BY BRAD STONE

WARNER MUSIC, THE fourth largest music company in the world, has every reason to wage business and legal warfare against popular video-sharing site YouTube. The Internet upstart gives its 34 million users free access to songs and videos from the label’s entire stable of artists, including Madonna and Green Day. But instead of hostility, Warner digital-strategy exec Alex Zubillaga says he felt something like sympathy during a recent dealmaking visit to the firm’s Silicon Valley headquarters. YouTube’s 60 employees—who share a grand total of 10 landline phones—are so crammed into small offices over a pizzeria in downtown San Mateo that Zubillaga says, “I almost felt bad for them.”

Last month, Zubillaga’s fondness for the bootstrapped start-up and its founders, Chad Hurley, 29, and Steve Chen, 28, helped to produce a landmark deal between Warner Music and YouTube. By the end of the year, the label, run by media mogul Edgar Bronfman Jr., will be able to yank any unauthorized songs or video clips from the site if Warner doesn’t like the way they’re used, or if Warner doesn’t own all the rights. The two companies will then share the revenue YouTube plans to reap from advertisements placed alongside Warner material. Five years ago, the record labels jointly sued the pioneering file-sharing service Napster into oblivion. The YouTube-Warner partnership signifies, at the very least, a gentle thawing of relations between the music industry and the disruptive insurgents of high tech.

But the latest, hottest company to emerge from Silicon Valley isn’t out of the woods yet. YouTube still faces huge legal, business and competitive challenges in its struggle to become an actual moneymaker. The first obstacle: striking deals with the other three major labels, including the largest, Vivendi’s Universal Music Group. Its CEO, Doug Morris, ominously told investors last month that “copyright infringers” like YouTube and MySpace “owe us tens of millions of dollars.” YouTube must also find actual revenue to cover the enormous costs of serving up an astounding 100 million videos a day over the Web. Both tasks are formidable, which is why most analysts and media insiders scratch their heads at recent published reports that the company’s acquisition price is $1.5 billion. “I draw a lot of parallels to Napster,” says Fox Interactive chief Ross Levinsohn, who spearheaded News Corp.’s $580 million acquisition of MySpace. “The minute a Yahoo, Microsoft or News Corp. buys YouTube, you have a target for anyone who wants to sue.”

Nevertheless, its deal with Warner Music is a promising accomplishment for the 20-month-old firm. The company was founded by two former PayPal employees, Chen and Hurley, to allow Internet users to easily post and watch videos on the Web. The idea was so instantly compelling that ever since, the site has generated a stream of cultural sensations: Lazy Sunday, Lonelygirl, Nobody’s Watching.

The site’s growth rate has spawned nonstop rumors about a possible acquisition, even though Hurley has told associates he wants to build “the next Google” and eventually go public.

From its inception, You-
Tube has tried to distinguish itself from earlier Internet copyright infringers like Napster. It hasn’t been easy. Users have posted countless bootleg recordings of live concerts and entire episodes of shows like “The Simpsons,” while using copyrighted songs as soundtracks to their own living-room lip-sync sessions. YouTube responds to any objections of rights holders by quickly taking down the material, which, according to most legal experts, places it squarely under the “safe harbor” provisions of the 1998 Digital Millennium Copyright Act. As part of the Warner deal, the company will soon begin taking an extra step—using audio “fingerprinting” technology from Silicon Valley firm Audible Magic, which automatically determines if a song on the site belongs to Warner.

Even if that technology works, other record labels may not be satisfied. An exec at one music company, who doesn’t want to be named because there are ongoing negotiations between YouTube and his firm, says that the terms of the Warner deal don’t make sense because “YouTube has no ad revenue to split.”

That’s YouTube’s second big challenge: using its momentum and audience to find a workable business model. The company is now beginning to develop advertising muscle aside from the predictable banner ads. Every day since late August, a single advertiser, like videogame maker 2K Sports, has posted an ad on the well-trafficked YouTube homepage; the commercial routinely gets played hundreds of thousands of times in 24 hours. But the real money lies in tapping the millions of buried pages of user-created videos, many of which feature potentially distasteful fare and are therefore unappealing to advertisers. YouTube’s senior director of marketing Julie Suppan says the firm is “weighing and evaluating” placing short commercials after videos from the site’s most effective contributors and splitting the revenue—a model developed by a YouTube rival, Rever.com.

But the clock is ticking for the Silicon Valley star. YouTube has raised $11.5 million in venture capital, mostly from Google backer Sequoia Capital. But its operating expenses, which it doesn’t publicly disclose, are undoubtedly massive and growing. An exec at a rival video-sharing firm that operates in a similar manner calculates the cost of streaming 100 million videos a day over the Internet at more than $2 million a month. RBC Capital Markets analyst Jordan Rohan calls this “the winner’s curse.” The more popular YouTube becomes, the more expensive it is to store and serve videos and keep the business afloat.

YouTube also faces growing competition. Last week Microsoft announced a similar video-sharing service, Soapbox, joining Google, Yahoo and MySpace as aspiring YouTube killers. The Internet giants, with their deep pockets, are better able to finance the steep overhead and can spend more to display video at higher resolution. They also have established relationships with the very same media companies that might now be weighing partnerships against lawsuits when it comes to video sharing on the Web.

While it figures all this out, YouTube hopes its audience and biggest contributors will remain faithful. But even that’s a lingering question. Creators like Doug Sarine, the 33-year-old co-mastermind behind the popular “Ask a Ninja” series, want to get paid, too. Though his videos have been watched on YouTube millions of times, and YouTube recently approached him about building an ad-supported “Ninja” channel on the site, Sarine has started experimenting elsewhere, advertising on his own Web site and trying out Rever.com. He wonders “whether YouTube is a practical advertising space.” That’s precisely what the rest of the world is waiting to find out.

With NGAI CROAL

Other Online Competitors
Like Yahoo, Google and MySpace, Microsoft now has a user-generated video service too.

Hostile Media
Universal Music CEO Doug Morris says “copyright infringer” YouTube owes his company millions. A deal—or lawsuit—is pending.

Advertisers
Movie studios and videogame companies love the huge audience. Getting their ads next to user-created videos is another story.

LEGAL? Universal’s Beck
HIT: ‘Nobody’s Watching’
HOAX: ‘Lonelygirl15’