

A Closer Look at Copyright and New Technological Uses

By Joseph P. Liu¹

Introduction

When is a copyright owner entitled to exert control over a new and unanticipated market created by new technology? This is an important and difficult question in copyright law today, and one for which copyright law currently has no good answer. The question arises when a new technology enables third-parties to make new and unanticipated uses of copyrighted works. For example, the invention of the photocopier allowed researchers to make multiple copies of journal articles, exploiting them in a way never envisioned by the original authors and publishers.² Similarly, the invention of the VCR allowed consumers to tape on-air broadcasts of television, an ability not anticipated by the owners of the television shows.³ Most recently, the advent of cheap scanning technology has enabled the creation of a searchable database of books, which the original authors and book publishers never anticipated.⁴

In each of these cases, who controls the new market is not clear because copyright's fair use defense provides conflicting answers. As an initial matter, the copying enabled by the new technology violates a copyright owner's exclusive right to reproduce the work.⁵ So when a researcher makes a copy of the journal article, she is infringing, at least as an initial matter. The copyist's response is to argue that the copying is privileged under the fair use defense. And it is here that copyright doctrine fails to provide a good answer. One of the elements in fair use analysis is the impact of the copying on the actual or potential market for the copyrighted work.⁶ Where a new technology would have a negative impact on an actual, existing market, the answer is easy: no fair use. So, for example, the personal copying of pre-recorded music by individuals using peer to peer file sharing is not fair use because it harms the existing market for sales of recorded music.⁷

But what about situations where the impact on an actual, existing market is negligible or highly uncertain? In this situation, the copyright owner claims harm, not to an actual market, but to a potential market. For example, private taping of broadcast television harms the potential market for private taping licenses. Similarly, photocopying individual journal articles harms the potential market for licenses to copy individual journal articles. Yet a moment's reflection reveals that there is a certain circularity to this argument. Every asserted fair use can be re-cast as harming the market for licenses for that use.⁸ For example, taking a quote and placing it in a term paper harms the market for term paper quotes. Such a definition of harm presupposes the answer to the underlying question. It already assumes that the use is not fair, for if it were fair, there would be no market for licenses. Taken to an extreme, such a view would eliminate fair use completely.

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² *American Geophysical v. Texaco*.

³ *Sony v. Universal City Studios*.

⁴ *Google Book Search*.

⁵ 17 U.S.C. 106(1).

⁶ 17 U.S.C. 107.

⁷ *A&M v. Napster*. But see discussion below.

⁸ Nimmer; Frank Pasquale, *Breaking The Vicious Circularity: Sony's Contribution To The Fair Use Doctrine*, 55 *Case W. Res. L. Rev.* 777 (2005).

So how do we tell which potential markets belong to the copyright owner and which do not? The Second Circuit case *American Geophysical v. Texaco*⁹ contains, to date, the most careful and thorough judicial treatment of this question. In that case, the Second Circuit panel expressly recognized the circular nature of the argument and sought to break the circle by stating that only “existing, traditional, or likely to be developed” markets would be considered in the analysis. That case involved Texaco’s practice of circulating expensive scientific journals among its large staff of research scientists, who would make photocopies of individual articles for their files. The court ultimately found that there existed a sufficient market for licensing such uses, so that the use was not fair.

The decision in *American Geophysical*, however, left many questions answered. Why, precisely, should copyright owners be limited to markets that are “existing, traditional, or likely to be developed”? And how “likely” must a market be, before we consider it in the calculus? The dissent in *American Geophysical* highlights some of these ambiguities, taking issue with the majority’s assertion that there existed a sufficient market for such uses. More broadly, what is the rationale for this standard? How does this standard measure up against the broader purposes of copyright law more generally? The opinion itself does not say.

The lack of clear guidance on this issue is problematic as technology enables ever more unanticipated uses of copyrighted works. The photocopier and the VCR each led to cases addressing this issue.¹⁰ The recent advent of digital technology has also raised this issue in a host of different circumstances.¹¹ Most recently, the issue has been raised in litigation over Google Book Search, an initiative by Google to scan and index millions of books, many of which are still subject to copyright. Google claims fair use and argues that its practice will not harm the primary market for the books. The authors and publishers respond that this practice undercuts their potential market for authorizing indices for the books. So the question is: is this a relevant market for fair use purposes?

To date, academic commentary has looked at this question primarily (though not exclusively) through the lens of transactions cost analysis.¹² Under this analysis, the question is whether a market would develop for licenses of this kind of use. Yet this mode of analysis has produced conflicting positions. Some commentators are quick to find that transactions costs hinder licensing, and therefore the use should be fair.¹³ Others assert that the market should be given an opportunity to develop transactions-cost-reducing institutions.¹⁴ Still others have argued that this narrow focus on transactions costs is misguided, and that we should look to broader copyright interests, such as promoting the dissemination of knowledge and information.¹⁵

Although these perspectives have shed valuable light on the issue, what has been missing from the discussion thus far is a more concrete view that provides courts with an implementable standard to apply when these questions arise. This paper seeks to develop such a standard and, in the process, bridge the gap between the theoretical analyses of the issue and the existing caselaw. The paper thus takes a close look at many of the theoretical arguments that have been advanced in this area, seeking to place them in a single, broader framework. It also adds a number of

⁹ 60 F.3d 913 (2d Cir. 1994).

¹⁰ *Sony*; *William Wilkins*; *American Geophysical*.

¹¹ *Kelly v. Arriba Soft*.

¹² See, e.g., *Gordon*; *Merges*; *Goldstein*; *Bell*.

¹³ See, e.g., *Liu*.

¹⁴ See, e.g., *Merges*.

¹⁵ See, e.g., *Lunney*; *Loren*; *Cohen*; *Benkler*.

refinements to existing theories, focusing on a number of aspects that have not been as thoroughly developed. The goal is to craft a more nuanced standard that allows courts to ensure that the results are tied more closely to the policies and purposes underlying copyright more generally.

Part I begins by introducing the question. It starts by presenting a number of situations in which the question arises. It then takes a close look at the answer provided by *American Geophysical v. Texaco*. It ends by highlighting some of the questions left unanswered by that case. Part II applies an economic analysis to the question, summarizing existing approaches and highlighting aspects of the analysis that have been thus far missing from the debate. In particular, it suggests that existing approaches have not fully appreciated the complex relationship between new markets and old markets. Part III then takes a look at non-economic perspectives, and argues that these perspectives shed additional light on the issue. Part IV circles back to the doctrine and proposes a modified and more nuanced version of the *Texaco* test, which courts can apply to future cases. Part V then applies this test both to prior cases and to new and upcoming cases, and then responds to anticipated objections.

I. The Problem of New Technological Markets

A. Some Examples and the Problem

Copyright law is subject to constant technological change. This is a truism, and examples abound, from the technology of the printing press, to the piano roll, to the record player, photocopier, tape recorder, VCR, and so forth. Each new technology greatly lowers the costs of copying, and therefore in some sense increases the risk of unauthorized copying. At the same time, each new technology leads to unexpected uses. So, for example, the technology of the VCR allowed viewers of broadcast television to record shows for later viewing. Similarly, the technology of the photocopier allowed researchers to quickly and easily copy journal articles, which they could annotate and archive. Thus, just as technology lowers the cost of copying, it expands the universe of possible uses of copyrighted works.

When these new uses arise, the natural question is: who controls them? Specifically, does the copyright owner have the right to control these new uses? In some cases, the answer is a straightforward “yes.” Where a new technology clearly threatens the underlying original market for the work, copyright steps in. So, for example, an audio tape of a record album can act as a complete substitute for that album. The owners of copyrights in musical works should thus have the right to prevent the making and selling of audio tape copies of their works without permission. This preserves the underlying incentive to create the musical works in the first place.

But what about cases where the harm to the original market is negligible or highly uncertain? Take, for example, the case of home video taping of broadcast television. Here, the evidence is far more ambiguous. The direct economic impact is harder to measure. After all, the broadcasts are generally free, supported by paid advertising. Thus, a home copy for later viewing probably does not deprive the copyright owner directly of any revenue. But what if the home tapper fast forwards over the commercials? If home viewers routinely do so, this may reduce the compensation the copyright owners can demand from advertisers.

Even if we are relatively assured that the direct economic impact will be minimal, what about the potential market for the use? For example, once the VCR was invented, the technology created demand for a new use – namely the recording of individual shows for later viewing. In theory, copyright owners could have exploited this market by offering licenses to record individual shows. But at the time, of course, they didn’t. Should this potential market be

considered part of the copyright owner's market, for purposes of deciding whether the copying causes the copyright owner harm?

The Copyright Act itself does not provide a clear answer. The Act states that courts, in deciding whether a particular use is fair, should consider, among other elements, the "effect of the use upon the potential market for or value of the copyrighted work."¹⁶ Yet the Act itself provides no definition of "potential market." What constitutes a potential market? The majority opinion in *Sony v. Universal City Studios*¹⁷ focused its attention on the primary or actual market for the broadcasts and found insufficient evidence of harm to this market. However, the dissent in *Sony*, in addition to arguing that there was sufficient evidence of harm to the actual market, also noted that the VCR deprived the copyright owners of the potential market represented by those who would be willing to pay for time-shifted viewing of the shows. Although the majority did not answer this charge, the opinion left open the possibility that this might result in harm to the potential market.

Subsequent cases have built upon this idea of harm to the potential market. The Supreme Court itself briefly revisited this issue a number of years later in *Campbell v. Acuff-Rose*.¹⁸ Although the case is known for its discussion of parody as fair use, the Court, in assessing the impact of the parody on the market, expressly referred to the potential market for non-parodic rap versions of the copyrighted work and remanded the case below for a consideration of the impact on this market. A number of lower federal courts have also considered potential markets in deciding whether a use is fair, although without much elaboration.¹⁹

B. American Geophysical v. Texaco

To date, the most thorough judicial consideration of the definition of a "potential market" in fair use analysis can be found in *American Geophysical v. Texaco*.²⁰ In that case, Texaco circulated among its large staff of research scientists expensive scientific journals. These scientists routinely made photocopies of journal articles for their offices before passing the issues along. A number of publishers sued, arguing that this infringed upon their copyrights. Texaco defended, arguing that this constituted fair use.

In the course of rejecting the fair use claim, the Second Circuit panel, through Judge Newman, considered the impact of the photocopying on the market. Judge Newman first examined the direct market for journal subscriptions, and found that the photocopying would have some impact on subscriptions, but not a large one (i.e. companies would by a couple of additional subscriptions, but not substantially more). Judge Newman then considered the market for photocopying licenses. Addressing the argument that this was a circular consideration, Judge Newman said circularity was not a problem, as the relevant markets would be limited to those that were "traditional, reasonable, or likely to be developed." Judge Newman then found that a market for photocopying licenses in fact already existed, via the Copyright Clearance Center (CCC), which provided blanket photocopying licenses for journals they managed the copyrights for.

¹⁶ 17 U.S.C. 107.

¹⁷ 464 U.S. 417, 429 (1984).

¹⁸ 510 U.S. 569 (1994).

¹⁹ *Kelly v. Arriba Soft*.

²⁰ 60 F.3d 913 (2d Cir. 1994).

In a sharp dissent, Judge Jacobs argued that the majority's opinion did not in fact solve the circularity problem. The dissent also took issue with the majority's factual contention that a real market existed for photocopy licenses. The dissent noted that the CCC provided licenses for only a fraction of the journals that the research scientists would be interested in copying. It ultimately concluded that the market was illusory. This paper will consider the dissent's arguments in more detail below, but for present purposes it is important to note the contribution that Judge Newman's opinion made in both recognizing the circularity and attempting to address it by limiting the definition of the potential market. This provided a check on the most extreme versions of the argument that all fair use is merely a failure to license.

Subsequent cases have cited the same standard and applied it. Most notably, the standard has appeared in the copy shop case, *Princeton University Press v. Michigan Document Services*.²¹ In that case, a photocopying shop produced and sold to students coursepacks, which included photocopied excerpts from numerous copyrighted works. The publishers sued and the Sixth Circuit panel, sitting en banc, held that this was not fair use, relying extensively on the existence of a market for permissions. More recently, the standard was applied in *Kelly v. Arriba Soft*,²² which involved a search engine that made smaller thumbnails of copyrighted images on the internet. The court, in finding fair use, noted that no market existed for such licenses.

C. Open Questions and Issues

Although *American Geophysical* provides a way of breaking the circularity, it leaves a number of questions unanswered. In particular, how "likely" must it be that a market will develop, before we can consider it in the fair use analysis? What sort of evidence would we want to look at? What does it mean for a market to be "reasonable"? And is this even the proper standard? Although the *American Geophysical* standard gives courts a way to break out of the circularity, does this way make sense when measured against the underlying policies supporting copyright?

To date, most academic commentary has focused on one particular aspect of the issue, namely the transactions cost argument. Building off of the influential view of fair use as a response to market failure,²³ much academic commentary has looked at whether a market is likely to develop for the use in question. If the answer is yes, then the use should not be fair. If the answer is no, then the use should be fair. Most critically, some proponents of this view argue that, even if a market does not yet exist for the use, the market should be given an opportunity to develop.²⁴ Thus, courts should tend to find against fair use in new technological markets in order to give copyright owners a chance to create licensing programs or start collective rights organizations. This view is consistent with, and may perhaps expand upon, the view expressed in *American Geophysical*.

Other commentators have opposed this view from within the transactions cost framework, taking issue with the prediction that licensing programs and collective rights organizations are likely to arise.²⁵ Thus, these commentators would be quicker to find transactions costs standing in the way of licensing. Many of these commentators also express

²¹ 99 F.3d 1381 (6th Cir. 1996) (en banc). See also *Basic Books, Inc. v. Kinko's Graphics Corp.*, 758 F.Supp. 1522 (S.D.N.Y.1991).

²² 336 F.3d 811 (9th Cir. 2003).

²³ Gordon.

²⁴ Merges; Goldstein; Bell.

²⁵ Netanel; Liu.

doubts about the usefulness of collective rights organizations, pointing to the potential anti-competitive nature of such organizations. Still others have noted that, even if licensing schemes develop, the market may fail insofar as the uses generate positive externalities, which the users cannot internalize and which therefore will not be reflected in the prices they are willing to pay for licenses.²⁶

Finally, several commentators have critiqued this perspective by arguing that this focus on transactions costs is largely misplaced.²⁷ Noting the inherent circularity of this kind of analysis, these commentators argue that such a perspective assumes that the copyright owner is entitled to the new use to begin with. These commentators take issue with the underlying assumption that, so long as licensing markets are efficient, copyright owners are and should be entitled to appropriate the full economic value of their works.

Although all of these perspectives have contributed substantially to our understanding of the underlying problem, what has been missing is an account of the problem that provides more concrete guidance to courts faced with actual cases. This problem will only become more acute as new technologies continue to expand the range of uses of copyrighted works. Courts will increasingly feel a need to make determinations about which uses are fair, and the stakes in these determinations will be high.

This paper thus seeks to fill the gap between the broader theoretical discussions and the concrete need for an implementable standard in fair use cases involving new technologies. In seeking to craft such a standard, this paper will draw on the existing theoretical perspectives that have already advanced, and try to summarize and organize many of the different insights that have been produced in various spots in the literature. It will also seek to supplement these perspectives with at least two additional views that have thus far been largely absent, namely: (1) a renewed focus on the impact of uses on the direct market, and (2) a non-economic account of who should properly control new uses of copyrighted works. Both of these perspectives are more traditional copyright perspectives, and should thus provide a bridge between theory and practice. The ultimate goal will be to produce a relatively clear and workable standard for courts to use in determining precisely which markets properly belong to the underlying copyright owner.

II. Economic Analysis of the Problem

At its core, the copyright system in the U.S. is an instrumental system, and the place to start is therefore an instrumental analysis. Under this analysis, this paper will focus on both the direct market for the copyrighted work and what I will call the indirect market, i.e. the new market enabled by technology. As this paper will attempt to show, the analysis is a bit more complicated than often assumed. In particular, courts and commentators have not given sufficient attention to the problem of uncertainty surrounding the impact on the direct market. Nor have they, at least until recently, thoroughly considered the complex relationship between the direct and indirect markets.

A. The Direct Market – The Costs of Uncertainty

1. Actual Harm

²⁶ Loren; Lunney.

²⁷ Cohen; Benkler.

Fair use analysis directs courts to analyze the impact of the use on the potential market for the work. Where a new technological use would have a direct impact on the existing market for the work, courts can easily find against fair use. So, for example, the invention of audio tape gave rise to a new technological use, namely taping record albums. If taping an entire record album were always and invariably fair use, then the sale of taped albums would act as a near-perfect substitute for the record album, thus harming the underlying market for record albums. This goes to the core justification for copyright. Thus, in cases where there is clear actual harm to the market, the answer is easy.

Often, however, in cases involving new technology, the precise impact of a use on the underlying market will not be entirely clear. Take, for example, the advent of the VCR and home taping of television broadcasts. One of the central factual issues in the Sony case was whether home taping would have an impact on the market for the copyrighted shows being broadcast. Extensive evidence was presented at the district court level,²⁸ and then reviewed by the Supreme Court, on precisely this issue. Each side presented survey evidence, seeking to establish whether and to what extent home taping would affect the market.

The Sony decision itself illustrates the difficulty of making a good determination on this point. The majority opinion reviewed the evidence and noted, in particular, the fact that broadcast television was generally provided free of charge to recipients and supported indirectly through advertising. Thus home taping for time-shifting purposes did not directly deprive the copyright owners of a sale – it merely changed the timing of the viewing. If anything, the practice expanded the potential audience for the work. The dissent, by contrast, took issue with this finding. [more].

In retrospect, the Sony court appears to have gotten this one right. The widespread adoption of the VCR and the permissibility of home-taping did not have an appreciable impact on the market for the broadcasts themselves. Indeed, the extensive installed-base of VCRs created a new market for pre-recorded video tapes, which subsequently benefited the movie industry tremendously. The starkest predictions of harm to the movie and television industries never materialized.²⁹ Thus, as an empirical matter, it appears that the Court made the correct decision, at least on the factual question concerning harm to the actual, existing market.

Yet this should not lead us to underappreciate the difficulty of the decision that faced the Sony courts. New technologies and new markets are incredibly difficult to predict. Technology, by its very nature, disrupts existing markets, and even the participants in those markets often have a difficult time predicting exactly how those markets will shake out. And if the participants themselves have a hard time making this prediction, what hope do courts have of making sensible choices here? Recall that courts often must make these decisions about harm to the market when a technology is nascent and the market not yet mature. The courts thus have no access to future facts, which might affect the analysis dramatically. To appreciate this difficulty, consider whether a digital video recorder like TiVo, with an unlimited ability to share broadcasts with others, would have an impact on the market for broadcasts. How certain could you be of your answer? What kind of evidence could be developed to help a court answer this question with any degree of assurance? The evidence to answer this question definitively might simply not exist.

Indeed, the judicial focus on the impact on the potential or indirect market can be seen as a way of avoiding the need to make this difficult determination. In other words, a sufficiently

²⁸ Universal City Studios, Inc. v. Sony Corp. of America, 480 F.Supp. 429 (C.D.Cal. 1979)

²⁹ Valenti quote.

broad definition of the potential market may obviate entirely the need to consider whether there will be an impact on the direct market. Thus, if home taping licenses are considered a potential market belonging to the copyright owner, the impact of home taping on the direct market is less critical or relevant. A court does not need to make the difficult factual inquiry.³⁰

Yet this perspective neglects an important part of the fair use analysis. In the end, the direct harm of a use on a copyright owner's existing markets is of critical importance in assessing the strength of the fair use claim. If the use is likely to have an effect on the direct market, then this answers the fair use question far more effectively than any analysis of a potential market. Conversely, if a use is likely to have no appreciable effect on the direct market, then this affects how we view the impact on the indirect market. The allocation of control over the indirect market becomes somewhat less urgent, as it will not have a direct impact on the copyright owner's existing incentives. By glossing over this analysis and looking instead to the potential harm on an indirect market, courts may improperly be giving insufficient weight to the actual market and perhaps overweighting the importance of the indirect market by effectively equating it with harm to the direct market.

2. Potential Harm and the Costs of Uncertainty

So if courts should always consider the impact of a new technology on the actual market, and if such an impact is almost always difficult to predict, how should courts respond? How should courts deal with the substantial uncertainty? Who should bear the costs of uncertainty? Initially, this can be answered by examining who bears the burden of proof. In the copyright context, the answer is generally the party engaging in the fair use, as fair use is an affirmative defense. Thus, that party must establish that the use will likely have no impact on the direct market for the copyrighted work. The burden shifts, however, in cases where the use is non-commercial. Under such circumstances, the burden now rests on the copyright owner to show that the use will in fact have an impact on the direct market.

As an initial starting point, this allocation of the costs of uncertainty seems appropriate. In cases where the future impact on the direct market is truly uncertain, a court's bias should be to assume an impact on the market, unless proven otherwise. After all, the impact on the direct market affects the core incentive that authors have to engage in the creative activity in the first place. But when a use is non-commercial, the likelihood that it will impact the direct market is somewhat reduced.³¹ Therefore, shifting the burden to the copyright owner makes sense. [More on how to allocate burden of proof/uncertainty].

In many cases, the parties will submit evidence and the question becomes how a court should assess the competing arguments. In some cases, basic economic theory may provide a sound basis for prediction. Where a new technological use acts as a direct substitute for the previous work, economic theory predicts that there will be harm to the direct market. And indeed, the first factor in fair use analysis accounts for this, in considering whether the use of the work is transformative. Where there is no transformation at all, it is more likely that the use acts as a substitute. Thus, there may be no need to present empirical evidence of actual or predicted harm.

Indeed, if the theoretical argument is strong enough, it may be able to counteract empirical evidence that tends to point the other way. This is due to the nascent nature of many of

³⁰ Accord Pasquale.

³¹ Sony.

these markets. For example, in the peer-to-peer cases (i.e. Napster, Aimster, and Grokster), some attempts were made to argue that file sharing constituted fair use. And indeed, the empirical evidence of impact to the market was mixed. Some studies showed a correlation between file-sharing and reduced sales, while others showed no such correlation (or only a minimal correlation). If the music download market had been a mature market, then evidence showing minimal market harm might have counted heavily in favor of fair use. Yet the nascent nature of the market, combined with a strong theoretical case for direct harm, provided sufficient evidence for the court to conclude, without much difficulty, that legalizing file sharing would likely have a detrimental impact on the direct market for music.

What about cases where economic theory provides no clear answers? For example, home taping of broadcast television could have had the effect of reducing television viewership, if consumers viewed such tapes repeatedly instead of watching new shows or reruns. On the other hand, it could have had the effect of increasing television viewership by enabling consumers to view shows they otherwise would have missed. Where theory provides conflicting plausible accounts, then direct evidence becomes important. And here, courts are put in the difficult position of making predictions about the future course of technology markets.

The Sony case itself presents a good case study of the nature of the inquiry. The district court in Sony considered extensive evidence from both sides regarding the likely impact of home taping on copyright incentives. It identified a number of separate markets that could be affected by the home taping. It then carefully considered and evaluated conflicting survey evidence regarding the likely behavior of consumers engaging in home taping. After a careful analysis of this information, the court concluded (correctly, it turns out) that there would be at most a minimal impact on any of these markets.

The district court's opinion is notable for the extent to which it refuses to adopt simplifying assumptions about the likely course of future technology and grapples with the actual evidence and the complexities of the market. It thus serves as a useful counter-model to the cases that quickly reach the impact on the indirect market, without first engaging in this more searching inquiry. It is also useful insofar as it highlights a healthy skepticism to enshrining existing business models through the law and provides room for future markets to adapt and develop in response to current conditions. This kind of searching and difficult factual inquiry is something that district courts must undertake as an initial matter, before reaching the question of the indirect market.

A related issue is what should be done if the facts subsequently change. For example, assume that a district court gets it wrong, that a fair use later can be shown to have a demonstrable impact on the underlying market for the work itself. Can anything be done? One possibility might be to permit courts to revisit the issue if the facts turn out to be different. Elsewhere, I have made the argument that fair use analysis might be affected by the passage of time, and this is one area where that might happen.³² Alternatively, we could look to scholarship in other areas where there is substantial uncertainty and fast technological change, and adopt similar responses. [More].

Ultimately, however, the costs of uncertainty about the impact of the use on the primary market should be borne by the party asserting the fair use privilege. This does not mean that a court should uncritically accept a theoretical argument that there will be harm. As the Sony example shows, a court must grapple carefully with the available evidence and make the best

³² Liu.

judgment it can, in light of all the circumstances. The court should also be properly sensitive to the ability of markets to adapt to new circumstances. And courts should have available to them the possibility that they may re-visit the issue some time in the future. Nevertheless, subject to all of these qualifications, the core incentive function of copyright must be protected. If, after a searching and careful review of the evidence, a district court believes there is substantial uncertainty over the future impact of a use, then the court should err on the side of finding a harm to the market.

Of course, this conclusion about potential harm must be weighed against other considerations before a finding of fair use can be made. The other factors must be considered. Thus, if a work is sufficiently transformative and non-commercial, this might tilt the analysis toward fair use, despite a finding of a high degree of uncertainty regarding market harm. Similarly, if the use is minimal or the underlying work factual in nature, these will need to be balanced against market harm. In addition to the other fair use factors, a court must consider the impact of the use, not only on actual markets, but on potential markets as well.

B. The Indirect Market – The Expectation of Reward

The Copyright Act also directs courts to consider the impact of the use on the potential market for the work. In determining who should control the follow-on market, courts should examine a wide range of considerations. Initially, there is the question of incentives for creative activity, both in the initial market and the indirect market. There is also consideration of transactions costs and licensing, which the existing literature tends to focus on. Finally, there are interesting questions regarding the comparative competencies and informational advantages of the different participants in the original and follow-on markets. Ideally, all of these considerations should inform a court's decision. The basic point here is that consideration of the impact of the use on a potential market should go well beyond simply noting that such a market exists. It requires a far more nuanced analysis than some courts have given.

1. Relationship to Direct Market

One factor that should affect the analysis of the indirect market is its relationship to the direct market. If there is strong evidence of actual harm to the direct market, then analysis of the indirect market is largely superfluous. The evidence of harm to the direct market should be sufficient, without further analysis, to weigh against fair use. On the other hand, where a new use clearly will not harm the direct market, then this affects how we view the indirect market. After all, if the underlying original market is protected, the incentive to create is preserved, and the question of the indirect market becomes a question of how to allocate a technological windfall.

Somewhat trickier are cases where the impact on the direct market is uncertain. Here, the indirect market is important, but its relationship to the underlying direct market is more complex. The new use may be responsible in some way for a future reduction in revenue from the direct market. The magnitude might be small – i.e. it may only slightly reduce the size of the direct market. Alternatively, the new use may represent the future direction of the market, entirely supplanting the direct market. This situation thus warrants a careful analysis of the evidence and attention to the costs of uncertainty.

The broader point, however, is that the relationship between the direct and indirect markets critically informs analysis of the impact on the indirect market. Take, for example, the

question of liability for digitizing and constructing an index for printed books.³³ Here, the impact on the direct market is most likely minimal. Moreover, it seems highly unlikely that a market for indices will supplant the market for the underlying work itself. The new use appears to be a technological windfall, and we should analyze it accordingly.³⁴ By contrast, take the example of photocopying coursepacks.³⁵ Here, the impact on the underlying market is more significant. In addition, a real possibility exists that this market could supplant the underlying direct market.

The above analysis illustrates why it is so important for courts not to skip over analysis of the direct market. Without such an analysis, it becomes difficult to accurately assess the importance of the indirect market. Particularly in cases where there is no actual harm to the direct market, courts should note this fact before proceeding. Otherwise, there is a risk that harm to the indirect market will be equated to harm to the direct market, when, as developed in more detail below, these two harms are in fact quite different. The remaining discussion in this section regarding the indirect market assumes that the impact on the direct market is either minimal or highly uncertain, since if a party could show likely harm to the direct market, then a court would not need to reach the issue of the secondary market.

2. Incentives (Initial and Follow-On)

Having determined the relationship between the direct and indirect markets, the next issue to consider is the impact of the allocation of the right on underlying incentives to create. That is, if we give control of the indirect market to the original copyright owner, how does this affect creative activity on the whole? This question goes to the heart of copyright. Moreover, it is often overlooked in the rush to reach the transactions cost question. Yet this issue is logically prior to that one and is a bit more complex than sometimes appreciated.

As an initial matter, one might start with the proposition that we would increase creative activity by giving the entitlement to the copyright owner. After all, by giving the market to the original creator, we increase the return to the copyright owner (assuming costless licensing, which this paper will discuss in more detail below). All other things being equal, more incentive would mean more works, on the margin. Thus, if a costless licensing system had been in place, then giving the broadcast industry the right to control home taping for time-shifting purposes would have resulted in a net increase in incentives for creating copyrighted works, as these industries would have found a new revenue stream.

Yet it is important to note that this incentive effect would operate only prospectively. That is, for future works, the incentive would be increased. But for pre-existing works (i.e. works created before the new technological use), this extra revenue stream would be a windfall. Because it was an unanticipated use, it could not have played a role in the economic decision whether to invest the effort in the creation of the work.³⁶ Rather, the economic decision was based on an expectation of exploitation in the primary market for the work. And, as stipulated above, if a court is now discussing the impact on the potential market, then it has already concluded that there will either be no impact on the direct market or that the evidence of such impact is highly uncertain. Thus, that market may already be protected.

³³ Google Book Search.

³⁴ Note additional complicating factors.

³⁵ Princeton University Press.

³⁶ Compare Eldred discussion.

Viewing the problem this way has some important consequences. First, it emphasizes the fact that the allocation of an unanticipated new use is, at least for existing works, largely a question of allocation of a financial windfall. It may make sense to allocate that windfall to the original copyright owner, or it may not. But such a decision will have less to do with the question of underlying incentives to create the work in the first place. Second, for future works, this perspective emphasizes the fact that the additional incentive will be marginal incentive, above and beyond the incentive that will exist under the primary markets. Thus, we will need to weigh the desirability of this added marginal incentive against potential costs.

One response to this argument might be to argue that, even for existing works, the new use has an incentive impact because, even if the original author did not specifically anticipate the new use in question, he or she expected technology in general to provide new uses, and this more generalized expectation provided an additional incentive.³⁷ This may indeed be true. Yet the magnitude of this interest will depend heavily on the specific factual context, the nature of the technological innovation, the size of the potential market, and the likelihood that it will develop. For example, the author of a book written five years ago relied primarily on incentives from sales of the books, and perhaps hoped for further compensation from established derivative markets, such as sequels, movies, and the rest. The author might also have reasonably expected new opportunities to exploit the work via e-books, etc. However, the author of that book probably did not, as a factual matter, rely heavily on future licensing royalties for indexing of his or her book.

This highlights the importance of reasonable expectations in determining the incentive impact of a new technological use. Completely unexpected and unanticipated uses of works play, at most, a minimal role in providing incentives for creativity. By definition, they were not anticipated. And the vaguer, generalized expectation of future reward plays only a marginal role in providing incentives, above and beyond the incentives from the direct market. By contrast, new technological uses that were better anticipated, or for which hints existed at the time, might have a greater impact on authorial incentives. A critical question a court should consider, then, would be to what extent the new use was anticipated and affected the incentives of the authors to engage in creative activity.

Of course, this still leaves the question of whether it makes sense to allocate the use to the copyright owner for purposes of increasing incentives for future works. Even if we believe that a use was unanticipated and therefore had no impact for existing works, we might conclude that the marginal incentive is worth granting to copyright owners in order to increase incentives for future works. Here, too, the existence of the direct market is important. If we are relatively certain that the direct market will not be affected, sufficient incentives exist, and the question is simply whether we believe that the added marginal incentive outweighs any potential costs.

On balance, it would be entirely appropriate to start with the assumption that the use belongs with the copyright owner, unless there is a good reason to allocate the use differently. As a baseline matter, the added marginal incentive for creativity is a good thing. However, the significance of this interest depends heavily on a host of considerations, including the size of the market for the new use and the likelihood that it will develop. The bigger the market, the more this weighs in favor of granting the use to the copyright owner. By the same token, if the new use is trivial or unlikely to develop, then this interest is reduced as the incentive impact will be minimal.

³⁷ Merges, *One Hundred Years of Solicitude*; Goldstein.

This interest would then be weighed against the potential costs. Some of these costs will be addressed in more detail below. For example, a wide range of market imperfections might prevent licensing, and therefore undercut the argument that the copyright owner should have the use. But before even reaching that determination, we should first consider the impact on incentives, not only for creating the initial copyrighted works, but also for creating follow-on works and for developing new technologies. Even assuming that costless and perfect licensing schemes would develop, the allocation of the entitlement has a distributional impact.³⁸ If we give the copyright owner control of the use, we make copyright owners wealthier and increase their incentives to create. Conversely, if we deny them such control, we make fair users and technology companies wealthier, because they will not need to seek licenses.

Which option we choose will have an impact on incentives for the various types of activity. A more expansive vision of fair use would provide additional incentives for individuals to engage in such uses, free from any licensing requirement. Moreover, technology companies could engage in development of new technologies with less concern about potential third-party liability.³⁹ This would, however, come at the expense of some degree of added incentive for creating original works in the first place. If the financial value of the new use is relatively modest and we are relatively confident that the underlying direct market is protected, then the small marginal increase in incentives may be outweighed by the desire to provide incentives for new uses or technologies.

To some extent, this reflects a substantive value choice regarding the competing works and uses, rather than a question about incentives. The impact of incentives is relatively clear; the question is what kind of activity do we want to promote. This question finds doctrinal expression, not in the fourth factor, but in the first factor of fair use analysis, when courts are directed to consider the purpose and character of the use. Where a purpose is transformative or would confer certain public benefits, this will inform the decision regarding what kinds of activities we wish to provide incentives for. For example, if a searchable index of books would provide substantial social benefits, then this might support a finding of fair use.

Note, finally, that the balance of interests here is affected by the security of the underlying direct market. Up to now, the analysis has generally assumed that there would be little or no impact on the direct market. However, if there is substantial uncertainty about the impact on the underlying direct market, then the analysis of the indirect market becomes more critical. The indirect market may play a bigger role compensating for future potential losses in the direct market. Or it may represent the future direction of the market, eventually supplanting the direct market entirely. Thus, where there is uncertainty in the direct market, this provides added support to granting the indirect market to the copyright holder. This is particularly true if there is a plausible argument that the new, indirect market may represent the future direction of the entire market.⁴⁰ Note that this is not so much because of the added marginal incentive from the indirect market, but rather the result of careful consideration and protection of the underlying direct market.

3. Market Imperfections

Assuming that we conclude that there is a good reason for the new technological use to be controlled by the copyright owner (whether because of uncertainty over the ultimate direction

³⁸ See Lunney; Benkler; Cohen.

³⁹ See Grokster and relevant commentary.

⁴⁰ See Princeton University Press. See also TiVo; Grokster. But see Google Book Search.

of the market or because we want to provide additional incentives for creative activity), we still must consider the possibility that imperfections in the market might nevertheless warrant transfer of the right to the fair user. This is where we encounter the perspective that fair use is a response to market failure. Note, however, that this consideration must take place in context, after an initial evaluation of the impact on the direct market and an assessment of the magnitude of the likely incentive impacts. Only after that consideration, should courts move on to consider the transactions cost question. Because this literature is quite extensive, the paper will only collect and summarize those perspectives briefly here.

a. Transactions Costs

Perhaps most clearly, if transactions costs would hinder efficient licensing of the copyrighted work, then this supports a finding of fair use. So, for example, if it were clear that the costs of licensing home taping of on-air broadcasts would exceed the value of such a use to the user, then copyright should step in to transfer that right to the fair user. This view finds broad support in both the courts⁴¹ and academic literature.⁴² Yet the difficult question is deciding how to implement this standard in nascent markets, particularly new markets created by technology. Such markets are in a state of flux, and licensing practices may not have developed. And even if licensing costs are initially high, the possibility exists that institutions may arise to mitigate these costs and make licensing efficient.

Courts thus face once again the difficult prospect of predicting the future course of new markets and technology. This time, the question is not the impact on the direct market, but rather the development of the indirect market. To some extent, this will have to be an intensely factual inquiry. In the same way that a court must carefully consider evidence predicting future harm to the market, a court must carefully weigh evidence that a realistic licensing model will develop. On this score, the existence of similar past licensing arrangements would be very probative.⁴³ Some history of collective licensing in an industry might also suggest that such an arrangement might develop. At the same time, courts should be suspicious of licensing arrangements that do not reflect a real market but instead were entered into in anticipation of litigation.⁴⁴

Another consideration should be the reversibility of any judicial decision. Some have argued that a determination of fair use necessarily eliminates the possibility that any market will develop in the future, and therefore courts should err on the side of finding no fair use in order to give private parties an opportunity to develop transactions-cost-reducing institutions.⁴⁵ This may be a prudent initial starting point. However, courts should examine this assumption critically in light of the actual evidence in order to arrive at a real assessment of likelihood that such practices will develop. In addition, courts should consider the possibility that a licensing market may develop even if a court finds fair use. For example, if fair use is narrow, there might be incentives to create licensing markets that would provide rights above and beyond those granted by fair use.⁴⁶

⁴¹ Sony; William Wilkins; American Geophysical.

⁴² Gordon; Goldstein.

⁴³ American Geophysical. Princeton University. (noting existence of licensing market relevant though not dispositive).

⁴⁴ Loren (noting possibility of strategic behavior).

⁴⁵ Merges.

⁴⁶ See, e.g., market for cover licenses.

Finally, as in the case with predictions about market harm, there should be an opportunity to revisit the fair use determination if market conditions dramatically differ from initial predictions. Thus, if a court finds no fair use based on anticipation that a realistic licensing market will develop, and it turns out that such a market never in fact develops, then courts should have an opportunity to revisit the fair use determination in order to correct the error. Care would need to be taken to prevent constant re-litigation of the fair use question, by perhaps placing a minimum time limit on such a claim. However, this would provide a way for courts to deal with the potential costs of error in predicting the future direction of a market.⁴⁷

b. Positive Externalities

As some commentators have noted, markets may fail for reasons unrelated to transactions costs.⁴⁸ Many fair uses confer positive benefits on society that are not captured by the fair user. For example, education, commentary, and criticism provide additional social benefits. If those benefits are not completely captured by the fair user, then the user's willingness to pay for a license will not reflect the true social value of that use. Where such positive externalities exist, a licensing market may be less than socially optimal.

This consideration finds doctrinal expression in the first fair use factor. In considering whether a use is transformative, courts are implicitly considering whether there is a broader social benefit to the use. However, a narrow focus on transformation does not adequately capture this interest in full. Instead, courts should look to the broader language in this factor, namely the "purpose and character of the use." Where such a use would confer a significant public benefit, which might not be adequately captured by the fair user, then this supports a finding of fair use even in cases where a licensing market may be well-developed.

There is some indication that courts have broadened this consideration. For example, in *American Geophysical*, the Second Circuit expressly considered the fact that the research conducted by Texaco could have a broader social benefit by furthering the production and dissemination of scientific research. It stated that this was a proper consideration for fair use purposes. Although it ultimately concluded that this interest was outweighed by other considerations, it does suggest that courts should consider this possibility in deciding whether a use is fair.

c. Information Asymmetry and Risk Aversion

In addressing the question of competing incentives above, we noted that the allocation of the right to control the new market would have an impact on incentives for creating more original works and incentives for finding new uses for existing works. As noted above, to some extent a determination on this score reflects a substantive value judgment regarding the relative worth of those two types of creative activities. Yet even if we reach agreement on the relative worth of these two creative activities, there may be additional reasons to support a finding of fair use. These reasons are based on the nature of these new uses and the impact of technology.

It is quite likely that, as between existing copyright owners and potential fair users, the latter have access to better information about potential new technological uses for copyrighted works. Information about new technological uses may be quite dispersed and decentralized.

⁴⁷ Compare *American Geophysical* with *Williams & Wilkins Co. v. United States*, 487 F.2d 1345 (Ct. Cl. 1973). See Liu.

⁴⁸ Loren. See also Lunney.

Copyright owners may not be in the best position to learn about such uses or to appreciate their significance. This may especially be the case if these uses are relatively minor in scope. And indeed, cases involving new technological uses almost invariably involve uses that were never anticipated or appreciated by the underlying copyright owners.

For example, the desire for home taping of broadcast television was initially exploited not by the movie studios but by the technology companies. Similarly, the idea to create a searchable index of all printed books was generated, not by the publishers, but by an internet search engine company. The now-ubiquitous consumption of music in portable, digitized form was developed initially not by the music industry, but through an infringing service such as Napster. The history of copyright is rife with examples where third-parties came up with new uses of copyrighted works.

If this is the case, then fair use may play an important role in providing incentives for individuals to find and develop new uses for existing copyrighted works. Because knowledge of technology is dispersed, copyright owners may not be in the best position to develop such uses.⁴⁹ The breathing space provided by fair use thus gives users an opportunity to develop these new uses without concern about liability. In the absence of such protection, third parties may not have sufficient incentive to develop such new uses.

One response to this claim is that new users can still negotiate with copyright owners for a license to engage in the new use. Thus, even if they have information that is not generally available to the copyright owners, they should be willing to pay more for their licenses based on their superior knowledge of both technology and the demand for new uses. Yet to some extent, this runs into problems about the uncertainty associated with new uses and new technologies. Many of these new uses are highly speculative. Thus, the benefits (and potential costs) are difficult to quantify. This uncertainty may stand in the way of licensing.

This is exacerbated by the demonstrated risk aversion of copyright owners in the face of new technologies. The copyright industries have historically been quite slow to embrace new technologies. Moreover, they have historically tended to over-estimate the harm resulting from new technological uses of their products.⁵⁰ And indeed, even in cases where direct harm is hard to establish, copyright owners frequently justify their claims based on a desire to preserve their options and maintain control over their works.⁵¹

This tendency should be another consideration in determining who should control the new use. If copyright owners systematically overestimate harm and underestimate the benefits from new technological uses, then this should tend to count in favor of such new uses. To the extent we are concerned about providing incentives, not only for the underlying copyrighted works, but for faster and more aggressive development of new uses and technologies, we might put a thumb on the side of the scale supporting fair use.

C. Summary

In the end, the discussion above sets forth a wide range of factors that should inform a court's decision regarding the ownership of a new technological market. It suggests that courts should pay increased attention to the impact of a new use on the direct market for that work, with a good appreciation of the potential uncertainty surrounding that determination. It also suggests

⁴⁹ See Wu.

⁵⁰ See VCR; Radio. Lessig.

⁵¹ Google Book Search quotes.

that courts should be more sensitive to the relationship between the direct market and the indirect market. Finally, it provides a list of factors that courts should consider in making determinations about the indirect market itself.

III. Relevant Non-Economic Interests

- A. Rewarding Labor
- B. Unjust Enrichment and Free-Riding

IV. Doctrinal Implementation

- A. Direct Market Harm
- B. Indirect Market Harm – American Geophysical Revisited
 - 1. “Traditional”
 - 2. “Reasonable”
 - 3. “Likely to Develop”
 - 4. Additional Considerations
- C. Remaining Fair Use Factors
- D. Liability Rules
- E. Burden of Proof
- F. Reconsideration

V. Application

- A. Past Cases – Test Suite
 - 1. Sony v. Universal City Studios
 - 2. Princeton University Press v. MDS
 - 3. UMG v. MP3.com
 - 4. Kelly v. Arriba Soft
- B. Google Library Project
- C. Objections

. Conclusion