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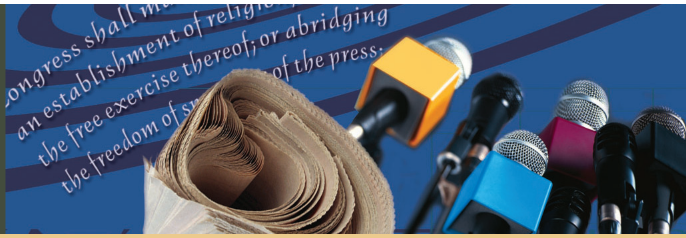
Davis Wright Tremaine LLP

# FIRST AMENDMENT LAW LETTER




FALL 2006

## INTERNET RADIO—THE BASICS OF MUSIC ROYALTY OBLIGATIONS

**by David D. Oxenford**

As over-the-air broadcasters and Internet-only companies make more and more use of music on the Internet, they need to be aware of their liabilities for music royalties. There are many dangerous myths currently circulating that could very well get a company streaming music on the Internet into trouble. For instance, many broadcasters believe that ASCAP and BMI royalties cover them for all on-line music use. This is not true. ASCAP and BMI cover the broadcaster only for the public performance rights to the underlying music composition—the song itself—when an ASCAP or BMI song is played over-the-air and simultaneously streamed on the Internet. As set out below, for digital transmissions—like the Internet—there is an additional royalty, payable to a company called SoundExchange. This additional royalty compensates the performers of music. This royalty must be paid in addition to the fees paid to ASCAP, BMI, and SESAC.

Another myth is that no royalty is due because the SoundExchange royalties expired at the end of 2005. While the negotiated royalties set out below did technically expire at the end of last year, by law, Internet radio services must continue to pay at the old rate until new rates are established. Any payments made are subject to retroactive adjustment when the new rates are established.

Yet, even with these royalty obligations, the use of music on-line continues to expand. Increasingly, consumers are looking to the Internet for the kinds of entertainment that was once provided exclusively by over-the-air

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## CALIFORNIA SUPREME COURT EXPANDS REACH OF STATE'S WIRETAPPING STATUTE

**by Alonzo Wickers IV[1]**

California is one of a minority of states that requires the consent of all parties to record most telephone calls. It's well settled that when a caller in California wishes to record a telephone conversation with another person in the state, Penal Code § 632 requires the consent of both parties to the call. The statute's application had been uncertain, however, when a person in a one-party-consent state recorded a call placed into California. In that scenario, it was unclear whether a California court would apply the state's two-party-consent statute, or the one-party-consent statute of the caller's home state.

The California Supreme Court recently resolved this issue in a unanimous decision with significant implications for reporters, producers of entertainment programming, telemarketers, and others who do business in California.

In *Kearney v. Salomon Smith Barney,* 39 Cal. 4th 95 (2006), the court held that California's two-party-consent statute governs calls into the state, even if a call is made from and recorded in a one-party-consent state. Reversing the Court of Appeal, the Supreme Court enjoined financial-services firm Salomon

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broadcasters. Music, and now video, is available on a myriad of websites, and the availability of these services on the Internet only seems to be growing. The future promises even more availability of this kind of content, as wireless access to the Internet becomes more common. Soon, the digital consumer will be connected to the Internet anywhere, anytime. Thus, the advantage of the traditional broadcaster—that its signal is ubiquitous—will be matched by its Internet brethren.

In today's world, the broadcaster wants to go where its audience is, and that will include the Internet. The over-the-air broadcaster can widen its reach, both geographically and into places where its current signal does not reach. Those steel buildings that block the signal of broadcast stations need no longer be an obstacle to the listener who can tune into their favorite station by going to their computer. In recent months, more and more broadcasters seem to be putting their signals onto the Internet to be competitive to the programming that is already there.

But, in making the decision to become an Internet broadcaster, there are many legal issues that need to be understood. This memorandum describes the issues relating to music royalties. Any Internet radio operator needs to be aware of the rules of the road, and this memo provides a basic overview of those rules. This memo is not meant to provide a full guide to all the legal issues that may arise in operating an Internet radio station, and it cannot even provide a full picture of all the legal issues involved with the music royalty obligations of such an operation. Any business decision should be made only after assessing the particular business plan the broadcaster may have in mind with someone well versed in the details of the royalty obligations. This memo should be looked at as a starting point for assessing the liabilities that broadcasters may face in any Internet radio venture.

As is clear by the conditions set forth below, this memorandum addresses the music royalty issues only as they affect Internet radio services. There are other statutory licenses for satellite radio, digital cable radio, and digital business services. These royalties are not addressed by this memorandum. For on-demand services, including downloads and podcasts, there is no fixed music royalty. Instead, permission must be obtained directly from the copyright holders in any performance before it can be used by such services. The royalties set out below do not apply. Individual negotiations with copyright holders are required to use music in connection with these on-demand services.

As noted above and as described in the final section of this memo, the current music royalties for Internet radio are in a state of flux. At the time this memo was written, a proceeding was underway before the Copyright Royalty Board to determine the music royalties for the use of sound recordings on Internet radio stations for the period of 2006 through 2010. As these royalties have not been established, those currently streaming are doing so at the risk of having royalties established that would create unanticipated, retroactive royalties for all streaming done after Dec. 31, 2005. So, all Internet radio broadcasters should proceed with caution.

**Traditional Performing Rights Organizations**

Traditional broadcasters are accustomed to paying royalties for the use of music to ASCAP, BMI, and SESAC. These royalties compensate the composers of music that is broadcast by traditional radio stations. In the Internet radio world, ASCAP, BMI, and SESAC are still paid for the use of their music. For an Internet-only station, each of these organizations has its own license for Internet music use, and each works in a slightly different manner.

All involve a minimum fee. In addition to the minimum fee, there are royalties based either on revenues or website usage. Information regarding the specific fees that are due to each service can be found on each of these companies' websites:

www.ascap.com/weblicense/
www.bmi.com/licensing/webcaster/
www.sesac.com/licensing/internetLicensing.asp

For Internet radio stations that simulcast the signal of an over-the-air broadcast station on a nonsubscription basis, fees for Internet usage of the music licensed by ASCAP and BMI are covered by the current broadcast licenses. However, the broadcast licenses cover only the over-the-air programming which is simultaneously streamed on the Internet. If a broadcaster is operating a "side channel" not being broadcast over-the-air and that channel features music, a separate Internet-only license must be obtained.

### Performance Rights in Sound Recordings

In the digital world, the royalties paid to composers of music through ASCAP, BMI, and SESAC are joined by a new royalty due to SoundExchange. Unlike traditional broadcast music royalties that pay the composers of music, the SoundExchange fee goes to the performers who are featured on a recording of a piece of music. The Digital Millennium Copyright Act (DMCA) required that royalties be paid to the performers for all digital uses of music except those in an over-the-air digital transmission by a broadcast station, e.g., through the Ibiquity digital radio system or as part of a Digital Television stream. The royalty to SoundExchange is paid both to the owners of the copyright in the performance of a piece of recorded music and to the performers of that music. Half of the fees collected go to the performers, and half to the copyright owner in the performance (usually the record company). This royalty comes about as the result of a "compulsory license" which allows Internet broadcasters to use music without the explicit permission of the artists and copyright holders, provided that the broadcasters pay this royalty fee and comply with certain usage restrictions described below. The royalty rate is set by a government agency called the Copyright Royalty Board.

The rates charged to a webcaster under the compulsory license are discussed later in this article. In order to qualify for the compulsory license, an Internet radio station must meet a number of requirements. If these requirements are not met, and the webcaster does not, through some private negotiation with the copyright holder, directly obtain permission to use the music in its transmission, then the webcaster has violated the law and is subject to damages and penalties for copyright infringement. Thus, to get the benefit of this statutory license, the Internet radio operator should carefully observe all of the requirements set out below.

### Step one—registration with Copyright Office

To qualify to use the compulsory license, a webcaster must register with the Copyright Office, filing a Notice of Use of Sound Recordings Under Statutory License. That form is to be filed before the commencement of service, and must be submitted with a filing fee, currently $20. A single filing can be used to register multiple streams available on the same website. The required form can be found on the Copyright Office's website:

www.copyright.gov/forms/form112-114nou.pdf

The form appears somewhat confusing, as it asks if the applicant is registering for a Section 114 license and/or a Section 112 license. In fact, webcasters need both, as Section 114 deals with the right to perform a musical work, while Section 112 gives a webcaster the right to make "ephemeral copies" of the work. An ephemeral copy is the transient copy of the recording that is made in any digital transmission process, as data is transmitted from server to server and, theoretically, copies reside on the memory of a computer for at least some period of time, no matter how short that time may be. While some have argued that the ephemeral copy has no independent value, technically, there is still a portion of the royalty paid to cover the making of that copy.

The applicant also is required to indicate whether it will be a subscription or nonsubscription service. There is a box for "Pre-existing Subscription Services." These were the few digital subscription services that existed in 1998, that are subject to a different royalty than services which have come into existence since then. Other than the handful of Pre-existing Services, everyone else would be a "New Subscription Service" or a "New Nonsubscription Service," depending on whether a fee is charged to the consumer for the use of the service.

### Step two—compliance with performance restrictions

Under the provisions of the DMCA, a service must meet a number of restrictions on the way in which the sound recordings are used. Adopted principally as a means to make it difficult for listeners to capture a digital copy of a sound recording played on a digital service, these rules impose restrictions which may make some familiar broadcast practices difficult to replicate on the Internet, and may cause some broadcast stations to forfeit their rights to the compulsory license if they do not modify their practices. These rules include the following:

*No interactive service*
A webcaster cannot provide an "interactive service." An interactive service is one which allows a listener to receive a specially created stream where the listener can dictate the songs being played. In other words, a broadcast-type transmission in which the broadcaster makes the musical selections, is permitted. However, allowing a consumer to determine the songs played on an Internet stream by picking from a menu of songs would take the website out from under the compulsory license. Playing call-in requests

is not prohibited, as long as the Internet station selects which requests to play, and when to play them. Services providing a limited degree of interactivity—those that allow a listener to select or de-select particular artists to be included in a stream, or to skip a limited number of songs, without guaranteeing that any particular song or artist will be played at any particular time—are in a gray area where hard and fast lines have yet to be drawn delineating what is permissible under the statutory license and what is not.

*Transmission of copyright information*
An Internet radio service must identify in text on its site during (but not before) the time that any song is being played, (i) the title of the sound recording (i.e. the song title), (ii) the album or CD from which the song came, and (iii) the featured artist. And, if technically feasible, the sound recording must be accompanied by information that is encoded by the copyright owner that identifies the sound recording title, the featured artist and related information concerning the underlying musical composition.

*Sound recording performance complement*

The Internet radio service is also subject to a number of restrictions on how often songs by the same artist or from the same album can be played. These restrictions are referred to as the "sound recording performance complement." These restrictions have two components:

(1) One Album or CD Restriction. On a particular channel, within any three-hour period, the programming can contain no more than three selections from any one album or CD, and no more than two such selections can be played consecutively; and

(2) Featured Artist Restriction. On a particular channel, within any three-hour period, the programming can contain no more than four different selections by the same featured artist or from any set or compilation, and no more than three such selections can be played consecutively.

*Advance program schedules*
With a very limited exception for noncommercial classical music broadcast stations that had published program guides prior to 1998, the webcaster cannot publish an advance program schedule which identifies when a specific recording, album or CD, or featured artist will be played on its stream. This does not prohibit a DJ from announcing that a particular song is coming up, though the exact time cannot be given.

Additional restrictions prohibit the use of music in association with visual images of a product in such a way so as to imply an association between the music and the product. Music must also be used on a site that is principally related to music, not to the sale of a particular product.

The compulsory copyright only applies to legal recordings—so broadcasters may not use bootlegs. Webcasters are also required to cooperate in various anti-piracy efforts, to make it more difficult to record songs off of the music stream that is provided.

**Step three—calculation and payment of the royalties**

The royalties that SoundExchange collects from the webcaster are set on an industry-wide basis. The royalties were originally to be revised every two years, through an arbitration proceeding. However, the first arbitration proceeding was quite long and expensive, and it produced a result about which no party was happy, so Congress changed the rules last year. Now, royalties will be adjusted once every five years. A new government board, the Copyright Royalty Board, has been created. The Board has three permanent judges who will hear cases having to do with various compulsory licenses.

The initial royalty rates were established in 2002, and modified by various settlement agreements between the recording industry and different webcasting factions. All of the current royalty rates for webcasting technically expired at the end of 2005. There is currently a proceeding underway before the Copyright Royalty Board to determine the rates for 2006 through 2010. As you might expect, SoundExchange is suggesting that the rates be raised, while the various webcasting groups are asking that the rates be reduced. Unless there is a settlement, a decision as to the royalties may not come out until early 2007. However, the rates that are established will be retroactive to the beginning of 2006. Under the law, Internet radio companies must continue to pay royalties at the old rate until the Copyright Royalty Board sets the new rates. **Thus, Internet radio services should keep paying at the rates in effect through 2005, knowing that the services may be either entitled to a rebate, or they may have to pay more, depending on the outcome of the current proceeding.**

A summary of the rates that were in effect in 2005, which Internet radio webcasters should still be paying until the new rates are established, is set out below. Forms for submitting royalty payments to SoundExchange can be found on the SoundExchange website:

www.soundexchange.com/licensee_home.html.

SoundExchange does not send a bill to webcasters. Instead, each webcaster is responsible for determining the amount of its own royalties and submitting those royalties when due, with required reports computing the applicable fee. For the most part, fees and reports are to be filed on a monthly basis. SoundExchange also has the right to audit Internet services. Early this year, it announced that it had exercised that right with regard to several Internet radio services, though the results of those audits have not been made public.

Different types of services pay at different rates. The rates at which services should currently be paying are as follows:

*Nonprofit associations, educational institutions and government agencies*

Nonprofit webcasters pay a specially negotiated rate. Nonprofit music stations pay $500 yearly, which entitles them to stream to an average of 200 simultaneous listeners (146,000 aggregate monthly tuning hours). If a service streams more than that amount, the nonprofit webcaster pays either on the basis of "performances" (one listener who listens to one song is one "performance," two listeners who listen to the same song would be two performances and so on) or on the basis of aggregate tuning hours (one listener who listens for one hour would be one "aggregate tuning hour," two listeners who listen for half an hour each would be one tuning hour, as would four listeners who listen for 15 minutes each). The nonprofit royalty for that listening above 146,000 aggregate tuning hours in a month is .02176 cents ($0.0002176) per performance or .251 cents ($0.00251) per aggregate tuning hour. The webcaster makes an election as to whether to pay on a per performance basis or based on aggregate tuning hours.

Note that the Corporation for Public Broadcasting had negotiated a private deal with the recording industry that allows its member stations to stream music on their websites without paying these or other royalties. The terms of this deal are confidential. Broadcasters receiving CPB money should discuss the deal with the CPB to see if their streaming activities are covered. If they are, no additional, independent royalty payment would be due. Note, however, that the CPB deal has apparently expired, as NPR is one of the parties currently participating in the Copyright Royalty Board proceeding.

*Small commercial webcasters*

In late 2002, after a public outcry claiming that the royalties established by the initial royalty arbitration proceeding would put smaller commercial entities out of business, the recording industry reached an agreement to establish a special rate for "small commercial webcasters," essentially those with less than $1.2 million in revenue. While the rates are high as compared with traditional ASCAP and BMI rates, they were the first industry-wide percentage of revenue rates agreed to by the recording industry.

This agreement requires that a small commercial webcaster pay a royalty equal to 10 percent of its revenues on the first $250,000 of its revenues, and 12 percent of all revenues thereafter, or 7 percent of its expenses, whichever is higher. A minimum fee of $2,000 per year is established for those webcasters who make less than $50,000 in revenues. For those who make more, the minimum fee is $5,000.

The $1.2 million eligibility figure looks at revenues of the webcaster and any company under common control which uses sound recordings as the basis of its income. Thus, a broadcaster which has revenues greater than $1.2 million is not eligible for the small webcaster deal, even if the webcasting is done through a separate company, if the broadcast and webcasting companies are under common control.

*Commercial webcasters (including broadcasters)*

For all other nonsubscription webcasters who are eligible to pay royalties under the compulsory license, payment is based on listening. These webcasters have the option of either paying on a per performance basis (per song per listener) or based on aggregate tuning hours. The webcaster must track its listenership using either of the measurement standards set forth below. Most services opt for the Aggregate Tuning Hour payment, as there are few commercially available tools that track and report on listenership on a per song basis. The rates are as follows:

Per Performance: The rate is .0762 cents ($0.000762) per song per listener, except that 4 percent of all performances can be excluded. The 4 percent exclusion is meant to take into account partial performances due to listeners tuning out, player malfunctions and similar factors—but does not include situations where the webcaster offers a "skip button" permitting a song to be skipped.

Per Aggregate Tuning Hour: The other option is to pay based on aggregate tuning hours. A pure webcaster would pay 1.17 cents ($0.0117) per aggregate tuning hour. A broadcast simulcast (identical to the over the air broadcast but for the commercials, which can be changed) would be charged at the rate of .88 cents ($0.0088). The lower rate offered broadcasters was premised on the assumption that, due to higher commercial loads, more informational programming, etc., broadcast simulcasts are likely to have fewer songs in a typical hour.

The minimum fee for such services is $2,500 or $500 per channel, whichever is less. There are lower rates for programming that is primarily "talk" in nature.

*Subscription services*

A webcaster offering a subscription service can pay either based on the per performance or aggregate tuning hour options listed above, or it may elect to pay based on a percentage of revenue. Under the current rules, this election is to be made when the webcaster begins its service, and cannot be changed. If the subscription webcaster decides not to pay on the basis of usage, it can elect to pay 10.9 percent of its subscription revenues to SoundExchange. The subscription revenues would include revenues received from subscription fees, advertising in the subscription streams, banner ads unique to the subscription page, and any sale or other use of information gathered about the subscribers. Those subscription webcasters electing the percentage of revenue model are required to pay a minimum fee of 27 cents per subscriber (including trial subscribers) per month, with a minimum annual fee of $5,000.

**Conclusion**

This article addresses only the basics of the webcasting royalties. Each of the royalty options addressed above has numerous filing requirements and paperwork reporting obligations that must be met, and all require the reporting of information to SoundExchange to demonstrate that the webcaster is properly computing its payments. And, as set forth above, these royalties, while they still must be paid, are subject to retroactive adjustment once the Copyright Royalty Board determines the rates for 2006-2010.

While complicated, the system can be learned and compliance has been achieved even by the smallest of companies. So, while the royalties present a new challenge to those companies interested in streaming their content on the Internet, they should not present a bar. Companies are doing it today—and competition will only be more difficult as time passes.

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Smith Barney from surreptitiously recording calls placed from Georgia, a one-party-consent state, to clients in California. The court refused to allow plaintiffs to recover monetary damages, on the grounds that the law had been unsettled when the firm recorded the calls. In the future, however, a person in a one-party-consent state who records a call into California may be liable for monetary damages (or, potentially, criminal penalties) under Penal Code § 632. Following the Court's unanimous decision in *Flanagan v. Flanagan*, 27 Cal. 4th 766 (2002), which expanded the categories of "confidential communications" subject to section 632, the *Kearney* decision underscores the Court's broad construction of the statute and its determination to protect the privacy interests of Californians. Media companies and others who do business in the state thus should exercise extreme care when recording calls with any connection to California.

**Background**

The federal statute governing the interception and disclosure of wire communications, 18 U.S.C. § 2511, allows the recording of phone calls and other electronic communications with the consent of at least one party to the call. A majority of states has adopted recording statutes based on the federal law, and most of these "one-party-consent" states have extended their recording statutes to both in-person communications and telephone calls. But California and twelve other "two-party-consent" states require the consent of all parties to a conversation before it lawfully may be recorded. Until *Kearney,* California courts had not addressed the issue of which state's recording statute would govern a call to an individual in California that was placed from and recorded in a one-party-consent state.

The plaintiffs in *Kearney* were Kelly Kearney and Mark Levy, two WorldCom employees who were granted stock options that could be exercised only through defendant Salomon Smith Barney. In 1998, both Levy and Kearney opened accounts with Salomon's Atlanta office, and "during the course of their relationships with SSB, each plaintiff, while in California, made and received numerous telephone calls from individual brokers in the Atlanta office." In the course of unrelated litigation against Salomon, Kearney and Levy learned that many telephone calls made and received by Salomon's Atlanta office to and from California clients were tape-recorded by Salomon without the client's knowledge or consent.

Kearney and Levy filed a complaint on their behalf and on behalf of other Salomon clients who reside in California and whose accounts were serviced by the Atlanta office, alleging that "during the course of their relationship with [Salomon], plaintiffs took part in numerous telephone conversations concerning their personal financial affairs, had an expectation of privacy in those communications, were unaware that their conversations were being recorded, and did not give consent to the recording of such conversations." Plaintiffs maintained that Salomon's conduct was actionable under Penal Code §§ 632 and 637.2. The trial court sustained Salomon's ensuing demurrer without leave to amend, reasoning that "under both Georgia and federal law recordings may lawfully be made in Georgia with one party's consent." The trial court thus concluded that any attempt to apply Penal Code § 632 to recordings made in Georgia would be preempted by federal law and would violate the commerce clause. The Court of Appeal affirmed the dismissal of plaintiffs' complaint, holding "that, on the specific facts of this case, Georgia has the greater interest [than California] in having its law applied." The California Supreme Court subsequently granted plaintiffs' petition for review "to address the novel choice-of-law issue presented" by the case.

Salomon offered three arguments to support the lower courts' decisions that California's one-party-consent statute should not apply to calls recorded by Salomon employees in Georgia:

(1) California could not exercise personal jurisdiction over Salomon;

(2) the application of California law would "exceed the constitutional limits imposed by the federal due process clause by seeking to impose California law on activities conducted outside of California as to which California has no legitimate or sufficient state interest"; and

(3) federal law preempts the application of California's more protective privacy provision.

Chief Justice Ronald George, writing for a unanimous court, rejected each of Salomon's arguments. With respect to the issue of personal jurisdiction, the court found that Salomon "is clearly subject to the personal jurisdiction of California courts under both the ‘general’ and ‘specific’ categories of personal jurisdiction" because the action "plainly arises out of [Salomon’s] business activity in this state." With respect to Salomon’s due-process argument, the court held that protecting the privacy of Californians’ telephone conversations was sufficient to give California an interest in applying its laws to Salomon’s surreptitious recording of calls to clients in the state. The court also dismissed Salomon’s preemption argument, noting that federal law "does not preempt the application of California’s more protective privacy provisions." Citing *People v. Conklin,* 12 Cal. 3d 259 (1974), the court found that Congress intended that the states be allowed to enact more restrictive laws to protect their citizens’ privacy rights. Finally, the court rejected the trial court’s commerce clause analysis, emphasizing that applying California law "would not compel any action or conduct of the business with regard to conversations with non-California clients or consumers." Having disposed of these arguments, the court turned to the choice-of-law issue that it described as "the only substantial issue presented by the case."

**The Court’s choice-of-law analysis**

California has adopted a three-step "governmental interest" test for analyzing choice-of-law issues. After ascertaining the relevant law of each potentially affected jurisdiction, a court must "examine [each] jurisdiction’s interest in the application of its own law under the circumstances of the particular case to determine whether a true conflict exists." If the court finds that there is a "true conflict," it must "evaluate[] and compare[] the nature and strength of the interest of each jurisdiction in the application of its own law to determine which state’s interest would be more impaired if its policy were subordinated to the policy of the other state." The court then must apply "the law of the state whose interest would be the more impaired if the law were not applied."

The recording of telephone conversations in California is governed by Penal Code §§ 632 and 637, which make it illegal to "intentionally and *without the consent of all parties to a confidential communication,* by means of any electronic amplifying or recording device, … record[] the confidential communication whether the communication is carried on among the parties in the presence of one another or by means of a telegraph, telephone, or other device." *Id.* § 632(a) (emphasis added). Section 632(c) provides that "the term ‘confidential communication’ includes any communication carried on in circumstances as may reasonably indicate that any party to the communication desires it to be confined to the parties thereto," but excludes communications made in public "or in any other circumstance in which the parties to the communication may reasonably expect that the communication may be overheard or recorded." In *Flanagan,* the court clarified that "a conversation is confidential if a party to that conversation has an objectively reasonable expectation that the conversation is not being overheard or recorded." 27 Cal. 4th at 768. As the statute makes clear, and as the California Supreme Court reiterated in *Kearney,* a business that advises all parties of its intent to record at the outset of a call does not violate section 632. The statute simply prohibits a party from secretly recording the conversation.

Although the California Legislature did not specify whether the statute applies when one party to a call is in California and the other party is not, the court found that the purpose of the statute, "to protect the privacy of the people of this state," supported its application in such a setting. The court explained that "[t]he privacy interest protected by the statute is no less directly and immediately invaded when a communication within California is secretly and contemporaneously recorded from outside the state than when this action occurs within the state." Accordingly, the court found that section 632 "applies when a confidential communication takes place in part in California and in part in another state."

The court next turned to the relevant Georgia statute, which prohibits a person from overhearing, transmitting, or recording or attempting to overhear, transmit, or record "the private conversation of another which shall originate in any private place[.] …" Ga. Code Ann. § 16-11-62. In contrast to California Penal Code § 632, the relevant Georgia privacy statutes are "not applicable to a situation in which a conversation is recorded by one of the participants in the conversation." The California Supreme Court concluded that the Georgia privacy statutes "were intended, and reasonably should be interpreted, to apply" to a call in which one of the parties is in Georgia and one of the parties is in another state. Because the court concluded that both the California and Georgia statutes could apply to the telephone calls recorded by Salomon’s employees in Atlanta, and that "the law of each state differs with regard to the legality of such conduct," the court found that both

Georgia and California possessed a legitimate interest in having their respective laws applied. Consequently, the case presented "a true conflict of laws," and required the court to undertake the "comparative impairment" analysis. Through this process, the court sought "to the extent practicable, to achieve the maximum attainment of underlying purpose by all government entities." Under such an approach, "true conflicts are resolved by applying the law of the state whose interest would be the more impaired if its law were not applied."

**California's interest in applying its privacy statute**

The California Supreme Court concluded that failure to apply California privacy law to Salomon's recordings of its California clients would significantly impair California's interests. One of the principal purposes of the state's Privacy Act, including Penal Code § 632, was to protect "individuals in California from secret recording of confidential communications by or at the behest of another party to the communication." Consistent with this purpose, "California decisions repeatedly have invoked and vigorously enforced the provisions of section 632 … and have looked to the policy embodied in the provision in analyzing invasion-of-privacy claims in related contexts." Moreover, in recent years the California Legislature has "enacted new legislation in related areas in an effort to increase the protection of California consumers' privacy in the face of a perceived escalation in the impingement upon privacy interests caused by various business practices." Thus, the court emphasized that Californians have "a strong and continuing interest in the full and vigorous application of the provisions of section 632 prohibiting the recording of telephone conversations without the knowledge or consent of all parties to the conversation."

The court reasoned that failure to apply section 632 in the case "would substantially undermine the protection afforded by the statute." In light of the many national and international firms that do business in California, many of which have headquarters, administrative offices, or at least telephone operators located outside of California, failure to apply the statute would "represent a significant inroad into the privacy interest that the statute was intended to protect." Additionally, the court noted that failure to apply section 632 to out-of-state companies "very well might place local companies at a competitive disadvantage with their out-of-state counterparts," who would be able to selectively disclose recordings that served their interest, and to destroy or deny the existence of recordings that did not. Thus, the only way to treat such companies equally would be to apply the statute to all companies in their dealings with California residents. For these reasons, the court concluded that "the failure to apply California law in the present context would result in a significant impairment of California's interests."

**Georgia's interest in applying its privacy statute**

In contrast, the court articulated three reasons why the application of California law would have a "relatively less severe effect on Georgia's interest." First, the court observed that because the relevant portion of California privacy law "is more protective of privacy interests than the comparable Georgia privacy statute, the application of California law would not violate any privacy interest protected by Georgia law." In other words, applying California law would enhance the privacy protections afforded under Georgia law. Second, the court suggested that if California law applied only to calls made to or received from California, businesses could identify those calls and act in accordance with California law. According to the court, it would be feasible for a business to identify the calls its employees make to parties in California, and technologies such as "caller ID" would alert employees when they receive calls from California. Even absent such technologies, the court pointed out that an employee simply could inquire where the caller was located, and then inform any California callers of the business' intent to record the conversation.

Third, the court declared that "to the extent that Georgia law is intended to protect the right of a business to record conversations when it has a legitimate business justification for doing so, the application of California law to telephone calls between a Georgia business and its California clients would not defeat that interest" because California law prohibits only the secret recording of telephone conversations. The Georgia business still could record a call after notifying the other party in California.

**A choice-of-law analysis favors California's interest in applying its privacy statute**

The court found that the interests of California would be severely impaired if its law were not applied in *Kearney,* "whereas Georgia's interest would not be significantly impaired if

California law rather than Georgia law were applied." Thus, the court held that "California law should apply in determining whether the alleged secret recording of telephone conversations at issue in this case constitutes an unlawful invasion of privacy." Because the recordings violated section 632, the court allowed plaintiffs to "seek injunctive relief to require [Salomon] to comply with California law in the future."

However, the court declined to permit plaintiffs to recover monetary damages from Salomon for its past recordings. It found that "denying recovery of damages for conduct that was undertaken in the past in ostensible reliance on the law of another state—and prior to the clarification of which state's law applies in th[e] context—[would] not seriously impair California's interests." The court also noted that "ascribing a monetary value to the invasion of privacy resulting from the secret recording of a telephone conversation is difficult in any event," and that "the deterrent value of such monetary recovery cannot affect conduct that has already occurred."

Although it declined to allow plaintiffs in *Kearney* to pursue monetary damages, the court put out-of-state companies that do business in California "on-notice" that "with regard to future conduct, they are subject to California law with regard to the recording of telephone conversations made to or received from California, and that the full range of civil sanctions afforded by California law may be imposed for future violations."

**Implications for companies doing business in California**

The California Supreme Court's decision expanding the range of telephone calls that are covered by the state's Privacy Act has significant ramifications for companies doing business in the state. The court's decision is important not only for companies, like Salomon, that record telephone conversations as a means of protecting themselves from false claims of malfeasance or misconduct, but also for a wide range of businesses and individuals that routinely record telephone calls. For example, the *Kearney* decision will likely affect, among others:

- Producers of reality shows and other entertainment programs who may record calls from one-party-consent states into California;
- Reporters from one-party-consent states who call interview subjects in California and may wish to record their conversations; and
- Telemarketers who call into California from one-party-consent states and who may record conversations for quality-control purposes.

It is important to note that while the court's decision potentially affects any business that records calls that have a connection to California, it may not significantly alter many businesses' practices. As the California Supreme Court pointed out, "[a] business that adequately advises all parties to a telephone call, at the outset of the conversation, of its intent to record the call would not violate the provision." Nevertheless, the *Kearney* decision demonstrates that a business cannot rely on another state's one-party-consent statute when recording calls made into California, and serves as a reminder that recording calls having any connection to California without the consent of all parties may expose the business to civil and criminal liability.

NOTES

1. Jerod Partin, a summer associate in the Los Angeles office of Davis Wright Tremaine, provided valuable assistance in researching and writing this article.

# FREE SPEECH HAS "FRIENDS" AT CALIFORNIA SUPREME COURT

**by John P. LeCrone and Rochelle L. Wilcox**

The California Supreme Court issued its highly anticipated decision in *Lyle v. Warner Brothers Television Productions* on April 20, 2006.[1] In a victory for defendants—and every business whose product is protected by the First Amendment—a unanimous Supreme Court held that sexually coarse and vulgar language in the workplace does not give rise to a claim for sexual harassment, where the language is not aimed at a particular employee and is part of a "creative workplace." 38 Cal. 4th 264 (2006). The case was filed by Amaani Lyle, a writers' assistant on the popular television show Friends, who was fired after four months on the job because of problems with her typing and transcription. Lyle subsequently filed suit, alleging that the writers' use of sexually suggestive and vulgar language, both during and outside of script meetings, constituted sexual harassment in violation of California's Fair Employment and Housing Act.

**California's Court of Appeal holds defendants may be liable for sexually explicit speech by writers**

This case sent tremors through the entertainment industry in April 2004, when the California Court of Appeal held that Warner Brothers Television Productions, which produced Friends, and three of the program's writers could be held liable for "hostile environment sexual harassment" based on explicit jokes and discussions about sex by the writers. *Lyle v. Warner Bros. Television Productions,* 117 Cal. App. 4th 1164 (2004). The jokes and discussions were, according to plaintiff, coarse and vulgar—discussions about the writers' sexual preferences and their claimed exploits and fantasies, among other things—but with minor (and ultimately irrelevant) exceptions, those discussions were not directed at plaintiff. Plaintiff claimed that she was harassed by being subjected to that allegedly hostile work environment.

The court of appeal ruled that plaintiff's claims raised questions of fact, and that she was entitled to a jury trial. It concluded that although none of the alleged harassment was directed at plaintiff, she still could establish that her workplace was so disrupted by the alleged harassment that it interfered with or undermined her "personal sense of well-being," giving rise to a claim. The court stated that the "barrage of gender denigrating conduct occurred during writers' meetings which [Plaintiff] had the duty to attend as a writers' assistant as well as in common areas such as the hallways and break room." Consequently, plaintiff may be able to establish, as required to state a claim, "that she personally witnessed the harassing conduct and that it was in her immediate work environment."

After reviewing the alleged conduct on which plaintiff's claims were based, the court found that "there is sufficient evidence from which a reasonable jury could find the writers' room on 'Friends' was a hostile or offensive environment for a woman." It also opined that "[a] jury could find the sexual conduct in this case particularly severe because Lyle was a captive audience" insofar as her job required her to be in the writers' room and to take notes regarding all of the writers' jokes.

The court of appeal rejected defendants' First Amendment argument in a short footnote, relying on a California Supreme Court case involving sexual harassment directed at other employees in a rental car company. As to defendants' argument that the context in which the alleged harassment occurred precluded the imposition of liability for alleged hostile environment sexual harassment, the court held only that defendants may assert this argument as an affirmative defense during trial. The court concluded that "defendants' theory of 'creative necessity' has merit under the distinctive circumstances of this case and defendants are entitled to pursue their theory at trial." However, it reversed the summary judgment the trial court had granted for defendants because "'context' is only one factor to be considered in determining the existence of a hostile working environment and because there are triable issues of fact as to whether defendants' conduct was indeed necessary to the performance of their jobs."

**California Supreme Court holds state employment laws do not bar defendants' conduct**

Both parties petitioned for review. Defendants' Petition for Review was granted by the California Supreme Court, which ordered briefing on the following issues:

(1) Can the use of sexually coarse and vulgar language in the workplace constitute harassment based on sex within the meaning of the Fair Employment and Housing Act (FEHA)?

(2) Does the imposition of liability under the FEHA for sexual harassment based on such speech infringe on defendants' rights of free speech under the First Amendment to the federal Constitution or the state Constitution?

Ultimately, the majority answered only the first question accepted for review, but it did so in a way that protects the First Amendment rights of defendants and others like them. First, the court held that plaintiff was not harassed "because of … sex," as required to establish a sexual harassment claim. Relying on United States Supreme Court authority, the court explained that "the critical issue … is whether members of one sex are exposed to disadvantageous terms or conditions of employment to which members of the other sex are not exposed." The court elaborated that "it is the disparate treatment of an employee on the basis of sex—not the mere discussion of sex or use of vulgar language—that is the essence of a sexual harassment claim." Vulgar or coarse language, standing alone, does not give rise to a sexual harassment claim. "[A] hostile work environment sexual harassment claim is not established where a supervisor or coworker simply uses crude or inappropriate language in front of employees or draws a vulgar picture, without directing sexual innuendos or gender-related language toward a plaintiff or toward women in general."

To conclude that no harassment "because of … sex" occurred here, the court first pointed out that none of the offensive conduct "involved or was aimed at" plaintiff. The court next evaluated the context in which the alleged harassment occurred. Friends was a situation comedy that featured sexual humor as well as sexual language, innuendo, wordplay and physical gestures. The court explained that "[t]he circumstance that this was a creative workplace focused on generating scripts for an adult-oriented comedy show featuring sexual themes is significant in assessing the existence of triable issues of facts regarding whether the writers' sexual antics and coarse sexual talk were aimed at plaintiff or at women in general, whether plaintiff and other women were singled out to see and hear what happened, and whether the conduct was otherwise motivated by plaintiff's gender."

Moreover, the sexual banter and conduct occurred in groups of both men and women, and women writers participated by discussing their own sexual experiences to help generate material for the program. In addition, plaintiff was warned before she took the position that "the humor could get a little lowbrow in the writers' room," and she responded that it would not be a problem. The court found that "considering the totality of the circumstances, especially the nature of the writers' work, the facts largely forming the basis of plaintiff's sexual harassment action … did not present a triable issue whether the writers engaged in harassment 'because of … sex.'"

Some of defendants' alleged statements were directed at other women on the program or were derogatory of women, which plaintiff argued sufficed to support her claim that defendants' behavior was "because of … sex." However, the court held that plaintiff failed to raise a triable issue of fact on her claim that these statements were "severe enough or sufficiently pervasive to alter the conditions of the plaintiff's employment and create a hostile or abusive work environment." Quoting the United States Supreme Court, the court emphasized that the inquiry regarding whether alleged harassment is sufficiently severe to be actionable "requires careful consideration of the social context in which particular behavior occurs and is experienced by its target." Thus, "[c]ommon sense, and an appropriate sensibility to social context, will enable courts and juries to distinguish between simple teasing or roughhousing … and conduct which a reasonable person in the plaintiff's position would find severely hostile or abusive." The analysis is both objective and subjective.

The court considered and rejected plaintiff's claim based on the few comments from the writers that were directed at particular women, finding that the comments were not severe or pervasive enough to alter plaintiff's working conditions. The court concluded that while plaintiff might be able to state a claim based on alleged sexual harassment directed toward others, she could do so only by meeting a high threshold, and establishing that those comments "permeated" plaintiff's "direct work environment" or were so pervasive and destructive of the work environment that they justified affording plaintiff recovery. However, plaintiff only offered evidence of a few instances of derogatory comments directed at other women—two actresses on the show—and she belatedly offered evidence that two of the writers referred to women in general by derogatory terms. Plaintiff failed to provide specifics regarding when the writers used epithets regarding women in general, relying instead on her generality that they used epithets "'regularly' when they were displeased or mad." The court concluded that this evidence was "insufficient to warrant reversal of the summary judgment order." With this evidence, plaintiff could not establish "an objectively abusive or hostile work environment."

Thus, the court concluded:

> Based on the totality of the undisputed circumstances, particularly the fact the Friends production was a creative workplace focused on generating scripts for an adult-oriented comedy show featuring sexual themes, we find no reasonable trier of fact could conclude such language constituted harassment directed at plaintiff because of her sex within the meaning of the FEHA.

The court did not reach the second question—whether imposition of liability would have offended defendants' First Amendment rights—but there was no need. Resolution of the first issue in defendants' favor, along with the court's emphasis on the context in which the discussion occurred, should fully protect those who create or disseminate works protected by the First Amendment. Just as the writers were protected in what plaintiff alleged was extreme and caustic sexual banter, editors, writers and others whose businesses are the creation of works protected by the First Amendment should be protected as they discuss controversial issues—whether those discussions revolve around deciding how best to cover a story, brainstorming regarding a work of fiction, or developing a storyline for a television program, motion picture or play.

**Justice Chin concurs, stresses importance of First Amendment rights at stake**

Justice Chin authored a concurring opinion emphasizing the importance of the First Amendment rights at stake. As Justice Chin explained, he "wr[o]te separately to explain that any other result would violate free speech rights" under the United States and California Constitutions. He emphasized that "[t]his case has very little to do with sexual harassment and very much to do with core First Amendment free speech rights." The First Amendment protects creativity, and it protects defendants engaged in the creative process. Thus, "[w]hen, as here, the workplace product is the creative expression itself, free speech rights are paramount. The Friends writers were not renting cars and talking about sex on the side. They were writing adult comedy; sexual repartee was an integral part of the process." Justice Chin emphasized his belief that free speech rights are placed in "clear and present danger" when the process by which the speech is created is challenged.

Relying on an amicus brief submitted by a "'who's who' of television and motion picture writers and directors," Justice Chin emphasized the importance of freedom during the creative process. He explained that "[t]he creative process must be unfettered, especially because it can often take strange turns, as many bizarre and potentially offensive ideas are suggested, tried, and, in the end, either discarded or used." Writers must be free to push the limits, particularly if they are addressing controversial issues. Quoting the United States Supreme Court, Justice Chin emphasized that "speech may not be prohibited because it concerns subjects offending our sensibilities."

Juries cannot be allowed to dissect the creative process to determine—after the fact—whether a certain statement was "necessary" to the final product, and to impose sexual harassment liability for that which the jury deems "unnecessary." Courts "may not constitutionally ask whether challenged speech was necessary for its intended purpose. … The courts do not, and constitutionally could not, sit as superior editors of the press." It matters not that some—or most—of what was said was not, ultimately, incorporated into any script. "The First Amendment also protects attempts at creativity that end in failure."

Thus, Justice Chin declared:

> I agree with the general test proposed in the amicus curiae brief of the California Newspaper Publishers Association et al.: "Where, as here, an employer's product is protected by the First Amendment—whether it be a television program, a newspaper, a book, or any other similar work—the challenged speech should not be actionable if the court finds that the speech arose in the context of the creative and/or editorial process, and it was not directed at or about the plaintiff."

Justice Chin explained that this test presents the proper balance because "in the creative context, free speech is critical while the competing interest—protecting employees involved in the creative process against offensive language and conduct *not directed at them*—is, in comparison, minimal." (Emphasis in original.) Justice Chin emphasized that summary judgment is a favored remedy whenever First Amendment values are at stake, to ensure that unnecessarily protracted litigation cannot chill the exercise of First Amendment rights, and that demurrer (California's form of a motion to dismiss on the pleadings) is even better. "The threat of litigation must not be permitted to stifle creativity."

Justice Chin concluded:

> We must always remember that the widest scope of freedom is to be given to the adventurous and imaginative exercise of the human spirit. … We must not tolerate laws that lead to timidity and inertia and thereby discourage the boldness of expression indispensable for a progressive society. The allegedly offending conduct in this case arose out of the protected creative process and was not directed at plaintiff. Accordingly, the trial court properly granted summary judgment in defendants' favor. The First Amendment demands no less.

**Lessons for the future**

The decision by the California Supreme Court in *Lyle* is good news for the media in California and throughout the nation. Although the majority did not directly address the First Amendment issue, the Court's reasoning provides strong protection for businesses whose products are protected by the First Amendment. Its repeated discussion of the context in which the speech in this case arose, and its emphasis on the advance warning given to plaintiff that she might be subjected to sexually suggestive speech, demonstrates that these businesses will have more leeway in the speech permitted in the workplace than businesses whose products are not protected by the First Amendment. Thus, absent harassing activity directed at an individual, or activity that is blatant and unrelated to the business's product, the courts should defer to businesses in deciding what is permitted during the creative context. Of course, these businesses still must be vigilant to ensure that their speech does not fall within FEHA's prohibitions. However, the California Supreme Court has affirmed that these businesses possess—as they always have known—the freedom to create their products without interference by the government, as guaranteed by the First Amendment.

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NOTES

1. Davis Wright Tremaine attorneys Kelli Sager and Rochelle Wilcox represented Amicus Curiae California Newspapers Publishers Association, the Reporters Committee for Freedom of the Press, The Daily Journal Corporation, The Copley Press, Inc., Los Angeles Times Communications LLC, California First Amendment Coalition, Freedom Communications, Inc., and the American Society of Newspaper Editors in this matter.

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