
On July 27, 2000, the World Trade Organization (“WTO”) Dispute Settlement Body (“DSB”) adopted a Panel Report containing the first ruling of a WTO panel on the scope of copyright protection under the TRIPs Agreement. Based on a complaint against the United States brought by the European Commission (“EC”), the Report concluded that § 110(5)(B) of the US Copyright Act, as amended by the Fairness in Music Licensing Act (“FMLA”) of 1998, is incompatible with the rights of public performance and communication to the public under Arts 11bis(1)(iii) and 11(1)(ii) of the Berne Convention, and by virtue of incorporation of those rights in the TRIPs Agreement, with the “three-step test” in Art.13 of TRIPs. On the basis of the Panel Report, the DSB requested that the United States bring its legislation into line with TRIPs within “a reasonable period of time”, which came to an end on December 31, 2001 without amendment of the Copyright Act.

On July 23, 2001, the EC and the United States asked an arbitration panel constituted under Art.25 of the WTO Dispute Settlement Understanding (“DSU”) to determine “the level of nullification or impairment of benefits to the European Communities as a result of the operation of § 110(5)(b) of the US Copyright Act”. On October 12, 2001 the arbitrators issued their award, which was notified to the DSB and the TRIPs Council on November 9, 2001. According to the award, the level of EC benefits that are being nullified or impaired as a result of the operation of Section 110(5)(B) is #1,219,900 per year, or US$1.1 million.

Following on non-compliance by the United States with the Panel Report, the award of the arbitrators in the Fairness in Music case raises worrying concerns for the enforcement of intellectual property rights under TRIPs which could reverberate well beyond the sphere of copyright.

**Background**

The Fairness in Music case was initiated in late 1998 by the EC following complaints from the Irish copyright management organisation (“CMO”) IMRO. As amended by the FMLA in 1998, § 110(5)(B) of the US Copyright Law exempts eating, drinking and retail establishments that do not exceed a certain size (2,000 or 3,750 square feet, depending on the type of establishment) or exceed specified audio or audiovisual equipment requirements, from liability for the public performance of music played from radio and television. Section 110(5)(B) is an expanded version of the so-called “homestyle” exemption to the right of public performance contained in the Copyright Act of 1976 and based on the 1975 Aiken decision of the US Supreme Court, which absolved small “mom-and-pop” establishments from copyright liability for playing radio music using amplification equipment that would normally be used in a home setting. Underlying the original “homestyle” exemption (and the later FMLA) was that such establishments were not widely licensed by the US CMOs, owing to high transaction, administration and enforcement costs in relation to the licensing revenue likely to be generated. Notwithstanding the pre-existence of the “homestyle” exemption and low levels of licensing by US CMOs, the arbitrators relied on figures estimating actual licensing of relevant establishments by US CMOs in the three years prior to entry into force of the FMLA in their methodology for determining the level of nullification and impairment of EC benefits as a result of § 110(5)(B). The impact of that methodology in the award will be addressed below.

**The Panel Report**

The Panel Report found that § 110(5)(B) is inconsistent with all three prongs of the “three-step” test in Art.13 of TRIPs. In doing so it established important principles for application of Art.13 in future cases, particularly in regard to the second and third prongs of the test. First, the Panel found that § 110(5)(B) is not limited to “certain special cases”. In a 1999 study requested by ASCAP based on 1998
data and the criteria in the 1998 FMLA amendment, Dun & Bradstreet had estimated that 70 per cent of吃饭 establishments, 73 per cent of drinking establishments, and 45 per cent of retail establishments fell under the FMLA size limitations and would qualify for the exemption. The Panel stated, “[w]e fail to see how a law that exempts a major part of the users that were specifically intended to be covered by ... Article 11bis(1)(iii) [of the Berne Convention] ... could be considered as a special case in the sense of the first condition of Article 13 of the TRIPs Agreement” (emphasis in original).

Applying the second prong of the test, the Panel found that § 110(5)(B) conflicts with a normal exploitation of the work, based on the principle that exempted uses may not compete with actual or potential sources of gain from economic exploitation of the right in question:

“We believe that an exception or limitation to an exclusive right in domestic legislation rises to the level of a conflict with a normal exploitation of the work (i.e., the copyright or rather the whole bundle of exclusive rights conferred by the ownership of the copyright), if uses, that in principle are covered by that right but exempted under the exception or limitation, enter into economic competition with the ways that right holders normally extract economic value from that right to the work (i.e., the copyright) and thereby deprive them of significant or tangible commercial gains” (emphasis added).

The Panel rejected the United States’ “double payment” argument that § 110(5)(B) does not conflict with a normal exploitation of the work because rightholders already receive royalties from economically more significant uses involved in “primary” performance and broadcasting. In assessing this argument the Panel noted that the TRIPs Agreement confers a number of exclusive rights under copyright, and thus “whether a limitation or an exception conflicts with a normal exploitation of a work should be judged for each exclusive right individually”. It also emphasised that the current licensing practices of CMOs are not necessarily indicative of the scope of normal extraction of economic value under the second prong of the three-step test. The Panel stated that such a proposition “would equate ‘normal exploitation’ with ‘normal remuneration’ practices existing at a certain point in time in a given market or jurisdiction”.

Applying the third prong of the three-step test, the Panel found that § 110(5)(B) “unreasonably prejudice[s] the legitimate interests of the right holder”, based on several principles. First, while a certain degree of “prejudice” to legitimate interests must always be presumed, the Panel stated that such prejudice becomes “unreasonable” when, as in the case of § 110(5)(B), an exception causes or has the potential to cause an unreasonable loss of income to the copyright holder. It also declared that both actual and potential prejudice to rightholders caused by the exemption in question must be taken into account. Finally, the Panel stated that analysis of unreasonable prejudice should not be applied only to the interests of rightholders of the WTO Member that initiated the complaint, but should take into account the legitimate interests of copyright holders at large. This principle is particularly significant in the light of the approach taken later by the arbitrators.

The Award of the Arbitrators

On the basis of its conclusions, the Panel Report recommended that the DSB request the United States to bring § 110(5)(B) into conformity with its obligations under Art.13 of TRIPs. When it became clear by mid-2001 that amendment of the law to comply with the Panel Report was unlikely to occur within the reasonable period of time agreed between the United States and the EC, the United States and the EC submitted the case to arbitration under Art.25 of the DSU.

Before the arbitrators, the EC and the United States advanced fundamentally different arguments on methodology for determining the benefits involved. Consistent with the Panel Report’s broad interpretation and application of the three-step test under TRIPs Art.13, the EC claimed that the level of benefits EC rightholders could expect to receive should be the potential licensing income realisable from exercise of the public performance right—with no deduction for costs of administration and enforcement—if the US CMOs were to license all eating, drinking and retail establishments which play radio and television music. Put another way, the EC argued that the basis for calculating the level of
nullification and impairment of EC benefits should be the potential value of the right of public performance itself. On the basis of what the Panel Report characterised as a “bottom up” approach, the EC claimed that the benefits denied to EC rightholders amounted to US$25.5 million per year.

By contrast the United States argued that the number of users that US CMOs seek to license is a function of the ratio between transaction, administration and enforcement costs, on the one hand, and expected revenue per licence on the other. Thus the United States argued that the level of EC benefits nullified and impaired should be based on a “top-down” approach focusing on the number of establishments that would normally be licensed but for the exemption in § 110(5)(B). Though complete and accurate information on licensing levels was not available, the United States put forward a calculation based on payments by the US CMOs ASCAP and BMI to European rightholders in the three years prior to entry into force of the FMLA (1996-98), arriving at an estimate of benefits to EC rightholders nullified and impaired as a result of § 110(5)(B) of between US$0.4 and 0.7 million per year.

The arbitrators accepted the US “top-down” approach, as it focused on “historical figures” rather than the value of the public performance right based, inter alia, on theoretical higher levels of licensing of retail establishments by US CMOs. The arbitrators stated that the US approach was also preferable because it limited the number of assumptions and inferences necessary, while the EC “bottom-up” approach might require basing the calculation on what some arbitrations have described as a “counterfactual”, i.e. basing the calculation on an “as-if” situation at the end of the reasonable period of time predicated on full licensing by CMOs of all establishments covered by the exemption. A third reason for acceptance of the US “top-down” approach was that “the Arbitrators have encountered particular difficulties due to the lack of precise information available”, which “played a major role in the choices made ... with respect to the methodology and the calculations”.

In accepting the “top-down” methodology and focusing only on historical licensing data from US CMOs, the arbitrators declined to apply the Panel Report’s rulings on application of the second and third prongs of the three-step test in Art.13 of TRIPs, namely that both actual and potential sources of revenue are to be taken into account in determining whether an exception conflicts with a normal exploitation of the work in question, and that actual and potential economic losses are to be considered in determining whether an exemption causes unreasonable prejudice to the legitimate interests of rightholders. It is worth quoting in full from the Panel Report on application of the third prong of Art.13:

“As regards the third condition [of Art.13] in particular, we note that if only actual losses were taken into account, it might be possible to justify the introduction of a new exception to an exclusive right irrespective of its scope in situations where the right in question was newly introduced, right holders did not previously have effective or affordable means of enforcing that right, or that right was not exercised because the right holders had not yet built the necessary collective management structure required for such exercise. While under such circumstances the introduction of a new exception might not cause immediate additional loss of income to the right holder, he or she could never build up expectations to earn income from the exercise of the right in question. We believe that such an interpretation, if it became the norm, could undermine the scope and binding effect of the minimum standards of intellectual property rights protection embodied in the TRIPs Agreement” (emphasis added).

The arbitrators noted that the EC had not alleged violation of the enforcement provisions of TRIPs, implying that such a claim might have required them to consider potential prejudice to rightholders’ legitimate interests in their choice of methodology. As it was, in a comment on the above passage from the Panel Report the arbitrators distinguished their task of determining the level of benefits denied to EC rightholders resulting from operation of § 110(5)(B), on the one hand, from the task of the Panel in determining whether the exemption was compatible with Art.13 of TRIPs on the other.

As indicated above, the arbitration ended with a determination that the level of nullification and impairment of EC benefits as a result of the operation of § 110(5)(B) was ##1,219,900 per year, or US$1.1 million.
Repercussions of the Award

As stated at the beginning of this opinion the Fairness in Music arbitration raises worrying concerns that future WTO dispute settlement proceedings might undercut the minimum standards for intellectual property protection included in the TRIPs Agreement. First and foremost, non-compliance with Panel Reports followed by resort to arbitration over compensation for nullification and impairment of benefits may become more widespread, based on the US example set in this case. Such a result is clearly inconsistent with the objectives underlying the DSU, which provides that compensation is a temporary measure to be applied in the event that recommendations and rulings are not implemented within a reasonable period of time. It also makes clear that full implementation of a recommendation or ruling to achieve conformity with the WTO agreement in question is to be preferred to compensation.

Arbitration under Art.25 of the DSU was used in this case for the first time since establishment of the WTO. Its application could produce results of dubious consistency with the overall objectives of the TRIPs Agreement, particularly when compared with arbitrations under Art.22.6, which are fully integrated into DSB procedure. Generally, when a WTO Member fails to comply with a Panel Report within a “reasonable period of time”, Art.22.6 allows the country that initiated a complaint to suspend trade concessions to the offending country in an amount corresponding to a “mutually acceptable level of compensation”. Art.22.6 provides for arbitration if the two countries do not agree with the level of suspension proposed by the complainant country. Several Art.22.6 arbitrations have already taken place between WTO Members to determine the appropriateness of a proposed suspension of concessions for non-compliance with a Panel Report.

By contrast, arbitration under Art.25 does not require DSB approval and is open-ended as to both the mandate and procedures to be followed. Art.25 provides only that “resort to arbitration shall be subject to mutual agreement of the parties which shall agree on the procedures to be followed”, and that “the parties to the proceeding shall agree to be bound by the arbitration award”, i.e. there is no appeal. There is thus no formal linkage between Art.22.6 and Art.25 arbitrations, meaning that arbitrators acting under Art.25 are not obliged to follow precedent established in Art.22.6 arbitrations, nor are they bound to a single course of action (e.g. suspension of concessions by the complainant country or direct payment of compensation by the offending country) approved by the DSB after the arbitrators have rendered their decision. One may speculate that it was this inherent “flexibility” under Art.25, allowing parties to a dispute to define and control precisely the terms of reference of the arbitrators, that led the parties in the Fairness in Music case to select it once it became obvious that US compliance with the Panel Report was unlikely to occur within the agreed “reasonable time”. Yet the result was a valuation of “benefits” flowing from an exclusive right under TRIPs that can only be described as derisory.

Arbitration leading to compensation for non-compliance can also have the effect of undercutting the effectiveness of Panel Reports in identifying legislative measures that are incompatible with TRIPs. As demonstrated by the Fairness in Music arbitration, arbitrators will generally focus on levels of nullification and impairment of benefits to nationals of the WTO Member that originated the complaint, rather than on measuring the prejudicial effects of TRIPs-incompatible legislation on rights provided under the Agreement to rightholders in all WTO Members. As a consequence, insidious macro-economic effects resulting from a measure may never be taken into account by arbitrators aiming only to set levels of compensation, irrespective of the importance attached to such effects by the Panel in finding the measure incompatible with TRIPs. In the present case, the arbitrators were only mandated to determine the level of nullification and impairment of benefits to EC rightholders, who at the highest (EC) estimate account for no more than 25 per cent of the relevant affected works. As a result the economic benefits denied to the other 75 per cent of right holders (including US copyright owners) resulting from operation of § 110(5)(B) were totally ignored.

The arbitrators’ ruling may also imply that it will be increasingly in the interests of WTO Members to replace effective enforcement of intellectual property rights with a cynical “exemptions plus compensation” approach to TRIPs. Under this scenario, “a long-term incentive would be created whereby
countries could reduce future compensation levels by introducing a harsh domestic environment ... through pursuit of a lack of governmental support for copyrights and their enforcement, thereby raising transaction costs for right holders”. Clearly this scenario could have a disastrous effect on the ability of intellectual property owners to enforce their rights under TRIPs. In terms of copyright alone, where the US-based International Intellectual Property Alliance has reported that core US copyright industries in 1999 accounted for 13 per cent of US foreign earnings, future efforts to use WTO dispute settlement procedures to redress inadequate levels of copyright enforcement, including piracy, could be severely compromised.

Moreover, the presence of an exemption could also reduce or remove the incentive of right holders to enter a market or become more efficient. Because an exemption has the welfare effect of “robbing Peter to pay Paul”—i.e. reallocating welfare benefits from one country to another—it may result in retaliation by countries disadvantaged in the process, enhancing the likelihood of intellectual property trade wars. In sum, “a strategic arena of passing off the cost of the creation of new works to other nations and markets is created”.

It is also unlikely that the pernicious effects of the above scenario would be limited to the copyright sphere. For all holders of intellectual property rights, there is great mischief in the notion underlying the Fairness in Music arbitration that a certain degree of unauthorised or uncompensated use of protected subject-matter must always be tolerated in determining whether an exception or limitation on rights in national legislation (including compulsory licensing) conflicts with a normal exploitation of potential markets for protected subject matter, or potentially causes unreasonable prejudice to legitimate rightholder interests, under TRIPs standards. Any number of local conditions can be asserted to justify less-than-full exercise of particular rights at a given point in time, including, as noted in the Panel Report, the fact that a right is newly introduced and has never been subject to a “normal exploitation” in the market concerned. The introduction of product patent protection in developing countries at the end of TRIPs transition periods is an interesting example. The timing and possible economic effects of such an introduction are a factor in discussions over how to make HIV drugs available affordably, including through possible supply by generics manufacturers in countries where product patent protection is not yet in force. Likewise, at least one commentator has already made a connection between the outcome of the Fairness in Music arbitration and proposals to allow WTO Members to opt out of certain TRIPs patent requirements if they substitute a public sector contribution to R&D for drug development. From a rightholder perspective it is interesting to speculate on how the methodology in the Fairness in Music arbitration to determine levels of nullification and impairment of TRIPs-based benefits might apply, or evolve, in such contexts.

Conclusion

The extent to which the Award in the Fairness in Music case has any of the negative consequences outlined above for holders of copyright or other intellectual property rights depends almost entirely on whether (and when) the United States amends the Copyright Law to comply with the Panel Report. If the exception in § 110(5)(B) is removed, the award becomes redundant. The longer the exception remains in place, the more damaging its outward ripple effects may be to TRIPs standards and the WTO dispute settlement system as a whole.

The United States and the EC have agreed that the Bush Administration would seek a congressional appropriation of US$3.3 million to contribute to a fund for unspecified “projects and activities for the benefit of EC music creators” over a three-year period, during which it is hoped that the law would be amended. In the meantime, the European music collecting society organisation GESAC is evaluating how best to use the limited funds when they are made available.