

# THE IPOD TAX: WHY JAPANESE LAW PROFESSORS REJECTED THE DIGITAL COPYRIGHT SYSTEM OF AMERICAN LAW PROFESSORS' DREAMS

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## I. Introduction

It's an iPod world, and we just live in it.<sup>2</sup> Or so goes the not-necessarily-unjustified hype. But with the benefits of technology comes the cost of legal conflict. Of particular note is the risk that the Internet and digital copying pose for copyright owners in the recording and motion picture industries.

A number of prominent American law professors have endorsed the notion of a tax on digital recording with the proceeds to be paid into a general fund. Some call it an "iPod tax,"<sup>3</sup> although these proposals envision revenue from a broader range of sources than iPods, including peer-to-peer filesharing and internet service providers. Since the common feature of these proposals is the creation of an intermediary<sup>4</sup> to serve as an intermediary between consumers and copyright holders, collecting the tax revenue from users in exchange for a "blanket license,"<sup>5</sup> a more

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<sup>2</sup>Alex Beam, "Wherever iTunes, it's an iPod World," *Boston Globe*, Nov. 22, 2006 ("It's an iPod world and we only live in it."), available at [http://www.boston.com/news/globe/living/articles/2006/11/22/wherever\\_itunes\\_an\\_ipod\\_world/](http://www.boston.com/news/globe/living/articles/2006/11/22/wherever_itunes_an_ipod_world/); see generally Posting of Mark Liberman & Benjamin Zimmer to Language Log, <http://itre.cis.upenn.edu/~myl/language-log/archives/002947.html> (March 21, 2006, 20:07 EST) (tracing the origins of the "snowclone" (formula-based cliché): "It's X's World, We Just Live In It," with specific references to the proliferation of iPod- and Steven Jobs- related examples of the cliché).

<sup>3</sup>See generally John Borland, *No iPod tax for Canada*, CNET NEWS.COM, July 28, 2005, [http://news.com.com/No+iPod+tax+for+Canada/2100-1041\\_3-5809117.html](http://news.com.com/No+iPod+tax+for+Canada/2100-1041_3-5809117.html) (discussing the decision by Canada's Supreme Court to not hear a case about imposing a fee on iPods and other hard-drive players that are capable of copying files). German courts have ruled that that country's existing copyright levy, which resembles Japan, should be extended to computers. See "German Court Sets Copyright Levy on New PCs," available at <http://www.itworld.com/Man/2681/041224germanlevy/> (last visited July 12, 2007).

<sup>4</sup>See *Broad. Music, Inc. v. Columbia Broad. Sys., Inc.*, 441 U.S. 1, 5 (1979) (describing the function of ASCAP as a "clearing-house" for the negotiation and licensing of music performance); see generally Merriam-Webster, <http://www.m-w.com/dictionary/clearinghouse> (last visited July 2, 2007) (defining a clearinghouse broadly as an informal channel for collecting, classifying and distributing materials, especially information).

<sup>5</sup>See *Section 115 Reform Act (SIRA) of 2006: Hearing Before the Subcomm. on Courts, the Internet, and Intellectual Property of the H. Comm. on the Judiciary*, 109th Cong. (2006), available at <http://www.copyright.gov/docs/regstat051606.html> (statement of the U.S.

accurate name for the system may be “digital rights clearinghouse” (DRC) [global: choose a better term? Acronym? conform to term!].<sup>6</sup> The digital clearinghouse proposals would apply collective licensing to the copying and file-sharing of digital content and a formula to translate this data into a gauge of the relative popularity of musical works. Finally, the digital clearinghouse would divvy up the revenues – the iPod tax proceeds, if you will – to the individual rightsholders.

The digital clearinghouse approach addresses important concerns about infringement and DRM.<sup>7</sup> The digital clearinghouse

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Copyright Office) (describing the proposed blanket license as a statutory and compulsory license to be used by all music creators, distributors and users); cf. ASCAP, *Common Music Licensing Terms*, <http://www.ascap.com/licensing/termsdefined.html> (last visited June 28, 2007) (defining a “blanket license” as a license that allows music users to perform any or all copyright protected music in ASCAP’s repertory).

<sup>6</sup>The term “clearinghouse” denotes an organization that administrates creators’ rights collectively, as organizations such as ASCAP have done in the U.S. for nearly a century. See *infra* nn.[ ] and surrounding text (explaining the role of the clearinghouses in these proposals). These organizations are often referred to as “collective rights organizations.” See Robert P. Merges, *Contracting Into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 CAL. L. REV. 1293, 1295, 1329 (1996) (referring to collective copyright licensing organizations such as ASCAP, formed in 1914, and BMI as collective rights organizations); see also ASCAP, <http://www.ascap.com/about/> (last visited July 2, 2007) (describing The American Society of Composers, Authors and Publishers as a performing rights organization comprised of U.S. composers, songwriters, lyricists, and music publishers that licenses and distributes royalties for non-dramatic public performances of its members’ copyrighted works); see also BMI, <http://www.bmi.com/about/?link=navbar> (last visited July 2, 2007) (explaining the fact that Broadcast Music, Inc. is a performing rights organization that issues licenses to various users of music, and collects and distributes licensing revenues to the songwriters, composers and music publishers it represents); Copyright Management Center, <http://www.copyright.iupui.edu/permorg.htm> (last visited July 2, 2007) (providing a list of collective rights organizations that either put users in contact with copyright owners or grant permission on behalf of copyright owners). However, the term “collective rights organization” suggests a union of private rights holders – as opposed to a possible public or quasi-public body, such as the proposed digital clearinghouse.

<sup>7</sup>This article strives to use the term DRM throughout while avoiding a value-laden terminology choice as to whether DRM is appropriately characterized as legitimate “rights enforcement” for copyright holders (“digital rights management”) or an unfairly imposed restriction on consumers (“digital restriction management” per John Perry Barlow). See Stefan Krempl, *Wrapped Up in Crypto Bottles: A talk with cyber-rights pioneer John Perry Barlow about Digital Restrictions Management and the future of human knowledge*, HEISE

model functions much as a mandatory, universal license, so that what is currently unauthorized use becomes legitimate, compensated use. Accordingly, the digital clearinghouse approach can “head off” the need to impose DRM on consumers. DRM technologies simultaneously hold promise and generate fear. For copyright holders victimized by rampant infringement, DRM may supply an antidote to lost revenue and diminished assets. For those who use copyrighted material, DRM may allow for a clearer resolution of the question of what is an appropriate use than the vagueries of the “fair use” doctrine provide. However, DRM also creates fears based on concerns of liberty and efficiency. Commentators decry the possibility that DRM – combined with anticircumvention law – may impoverish free expression by sucking the oxygen out of the common cultural atmosphere. But with a clearinghouse system in place to compensate rights holders, there may be decreased demand for expensive and intrusive DRM.<sup>8</sup>

The vehicle of a digital clearinghouse is not just a concept car. The U.S. would not be the first nation to implement such a system; Japan has actually run a very similar system since the early days of digital recording in 1993.<sup>9</sup> More recently, the question that has confronted Japanese policymakers was whether to expand their existing system into the kind of broader iPod, MP3, P2P and Internet use levy that American scholars have proposed.

The Japanese experience is striking and should give American policy makers pause. Like the United States, Japan is a large, highly-developed nation with important copyright holders, major electronics and computer manufacturers, and a thriving consumer culture. In 2005, faced with the iPod and similar computer memory-based devices, the Japanese decided not to

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ONLINE, TELEPOLIS, Sept. 3, 2003,  
<http://www.heise.de/tp/r4/artikel/14/14337/1.html> (talking with Barlow about his fear that “Digital Rights Management today is Political Rights Management tomorrow”).

<sup>8</sup>However, it should be noted that the supposition that rights holders would voluntarily forego DRM if compensated may not come to pass – and has not been correct in Japan. *See infra* nn[ ] and surrounding text. However, the forbearance from DRM could be made compulsory under a clearinghouse system.

<sup>9</sup>Other nations, such as Germany and Canada, also run copyright levy systems. *See supra* n.[ ]. But Japan appears to be unique in having delegated the examination whether to extend the system to iPods and other hard-disk based players to a committee stacked with professors.

expand their existing digital recording system to reach the new devices. Led by a committee dominated by professors – mostly from law schools – the Japanese stopped their current digital recording tax from morphing into an iPod tax and a digital clearinghouse system.

This Article tells an important, yet neglected story. Specifically, it looks at the nature of the digital clearinghouse model, and compares the American proposal with that of the existing system in Japan. In particular, it focuses on how and why Japanese experts decided that killing an iPod tax was in fact worth a departure from their existing rights structure. These experts, working with Japanese ministries, produced a wealth of publicly-available summaries of their discussions. This Article presents insights gleaned from surveying the wealth of publicly available details of their discussions as well as from interviews with participants in these discussions, and relates these insights to the American proposals.

The comparison suggests that the digital clearinghouse model may possess previously-ignored flaws. First, a digital clearinghouse system may require constant, and potentially very difficult, recalibration, to avert distortion by rights holders. Public choice theory predicts, and the Japanese experience seems to show, that relatively less numerous and focused rights holders will capture system and exploit the more diffuse and less organized users. Additionally, and relatedly, such a system requires transparency and consumer understanding. A poorly-informed public is ripe for the taking by rights holders; the perception that the public had been cheated out of the benefit of its bargain led Japanese experts to deem their clearinghouse system something of a failure. Accordingly, this Article draws on the comparison to propose a framework by which to consider similar American proposals. Section II explains the American proposals. Section III describes the Japanese system of audio home recording compensation, and Section IV explains Japan's decision not to extend this system to the iPod and like devices. Section V sets forth this Article's own proposal – aimed chiefly at avoiding the regulatory capture that spoiled Japan's system – and is followed by a brief conclusion.

## **II. The Digital Clearinghouse Model**

### **A. The American Proposals**

Great minds think alike. That is one way to explain how several American law professors simultaneously came to similar conclusions about how to solve the Internet challenge to the rights of copyright holders.<sup>10</sup> Another way to explain this convergence is by noting the degree to which Ronald Coase's *The Problem of Social Cost* anticipates these proposals. In other words, perhaps great minds think alike because of the critical importance of shrinking transaction costs to enable – or mirror – welfare-enhancing bargains. To that end, Professor William Fisher has proposed an “Alternative Compensation System” for copyright to deal with file sharing. Additionally, Professor Neil Netanel has put forth his “Noncommercial Use Levy” with to achieve similar goals. Likewise, Prof. Jessica Litman has advocated a “voluntary blanket license” to do the same. Others have endorsed similar systems where they have appeared in other contexts.<sup>11</sup>

These American proposals share several features. First, they create defined rights on each side. On the copyright holder's side, the proposals recognize that private home recording – of audio, video, and perhaps other material – should yield compensation to the copyright holder.<sup>12</sup> On the other side,

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<sup>10</sup>See WILLIAM W. FISHER III, *PROMISES TO KEEP: TECHNOLOGY, LAW, AND THE FUTURE OF ENTERTAINMENT* 199-258 (Stanford University Press 2004) (recommending the government administer a reward system using tax revenues collected from consumers to pay creators of works registered with the Copyright Office); Raymond Shih Ray Ku, *The Creative Destruction of Copyright: Napster and the New Economics of Digital Technology*, 69 U. CHI. L. REV. 263, 312-15 (2002) (calling for Congress to enact a Digital Recording Act that would provide musicians, songwriters and publishers with a source of revenue based on the popularity of their work and derived from statutory levies on subscriptions to Internet services and the sales of computer, audio, and video equipment); Neil Weinstock Netanel, *Impose a Noncommercial Use Levy to Allow Free Peer-to-Peer File Sharing*, 17 HARV. J.L. & TECH. 1, 35-60 (2003) (delineating a noncommercial use levy for peer-to-peer file sharing and streaming of copyright-protected material); see also Tom W. Bell, *Fair Use vs. Fared Use: The Impact of Automated Rights Management on Copyright's Fair Use Doctrine*, 76 N. CAROLINA L. REV. 557, (1998) (positing that greater access to copyright protected materials will result if copyright owners and consumers use automated rights management technologies to create an efficient fared use system).

<sup>11</sup>Glynn S. Lunney, Jr., *The Death of Copyright: Digital Technology, Private Copying, and the Digital Millennium Copyright Act*, 87 VA. L. REV. 813, 852-54 (2001) (discussing the European Union's authorization of levies imposed by its member states on equipment used for private copying); Randal C. Picker, *Centennial Tribute Essay: From Edison to the Broadcast Flag: Mechanisms of Consent and Refusal and the Propertization of Copyright*, 70 U. CHI. L. REV. 281, 290 (2003) (discussing the Audio Home Recording Act of 1992's copyright tax on digital recording devices).

consumers would have a clearly-defined right to make private copies of copyrighted work. Second, a tax and a digital clearinghouse would try to track the bargains that individual rightsholders and consumers might make absent the daunting transaction costs. Specifically, consumers who made private copies would pay an appropriate tax to the digital clearinghouse. The digital clearinghouse would then divvy this levy up to individual rights holders, based on the frequency with which each rights holder's works were copied.

Despite their overall similarities, the American proposals deserve to be examined for their specifics. Although, the proposals resemble each other more than they differ, they do vary based on the whether they would supplement or replace existing copyright law. Additionally, they differ on whether they would cover only noncommercial activity or broader use. While there are numerous similar proposals,<sup>13</sup> this Article sets forth three that demonstrate differing degrees of ambition and scope.

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<sup>12</sup>See FISHER, *supra* note 7, at 199-258; LAWRENCE LESSIG, FREE CULTURE 296-306 (The Penguin Press 2004) (advocating for free access to music that is not copyrighted or is used only in a noncommercial context, and proposing a charge or tax on other peer-to-peer file sharing activities such as copying to avoid the purchase of CDs, and accessing copyrighted music that is either no longer sold or not easily accessible outside of the internet); RICHARD M. STALLMAN, FREE SOFTWARE, FREE SOCIETY: THE SELECTED ESSAYS OF RICHARD M. STALLMAN (Free Software Foundation 2002), available at <http://www.gnu.org/philosophy/misinterpreting-copyright.html> (urging a reduction of publishers' and authors' copyright privileges for the benefit of users, such as readers, music listeners, movie watchers and software runners, without sacrificing desired publication levels); Daniel J. Gervais, *The Price of Social Norms: Towards a Liability Regime for File-Sharing*, 12 J. INTELL. PROP. L. 39, 55-70 (2004) (suggesting the proper response to peer-to-peer file sharing may include licensing through internet service providers, copyright collectives, or technology companies); Ku, *supra* note 6, at 312-15; Jessica Litman, *Sharing and Stealing*, 27 *Hastings Comm. & Ent. L.J.* 1, 41- 49 (2004) (proposing a blanket license which features terms and conditions prescribed by copyright law, and allows for voluntary participation by individual copyright owners); Lunney, *supra* note 7, at 844-68; see generally Electronic Frontier Foundation, "A Better Way Forward: Voluntary Collective Licensing of Music File Sharing" (Feb. 2004), available at [http://www EFF.org/share/collective\\_lic\\_wp.pdf](http://www EFF.org/share/collective_lic_wp.pdf) (urging the music industry to offer the right to share files in exchange for a small monthly fee).

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

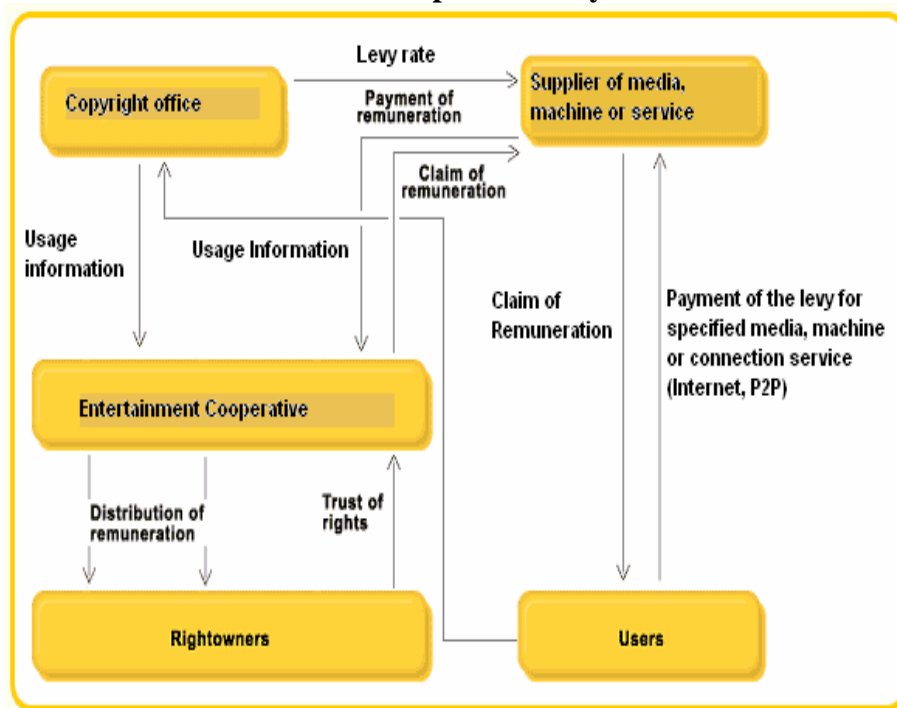
1. *Broader Ambition and Scope: William Fisher's  
"Alternative Compensation System"*

In his book *Promises to Keep*, Professor William Fisher presents perhaps the most detailed proposal (see figure 1). He casts his proposal as an "alternative" to two existing models of encouraging creativity: traditional copyright and "private access control systems." The first, traditional copyright law, is perhaps the most familiar. Under this paradigm, the government grants a creator protection against competition – typically by giving them exclusive rights to sell their product to the public.<sup>14</sup>

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<sup>14</sup>See FISHER, *supra* note 7, at 200 (citing the common practice in the nineteenth century by American state governments of (1) authorizing the building of roads, bridges and canals by private companies, (2) allowing these companies to charge tolls, and (3) guaranteeing that no competitive transportation system(s) would be built for a certain period of time).

**Figure 1. The Digital Clearinghouse Model – William Fisher’s Alternative Compensation System**



However, Fisher argues that technological innovation has “destabilized” traditional copyright law. Digital recording technology plus Internet communication greatly amplified the possibility of unauthorized copying undercutting copyright holders’ ability to receive compensation for their efforts. Further technological innovation then made possible advanced systems of “private access-control systems” – that is, digital rights management (DRM) techniques – that try to thwart unauthorized copying, with varying degrees of success. To augment the power of such DRM technology, copyright holders have obtained legal protection against circumvention of it.

Fisher points out that this situation may impose significant costs for the legal system and also chill important rights to free expression and “fair use.” As a result, he proposes an “Alternative Compensation System” under which the government would tax both copying devices and recording media. Copying devices would include such things as CD burners and digital video recorders (“DVRs,” such as TiVos). Recording media would include blank CDs and DVDs and hard-disk based copying devices

such as MP3 players and iPods.<sup>15</sup> Additionally, under Fisher's proposal Internet access would also be taxed.<sup>16</sup>

Under the Alternative Compensation System, the Copyright Office would engage in methods such as surveys, statistical sampling and analysis of consumption data to divine which works are more likely to have been copied by users. Those works copied more frequently would earn their creators a larger slice of the collected tax revenue. That data would be used by an "Entertainment Cooperative" to distribute the tax revenue to copyright holders in an equitable manner.

A key feature of Fisher's proposal is that once the system were in place, copyright law would be modified "to eliminate most of the current prohibitions on unauthorized reproduction, distribution, adaptation, and performance of audio and video recordings," so that "[m]usic and films would thus be readily available, legally, for free."<sup>17</sup> Thus, Fisher's proposal, while perhaps envisioned as a response to uncontrollable private unauthorized copying, in fact reaches well beyond today's noncommercial use.

Fisher's model is aimed at supplementing existing copyright law at first. However, he clearly envisions it replacing existing copyright law. The initial challenge that drives the proposal is P2P and private digital copying, but the Alternative Compensation System is designed to effectively supplant the entire copyright system, not merely create a private copying regime.

## 2. *Broader Ambition, Narrower Scope: Neil Netanel's "Noncommercial Use Levy"*

Professor Neil Netanel of UCLA also has proposed a taxation-based system for compensating copyright holders. Netanel's system is arguably more restrained in its scope than

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<sup>15</sup>See FISHER, *supra* note 7, at 218 (treating iPods as MP3 players, despite the fact that iPods play a different, proprietary Apple format that limits the portability of the encoded sound or music, although this is perhaps not an important distinction for his taxation purposes).

<sup>16</sup>See FISHER, *supra* note 7, at 219-20 (suggesting the taxation of internet access services is appropriate because American consumers will not be able to avoid such a tax, and it will capture revenue that would otherwise be lost as a result of peer-to-peer file sharing).

<sup>17</sup>*Id.* at 202.

Fisher's. Specifically, Netanel proposes a "Noncommercial Use Levy" to "give noncommercial users and creators freedom to explore, share and modify" the "works that populate our culture."<sup>18</sup> His goal appears to be relatively modest, viewing copyright law as "broad enough to encompass both" the Noncommercial Use Levy and copyright holders' proprietary control. Thus, Netanel does not appear to envision the wholesale replacement of copyright law as does Fisher.

Other than its limitation to noncommercial uses, Netanel's proposal greatly resembles Fisher's. The Noncommercial Use Levy would be imposed upon "commercial providers of all consumer products and services whose value is substantially enhanced" "by P2P file sharing." The exact determination of the levy's targets would be made by the U.S. Copyright Office, but would likely include Internet Service Providers, computer hardware manufacturers, consumer electronics manufacturers (including MP3 players and DVRs), and manufacturers of storage media (blank CDs, DVDs, etc.).<sup>19</sup>

Like Fisher's Alternative Compensation System, the proceeds of Netanel's Noncommercial Use Levy would be divvied up among rights holders, gauging the relative usage of individual works to fairly apportion revenues. Both proposals also envision a significant role for the Copyright Office, particularly in setting the appropriate tax rate. Netanel's discussion of rate setting, however, is somewhat more detailed. In the short term, he envisions a tax rate gauged to replace the revenue that copyright holders currently lose to unauthorized use such as peer-to-peer file sharing. In the longer term, he advocates a transition to a tax rate based on broader social concerns about widespread user access as well as fair compensation. Such a measure would not necessarily track expected market bilateral bargains between users and rights holders. Instead, in an effort to foster the perceived social goods of wider dissemination of works, it would more closely resemble the relatively lower royalty rates currently paid by satellite radio broadcasters to copyright holders under the existing compulsory license system.<sup>20</sup>

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<sup>18</sup>Netanel, *supra* note 7, at 6.

<sup>19</sup>Netanel, *supra* note 7, at 43.

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

### 3. *Narrower Ambition and Scope: Jessica Litman's Voluntary Blanket License*<sup>21</sup>

Professor Jessica Litman has advocated a system explicitly modeled on those of Fisher and Netanel. However, she modifies the digital clearinghouse model based on her reading of political realities.<sup>22</sup> Her proposal would apply only to private use of copyrighted music, containing an explicit opt-out for those copyright holders who wish to eschew “sharing” music in favor of “hoarding” it under their direct control.

Litman's proposal appears less ambitious, and of smaller scope. But in truth, she stoops to conquer. To avoid a direct confrontation with powerful music lobbies, Litman hopes to preserve a space for the sixty million consumers engaged in P2P networks in the United States.<sup>23</sup> Indeed, she effectively seeks to channel P2P users into a lobby with a seat at the legislative bargaining table.<sup>24</sup> Embedded in her proposal is the belief that drawing the efficiency of P2P into a blanket license for private user copying will prove very successful for both users and those copyright holders who do not opt out. Indeed, Litman is optimistic that the “voluntary, blanket license” could draw in hold-outs based on its own success as a competitor to the traditional model of copyright industries.

### 4. The Digital Clearinghouse Proposals Contrasted

Besides Fisher, Netanel and Litman, others have made similar proposals for modifying American copyright law. Proposals by Daniel Gervais, Raymond Ku, Lawrence Lessig and Glenn Lunney all share the common features of addressing P2P and digital copying by users and advocating some kind of digital clearinghouse or collective license.

As shown in Figure 2, the proposals do contain a couple of important differences. The first is whether they aim merely to

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<sup>21</sup>See Litman, *supra* note 9, at 41-9 (proposing the use of a voluntary blanket license that features terms and conditions prescribed by copyright law).

<sup>22</sup>*Id.* at 39-49.

<sup>23</sup>*Id.* at 40.

<sup>24</sup>*Id.*

become private copying regimes, or whether their scope of design is broader. The second key difference is whether they seek to mandate a replacement for existing copyright law, or whether they provide an opt-out so they can supplement existing copyright law for those copyright holders who seek to use these regimes.

**Figure 2. The Digital Clearinghouse Proposals**

	Replace Existing Copyright Law?	Supplement Existing Copyright Law?
All use?	Fisher <sup>25</sup>	Fisher <sup>26</sup>
Noncommercial use?	Lunney <sup>27</sup> Netanel <sup>28</sup> <i>Japan's Existing System</i> <sup>29</sup>	Gervais <sup>30</sup> Ku <sup>31</sup> Lessig <sup>32</sup> Litman <sup>33</sup>

<sup>25</sup>See FISHER, *supra* note 6, at 9-10, 199-258. Fisher's proposal would at first be voluntary and supplemental, but he envisions it to completely replace current copyright law.

<sup>26</sup>*Id.*

<sup>27</sup>Lunney, *supra* note 9, at 911-16. Lunney proposes a levy on copying technology and storage devices used in private copying, together with some legitimization of private copying as an activity. His proposal is perhaps the closest to Japan's existing private home recording levy system.

<sup>28</sup>Netanel, *supra* note 7, at 35-9 (delineating a noncommercial use levy that would allow for private digital and nondigital copying of all expressions, and remixing and dissemination of existing works through peer-to-peer networks).

<sup>29</sup>See *infra* Section III.

<sup>30</sup>Gervais, 12 J. INTELL. PROP. L. at 58-73. Gervais proposes a system of collective licensing of P2P filesharing, with proceeds of the licenses to be distributed to copyright holders. His proposal would make the collective license system voluntary via either an opt-in or an opt-out.

These categories are not hermetically sealed, however. A supplemental regime can evolve to replace its predecessor; that appears to be Fisher's aim, and also Litman's. Additionally, an efficient private copying regime may tend to lead creators to provide material for it, rather than through established commercial distribution channels. Thus, the division of these proposals to some extent reflects their initial impact, and not necessarily their hypothetical final outcomes.

## **B. Alternatives to the digital clearinghouse model**

While the appearance of many similar proposals suggests consensus, several writers in fact dissent.<sup>34</sup> Their reasons vary, but largely fall into two categories: practical doubts and substantive objections. Practical doubts include concerns about the government's role in administering a digital copyright tax system. Substantive objections encompass beliefs that greater individual control of copyright holders – as opposed to the broad collective licenses in the digital clearinghouse models – will lead to superior outcomes.

Practical doubts include familiar public choice worries about the real effectiveness of regulation.<sup>35</sup> In an article that

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<sup>31</sup>Ku, *supra* note 7, at 311-24. Ku places emphasis on the way in which digital distribution changes the effects of current copyright law. Ku would bifurcate existing law, so that current law would remain for analog distribution, but digital distribution would be handled through the noncommercial use levy.

<sup>32</sup>LESSIG, *supra* note 9, at 300-03. Lessig explicitly describes his proposal as a modification of Fisher's. "Fisher imagines his proposal replacing the existing copyright system" but Lessig "imagine[s] it complementing the existing system" where necessary. Among other applications, Lessig's proposal would encompass works that are copyrighted but not currently commercially available – the proposal would authorize those other than the copyright holder to distribute such works digitally so as to increase dissemination of information.

<sup>33</sup>Litman, *supra* note 9, at 41. Litman proposes a statutory blanket license for voluntary rather than compulsory "sharing" music over digital networks. That is, copyright holders could decide to "opt out" of the new system. *Id.* at 45.

<sup>34</sup>*See e.g.* Jane C. Ginsburg, *Copyright and Control Over New Technologies of Dissemination*, 101 COLUM L. REV. 1613, 1642-45 (2001) (describing problems with existing compulsory licenses); Merges, *supra* note 4, at 1308-16 (1996) (criticizing compulsory licensing regimes).

<sup>35</sup>*See e.g.* DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A*

significantly predated – and yet anticipated – some of the digital clearinghouse proposals, Robert Merges opposed the idea of a Congressionally mandated compulsory license for digital content.<sup>36</sup> The beneficiaries of the proposal he critiqued were admittedly different from those advanced to deal with P2P users; Merges addressed a compulsory license to help multimedia industry producers.<sup>37</sup> Nonetheless, his doubts about compulsory licensing remain germane to the more recent proposals. Echoing Richard Epstein’s general argument for the preferability of property rules over liability rules,<sup>38</sup> Merges questioned whether government-administered compulsory license would accurately set and manage the price for the license in the face of interested parties’ rent-seeking behavior.<sup>39</sup>

Other criticisms of the digital clearinghouse models stem from differing views about the copyright holder’s role and the best end result. Some of these criticisms appear to stem from naked ideological fear that these proposals will bind creativity in “a

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CRITICAL INTRODUCTION (Chicago 1991) (discussing the possible effects of special interest groups’ activities, such as an increase in judicial activism with the advent of more economic regulations, and the elimination of other public goals as a result of the government devoting its resources to the pursuit of economic efficiency); Richard A. Posner, *Theories of Economic Regulation*, 5 *BELL J. ECON. & MGMT. SCI.* 335, 336-41 (1974) (discussing the high cost of effective economic regulation, the distortion of the efficient functioning of the regulated markets, and the perceived absence of a link between the public interest and legislative action).

<sup>36</sup>Robert P. Merges, *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 *CALIF. L. REV.* 1293, 1299 (1996) (arguing a compulsory license imposed by Congress would involve lobbying by copyright holders to set high royalty rates, wasting of resources to educate Congress, and the maintenance of high royalty rates despite changing conditions in the market).

<sup>37</sup>Merges, *supra* note 31, at 1308-17 (discussing the shortcomings of 1909 Act, which required manufacturers of recordings or mechanical reproductions to obtain a license from the copyright owner and pay a statutory royalty).

<sup>38</sup>See Richard Epstein, *A Clear View of the Cathedral: The Dominance of Property Rules*, 106 *Yale L. J.* 2091, 2093 (1997) (claiming that liability rules create the “cheap option” of lobbying regulators rather than bargaining with property owners).

<sup>39</sup>See Posner, *supra* note 29, at 341-343 (analyzing the “capture” theory of regulation, which sets forth the proposition that over time regulatory agencies become dominated by the industries they regulate).

socialist gulag.”<sup>40</sup> Others find more nuanced reasons to dissent. The argument that fair use is exclusively a response to market failure<sup>41</sup> had led some to a different conclusion about how to deal with private copying. Specifically, these commentators advance the claim that if an exception for unlicensed private copying derives from the fact that, historically, the transaction costs of licensing such copying outweighed the benefits, then as transaction costs decline, the justification for allowing such unauthorized use should fall in tandem.<sup>42</sup>

As a result, some commentators have endorsed a kind of technological optimism that would obviate the need for a digital clearinghouse. In particular, they claim that technology such as DRM can facilitate licenses where they were previously precluded by transaction costs.<sup>43</sup> Under this view, technological fixes will enable contractual bargains between users and rights holders where they were previously thought impossible. Thus, runs the argument,

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<sup>40</sup> See e.g. Posting of James DeLong to IPcentral Weblog, [http://weblog.ipcentral.info/archives/2005/07/writer\\_jay\\_curr.html](http://weblog.ipcentral.info/archives/2005/07/writer_jay_curr.html) (July 6, 2005, 8:42 EST) (advocating instead “a combination of improved DRM, evolving systems of micropayments, and self-help measures designed to frustrate the pirates – reinforced by a clear legal doctrine that interfering with creators’ efforts to defend themselves is ipso facto evidence of evil intent”).

<sup>41</sup> See Wendy J. Gordon, *Fair Use as Market Failure: A Structural and Economic Analysis of the Betamax Case and Its Predecessors*, 82 COLUM. L. REV. 1600, 1602, 1614 (1982) (discussing the courts’ application of the fair use doctrine to cases in which the protection of a copyright owner’s interests conflicts with the public’s interest in dissemination).

<sup>42</sup> See e.g. *Texaco II*, 1994 WL 590563, at 3, citing *Harper & Row Publishers, Inc. v. Nation Enterprises*, 471 U.S. 539, 549-50 (1985) (concluding that the fair use’s reach correlates with high transaction costs associated with asking for permission and if such costs decrease, so should the fair use’s scope).

<sup>43</sup> See Bell, *supra* note 7, at 587-8, 596-7 (arguing DRM increases the value of copyrighted works, encourages their greater production and distribution, gives consumers better access to the copyrighted works, and introduces licensing to critics of such works); Robert P. Merges, *The End of Friction? Property Rights and Contract in the “Newtonian” World of On-Line Commerce*, 12 BERKELEY TECH L.J. 115, 132 (1997) (endorsing the argument, with some exceptions, that lowering of transaction costs can shrink fair use’s range); Maureen A. O’Rourke, *Copyright Preemption After the ProCD Case: A Market-Based Approach*, 12 BERKELEY TECH L.J. 53, 79, 81-91 (1997) (describing the “freedom of contract” approach to copyright preemption issues and endorsing a largely market-based solution to the copyright preemption problem, including DRM).

technology can augment the power of existing property rules in copyright.

It is not clear whether the digital clearinghouse proponents or the DRM proponents have it right; ultimately, it depends on the answer to a very difficult empirical question. Each group of adherents has a different view on optimal bargains between rights holders and users, and on maximizing social welfare. Making the question more difficult, both groups make predictions about *future* expected results depending on their proposals: a liability rule augmented with a digital clearinghouse, or a property rule enhanced with DRM.

There are several reasons to doubt that DRM or similar technology can cleanly replace the existing system of private copying allowed under fair use. First, as Professor Julie Cohen has pointed out, taking fair use totally private through DRM could diminish public goods under the existing system, since private bargains will not account for social welfare.<sup>44</sup> Additionally, the empirical case that DRM can actually achieve the claimed gains is doubtful. Engineers have recognized that, so long as content must be displayed or reproduced for users, there will exist an “analog hole” that creates vulnerability for any DRM system.<sup>45</sup> And DRM systems can also be more directly hacked by users, potentially leading to an arms race dynamic between rights holders and infringers that leaves both sides worse off than they started.<sup>46</sup> Finally, there are the noneconomic goals that existing fair use seeks to achieve. William Fisher explicitly designs his digital clearinghouse proposal to achieve both compensation for creators and to enhance “semiotic democracy” – that is, to enable more of the population to engage with and create cultural products.<sup>47</sup> It is unclear that DRM as it exists or is likely to exist can achieve this

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<sup>44</sup> Julie Cohen, *Lochner in Cyberspace: The New Economic Orthodoxy of “Rights Management,”* 97 MICH. L. REV. 462, 558-60 (1998).

<sup>45</sup> See e.g. Douglas Sicker, Paul Ohm & Shannon Gunaji, *The Analog Hole and the Price of Music: An Empirical Study*, 5 J. TELECOMM. & HIGH TECH. L. 1, 5 (2005) (describing how, slightly poorer quality, analog copies can be made of, e.g., music during playback through speakers).

<sup>46</sup> See Salil K. Mehra, *Review of “The Economic Structure of Intellectual Property Law” by William Landes and Richard Posner*, 99 Temple L. Rev. 957, 961 (2004).

<sup>47</sup> FISHER, *supra* note 9, at 247-48.

goal, given the currently relatively weak and diffuse users relative to powerful and concentrated rights holders.

### C. Three perspectives on the virtues of the digital clearinghouse proposals

The digital clearinghouse proposals do not emerge from thin air. They resemble the experience copyright already has with the composers' rights organizations, most notably BMI/ASCAP.<sup>48</sup> Additionally, digital clearinghouse proposals establish the preconditions for Coasean bargaining in all its law and economic glory. Finally, a digital clearinghouse proposals potentially preserve important aspects of "net neutrality" in the market for online music and video content.

#### 1. Experience with BMI/ASCAP

Proponents and opponents of the compulsory licensing involved in the digital clearinghouse proposals both refer to longstanding experience with "collective rights organizations," most notably Broadcast Music, Inc. (BMI) and the American Society of Composers, Authors and Publishers (ASCAP).<sup>49</sup> The primary business of BMI and ASCAP is to serve as an intermediary between music composers and publishers on one side, and radio and television broadcasters on the other. In particular, BMI and ASCAP aggregate the composers' rights into a blanket license which they then sell on to broadcasters, who thereby acquire the ability to publicly disseminate any work within BMI and ASCAP's repertoire of rights.<sup>50</sup>

The Supreme Court noted the efficacy of the BMI/ASCAP approach in a landmark antitrust decision just before the dawn of digital music, *Broadcast Music, Inc. (BMI) v. Columbia*

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<sup>48</sup> See *supra* n.[ ].

<sup>49</sup> Compare FISHER, *supra* note 7, at 50-2 (pointing out the "danger of oligopolistic behavior and pricing" on the part of performing rights organizations such as ASCAP and BMI), with Merges, *supra* note 31, at 1295 (arguing ASCAP and BMI have demonstrated the distinctive advantages offered by privately established collective rights organizations: "expert tailoring and reduced political economy problems").

<sup>50</sup> See Merges, *supra* note 31, at 1329 (explaining ASCAP's function as a central depository allowing members control over their works while issuing "blanket licenses" to potential users).

*Broadcasting System, Inc.*<sup>51</sup> There, a broadcaster challenged the collective licensing system of BMI and ASCAP as per se illegal price fixing.<sup>52</sup> The Supreme Court refused to apply the per se rule based on the ancillary efficiencies of the BMI/ASCAP system.<sup>53</sup> The efficiencies that the Court pointed to are relevant to the attractiveness of the digital clearinghouse proposals today. In particular, the collective license reduced the transaction costs involved in performing copyrighted music in several ways that benefited both rights holders and users. First, for both rights holders and users, the single blanket license substituted for thousands of individual transactions that would have been required if broadcasters had needed to negotiate separate licenses for each piece of music they played on the air.<sup>54</sup> Second, because a popular song may have a short “shelf life,” the blanket license allowed for longer term licenses with fewer negotiations per time period – a system of licensing by individual song would require many short-term licenses.<sup>55</sup> Additionally, BMI and ASCAP could collectively monitor for infringement by nonlicensees – a task that might prove impossible for individual rights holders.<sup>56</sup> Finally, the blanket license conferred relative *ex ante* certainty to broadcasters that they could play music without the fear of costly copyright infringement litigation.<sup>57</sup> This final benefit extends beyond rights holders and

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<sup>51</sup>441 U.S. 1, 20-24 (1979). *Broadcast Music* was decided coincidentally in the same year that Sony and Philips initiated a design team that led to the successful marketing of the Compact Disc (CD) three year later. The development of the CD has been called the “big bang of the digital revolution. See e.g. EDinformatics, [http://www.edinformatics.com/inventions\\_inventors/compact\\_disc.htm](http://www.edinformatics.com/inventions_inventors/compact_disc.htm) (last visited July 6, 2007) (relaying the development of the Compact Disc as told by Kees A. Schouhamer Inmink, *The CD Story*, 46 J. AUDIO ENG’G SOC’Y 458-65 (1998), available at <http://www.exp-math.uni-essen.de/~immink/pdf/cdstory.pdf>).

<sup>52</sup>See *Broadcast Music*, 441 U.S. at 4.

<sup>53</sup>*Id.* at 23-5.

<sup>54</sup>*Id.* at 20-1.

<sup>55</sup>*Id.* at 21-3.

<sup>56</sup>*Id.* at 20-1.

<sup>57</sup>*Id.* at 20.

users to the society at large, since judicial resources are publicly funded.

The BMI/ASCAP system thus reduces transaction costs with an important result. It mirrors – roughly – individual licenses that otherwise might not occur because the benefit of the license may be swamped by the transaction costs involved in negotiating it. And as both proponents and critics of digital licensing systems have observed, BMI and ASCAP successfully apportion and distribute the bulk of the license fees to the copyright holders.<sup>58</sup> To do this, they employ sophisticated surveying and sampling methods to estimate the popularity of individual copyright holders' works so as to accurately allocate the license fees.<sup>59</sup>

The BMI/ASCAP system inspires the digital clearinghouse proposals in that it strikes a collective licensing bargain where individual licensing might otherwise be very difficult. Nonetheless, critics of a compulsory digital license observe that the BMI/ASCAP system is privately negotiated.<sup>60</sup> Additionally, it is not an exclusive license; copyright holders and users retain the ability to negotiate individually, though this is rarely done.<sup>61</sup> However, it is difficult to cast BMI/ASCAP as a triumph of pure private ordering, since they have been operating under various consent decrees actively monitored by the Justice Department's Antitrust Division since 1941.<sup>62</sup> Regardless of whether

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<sup>58</sup>See FISHER, *supra* note 7, at 51 (recognizing ASCAP's and BMI's successful distribution of approximately 80 to 85 percent of their gross revenues to member writers and publishers); Merges, *supra* note 31, at 1335-40 (acknowledging ASCAP's success with the determination of royalty rates and fair distribution of royalty income among members).

<sup>59</sup>See FISHER, *supra* note 7, at 51(citing the fact that ASCAP, BMI and SESAC "use a combination of self-reporting by licensees and sophisticated sampling techniques to estimate the frequency" of each composition's performance); Merges, *supra* note 31, at 1335-38 (discussing ASCAP's use of self-reporting by licensees and sophisticated sampling techniques for determining royalty rates and distribution of royalty income).

<sup>60</sup>Merges, *supra* note 31, at 1295-7.

<sup>61</sup>See 441 U.S. at 29, (ASCAP does not have exclusive control over the copyrights and members are free to negotiate directly with composers and publishers).

<sup>62</sup>Original cases brought almost 70 years ago against BMI and ASCAP were both settled with consent decrees that have since been incorporated into and consolidated with later consent decrees. *United States v. ASCAP*, 1940-43 Trade

BMI/ASCAP provides a type of compulsory licensing, it does demonstrate the value in collective licensing that reduces transaction costs.

## 2. *Digital Clearinghouses, the Coase Theorem and Liability Rules*

The Coase Theorem's central claim is that in a world of zero transaction costs, allowing the free exchange of clear property rights generates an efficient outcome independent of the initial allocation of ownership. In Coase's famous example, ranchers' livestock eat farmers' crops.<sup>63</sup> Coase demonstrated that, absent transaction costs, achieving an optimal result did not depend on whether farmers "owned" the right not to have their crops eaten or whether ranchers had "owned" grazing rights; through voluntary transactions, resources would move to their highest use in either case.<sup>64</sup>

The digital clearinghouse proposals also provide a new lens through which to view the applicability of the Coase Theorem to copyright. By shifting entitlements between users and copyright holders, they implicate the Coase Theorem's teachings on legal endowments and transaction costs. By embracing compulsory licensing,<sup>65</sup> the digital clearinghouse proposals also stir up debate over the appropriateness of liability rules or property rules, as categorized by Calabresi and Melamed.<sup>66</sup> This debate is all the more heated due to existing intellectual property law's general endorsement of injunctions – a rule that effectively confers a judicially-enforced property right.<sup>67</sup>

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Cas. ¶56,104 (S.D.N.Y. 1941); *United States v. Broadcast Music, Inc.*, 1940-43 Trade Cas. ¶56,096 (E.D. Wisc. 1941).

<sup>63</sup>See R. H. Coase, *The Problem of Social Cost*, 3 J. L. & Econ. 1, 2 (1960).

<sup>64</sup>*Id.* at 8 (arguing that regardless of which party is liable for damages the end result is the same use of the resources).

<sup>65</sup>See *supra* n.[ ] and surrounding text. As discussed, only Prof. Litman's proposal contemplates an opt-out by rights holders.

<sup>66</sup>See Guido Calabresi and A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1092 (1972) (discussing the difference between protection by a property rule versus a liability rule).

<sup>67</sup>See Lemley and Weiser, 85 Tex. L. Rev. at 784 (observing "[p]ervasive use of property rules and limited uses of 'liability rules'" in IP); Merges, 94 Colum. L.

In general, commentators have rarely focused on the possibility that a world free of transaction costs where copyright holders must pay users not to infringe could be efficient.<sup>68</sup> That said, it is not immediately clear why users and copyright holders are not analogous to Coase's ranchers and farmers.<sup>69</sup> After all, if a user's use yields greater utility than a rights holder's price to exclude that use, the important thing from a social perspective is not the initial allocation of rights or the distribution of gains, but instead that the creation is created and that the use occurs. The digital clearinghouse proposals represent a partial "flipping" of rights, as they would legitimize current private copying and peer-to-peer filesharing that is arguably "infringement."<sup>70</sup>

When commentators have addressed this possibility, they have tended to view Coase's insights as not well-suited to intellectual property generally.<sup>71</sup> Robert Merges has alluded to several problems with the Coase Theorem's applicability to intellectual property. In particular, he points to the difficulty of clearly defining intellectual property rights and their transgression, the likelihood of strategic bargaining, and the built-in bias in

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Rev. at 2667 ("[a]ll familiar with the IP[] field recognize the strong presumption in favor of injunctions").

<sup>68</sup>Paul Heald has written on the implications of this hypothetical upside-down Coasean world for patent reform. See Paul Heald, *Transaction Costs and Patent Reform*, 23 Santa Clara Computer & High Tech. L. J. 447, 457-458 (2007). In addition to transaction costs, there is debate generally over whether the Coase Theorem's indifference to starting entitlements is correct since distributions of rights can affect where on the parties' supply and demand curves they find themselves; if those curves are nonlinear, the ending point will be different depending on the initial entitlements. See Parisi, *supra* n.[ ].

<sup>69</sup>See Merges, 94 Colum. L. Rev. at 2657.

<sup>70</sup>See Lemley and Weiser, *Should Property or Liability Rules Govern Information?*, 85 Texas L. Rev. 783, 792 (2007) (arguing there are certain circumstances where the copyright owner's control over use should be limited). But see Jessica Litman, *Lawful Personal Use*, 27 Hastings Comm. & Ent. L.J. 1, 25-29 (2004) (presenting potential favorable outcomes in support of peer-to-peer filesharing).

<sup>71</sup>See, e.g., Robert P. Merges, *Of Property Rules, Coase, and Intellectual Property*, 94 Colum. L. Rev. 2655, 2662 (1994) (arguing the presence of high transaction costs does not necessarily halt exchanges). See also Wendy J. Gordon, *Fair Use as Market Failure: A Structural and Economic Analysis of the Betamax Case and its Predecessors*, 82 Colum. L. Rev. 1600, 1613 (1982) (discussion of the copyright market).

intellectual property law that favors distributing rights to creators rather than infringers.<sup>72</sup>

The digital clearinghouse proposals themselves, however, address Merges' qualms, which track traditional critiques of the Coase Theorem in wider fields than intellectual property, that is, the real-world results of transaction costs and distribution effects. Despite the fact that the proposals by and large do not explicitly reference Coase,<sup>73</sup> they strongly relate to both the normative and positive Coase Theorem. First, as discussed in the previous section, they are designed to track agreements that could occur were it not for inhibitive transaction costs. Second, to the extent that transaction costs derive from strategic bargaining, the universal nature of several of the proposals should prevent holdout problems. Finally, the built-in bias towards distributing rights to creators would not necessarily change. The digital clearinghouse proposals merely envision copyright holders owning a right to revenue rather than a right to exclude.<sup>74</sup> In short, they picture a liability rule rather than a property rule.

Liability rules, as in tort law, involve governmentally-set prices or damages for transgressions; property rules give owners the absolute right to prohibit transgression subject to negotiation with them. Drawing on the landmark work of Calabresi and Melamed,<sup>75</sup> commentators have argued about whether property rules (injunctions) or liability rules (damages or compulsory licenses with a socially set fee) are more appropriate for

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<sup>72</sup> See Merges, *supra* n. 63 at 2657-2663 (discussion of how intellectual property differs from the examples used by Coase).

<sup>73</sup>They generally do seem to apply Coasean concepts implicitly, however. See, e.g., Ku, *supra* n. [ ], at 266-8, 306-12 (arguing that copyright is irrelevant in the context of internet peer-to-peer file sharing because digital technology has trivialized, if not eliminated, the transaction costs of creating and distributing music); Lessig, *supra* n. [ ], at 172-3; Gervais, *supra* n. [ ], at 46-50, 54-70); Litman, *supra* n. [ ], at 29-32, 42 (suggesting that reduction of "unnecessary barriers" to file sharing by allowing consumers to compensate creators directly in some instances, and letting contract law govern the mutual obligations of intermediaries and creators in other instances); Lunney, *supra* n. [ ], at 821, 869-912; Netanel, *supra* n. [ ] at 5-6, 24-5, 35-6 (arguing a noncommercial use levy would track consumer demand, distribute payments to copyright owners, support the production and dissemination of creative works, and value different types of expressions more efficiently than proprietary copyright).

<sup>74</sup>See *supra* nn. [ ] and surrounding text.

<sup>75</sup>See *supra* n. [ ].

intellectual property.<sup>76</sup> The digital clearinghouse proposals, which largely include compulsory licensing, replace the property rules that dominate intellectual property with tort-like liability rules.<sup>77</sup> Administrative or judicial price setting on users' activities would replace private negotiation between users and rights holders subject to the latter group's ability to enjoin use.<sup>78</sup>

Professor Merges has argued that, under the Calabresi-Melamed framework, property rules prove superior to liability rules, citing the simple bilateral nature of a rights holder-user license, the relatively low transaction costs involved and the difficulty a court would have to accurately set the price involved in a liability regime.<sup>79</sup> He also cites Professor Paul Goldstein's thesis that the kind of compulsory licensing involved in a liability rule can inhibit the evolution of technologies and innovations that could more efficiently handle such licensing.<sup>80</sup> Given the "cheap option" of a potentially favorable administrative remedy, users might eschew direct negotiation with rights holders in favor of lobbying the administrators.<sup>81</sup>

In contrast, Professors Mark Lemley and Phillip Weiser argue that liability rules may better suit intellectual property. They key on the idea that the definition and enforcement of intellectual property rights is more difficult than real property.<sup>82</sup> They theorize

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<sup>76</sup>*Compare* Merges, 94 Colum. L. Rev. 2655 (arguing for property rules) *with* Lemley and Weiser, 85 Texas L. Rev. 783 (arguing for liability rules).

<sup>77</sup>*See supra* nn. [ ]. and surrounding text.

<sup>78</sup>*See* Merges, 94 Colum. L. Rev. at 2664 and 2667 (arguing that the parties should left alone to make their own deals regarding value of the property); *and* Lemley and Weiser, 85 Texas L. Rev. at 839 (supporting the use of regulatory and administrative bodies).

<sup>79</sup>*See* Merges, 94 Colum. L. Rev. at 2665-2666 (discussion of the difficulty for a court to properly value a copyright holder's loss in an infringement case).

<sup>80</sup>*See* Merges, 94 Colum. L. Rev. at nn. 53-55 (citing Paul Goldstein's treatise on copyright law, in particular Goldstein's discussion of compulsory licenses).

<sup>81</sup>*See* Richard Epstein, *A Clear View of the Cathedral: The Dominance of Property Rules*, 106 Yale L. J. 2091, 2093 (1997). *See also* Paul Goldstein, *Copyright: Principles, Law and Practice* s 11.0, at 247-48 (1989); Merges, 94 Calif. L. Rev. at 2662.

<sup>82</sup>Lemley and Weiser, 85 Tex. L. Rev. at 784.

that the property rule of injunctive relief may yield broader rights than are actually merited, encouraging a “holdup strategy” for the rights holder.<sup>83</sup> In short, their fear is that a property rule may encourage strategic behavior by rights holders that promotes a suboptimal result. However, Henry Smith believes that this view may understate the virtue of a property rule in creating a simple modular signal to potential infringers.<sup>84</sup>

The digital clearinghouse proposals address the problems of both liability and property rules. Under the digital clearinghouse regime, rights holders have a claim to compensation, but not injunction, and so they can avoid the Lemley-Weiser holdup concern. The proposals also are designed to deal with a phenomenon that differs from the traditional bilateral IP license Merges confronts. The digital clearinghouse proposals target multilateral behavior like peer-to-peer and of private use where transactions costs can outweigh the value of the transaction. Several of the proposals explicitly propose a price-setting and revenue-splitting regime designed to reduce the opportunities for seeking economic rents.<sup>85</sup> As a result, the design of these proposals makes sense under the frameworks set forth by commentators who have directly addressed Coasean bargaining, property/liability rules and IP.

### 3. *Content/Net neutrality*

The digital clearinghouse proposals envision a licensing scheme that is ultimately content-neutral. Professor Tim Wu describes the “net neutrality” principle, as stemming from the idea

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<sup>83</sup>*Id.* at 818-820 (applying this insight to copyright jurisprudence).

<sup>84</sup>Henry Smith, “Intellectual Property as Property,” 116 *Yale L. J.* 1742, 1781, 1812 (2007). Professor Smith does accept that copyright may be more susceptible than patent to liability rules like compulsory licenses because of the relative ease of assessing costs and benefits in copyright.

<sup>85</sup>Proponents of these models recognize that it is inefficient to pay creators more than the minimum it would require for them to produce their creation – just as other economic rents are represent welfare losses. *See* Lessig, *supra* n.[ ], at 232, 287-306 (suggesting that copyright should expire when it ceases to provide authors with incentives to create works, and that file sharing should be taxed when it is used as a substitute for buying CDs); Fisher, *supra* n.[ ], at \_\_\_ (suggesting the “full social value” of their creations or “what [creators] deserve” may generate overcompensation).

that a public information network should treat all content equally to promote competition on merits.<sup>86</sup> A common feature of the digital clearinghouse proposals is to treat different rights holders' creations the same save for their popularity of use. The compensation creators receive would depend solely on measures of utility to users and the system itself would not promote some rights holders over others.

This popularity-driven compensation system prevents the "segmentation" of content distribution into competing proprietary networks that could hurt consumer and social welfare.<sup>87</sup> That is, these systems rule out the creation of proprietary networks that promote favor some content over others and may to a degree "lock in" users. The incentives established by the digital clearinghouse proposals also would focus creators on producing the best work for their users, rather than leading them to cater to particular publishers or distribution networks who might skew incentives.

The digital clearinghouse proposals address numerous concerns stemming from experience with collective rights organizations, theory on Coasean bargaining and rules, and insight about content and network neutrality. Small wonder, then, that so many American law professors seem to have reached a consensus on these proposals.<sup>88</sup> The question that remains, however, is why, presented with a similar proposal, Japanese law professors rejected it.

### **III. The Japanese Digital Clearinghouse**

Japan has used a system resembling the digital clearinghouse proposal for years to compensate copyright holders for digital copying of their works. Under the Japanese system, consumers pay a digital recording levy when they purchase devices or media usable for private recording. Proceeds from digital recording levies are distributed to the copyright holders.

The Japanese system did not emerge spontaneously. Rather, it was a legislative bargain in response to copyright

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<sup>86</sup>Tim Wu, *Network Neutrality, Broadband Discrimination*, 2 J. Telecomm. & High Tech. L. J. 141, 147-48 (2003).

<sup>87</sup>See Dan Hunter, *Walled Gardens*, 62 Wash. & Lee L. Rev. 607, 611 (2005) (arguing against restricted access to academic scholarship).

<sup>88</sup>See Jessica Litman, *Sharing and Stealing*, 27 Hastings Comm. & Ent. L. J. 1, 33 (2004) (discussion of different American law professors' proposals for adopting peer-to-peer filesharing).

holders' concerns about proliferating CD rental shops and their customers – analogous, in some respects, to the current U.S. constituency of millions of P2P users. This Japanese response took the form of a liability rule combined with a digital clearinghouse. However, the system evolved as a reaction to technological advances that enabled high-quality copying of works.

#### A. Pssst . . . Would you like to rent a CD?

Japan's CD rental stores predate peer-to-peer filesharing and iPods. In fact, they predate MP3s, consumer CD recorders and even Digital Audio Tape.<sup>89</sup> With zany names like *You and I* (a homonym for the Japanese words for "Friendship" and "Love"),<sup>90</sup> these stores proliferated in the 1980s, renting out CDs, selling blank analog cassette tapes and even providing in-store recording machinery.<sup>91</sup>

These stores benefited from quirks of drafting that became statutory loopholes when technological and business innovation emerged to take advantage. The current version of Japan's Copyright Law became effective in 1971, though it has since been amended. Article 30 of the Copyright Law, both before 1971 and since, has included a general right for citizens to reproduce copyrighted material for private use.<sup>92</sup> Prior to 1971, Article 30

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<sup>89</sup>See "A CD Business," *The Economist* (Sept. 15, 1990) (predicting, incorrectly, that the widespread transfer to cassettes of compact discs (CDs) that people rent in Japan looks like being outlawed"); Guy de Launey, "Not-so-big in Japan" *Popular Music* 14:2 (1995) (observing that CD "[r]ental shops eventually became" a "political football between the US and Japan, the American side claiming that 'rental shops are closely allied to the political lobby of Japanese consumer-electronics and blank-tape manufacturers'" and adversaries to the music industry and performers, including American artists and record companies).

<sup>90</sup>"A CD Business," *supra* n.[ ].

<sup>91</sup>*Id.*

<sup>92</sup>The current Article 30, section 1, states in relevant part that, subject to certain exceptions:

A work of authorship which is the subject matter of copyright (referred to as a "work of authorship") may be reproduced by the user for using it personally or at his home or within a similarly limited circle . . .

included the qualification that such private reproduction should not be “by means of mechanical or chemical techniques.”<sup>93</sup> However, the 1971 version of section 30 dropped that qualification as too restrictive.<sup>94</sup>

The omission of the provision excluding mechanical reproduction was not at first a major issue, since at that time, reel-to-reel tape recorders the size of small suitcases were the only reproduction machines available for use in private homes.<sup>95</sup> Unlike Walkmans – let alone iPods – reel-to-reel players did not greatly increase consumers’ space-shifting ability when enjoying recorded music. However, the emergence of smaller cassette tapes and devices for playing and recording them created concern for music copyright owners.<sup>96</sup> The development of the audio CD in the early 1980s was the final ingredient for large-scale private copying. Taking advantage of the statutory hole, CD rental shops thrived, selling blank cassette tapes and providing in-store recording equipment.

In response, copyright holders in Japan lobbied and won a 1984 amendment explicitly excluding reproductions by use of publicly available machines – such as high-speed cassette dubbing machines in music rental stores.<sup>97</sup> But the amendment also recognized a “rental right” for copyrighted music, thereby legitimizing the CD rental industry.<sup>98</sup> Given the newly available and superior CD and the formal legitimization of their activities, CD

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Copyright Law, Article 30(1).

<sup>93</sup>Masakira Katsumoto, *The New Japanese Copyright Law* (Vienna: Mansche Verlags, 1975), p. 137. See Copyright Act, Law No. 39 of 1899, in Teruo Doi, *Japanese Copyright Law in the 21<sup>st</sup> Century* (Oceana, 2001), p.289 (pre-1970 Article 30(i) stated that “[r]eproduction without the intention of publishing and not by mechanical or chemical means” “shall not be regarded as an infringement” of copyright).

<sup>94</sup>*Id.*

<sup>95</sup>Doi, *supra* n.[ ], p. 103.

<sup>96</sup>*Id.*

<sup>97</sup>Peter Ganea and Christopher Heath, “Economic Rights and Limitations,” in *Japanese Copyright Law* (Kluwer, 2005), p. 59

<sup>98</sup>*Id.*

rental shops mushroomed from 34 nationwide in 1980 to 6184 by 1989 (see Table 1).<sup>99</sup>

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<sup>99</sup>“A Very CD Business,” *The Economist*, Sept. 15, 1990.

**Table 1. The CD Rental Industry and Audio Recording Levy Proceeds.**

Year	CD Rental Shops <sup>100</sup>	CD Rental Revenues (in Million Yen) <sup>101</sup>	Recording Industry Sales Rev (Million Yen) <sup>102</sup>	Audio Recording Levy Revenues (in Million) <sup>103</sup>
1983	1759	n/a	281600	n/a
1984	1901	n/a	274100	n/a
1985	2324	n/a	281400	n/a
1986	3023	n/a	298900	n/a
1987	3562	n/a	311600	n/a
1988	4988	n/a	342900	n/a
1989	6150	n/a	383300	n/a
1990	6001	n/a	387800	n/a
1991	5540	n/a	449300	n/a
1992	4925	n/a	478200	n/a
1993	4836	n/a	513700	n/a
1994	4688	n/a	519200	114.6
1995	4549	n/a	574000	182.4
1996	4478	63600	583900	1007.2
1997	4486	67100	588000	1814.6
1998	4363	68800	607500	2550.8
1999	4135	64600	569600	3057.8
2000	3879	62900	539800	3894.7
2001	3678	65000	503100	4036.3
2002	3591	65300	443100	3303.7
2003	3437	61000	399700	2824.3
2004	3311	59900	377400	2339.4
2005	3234	59800	367200	2018.0
2006	3187	62300	351600	n/a

<sup>100</sup>Nihon konpakuto deisuku bideo rentaru shougyou kumiai [Japan CD and video rental trade association], CD Rentaru ni kansuru shiryō [Data on CD rentals], May 10, 2007, available at [http://www.mext.go.jp/b\\_menu/shingi/bunka/gijiroku/020/07051108/001.pdf](http://www.mext.go.jp/b_menu/shingi/bunka/gijiroku/020/07051108/001.pdf) (report to Ministry of Cultural Affairs), p.7.

<sup>101</sup>*Id.*

<sup>102</sup>*Id.*, p.7 (citing Recording Industry Association of Japan data).

<sup>103</sup>See Society for Administration of Remuneration of Audio Home Recording (SARAH) (Japan), *The Practices of SARAH*, available at

The existence of the Japanese rental CD industry did not escape overseas notice. Indeed, Japanese CD rental shops became both a trade irritant and a cautionary tale for the American recording industry. The significant share of foreign music available for rent, combined with perceived differential treatment of foreigners under Japanese copyright law, led American trade negotiators to press the issue of Japanese CD rental stores both bilaterally with the Japanese government and during the TRIPS negotiations of the late 1980s and early 1990s.<sup>104</sup> Additionally, when the U.S. Congress passed legislation greatly reducing the possibility of CD rental shops in the United States,<sup>105</sup> testimony was presented specifically warning of the degree to which such shops in Japan had accelerated the rate of private copying.<sup>106</sup> During the U.S. debate over what would ultimately become the Audio Home Recording Act – the response to the near-perfect copying ability of the then newly-invented digital audio tape – evidence was introduced of the effects of Japanese CD rental shops.<sup>107</sup>

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[http://sarah.or.jp/index\\_e.html](http://sarah.or.jp/index_e.html) (last visited June 20, 2007) (outlining revenues from private recording levy).

<sup>104</sup>*Id.* (stating that foreign music made up from 25% to 50% of Japan’s music market in the preceding decades and noting complaints of differential treatment of foreign music companies concerning rental royalties); Kyoko Sato, “Compact disc renters fret over right to rock; U.S. demands stronger copyright rules,” *Nihon Keizai Shimbun*, Nov. 30, 1991 (reporting U.S. demand for “tighter copyright laws on rental CDs” in the context of the Uruguay Round, which involved TRIPS); Bill Holland, “RIAA Adds to the Pressure Politely,” *Billboard*, Dec. 7, 1991 (reporting U.S. Trade Representative and Recording Industry Association of America’s direct talks with Japanese government officials).

<sup>105</sup>The Record Rental Amendment of 1984 excluded CD rentals from the first sale doctrine. Record Rental Amendment of 1984, [Pub.L. No. 98-450, 98 Stat. 1727](#) (codified at [17 U.S.C.A. § 109\(b\)\(1\)\(a\) \(West Supp.1991\)](#)). Under this amendment, the owner of a copy of a phonorecord containing copyrighted material must obtain the permission of the copyright owner in order to rent out the phonorecord for direct or indirect commercial advantage. *Id.*

<sup>106</sup>H.R. 1029, 98th Cong., 2d Sess. (1983), reprinted in Audio and Video First Sale Doctrine: Hearings on H.R. 1027, H.R. 1029 and S. 32 Before the Subcomm. on Courts, Civil Liberties and the Admin. of Justice of the House Comm. on the Judiciary, 98th Cong., 1st Sess. 729 (1984, 1985) [hereinafter House Audio and Video Hearings], p.33.

As in the United States,<sup>108</sup> the new threat of widespread use of digital audio tape in the late 1980s and early 1990s threw Japanese music copyright holders into a panic. In response, the Japanese government took two fundamental steps. First, while the law continued to allow CD rental without consent of the copyright holder, new amendments created a “waiting period” before a newly released CD could be made available in a CD rental shop.<sup>109</sup> Interestingly, although the waiting period was legislated at one year, Japanese record companies and the rental shops – the latter allied to domestic consumer electronics and recording-media manufacturers and their customers<sup>110</sup> – agreed to shorten the waiting period to mere weeks in exchange for royalty payments.<sup>111</sup> More relevantly, the Japanese government established a digital clearinghouse system to transfer the proceeds of a new

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<sup>107</sup>See Digital Audio Tape Tariff Act, 132 Cong.Rec. S13107-04 (Sen. Danforth) (including text of the proposed act, along with *Billboard* article referencing Japanese CD rental industry).

<sup>108</sup>See Randy Picker, *Mistrust Based Digital Rights Management*, 5 J. Telecomm. & High Tech. L. 47, 55-56 (2006) (discussing copyright holders and music producers fears).

<sup>109</sup>See Copyright Law article 95 *ter*, in Doi, *Japanese Copyright Law* (establishing that waiting period can range from one month to twelve months depending on administrative order); Copyright Administrative Order article 57 *bis* (administrative order specifying that the period will be twelve months), in Doi, *Japanese Copyright Law*.

<sup>110</sup>See “A CD Business,” *The Economist*, Jan. 3, 1992 (observing the Japanese government’s reluctance “to upset potential supporters” including “over 6200” rental shops and “tens of millions” of customers); Holland, *supra* n.[ ] (stating that “rental shops” were “closely allied to the political lobby of Japanese consumer-electronics and blank-tape manufacturers”). Cf. *Litman*, *supra* n. 76 at 32-33 (arguing for peer-to-peer filesharing).

<sup>111</sup>In general, since 1994, there has been a three-week embargo after the initial CD sale release date on CD rentals– lengthened from 2 weeks in 1992 and 1 week in 1991, when the waiting period was introduced. See Data on CD rentals, *supra* n.[ ] at p. 7. However, there is longer waiting period for CD releases by new artists or low-sales volume niche artists. *Id.* at p. 7. See also Steve McClure, “Trouble for Japan’s Rental Outlets,” *Billboard*, Jun. 1, 1991, p.5 (stating that “Japan’s record companies and rental stores . . . reached a gentleman’s agreement” that rendered “the law’s one-year-window provision . . . essentially a dead letter”); Steve McClure, “Japan’s Record-Rental Biz Tries to Avert One-Year Lag,” *Billboard*, Apr. 4, 1992 (reporting that the rental shops were paying Japanese record companies “a one-time fee of 400 yen . . . in exchange for the right to rent [CDs] . . . one week after release”)

noncommercial use levy to copyright holders.<sup>112</sup> Under this bargain, CD rental shops continue in Japan to the present day, though they have also diversified into CD sales, DVD rentals and sales.<sup>113</sup>

## B. SARAH is born

The Japanese digital clearinghouse established in 1993 was the product of several forces. Several contending lobbies pushed their cases, including: widespread CD rental shops backed by powerful domestic electronics manufacturers,<sup>114</sup> Japanese copyright holders irritated at increasing private copying,<sup>115</sup> and

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<sup>112</sup>See Copyright Act, Article 30(2), stating that:

A person who makes a sound or visual recording for private use by equipment having the function of sound or visual recording in digital form specified by a Ministry order (other than one having a special function for broadcasting business or any other special function which is not usually designed for private use, or one having a sound or visual recording function auxiliary to the primary function, such as a telephone apparatus having a sound recording function) on a recording medium designed for sound or visual recording in digital form by such equipment specified by a Ministry order shall be liable to pay a reasonable amount of compensation to the copyright owner.

Article 30(2). This provision was created by a 1992 amendment to the Copyright Act that became effective on June 1, 1993. Doi, *supra* n.[ ], at 105.

<sup>113</sup>See Steve McClure, "Japanese CD-Rental Chain CCC Strikes Cost-Cutting Deal," *Billboard*, Nov. 9, 2002. In recent years, Japan's largest CD rental chain, Culture Convenience Club (Tsutaya), has also become its largest rental video chain, see Yuji Utsunomiya, "Tsutaya Rental Chain Charts Diversification Course," *The Japan Times*, Aug. 5, 2003. The shift in the industry due to technology is captured in the name changes of its trade association, which before August 1994 was the "Japan Record Rental Trade Association," then changed its name to the "Japan Compact Disc Rental Trade Association," and since June 1998 has become the "Japan Compact Disc and Video Rental Trade Association." See *CDV-Japan ni tsuite* [about CDV-Japan] (describing name changes of trade association currently representing 3628 stores), available at <http://cdvnet.jp/modules/xoopscdv/> (last visited on June 20, 2007).

<sup>114</sup>See *supra* nn.[ ] and surrounding text.

<sup>115</sup>See *supra* nn.[ ] and surrounding text.

American copyright holders aggravated by both private copying and perceived discriminatory treatment.<sup>116</sup> The development of CDs with high-quality audio playback and the advent of Digital Audio Tape (DAT) brought matters to a head.

The result was a digital clearinghouse system that bears some resemblance to the recent American proposals to deal with P2P filesharing, digital copying, MP3 players and iPods. In particular, 1993 amendments to the Japanese Copyright Law provide a liability rule for private digital copying.<sup>117</sup> Japanese consumers continue to possess the right to make private digital copies, but must pay an administratively set fee on the digital devices and media they use.<sup>118</sup> The Ministry was granted the power to receive and approve royalty rate proposals from copyright holders' trade associations and to authorize these associations to gather and distribute revenues to their membership.<sup>119</sup> The Society for Administration of Remuneration for Audio Home Recording (SARAH) was granted such authority in 1993<sup>120</sup>; a counterpart plays a similar role for digital video recordings.<sup>121</sup> SARAH distributes the revenue it collects to

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<sup>116</sup>See *supra* nn.[ ] and surrounding text. See also Dan Rosen and Chikako Usui, *The Social Structure of Japanese Intellectual Property Law*, 13 UCLA Pac. Basin L. J. 32, 62 (1994)

<sup>117</sup>Article 30(2) (stating "a person who makes [a digital] sound or visual recording . . . shall be liable to pay a reasonable amount of compensation to the copyright owner").

<sup>118</sup>There is an exemption for devices that the purchaser can demonstrate will not be used for private copying, but that exemption is rarely used since the cost of taking advantage of it is substantial in light of the refund. Minutes of the Meeting of the Legislative Issues Study Group of the Copyright Section of the Ministry of Cultural Affairs Advisory Council, available at [http://www.mext.go.jp/b\\_menu/shingi/bunka/gijiroku/013/05070401.htm](http://www.mext.go.jp/b_menu/shingi/bunka/gijiroku/013/05070401.htm) (trans. Joe Jones & Salil Mehra), p. 47 (comment of member Maeda) (stating that "the current lump sum collection [levy], that is from people who buy devices and recordable media, is first, collected in a lump sum at the time of purchase, and the current system provides that a person who can prove they are not conducting private audiovisual recording can get a refund, but that refund system is . . . one in which 80 yen is necessary to get 8 yen back, and so it has been pointed out that it does not really function").

<sup>119</sup>Copyright Law Enforcement Orders [Chosakukenhou shikou kisoku] Articles 22-3 and 22-4

<sup>120</sup>Doi, *supra* n.[ ] at 114-15.

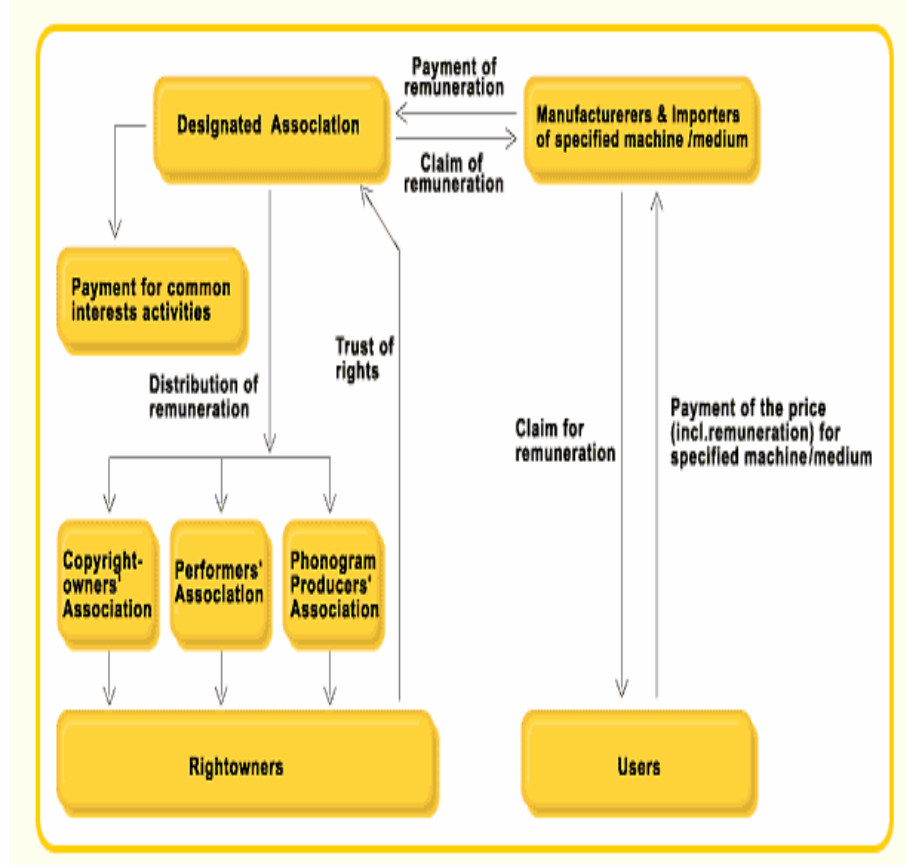
organizations representing composers, performers and publishers, who then distribute this money to their members.<sup>122</sup> As a result, a flow of revenue runs from users to rights holders, mediated by government oversight and private trade association participation (see Figure 3). The picture is similar to William Fisher's proposal (see Figure 1), save for the fact that SARAH does not yet capture hard-disk based devices and Internet filesharing.

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<sup>121</sup> See What is SARVH? [SARVH to wa?], available at [http://www.sarvh.or.jp/dis/c\\_navi.html](http://www.sarvh.or.jp/dis/c_navi.html) (last visited June 20, 2007) (describing SARVH as "a nonprofit corporation that receives royalty revenues from [video] device makers that consumers have paid, and then distributes that revenue to copyright holders").

<sup>122</sup> See SARAH, *The Practices of SARAH*, available at [http://sarah.or.jp/index\\_e.html](http://sarah.or.jp/index_e.html) (last visited June 20, 2007) (describing payments to the Japanese Society for Rights of Authors, Composers and Publishers (JASRAC), the Japan Council of Performers' Organizations (GEIDANKYO) and the Recording Industry Association of Japan (RIAJ)).

**Figure 3. Japan's Society for Administration of Remuneration for Audio Home Recording (SARAH)<sup>123</sup>**



Japan's system also authorizes the Ministry of Cultural Affairs to designate digital devices and media as objects for a noncommercial use levy.<sup>124</sup> Over time, these media have come to include not just digital audio tape but also several types of recordable CDs, and the devices have expanded from digital audio tape recorders to include mini-disc (MD) and CD recorders.<sup>125</sup> Under the current royalty schedule submitted by SARAH and

<sup>123</sup> See Society for Remuneration of Audio Home Recording, *Outline of Remuneration System*, available at [http://www.sarah.or.jp/index\\_e.html](http://www.sarah.or.jp/index_e.html) (last visited June 1, 2007).

<sup>124</sup> *Id.*

<sup>125</sup> See Doi, *supra* n.107-09 (setting forth the chronology of expansion of designated devices).

approved by the Ministry, devices are levied at 2% of their scheduled base price, up to 1000 yen (about \$8) and media at 3% of their base price.<sup>126</sup> Under this system, SARAH had collected a high of 4.0 billion yen (about \$33 million) at its peak in 2001.<sup>127</sup> While this may seem low in comparison with CD sales of 491 billion yen (about \$4.1 billion) in the same year,<sup>128</sup> it should be remembered that user royalty fees are separate from rental royalty fees paid on a per CD basis by rental shops, and that many CDs are sold to private consumers who will not rent them out commercially.<sup>129</sup>

Despite the liability rule enshrined in its system, Japan has not escaped the issues that confronted by the U.S. system of property rules for copyrighted music: increased digital copying, P2P filesharing and MP3 players and iPods. Revenues collected under the system fell roughly in half from 2001 to 2005,<sup>130</sup> thought to reflect the effects of P2P filesharing as well as increased use of hard-disk based digital music players not under the system.<sup>131</sup> Under the Japanese system, the Ministry of Cultural Affairs first needed to address the question of whether digital music players such as MP3 players and iPods should be included in Japan's digital clearinghouse system. To aid in this determination, the Ministry asked experts to do a study. As a result, those experts –

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<sup>126</sup> See SARAH, *The Practices of SARAH*, available at [http://sarah.or.jp/index\\_e.html](http://sarah.or.jp/index_e.html) (last visited June 20, 2007)

<sup>127</sup> *Id.*

<sup>128</sup> See Japan External Trade Organization (JETRO), *Japan's Music Industry*, available at [http://www.jetro.go.jp/en/market/report/pdf/2004\\_28\\_r.pdf](http://www.jetro.go.jp/en/market/report/pdf/2004_28_r.pdf) (last visited June 20, 2007), p.5 (Fig. 5).

<sup>129</sup> See *supra* n. [ ] and Table 1.

<sup>130</sup> See *The Practices of SARAH*, *supra* n.[ ] (showing 2.0 billion yen collected in 2005).

<sup>131</sup> See Steve McClure, "We've Got High Expectations," *Japan Times*, Feb. 6, 2002 (noting growing popularity of filesharing as well as the check on their popularity provided by rental CD shops); Chester Dawson, "Japan's Music Industry is Losing Its Groove," *BusinessWeek*, Jun. 10, 2002 (citing "epidemic of illegal copying" via the Internet for lost sales). *But see* Tatsuo Tanaka, *Does Filesharing Reduce CD Sales? A Case of Japan*, available at <http://www.iir.hit-u.ac.jp/file/WP05-08tanaka.pdf> (last visited June 20, 2007) (concluding that the answer to the title question is no).

mostly academics, especially law professors – were forced to consider the possibility of an iPod tax.

#### **IV. The iPod Tax**

##### **A. The Tax and Its Rejection**

The Japanese iPod tax proposal and the examination surrounding it represent a real-world attempt to create a digital clearinghouse and noncommercial use levy system. The information and arguments involved show that an American digital clearinghouse system would face serious practical management problems. Additionally, the Japanese experience suggests concern that an American system based on a compulsory license could morph into a deal between mobilized producer groups quietly extracting rents from more diffuse and disorganized consumer groups – a classic result predicted by public choice theory.

These arguments came to light as a result of Japan's wide-ranging use of advisory councils (*shingikai*) to channel the observations and opinions of outside experts into the legislative process. How much power the *shingikai* have to influence decision making is difficult to say. In the past, some critics have alleged that they are "puppet shows" controlled by bureaucrats.<sup>132</sup> According to these critics, the bureaucrats frame the agenda of the *shingikai* and fill them with members who can be manipulated.<sup>133</sup> However, competing accounts observe that the *shingikai* provide real access for interest groups to influence policy.<sup>134</sup> Thus, there is a debate over whether the *shingikai* promote interest group "capture" of government, or government "cooptation" of interest

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<sup>132</sup>See Mark Levin, 8 Stan. L. & Pol'y Rev. 99, 101 and n.38 [fill out this cite]; Frank Schwartz, *Of Fairy Cloaks and Familiar Talks: The Politics of Consultation*, in Political Dynamics in Contemporary Japan 217 (Gary D. Alinson & Yasunori Sone eds., 1993); Chalmers Johnson, *MITI and the Japanese Miracle*, 47-48 (1982); Frank Upham, *Law and Social Change in Postwar Japan*, 168-69 (1987).

<sup>133</sup>See Tom Ginsburg, *Dismantling the Developmental State? Administrative Procedure Reform in Japan and Korea*, 49 Am. J. Comp. L. 585, 592-93; David Bolling, 34 Stan. J. Int'l L 1, 20 (1998).

<sup>134</sup>See Levin, *supra* n.\_ at n.38; Ulrike Schaede, *Cooperative Capitalism*, *supra* n.2 at 37-40.

groups.<sup>135</sup> This is relevant given some government voices outside the Ministry of Cultural Affairs who questioned the existing digital clearinghouse system during the council's study.<sup>136</sup>

The debate over the *shingikai* largely predates the 2001 enactment of Japan's Information Disclosure Law. While the law possesses some notable exceptions to disclosure, it has nonetheless created greater transparency on Japan's bureaucracy, and by extension the *shingikai*.<sup>137</sup> One result of this is that significant portions of the discussion, meeting minutes and reports of the debate over the iPod tax have become public – and thus a window into what a real-world debate over a proposed digital clearinghouse looks like.

In Japan's debate, the iPod tax proposal lost. The irony of this result is that the legislative council of the *shingikai* whose inquiry justified this defeat was dominated not by copyright industry representatives but by academics.<sup>138</sup> Indeed, the chair, Prof. Nobuhiro Nakayama of Tokyo University Law School, now heads the Japanese branch of Creative Commons<sup>139</sup> – a nonprofit

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<sup>135</sup>Ginsburg, *supra* n. [ ] at 592.

<sup>136</sup>See, e.g., Yutaka Fujiwara, *Hotondo no shouhisha ga shirazu ni haratte iru shiteki rokuon rokga hosyoukin* [The private audio/video recording levy that most consumers pay unknowingly] (part one), *Nikkei Business Plus*, Apr. 25, 2005, available at <http://chizai.nikkeibp.co.jp/chizai/gov/medi20050425.html> (last visited June 25, 2007) (essay by member of policy planning office of the Ministry of Economy Trade and Industry (METI)) (claiming that few consumers know about the existing private recording levy, and that the management of only one in ten consumer organizations seemed to know about it).

<sup>137</sup>See Jeff Kingston, *Information Disclosure in Japan* (2005), available at [http://law.anu.edu.au/anjel/documents/ResearchPublications/Kingston2005\\_InformationDisclosureInJapan.pdf](http://law.anu.edu.au/anjel/documents/ResearchPublications/Kingston2005_InformationDisclosureInJapan.pdf) (last visited June 22, 2007).

<sup>138</sup>See *Shiteki rokuon rokuga hoshyoukin no minaoshi ni tai suru housei mondai shyouiinkai kakuiin teishutsu iken* [submitted opinions of each member of the legislative issues study group for revision of the private audio/video recording compensation system], available at [http://www.mext.go.jp/b\\_menu/shingi/bunka/gijiroku/013/05070401/003\\_2.htm](http://www.mext.go.jp/b_menu/shingi/bunka/gijiroku/013/05070401/003_2.htm) (last visited June 25, 2007) (including roster showing 21 members, 14 of whom were listed as professors – 10 of whom teach law).

<sup>139</sup>See Fujiwara part two, *supra* n.[ ] (describing Nakayama as heading the study); Minutes of the Meeting of the Legislative Issues Study Group of the Copyright Section of the Ministry of Cultural Affairs Advisory Council, available at [http://www.mext.go.jp/b\\_menu/shingi/bunka/gijiroku/013/05070401.htm](http://www.mext.go.jp/b_menu/shingi/bunka/gijiroku/013/05070401.htm) (trans. Joe Jones & Salil Mehra) (identifying Nakayama as leader in transcript);

organization aimed at reforming the existing system of copyright law.<sup>140</sup>

The iPod tax was first proposed in January 2005, and the study group spent most of the year considering the question.<sup>141</sup> In doing so, they were forced to confront not only iPods and other hard-disk based devices but also the delivery of music via cellphones and Internet connections. Thus, the press description as the study of an iPod tax was something of a misnomer, since the debate was actually wider.<sup>142</sup>

The reasons behind the defeat of the iPod tax are like two sides of the same coin. First, the panelists expressed dissatisfaction with the existing digital clearinghouse system, and doubts about extending it. Additionally, they hoped for something better – echoing in part the optimism of some American commentators on DRM technology. Members generally voiced concerns about lack of public understanding of what they were being levied for and how much.<sup>143</sup> In short, they thought that the

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Creative Commons Japan website, available at <http://www.creativecommons.jp/about/people/post/> (last visited June 24, 2007) (describing Nakayama as executive).

<sup>140</sup>Creative Commons seeks "to build a layer of reasonable, flexible copyright in the face of increasingly restrictive default rules." Lydia Pallas Loren, *Building a Reliable Semicommons of Creative Works: Enforcement of Creative Commons Licenses and Limited Abandonment of Copyright*, 14 Geo. Mason L. Rev. 271, 273 (2007) (describing Creative Commons as "an international phenomenon").

<sup>141</sup>The legislative study group was tasked with the question of how the existing system ought to handle hard disk based players in January 2005. See Yutaka Fujiwara, *Hotondo no shouhisha ga shirazu ni haratte iru shiteki rokuon rokuga hoshoukin* [The private audio/video recording levy that most consumers pay unknowingly] (part two), Nikkei Business Plus, Apr. 27, 2005, available at <http://chizai.nikkeibp.co.jp/chizai/gov/meti20050427.html> (last visited June 25, 2007). The report of the study group was issued in early December. *Bunka shingikai chosakuken bunkakai housei mondai shyouiinkai houkokusho* [report of the legislative issues subcommittee of the Ministry of Cultural Affairs' Advisory Council's Copyright Section]

<sup>142</sup>See, e.g., Yuri Kageyama, "Japan mulling 'iPod Tax,'" *The Seattle Times*, Oct. 12, 2005; Martin Fackler, "Japanese Music Industry Calls for an iPod Tax," *The New York Times*, Oct. 9, 2005.

<sup>143</sup>See Minutes, *supra* n.[ ], at 43 (statement of member manga artist Machiko Satonaka) (stating that she "think[s] there are many misunderstandings overall, so if we are to expand the scope of the system from here on, I think it is necessary to more and more intensively publicize how much of this is being used to protect copyrights").

existing system had a kind of democratic deficit. In particular, echoing the U.S.'s *Grokster* case,<sup>144</sup> members expressed doubts about the ability to decide whether all hard-disk based devices should be deemed as aimed at copyrighted music or video, or whether this risked over-inclusion of devices that can be used for other purposes.<sup>145</sup> The spectre of DRM also loomed large over the proceedings. Like American commentators, some *shingikai* panelists believed that DRM, which could supply the technological ability to solve the market failures that at least partially justify fair use, could also make the existing Japanese digital clearinghouse system unnecessary.<sup>146</sup> Others pointed out that from the consumer side, it seemed unfair to continue to impose the levy for private copying if DRM would reduce the ability of consumers to make such copies. In effect, they feared that consumers would be deprived of the benefit of their bargain by rights holder-imposed restraints.<sup>147</sup>

In written summaries, the council did put forth several arguments in favor of extending the current levy into an iPod tax. First, their fact-finding showed that purchases of iPods, MP3 players and other similar devices were used primarily to make digital copies of music; indeed, it seemed inequitable to treat hard-disk based devices differently from recordable CDs and mini-disks

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<sup>144</sup>See *supra* n.[ ].

<sup>145</sup>See Minutes, *supra* n.[ ], at 30-31 (statement of member attorney Takashi Yamamoto) (stating “when I consider that the things themselves are hard disks which can be used for any purpose for which one would store information, doesn’t the issue arise in this situation of whether it is fair to place something within or outside the scope of remuneration?”).

<sup>146</sup>See Minutes, *supra* n. [ ] at 30 (statement of Takashi Yamamoto) (asking “isn’t it the case that the grounds for the remuneration system to apply disappear when DRM and other rights management systems operate to protect the rights of the rights holders?”).

<sup>147</sup>Minutes, *supra* n. [ ], (statement of member Prof. Hiroshi Morita) (stating that “I think the private audiovisual recording remuneration system is premised on the meaning that if you pay the remuneration, you can freely conduct private audiovisual recording if you want, but in contrast to that, copy controls like DRM are expanding, and if private audiovisual recording can no longer be freely conducted, it may be time to do away with the remuneration system for private audiovisual recording”); *id.*, p. 50 (statement of member Professor Doi) (observing that “technological preservation measures are being developed” and concluding that “we should consider . . . a structure” in which works containing such controls are excluded from the remuneration system).

which were already covered by the levy.<sup>148</sup> Additionally, the council found that, while there may be cases to which the levy cannot be extended, it is inevitable that technological change would require its application to some new cases.<sup>149</sup> Finally, the council observed that if the iPod tax were imposed, it would be necessary to address the contracts and burdens that stronger DRM would impose on consumers and the impact this would have on Japan's existing system of "fair use"-like permissible private copying.<sup>150</sup>

The *shingikai* minutes also contain several arguments against adopting the iPod tax. Some members believed that the existing digital clearinghouse system contained substantial problems already, and that it would be improper to enlarge it without serious revision.<sup>151</sup> There was also the problem that users who bought music downloads from online services to put on their hard-disk players would essentially be double-taxed – once in the fee to the online service, and a second time via the noncommercial use levy.<sup>152</sup> Some panelists were concerned about fairness; because the levy is incorporated in the price of the device and/or media, consumers pay without understanding why or how much.<sup>153</sup> Additionally, the hard-disk players differ from previously levied devices because the media and the device were physically integrated into machines that could have more general use than duplicating copyrighted works.<sup>154</sup> Essentially, this problem partly resembles the U.S. issue of how to deal with devices capable of a substantial noninfringing use – the chief problem in *Sony* and

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<sup>148</sup>Ministry of Cultural Affairs, Copyright shingikai, legislative subcommittee, *Chief Opinions Concerning the Designation of Hard-disk based devices*, available at [http://www.mext.go.jp/b\\_menu/shingi/bunka/gijiroku/013/05072901/001.htm](http://www.mext.go.jp/b_menu/shingi/bunka/gijiroku/013/05072901/001.htm) (last visited June 21, 2007).

<sup>149</sup> *Id.*

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Id.*

*Grokster*.<sup>155</sup> Finally, there was some doubt about the ability to properly craft a rule that would attach the levy only to the “right” hard-disk based devices.<sup>156</sup>

Ultimately, it was the inability to gather a consensus that doomed the Japanese iPod tax.<sup>157</sup> As a result, as private copying shifts away from devices such as recordable CDs and towards hard-disk and flash-memory based devices, and as the delivery system moves from CD rental shops to cell phones and the Internet, Japan’s digital clearinghouse system may sunset through inaction in the face of technological change. The debate over Japan’s iPod tax suggests that this result derives at least in part Japan’s ambivalence towards its digital clearinghouse system.

## B. A Proposal

The failure of Japan’s iPod tax demonstrates several problems that the adoption of an American clearinghouse model must address. Although Japan’s system of policy-making differs from ours, there are some similarities. Like Japan, America has a political system that many characterize as relatively favorable to producer lobbies over consumer groups, particularly in the IP area.<sup>158</sup> Despite that producer bias, just as Japan had an incumbent industry of CD renters and rental shops, America has an existing base of music file sharers and iPod users. Perhaps most importantly, like Japan, it is difficult to imagine producers, consumers, academics and government officials reaching

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<sup>155</sup>See *supra* n.[ ].

<sup>156</sup>*Id.*

<sup>157</sup>See Martin Fackler, “Japanese panel rejects ‘iPod tax,’” Dec. 1, 2005 (citing Ministry of Cultural Affairs official statement that “without a consensus” the proposal could not proceed); Kageyama, *supra* n.[ ] (observing that the “divided” study group was “highly unlikely” to come up with an agreement, thereby dooming the proposal).

<sup>158</sup>See, e.g., Timothy Lee, *Entangling the Web*, THE NEW YORK TIMES, Aug. 3, 2006 (likening the dangers that net neutrality legislation would be captured by the regulated industry to the history of the Interstate Commerce Commission’s capture by the railroad industry).

consensus. And certainly, America also has its own history of capture of well-intentioned regulatory bodies.<sup>159</sup>

The proposal here seeks to modify the existing clearinghouse proposals to make capture more difficult. Regulatory capture is often looked at as a pathology; to the extent it is one, there is no widely-agreed on panacea. Nevertheless, some commentators have suggested several preventive measures to avoid capture. Cass Sunstein has advocated cost-benefit analysis to move beyond the question of which interest group pays more to regulation based on wider concerns.<sup>160</sup> Ian Ayres and John Braithwaite have suggested that rules that keep a single maverick private player in an industry “honest” can be preferable to the kind of industry-wide regulation that leads to capture.<sup>161</sup> Others have suggested that transparency of policymaking to the public particularly aids the effort to avoid regulatory capture.<sup>162</sup>

In view of these critiques and the Japanese experience, this Article makes the following proposal. The digital clearinghouse

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<sup>159</sup>*Id.* See George Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. 3 (1971); Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision Making. A Theory of Regulatory Capture*, 106 Quarterly Journal of Economics, 1089 (1991).

<sup>160</sup>See Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. Leg. Stud. 1059, 1064-73 (2000); see also Steve P. Calandrillo, *Responsible Regulation: A Sensible Cost-Benefit, Risk Versus Risk Approach To Federal Health And Safety Regulation*, 81 B.U. L. Rev. 957, 975 (2001) (stating that “the implementation of cost-benefit and risk-risk analysis should help avoid such misallocation of resources based on inappropriate private pressure”).

<sup>161</sup>Ian Ayres & John Braithwaite, *Partial-Industry Regulation: A Monopsony Standard for Consumer Protection*, 80 Cal. L. Rev. 13, 52-53 (1992) (proposing regulation of a single player or part of the market to “delegate[e] part of the regulatory role to the competitive process, partial-industry regulatory regimes seek to restrain the private exploitation of monopoly power without substituting the potential for public exploitation through capture”). See also Jonathan B. Baker, *Mavericks, Mergers, and Exclusion: Proving Coordinated Competitive Effects Under the Antitrust Laws*, 77 NYU L. Rev. 135, 174-76 (2002) (explaining how a single “maverick” firm in an industry can prevent others from colluding and achieving anti-consumer results).

<sup>162</sup>See Cary Coglianese, Richard Zeckhauser, and Edward Parson, *Seeking Truth For Power: Informational Strategy And Regulatory Policymaking*, 98 Minn. L. Rev. 277, 334 (2004); David Spence & Lekha Gopalakrishnan, *Bargaining Theory and Regulatory Reform: The Political Logic of Inefficient Regulation*, 53 Vand. L. Rev. 599, 622-623 (2000) (noting belief that “only transparent standards” “can prevent regulatory capture” in the environmental regulatory context).

model with the features common to the proposals discussed should be adopted. However, it should have three features not previously proposed:

- The clearinghouse should be structured as a cooperative owned by users pro-rata based on their annual level of purchasing copyrighted works.
- The prices for copyrighted works should be set by the clearinghouse itself.
- A portion of the clearinghouse's revenues should be rebated back to users annually.

This structure would achieve several goals in line with preventing regulatory capture. First, by turning users into owners, this structure would give users more of a stake in getting the prices involved right.<sup>163</sup> By rewarding users with a share of the profits from the distribution, users would have to make their own “cost-benefit analysis.” Get the prices too low, and too few works would be created and sent through the clearinghouse<sup>164</sup>; too high, and users would buy fewer works. Additionally, an individual work that, all things being equal, was encumbered with burdensome DRM would be “overpriced” and thus fail in competition with less “locked-up” works. The copyright holder would have to decide whether to drop the DRM or face a drop in price.

Second, a user-owned cooperative would be independent of other distribution channels. While agency problems will always exist, keeping ownership based on current-year use prevents the acquisition of the clearinghouse. Thus, it is more likely to remain an independent player in the industry. Even if other competing, proprietary channels emerge, the clearinghouse's maverick status may hinder the industry-wide collusion necessary for the capture of copyright regulation.

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<sup>163</sup>Jessica Litman's proposal, *see supra* n.[ ], did seem to reflect her view, expressed more fully in her later work, *see supra* n.[ ], that users should be recognized as possessing some kind of cognizable right.

<sup>164</sup>Some might fear that users would be tempted to set prices quite low, since the lost rebate to them would be outweighed by reduced expenditures on copyrighted works. However, that temptation would be (a) partially offset by increased sales volume at the lower price and (b) lowered incentive to create works for the system due to overly low prices.

Third, and perhaps most relevantly to the Japanese debate, a user-owned clearinghouse is most likely to be transparent. For its own operation, it will likely have to make significant disclosures to users. Their financial interest in the clearinghouse's workings suggest that they will have an incentive to push for such information. And this financial stake also gives diffuse users a tangible reason to organize – so as to counteract the inherent advantage that producers have in this regard.

Finally, this structure is particularly suited to some sort of private right of action. The legal infrastructure for the adjudication of such claims already exists in the United States.<sup>165</sup> Additionally, embracing the American tradition of private litigation on behalf of consumers can help keep in check industry capture of an American digital clearinghouse.

## **V. Conclusion**

Japan's rejection of the kind of digital clearinghouse that some American law professors seek does not involve a repudiation of the proposal on the merits. Rather, the debate shows the difficulty of implementing such a system in the real world – even when it is primarily just an extension of an existing system. Thus, any such system must be designed to be able to respond to attempts to capture it.

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<sup>165</sup>See Richard Nagareda, *The Preexistence Principle and the Structure of the Class Action*, 103 Colum. L. Rev. 149, 151 (2003) (describing American “class actions today [as] serv[ing] as the procedural vehicle not ultimately for adversarial litigation but for dealmaking on a mass basis” “in which class members' rights to sue are “bought and sold”). Class actions in civil litigation may come to be less particular to America. See Hannah Buxbaum, *Transnational Regulatory Litigation*, 46 Va. J. Int'l L. 251, 296 (2006) (describing growing adoption of group claims in European consumer protection law).