

Angel Investors: Secondary Liability for DCI Copyright Infringement

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Digital content intermediaries (DCIs) such as YouTube, Facebook, Ebay and others handle vast quantities of digital content uploaded by users, raising questions about their potential secondary liability for copyright infringement. Congress partially addressed the problem in the Digital Millennium Copyright Act ("DMCA"), which, among other things, created a safe harbor for certain "service providers." But a variety of issues have remained unclear. One issue of particular concern to the venture community has been the extent to which investors in DCIs can be held liable for activities ultimately deemed to be copyright infringement. A recent survey of angel investors, for example, reveals that many investors have become reluctant to invest in DCIs for fear of copyright liability. <http://www.booz.com/media/uploads/BoozCo-Impact-US-Internet-Copyright-Regulations-Early-Stage-Investment.pdf>

The Ninth Circuit Court of Appeal recently came down on the side of investors in an opinion entitled *UMG Recordings, Inc. v. Shelter Capital Partners LLC*, 667 F.3d 1022 (9th Cir. 2011) ("*Shelter Capital*"). The *Shelter Capital* case centered on a video-sharing network company, Veoh Networks, Inc., in which venture firm Shelter Capital Partners and others (the "Investor Defendants") had invested. Music publisher UMG contended that Veoh infringed their copyrights by making infringing music available at their website, and that the Investor Defendants should be held secondarily liable for Veoh's primary copyright infringement.

The principal theory at issue was contributory infringement, according to which a party may be liable for another's copyright infringement if, "with knowledge of the infringing activity, [it] induces, causes or materially contributes to the infringing conduct of another." *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259, 264 (9th Cir. 1996) ("*Fonovisa*"). UMG did not argue that investors "materially contribute" to a DCI's infringement merely by providing funds. *Shelter Capital*, 667 F.3d at 1046. Rather, in accusing the Veoh investors of contributory infringement, UMG relied on a prior case involving the file-sharing network Napster, in which the court allowed the complaint to go forward based on allegations that the investors has "assum[ed] control over Napster's operations and direct[ed] the infringing activities." *UMG Recordings, Inc. v. Bertelsmann AG*, 222 F.R.D. 408, 412 (N.D. Cal. 2004) ("*Bertelsmann*"),

The Ninth Circuit panel in *Shelter Capital* reached a different result than the Napster court for several reasons. For one, Veoh had multiple investors, so UMG could not claim that any of the investor defendants could individually control Veoh by leveraging its status as the "only available source of funding." *Shelter Capital*, 667 F.3d at 1046-47. Nor did any individual investor hold a majority of seats on the Board or otherwise have the means to control the company's actions. *Id.* Rather, UMG "hinge[d] its novel theory of secondary liability on the contention that the three Investor Defendants *together* took control of Veoh's operations by 'obtain[ing] three of the five seats on Veoh's Board of Directors,' and . . . wielding their majority power to direct spending." *Id.* Assuming, without deciding, that the exercise of such joint control *could* suffice for contributory infringement liability, the Ninth Circuit panel found that "UMG's argument fails on its own terms, because the complaint nowhere alleged that the Investor Defendants agreed to work in concert to this end." *Id.* The court emphasized that "three investors individually acquiring one seat apiece is not the same as agreeing to operate as a unified entity to obtain and leverage majority control." *Id.* "This missing allegation is critical," the court noted, "because finding secondary liability without it would allow plaintiffs to sue any collection of directors making up 51 percent of the board on the theory that the constitute a majority, and therefore together they control the company." *Id.*

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UMG's failure to allege that the Investor Defendants acted in concert was likewise fatal to its theories of vicarious liability and inducement to infringe. A defendant may be vicariously liable for another's copyright infringement if it "has the right and ability to supervise the infringing activity and also has a direct financial interest in such activities." *Fonovisa*, 73 F.3d at 262. As for inducement, "one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties." *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913, 936-37 (2005). Finding that "UMG's arguments that the Investor Defendants 'distribute[d]' Veoh's services and had the right and ability to supervise the infringing users are premised on the unalleged contention that the Investor Defendants agreed to act in concert," the Ninth Circuit affirmed the district court's rejection of both theories. *Shelter Capital*, 667 F.3d at 1047.

The *Shelter Capital* decision offers useful insight into the Ninth Circuit's view of DCI investor liability in general. The court noted, for example, concern over the irony that applying traditional secondary liability theories to "tangentially involved" investors might hold them responsible for copyright infringement "while those accused of direct infringement receive safe harbor protection" under Section 512(c) of the DMCA. *Shelter Capital*, 667 F.3d at 1046 n.18. While the court declined to rule on that issue, it noted that secondary liability under those circumstances is contrary to the purposes of the DMCA which, by limiting the liability of service providers through the safe harbor provisions "sought to assuage any 'hesitat[ion]' to make the necessary investment in the expansion of the speed and capacity of the Internet.'" *Id.* (quoting S.Rep. No. 105-190, at 7). The court noted that "were we to hold that Veoh was protected, but its investors were not, investors might hesitate to provide the necessary funding to companies like Veoh, and Congress' purpose in passing the DMCA would be undermined."

The district court's decision in *Shelter Capital* offered further encouragement to the VC community that did not find its way into the Ninth Circuit opinion. In *UMG Recordings, Inc. v. Veoh Networks, Inc.*, No. CV-07-5744, 2009 WL 334022 at *5 (N.D. Cal. Feb. 2, 2009), Judge Matz's lower court opinion focused on the prong of the vicarious liability test as to whether the Investor Defendants had a "direct financial interest in [the infringing] activities." UMG argued that the Investor Defendants received a direct financial benefit from the alleged infringement because the presence of infringing content on Veoh's website served as a "draw" for users. The district court rejected that theory, holding that the "draw" of infringing content qualifies as a "direct financial interest" for purposes of vicarious liability only if the defendant receives it directly from the alleged infringer. *Id.* at *5-6. UMG, though, had not alleged that the Investor Defendants had received fees paid by customers or advertisers, or dividends or distributions paid by Veoh. *Id.* at *6. Rather, UMG's complaint alleged only that "each [of the Investor Defendants] will profit from their investments through the sale of Veoh to a potential acquiring company or through a public offering." *Id.* That potential benefit, the district court concluded, was "too far removed from the alleged infringement to be considered a 'direct' financial interest." *Id.*

While the *Shelter Capital* opinions offer useful precedent for investors in DCIs, the law of investor liability for copyright infringement has unsettled questions and the outcome in any case may be highly fact specific. Investors are well advised to consult with their own counsel before making an investment in a DCI, but a few broad principles may help investors protect themselves. For one, it may make sense for investors to broaden their legal due diligence to include secondary liability issues. Sophisticated investors will often devote considerable due diligence to the copyright issues inherent in the underlying business, and whether, for example, the company qualifies for DMCA safe harbor protection. While such due diligence is valuable, another level of analysis may be warranted, focused on potential investor liability. Secondly, the *Shelter Capital* case suggests that there is "safety in numbers" and that being the sole investor in a DCI can increase exposure to the kinds of claims allowed to proceed in the Napster cases. Third, being on the Board of a DCI as part of the investment may increase the chances of liability; under *Shelter Capital*, creative plaintiffs may try to characterize cooperation with similarly minded Board

members as a "conspiracy to control" a company "devoted to copyright infringement." Finally, the business model of the company needs to be considered in terms of how money flows to investors relate to potentially infringing activity; Shelter Capital suggests that the tighter the connection, the higher chances of liability based on "direct financial interest."

In short, Shelter Capital is encouraging, but traps for the unwary remain in the area of secondary liability for DCI copyright infringement.



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