Grokster, the Supreme Court, and You:

Why the VC Community Should Care About Contributory and Vicarious Copyright Infringement

BY C. COLIN RUSHING

On March 29, 2005, the Supreme Court of the United States heard oral argument in *Metro-Goldwyn-Mayer Studios, Inc. et al. v. Grokster Ltd., et al.*, a case that has the potential to redefine the law governing the intersection of copyright and technology and, as such, is significant to the venture capital community. In *Grokster*, the Court is poised to reconsider the doctrine of "contributory infringement" — a doctrine that allows the imposition of copyright liability on a person who knows about infringing activity and induces, causes or materially contributes to that activity. The Supreme Court last explored the doctrine of contributory infringement in 1984, in the context of the technological marvel of that age, the VCR. *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417 (1984). The Court also has been asked to consider the related doctrine of "vicarious" liability.

In *Sony*, the Court held that a distributor of a product could not be held liable on a theory of contributory infringement for users' infringement so long as the product is capable of substantial noninfringing uses. The lower courts in *Grokster* made the same holding for the *Grokster* defendants. This time, however, the technology is not the VCR, it is peer-to-peer file-sharing technology, and the defendants before the Court, Grokster, Ltd. and StreamCast Networks, Inc., are not established manufacturers, but a pair of companies distributing relatively simple software to millions of users for free.

The plaintiffs are urging the Supreme Court to clarify or revise its holding in *Sony* to allow liability for contributory infringement to be imposed "whenever infringement is the principal or primary use" of the product or service, even if it is capable of some "noninfringing use." The standard, according to the plaintiffs, would protect the distributors of products that have "commercially significant" noninfringing uses while allowing those whose products are "principally" used for infringing purposes to be held liable.

Grokster and related cases are significant to the venture capital community for three reasons. First, whatever the Supreme Court decides, the legal issues in *Grokster* are at the core of technology policy. Any company that develops technology related to the copying, distribution, display, or broadcast of any kind of media will be affected by the result. Second, if Grokster is ultimately decided in favor of the plaintiffs, investors will need to determine whether and how the ruling adversely affects the business models of their portfolio companies. Thirdly, and certainly not least, as taught by *UMG Recordings, Inc. et al. v. Bertelsmann AG et al.*, a case brought by copyright plaintiffs against Hummer Winblad Venture

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Partners and Bertelsmann AG based on their investment in and involvement with Napster, Inc., in some circumstances *investors* may be subject to potential copyright infringement liability.

The Context: Grokster and StreamCast and Napster

Peer-to-peer technology is in essence a networking protocol that allows individual users to communicate directly with one another over the Internet without having to first connect through a shared server. Grokster and StreamCast distribute a basic form of peer-to-peer software that allows users to search for and download files stored on other users' computers. The defendants concede that the vast majority of files transferred by Grokster and StreamCast users are unauthorized copies of media — mainly, digital copies of popular songs and films. Because the software facilitates peer-to-peer communications, however, Grokster and StreamCast do not actually participate in the transfer of the files. Nonetheless, they do remain in contact with their users: The companies occasionally provide updates to the software, and they also deliver or "push" advertisements to users' computers.

The entertainment industry, represented in this case principally by the major movie studios and record companies, seeks to shut down Grokster and StreamCast. This is not without precedent: In the Napster litigation, record companies convinced the federal district court in California and the Court of Appeals for the Ninth Circuit that *Napster* should be held liable for its users' infringing acts, they prevailed against Aimster in the Seventh Circuit, and they advanced similar theories against Grokster and StreamCast.

But Napster differed from Grokster and StreamCast in a key respect: Napster's file-sharing service relied on central servers operated by Napster, whereas the software products distributed by Grokster and StreamCast do not. Once the software is distributed, it continues to function, and will continue to do so, even if Grokster and StreamCast shut their doors. According to Grokster and StreamCast, that fact, combined with the noninfringing uses to which their services may be put, should be the difference between a possible finding of contributory infringement and a finding that they are protected by the *Sony* holding. The entertainment industry plaintiffs, on the other hand, assert that distributors such as Grokster and StreamCast that distribute software that is used primarily to engage in copyright infringement should be deemed subject to copyright infringement liability.

The Ninth Circuit agreed with Grokster and StreamCast. Now, it is up to the Supreme Court to decide.

Copyright Liability in a Nutshell

Copyright and Infringement Generally

At its most basic form, copyright is the exclusive right of the author to make certain uses of her copyrighted work. These exclusive rights generally include the right to copy, perform, broadcast, display, and distribute the work. The copyright owner may authorize others to exercise any of these rights.

Copyright infringement occurs when a person who is not authorized to do so exercises one of the copyright owner's exclusive rights and the use does not constitute a "fair use" of the work. "Fair use" is an extremely fact-intensive and malleable defense to a copyright infringement claim, where a use is deemed "fair" when the use is for certain purposes and when it comports with certain factors specified in the copyright statute. The most famous "fair use" defense is probably the conclusion of the Supreme Court in *Sony* that "time shifting" television programs using a VCR was a protectible "fair use."

Direct and Secondary Liability

Copyright law recognizes both direct and secondary liability for copyright infringement. Direct liability is imposed on the person who engages in the actual infringement. Thus, the users who share copies of music and movie files on file-sharing networks are the direct infringers. Claims of direct liability are typically straightforward: The court must determine whether the alleged infringer exercised one of the copyright owner's exclusive rights (did she distribute pirated copies of *Fletch* to thousands of her closest friends) and, if so, was that exercise authorized by law or otherwise defensible?

The doctrine of secondary liability is, at an extreme level of generality, intended to impose copyright liability on those who are not direct infringers but who are sufficiently related to the infringing activity that courts think they *should* be liable for the infringement.

Secondary liability has been a part of copyright doctrine for decades, but it has taken on a new importance in the digital age. Because it is so easy to copy and distribute media that is in electronic form, and because the prospect of bringing claims against anything more than a handful of the millions of individual infringing users (as occurred recently as part of a campaign by recording companies to apparently educate the public about the importance of copyright and the risk of infringement) is daunting to say the least, content owners have generally focused on the intermediaries who facilitate the distribution.

The most famous claims of secondary liability in recent years are those brought against the file-sharing enterprises — Napster, Aimster, Grokster, and StreamCast. But content owners have also brought claims against other types of services on a theory of secondary liability, including internet service providers that host allegedly infringing user content, other online services that perform similar services, and even financial intermediaries (such as credit card companies) that facilitate transactions between the infringer and its customers.

The case law recognizes two forms of secondary copyright liability: Contributory infringement and vicarious liability. Although they each have distinct roots in the law, the factors contributing to a finding of liability under either theory are becoming increasingly related. Both categories are discussed below. To provide context, the sections include a discussion of how the doctrines were applied in the *Napster* litigation.

Contributory Infringement Contributory infringement stems from the tort doctrine of enterprise liability and is ultimately based on the general principle that those who are involved in the copyright infringement should be held jointly liable for the infringement. Thus, this form of liability is generally imposed on a person who (i) knows or has reason to know about the infringing conduct of another and (ii) induces, causes, or materially contributes to that conduct.

In the context of a product that enables infringement, such as the peer-to-peer software at issue in *Grokster* or the Betamax device at issue in *Sony*, it may not be difficult to establish that selling the product to a user "materially contribute[s]" to infringement committed by that user with that product. Instead, the question often focuses on whether the person who supplied the product knew or had reason to know of the infringement — including, as some courts require, whether the person knew of the *specific acts* of infringement for which the copyright owner seeks to impose liability.

In *Sony*, the Supreme Court confronted the question whether Sony should be liable for copyright infringement by virtue of its manufacture and distribution of the Betamax videotape recorder (the less fortunate competitor of the VHS VCR). The studios in that case argued that Sony should be liable for copyright infringement by purchasers of the Betamax on the grounds that Sony was well aware that users were putting the device to infringing use. For example, because people were using the Betamax to create a library of television programs (which would infringe the copyright in those programs) and Sony knew that they were buying Betamax machines to do so, it was appropriate to conclude that Sony was a contributory infringer.

The Supreme Court disagreed. The Court noted that Sony could only be liable for copyright infringement on a theory of contributory infringement if it had actual or constructive knowledge of the specific acts of infringement. But the Court refused to impute the knowledge of the purchasers of the Betamax to Sony: Because the Betamax was "capable of substantial noninfringing uses," the Court held, it was improper to ascribe to it knowledge of infringing uses. The "substantial noninfringing use" in that case was time shifting — recording a program to make it possible to watch it later.

Napster asserted that it was entitled to the *Sony* defense on the ground that its file-sharing service was also capable of substantial noninfringing uses, even if the file sharing that was the core of its operations was otherwise infringing. (Napster also argued that file sharing of copyrighted files was itself a fair use, but that argument did not get very far.) Napster's *Sony* argument was generally rejected by the courts because Napster was much more involved in its users' acts of infringement. Unlike Sony, which had no involvement in its customers' uses of the Betamax, Napster was involved in the actual file-sharing activities of its users, because Napster's servers facilitated that file-sharing, and Napster even had the ability to monitor and block the sharing of files. In other words, because Napster was involved in the actual infringing activities, it was not necessary to impute to Napster its customers' knowledge.

Vicarious Liability The theory of vicarious liability is based on the doctrine of respondeat superior — that is, the doctrine that a person is generally responsible for the acts of her agents, employees, or others acting for her benefit. Typically, to prove that a person is liable for copyright infringement on a theory of vicarious liability, the plaintiff must prove (i) that the person has the right or ability to supervise or control the activity that constitutes infringement and (ii) the person gets a benefit from the infringement. Importantly, it is not necessary for the person to have actual or even constructive knowledge of the infringement. Because vicarious liability is based on the person's control of the infringer's activity, and not her contribution to or knowledge of the specific infringing activity, the *Sony* limitation on liability generally is not relevant.

The doctrine of vicarious liability in copyright law reaches far beyond the traditional boundaries of the principal-agent or employer-employee relationships, however, extending to a wide variety of circumstances. Thus, dance hall operators have been held liable for infringement by visiting bands and flea market operators have been held liable for infringement committed by vendors that rent space to sell infringing wares.

Vicarious copyright liability has reached its broadest construction in the context of the liability of online services, because the "right to supervise" has been deemed to include the technical ability to block or control access to certain services or files. Thus, some courts have concluded that a service that has the contractual right to police its user's content or activities, and that has the technical ability to do so, also has sufficient supervisory rights to establish the basis for the vicarious liability. For example, Napster was deemed to have the ability to "supervise" the infringing activity because it reserved the right to terminate user access and also had the technical ability to block access to specified files or, indeed, to block a particular user's access to the services altogether. Because Napster obviously "benefited" from the infringing activity, establishing that it was vicariously liable for its users' infringement was not difficult.

Grokster's Potential Effect on the Doctrine of Secondary Liability

The *Grokster* litigation turns on the question whether the operation of the Grokster and StreamCast software is sufficiently different than that at issue in *Napster* to warrant different treatment than Napster received.

Grokster and StreamCast distinguish themselves from Napster in several ways: They emphasize that their "networks" or "services" are not a "network" or "service" in the common understanding of the term because they do not have any role in the communications that flow between users of their software: Unlike Napster, the peer-to-peer searching and file-transfers do not depend in any way on network components operated by Grokster or StreamCast. Once a user has the software, she could use it to communicate with other users even if Grokster and StreamCast stopped operating altogether. Likewise, Grokster and StreamCast cannot terminate users, block certain files, or otherwise supervise or control their infringing activity.

The plaintiffs do not really dispute this basic description of Grokster and StreamCast, but they nonetheless paint a much different picture of those companies. Above all, they emphasize that Grokster and StreamCast actively induce the infringement of copyright on a mass scale: Grokster and StreamCast were offered and advertised as alternatives to Napster after Napster's demise, in its first incarnation. The software that they each distribute is not designed to enable the creation of robust personalized peer-to-peer networks, but instead consists of a basic search feature that allows users to search the computers of fellow users for files with a specific name — a feature that is largely useless except where a file name describes the contents of the file in sufficient detail (i.e., the names of songs and movies). As a conceded factual matter, the vast majority of the files available and shared with the software are infringing media files. And although the Grokster and StreamCast software at issue operate without Grokster's and StreamCast's direct involvement, those companies do update the network software from time to time so that it operates more smoothly. Finally, Grokster and StreamCast actually deliver or "push" advertisements to their users, resulting in a stream of profit to them based on the time their users spend operating their software.

As in *Napster*, the case against the peer-to-peer services in *Grokster* thus turns on the application of the principles of secondary liability. Because of the fundamental differences between Grokster and StreamCast on the one hand, and Napster on the other, however, this case has the potential to refine if not redefine those principles.

Contributory infringement: Perhaps most important for technology policy is that Grokster presents the Supreme Court with an opportunity to revisit the doctrine of contributory infringement spelled out in Sony. As set forth above, Grokster's defense in this litigation turns almost entirely on its contention that it cannot be held liable for the infringing uses of the users of its product because its software is *capable* of substantial noninfringing uses, even if those uses are not the actual uses to which the service is put.

Importantly, the Ninth Circuit agreed with Grokster that its distribution of software was more akin to the manufacture of a device such as a VCR than to the file-sharing service operated by Napster. This view, if affirmed, could ultimately be deemed to create in the copyright law a form of immunity for the developers of new technologies from copyright liability.

As noted above, the plaintiffs are urging the Supreme Court to clarify or revise its holding in *Sony* to allow liability for contributory infringement to be imposed "whenever infringement is the principal or primary use" of the product or service, even if it is capable of some "noninfringing use." The standard would protect the distributors of products that have "commercially significant" noninfringing uses while allowing those whose products are "principally" used for infringing purposes to be held liable. Under such an approach, it would be necessary in many contributory infringement cases to assess the relative quantity and quality of infringing and non-infringing uses of the technology at issue.

Vicarious Liability: This case presents an opportunity for the Court to examine the doctrine of vicarious liability as well. Grokster and StreamCast argue that they cannot be held vicariously liable because they do not have the ability to control how their users use their services. Because the ability to supervise is an element of the doctrine of vicarious liability, they argue, that form of liability cannot be imposed on them.

The plaintiffs, however, ask the Supreme Court to hold that companies such as Grokster and StreamCast may not escape vicarious liability by turning a blind eye to infringement and refusing to establish the sort of mechanisms that could expose them to vicarious liability. Specifically, they point out that Grokster and Stream cast *could have* designed their peer-to-peer service to allow them to monitor their users activity, filtering infringing content, and terminate the access of repeat infringers to their networks. Because it is technically possible to supervise their users, the plaintiffs in essence contend, the defendants must do so.

In short, the factual and legal context of this case puts the Court in the position to substantially redesign the operation of secondary copyright liability, and the obligations that the doctrine imposes on technology companies. There is thus no doubt that the ruling in *Grokster*, whatever it is, will have an effect on technology companies.

At its core, the legal question presented in *Grokster* is whether the copyright law recognizes a form of immunity from copyright claims for companies that merely develop so-called dual-use technologies — technologies that have infringing and non-infringing purposes — or if instead, the law imposes on technology companies a duty to anticipate, at least to some degree, the copyright implications of their products. Some argue that such immunity is necessary in order to avoid chilling

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technological innovation. If the copyright laws require innovators to anticipate possible or actual infringing uses, the argument goes, innovation will be stifled by fear of liability. According to this view, CD burners, the iPod, and even the internet exist principally because of the protection afforded by *Sony*.

Others, such as MGM and the Recording Industry Association of America ("RIAA"), contend that such immunity actually retards more important and useful innovations, namely, the development of technologies and services that are both innovative and respectful of intellectual property rights. According to this view, the operation of the Grokster and StreamCast networks actually makes it *more* difficult for legitimate services to emerge because the market for those services, which because of licensing costs will almost always cost consumers *something* (such as the cost of $.99 per song on iTunes), will have as their major competitors services that are free. Likewise, free services based on widespread copyright infringement also support an atmosphere of distaste for copyright protection — an atmosphere in which users think that they do not need to compensate copyright owners to obtain and distribute their works.

In short, there are competing views about whether the Grokster view or the views of MGM and the RIAA are more likely to spur the development of new technologies.

Issues for VC Firms: Protecting Their Investments and Protecting Themselves

Venture capital firms have two principal issues when it comes to potential copyright liability: (1) Ensuring that their investments are not swallowed in the costs of copyright litigation or, worse, destroyed by case law hampering the business models of their portfolio companies; and (2) avoiding liability being imposed on themselves.

Protecting their Investments In general, it is very important to investigate whether a potential or existing portfolio company takes its obligations under the copyright laws seriously. The risk of copyright liability exists for any company that is engaged in the business of distributing content, or of facilitating the distribution of content. Although copyright law can be murky, and may be the least clear in the areas that are subject to rapid growth, companies can take steps to reduce their exposure to copyright liability while at the same time signaling their good faith to copyright owners.

Venture capital firms will thus want to ensure that companies they invest in are taking the right steps and sending the right signals. For example, the company could implement and enforce a clear copyright policy, and impart to its employees — including and especially its developers and its marketing staff — the importance of respecting the copyright laws. Likewise, the company should investigate and respond to all allegations of copyright infringement, and otherwise take seriously concerns raised by copyright interests. Where applicable, the company should take all steps that it can to ensure that it is subject to the safe harbors for copyright liability provided for some online service providers by the Digital Millennium Copyright Act.

Potential Liability of VC Firms No matter what the Court decides in Grokster, investors should pay close attention to *UMG Recordings, Inc. et al. v. Bertelsmann AG et al.*, a case brought by copyright plaintiffs against Hummer Winblad Venture Partners and Bertelsmann AG based on their investment in and involvement with Napster. Just last summer, a district court in California refused to dismiss that case on the ground that investors who are sufficiently involved in the infringer's operations can be held liable for copyright infringement on theories of contributory infringement and vicarious liability.

Both firms funded Napster and also participated very deeply in its operations, and both were sued as a result. Hummer Winblad invested $13 million in Napster in 2000. Hank Barry, Hummer Winblad's general partner, was Napster's CEO and had a seat on its board of directors, and John Hummer, a Hummer Winblad colleague and co-founder, also sat on the board. (With two seats on the board, Hummer Winblad effectively had a controlling plurality.) Likewise, Bertelsmann invested millions of dollars in Napster, intending ultimately to use Napster to help launch a noninfringing online music service. The plaintiffs alleged that Bertelsmann, like Hummer, exercised operational control of Napster and directed it to continue to operate in an infringing manner until a noninfringing service was devised. Both Hummer and Bertelsmann became involved with Napster *after* Napster had been sued by numerous copyright owners for copyright infringement, and nonetheless got involved in its daily operations.

Based on these allegations, the district court refused to dismiss the claims of contributory and vicarious infringement brought against both firms:

For the purposes of this motion, plaintiffs have thus stated a claim that Bertelsmann and Hummer Winblad—as entities exercising full control over Napster's operations—were directly responsible for the infringing activity perpetrated by Napster's online users; more than merely knowing of and contributing to the infringing activity, they are alleged to have specifically ordered that such activity take place.

UMG Recordings, Inc. et al. v. Bertelsmann AG et al., 222 F.R.D. 408, 413 (N.D. Cal. 2004). Importantly, the court did *not* reach "the question of whether mere financial support of a contributing and vicarious infringer such as Napster—without more direct involvement—would give rise to a claim for contributory or vicarious infringement against the party providing the funding." *Id.* at 414. The "far more extensive allegations" of the investors' involvement was enough to state a claim of both contributory and vicarious liability. *Id.* Thus, the claims against Hummer and Bertelsmann are proceeding not because they provided financial support, but because they had the power to direct Napster's daily operation — although it is important to note that the court did not rule out the possibility of imposing liability based on financial support alone.

The most important lesson for investors to take from the case against Hummer Winblad is that they should carefully investigate any enterprise that may be engaged in infringing activity. At this point, that category includes any company that is in the business of (or whose technology could readily be used for) facilitating the dissemination of content without a license from the pertinent copyright holders. If they do invest in such a company, they should investigate the copyright implications of the business model before taking a controlling position on a board of directors, assuming an active management role, or otherwise getting involved in the operation of the company. Any of those steps risks establishing the type of "control" or "knowledge" that is key to a finding of vicarious or contributory liability. Indeed, it is even possible that a court would conclude that passive investment alone would form the basis for a claim of contributory infringement, on the theory that the investor "knew or should have known" about and materially contributed to the infringement by that investment.

Finally, although the legal questions presented in *Grokster* do not really bear on the legal issues implicated by holding venture capital firms liable for contributory infringement, Grokster, along with *Napster, Aimster*, the numerous cases filed against individual infringers, as well as the cases filed against Bertelsmann and Hummer Winblad, should send venture capital firms an important message: Copyright owners are genuinely and profoundly concerned about the intersection of technology and copyright. And whatever the Supreme Court decides in *Grokster*, that will not change. ◎