iTunes Case Study
Overview and Summary of Conclusions

Introduction

In the iTunes Case Study, the Berkman Center's Digital Media Project Team has analyzed Apple's iTunes Online Music Store (iTMS), which has become the pacesetter in the digital media marketplace. The study covers a broad range of issues and includes, among other things,

- an analysis of the complex interactions between copyright law, contract law, digital rights management schemes and business modeling processes;
- a comparative law analysis of the critical legal issues in the digital media debate in Europe, Japan, and China;
- a tentative assessment of the (potential) impacts of the digital music store model on key players in the digital media marketplace.

The following overview focuses on the comparative law analysis on the one hand and the impact assessment on the other hand, and summarizes some of the key findings.

Comparative Law Analysis

One of the most important insights of the study is that there is an international trend toward *convergence* on many of the basic principles in copyright law, contract law, anti-circumvention laws, etc.. Signs of convergence are:

- *License Agreements*: In the U.S. as well as in Europe and Asia-Pacific, contract law regarding digital media uses provisions like "terms of service" and "license agreements" to govern the way consumers manage digital content. License agreements may override rights consumers would otherwise enjoy under copyright law. In both Europe and Japan, these provisions often prohibit users from reselling, lending, or transferring songs -- actions which are ordinarily protected under the doctrines of first sale or fair use.

- *Digital Rights Management Schemes*: Increasingly, digital content providers are turning to technological protection measures, generally referred to as DRM schemes, to constrain uses of e-content. Apple, for instance, developed a system called FairPlay to restrict transformative use of music and limit the number of burns allowed per playlist.

Technological protection measures are often bolstered by laws that prohibit circumvention of DRM. At the international level, the World Intellectual Property Organization (WIPO) treaties call for "adequate legal protections and effective legal remedies against the circumvention of effective technological measures." Legislatures around the globe have enacted policies like the DMCA in the U.S. and the European Union's Copyright Directive to implement the WIPO treaties. Copyright holders and online music stores have relied on this combination of self-enforcing technical protections and strong anti-circumvention legal codes to retain control of their content.

- *First Sale Doctrine*: A trend toward international legal convergence is also evident in doctrines such as "first sale," or as it is known under international law, the principle of exhaustion. If certain requirements are met, this doctrine holds that the copyright holder's exclusive rights to control sale and distribution of a copyrighted work stop with the first sale of the work (it allows, for instance, an owner, but not someone who merely possesses the content, to resell a copyrighted CD, DVD, etc., without the copyright holder's permission). Currently, U.S. and European Union law have denied that the first sale doctrine applies to digital works distributed over the Internet, despite good arguments to the contrary. And the principle has yet to emerge in Asian-Pacific jurisdictions. The WIPO treaties currently stipulate application of the first-sale doctrine to tangible goods like books and CDs and not to "intangible" content distributed over the Internet.

Despite this overall trend toward convergence, the iTunes Case Study reveals several significant *differences* among international jurisdictions in four main areas:

- *Anti-circumvention laws*: The anti-circumvention provisions of the DMCA and the EU Copyright Directive prohibit circumventing DRM or trafficking in devices for circumvention. Many European nations are still in the process of determining exact implementation of the EU directive, and the case law on this subject is just beginning to emerge. It is too early to predict exactly how European nations will interpret anti-circumvention provisions, but based on statements from government officials, a range of interpretations is likely to emerge, specifically with regard to circumventing "access controls" such as those used in DVDs' region coding.

- *Fair Use rights*: The fair use doctrine in the U.S. codifies reasonable exceptions to rights-holders' exclusive control of copyrighted material. This idea of "fair use" appears in most foreign copyright regimes, but the specifics of implementation and the granting of privileges vary widely. These differences may have two important effects on online music services. First, broad fair use privileges might decrease the record industry's willingness to license its music to online music services. Second, and even more importantly, fair use doctrines affect users' expectations regarding what they can and cannot do with purchased digital content. In order to be successful abroad, services like the iTMS must address both the concerns of copyright holders and the different expectations of users around the world.

- *Consumer protection laws*: Online music providers may face a wide range of consumer protection laws in different jurisdictions, including consumer rights that are not clearly present within the U.S. For example, the EU Parliament and the Council have enacted two

important directives that affect agreements between an online music service and its users -- the Distance Contracts Directive and the Electronic Commerce Directive.

- The Distance Contract Directive, for instance, grants consumers the right to withdraw from certain contracts with a supplier where contract formation did not involve the simultaneous physical presence of the consumer and the supplier (i.e., a contract made over the telephone). Consumers may withdraw within seven business days without penalty, and the right cannot be waived by contract. To comply with this regulation, some European music stores such as Tiscali Music Club grant customers the right to "return" downloaded digital music within seven days. Some EU member states, however, do not grant such a right of withdrawal for online purchases of music and videos.
- The E-Commerce Directive for instance, requires online suppliers to inform consumers in great detail about their products, contract terms, rights of withdrawal, and other contract-related information *before* the user places an order. Whether these EU consumer protection provisions apply to U.S.-based services depends on the location of the store's European business center.

- *Law Enforcement*: While there is a trend toward international convergence in the substance of many laws, enforcement of contractual and copyright obligations continues to vary widely around the world. In the U.S., barriers to litigation are relatively low, as the RIAA's lawsuits against individual file-sharers indicate. By contrast, the European music industry had been more reluctant to bring lawsuits. In fact, the foreign recording industry had placed greater emphasis on developing DRM, drawing public attention to the illegality of file-swapping, and increasing cooperation with ISPs rather than pursuing litigation. In March 2004, however, the International Federation of the Phonographic Industry (IFPI) announced that legal actions against 247 alleged illegal file sharers were taken in Denmark, Germany, Italy, and Canada by the national record associations on behalf of their member record companies. The international legal campaign illustrates the differences in law enforcement. In fact, the procedure of the legal actions taken against individual file sharers varies significantly from country to country, ranging from sending out civil demand letters in Denmark, to the initiation of criminal investigations in Germany to get the names of alleged copyright infringers. Recently the IFPI reported the first conviction of a music file sharer by a German criminal court. Moreover, the IFPI announced a second wave of lawsuits.

These structural differences in law enforcement and substantive law are critical to the international expansion of industry-supported online music stores.[1] It remains to be seen what the economic effects of the international legal campaign against file-sharing will be, and what role new legislation such as the pending EU Directive on Enforcement of Intellectual Property Rights will play.

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[1] A recent ruling by a *Canadian* federal judge also reveals differences in substantive law: The court has denied a motion brought by the Canadian Recording Industry Association (CRIA) seeking the identity of 29 customers of five Canadian internet service providers (ISPs). The ruling indicates that downloading is lawful under Canadian copyright law. The CRIA has filed an appeal.

Impact Analysis

As mentioned above, the Case Study also offers a *tentative assessment* of the (potential) impacts of the digital music store model on key players in the digital media marketplace. It summarizes possible *effects* on consumers, labels, and artists:

- *Effects on Consumers*: An initial analysis conducted in the case study diagnoses a shift of the legal and regulatory balance in favor of copyright holders' interests and, *vice versa*, at the expense of users' freedom. This shift, by and large, is global in its reach as far as the analyzed key issues are concerned.

- *Potential Impacts on Labels*: Online music stores such as the iTMS are likely to have several positive impacts on both major and independent labels:
    - First, online music stores might be seen as attempts to (re-)build new structures for selling copies of music in the digital realm in the aftermath of Napster and *vis-à-vis* its successors. With rich song catalogs, ease-of-use interfaces, permissive DRM schemes, relatively low prices, and special features such as recommendation systems, information on live concerts, etc. online music stores try to compete with free.
    - Second, the distribution of songs and albums via online music stores—in contrast to traditional distribution channels—eliminates costs such as packing, breakage, etc. Given the cost-savings, the labels' revenue streams are comparable to offline distribution schemes.

  Particularly independent labels might benefit from emerging online music services. The architectural constraints of offline music stores, which often result in a less prominent in-store placement of works by independent artists, do not apply to their online counterparts. Due to ease-of-use search functionalities and autonomous recommendation systems, consumers are more likely to find lesser-known artists and music.
  However, online music stores such as iTMS may also have an impact on existing licensing schemes and marketing practices. For example, the longstanding practice of staggered release cycles in Europe, which prevents music labels from organizing a pan-European launch of an artist, conflicts with the functionality of music services in global cyberspace. Recent developments suggest that successful vendors such as the iTMS might be the real driving forces behind changes in labels' business practices.

- *Potential Impacts on Artists*: The potential impacts on artists are difficult to evaluate since information about the contracts between artists and labels, respectively, and the iTMS have not been made public. Moreover, since no blanket contracts exist, one cannot assume any homogeneity in the allocation of revenues between label and artist. It seems likely that the iTunes business model has not significantly changed the revenue streams between the key players—despite the efficiencies created by online distribution. Nevertheless, emerging online music stores such as the iTMS might benefit at least some categories of artists in other ways: First, the iTMS and its competitors have widened their offerings through deals with independently distributed labels and freestanding imprints. Based on such contracts between independent music labels and iTunes, independent artists can place their music more easily in online stores rather than traditional (offline) music stores. Second, iTMS'

advanced search functions and recommendation systems might help users to find songs by lesser-known artists more easily than in brick-and-mortar stores. Earlier sales data suggest that iTunes has sold more than 95% of the songs in its catalog at least once. Thus, it seems that consumers, in fact, are downloading songs from lesser-known artists and encourage new entrants.