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"Capital" Punishment: Evaluating an Investor's Secondary Copyright Infringement Liability after *Veoh*

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“CAPITAL” PUNISHMENT: EVALUATING AN INVESTOR’S
SECONDARY COPYRIGHT INFRINGEMENT LIABILITY AFTER
VEOH

James L. Proctor, Jr.^{*}
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ABSTRACT

In UMG Recordings, Inc. v. Veoh Networks, Inc., the U.S. District Court for the Central District of California considered claims that investors in a privately-held corporation were secondarily liable for copyright infringement. The Veoh court findings, which set out current secondary copyright infringement law, provide guidance for investors by clarifying their potential liability for copyright infringement committed by the company in which they invested. However, because the decision was fact-specific, this guidance is incomplete. For example, the court found that the investor neither controlled the infringing activities nor reaped direct financial benefit from them. This leaves open for further decisions the situation in which only one factor is present. In addition, Veoh bases secondary liability on such subjective concepts as “control,” “supervision,” “ability to supervise,” “reason to know,” “material assistance,” “encouragement to infringe,” and “direct financial interest.” Therefore, future cases involving similar facts are susceptible to contrary

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results based on the court's interpretation of these concepts. This Article examines the standards established and the cases distinguished by the Veoh court to determine conditions under which an investor may be held liable for the copyright infringement of the investment target and proposes practical steps to minimize liability exposure.

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INTRODUCTION

With the rapid emergence of Internet-based technologies, investors increasingly seek guidance regarding potential secondary liability for copyright infringement. Penalties for secondary infringement can be high, ranging from an injunction against the infringing conduct to an award of damages. Attorney's fees are routinely awarded to successful plaintiffs. Moreover, with respect to start-up companies, investors may have deeper pockets that claimants can pursue for recovery.

Statutory coverage related to the rights of copyright holders is limited to protection against direct infringement.¹ However, this lack of statutory coverage does not preclude the imposition of secondary

¹ 17 U.S.C. § 501(a) (2006).

liability.² To account for parties who indirectly benefit from copyright infringement, courts have developed concepts of secondary liability.³ Nevertheless, they have provided this guidance piecemeal, reflecting the challenge of maintaining the correct balance between copyright holders' rights and the encouragement of commerce. As the Supreme Court noted in *MGM v. Grokster*, "the more artistic protection is favored, the more technological innovation may be discouraged; the administration of copyright law is an exercise in managing the tradeoff."⁴

In February 2009, the United States District Court for the Central District of California provided some direction for investors in *UMG Recordings, Inc. v. Veoh Networks, Inc.*⁵ The federal district court considered claims of contributory, vicarious, and inducement liability against investors in an Internet company providing services used to infringe copyrights.⁶ The court, in dismissing the case, found, under the facts as pled, that the investor defendants did not exercise sufficient control over the infringing activity to be held liable for contributory infringement⁷ and lacked a sufficient financial interest tied to the infringement to be held liable for vicarious infringement.⁸

² 3 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 12.04 (2010) (quoting *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 435 (1984) ("The absence of such express language in the copyright statute does not preclude the imposition of liability for copyright infringement on certain parties who have not themselves engaged in the infringing activity.")).

³ *See, e.g.*, *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913 (2005) (secondary liability found for inducement, encouragement and profiting from direct infringement while declining to exercise a right to stop or limit it); *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 435 (1984) (Active steps taken to encourage direct patent or copyright infringement incurs secondary liability); *Perfect 10, Inc. v. Visa Int'l Service Ass'n*, 494 F.3d 788 (9th Cir. 2007) (copyright infringement exists when one has knowledge of another's infringement and either materially contributes to or induces the infringement). *But see, e.g.*, *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 442 (1984) (no secondary liability for copyright infringement when the product provided is widely used for legitimate, unobjectionable purposes).

⁴ *Grokster*, 545 U.S. at 928.

⁵ *UMG Recordings, Inc. v. Veoh Networks Inc.*, No. CV 07-5744 AHM, 2009 WL 334022, at *6 (C.D. Cal. Feb. 2, 2009).

⁶ *Id.* at *1.

⁷ *Id.* at *3.

⁸ *Id.* at *6.

The court also found that the defendants did not encourage the direct infringement in a manner to be held liable for inducement to infringe.⁹

This Article examines *Veoh's* analysis of investor liability in light of the then-existing state of secondary copyright infringement law, and provides practical suggestions for potential investors in companies providing products or services that customers could use to infringe copyrights.

I. CONTRIBUTORY AND VICARIOUS COPYRIGHT INFRINGEMENT UNDER *VEOH*

In September 2007, Universal Music Group, Inc. (“UMG”), a major record company, filed suit in federal court against Veoh Networks, Inc. (“Veoh”). In its initial complaint, UMG claimed that Veoh was liable for direct, contributory and vicarious copyright infringement, and for inducement of copyright infringement. The ground for this claim was that Veoh allowed customers to upload copyright-protected video files via its Internet-based video network.¹⁰ UMG later made secondary liability claims against Veoh’s investors, who were also shareholders and collectively controlled a majority of Veoh’s board seats, for facilitating this infringing technology by providing financial and management support.¹¹

The court granted the investor defendants’ motion to dismiss the case.¹² In doing so, the court held that, based on the facts pled by plaintiff, the investors did not provide sufficient material assistance to support a claim of contributory copyright infringement.¹³ The court also found that the investors lacked sufficient financial interest in the infringing activities to support a claim of vicarious copyright infringement.¹⁴ The district court distinguished several cases that previously set the boundaries of secondary copyright infringement

⁹ *Id.*

¹⁰ *UMG Recordings, Inc. v. Veoh Networks Inc.*, 665 F.Supp.2d 1099, 1100 (C.D. Cal. Sep. 11, 2009).

¹¹ *Id.* at *6.

¹² *Id.* at *6.

¹³ *Id.* at *3.

¹⁴ *Id.* at *5.

liability. The court provided UMG an opportunity to amend its complaint, although it discouraged it from doing so, in part, because the claims could raise "vexing issues of corporate governance."¹⁵ UMG amended the complaint, but the district court dismissed it with prejudice.¹⁶ The district court's dismissal of the claims in *Veoh* is on appeal to the Ninth Circuit and a decision is expected within the year.¹⁷

The liability boundaries for investors in companies found to have infringed copyrights will almost certainly continue to develop. However, at least for the time being, the *Veoh* analysis may be instructive for those seeking to predict future developments in secondary copyright infringement liability.

II. CONTRIBUTORY LIABILITY REQUIRES ACTION TO EFFECT INFRINGEMENT

In *Veoh*, the subscribers allegedly committed direct copyright infringement by uploading copyrighted television shows onto the *Veoh* network. *Veoh* itself was sued for contributory infringement but successfully asserted that it was protected by section 512(c) of the Digital Millennium Copyright Act.¹⁸

"The theory of contributory liability generally permits direct action against those who aid and abet the offender in his infringing activities."¹⁹ These principals need not necessarily exercise dominion over the primary tortfeasor or criminal. However, generally, they

¹⁵ *Id.* at *6.

¹⁶ *UMG Recordings, Inc. v. Veoh Networks Inc.*, No. CV 07-5744 AHM, 2009 U.S. Dist. LEXIS 70553 (C.D. Cal. May 5, 2009), *appeal docketed*, No. 09-56777 (9th Cir. Nov. 4, 2009).

¹⁷ *Id.*; Brief of Appellants, *UMG Recordings, Inc., v. Shelter Capital Partners, LLC*, No. 09-55092, 2010 WL 3708623 (9th Cir. Apr. 20, 2010); Consolidated Answering Brief of Defendants-Appellees, *UMG v. Shelter Capital Partners*, No. 09-55092, 2010 WL 3708628 (9th Cir. Jun 3, 2010); Reply Brief of Appellants, *UMG v. Shelter Capital Partners*, No. 09-55092, 2010 WL 3708631 (9th Cir. Jul 15, 2010).

¹⁸ *UMG Recordings, Inc. v. Veoh Networks Inc.*, 665 F.Supp.2d 1099 (C.D. Cal. Sep 11, 2009). This decision of the District Court is on appeal as well, and has been consolidated with the appeal, see *supra* note 16, against the investors.

¹⁹ David R. Plane, *Going After the Middleman: Landlord Liability in the Battle Against Counterfeits*, 99 TRADEMARK REP. 810, 817 (2009).

must know (or, as the court in *Veoh* framed it, have “reason to know”) about the infringing activity and must provide material assistance to the infringer.²⁰ Courts finding sufficient knowledge and contribution can find the principal jointly and severally liable with the primary tortfeasor.²¹

The *Veoh* court found that, although UMG sufficiently claimed that the investor defendants *knew* of Veoh’s infringement, it failed to state a claim that the investors provided material assistance to the primary infringers.²² A number of findings supported this holding, the most important being that the Veoh investors merely exercised “plain vanilla” control characteristic of board members rather than actual control over the infringing activity. Indeed, some examples of control pled by plaintiff were fairly generic (e.g., the hiring of employees and determining what content should be carried on the Veoh network).²³ However, other examples of control related more closely to the infringing conduct (e.g., approving the launch of software that facilitated uploading and deciding not to employ filters to identify copyrighted content).²⁴ The court rejected UMG’s claim that holding board meetings at an investor-stockholder’s office constituted control on the ground that such action, in itself, was normal director behavior.²⁵ There was also no claim that the board appointees were merely puppets of the investors.²⁶

Prior to *Veoh*, the leading case on investor liability for copyright infringement was *UMG Recordings, Inc. v. Bertelsmann AG*.²⁷ The *Bertelsmann* case involved a lawsuit for copyright infringement

²⁰ See *UMG Recordings, Inc. v. Veoh Networks Inc.*, No. CV 07-5744 AHM, 2009 WL 334022, at *3 (C.D. Cal. Feb. 2, 2009) (quoting *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1019-22 (9th Cir. 2001)); *Perfect 10*, 494 F.3d at 795; 6 WILLIAM F. PATRY, PATRY ON COPYRIGHT § 21:41 (“[T]he essence of contributory infringement is knowledge of the infringing conduct and facilitating the means by which the direct infringement is accomplished.”).

²¹ See, e.g., *Screen Gems-Columbia Music, Inc. v. Mark-Fi Records, Inc.*, 256 F.Supp. 399, 404-405 (S.D.N.Y. 1966).

²² *Veoh*, 2009 WL 334022, at *3

²³ *Id.* at *1.

²⁴ *Id.* at *2.

²⁵ *Id.* at *4.

²⁶ *Id.*

²⁷ *UMG Recording, Inc. v. Bertelsmann AG*, 222 F.R.D. 408, 412-413 (N.D. Cal. 2004).

damages against an investor in Napster, an online music file-sharing service. The direct infringement was committed by the company, which maintained a library of infringing music uploaded by users. *Bertelsmann* held that the investor-defendant (Bertelsmann AG) incurred contributory liability for Napster's copyright infringement.

The *Veoh* court made several distinctions with *Bertelsmann* in determining that UMG's contributory infringement claims were insufficiently pled. First, unlike *Veoh*, the *Bertelsmann* plaintiff complained that Napster's investor knew about the infringing activity before it invested in Napster.²⁸ In addition, one of the plaintiffs in *Bertelsmann* claimed that Bertelsmann's management, not just its board appointees, caused Napster to engage in infringement.²⁹ Also, the *Bertelsmann* plaintiff accused the defendants of specifically ordering "such activity [to] take place," rather than merely knowing of it, as was the case in *Veoh*.³⁰ Finally, Bertelsmann was Napster's only available source of funding, a fact not pled in *Veoh*. Thus, Bertelsmann was assumed to have the absolute power to stop Napster's infringement by withholding funds.³¹

Based on *Bertelsmann* and *Veoh*, actions an investor may undertake without incurring liability for contributory infringement include those categorized as routine day-to-day management of the investment target, provided that the investor does not direct the continuance of activities that are known to be infringing. However, to preclude secondary copyright infringement on any other theory, the investor must also be mindful of vicarious liability and inducement to infringe claims, as discussed below.

III. VICARIOUS LIABILITY REQUIRES DIRECT FINANCIAL INTEREST AND OPERATIONAL CONTROL

In general, under the principle of vicarious liability in tort, courts can hold an investor strictly liable to a third party for the acts of the

²⁸ *Veoh*, 2009 WL 334022, at *4.

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* See also *UMG Recording, Inc. v. Bertelsmann AG*, 222 F.R.D. 408, 412-413 (N.D. Cal. 2004).

primary tortfeasor.³² Vicarious liability grew out of the agency doctrine of *respondeat superior*,³³ which holds a principal liable for its agent's wrongful acts committed within the scope of the agency.³⁴ In general, courts will hold an investor liable to a third party for the acts of the primary tortfeasor. Under the theory of vicarious liability, courts may find a person strictly liable for a second person's torts "simply because there is a relationship between the two people and the second person was acting within the scope of that relationship when he committed the tort."³⁵

Factors influencing a finding of liability for vicarious infringement of copyrights include the investor's right and ability to supervise the infringing activity and its direct financial interest in such activities.³⁶ Unlike contributory liability, the court need not find that the investor had knowledge of the specific infringement in order to establish vicarious liability.³⁷

The *Veoh* court determined that UMG failed to sufficiently state a claim of vicarious copyright infringement liability. It did not consider allegations regarding Veoh's investors' ability to supervise Veoh's infringing conduct because the investors had an insufficient direct financial interest in the infringement to be held vicariously liable. In particular, the plaintiff in *Veoh* did not claim investors received fees

³² Andrew J. Lee, *MGM Studios, Inc. v. Grokster, Ltd. & In Re Aimster Litigation: A Study of Secondary Copyright Liability in the Peer-To-Peer Context*, 20 BERKELEY TECH. L.J. 485, 487 (2005).

³³ *Id.*

³⁴ 3 NIMMER & NIMMER, *supra* note 2, at § 12.04.

³⁵ See Thomas B. Foley, *Show Me The Money!: Third-Party Copyright Infringement Liability Reaches Investors & Lenders*, 38 SW. U. L. REV. 89, 93 (2008).

³⁶ *E.g.*, Warner Bros., Inc. v. Lobster Pot Inc., 582 F.Supp. 478, 482 (N.D. Ohio 1984) (citing Famous Music Corp. v. Bay State Harness Horse Racing and Breeding Ass'n, Inc., 554 F.2d 1213, 1215 (1st Cir. 1977)). See also *Grokster*, 545 U.S. at 914; *Gershwin Pub. Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d 1159, 1163 (2d Cir. 1971); *Shapiro, Bernstein & Company v. H.L. Green Company*, 316 F.2d 304, 307 (2d Cir. 1963); 6 PATRY, *supra* note 20, at § 21:41 ("The essence of vicarious liability is the right to control the infringing conduct and derivation of a financial benefit from that conduct.").

³⁷ *Gershwin Pub. Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d at 1162 (one who promotes or induces the infringing acts of a performer need have no actual knowledge of copyright monopoly impairment in order to be held jointly and severally liable as a "vicarious"-infringer).

from customers or advertisers, or dividends or distributions from Veoh.³⁸ Instead, UMG alleged that infringement "attract[ed] users and advertising dollars to Veoh, and increase[d] the value of [the investors'] financial interests . . . [and] profit . . . through the sale of Veoh . . . [or] public offering."³⁹ The Court concluded that the investors' financial benefit was too far removed from the alleged infringement to be considered a "direct" financial interest.⁴⁰ Merely having an objective of increasing ownership value is neither sufficiently invidious nor of sufficiently "direct" benefit to make an investor secondarily liable for copyright infringement.⁴¹

The *Veoh* court distinguished three leading cases on vicarious infringement. *Fonovisa, Inc. v. Cherry Auctions, Inc.*⁴² and *A&M Records, Inc. v. Napster Inc.*,⁴³ where liability was found, and *Ellison v. Robertson*,⁴⁴ where it was not. As none of these cases involved investors in the classic sense, their holdings are only analogous.

In *Fonovisa*, the plaintiff sued a flea market operator for facilitating copyright infringement through "swap meet" style sales of musical recordings.⁴⁵ The Ninth Circuit reversed the district court's decision to dismiss the suit and held the complaint sufficiently alleged vicarious copyright infringement arising from the sale of pirated music by vendors. The defendant derived substantive benefit from vendor rental fees, customer admissions fees, and revenues from supporting services.⁴⁶ The court of appeals also found that the defendant financially benefitted from the infringement because the availability of pirated recordings "drew" customers, thereby increasing defendant's revenues.⁴⁷

In *Napster*, eighteen record companies sued to enjoin Napster

³⁸ UMG Recordings, Inc. v. Veoh Networks Inc., No. CV 07-5744 AHM, 2009 WL 334022, at *6 (C.D. Cal. Feb. 2, 2009).

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259 (9th Cir. 1996).

⁴³ *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004 (9th Cir. 2001).

⁴⁴ *Ellison v. Robertson*, 357 F.3d 1072 (9th Cir. 2004).

⁴⁵ *Fonovisa*, 76 F.3d at 261.

⁴⁶ *Id.* at 263.

⁴⁷ *Id.*

from offering its file-sharing technology to its subscribers.⁴⁸ The plaintiffs based their lawsuit on the ground that customers were using Napster's technology to commit copyright infringement.⁴⁹ The court granted a preliminary injunction until Napster took action to prevent future infringement.⁵⁰ The Ninth Circuit held Napster liable for vicarious copyright infringement, finding "ample evidence . . . that Napster's future revenue is directly dependent upon 'increases in userbase.' More users register with the Napster system as the 'quality and quantity of available music increases.'"⁵¹

Ellison involved an appeal of summary judgment dismissing a copyright infringement lawsuit filed by an author.⁵² The suit claimed that an individual, the alleged direct infringer, had posted a copy of the plaintiff's copyrighted works on a peer-to-peer file-sharing network.⁵³ The suit also alleged that the Internet service provider, America Online ("AOL"), was vicariously liable for copyright infringement due to the direct financial benefit it received because of the defendant's actions.⁵⁴ The Ninth Circuit upheld the dismissal of plaintiff Ellison's liability claim against AOL.⁵⁵ As to AOL, the court found no proof that it benefitted financially from attracting subscribers who infringed copyrights or failing to obstruct subscriber infringement.⁵⁶

The *Veoh* holding suggests that establishing investor liability for vicarious infringement requires more than merely proving an investment objective. Instead, plaintiffs need to demonstrate that the investors derived direct financial benefit from the infringement itself.

⁴⁸ *A&M Records, Inc. v. Napster, Inc.*, 114 F.Supp.2d 896, 900 (N.D. Cal. 2000).

⁴⁹ *Id.*

⁵⁰ *Id.* at 927.

⁵¹ *A&M Records, Inc. v. Napster, Inc.*, 239 F.3d 1004, 1023 (9th Cir. 2001) (citing *A&M Records, Inc. v. Napster, Inc.*, 114 F.Supp.2d 896, 902 (N.D. Cal. 2000) ("The existence of a large user base that increases daily and can be "monetized" makes Napster, Inc. a potentially attractive acquisition for larger, more established firms.")).

⁵² *Ellison v. Robertson*, 357 F.3d 1072, 1074 (9th Cir. 2004).

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 1079.

⁵⁶ *Id.*

Veoh did not demonstrate the latter, as the "ability to supervise" prong of the vicarious liability test was not considered by the court because it found no direct financial benefit. Investors must also be vigilant to avoid the third type of secondary copyright infringement liability, namely, inducement of copyright infringement.

IV. INFRINGEMENT LIABILITY REQUIRES INDUCEMENT VIA PRODUCT DISTRIBUTION

Liability for inducement to infringe copyright requires distribution of a product "necessary for the infringement to occur."⁵⁷ As the *Veoh* court stated it, "Inducement to infringe copyright requires distribution of 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."⁵⁸

Veoh did not analyze criteria for determining when investing in a company distributing a service, such as an Internet TV network, rather than a product, would result in secondary liability for infringement under an inducement theory. This was because *Veoh* found the allegations of the complaint insufficient to assert encouragement of infringement in connection with the distribution of such services. However, prior to financing file-transfer technology, investors should consider potential legal ramifications of distributing copyrighted material via these media as they have already been considered susceptible to inducement to infringe claims.⁵⁹

In *In re Aimster Copyright Litigation* ("*Aimster*"),⁶⁰ the Northern District of Illinois assumed that the provision of file-sharing software and a downloading service could form the basis of an inducement to infringement claim. *Aimster* was found liable for secondary copyright infringement.⁶¹ Specifically, by advertising that clicking on a "play"

⁵⁷ Foley, *supra* note 35, at 102 (quoting 2 PAUL GOLDSTEIN, GOLDSTEIN ON COPYRIGHT § 8:10 (3d ed. 2008)).

⁵⁸ UMG Recordings, Inc. v. Veoh Networks Inc., No. CV 07-5744 AHM, 2009 WL 334022, at *6 (C.D. Cal. Feb. 2, 2009).

⁵⁹ See *Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.*, 545 U.S. 913, 942 (2005); *In re Aimster Copyright Litigation*, 252 F. Supp. 2d 634, 653 (N.D. Ill. 2002).

⁶⁰ *In re Aimster Copyright Litigation*, 252 F. Supp. 2d 634 (N.D. Ill. 2002).

⁶¹ *Id.* at 652.

button would prompt the software to automatically create a connection between users' computers to facilitate finding, copying, and distributing copyrighted files, Aimster created a "road map" for its customers to commit copyright infringement.⁶² However, exceptions have been made for products widely used for legitimate, unobjectionable purposes, or capable of substantial non-infringing uses.⁶³ For example, although people can use a videocassette recorder to illegally copy and distribute a copyrighted movie, they are much more likely to use it to "time shift", that is, to record the movie for later personal viewing.⁶⁴ *Aimster* did not have substantial non-infringing uses and, in any event, the "substantial non-infringing use" defense was found inapplicable to services involving an ongoing relationship.⁶⁵

In its rather brief analysis of liability for inducement to infringe copyright, the *Veoh* Court cited the latest United States Supreme Court decision on inducement to infringe, *MGM Studios v. Grokster*.⁶⁶ In *Grokster*, artists, music publishers, and movie studios sued the distributors of peer-to-peer file sharing software for copyright infringement inducement.⁶⁷ The Supreme Court, in finding the defendant liable for inducement to infringe copyright, held that "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."⁶⁸ The *Veoh* Court distinguished *Grokster* by finding that UMG did not claim the investors "encouraged" infringement through the mere distribution of *Veoh*'s video downloading service.⁶⁹

⁶² *Id.*

⁶³ *Sony Corp. of Am. v. Universal City Studios, Inc.*, 464 U.S. 417, 442 (1984).

⁶⁴ *Id.* at 443.

⁶⁵ *Aimster*, 252 F.Supp. 2d at 653.

⁶⁶ *UMG Recordings, Inc. v. Veoh Networks Inc.*, No. CV 07-5744 AHM, 2009 WL 334022, at *6 (C.D. Cal. Feb. 2, 2009).

⁶⁷ *Grokster*, 545 U.S. at 913.

⁶⁸ *Id.* at 936-37.

⁶⁹ *Veoh*, 2009 WL 334022, at *6.

V. IMPACT OF *VEOH*: INVESTORS NOT PER SE LIABLE, BUT DUE DILIGENCE STILL ESSENTIAL

The development of secondary copyright infringement law has historically favored the rights of copyright holders. Investors, therefore, face the risk of being held liable for the infringing activities of their target companies. This risk creates a potential chilling effect on capital investment.⁷⁰

Veoh provides some comfort to investors considering providing funds to high-technology companies. Nevertheless, issues related to secondary liability remain unresolved by *Veoh*. First, because the court found UMG's direct financial interest insufficient, it bypassed the "ability to supervise" prong of the vicarious liability test.⁷¹ In addition, the court's inducement to infringe analysis in *Veoh* was very cursory, making it of little use in refining the boundaries of this cause of action as applied to investors. As a general matter, the factors on which secondary liability rests involve subjective concepts such as "control," "supervision," "ability to supervise," "reason to know," "material assistance," "encouragement of infringement," and "direct financial interest," which seem bound to lead to contrary results on similar facts. All of this foreshadows additional showdowns between investors and copyright advocates looking to improve their respective rights.

Yet, even though *Veoh* does not resolve all issues of secondary liability, it still provides several important lessons for investors. Investors should carefully assess their potential exposure to liability for the infringing actions of their investment targets. Courts strive to support commerce and the arts by maintaining balance between investor and copyright holder rights when applying copyright law. Practitioners and investors, however, must understand that case law has historically favored the rights of copyright holders.

Prospective investors should obtain a "warranty of no knowledge"

⁷⁰ Foley, *supra* note 35 at 92. See also 6 PATRY, *supra* note 20, at § 21:48.50 (stating that holding investors liable for copyright infringement for merely providing financial assistance "gives a tool of evil to those who need no further such further tools in their unshakable thirst for crushing innovation, competition, and consumers.").

⁷¹ *Veoh*, 2009 WL 334022 at *5.

of copyright infringement from their targets in order to minimize exposure to secondary liability.⁷² This warranty should include a statement that the target has not received copyright infringement complaints, or, alternatively, full disclosure of all known infringements. In addition to providing comfort as to the facts, such a warranty may be useful to the investor in defending against a secondary infringement claim. Specifically, the absence of infringements mentioned in the warranty could be cited to defeat the knowledge prong of contributory infringement.

However, obtaining a “no knowledge” warranty does not relieve the investor of the need to thoroughly research the activities of investment targets.⁷³ As a practical matter, infringements could still exist without knowledge and be the source of vicarious liability, where knowledge is not an issue. More significantly, the entity making the representation may be poorly capitalized and unable to compensate the investor for the damages resulting from infringement claims.

The final lesson is that investors should remain vigilant to avoid any conduct on their part after investment that could be causally linked to copyright infringement. Examples of such actions include specifically ordering infringing activity to take place⁷⁴ or the failure of the investor to use its operational control (to the extent it has it) to order stoppage of copyright infringement once made aware of it.⁷⁵

In sum, *Veoh* and analogous cases expose the infringement liability risks of investing in firms providing high-technology services or products. The fact that the investors were found not liable in *Veoh* is encouraging to investors hoping to avoid secondary liability for making such investments. However, because of the prohibitive penalties for copyright infringement (not to mention the potential for loss of the investment if the infringing conduct is enjoined), the dearth of cases, and the lack of clear guidelines, caution is still

⁷² Foley, *supra* note 35 at 129.

⁷³ *Id.* (“Any such guarantee by the financing target should also be coupled with the financier’s own due diligence. Financiers rely on others’ due diligence at their own detriment.”).

⁷⁴ UMG Recording, Inc. v. Bertelsmann AG, 222 F.R.D. 408, 413 (N.D. Cal. 2004).

⁷⁵ A&M Records, Inc. v. Napster, Inc., 239 F.3d 1004, 1023 (9th Cir. 2001)

advisable. Investors should perform thorough due diligence before and after making a capital investment in high-technology companies. The practice pointers following this Article provide suggestions for legal practitioners advising investors looking to anticipate and limit their secondary liability.

CONCLUSION

The *Veoh* court has demonstrated that the standards for determining secondary copyright infringement liability are still far from settled. Investing in an infringing company and controlling its overall operations are not, in and of themselves, sufficient grounds for derivative liability. The absence of knowledge (or reason to know) of the infringing activity protects against liability for contributory infringement, but not vicarious infringement if there is a direct financial benefit derived from the infringement. To distill it down conceptually, the plaintiff must establish sufficient causation between the infringing activity and the investor’s financial benefit and operational control. In making such determinations, courts strive to balance investor and copyright holder rights.

PRACTICE POINTERS

- Perform due diligence to determine current and potential uses of the target company’s technology. This effort should include the compilation and review of documents held by the company providing permission to use copyrighted works of third parties. Where due diligence does not provide clear answers about infringement, consider the company’s potential value without the arguably infringing elements, should they be enjoined or discontinued, before making the investment.
- Negotiate for a warranty and representation from the investment target company that, to the target’s knowledge, no third party is using the target’s technology to infringe copyrights. In addition, the target should warrant and represent that it has not received complaints from copyright holders or, if the company has received complaints—or will receive such complaints in the future—it must disclose germane information to the investor by giving proper notice.

- Obtain indemnification from the target against all losses resulting from any third-party copyright infringement claims arising from use of the target's technology. Note, however, that indemnity is only as good as the capitalization of the entity providing it; if the indemnity would merely come out of one pocket and go into another—with respect to equity investors—then investigate whether insurance is an option.
- Be mindful that if the returns on the investment are paid directly out of revenues, and the revenues are heavily influenced by infringing activities, then the risk of liability for vicarious infringement appears somewhat greater than if the return on investment will come from the ultimate appreciation of the equity.