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The Economics of California's Proposed Bill AB 1385 (the Free Artists from Industry Restrictions Act)

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About the Author

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Executive Summary

California's proposed bill AB 1385 is meant to change the rules of engagement between recording artists and record labels by amending existing law that governs that relationship. If enacted, the proposed legislation would mean that if the number of agreed-upon albums were not delivered by the end of seven years, artists could simply walk away and leave the record label without the value for which it contracted. In addition, it would force record labels to make option decisions on an expedited time frame – within six months of the *delivery* of a contracted album, whereas standard terms currently are keyed off the *release* of an album, and often with longer windows. In this note, I discuss the law itself and the changes it would make, summarize the existing relationship and engagement between artists and labels, and begin to analyze the effects that the proposed legislation might have, by focusing on how the legislation would be likely to change the economic incentives artists and labels face.

I demonstrate that the effects of the proposed change and the upheaval it would cause (including harms to recording artists) should clearly be expected, even if the extent and scope of these changes are less certain and would require significant study and research to model and predict with more precision. Most directly, enacting AB 1385 into law should be expected to weaken record labels' economic incentives to invest in artists (both recording artists already under contract and new artists) and to reduce the information available to record labels and artists as contractual decisions need to be made, leading to changes which would leave many artists worse off as well.

In summary, the economics of how the proposed legislation is likely to affect the relationship between recording artists and record labels are clear, and they raise significant and important questions that should be carefully considered and analyzed before any changes are enacted into law.

Introduction

The music industry has long been a significant part of California's economy and culture, and thus, it is not surprising that it is, at times, at the center of legislative issues.[1] On February 19, 2021, California State Assemblywoman Lorena Gonzalez introduced bill AB 1385 – the Free Artists from Industry Restrictions (FAIR) Act.[2] The proposed legislation is meant to change the rules of engagement between recording artists and record labels by amending existing law that governs that relationship. In this note, I discuss the law itself and the changes it would make, summarize the existing relationship and engagement between artists and labels, and begin to analyze the effects that the proposed legislation might have, by focusing on how the legislation would be likely to change the economic incentives artists and labels face.

As I describe below, the economics of how the proposed legislation is likely to affect the relationship between recording artists and record labels are clear, and they raise significant and important questions that should be carefully considered and analyzed before enacting any changes into law.

California Assembly Bill No. 1385

California's restriction on the length of personal service contracts dates back to the 19th century, and currently there is a general prohibition on the enforcement of personal service contracts that last for longer than seven years.[3] This was historically an issue for contracts between record labels and recording artists, which have typically been structured not based on a length of time, but instead on a certain number of albums; even if the parties expected a five-album contract to last seven years, all five albums may not have been completed within seven years. This meant that the restriction on contract length could often come into conflict with the ability to produce the agreed upon number of records.

The issue of fitting the square peg of album-based recording contracts into the round hole of time-based contracting restrictions was at least partially addressed in 1987 with the passage of a revision to Section 2855 of California's Labor Code.[4] Under these changes, if the number of albums agreed

[1] According to the "50 States of Music," a database maintained by a number of parties, including the RIAA and SAG-AFTRA (the latter a proponent of the proposed legislation), the music industry accounts for nearly $40 billion of economic activity each year in California, and supports over 430,000 jobs and over 70,000 establishments in the state. See https://50statesofmusic.com/state/california/, accessed April 19, 2021.

[2] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB1385, accessed April 19, 2021.

[3] Gregg B. Ramer, Personal Service With A Smile: A History Of California's "Seven-Year" Rule, available at https://www.mondaq.com/unitedstates/employee-rights-labour-relations/279512/personal-service-with-a-smile-a-history-of-california39s-seven-year-rule, accessed April 19, 2021.

[4] Gregg B. Ramer, Personal Service With A Smile: A History Of California's "Seven-Year" Rule, available at https://www.mondaq.com/unitedstates/employee-rights-labour-relations/279512/personal-service-with-a-smile-a-history-of-california39s-seven-year-rule, accessed April 19, 2021.

upon in the contract were not delivered by the end of the term of the contract (limited to seven years), the record company would have the right to recover damages for any unproduced albums. This has been the guiding law under which record labels and recording artists have worked for the past 34 years, and, even as the industry has undergone numerous and seismic changes over that time, it has held. While the labels earned the right to recover damages for unproduced albums, this is a relatively rare occurrence. Instead, it is much more common that deals are either renegotiated or terminated – standard recording contracts are not for a fixed seven-year term, but rather have shorter terms (related to album production) with options that can be exercised (along with the payment of an artist advance to cover the costs of delivery for the optioned album, as well as to provide income to the artist) to extend the contract for a longer period based on the evolving circumstances and relationships between the artist and the label.

The proposed legislation seeks to upend the rules under which both sides have engaged for the past 34 years. As described in the bill itself:

> This bill would … repeal the provisions related to damages. The bill would instead authorize a music talent, as defined, to terminate, at any time, their personal services agreement … if an option has not been exercised within 6 months of the earlier of the satisfaction of the delivery obligation … by the musical talent or the initial commercial release of the applicable music product, and would also prohibit the inclusion of option periods that extend more than 6 months after the earlier of the satisfaction of the delivery obligation … by the musical talent or the initial commercial release of the applicable music product.[5]

That is, if enacted the proposed legislation would mean that if the number of agreed-upon albums were not delivered by the end of seven years, recording artists could simply walk away and leave the record label without the value for which it contracted. While I have noted that this provision is rarely invoked, as I will discuss below, its existence helps to define the relationship between recording artists and record labels. Second, the proposed legislation would force record labels to make option decisions on an expedited time frame – within six months of the *delivery* of a contracted album, whereas standard terms currently are keyed off the *release* of an album, and often with longer windows.[6]

Given the bilateral relationship between recording artists and record labels, these changes are likely (and, indeed, are intended) to swing the balance of the relationship away from the record labels. However, the relationship between artists and labels is more complicated than just the number of albums and financial terms disclosed in a recording contract, and for that reason,

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[5] https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202120220AB1385, accessed April 19, 2021.

[6] This shifting is, as I will describe in more detail below, potentially extremely important, given the importance of the information that becomes available upon the release of an album that would not be known upon the delivery of an album to the label.

changes to the regulations that govern these contracts are likely to disrupt the relationship more broadly.

The Relationship between Recording Artists and Record Labels

Upon signing with a record label, typical recording contracts allow for an advance to be paid to the recording artist to cover the costs of delivering the first album, as well as to provide income to the artist. This payment is referred to as an advance, because it is an upfront payment made on the royalties that would be due from the commercialization of the yet-unproduced album. While advances are not typically repayable if future royalties do not cover the advance, recording artists will not earn additional royalties from the album's commercialization until after the advance is repaid from the artist's earned royalties on the album.

The label will then typically work with the recording artist – in various ways – to help develop the artist, produce the album, and then to market and commercialize it. In this context, the role of A&R (Artist and Repertoire) staff at label is wide and varied. As noted by Professor Larry S. Miller of NYU, "the expertise of the A&R team is in bringing that initial promise to the next level" and A&R teams "coordinate with the artist and the marketing team on the nuts and bolts of the overall campaign — album name, art, photos, videos, biographical material, and more. A great song is the sum of all of these parts and all these creative collaborators, now as ever shepherded through the development process by talented A&R leaders. The magic happens in the writing sessions and the recording studio. And after that, it's really time for the label to make sure the magic gets noticed."[7]

And in recent years, as the recording industry has moved further and further away from sales of physical products, first to sales of digital products and then to a streaming and subscription model, this relationship has changed and deepened:

> …before streaming, music was a transactional business, where the peak of a label's promotional effort was aimed at an album's release — when it was monetized once, at the first point of sale. Now, with incremental income on every listen of a stream, "Music has become a consumption business where there is no peak but only a hill, with sales plateaus arriving faster and extending further," according to Jim Roppo, Executive Vice President and General Manager at Republic Records. For this reason, labels have instituted a continuous flow of product to drive fan engagement, rather than an every-other-year album cycle.[8]

[7] Larry S. Miller, *Same Heart, New Beat: How Record Labels Amplify Talent in the Modern Music Marketplace*, available at http://musonomics.org/modernlabelreport.

[8] Larry S. Miller, *Same Heart, New Beat: How Record Labels Amplify Talent in the Modern Music Marketplace*, available at http://musonomics.org/modernlabelreport.

This change means that the label is no longer primarily focused on releasing a physical album and marketing it along with a few singles over a limited window. Instead, tracks and releases are set up over a longer period by the label; in recent years, the amount of time that hit songs remain on the Billboard 100 has greatly expanded (as of this writing, The Weeknd's *Blinding Lights* is on its 72nd week on the Hot 100).[9] Among the newer ways that this is done is through a focus on playlists, which are foundational for the way that digital streaming services work, providing a personalized "lean back" approach to the user.

In addition, the relationship between record labels and recording artists today is often expanded in scope compared to even the relatively recent past, as the move to digital streaming services has provided access to more data, more possible touchpoints to customers, and new market opportunities. Again, as put by Professor Miller of NYU: "at the core, labels today are guided by the same fundamental drive to propel artists forward as they were years ago. The digital landscape has changed how they do so, leading to significant internal changes that enable them to leverage the new market opportunities."[10] These changes include involvement and collaboration on many other aspects of an artist's career than just producing and releasing albums and singles. Record labels are in the business of developing, supporting, and marketing artists across all platforms and on a global basis. This includes touring, which, although negatively impacted in 2020 by Covid-19, will continue to be an important source of exposure, growth, and revenue to artists, and is often supported by labels (for example, by helping to finance the tour) as part of modern record deals.

While not all of the aspects of a label's investment in, and coordination with, recording artists can be captured in simple statistics, that relationship has never been deeper. Even as proponents of the proposed legislation have referenced "an unprecedented bonanza" in recent years for the record labels,[11] investments in and payments to recording artists have been similarly booming. Indeed, Professor Miller has noted that deals are being made in greater numbers, for more money, and with a greater level of customization to match artists' needs than ever before.[12]

[9] https://www.billboard.com/charts/hot-100/2021-05-01, accessed April 30, 2021.

[10] Larry S. Miller, *Same Heart, New Beat: How Record Labels Amplify Talent in the Modern Music Marketplace*, available at http://musonomics.org/modernlabelreport.

[11] Elias Light, *Musicians, Irving Azoff Push for Labor Law Overhaul in California*, March 19, 2021, available at https://www.rollingstone.com/pro/news/fair-act-contract-limits-1141981/, accessed April 19, 2021.

[12] Larry S. Miller, *Same Heart, New Beat: How Record Labels Amplify Talent in the Modern Music Marketplace*, available at http://musonomics.org/modernlabelreport.

The Economic Incentives of Recording Artists and Record Labels: Questions Raised by AB 1385

With this context, I will now address how these two areas – the proposed legislation and the expanded relationship between recording artists and record labels – intersect and how that may affect the economic incentives involved. It is helpful to consider the timeline of the relationship first. Any relationship between an artist and a label will begin at the time the artist signs a recording contract with a label. At that time, the artist may have a single label offer or may have the option to sign with multiple different labels; of course, in today's world, it has become more accessible to go a do-it-yourself route as well, an option that all artists retain. While the particulars of the recording contract will vary based on a number of factors, including the options available to the artist, as I have noted above, agreeing to a recording contract will typically include agreements on, at least, (a) advances and budgets (or ranges) for the first album and any subsequent albums covered by the contract, (b) options, typically at the label's discretion and typically windowed for execution in a specified time frame keyed to the *release* of the album, and (c) the scope of the relationship, including several of the newer areas, such as tour assistance, merchandising, and many other lines of business that have recently become more common.

Thereafter, the work on the first album will begin and the relationship discussed in the prior section will begin and grow throughout, including involvement and assistance in, for example, developing the album, promotion, branding, touring, media exposure, and more. Upon the commercial launch of the first album, as described above, much of this work continues and the label typically will enter into the option period (currently, typically longer than six months from album *release*, not *delivery*) in which it will decide whether or not to exercise the option. If the option is not exercised, then the relationship ends and the recording artist is free – typically before the seven-year period ends – to turn elsewhere, whether DIY or with other record labels. If the option is exercised, then the cycle begins again with the next album under contract, typically with different financial terms. Following the commercial launch of the second album, another option window will typically be triggered. This process would – in theory - continue until an option is not exercised, the seven years expire, and the artist asks out or all albums are completed.

If options continue to be exercised in a deal, this would generally mean that the relationship has been a success and a new deal is often negotiated. While there are a few infamous examples of disputes about the end of a contract (including Hole and 30 Seconds to Mars), the need to invoke the damages provision of current law is extremely rare. Instead, recording artists and record labels commonly walk away prior to the end of the seven-year window or renegotiate a new deal. And if the term ends without a new deal, and the artist wishes to move on from the record company, the lack of litigation on damages indicates that the two sides have typically been able to amicably resolve any dispute about the value of unproduced albums.

So if the actual exercise of the right to damages is so rare, how does its existence impact the incentives of recording artists and record labels, and what impact might its removal have? It is important to recognize that there is significant uncertainty about the outcome of a recording contract. Many signed artists do not become commercially successful, and the investments (financial and otherwise) made by the labels into the recording process and the artist do not yield a profit. Moreover, the downside of this uncertainty is borne by the record company; as noted above, the advance paid to the artist at the start of album production is non-refundable. Even if a produced album earns no revenues, the artist is on the hook for none of the associated loss. Instead, the label has borne all the production (and other) costs itself without recoupment. This is the nature of the business for record labels.

Because record labels bear the potential loss of the investment, the economics of such investments can only make sense with significant upside potential as well. That is, record labels must be afforded a meaningful and protected share of the upside in order to be willing to take on the initial investment. Some of that upside is captured in the nature of the recovered royalty payments to recording artists – as royalties are earned by the artist, they are first used to pay off the royalty advance and other production costs from the making of an album. But other terms of the recording contract help to protect that upside as well, such as the right to exercise the options within the options window stated in the contract, and the right to collect damages at the end of a seven-year contract for any contracted, but unproduced albums. Why is this so? What does economic theory say about the risks of removing these protections for the record label?

First, the right to exercise the option during a time period starting after the album has been *released* means that the record company is able to make that decision with feedback from radio stations (terrestrial and satellite), data on plays, skips and other information from streaming services, sales data for physical and digital media, social media exposure as well as every other area in which the record label is working with the recording artist. This information is vital; the insights gained can be critical to making a good decision about the option and for the future of a developing artist. There is no doubt that reducing uncertainty helps make this decision-making process more accurate; imagine deciding whether or not a coin being flipped is biased in favor of heads. If you were given only a few flips to decide, it would be very difficult to identify a coin biased for heads as even an unbiased coin will have a similar number of heads oftentimes. But if you were given 100 flips (or a thousand flips), you would be significantly more likely to see more heads from a biased coin than from a fair coin. That extra information reduces, even if it does not eliminate, the uncertainty that clouds the decision-making process.

Thus, were the option window changed to be within six months of *delivery* of a completed album, the option clock would begin ticking before a great deal of this information would be available. As current windows typically last significantly longer than six months from album *delivery*, this change would lead record labels to have less post-launch information (or potentially none), and thus be forced to make more uncertain and less accurate decisions on options. All else equal, this further suggests that – given the costliness of mistakes – labels would be more likely to decline options, leading to more recording artists being dropped from their recording contracts.[13]

Second, the right to collect damages from unproduced albums protects the record labels on the back end. While the damages provision does not limit any recording artist's ability to switch labels after seven years, it does create an economic incentive to deliver what was agreed under the original contract. And this would likely only be the case for the rare, very successful acts. These are precisely the acts for which it is most imperative – for the labels and for other artists – that the record labels can earn a significant return on their investments. Because only a relatively small share of albums are able to turn a profit, labels are losing money on most albums. If the most successful recording artists of all were able to delay the production of albums past the seven-year window, in order to then walk away from the investments (financial and otherwise) made by the labels, that would serve to diminish the return earned by the record labels on the rare cases in which the investments most paid off. And those artists – the most successful ones – are precisely the artists that would be most able to turn to other alternatives beyond recording new music, due to popularity and/or financial wherewithal, in order to run the clock out on a recording contract.

Again, the economics of this are straightforward; if the profits earned on the rare and biggest successes are reduced, then the upside to one's investments have been similarly reduced and, all else equal, rational actors will choose to invest less.

The economics of both of these points may feed off each other; with more uncertainty about the likelihood of success available at the time a decision on an option is to be made and with less guarantee of the ability to capture any upside even if the option is exercised, the disincentive for investment is likely even further compounded.

There are open questions about the effects this would have on recording artists as well. If a reduction in investment in artists does result from the proposed legislation, there are likely to be more artists unsigned, both never signed artists and artists that have had their options declined. That is, all else equal, there is likely to be an increase in the supply of recording artists looking for record labels to work with at the same time there is likely to be a decrease in demand from labels to sign and invest in artists. While the entirety of the effects of a reduction in demand and an increase in supply is not always clear, the economics of one thing are clear – the contracts signed by the recording artists that do sign are likely to involve a lower "price" paid to them. Whether that takes the form of lower advances, a lower investment in album development, a reduced investment in marketing and branding, or some other form, a combination of more artists seeking

[13] It is also possible that the nature of contracts might change to adapt to this regulation. Rather than contract for one album at a time, and then an option, record labels may rationally choose to begin contracting to lock in two albums before exercising the option. As I discuss below, under the proposed legislation, labels will have incentive to invest less overall, so a change like this might be made alongside a commitment of smaller advances and less resources committed to album production, marketing, and the like. It is not clear that any party would prefer this to the status quo.

labels and a reduction in labels seeking artists is likely to be worse for recording artists looking to be signed as well as for the record labels.

There is a clear parallel here to the general question of protecting returns on investment. There are real similarities to the grant of patents. One seminal paper on the economics of the patenting process put it thus:

> Patents are applied for at an early stage in the inventive process, a stage in which there is still substantial uncertainty concerning both the returns that will be earned from holding the patents, and the returns that will accrue to the patented ideas. Gradually the patentors uncover the true value of their patents. Most turn out to be of little value, but the rare 'winner' justifies the investments that were made in developing them.[14]

This is precisely the pattern seen in the investments made by record labels with recording artists. And thus, proposing legislation that seeks to curtail the returns to the investments in artist development made by labels raises the same sorts of questions that would be raised by proposing legislation that reduces the returns to investments made in patentable research and development: what impact would this have on the rate of investment, the scope of investment, and the intensity of investment?

While the effects of the proposed change and the upheaval it would cause (including harms to recording artists) are clearly to be expected, the extent and scope of those costs are less clear and would require significant study and research to model and predict with more precision. As noted above, the legislation was only recently proposed – but real concern should be shown for the possibility that AB 1385 could have significant, unintended consequences on the investments made in the music business. The economics of how the proposed legislation is likely to affect the relationship between recording artists and record labels are clear, and they raise significant and important questions that should be carefully considered and analyzed before any changes are enacted into law. While this should concern anyone interested in the music industry, including artists who may not benefit from these proposed changes at all, given the music industry's importance to California's economy, it should be of even greater concern in California, which has the biggest music economy in the United States.

[14] Ariel Pakes, "Patents as Options: Some Estimates of the Value of Holding European Patent Stocks," *Econometrica,* Vol. 54, No. 4 (July 1986), pp. 755-84 at p. 780.

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