

## **How Recording Contracts Work by Marshall Brain**

So you and your friends can finally call yourselves a real band. You're known at bars, clubs and coffee houses outside of the neighborhood you grew up in. You have a great local following and a presence on the Internet. A recent self-google has actually turned up results that are about you.

The new music you are writing is resonating with the audience. Things are all heading in the right direction, and you're ready to take it to the next level -- you want a recording contract. Visions of huge record labels dance in your head... A&M Records, Capitol Records, Elektra... But how much do you really know about that part of the business? What does a recording contract look like? What happens after you sign one? How much money will you actually make? In this article, you will have a chance to explore some of the basic features of any big-label recording deal.

### **Sign on the Dotted Line**

Let's imagine that a miracle has happened and you have a big-label recording contract in your hands. You want to sign it because you and your band mates have been working your butts off to get to this. But some of the stuff in it sounds -- well, pretty scary.

The American Heritage dictionary defines a contract as - An agreement between two or more parties, especially one that is written and enforceable by law. The "enforceable by law" part is important. Once you sign a contract, you are bound by it. So, if you don't like the contract, don't sign it. That doesn't mean things end here. You may want to consider hiring a lawyer.

In many cases, when someone is about to sign a contract, he or she hires a lawyer to interpret the contract and (in some cases) to help negotiate terms. Since you're looking at a music contract, an entertainment lawyer would be best suited to help with its interpretation. An entertainment lawyer must be familiar with various agreements and contracts related to the entertainment industry, including recording contracts.

Whether you are a solo artist or you are a member of a band, you generally have two problems if you are an unknown who is signing your first recording contract:

Because you have never seen a recording contract before, you don't know what is "normal," and you do not know how the contract will affect you long-term. Your lack of experience and knowledge in this situation makes a lawyer even more important.

Even if you have a lawyer, you may have little or no leverage. If you try to negotiate, the record company can easily say, "Take it or leave it." If you decide not to agree with the terms and conditions, you have to wonder when and even if the next contract offer will come.

The goal of this article is to walk you through the typical features that any recording contract will normally have. It certainly does not replace a lawyer, but it does help you to educate yourself about the big issues and problems found in most big-label recording contracts today.

### **Royalties**

In addition to global exposure and fame, the biggest reason for signing a recording contract is to get paid for your music. The record company will record your act, master it, produce the recording or "album" (refers to CDs, tapes, etc.) and sell them through record stores. You get paid a percentage of each album sold. This percentage is known as a royalty. There are other ways for musicians to make money but royalties on the sales of albums is the main source of money coming from a recording contract.

The percentage that you receive for each album sold is a negotiating point, but typically it can fall anywhere between 10% and 20%. Most new artists get a royalty percentage at the low end of the range, and 10% is common. A royalty deal seems simple enough. If a CD sells for \$15 and the royalty percentage is 10%, the band should get \$1.50 for the sale of each CD. If your first album sells a million copies, your band should get \$1,500,000. What's not to like about that?

The first thing to keep in mind is reasonable expectations for the sale of an album. The music industry publishes tens of thousands of new albums every year, and only a small percentage of them are going to go gold (500,000 records sold) or platinum (1,000,000 records sold). You have about a 1-in-20 chance of producing an album that is a major hit.

The second thing to keep in mind, and this is a big one, is that the band does not get \$1.50 for each CD sold. This discrepancy comes from the fact that the retail price of an album is different from the wholesale price, and many recording contracts pay based on wholesale rather than retail prices. These different calculations have a big impact on the amount of money a band can make.

It is not uncommon in the music industry (or the book industry, for that matter), for retail stores to mark up the wholesale price by as much as 80% when a CD is put on the shelf. Then there are things like coupons, rebates, promotional discounts, etc. that can carve into wholesale prices. In addition, there is the concept of a sales channel. For example, record clubs represent a different sales channel from retail record stores, and record clubs usually get their CDs at a lower wholesale price. Therefore, the band gets less money from discs sold through record clubs. Foreign sales are often treated the same way. Even discount clubs like Sam's and Costco can be different channels with lower wholesale prices.

What this means is that the royalty payment usually does not get calculated based on the \$15 retail price for the CD. The royalty payment may be calculated based on a much lower wholesale price point. It depends on the contract you sign.

The royalty amount can also be reduced by various charges. For example, it is common for a recording contract to withhold 25% of the band's royalties for a packaging charge. There may also be a deduction for free CDs. It is not uncommon for a record company to give away free CDs to a vendor instead of discounting the wholesale price of a CD. If that happens, then the band will be paid nothing for the free CDs given away.

Another common practice is to charge the band for a variety of costs associated with producing an album. For example, the cost of recording the album, promoting the album, producing a music video and touring for the album may all be recoupable expenses. Which means all of these expenses may be deducted from the band's royalties before the band gets paid. The cost of recording an album can easily reach several hundred thousand dollars, and so can promotion, touring and music video costs. All of these costs get subtracted out of the band's royalty payment before the label writes the band a royalty check.

Finally, there is the concept of an advance against royalties. The record company may pay the band a set amount of money during the album's development so that the band can eat while they create an album. If so, that advance will be recouped before any royalties are paid.

If any money survives the recouping process, and the band actually gets a check, then the band's manager and/or agent will get a cut of the proceeds. A manager typically gets 20%, for example. Then, the money that remains gets divided among the band members.

What this system tends to do is create a situation where only those bands who create gold and platinum records ever get paid anything outside of their advance money.

From this discussion, you can see that you need to be aware of several things when reading a recording contract:

- ⤴ The amount of the royalty percentage.
- ⤴ Whether the percentage is calculated on the wholesale, channel price of the album or the retail price.
- ⤴ Where the recoupable expenses are applied. Do they get applied before the royalty rate is calculated or after?
- ⤴ The kinds of extra deductions (like packaging costs, breakage, freebies, etc.) that are taken.
- ⤴ The size of the advance. Since the advance may be the only money you ever see, you want it to be as large as possible.

It is interesting to compare the record industry with, for example, the publishing industry for books. Both industries pay on a royalty basis. However, in the book industry, while there may be an advance given, there are none of these other recoupable expenses, deductions, charge-backs, etc. A book author is paid a fixed percentage of the wholesale or retail price paid for the book.

Not all record companies handle the pay-out this way. Let's take a look at a different method.

### **Royalty Alternatives: Another formula**

In some cases (more common outside the U.S. or with indie labels), the record company and artists split the net profits of an album 50/50 (or along some other percentage in the range of 50/50). To calculate the net profits, the label takes the gross receipts for the album and deducts all of the direct costs. The gross receipts are all of the money that the label makes from the album through wholesale sales of the CD. The direct costs include things like:

- ⤴ Studio time and labor costs to record the album
- ⤴ The costs of producers, technicians, etc. to produce a master
- ⤴ The costs of pressing and packaging the album
- ⤴ Shipping costs to get the albums to retailers
- ⤴ Marketing, advertising and promotion costs
- ⤴ Warehousing costs
- ⤴ Legal costs
- ⤴ Taxes
- ⤴ Personnel costs
- ⤴ Royalties paid to songwriters

Here, too, there is still a fair amount of wiggle room for the label. For example, the record label may be paying personnel \$10 per hour but charge a retail price of \$40 per hour when charging the cost of the personnel to the album as a direct cost. Part of that is justified (e.g. the label pays more for an employee than the hourly rate, including things like FICA, benefits, etc., plus there's office space, equipment, and so on). But the markup is probably 100%. So the label is making a nice profit off of these expenses, and may still be making money even when the artist is making nothing.

This quote from Courtney Love's letter to recording artists summarizes the position of most artists:

*Record companies have a 5% success rate. That means that 5% of all records released by major labels go gold or platinum. How do record companies get away with a 95% failure rate that would be totally unacceptable in any other business? Record companies keep almost all the profits.*

*Recording artists get paid a tiny fraction of the money earned by their music. That allows record executives to be incredibly sloppy in running their companies and still create enormous amounts of cash for the corporations that own them. The royalty rates granted in every recording contract are very low to start with and then companies charge back every conceivable cost to an artist's royalty account. Artists pay for recording costs, video production costs, tour support, radio promotion, sales and marketing costs, packaging costs and any other cost the record company can subtract from their royalties. Record companies also reduce royalties by "forgetting" to report sales figure, miscalculating royalties and by preventing artists from auditing record company books.*

From this discussion, you can see that there is no guarantee at all that your band will make any money from a recording contract. You are gambling that your album will be able to break through into the top 5% of albums and go gold or platinum.

The bottom line is that you want to push for the highest royalty rate possible, especially if there are a lot of recoupable expenses in the contract. You also want to push for the highest advance possible, since that may be the only money the band actually receives. Keep three things in mind when you negotiate the rate:

It is likely that the first royalty number you see is negotiable. It is common to put a low-ball figure in the contract to give the label room to negotiate.

It can't hurt to ask for a higher rate. The fact that you have been offered a contract means something. The label looked at your band or your solo act and saw talent that looked profitable. If one label can see that, it is possible that other labels would have the same reaction. This gives you a bargaining position.

### **The Marketing Machine**

You will rarely see it written into a contract, but it is important to keep in mind the reason that you, as an artist, are signing the contract. Yes, you want to make money -- it is nice to be paid for your work. But there is another reason why most acts are interested in signing a contract, especially if you are signing with a big label. You are also looking for maximum exposure. You want the label to promote your record. Presumably, more promotion yields more sales, which is good for both parties. But even if there are no sales, promotion is good for your band because it gets your name out in the public more and more. If possible, you would like to see some sort of minimum dollar commitment on the part of the label in the area of promotion written into the contract.

### **Recording**

In return for royalties on albums sold, the band agrees to record those albums. That seems simple enough -- it is not possible to sell albums without recording them. The contract will normally set up a group of contract periods, with each period generating an album and one or more singles.

Normally the recording contract will specify the contract periods very clearly. An amount for the advance given with each contract period will be stipulated in the recording contract, and a deadline for the album will be stipulated as well. The first contract period generates the first album, the second contract period generates the second album, and so on.

So the band goes into the studio and records an album. The contract will specify that once it is recorded, it is the property of the label in perpetuity. In addition, the contract will normally have some sort of lock-out clause with a duration of five to 10 years. This clause prevents the band from re-recording any of the songs on the album for five to 10 years after the end of the contract. In other words, the label owns the songs you have recorded for a very, very long time.

If the label does not like the album, it has the right to reject it. In that case, the band has to record another album. Or the label can accept an album but shelve it and never release it. The lock-out clause will still apply in that case, even though the songs were never released.

## **Options**

Normally, a recording contract will have something like a one-year term to allow the first album to be recorded and released. The first contract period, in other words, lasts a year. Then the contract will have a number of options that the label can exercise to activate the second contract period, the third contract period and so on. For example, a contract might have five options. If the label likes the initial album, it can exercise its first option so that a second album can be produced.

During each option, the label is requesting a new album. The band usually gets another advance and goes into the studio to record the next album. This is definitely a one-way affair. The label can choose not to exercise its option, and in that case, the contract terminates. Or the label can exercise an option, but the band has no way to get out of the contract if things are uncomfortable. For example, if the band's first album is very successful and the band would like a higher royalty rate, there is no way to renegotiate that. The royalty rate applies across all of the contract periods in the contract. Or, if the band's first album was a bad experience and the band would rather not do another one, there is no way that the band can avoid additional albums. If the record company exercises an option, the band is obligated to produce the album.

The options have the effect of locking a band in for six or seven albums (or more if the label rejects an album). If a band is doing well, the options in the contract guarantee that the band will produce a large collection of albums according to the terms of the contract. For most bands that sign their first contract as unknowns, this arrangement is very advantageous to the label. The band produces six or seven albums at a low royalty rate. If the band is not doing well, the label simply terminates the contract, but the lock-out clause prevents the band from re-recording the material. Even if the label has no interest in the band, the label owns all the recordings. There is no way for the band to re-release an album on its own.

Contracts will sometimes specify that recordings of live performances do not count toward the total number of albums stipulated in the contract. So if the label wants to release a live album, it can, and it does not shorten the contract.

Finally, there is a concept called cross-collateralization. Let's say a band's first album does well, but not well enough to recover all the recoupable costs, charge-backs, etc.

For example: The record company sells 300,000 CDs and makes \$3 million. The band gets a 10% royalty. The recoupable expenses total \$500,000.

So the band "makes" \$300,000, but that money doesn't cover all the recoupable expenses. So the band is now \$200,000 in the hole. The band does not get a cheque, but the label probably cleared \$2 million from the album. So the record company exercises the first option. The band creates a new album. The income from the second album will have to cover all the remaining costs from the first album (\$200,000) and then all of the new costs for the second album before the band sees any money. In this way, a band may need to produce several albums before it gets paid anything. It is not a pretty picture for a band that "almost succeeds." The contract locks the band in, but the band makes no money from the contract outside of the advances.

This is why you would like the advances to be as large as possible. Since the advance money may be the only money you ever see, and is therefore the money that you and the band members will be living off of, you definitely want to try to negotiate an advance that allows the band members to live

a decent life and cover things like health insurance.

### **More fine print**

Depending on the record company that you sign with, there are a number of other things that the label will stipulate in the recording contract:

**Exclusivity** - The label has exclusive rights to the band's music, the band's name, the band's members, the band's image and likeness, etc. for the duration of the contract.

**Merchandising** - Any revenue earned from T-shirts, key chains and so on will go to the label. The label will own all merchandising rights for the band.

**Interviews and publicity** - The label can request, at pretty much any time, that the band make itself available for press interviews, personal appearances, photographic sessions, etc. If the label decides it wants a band to appear at the grand opening of a local mall, the label could, in theory, request the band's appearance and the band would need to show up. Any sort of "publicity" activity is fair game. The band probably will not be compensated for these activities outside of travel expenses.

**Creative control** - The label has the right to decide on the artwork for the CD label and jewel case. The label can also reject an album, or accept and then shelve an album.

**Other work** - Any outside work the band does must first be approved by the label.

**Personnel** - If someone resigns from the band (or, for example, dies), the label has the right to terminate the contract.

### **Alternatives**

So, you may have gotten this far and are now asking yourself, "Why would anyone sign a recording contract?" There are at least two good reasons for a band to sign a recording contract:

If you hit it big and your album goes multi-platinum, your band will make some money. You will not make a lot of money compared to the money that the label makes off a multi-platinum album, but you will make some.

A major record deal is probably the best way to get mass-media exposure. It is unlikely, for example, to find a band getting air time on places like MTV, VH1 and commercial radio stations unless the band has signed with a big label. If mass exposure is what you crave, then a big label is probably the way to go.

But let's say that you have read this article and you aren't liking the sound of things. What are your alternatives? You have perhaps five options:

- ♣ You can get out of the business.
- ♣ You can stay small and try to make a living off club performances and selling your own CDs at local shows.
- ♣ You can hire a big-name entertainment lawyer and hope that he/she can negotiate a better deal.
- ♣ You can go with an independent label and try to find a better deal.
- ♣ You can create your own record label.

The first option is obviously the easiest from a purely logistical standpoint. But, if you're like most musicians -- emotionally invested in making your music and having it heard -- this isn't an appealing option. The last option listed above is obviously the most complicated and requires a talent for business that leverages your talent for music. Despite the complexity, there are a lot of people who have formed their own labels and made money doing it.

By starting your own label, you have total control, and you make a lot more money per CD you sell. The downside is that you generally do not sell as many CDs.

**Article Source:** <http://entertainment.howstuffworks.com/recording-contract.htm>