their performing artists, utilization of the artists' auditing right must rectify the underpayment.<sup>8</sup>

### **III. Exploring the Labels' Auditing Policies**

“You don't really get to audit the record companies. It's an illusory thing at best.”<sup>9</sup>

Record labels generally make royalty payments twice a year, that is, once the performing artist is recouped. Most accounting periods become final 2-3 years after the statement was sent to the artist. The artist usually must give 30 days notice before the audit is to begin, of which the label may postpone for up to 2 months. And, the cost involved in auditing a record label could easily exceed \$50,000 - “a legal luxury only top-sellers [could] afford...”<sup>10</sup>

Nonetheless, once the decision to audit is made, the recording contract places numerous limitations on an artist's ability to carry out the audit. The following are examples of limitations placed in the auditing provision:

- ◇ The performing artist cannot hire an auditor on a contingency basis, meaning that the artist must pay the auditor the full costs of the audit regardless of the findings.
- ◇ The performing artist cannot hire an auditor or the auditor's accounting firm if they are currently involved in an audit of the record label.
- ◇ The auditor is limited to inspecting only certain records, excluding manufacturing statements and other records that do not involve actual sales.
- ◇ The audit is limited to the labels' regular places of business during business hours.
- ◇ Audit are limited to once every 12 months.
- ◇ An auditor is precluded from reviewing a statement more than once.
- ◇ If a royalty underpayment is proven, the record label is only liable for the amount owed.
- ◇ And, even if a royalty underpayment is proven, the performing artist is still bound to the contract.

#### **IV. On the Brink of Change: A Comprehensive Explanation**

The California Senate hearings have opened the labels' accounting and auditing practices to legislative and public scrutiny. The inquiry began as a review of the "auditing process and why artists are put into position[s] where they have to audit in order to be properly paid."<sup>11</sup> The auditing process examined in section III illustrated a label friendly system. The inquiry into the auditing process, however, would likely have never been undertaken except for the fact that numerous performing artists were claiming royalty underpayments and making auditing requests. Performing artists and their representatives, including the Recording Artists Coalition, have

argued that the complex and antiquated business practices of the music industry are partially to blame for the claims of underpayment and increase in audit requests.<sup>12</sup>

The royalty calculations and recoupable expenses discussed in section II illustrated the complex system under which the industry operates. Even the record labels admit that accounting disparities are the result of “contractual vagaries.”<sup>13</sup> If the labels cannot compute accurate royalty payments, they should not expect the performing artists to do so. The confusion created by their accounting practices have led to questioning, and inevitably, requests to audit.

And now, as the record labels’ accounting practices and auditing processes come under public scrutiny, threat of legislation is forcing the music industry to reexamine its business policies and practices. The performing artists are gaining momentum in their quest for “complete overhaul.”<sup>14</sup> Industry changes appear inescapable. What the changes are and how they will come about are the only questions that remain.

## **V. Restructuring a “Faulty System”<sup>15</sup>**

Spearheading legislative action in the California Senate, Senator Murray stated that combined changes to auditing practices and the royalty process would be “real reform.”<sup>16</sup>

### *A. Potential Legislative Action*

Although no specific reformations have been presented, Senator Murray and individual performing artists have hinted at particular legislative action. Due to the lack of liability for royalty underpayments, many have called for stiff penalties against record labels found to inaccurately compensate their artists.<sup>17</sup> The penalty system would discourage purposeful or neglectful behavior by the record labels. Not only would the label have to pay the underpaid amount, but it would have to pay the penalty as well. No further details were offered on the application of such a penalty system.

Another proposed legislative action would be to make the practice of paying royalties a fiduciary duty.<sup>18</sup> Hence, the record labels failure to pay accurate royalties would amount to breach of the fiduciary duty. No other details about the application of the duty were offered. Nevertheless, it appears that both remedies would provide similar monetary results.

A third option recommended reform to the record labels' business practices, namely royalty accounting and auditing limitations.<sup>19</sup> Senator Murray suggested that accounting practices should be simplified and restrictions should be removed from the auditing provision. He added, "if all of the labels say they are going to remove all the restrictions on auditing, it doesn't make sense to produce a bill asking for the removal of restrictions."<sup>20</sup> Two major record labels have heeded the California Senator's call to act by recently announcing reforms to their accounting and auditing procedures.

#### *B. Self-Regulated Reforms*<sup>21</sup>

As the first to make changes to its accounting practices, Bertelsmann Music Group [BMG] announced it was reducing its standard recording contract from 100 to 12 pages. BMG also plans to eliminate packaging, new technology, and free goods deductions. And, its royalty percentage will be based on the wholesale price, rather than the estimated SRLP. The reforms are not expected to affect royalty gains, as BMG will seek other artist revenue streams, such as concerts, merchandise, sponsorships, and film deals. Senator Murray, although encouraged by the reforms, noted that "streamlining royalty accounting practices [was] just one necessary change."<sup>22</sup> He was also very concerned with BMG's interest in new revenue streams.

Two weeks after BMG's announcement, Universal Music Group [UMG] hinted at its own business reforms through an internal e-mail sent from senior VP of global affairs Marjorie Fieldman. In addition to doubling its auditing staff, UMG plans to waive key restrictions on the

artists' auditing rights. It will remove the restrictions against contingency fees and simultaneous audits by one auditor. UMG will also allow auditors to review records, including its manufacturing records, outside its regular place of business. These reforms, according to the e-mail, are expected to be available to all artists on the label, regardless of current contractual rights. Finally, UMG will establish workshops intended to educate their artists on the company's accounting practices.

### *C. Proposed Solutions*

The proposed legislative actions, while not fully developed yet, focus solely on the auditing process of the record labels. Whereas, the record labels either proposed reforms to their accounting practices or auditing process, but not both. Senator Murray, who plans to introduce legislation this year, stated that "real reform" will only occur when changes are made to the entire royalty process.<sup>23</sup> Thus, comprehensive reforms are imperative, whether it be through legislative action or industry self-regulation. Such reforms should not be aimed to harm the labels' productivity. Instead, they should attempt to fairly balance the parties' interests.

#### **i. Accounting Practices**

The debate that took place over the past year has clearly labeled the music industry's accounting practices as complex and antiquated. While reforms may not necessarily decrease the complexity of the business, they would modernize accounting practices. More modernized and logical business practices would ultimately simplify the system. BMG's decision to remove outdated deductions and base royalty payments on the wholesale price is a step in the right direction.

BMG, along with other labels, should also consider bringing clarity and fairness to their recoupment practices as well. Recouping recording expenses, while claiming ownership to the

master recordings is, as U.S. Senator Hatch remarked, “the only industry in which, after you pay off the mortgage, the bank still owns the house.”<sup>24</sup> Other recoupable expenses should be made clear and capped for each album produced.

If the labels see the need to make their practices more transparent, the above suggestions only go so far in clarifying the system. To truly reform accounting practices, the record labels should state royalty computations as a monetary amount.<sup>25</sup> Rather than base payments on percentages of percentages, the recording contract should have a provision stating the exact amount of money an artist will make per album sold. Due to the necessity of escalations and royalty reserves, however, some uncertainty in calculating royalty payments may still exist. Nevertheless, those uncertainties would be clear to the performing artist

## **ii. Auditing Procedures**

Regardless of reforms to the accounting practices, some performing artists will still be unsure about the system. Others will have justified concerns over the accuracy of their royalty payments. In either case, retention of the auditing provision is crucial in keeping checks-and-balances on the record labels. If the provision is ridden with restrictions, however, carrying out an audit would be impractical. UMG’s decision to remove many of the concerning restrictions from its auditing provision is also a step in the right direction. Proposed legislative action suggests UMG did not go far enough in making the auditing process a fair procedure.

Even if limitations are removed from artists’ right to audit, the record labels are only liable for the amount of royalty underpayment. The artist must still pay the auditing fee, which could equal or exceed the amount of underpayment. Record labels should bear the burden of accuracy by including a fee shift provision into its auditing procedure. If an audit reveals a royalty underpayment, the record label should be obligated to pay the entire auditing fee, in

addition to the underpayment.<sup>26</sup> Such a policy would encourage accurate payments, and perhaps may produce negligible overpayments. In cases where intentional fraud are proven, performing artists should have the right to terminate their contracts.

## **VI. Conclusion**

As record labels face mounting pressure from performing artists and the California legislature, the solutions offered in this article intend to restructure a “faulty system.” Legislative involvement appears certain, although remarks suggested that industry self-regulation would be encouraged. Any self-regulation by the record labels would have to be sincere and extensive to avoid legislative action. BMG’s interest in other revenue streams should be very concerning. Legislation in California, however, would have a limited policing effect on the record labels as its laws would only apply to business in state. And since record labels do significant business throughout the country, other states would have to pass similar legislation. That is, unless the federal government uses its commerce powers to enact uniform industry practices. In any case, this is just the beginning of inevitable industry reform.

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<sup>1</sup> Tamara Conniff, *Artists' Reps Challenge Industry's Accounting Practices During Seven-Hour Hearing*, LOS ANGELES TIMES, August 3, 2002, at 4.

<sup>2</sup> Phil Hardy, *Record Companies' accounting practices to be probed by joint Senate hearing in California*, MUSIC & COPYRIGHT, August 8, 2002.

<sup>3</sup> See Conniff, *supra* note 1.

<sup>4</sup> Tamara Conniff, *Artists sing protests songs*, THE HOLLYWOOD REPORTER, September 25, 2002.

<sup>5</sup> See generally DONALD PASSMAN, ALL YOU NEED TO KNOW ABOUT THE MUSIC BUSINESS (2000).

<sup>6</sup> *Id.* at 173.

<sup>7</sup> *Id.*

<sup>8</sup> See Conniff, *supra* note 4; Many times the auditing right is used as leverage for settlement or renegotiation.

<sup>9</sup> Jennifer Ordonez, *Pop stars flock to testify as California holds hearings on labels' bookkeeping practices that may cut artists' royalties*, WALL STREET JOURNAL, September 25, 2002 at 55 (Statement by Senator Kevin Murray).

<sup>10</sup> See Conniff, *supra* note 1.

<sup>11</sup> Tamara Conniff, *Hearing set to clear haze over royalties accounting*, THE HOLLYWOOD REPORTER, September 24, 2002 (Statement by Senator Kevin Murray).

<sup>12</sup> See Ordonez, *supra* note 9.

<sup>13</sup> *Id.*

<sup>14</sup> Statement by Gregg Hessinger, director of the American Federation of Television and Radio Artists (AFTRA).

<sup>15</sup> Press Release, Recording Artists Coalition, Artists' Rights Advocacy Group Responds to BMG's Royalty Accounting Proposal (Nov. 21, 2002).

<sup>16</sup> Bill Holland, *Most Labels Mum on Royalty Reform*, Billboard, December 14, 2002.

<sup>17</sup> Chuck Philips, *Music Labels Urged to Revise Royalties*, LOS ANGELES TIMES, December 3, 2002 at pt 3, pg.1.

<sup>18</sup> *Id.*

<sup>19</sup> See Holland, *supra* note 16.

<sup>20</sup> *Id.*

<sup>21</sup> See Press Release, *supra* note 15; Holland, *supra* note 16.

<sup>22</sup> *Id.*

<sup>23</sup> See Holland, *supra* note 16.

<sup>24</sup> Edna Gundersen, *Rights issue rocks the music world*, USA TODAY, September 16, 2002 at 1D (Quoting U.S. Senator Orrin Hatch).

<sup>25</sup> Donald Passman, Speech at the American Bar Association's Forum on the Entertainment and Sports Industries Annual Meeting (Oct. 19, 2001).

<sup>26</sup> The interest groups should develop standards for auditing procedures to ensure uniform and fair audits.