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THE DAY THE MUSIC DIED (IN CALIFORNIA): AN ANALYSIS OF CALIFORNIA ASSEMBLY BILL AB-1385

Abstract: Over the past two decades, digital piracy has wreaked havoc on the music industry, with industry revenues falling over 60% between 1999 and 2009. Despite rising income from streaming services, total revenues (in real dollars) today remain well-below their historic peaks. Adding misery to an already challenging situation, the Covid pandemic has decimated musicians' ability to earn income from live performances. In California, legislation has been proposed which supporters claim will help these struggling recording artists by strengthening their position in negotiations with record labels. Economic analysis suggests otherwise. California Assembly Bill AB-1385 makes contracts between labels and recording artists nearly unenforceable, reducing the incentive for record labels to invest in recording artists—especially for new recording artists and recording artists serving less-popular genres—thus reducing recording artists' income. Statutory limits on the exercise of options likewise reduce recording artists' income. We expect AB-1385, if passed, to lead to a sizable contraction in the music business in California, as both record labels and recording artists are incented move to states where meaningful, voluntary contracts may be crafted and enforced.

I. Introduction

Music may be the universal language, but most recorded music in the United States originates in California, New York, Florida, Georgia, Texas and Tennessee. Most popular music is created under voluntary contracts between record labels and recording artists. In these agreements, recording artists obtain financial, production and marketing support in return for a specified share of the royalties of some specified number of albums. As very few recordings are successful (only 5% of albums sell more than 1,000 copies), the financial risk to the record labels is substantial. While contractual disputes between record labels and high-profile artists sometimes make headlines, for the most part the relationships between record labels and recording artists serve both parties since talent and financial means are often not possessed by the same persons.

In California, legislation has been proposed that could meaningfully alter the ability of record labels and recording artists to craft suitable, voluntary contracts for recorded music (AB-1385). Proponents of the bill claim that the modifications to existing law will strengthen the position of recording artists against the record labels in two ways. First, the bill aims to prohibit the record labels from seeking damages for contractual non-performance (e.g., the failure to produce an agreed-upon number of albums).[1] Second, the bill imposes a statutory limit (six months) on the exercise of options for more recordings by successful recording artists.[2] As we demonstrate here, however, neither provision will improve the position of recording artists. While the bill may provide a windfall to successful *established* recording artists, going forward the effect of AB-1385 will be to reduce the number of new artists supported by the record industry, to reduce the creation of new music, especially in less popular genres, and to lead to a contraction in the music business in California as meaningful contracts may become nearly impossible to craft in the state.

II. The Economics of Recording Contracts

Contracts play as important a role in economic theory as they do in the real economy. As understood by economists, contracts allow the contracting parties to take actions that will benefit both without concern that, once a mutually beneficial but costly action is made by one party, the counterparty will eschew its obligations and capture the benefits for itself. Because benefits can be realized only through joint action, the ability of the parties to write and, if necessary, enforce contracts is essential in most economic relationships. This mutual dependence is evident in the music industry and is illustrated by the nature of contracts between record companies and recording artists. New recording artists typically "sign" with a record company by means of a contract between them that specifies, *inter alia*, the artist's duty to provide one or more sound recordings in exchange for financial, promotional and other support from the record company in exchange for a specified share (royalty) of the proceeds when the music recording is sold to the public. Thousands of such contracts are signed each year. Both the recording artist and the record company undertake obligations under the contracts which, in the extreme, can be enforced through the legal system in the event of a

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[1] Legislative Counsel's Digest to Assembly Bill AB-1385 (February 19, 2021) ("This bill would [] repeal the provisions related to damages.") (available at: https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=202120220AB1385).

[2] *Id*. (AB-1385 "would also prohibit the inclusion of option periods that extend more than 6 months").

breakdown in relations between them. Such events are extremely rare, but that rarity itself reflects the workings of the legal system in delineating and enforcing contracts.

The nature of the business of creating and selling recorded music is reflected in the nature of the contracts observed in this industry. Because of the uniqueness of musical works, the future success of any recording is always subject to some degree of uncertainty, especially in the case of new or lesser-known artists. Further, new recording artists are rarely in the position to self-fund or secure funds to create, record, and distribute their work. Record companies provide the capital required for this process to commence: on signing, a new artist may receive a cash advance, financial support for recording and production of the work, a pledge to promote and advertise the work, and so on. Typically, advances and support to artists by record labels fall in the range of $500,000 to $2,000,000.[3] Thus, the record companies act as "venture capitalists," providing financial resources to "start-up" musicians, in exchange for a share of the proceeds, if any, generated by the creative work. In 2011, for instance, 94% of new albums released sold fewer than 1,000 copies.[4] A small percentage, however, become popular and generate substantial sales revenues. However, neither the recording artist nor the record company knows, and can demonstrate, that any particular record will be a "hit." This fact fundamentally affects the nature of the contracts signed between record companies and many recording artists.

From the economic perspective, the uncertainty surrounding the ultimate commercial success of a recording means that the contract agreed to by recording artist and record label will necessarily determine who bears the risk of failure and the expected return from the arrangement. Because most recording artists are unable to finance their work up front, they rely on financial support from their label through cash advances, production support, and so on. In return, the record label receives an agreed-upon share of the revenues generated by the work.

Most recording contracts also provide for options for the record label, allowing the label to obtain additional recordings from the recording artist at the label's discretion. Negotiation over the option typically leads to better terms for the recording artist. These options also reflect the uncertainty surrounding the commercial prospects for new artists. As the new recording artist becomes better-known, and the label is able to observe important indicators of the artist's potential for success—such as album or streaming sales, tour ticket revenue or any other factor—the record company can elect to exercise the option if the artist seems likely to be

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3 D.A. Wiebe, *How Much Advance Do Record Labels Give, And How Much Should You Try to Get?*, MUSIC INDUSTRY HOW TO (December 29, 2020) (available at: https://www.musicindustryhowto.com/how-much-advance-do-record-labels-give-and-how-much-should-you-try-and-get).

4 *Labels at Work: The Music Business in the Digital Age*, RIAA (September 2015) (available at: https://www.riaa.com/wp-content/uploads/2015/09/LabelsAtWork.pdf).

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profitable. The values of these options depend on the circumstances under which they may be exercised, and when they may be exercised. Thus, the legal rules governing the use of options will materially affect the value of the recording contract to the record label and, therefore, its willingness to sign the artist.

What, though, keeps the recording artist, if her early efforts bear fruit, from walking away from her contract to obtain larger shares of revenues for herself? Here the law of contract becomes determinative: having freely entered into the contract (presumably with the advice of legal counsel) and, having accepted its terms, the recording artist can expect to be required to fulfill her obligations, if necessary, through the legal process. In this way, the investments of the record label can be recovered and the investments justified. The record company must be able to participate in the revenues generated by successful acts if it is to fund new and unproven recording artists.

Record labels act as providers of capital, like banks, for recording artists, and they often compete to represent established and promising new artists. The financial and professional services offered by the record labels to artists are often vital to the success of artists. The rules governing contracts between record companies and recording artists, both parties represented by experienced attorneys and managers, can profoundly affect the expected returns of the record label which, in turn, will affect the level of label investment in recording artist careers and the creation of new musical works. By altering the rules for music contracts, one will necessarily alter the numbers and types of artists who are able to obtain recording contracts, thus affecting the creation of new music.

III. AB-1385 and Recording Contracts

The proposed changes in California's laws governing recording contracts contained in AB-1385 will alter the nature of recording contracts governed by California law in several ways. This, in turn, will affect the financial value of contracts to record studios and recording artists, and will change the number of such contracts signed and the variety of new music offered to the public. Economic theory can and should be used to analyze these changes in the legal framework.

The proposed law, AB-1385, now being considered by the California assembly, appears to make two profound changes in the rules governing recording contracts.[5] First, AB-1385 appears

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[5] The qualifier "appears" seems prudent here since it seems inevitable that AB-1385 will trigger a substantial amount of litigation. First, the effect of AB-1385 on existing recording contracts is unclear; the courts must sort out this lack of clarity. Second, the practical effects of AB-1385 will be determined by the application of the law by the courts, and by the likely responses to the law by record companies and artist. For example, one might expect some

(Footnote Continued….)

to provide for breach of contract by recording artists by statute. Recording artists not wishing to fulfill their obligations to produce sound recordings as specified in their recording contracts (say, four albums) could apparently decline to do so without the usual penalties for breach. This provision, if upheld and implemented completely, would largely render recording contracts useless. It seems unlikely the courts will interpret AB-1385 in such an extreme fashion, even if such extremes are intended by the statute. Certainly, it is safe to say that one purpose of AB-1385 is to make claims by record companies for undelivered music much more difficult.

Second, AB-1385 places an external time limit, not subject to negotiation by the parties, on the exercise of options for further recordings. In particular, the proposed legislation limits the time available for the record label to exercise an option to six months since the delivery of the last contracted recording. The ostensible purpose of this strange rule is to force the record company to decide on option exercise "quickly"—i.e., before it can receive additional market intelligence regarding the commercial potential of the recording artist. In general, the passage of time and events provides a growing body of information regarding the commercial prospects of the recording artist's work. By establishing an arbitrary, non-negotiated and non-negotiable deadline, AB-1385 will require that the record company make decisions before it would wish to, thus lowering the financial value of the contract.

While the ultimate implementation of the AB-1385 contract restrictions is, like the commercial viability of a new recording artist, currently unknown, it is fair to characterize the intent of AB-1385 as a reduction in the returns to record labels from recording contracts, this being accomplished by an allowance for statutory breach by artists, and by reducing the benefits of options, which would have to be exercised in greater ignorance of market reception than currently.

In the next section, we will review the basic economics of these restrictions in a simple model of a recording contracting process. That review will necessarily be somewhat technical. However, the basic insight of our analysis is neither technical, nor difficult to state. Contracts in the recording industry allow for a potentially profitable transaction between recording artist and record label. Such agreements will occur only when they benefit both parties, since the partnership is *voluntary*. The willingness of either party to enter into the agreement depends on the expected benefit they receive from doing so and, if that benefit is positive, the benefit they receive from their best alternative outside of the contract. AB-1385 will uniformly reduce the benefits record labels receive from recording contracts. These reduced benefits to the labels are

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recording business to flee the jurisdiction of California courts, and the way options are written into recording contracts will probably change, becoming much more complex.

not transferred to recording artists as increased benefits—this is not a zero-sum game. Instead, record labels will ink fewer contracts with recording artists, pay smaller advances on the contracts that are signed, and partner more frequently with artists who show a higher degree of economic promise than is currently the case. AB-1385 will not improve the position of recording artists relative to record labels; to the contrary, AB-1385 will result in fewer contracts, less music by new artists, a reduction in new music in smaller genres, and reduced economic activity in the California music business.

One may ask: if AB-1385 is so potentially damaging, then why is it being proposed and who could benefit from its provisions? The politics of the bill are beyond the scope of our analysis, but one regularly observes laws and regulations that are socially destructive. This phenomenon, well-known to economists, ordinarily arises because of the distributions of benefits and costs of a regulation, both across groups and across time. To understand this phenomenon, imagine a proposal in California to make it illegal for banks to sue homeowners for default on their mortgages. There are probably quite a few current homeowners who might welcome the opportunity to escape from their mortgage obligation through statute. And, there are many more people with mortgages than there are bankers, so such a law may be popular. The immediate effect of abolishing the legal obligation to pay a mortgage in California would be a transfer of wealth from banks (and their investors) to homeowners. What, though, is the likely effect of this law going forward? It is easy to see that such a change in the contract law governing mortgages would profoundly reduce the profitability of mortgages to lenders, who would then stop providing them. It would become impossible for any family needing a mortgage in California to obtain one. Thus, current homeowners would receive a windfall from lenders, but those hoping to own a home in the future, including many of those receiving the windfall, would become unable to do so unless they could pay for a home up-front.

Although the example given above is extreme, it largely captures the sorts of effects economists would expect from AB-1385. The bill might benefit some recording artists currently under contract, at least if they were commercially successful enough, but going forward one would expect fewer new artists, less new music, less music in smaller genres, and a contraction in the music business in California. We turn now to an economic analysis that explains these conclusions.

IV. An Economic Model of AB-1385

Economic models seek to focus attention on the basic mechanisms of interest, and this is done by simplifying the environment being studied. To that end we will make the following assumptions. First, we will analyze the interaction of a single record label and a recording artist the label might wish to sign. The label and recording artist will act over two periods. In the first period, neither the label nor the artist knows if the artist will be commercially successful or not. The probability that the recording artist is successful is observed by both parties, and we denote it Q, where $0 < Q < 1$. A successful recording artist will make commercially successful albums. Such an album has a market value of v. If the recording artist is not successful, then the resulting album(s) will have value 0 for simplicity. It costs c, where $v > c > 0$, to make and market an album. At the beginning of their first period interaction, neither the record label nor the recording artist knows if the artist will be successful, but both assign the probability Q to that outcome.

The recording artist and the record company negotiate at the beginning of the first period over an exclusive contract that specifies a price to be paid for an album and an option for the record company to exercise regarding the production, marketing, and sales of a second album in the second period. We will assume there is Nash bargaining regarding the price to be paid for an album each period. Prior to bargaining at the start of the first period, the probability the recording artist is commercially successful is Q and we will initially assume that bargaining during the second period will take place after sufficient signals from the first album have revealed with certainty the success of the artist. (We will examine the impact of changing this assumption below; AB-1385's requirement that options be exercised within six months of prior delivery may be thought of as requiring that the record company decide on exercising its option prior to learning whether the recording artist will be successful.)

One peculiarity of the actual practice of recording contracting is relevant for our modeling of the second stage of interaction when the recording artist has been revealed to be successful or not. It is common practice in the music industry to renegotiate contract terms with recording artists who show strong market performances. This renegotiation benefits the artist by providing better terms. In contrast, recording artists who do not sell well and are revealed to be commercially unsuccessful are not optioned for further albums, and usually the parties dissolve the contract, allowing the artist to seek another record company.

If it is revealed that the recording artist is not a commercial success, then the record company will not exercise the option for a second album. Presuming the artist is, in fact, revealed as commercially successful, then the option will be exercised and Nash bargaining over the price will occur. If there is disagreement and the recording artist walks away from the table and sells a second album to the market instead for a price denoted by $m \leq v - c$, then under the current laws the record company can pursue an expected legal recovery from the artist denoted by r. Hence, the disagreement utility of the record company in the second period is r, and the commercially successful recording artist's disagreement utility is $(m - r)$. The price the recording artist receives for the second album will maximize the following Nash product:

$$\max_{P_2}\left[\left(v-c-P_2-r\right)\left(P_2-(m-r)\right)\right]$$

The first-order condition for this optimization problem is:

$$\left(v-c-P_2-r\right)-\left(P_2-(m-r)\right)=0$$

Hence, the outcome of the Nash bargaining is the second album price:

$$P_2^* = \tfrac{1}{2}\left(v - c + m\right) - r$$

The expression above illustrates the economic effect of the provision of current California law that allows the record company to pursue damages for breach by the recording artist. The expectation of a recovery (r) in the case of a breach by the artist creates some bargaining leverage for the record company and this is reflected by the negotiated price being a decreasing function of the expected magnitude of the recovery. If the recording artist turns out to be commercially successful, then the payoff during the second period for the record company is $\tfrac{1}{2}\left(v - c - m\right) + r$, an increasing function of the expected recovery. Combining this with the expected payoff during the first period, the record company's expected total payoff is $\left\{Q(2(v-c) - P_2^*) - (1-Q)c - P_1\right\}$. The price for the first album will maximize the following Nash product:

$$\max_{P_1}\left\{\left[Q(2(v-c) - P_2^*) - (1-Q)c - P_1\right]\left[P_1 + QP_2^*\right]\right\}.$$

The first-order condition for this maximization problem yields the first-album price:

$$P_1^* = Q\left(\tfrac{1}{2}(v - m) + r\right) - \tfrac{1}{2}c\ .$$

The price paid for the initial album is increasing in the expected recovery given recording artist breach during the second period. Hence, the expected recovery shifts compensation to the recording artist up front. Likewise, the expected recovery allows the initial price to be positive for lower levels of Q, thus allowing more new recording artists to be given an opportunity. P_1^* is positive if and only if:

$$Q > \frac{c}{v - m + 2r}\ .$$

Although this analysis is relatively formal, it is a straightforward application of the most widely-used economic model of bargaining between agents. We assume both the record company and the recording artist (or, more likely, the recording artist's lawyer) are rational, forward-looking and self-interested. They reach contract terms that are most advantageous to themselves given the nature of their mutual dependence. Thus, what this analysis suggests can be said to reflect the most basic effects of the rules regarding breach in the applicable contract environment. So, what does this mean regarding AB-1385?

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First, the advance given to the recording artist for the first album is greater when the contracting rules allow greater recovery r for the artist's breach. In other words, the recording artist receives greater up-front money when breach is more severely sanctioned. This might seem paradoxical to many people, but it is actually quite sensible: the record company signs contracts hoping for a successful act, and only successful acts have any incentive to breach their contracts (a record label will not pursue breach of unsuccessful recording artists). By providing a form of insurance against breach through damages, the record label becomes willing to pay more for the first, unproven album.

Second, the analysis shows how the AB-1385 rules changes will suppress music, particularly with less conventional recording artists, or recording artists in genres such as Jazz, Classical, Folk, and so on. Recall that Q is the probability of a commercially successful recording artist. How big does Q need to be to induce the record label to sign the artist with a positive payment for the first album? We obtained the inequality $Q > c/(v - m + 2r)$, which indicates the role breach recovery plays in the willingness of the record label to sign a new act. As r decreases (breach becomes more difficult to prosecute), the label becomes willing to finance new recording artists only at increasingly high levels of Q. This means that more experimental or unusual acts, who are less likely to be commercially viable, will lose any chance to obtain a contract.

Third, and as an immediate implication of the prior point, reductions in the ability to recover damages for breach will result in less music being recorded. Only acts with the highest probabilities of commercial success will be signed.

We have seen above that, from the economic perspective, the change in the rules for breach in recording contracts proposed in AB-1385 should be expected to reduce returns to record companies, reduce advances to recording artists, and reduce the creation of new musical works. However, AB-1385 also intends to change the rules governing options in recording contracts. As described in the previous section, AB-1385 places a very tight limit on the time available to a record label considering exercising an option for additional recordings. When a record company exercises an option, it is expressing its belief that the recording artist's work is likely enough to be successful that further substantial investment is justified. The label's assessment of the recording artist's potential for success will consider all available data regarding the artist's market performance to date. As time passes, the record label receives further information, and updates its assessment accordingly. Thus, the accuracy and reliability of the label's forecast of the recording artist's potential sales increase over time.

Because the record company becomes better informed on recording artist potential over time, AB-1385's six-month limit on the exercise of options will reduce the information available to the record company in making its option decision. This in turn implies that there is a greater likelihood of making a mistake and optioning an unsuccessful record, or alternately failing to option a record that would prove successful. The economic consequences of the option restriction in AB-1385 can be analyzed using the economic model we applied to the issue of statutory breach. To simplify, we ask the question: how would recording contracts change if additional recordings had to be optioned prior to improvement in the information available to the record label? Thus, suppose we add a new legal restriction on recording contracts that forces an early exercise of options before the revelation of information regarding the recording artist's commercial success. In this case there remains a probability that a second album would be invested in even if it were not commercially successful. The price the recording artist receives for the second album would maximize the following adjusted Nash product which reflects this possibility:

$$\max_{P_2}\left[(Qv-c-P_2-Qr)(P_2-Q(m-r)\right].$$

The new outcome of the Nash bargaining for the second album price is given by:

$$\hat{P}_2^* = Q\left(\tfrac{1}{2}(v-c+m)-r\right)-(1-Q)\tfrac{1}{2}c = QP_2^* - (1-Q)\tfrac{1}{2}c\,.$$

The negotiated price for the second album, $\hat{P}_2^*$, under the six-month rule is clearly lower than the price that would be negotiated when allowing time for the revelation of information, P_2^*. This is as unsurprising as it is unfortunate. In effect, the option time limit in AB-1385 forces the contracting parties to make decisions in the absence of useful information about potential outcomes. This inefficient constraint harms artists by reducing the willingness of record labels to pay for optioned recordings.

V. Effects of AB-1385 on California's Economy

Common sense dictates that record labels will not invest large sums of money and other resources into recording artists when the contracts between them are unenforceable. As such, AB-1385 threatens to the viability of the music industry in California—a state that accounts for nearly one-quarter of the U.S. music industry and contributes $39.5 billion to California's Gross Domestic Product (or 1.5% of total GDP).[6] The harm to California's economy from AB-1385 arises from several sources.

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[6] R. Stoner & J. Dutra, *The U.S. Music Industries: Jobs & Benefits*, Prepared for the Recording Industry Association of America ("RIAA") (December 2020) (available at: https://www.riaa.com/wp-content/uploads/2021/02/The-U.S.-Music-Industries-Jobs-Benefits-2020-Report.pdf); S.E. Siwek, *The U.S. Music Industries: Jobs & Benefits*, Prepared for the Recording Industry Association of America ("RIAA") (April 2018) (available at: http://www.riaa.com/wp-content/uploads/2018/04/US-Music-Industries-Jobs-Benefits-Siwek-Economists-Inc-April-2018-1-2.pdf).

First, both the number of and dollar values of any agreements signed between record labels and recording artists will be smaller. This reduction in investment in recording artists will flow through to the industries that support music production such as recording studios, marketing services, and so forth. New recording artists and artists in less popular genres will find it difficult to obtain any support from the record labels. Second, the record labels will migrate contracting to other states with more sensible contract laws. Artists, especially the new recording artists and artists in less popular genres that are disproportionately harmed by AB-1385, will be drawn to these other states since record labels can make better offers in rival jurisdictions where contracts are enforceable. AB-1385 will be a boon to states like New York, Tennessee, Georgia and Texas.

How much will California's music economy shrink if AB-1385 is signed into law? It is difficult to predict and it will depend on how courts interpret the law. If the courts embrace the apparent intent of AB-1385, then we expect a sizable contraction in California's music recording industry. Record labels have alternatives to contracting in California, so we expect contracting to migrate to other states. The labels will be incented to make better offers to recording artists in other jurisdictions, so recording artists likewise are inclined to migrate. It is both the labels' and recording artists' interest to take business to other states. As contracting moves to other jurisdictions, it is reasonable to expect that many of the supporting industries and their employees will also migrate.

To get at least a rough sense of the potential impacts of AB-1385, note that record labels invest about $600 million annually in Artists & Repertoire ("A&R") and marketing expenses in California (about one-tenth of global A&R spending). This investment supports thousands of jobs and provides over $1 billion dollars in economic activity.[7] If, say, one-third of the investment in California is reduced or shifted to other states, then California loses $200 million in direct investment in recording artists and about $400 million in economic transactions. If investment in recording artists is reduced by half, then the loss to the state is $300 million in direct investment in recording artists and $600 million in economic transactions. The financial risk of AB-1385 to California's music industry, and its economy, are sizable.

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[7] Siwek, *id.*, (California output multiplier of 2.0); *The Value of a Label*, IFPI GLOBAL MUSIC REPORT (2019) (available at: https://powering-the-music-ecosystem.ifpi.org/download/GMR_The_Value_of_a_Label.pdf) (Global A&R and marketing investment is $5.8 billion. The U.S. account for about one-third of global sales and California about one-third of the domestic music industry); D. Rys, *US Recorded Music Revenue Reaches $11.1 Billion in 2019, 79% From Streaming: RIAA*, BILLBOARD (February 25, 2020) (available at: https://www.billboard.com/articles/business/8551881/riaa-music-industry-2019-revenue-streaming-vinyl-digital-physical); J. Aswad, *Global Recorded-Music Revenues Topped $20 Billion in 2019, but Streaming Growth Is Slowing*, VARIETY (May 4, 2020) (available at: https://variety.com/2020/music/news/global-music-revenues-20-billion-streaming-slowing-1234596953).

VI. Conclusion

In recent years, the music industry has made a comeback after decades of declining revenues from digital piracy. Streaming services have returned the industry to revenue growth, though the profits from streaming services for both record labels and recording artists are below those received in the now distant past of physical media. The industry continues to face challenges including the Covid pandemic that hit the industry, especially performing artists, particularly hard. Coming to the aid of struggling musicians may be a suitable task, but AB-1385 is counterproductive in this regard. Basic economic logic implies that while some successful recording artists may receive a windfall from the proposed changes in California law, the long-term consequences for recording artists are dire. Under the proposed law, record labels are expected to reduce, perhaps substantially, the support of recording artists, especially new artists and artists serving smaller genres. Also, since the limits on contracts proposed in AB-1385 may be avoided in other states, the music business may migrate to other music hubs like New York and Tennessee, or other states where voluntary and enforceable contracts may be written.

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