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Avoiding the Next Napster: Copyright Infringement and Investor Liability in the Age of User Generated Content

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AVOIDING THE NEXT NAPSTER: COPYRIGHT INFRINGEMENT AND INVESTOR LIABILITY IN THE AGE OF USER GENERATED CONTENT

*Truan Savage**

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I. INTRODUCTION

Rapid developments in digital technology over the past quarter century have made it easier than ever for people to create and instantly share content. These developments have served as the basis for countless innovations and have spawned some of today’s largest and most profitable companies. As content creation and distribution continues to evolve, businesses seek new ways to profit from these technological innovations. But while businesses continue to develop around new methods of content dis-

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tribution, the law of copyright, which generally aims to encourage the creation of content, has been slow to adapt.¹ This era of modern technological innovation thus operates in a legal environment developed primarily in the 1970s. Consequently, many innovative and groundbreaking ideas are stymied by legal conceptions that seem out of date in cyberspace. The result is excessive legal liability and disproportionate ramifications on innovation.

No company illustrates this dilemma more than Napster. Napster's peer-to-peer file sharing technology fundamentally disrupted the music industry when it debuted in 1999.² In 2000, lawsuits started pouring in. Napster was ultimately found liable for copyright infringement,³ which put the company out of business.⁴ The ultimate ruling against Napster, *A&M Records v. Napster*, illustrates a disconnect between innovation and copyright law. A recent study, citing conversations with hundreds of startups, explained that “[a]s the curation and distribution of creative content becomes an increasingly ripe source of innovation, old-fashioned notions of what it means to make a copy—and how infringement of copyright is enforced—lead to many potentially great business models being blocked.”⁵

Investors are hesitant to get involved in business models likely to implicate legal liability. Napster illustrates this as well: after *Napster*, innovation in the digital music area was severely affected by the fear of excessive liability.⁶ At the time, the fallout from *Napster* was described as a “wasteland” in investment and thereby in innovation in digital music.⁷ A recent survey found that even today many venture capital firms refuse to invest in digital music due to fears of potential liability.⁸ In the past, however, investors' fears over investing in ventures with potentially illegal business models had little to do with concerns about direct copyright infringement liability; investors were afraid of losing their investments, not about being

1. S. REP. NO. 105-190, at 2 (1998) (“Copyright laws have struggled through the years to keep pace with emerging technology. . .”).

2. Clyde Haberman, *Grappling With the ‘Culture of Free’ in Napster’s Aftermath*, N.Y. TIMES (Dec. 7, 2014), <http://www.nytimes.com/2014/12/08/technology/grappling-with-the-culture-of-free-in-napsters-aftermath.html>.

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

4. See David Kravets, *Napster Trial Ends Seven Years Later, Defining Online Sharing Along the Way*, WIRED (Aug. 31, 2007, 5:41 PM), <http://www.wired.com/2007/08/napster-trial-e>.

5. Edward Lee, *Copyright-Exempt Nonprofits: A Simple Proposal to Spur Innovation*, 45 ARIZ. ST. L.J. 1433, 1441 (quoting Jeff Lynn, *Copyright for Growth*, in INTELLECTUAL PROPERTY AND INNOVATION: A FRAMEWORK FOR 21ST CENTURY GROWTH AND JOBS 11, 14 (Ian Hargreaves & Paul Hofheinz eds., 2012)).

6. Michael A. Carrier, *Copyright and Innovation: The Untold Story*, 2012 WIS. L. REV. 891, 905–06 (2012).

7. *Id.* at 916.

8. *Id.* at 954.

held liable themselves.⁹ Today, such complacency about derivative liability is misguided.

Two contemporary developments show that investing in digital content distribution can implicate copyright infringement liability on the part of investors. First, there has been tremendous growth in the number of social media ventures dependent on user-generated content, raising unique and significant copyright infringement issues. Second, recent legal decisions have left the issue of investor liability for the indirect copyright infringement of the ventures in which they invest conspicuously unclear. Without legal clarity, investing in social media will remain risky and innovation in the area could consequently suffer. The potential ramifications of statutory damages for copyright infringement liability are huge; if even a single court finds an investor secondarily liable for copyright infringement, innovation in social media could take a huge hit. However, investors should not step back. By adequately identifying, valuing, and negotiating around potential liability, investors can safely navigate this uncertain legal landscape to promote activity and innovation.

This Note addresses the potential liability of investors in ventures with business models dependent on user-generated content, explores the ramifications of liability, and offers guidance to encourage continued investment in this area. This Note focuses specifically on Venture Capital firms and their individual investors (VCs) and Early Stage Ventures (ESVs) in the social media area. Part I describes the business landscape that has led to the explosion of user-generated content and a new breed of startup. Part II describes the law of secondary liability and the precedent for investor liability. Part III describes how the contractual relationship between VCs and ESVs can implicate secondary liability and how VCs should adjust negotiations to minimize liability.

II. THE BUSINESS LANDSCAPE

A. *The Rise of User-Generated Content*

Over the past decade, numerous technological, business, and cultural developments have led to the incredible rise of User-Generated Content (UGC) as a means of expression online.¹⁰ While there is no widely accepted definition of UGC,¹¹ a very basic definition, from the American Bar Association's Forum on the Entertainment and Sports Industry, is

9. See 1 JOSEPH W. BARTLETT, *EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS* § 9.2 (2d ed. 2015) ("Apart from a few isolated decisions or special fact situations generally involving lenders, it has as yet not been popular to impose liability, beyond the investment made, on investors. . . .").

10. See GEORGE B. DELTA & JEFFREY H. MATSUURA, *LAW OF THE INTERNET* § 6.18 (3d ed. 2013).

11. Len Glickman & Jessica Fingerhut, *User-Generated Content: Recent Developments in Canada and the United States*, ENTMT. & SPORTS LAW. (ABA Forum on the Entm't & Sports Indus., Chicago, Ill.), Nov. 2012, at 3.

“material uploaded to the Internet by website users.”¹² UGC can be in the form of text (such as blogs¹³, microblogs¹⁴, or user reviews¹⁵), images (such as photographs¹⁶ or videos¹⁷), or a combination thereof.¹⁸ Largely due to the rise of social media, which makes it easier than ever for users to create and share content online, UGC has become the basis for some of the largest and fastest-growing companies in the United States.¹⁹ Ventures with business models significantly dependent on UGC, so-called Digital Content Intermediaries (DCIs), allow users to upload, distribute, and search UGC content.²⁰ DCIs do not themselves distribute content but instead provide the means for users to distribute content.²¹ YouTube, Facebook, Instagram, Twitter, Vine, and Pinterest are examples of DCIs, all of which handle vast quantities of UGC.²²

The explosion of UGC has fundamentally transformed the Internet and in turn the media and technology industries. Len Glickman and Jessica Fingerhut neatly summarize the magnitude of UGC that DCIs deal with:

Two of the most visited websites on the Internet, Facebook and YouTube, are sites devoted to UGC. According to Facebook, which had one billion active users as of October 2012, every day more than 300 million photos are uploaded to the site In 2011, YouTube had more than one trillion views, and 72 hours of video are uploaded to the site each minute. More than half of the videos uploaded to YouTube have been rated or commented on by users, and more than 700 YouTube videos are shared on Twitter each minute. Twitter has become increasingly more popular with more than 140 million active users. According to Twitter, there are over 340 million “tweets” (posts

12. *Id.*

13. *See, e.g.*, WORDPRESS, <http://www.wordpress.com> (last visited Mar. 26, 2015).

14. *See, e.g.*, TWITTER, <http://www.twitter.com> (last visited Mar. 26, 2015).

15. *See, e.g.*, YELP, <http://www.yelp.com> (last visited Mar. 26, 2015).

16. *See, e.g.*, INSTAGRAM, <http://www.instagram.com> (last visited Mar. 26, 2015).

17. *See, e.g.*, YOUTUBE, <http://www.youtube.com> (last visited Mar. 26, 2015).

18. Glickman & Fingerhut, *supra* note 11, at 3.

19. *See* Frank Bell, *The Rise of User-Generated Content*, ENTREPRENEUR (Aug. 26, 2007), <http://www.entrepreneur.com/article/183432> (“Most of the fastest-growing sites on the internet are based on user-generated content.”); *see also* Robert P. Latham et al., *Legal Implications of User-Generated Content: YouTube, MySpace, Facebook*, 20 NO. 5 INTELL. PROP. & TECH. L.J. 1, 1 (“[P]ublication of user-generated content . . . has exploded. Many business and government entities, including the vast majority of traditional media companies, have developed frameworks to facilitate the distribution of content by end users.”).

20. MATTHEW LE MERLE, ET AL., THE IMPACT OF U.S. INTERNET COPYRIGHT REGULATIONS ON EARLY-STAGE INVESTMENT: A QUANTITATIVE STUDY 14 (2011).

21. *See* Jane C. Ginsburg, *Separating the Sony Sheep from the Grokster Goats: Reckoning the Future Business Plans of Copyright-Dependent Technology Entrepreneurs*, 50 ARIZ. L. REV. 577, 578 (2008).

22. STUART L. GASNER & MELISSA J. MIKSCH, KEKER & VAN NEST LLP, ANGEL INVESTORS: SECONDARY LIABILITY FOR DCI COPYRIGHT INFRINGEMENT, *available at* http://www.kvn.com/Templates/media/files/PDFs/VCExperts_Angel%20Investors-%20Secondary%20Liability%20for%20DCI%20Copyright%20Infringement.pdf.

uploaded to Twitter) created per day. Wikipedia, ranked as the sixth most visited website, provides access to over 18 million UGC articles in 279 languages.²³

The incredible size and scope of UGC and its implications for innovation in the media and technology industries has given rise to a new wave of entrepreneurs, who are attempting to extract value from the popularity of UGC in new and innovative ways.²⁴ Even existing companies with business models not primarily dependent on UGC have found ways to incorporate UGC into their business models.²⁵

The popularity of UGC has greatly contributed to recent deal activity among DCIs. 2012 through 2015 were record years for social media transactions.²⁶ Facebook's acquisitions of Instagram and WhatsApp, Twitter's acquisition of Vine, Microsoft's acquisition of Yammer, and Yahoo's acquisition of Tumblr all occurred in that period, accounting for over \$24 billion in deal activity.²⁷ The size and prevalence of these deals speaks not only to the confidence in UGC-based business models, but also to their penetration across various sectors.²⁸ As the industry matures, business opportunities are only expected to increase.²⁹

B. *The Prospect of Liability*

The rise of UGC raises significant concerns regarding the potential copyright infringement liability of DCIs.³⁰ Content managed by DCIs is

23. Glickman & Fingerhut, *supra* note 11, at 4 (internal citations omitted).

24. *Id.*

25. *See id.* ("Integrating customer product reviews into their website designs is another way companies utilize UGC. User reviews can be in the form of simple text or, as Amazon.com has done, by uploading user-generated videos . . . A number of companies use UGC in their advertising campaigns, a practice which enhances brand loyalty by enabling consumers to express their ideas and enthusiasm about products."); *see also* Jack Marshall, *Meet PetFlow, The Retailer that Hatched a Media Business*, WALL ST. J. (Nov. 14, 2014, 2:31 PM), <http://blogs.wsj.com/cmo/2014/11/14/meet-petflow-the-retailer-that-hatched-a-media-business> (explaining how PetFlow, an online retailer, started a company blog as a marketing tactic featuring pet-themed UGC, which ultimately attracted more than 20 million unique users a month and was spun off into a separate media business which helps drives traffic back to the retail site).

26. Conner Forrest, *The Top 7 Acquisitions of All-Time in Social Media, and Why They Matter*, TECHREPUBLIC (Mar. 12, 2014, 6:33 AM), <http://www.techrepublic.com/article/the-top-7-acquisitions-of-all-time-in-social-media-and-why-they-matter/>.

27. *Id.*

28. *See, e.g.*, Jessica Luteran Naeve, *This Year, Social M&A Will Venture Into the Enterprise*, ADEXCHANGER (Jan. 17, 2013), <http://adexchanger.com/data-driven-thinking/70169/>

29. *See* Press Release, BDO, Tech CFOs Project Surge in Revenue – BDO Survey (Feb. 2015), *available at* <https://www.bdo.com/insights/industries/press-releases/tech-cfos-project-surge-in-revenue>.

30. *See* DELTA & MATSUURA, *supra* note 10.

often material owned by third parties.³¹ Thus, DCIs often facilitate the dissemination of potentially infringing material.³² The amount of UGC distribution online makes claims of copyright infringement more commercially relevant than ever.³³ Further, the most effective of these types of copyright infringement claims are not directed at the users uploading content, but rather at the companies that provide the means for such activity, including their founders and investors.³⁴ As Lital Helman explains:

As a strategic decision, the fight is conducted not only against copyright infringers themselves, but also against the providers of various types of technologies that make such infringement possible. . . . The common thread among these lawsuits is that the defendants themselves have not engaged in any copyright infringement. Rather, infringing conduct of others—users of the defendants’ technology—is the basis of the claims.³⁵

UGC-associated liability can be a huge burden on DCIs, and even the threat of a lawsuit can effectively shut down young ventures.³⁶ As explained by Michael Carrier, this tactic is especially effective against startups because “expensive” and “demoralizing” lawsuits “ ‘distract the companies . . . [and] have an ‘absolute chilling effect,’ with their ultimate success . . . completely irrelevant.”³⁷

The threat of liability is not only expensive and distracting for DCIs; it can also chill investment because investors do not want to fund any venture facing the likelihood of expensive litigation.³⁸ If investors fear claims for statutory damages, they will be less willing to invest because, given the huge potential downside of infringement liability, few investments will be worth the risk.³⁹ A recent survey of VCs and angel investors showed that

31. See Michael Lasky & Joseph Lewczak, *User-generated Content Can Be Risky*, PRWEEK (July 14, 2008), available at http://www.dglaw.com/images_user/newsalerts/LaskyPRWeek.pdf.

32. See DELTA & MATSUURA, *supra* note 10; see also Ginsburg, *supra* note 21, at 578.

33. See Martin B. Robins, *Intellectual Property and Information Technology Due Diligence in Mergers and Acquisitions: A More Substantive Approach Needed*, 2008 U. ILL. J.L. TECH. & POL’Y 321, 341.

34. Ginsburg, *supra* note 21, at 578; see also Mark A. Lemley & R. Anthony Reese, *Reducing Digital Copyright Infringement Without Restricting Innovation*, 56 STAN. L. REV. 1345, 1379 (“Suits against third parties in the digital environment do not—indeed generally cannot—address specific conduct by particular end users. Suits against facilitators premised on individual cases of infringement would pose the same economic problem for copyright owners as suits against the individual infringers themselves. Rather, the class of suits we consider in this Article involves efforts to shut down a facilitator entirely or to require modification in the way the facilitator operates.”).

35. Lital Helman, *Pull Too Hard and the Rope May Break: On the Secondary Liability of Technology Providers For Copyright Infringement*, 19 TEX. INTELL. PROP. L.J. 111, 112 (2010).

36. Carrier, *supra* note 6, at 938.

37. *Id.* at 936–37.

38. See *id.* at 938.

39. Lee, *supra* note 5, at 1441–42. See also Timothy Wiseman, *Limiting Innovation Through Willful Blindness*, 14 NEV. L.J. 201, 224 (2013) (“Investors are naturally leery of investing in small companies with a high likelihood of being sued.”).

“[i]ncreasing liability for [DCIs] would have a greater negative impact on early-stage investments than would a weak economy and an increased competitive environment.”⁴⁰ This was the case after *Napster*, when music labels became more aggressive with litigation and venture capital funding of digital music startups declined significantly.⁴¹ VCs are vital to startups, but if personal liability is even a possibility, the specter of statutory damages will chill investment in DCIs.⁴²

To the extent that potential liability chills investment, it also chills innovation.⁴³ Early stage investing is critical to the future creation and growth of new companies that are creating new and innovative products and technologies.⁴⁴ Once the money dries up, it becomes “harder to find experienced entrepreneurs . . . who are willing to start a company in this space, which le[ads] to the loss of new disruptive technologies that deliver content to people.”⁴⁵ The massive and continuing growth of UGC means the ramifications of liability are greater than ever and underscores the importance of understanding the scope of liability.

III. THE LEGAL LANDSCAPE

A. Copyright Infringement Liability Generally

The owner of a copyright in a work maintains six exclusive rights: (i) to reproduce the work; (ii) to create derivative works based upon the original work; (iii) to distribute copies of the work; (iv) to publicly perform the work; (v) to display the work; and (vi) to digitally transmit the work.⁴⁶ If a third party exercises any of the copyright owner’s exclusive rights without permission, it is liable as a direct infringer.⁴⁷ A copyright owner who prevails against a direct infringer is entitled to choose between an award of actual damages or statutory damages.⁴⁸ Actual damages are compensatory; they entitle an aggrieved plaintiff to lost license fees, profits or royal-

40. LE MERLE ET AL., *supra* note 20, at 6.

41. Carrier, *supra* note 6, at 916.

42. See Lee, *supra* note 5, at 1440 (“The threat of massive copyright lawsuits deters venture capitalists and angel investors from investing in New internet platform even before they get off the ground.”); see also LE MERLE ET AL., *supra* note 20, at 11 (“Given the key role that angels and VCs play, not only in funding new companies but also in working with them to promote their success, their continued willingness to invest is critical to the future creation and growth of new companies.”).

43. See Lemley, *supra* note 34, at 1349 (“The key policy point is that going after makers of technology for the uses to which their technologies may be put threatens to stifle innovation. Similarly, going after necessary third parties like investors and law firms will stifle investment in innovation.”).

44. See LE MERLE ET AL., *supra* note 20, at 11.

45. Carrier, *supra* note 6, at 954.

46. 17 U.S.C. § 106 (2013).

47. 3 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 12.04[A][1] (Matthew Bender, Rev. Ed.) (2014).

48. 17 U.S.C. § 504(a) (2013).

ties.⁴⁹ Statutory damages, as the name implies, are stipulated via statute and fall along a sliding scale, entitling an aggrieved plaintiff to anywhere in the range of \$200 to \$150,000 per work infringed.⁵⁰ Because actual damages account for lost licensing fees and profits, they will generally be higher in cases where a single protected work is infringed numerous times.⁵¹ Statutory damages, on the other hand, can dwarf actual damages when a defendant infringes many separate protected works.⁵²

For defendants facing claims of UGC-associated infringement, statutory damages can be crippling.⁵³ Some defendants have even described statutory damages for copyright infringement as “effectively infinite.”⁵⁴ When Viacom sued YouTube and Google for copyright infringement, estimated statutory damages reached as high as \$24 billion, nearly 15 times what Google paid to acquire YouTube.⁵⁵ SONICBlue, the creator of one of the first DVR systems, faced statutory damages arguably as high as more than one trillion dollars due to the aggregation of copies needed to work their DVR software for thousands of users.⁵⁶ Such staggering statutory damages awards can bankrupt even the largest companies, and in turn encourage hefty settlements, such as when Grooveshark paid \$50 million to Universal Music Group, Sony Music Entertainment and Warner Music Group to avoid statutory damages of up to \$736 million.⁵⁷

B. *Secondary Copyright Infringement Liability*

Copyright infringement liability is not limited to the direct infringer. So-called secondary liability arises when a third party assists or is responsi-

49. Jason R. Bush, *De-Mystifying Damages for Copyright Infringement*, THE MISSISSIPPI LAWYER, Summer 2012, at 8, available at http://www.bakerdonelson.com/files/Uploads/Documents/Summer_2012_pdf.

50. NIMMER & NIMMER, *supra* note 47, at § 14.04[B][1][b].

51. See, e.g., Alex Stedman, ‘Blurred Lines’ Jury Orders Pharrell, Robin Thicke to Pay \$7.3 Million to Marvin Gaye Family, VARIETY (Mar. 10, 2015), <http://variety.com/2015/music/news/blurred-lines-verdict-pharrell-robin-thicke-ordered-to-pay-7-3-million-to-marvin-gaye-family-1201450117> (noting that the jury verdict entitling Marvin Gaye’s family to \$7.3 million was the result of a claim for actual damages).

52. See, e.g., Brief for Electronic Frontier Foundation as Amici Curiae Supporting Defendant-Appellee at 14-16, Sony BMG Music Entertainment v. Tenenbaum, 660 F.3d 487 (2011) (Nos. 10-1883, 10-1947, 10-2052).

53. COHEN ET AL., COPYRIGHT IN A GLOBAL INFORMATION ECONOMY 825 (3d ed. 2010).

54. See Carrier, *supra* note 6, at 941.

55. *Id.* at 940.

56. Brief for Electronic Frontier Foundation as Amici Curiae Supporting Defendant-Appellee at 14-16, Sony BMG Music Entertainment v. Tenenbaum, 660 F.3d 487 (2011) (Nos. 10-1883, 10-1947, 10-2052).

57. Bill Donahue, *Grooveshark’s Copyright Settlement With Labels Cost It \$50M*, LAW360 (May 1, 2015, 2:55 PM), http://www.law360.com/media/articles/650768?nl_pk=cfe3124c-1adb-47b9-8e57-9d3322681654&utm_source=newsletter&utm_medium=email&utm_campaign=media.

ble for the acts of a direct infringer.⁵⁸ The extension of direct liability to a third party does not stem from the Copyright Act;⁵⁹ secondary liability doctrines emerged from the common law principles of agency and respondeat superior.⁶⁰ There are numerous justifications for extending copyright infringement liability beyond direct infringers. First, it makes sense to impose liability on a party that may not be a direct infringer but otherwise played a significant role in the infringing act.⁶¹ Similarly, secondary liability is necessary to extend the reach of damages to a defendant who both profited off of direct infringement and is more able to pay up, especially considering that direct infringers are often judgment-proof.⁶²

Vicarious liability is one form of secondary liability. Under the theory of vicarious liability, a third party may be held liable for the acts of a direct infringer over whom they have a certain degree of authority.⁶³ Vicarious liability is based in agency law and thus arises most often in the employer/employee context, but is not limited to this area. Contributory liability is a second form of secondary liability. Contributory liability exists when one party knowingly facilitates direct infringement.⁶⁴ Contributory liability is based in tort law and, in the language of the Ninth Circuit, “stems from the notion that one who directly contributes to another’s infringement should be held accountable.”⁶⁵ Despite the differences between vicarious and contributory liability, it is not uncommon for a defendant to be held liable for both types of indirect infringement.⁶⁶

A claim of vicarious liability has two elements: (i) the right and ability of a defendant to supervise infringing conduct and (ii) a direct financial interest in that conduct.⁶⁷ The classic vicarious infringement case is *Shapiro, Bernstein & Co. v. H. L. Green Co.* In *Shapiro*, a storeowner rented out his space to concessionaires. The storeowner was ultimately found liability for the infringing acts of a concessionaire over whom he had “the ultimate right of supervision” and through which he received “a proportionate share of the gross receipts” from the infringing activity.⁶⁸ The right and ability to supervise means that, to be found vicariously liable, a defendant must have both the legal right and practical ability to stop or limit the directly infringing conduct and must have failed to do so.⁶⁹ Nor-

58. See *Arista Records v. Lime Group*, 784 F. Supp. 2d 398, 422 (S.D.N.Y. 2011).

59. See *Luvdarts v. AT&T Mobility*, 710 F.3d 1068, 1071 (9th Cir. 2013).

60. See *id.*

61. See *Arista*, 784 F. Supp. at 422.

62. Helman, *supra* note 35, at 158-60.

63. See COHEN, *supra* note 53, at 476.

64. *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259, 264 (9th Cir. 1996).

65. *Id.*

66. COHEN, *supra* note 53, at 476.

67. *Shapiro, Bernstein & Co. v. H. L. Green Co.*, 316 F.2d 304, 307 (2d Cir. 1963).

68. *Shapiro*, 316 F.2d at 308.

69. *Perfect 10, Inc. v. Amazon.com, Inc.*, 508 F.3d 1146, 1173 (9th Cir. 2007); see also *Arista Records v. Lime Grp.*, 784 F. Supp. 2d 398, 435 (S.D.N.Y. 2011).

mally, “legal right” implies some form of contractual or employment relationship between the direct and indirect infringers.⁷⁰ A direct financial interest exists where there is a causal relationship between infringing activity and a financial benefit.⁷¹ A defendant profiting from direct infringement would constitute such a connection, as would the ability to attract new customers.⁷²

The elements of contributory infringement are (i) knowledge and (ii) facilitation of direct infringement.⁷³ The knowledge element requires that a defendant know or have reason to know of direct infringement.⁷⁴ Actual or constructive knowledge is sufficient, but something more than “generalized” knowledge of a “possibility” of infringement is necessary.⁷⁵ The facilitation element is satisfied when there is a substantial amount of participation in the infringing activity.⁷⁶ “Participation” can mean inducing, encouraging, causing or materially contributing to infringing activity.⁷⁷ The Ninth Circuit has described the test of facilitation as whether “the defendant engages in personal conduct that encourages or assists the infringement.”⁷⁸ In one particularly expansive interpretation of the facilitation test, the same court found a swap meet operator contributorily liable for renting out booth space to vendors who were directly liable for copyright infringement.⁷⁹

The tests of vicarious and contributory liability are not dependent on the literal proximity between the direct and indirect infringers.⁸⁰ In other words, secondary liability can extend beyond scenarios where there is a direct relationship between the defendant and the primary infringer.⁸¹ The requirements of right and ability to supervise, direct financial interest, knowledge, and facilitation certainly imply a close connection between the

70. *Perfect 10*, 508 F.3d at 1173.

71. *See Arista*, 784 F. Supp. at 435.

72. *Shapiro*, 316 F.2d at 308 (“By reserving for itself a proportionate share of the gross receipts from [direct infringer’s] sales of phonograph records, [defendant] had a most definite financial interest . . .”). *See also* *MGM v. Grokster*, 545 U.S. 913, 930 (2005); *Perfect 10, Inc. v. Visa Int’l Serv. Ass’n*, 494 F.3d 788, 816 (9th Cir. 2007) (Kozinski, J., dissenting) (equating profiting with “tak[ing] a cut of virtually every sale”).

73. *Fonovisa*, 76 F.3d at 264.

74. *A&M Records, Inc. v. Napster Inc.*, 239 F.3d 1004, 1020 (9th Cir. 2001).

75. *See id.* at 1020–21 (arguing that conclusory allegations of specific knowledge were insufficient to support the knowledge prong); *see also* *Luvdarts v. AT&T Mobility*, 710 F.3d 1068, 1072 (9th Cir. 2013).

76. *Religious Tech. Ctr. v. Netcom On-Line Commc’n Servs.*, 907 F. Supp. 1361, 1375 (N.D. Cal. 1995).

77. *Gershwin Pub. Corp. v. Columbia Artists Mgmt., Inc.*, 443 F.2d 1159, 1161–62 (2d Cir. 1971); *see also* *Luvdarts*, 710 F.3d at 1071.

78. *Napster*, 239 F.3d at 1019.

79. *Fonovisa, Inc. v. Cherry Auction, Inc.*, 76 F.3d 259, 261–63 (9th Cir. 1996).

80. Benjamin H. Glatstein, *Tertiary Copyright Liability*, 71 U. CHI. L. REV. 1605, 1605 (2004).

81. *See id.* at 1611.

direct infringer and the third party defendant, and traditional applications of those requirements reflect that understanding of the elements.⁸² However, in cyberspace, the same requirements of secondary liability can be satisfied in situations where the real-world relationship between a direct and secondary infringer is more tenuous.⁸³ One judge on the U.S. Court of Appeals for the Ninth Circuit justified extending liability to tangentially related parties by reasoning that secondary liability turns on “how significantly [their] activity helps infringement, not on whether it’s characterized as one step or two steps removed from it.”⁸⁴

This application of secondary liability has sometimes been labeled “tertiary liability.” In the context of copyright infringement, tertiary liability represents secondary liability that is applied to seemingly tertiary parties: parties who assist secondary infringers.⁸⁵ However, tertiary liability as a doctrine distinct from other forms of secondary liability has no support in case law.⁸⁶ Still, to the extent that tertiary liability stands for the proposition that direct infringement has the ability to flow down the chain of relationships to reach tangentially involved parties such as investors, it is a relevant and appropriate label.⁸⁷ Investor liability is, of course, contingent on the secondary liability of portfolio companies, so to the extent that an investor assists a DCI that is itself secondarily liable, tertiary liability suggests that direct liability can extend down the chain to investors.

C. Secondary Liability for Digital Content Intermediaries

Traditional conceptions of secondary liability have evolved in the modern information economy, and courts have struggled to apply the tests to new, complex relationships that exist in cyberspace. For example, in *Religious Tech. Ctr. v. Netcom*, the U.S. District Court for the Northern District of California distinguished the operator of an online bulletin board from a landlord for purposes of the knowledge prong of contributory liability. It argued that a system operator “does not completely relinquish control” upon engaging with the direct infringer, but rather actively and continuously provides its services.⁸⁸ Thus, “the relevant time frame for knowl-

82. See Ginsburg, *supra* note 21, at 580 (“In the early cases, the relationship between the supplier and the user of the means was sufficiently close that there could be little doubt of either the knowledge or the nexus between the means and the infringement.”).

83. See, e.g., *Religious Tech. Ctr. v. Netcom On-Line Commc’n Servs.*, 907 F. Supp. 1361 (N.D. Cal. 1995) (allowing a claim of secondary liability to move forward against a defendant accused of being liable for the direct infringement of a subscriber to an online bulletin board).

84. *Visa*, 494 F.3d at 812 (Kozinski, A., dissenting).

85. See, e.g., Glatstein, *supra* note 80, at 1605, 1610.

86. See, e.g., *In re Napster, Inc. Copyright Litig.*, No. C 00-1369 MHP, 2001 WL 36593841, at *2 (N.D. Cal. July 9, 2001) (holding that a claim of tertiary liability was unsupported by any precedent).

87. See Glatstein, *supra* note 80, at 1618.

88. *Netcom*, 907 F. Supp. at 1375.

edge is not when Netcom entered into an agreement with [the direct infringer]. It should be [during the period] when Netcom provided its services to allow [the direct infringer] to infringe.”⁸⁹ *Netcom* thus stands for the proposition that, to the extent DCIs have an ongoing service relationship with their users, there is a lower threshold in cyberspace to satisfy the knowledge prong of contributory liability.

Similarly, in *Perfect 10 v. Visa*, the Ninth Circuit grappled with how the facilitation prong of contributory liability applied to a search engine that provided links to infringing material as compared to an online payment processor that facilitated payment transactions related to infringing material.⁹⁰ The court distinguished the two by arguing that “helping users to locate an image might *substantially assist* users to download infringing images, but processing payments does not.”⁹¹ The court reasoned that there was a “direct connection” between a search engine and the distribution of infringing content.⁹² The payment processor, on the other hand, was too peripherally involved and therefore did not materially contribute to the infringing conduct.⁹³ Similar reasoning was applied to the right and ability to supervise element of vicarious liability. *Visa*, in the view of the court, was too far removed from the infringing activity to have the requisite amount of control over it. The only allegation was that *Visa* could “take certain steps that may have the indirect effect of reducing infringing activity on the Internet,” which did not constitute the requisite ability to control the infringing activity.⁹⁴ The court further reasoned that “mere ability to withdraw a financial ‘carrot’ does not create the ‘stick’ of ‘right and ability to control’ that vicarious infringement requires.”⁹⁵

If a search engine has a direct connection to the distribution of material, then a DCI certainly does as well. Much like in the search engine context, there is a contractual relationship between a DCI, its users, and the infringing content to the extent that users agree to terms of use in exchange for the ability to post and search UGC. This direct relationship forms the basis for new applications of traditional secondary liability tests. For example, the knowledge element of contributory liability is easier to satisfy when DCIs have notice systems in place to alert them of infringing material. Moreover, due to their ongoing relationship with the infringing activity, DCIs are assumed to be able to take simple steps to prevent further infringement upon notice of infringing activity.⁹⁶ Failure to do so

89. *Id.* at 1374.

90. *Perfect 10, Inc. v. Visa Int’l Serv. Ass’n*, 494 F.3d 788, 797 (9th Cir. 2007).

91. *Id.* (emphasis added).

92. *Id.* at 796.

93. *See id.* at 800; *see also* *Arista Records v. Lime Grp.*, 784 F. Supp. 2d. 398, 432 (S.D.N.Y. 2011).

94. *Visa*, 494 F.3d at 803.

95. *Id.*

96. *See Religious Tech. Ctr. v. Netcom On-Line Comm’n Servs.*, 907 F. Supp. 1361, 1375 (N.D. Cal. 1995) (explaining that not completely relinquishing control over how its sys-

would likely constitute both facilitation for purposes of contributory liability⁹⁷ as well as the right and ability to supervise for purposes of vicarious liability.⁹⁸ The relationship of DCIs to infringing activity also creates a multitude of profit vehicles.⁹⁹ Therefore, the requirement of a direct financial interest for purposes of vicarious liability is loosened, and courts have found that element satisfied even where a DCI was only *potentially* profitable¹⁰⁰ or merely had the ability to attract infringing users.¹⁰¹

D. DCIs and the Digital Millennium Copyright Act

What the summary above does not address is that the Digital Millennium Copyright Act (DMCA) largely renders the issue of secondary liability moot for DCIs. Section 512 of the DMCA establishes safe harbors for Online Service Providers (OSPs) and provides immunity from infringement in exchange for compliance with a set of statutory requirements.¹⁰² In enacting the DMCA, Congress specifically aimed to address the issue of DCI secondary liability for copyright infringement.¹⁰³ Importantly, the DMCA does not alter or reinterpret traditional notions of secondary liability. Instead:

[without] imply[ing] that a service provider is or is not liable as an infringer either for conduct that qualifies for a limitation of liability or for conduct that fails to qualify[.] . . . the limitations of liability apply if the provider is found to be liable under existing principles of law . . . [and] protect [them] from liability for all monetary relief for direct, vicarious or contributory infringement.¹⁰⁴

The DMCA thus acts as a shield against liability, but only for entities that fall within its scope.

The DMCA exclusively covers OSPs, and the degree to which its safe harbors extend to third parties is unclear.¹⁰⁵ Therefore, while the DMCA

tem is used is unlike a landlord, and implies being able to take simple measure to prevent further damage to P's copyrighted works).

97. See *id.* at 1374 (pointing out that failure to stop infringing conduct from being distributed constitutes substantial participation).

98. See *Arista Records v. Lime Grp.*, 784 F. Supp. 2d 398, 435 (S.D.N.Y. 2011) ("Defendant had the ability to supervise . . . and failed to do so . . . evidence includes ability to."); see also *MGM v. Grokster*, 545 U.S. 913, 930 (2005); see also *A&M Records, Inc. v. Napster Inc.*, 239 F.3d 1004, 1024 (9th Cir. 2001) ("Napster . . . [had] the ability to locate infringing material listed on its search indices, and the right to terminate users access to the system.").

99. See Helman, *supra* note 35, at 116–17.

100. See *id.*

101. See *Arista*, 784 F. Supp. 2d at 435.

102. S. REP. NO. 105-190, at 19 (1998).

103. S. REP. NO. 105-190, *supra* note 1, at 8 ("[B]y limiting the liability of service providers, the DMCA ensures that the efficiency of the Internet will continue to improve and that the variety and quality of services on the Internet will continue to expand.").

104. *Id.* at 17.

105. See John Blevins, *Uncertainty as Enforcement Mechanism: The New Expansion of Secondary Copyright Liability to Internet Platforms*, 34 CARDOZO L. REV. 1821, 1855 (2013) ("[O]ne concern is that investors facing personal liability suits have significantly less protec-

may be a viable defense for the DCIs, infringement liability may still extend further down the chain to parties such as investors.¹⁰⁶ The US Court of Appeals for the Ninth Circuit recently declined to specifically rule on this issue, but did note that extending secondary liability to investors of a venture that was protected by the DMCA would undermine Congress' purpose in passing the DMCA.¹⁰⁷ Yet, the justifications for allowing a safe harbor for OSPs do not easily extend to their investors. One of the underlying reasons for giving OSPs voluntary safe harbors was because of their inability to sufficiently allocate the risk of potential liability.¹⁰⁸ Investors, however, are in a much better position to transactionally maneuver around liability and can obtain insurance and indemnification from the OSPs to insulate themselves. Also, in exchange for safe harbor protection, OSPs voluntarily comply with a variety of statutory requirements.¹⁰⁹ Their investors are not part of this quid pro quo, however, and therefore may not be able to reap the benefits of the safe harbors.¹¹⁰ Thus, the DMCA is not a panacea for investors in DCIs.

Similarly, just as OSPs and their investors should be evaluated separately for purposes of the DMCA safe harbors, they should be evaluated separately for the purposes of the secondary liability tests. The elements of knowledge, financial interest, facilitation, and right and ability to supervise may sometimes be attributable solely to the DCI in question, but they also may be attributable to parties with whom the DCIs interact. In certain circumstances, DCIs may look less like actors and more like mere instrumentalities of third parties who pull the strings and reap the benefits. In such a case, it does not make sense to evaluate DCIs and their investors on the same spectrum of liability. To the extent that DCI investors are independently satisfying the secondary infringement tests, it is justifiable for courts to continue to hold them liable while allowing their portfolio company to benefit from the DMCA safe harbors.

tion than the Internet platforms themselves. Because individual investors are not 'service providers,' they cannot invoke the DMCA safe harbors.").

106. See Gasner & Misch, *supra* note 22.

107. See *UMG Recordings, Inc. v. Shelter Capital Partners*, 718 F.3d 1006, 1031 n.20 (9th Cir. 2013) ("We remain concerned about the possibility of imposing secondary liability on tangentially involved parties, like Visa and the Investor Defendants, while those accused of direct infringement receive safe harbor protection. '[B]y limiting the liability of service providers,' the DMCA sought to assuage any 'hesitat[ion] to make the necessary investment in the expansion of the speed and capacity of the Internet.' Congress was no doubt well aware that service providers can make the desired investment only if they receive funding from investors like the Investor Defendants. Although we do not decide the matter today, 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.").

108. See COHEN, *supra* note 53, at 503.

109. See generally 17 U.S.C. §512.

110. One could argue that to the extent investors have enough control to be deemed secondarily liable, they likely controlled the decision to comply with the DMCA safe harbor tests.

E. Extending Secondary Liability to Investors

Because investors cannot rely on the DMCA for protection, they must be especially cautious about the extent to which they can be found secondarily liable for copyright infringement. Unfortunately, the law of investor liability for secondary copyright infringement is unsettled and still developing.¹¹¹ The prospect for investor liability has increased significantly over the past 15 years, beginning with the adaptation of secondary liability to parent companies for the acts of their subsidiaries.¹¹² The relationship between an investor and a debtor is not unlike that of a parent and a subsidiary corporation: parent companies have a similarly complicated relationship that mixes an economic interest with a control interest. Much like the relationship between a landlord and tenant, there is an assumption that the acts of a parent are “intimately associated” with that of the subsidiary.¹¹³ The Ninth Circuit has held that a parent corporation can be held liable for the infringing acts of its subsidiary if there is a “substantial and continuing connection between the two with respect to infringing acts.”¹¹⁴

A parent cannot be held vicariously liable for the infringing acts of its subsidiary simply by nature of the legal relationship between the two.¹¹⁵ It must be shown, in the words of one court, that a parent “has a direct financial interest in the infringing activity and that the parent has the right and ability to supervise the subsidiary, which is evidenced by some continuing connection between the two in regard to the infringing activity.”¹¹⁶ In *Banff v. Limited*, the District Court for the Southern District of New York held that a parent of a retail clothing store did not exercise sufficient control over the subsidiary to be vicariously liable for the latter’s direct infringement because the subsidiary made its own day-to-day decisions linked to the infringement and because the parent had no “continuing connection” with the activities or people involved in the alleged infringement.¹¹⁷

As *Banff* illustrates, “control” forms the basis of applying secondary liability to investors, but courts grapple both with what control actually means, and how much control is sufficient to implicate liability. Two recent cases that specifically addressed the issue of investor liability illustrate this. The first is *UMG v. Bertelsmann*, which directly stemmed out of the *Napster* litigation.¹¹⁸ Plaintiffs UMG Recordings, Capitol Records, and

111. Gasner & Miksch, *supra* note 22.

112. *See, e.g., Banff Ltd. v. Limited, Inc.*, 869 F.Supp. 1103 (S.D.N.Y. 1994).

113. *Banff Ltd. v. Limited, Inc.*, 869 F.Supp. 1103, 1109 (S.D.N.Y. 1994).

114. *Frank Music Corp. v. Metro-Goldwyn-Mayer Inc.*, 886 F.2d 1545, 1553 (9th Cir. 1989)

115. *Banff*, 869 F. Supp at 1110.

116. *Id.*

117. *Id.*

118. *UMG Recordings v. Bertelsmann AG*, 222 F.R.D. 408, 409 (N.D. Cal. 2004).

Jerry Lieber, argued that Bertelsmann AG and the Venture Capital firm Hummer Winblad were contributorily and vicariously liable for copyright infringement through their relationship with Napster.¹¹⁹ The plaintiffs claimed that the defendants “exercise[ed] full control” over Napster and that, with full knowledge of infringing activities, supported Napster and even ordered the infringing activities to continue.¹²⁰ The defendants filed a motion to dismiss, but the court allowed the claims to move forward. However, the court never evaluated the claim of “control” on the merits: Bertelsmann and Hummer Winblad settled the case, and Bertelsmann agreed to pay approximately \$60 million.¹²¹ Thus, while *Bertelsman* stands for the proposition that an allegation of investor having “control” over a venture’s infringing activity constitutes a “viable claim for relief under theories of both contributory and vicarious liability,”¹²² it leaves the question of what actually constitutes “control” conspicuously unclear.

A more recent case further addressed the extent to which an investor has the requisite amount of control to satisfy a secondary liability claim.¹²³ *UMG v. Shelter Capital Partners* stemmed from an action by UMG Recordings against Veoh Networks, a video sharing website similar to YouTube.¹²⁴ In the original action, UMG added three investors as defendants alongside Veoh.¹²⁵ On appeal to the Ninth Circuit, Veoh appealed the district court’s dismissal of its cause of action against the investors.¹²⁶ The Ninth Circuit allowed the claims against the investors to move forward despite the fact that Veoh itself would have been able to avoid liability through the DMCA safe harbor.¹²⁷ On remand, the district court came down on the side of the investors on both claims of secondary liability. Addressing both contributory and vicarious liability, the Ninth Circuit found that the three investors did not together have the requisite amount of control over Veoh.¹²⁸ Distinguishing *Bertelsmann*, where the investor in question was Napster’s “only available source of funding,” no single investor individually controlled Veoh.¹²⁹ The court rejected the theory that the three investors “together took control of Veoh’s operations” by occupying a majority of the Board’s seats because there was no allegation

119. *Id.*

120. *Id.* at 413.

121. John Ottaviani, *The End is Near – Bertelsmann Settles EMI Claims Over Napster*, TECH. & MKTG. LAW BLOG (Mar. 28, 2007), http://blog.ericgoldman.org/archives/2007/03/the_end_is_near.htm.

122. *UMG Recordings v. Bertelsmann AG*, 222 F.R.D. 408, 414 (N.D. Cal. 2004).

123. *See generally* *UMG Recordings, Inc. v. Shelter Capital Partners*, 718 F.3d 1006 (9th Cir. 2011).

124. *Id.* at 1011.

125. *Id.* at 1013.

126. *Id.* at 1011.

127. *Id.* at 1011.

128. *Id.* at 1032.

129. *Id.*

that the three investors “agree[d] to operate as a unified entity to obtain and leverage majority control.”¹³⁰ Without such an allegation, the court feared the ability for a plaintiff to sue “any collection of directors making up 51% of the board on the theory that they constitute a majority.”¹³¹ *Shelter Capital Partners* thus shows that control of the board alone is not sufficient to constitute control for purposes of secondary liability.

The takeaway from *Banff*, *Bertelsmann* and *Shelter Capital Partners* is that the distinction between “legal” and “practical” control is essential to defining the scope of investor liability. Practical control is an issue of fact. In *Banff*, practical control was implied by the parent/subsidiary arrangement; in *Shelter Capital Partners*, board control constituted practical control. Less clear is the point at which practical control constitutes legal control. This fine line has enormous ramifications, because where practical control constitutes legal control, liability exists.

F. Painting the Picture of Investor Liability

Bertelsmann and *Shelter Capital Partners* establish the potential for investor liability, and show that liability hinges on the issue of legal control. This means that all the elements of secondary liability—the right and ability to supervise, a direct financial interest, knowledge and facilitation—ultimately boil down to the macro-issue of control. Therefore, to fully evaluate the scope of investor control we must look to the traditional tests of secondary liability. Combined with *Bertelsmann* and *Shelter Capital Partners*, a roadmap for assessing investor liability emerges.

i. Contributory Liability

The elements of contributory liability are knowledge and facilitation. Either actual or constructive knowledge can form the basis of contributory infringement liability for an investor.¹³² Knowledge can exist in the form of a copyright holder giving notice of infringement to investors,¹³³ or can be implied from investors’ communications to ventures.¹³⁴ To find constructive knowledge, courts look to the sophistication of an investor with regards to the venture or technology with which they are working.¹³⁵ For example, in *Napster*, the District Court for the Northern District of California held that Napster had “constructive knowledge because its executives, who had recording industry experience and had previously enforced

130. *Id.*

131. *Id.*

132. *Arista Records v. Lime Grp.*, 784 F. Supp. 2d. 398, 432 (S.D.N.Y. 2011).

133. Thomas B. Foley, *Show Me The Money!: Third-Party Copyright Infringement Liability Reaches Investors & Lenders*, 38 SW. L. REV. 89, 114 (2008).

134. *Id.*

135. *Id.*

IP rights, downloaded copyrighted songs and promoted the website with screen shots listing infringing files.”¹³⁶

Facilitation boils down to some form of material assistance in accomplishing infringement.¹³⁷ Thus, the difference between investors with very little role in a venture and investors who lend with the expectation of a significant control stake is particularly salient in a contributory liability analysis.¹³⁸ As Scott D. Baker and Emily B. Kirsch explain, investors become especially vulnerable when they “exercise enough control over the business or strategic operations of [their] debtor to be considered to be supervising, inducing, causing or materially contributing to an infringing activity of its debtor[.]”¹³⁹ Funding can help establish a claim of material assistance, but funding alone is not enough.¹⁴⁰ Instead, funding must be coupled with some other form of action, such as authority over how such funding is spent.¹⁴¹ This type of authority will sometimes be implied, such as when the funding in question is from the only available source, as was the case in *Bertelsmann*.¹⁴² However, *Shelter Capital Partners* teaches that solely a majority board or voting stake will not infer material assistance without it being attributable to a single investor or a group of investors acting in concert.¹⁴³

ii. Vicarious Liability

The elements of vicarious liability are the right and ability to supervise and a direct financial interest in the infringing activity. The right and ability to supervise element can be tricky for investors to navigate, but traditionally exists when a defendant “has both a legal right to stop or limit the directly infringing conduct, as well as the practical ability to do so.”¹⁴⁴ A contractual relationship, for example, constitutes a legal right to act, but perhaps not a practical one.¹⁴⁵ Thus, until a contractual right is exercised, the right and ability to supervise may not exist.¹⁴⁶ Like the facilitation

136. See *A&M Records Inc. v. Napster Inc.*, 114 F. Supp. 2d 896, 919 (N.D. Cal. 2000).

137. *UMG Recordings, Inc. v. Shelter Capital Partners*, 718 F.3d 1006, 1031–32 (9th Cir. 2013).

138. See Scott D. Baker & Emily B. Kirsch, *Does Lender Liability Exist for Copyright Infringement?*, MONDAQ (July 23, 2007), <http://www.mondaq.com/unitedstates/x/50402/Corporate+Commercial+Law/Does+Lender+Liability+Exist+For+Copyright+Infringement> [hereinafter *Lender Liability*].

139. See *id.*

140. *UMG Recordings, Inc. v. Shelter Capital Partners*, 718 F.3d 1006, 1032 (9th Cir. 2013). The *Bertelsmann* court had previously expressly declined to rule on this point. See generally *UMG Recordings v. Bertelsmann AG*, 222 F.R.D. 408 (N.D. Cal. 2004).

141. *Shelter Capital Partners*, 718 F.3d at 1032.

142. *Bertelsmann*, 222 F.R.D. at 412.

143. *Shelter Capital Partners*, 718 F.3d at 1032.

144. *Perfect 10, Inc. v. Amazon.com, Inc.*, 487 F.3d 701, 730 (9th Cir. 2007).

145. See Glatstein, *supra* note 80, at 1632.

146. See *id.*

element of contributory liability, *Shelter Capital Partners* establishes that the right and ability to supervise element of vicarious liability was not satisfied when there was no allegation that investors “agreed to act in concert, and thus *together*” exercised practical control.¹⁴⁷

Of significant concern to investors is the direct financial interest prong of vicarious liability. This prong has traditionally been satisfied by evidence of a direct economic benefit from the infringing activity.¹⁴⁸ Thus, under a traditional conception of financial interest, an investor’s proportional share of the business would likely be considered a financial benefit.¹⁴⁹ However, where an investor’s return is independent of the infringing activity, no direct financial benefit exists.¹⁵⁰ As investment structures become more complex, it is more difficult to find the direct commercial benefit that existed in shares of gross revenues or profits from an infringing business.¹⁵¹ Consider loans, for example. A lender who gets back nothing more than what he put in is not receiving a financial *benefit*.¹⁵² One who charges an interest rate for a loan likely is receiving a benefit,¹⁵³ but the interest rate may arguably be deemed independent from any infringing activity.

Things become even more complicated when we consider investment structures such as convertible debt and warrants. On the one hand, a warrant holder certainly derives a financial benefit to the extent that the infringing activity increases the value of the venture.¹⁵⁴ On the other hand, there is arguably no financial benefit for a holder of convertible debt until that debt is converted into equity.¹⁵⁵ However, the terms of the convertible note may be determinative: if the note’s conversion occurs at the discretion of the lender, then the note holder’s benefit begins to look more like that of the warrant holder.¹⁵⁶ Alternatively, if conversion is conditioned upon certain business milestones that, in turn, are related to infringing activity, then the note holder’s benefit would be directly linked to that activity. Thus, today the extent to which an investor receives a financial benefit sufficient to constitute vicarious liability is highly complex and fact specific.

147. *Shelter Capital Partners*, 718 F.3d at 1033 (emphasis added).

148. See Glatstein, *supra* note 80, at 1630.

149. See *Religious Tech. Ctr. v. Netcom On-Line Comm’n Servs.*, 907 F. Supp. 1361, 1376 (N.D. Cal. 1995).

150. See *id.*

151. See Foley, *supra* note 133, at 104 n.119.

152. See *id.* at 118–19.

153. See *id.* at 119–20.

154. See *id.* at 120–21.

155. See *id.*

156. See *id.*

IV. INVESTOR PROTECTION

A. *Implications of Liability*

When making investment decisions, VCs are faced with two broad types of economic risk: (i) the risk of losing their investment and (ii) the risk of incurring liability that extends beyond that investment.¹⁵⁷ To mitigate the first type of risk, VCs negotiate for control mechanisms to “add value” to their portfolio companies and to hopefully earn a return.¹⁵⁸ However, in exchange for these control mechanisms, VCs open themselves up to the second type of risk.¹⁵⁹ In the world of copyright infringement, a small risk of liability may constitute an enormously disproportionate cost.¹⁶⁰ Investing in copyright infringement therefore may constitute an insurmountable amount of monetary damages that could deter future investment and significantly chill innovation.¹⁶¹

The lack of legal clarity with respect to investor liability for UGC has both negative and positive implications in this regard. On the one hand, it means that VCs are especially vulnerable, given their tendency to be involved in the strategic direction and operations of the venture¹⁶² and their inability to safely rely on DMCA protection.¹⁶³ On the other hand, VCs can utilize what little precedent exists to help guide their conduct in a way to both minimize the extent of practical control when it is unnecessary and shield themselves from liability when practical control is desired. VCs should acknowledge the enhanced potential for liability by proactively altering their investment conduct. Specific case law regarding investor liability may be scant, but the traditional secondary liability tests provide sufficient guidance for VC behavior. In the interest of promoting innovation and encouraging new DCIs, VCs should continue to invest in UGC-based ventures. VCs can safely invest in DCIs by taking various transactional steps to protect themselves against liability.

B. *Identifying and Pricing Potential Liability*

The first step for investors in addressing expansive liability is to correctly identify and attempt to value such liability. VCs should gain as

157. BARTLETT, *supra* note 9, § 9.2 (“Venture capital investment is risky enough if all that has been put at risk are the dollars invested in the enterprise. If, in addition, an investor can be held liable to the creditors, and, indeed, to other investors, in an insolvent enterprise, his risk parameters are undoubtedly exceeded.”).

158. *Id.* (“When raising money from his own investors—the limited partners in his venture pool—the professional manager of a venture capital partnership holds himself out as someone with the expertise to “add value” to the investments under his control.”).

159. *Id.*

160. See Mitch Stoltz, *To Safeguard the Public Domain (and the Public Interest), Fix Copyright’s Crazy Penalties*, DEEPLINKS BLOG (Jan. 14, 2014), <https://www.eff.org/deeplinks/2014/01/safeguard-public-domain-and-public-interest-fix-copyrights-crazy-penalties>.

161. See BARTLETT, *supra* note 9, § 9.2.

162. See Baker & Kirsch, *supra* note 138.

163. See *infra* Part II.D.

much information about potential debtors' relationships with intangible assets and any potentially related liability. The suggested protocols fall under the broad umbrella of due diligence, with a special emphasis on copyright infringement liability.¹⁶⁴ The due diligence phase is the point at which VCs dig deeper into their ventures' materials to assess risk prior to investing.¹⁶⁵ Because of the heightened possibility of potential liability, investors must be fully knowledgeable about the technology and business models of their potential investments to fully understand the risks they are undertaking and to cost-adjust appropriately.¹⁶⁶ Simply put, the due diligence process is about identifying risks that may implicate enormous statutory damages claims.

Intellectual property due diligence is a crucial step for investors prior to investing.¹⁶⁷ This is especially true for investments in technology companies, including DCIs. Technology companies rely disproportionately on intangible assets, whether their own or others'. DCIs like Instagram and Pinterest derive significant value from user-generated intangible assets, even though they do not own those assets themselves. The strategic importance and complicated nature of intangible assets with DCIs makes identifying and addressing the relevant risks even more important for potential investors.¹⁶⁸

The due diligence process is crucial to identifying and valuing any potential liabilities, and the process prior to investments in DCIs should emphasize potential copyright infringement liability.¹⁶⁹ Potential liability can significantly affect the "value" of the transaction, which in the case of

164. See IPR HELPDESK, *IP DUE DILIGENCE: ASSESSING VALUE AND RISKS OF INTANGIBLES* 1 (2012), available at https://www.iprhelpdesk.eu/sites/default/files/newsdocuments/IP_due_diligence_0.pdf; see also Gasner & Miksch, *supra* note 22 ("While such due diligence is valuable, another level of analysis may be warranted, focused on potential investor liability.").

165. See BRAD FELD & JASON MENDELSON, *VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST* 23, 26 (2d ed. 2012) ("[Due Diligence is] code for 'I'm taking my exploration to the next level.'").

166. See Deborah A. Marshall et al., *Derivative Liability for Copyright Infringement: Napster, Grokster, Hummer Winblad and Bertelsmann*, VC EXPERTS, https://vcexperts.com/buzz_articles/364 ("Due diligence will be more critical than ever in making investment decisions. Investors and entrepreneurs must arm themselves with a clear understanding of how the technology is designed in order to understand the risks of infringement in the volatile legal framework of pending cases, decided cases (and the questions they leave unanswered) and potentially inconsistent decisions among the courts.").

167. See *id.*

168. See Robins, *supra* note 33, at 344. IP due diligence has also become a priority in M&A deals, recently being described as "critical," both in terms of priority and importance. See Efrat Kasznik, *Industry Report – IP Due Diligence in M&A Transactions: How to Avoid Another Rolls Royce*, IAM (May 21, 2014) <http://www.iam-magazine.com/industryreports/Detail.aspx?g=de977cd5-bdbc-437a-b568-44926d4bf239>.

169. See DANIEL GLAZER, *INTELLECTUAL PROPERTY: ASSET PURCHASES* 2 (2001), available at http://tech.friedfrank.com/wp-content/uploads/2013/05/Marketing_TTG_PLC-IP-Asset-Purchases_Glazer.pdf.

early stage investments means the amount invested.¹⁷⁰ Also, VCs should expand due diligence procedures to include secondary liability concerns.¹⁷¹ *Shelter Capital Partners* and *Bertelsman* do not give clear answers, and so there is more pressure than ever on investors to make sure they understand the full risks they are undertaking.¹⁷² Given the lack of legal clarity in the area, even the threat of spurious claims should be taken very seriously and priced accordingly.¹⁷³

A thorough due diligence process for DCIs entails multiple steps. First, a DCI's user-generated intangible assets should be identified and isolated from its own intangible assets. Second, the income stream from these intangible assets should be approximated.¹⁷⁴ Next, the due diligence process should identify and assess infringement exposure related to the user-generated intangible assets.¹⁷⁵ Any potential legal threats should be thoroughly evaluated to address their merit and realistic chances for proceeding.¹⁷⁶ For known and anticipated infringement claims, properly evaluating infringement exposure entails considering:

- the materiality of the dispute;
- best- and worst-case outcomes;
- the likelihood and expected cost of a settlement;
- past and future costs of the dispute;
- the ability to isolate the venture's liability;¹⁷⁷ and
- the possibility of business model alternatives.¹⁷⁸

The next step in the due diligence process deals with future, or unknown and unanticipated, infringement actions. This involves evaluating the venture's internal compliance processes to establish the degree to which it "minimize[s] the likelihood of involvement in disputes concerning alleged infringement of third-party IP[.]"¹⁷⁹ This step also involves inquir-

170. See Robins, *supra* note 33, at 324.

171. Gasner & Miksch, *supra* note 22 ("[B]roaden their legal due diligence to include secondary liability issues.").

172. See James L. Proctor, Jr., "Capital" Punishment: Evaluating an Investor's Secondary Copyright Infringement Liability after *Veoh*, 6 WASH. J. L. TECH. & ARTS 217, 229 (2011).

173. See Robins, *supra* note 33, at 327.

174. See *id.*

175. Ethan Horwitz & Kandis Koustenis, *A Guide To Conducting IP Due Diligence In M&A*, KING & SPALDING LLP (Jan. 7, 2014, 10:48 AM) http://www.kslaw.com/imageserver/KSPublic/library/publication/2014articles/1-7-14_Law360.pdf ("[I]dentify and evaluate all assertions of copyright infringement . . . [.]").

176. See Robins, *supra* note 33, at 327.

177. This step includes addressing indemnification, insurance, and other transactional maneuvers discussed below.

178. See Glazer, *supra* note 169, at 7.

179. Robins, *supra* note 33, at 327.

ing into the venture's procedures for obtaining copyright clearance as well as their compliance with the DMCA requirements.¹⁸⁰

C. Avoiding Potential Liability

Once potential liability is identified and quantified, investors can take a variety of affirmative steps to isolate it. Boiled down to the most basic level, investor liability is implicated by control.¹⁸¹ But because courts have not specifically defined the parameters of control that will implicate liability, it is difficult to correlate practical control with legal control. Therefore, the best approach for isolating liability is for investors to minimize the amount of practical control they have over a portfolio company, both transactionally (through contract negotiations) and affirmatively (through conduct). Identifying potential liability is not meant to discourage investment, it is meant to allow investors to invest without fear of potential liability.

When a VC formally decides to move forward with an investment, the transaction is normally carried out through "a set of contracts."¹⁸² These transactions are private placements and therefore there is no public database from which to glean their structures.¹⁸³ However, numerous empirical studies have shown that unlike other types of investors, VCs are not passive investors and "often control or influence the decision to replace the CEO and make other key business decisions."¹⁸⁴ The right to do this comes from the VC as "someone with the expertise to 'add value' to the investments under his control."¹⁸⁵ While more recent empirical studies have shown that the conception of the VC as insisting on outright control exists only in a minority of cases, VCs still maintain a larger degree of control over their investments than more traditional passive investors.¹⁸⁶

The relationship between VCs and entrepreneurs is much like an agency relationship.¹⁸⁷ Through a variety of contractual mechanisms, VCs protect themselves against opportunistic behavior by their portfolio companies by giving themselves significant control rights.¹⁸⁸ Control is not achieved through day-to-day management decisions, but rather by monitoring business operations, creating contractual incentives, assisting in strategic planning, maintaining veto rights, recruiting executives, negotiat-

180. *Id.* at 345; Horwitz & Koustenis, *supra* note 175 ("Evaluate the target company's procedures for obtaining copyright clearance . . . [.]").

181. *See infra* Part II.E

182. D. Gordon Smith, *Venture Capital Contracting in the Information Age*, 2 J. SMALL & EMERGING BUS. L. 133, 144 (1998).

183. William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 898 (2002).

184. *Id.* at 915.

185. BARTLETT, *supra* note 9, § 9.2.

186. *See* Bratton, *supra* note 183, at 894; *see also* Smith, *supra* note 182, at 146-47.

187. Smith, *supra* note 182, at 138.

188. *Id.*

ing employment contracts, assisting in additional financing, and influencing exit strategies.¹⁸⁹ The VC/entrepreneur relationship is not purely an agency relationship because it begins with a negotiation.¹⁹⁰ However, in many cases, and particularly in cases where a venture is a liability risk, VCs have superior bargaining power.¹⁹¹ To the extent that VCs are able to negotiate for a lopsided allocation of authority, they start to look like the venture's principal.¹⁹² Here, "control" means the various rights and incentives that VCs contract for when negotiating financing with ventures allowing them to affect business decisions.¹⁹³ These are therefore the elements that need to be addressed to avoid legal liability.

i. Contractual Benefits and Control

Early-stage investors are concerned primarily with two things when negotiating a financing contract: economics and control.¹⁹⁴ Economics and control are precisely the same things that can implicate investors for infringement liability. The right and ability to supervise a portfolio company is informed by how much control the VC negotiates for at the financing stage.¹⁹⁵ Similarly, the degree to which an investor facilitates a portfolio company engaged in infringing activity, in addition to how much knowledge they have about that activity, hinge largely on the amount of control they have over the venture's business model.¹⁹⁶ The economics of a deal not only help inform the extent of the financial benefit that an investor receives, but also help inform the right and ability to supervise to the extent that financing is conditioned more or less on financing on certain activities.¹⁹⁷ The interrelationship between economics, control, and secondary liability create a strong incentive on the part of investors to use the financing negotiations phase to structure their rights and benefits in a way that reduces their liability exposure while maximizing their business objectives and interests.

ii. Economic Provisions

Investors maintain the most fundamental decisions associated with investor-venture relationships: whether to invest and how to invest.¹⁹⁸ In-

189. *Id.* at 137–38, 140–42.

190. *Id.* at 139.

191. Bratton, *supra* note 183, at 897; *see also* BARTLETT, *supra* note 9, § 9.2 ("The real power the investor group has over a cash-poor corporation is economic, not legal.").

192. Smith, *supra* note 182, at 137.

193. *See id.* at 141.

194. FELD & MENDELSON, *supra* note 165, at 32.

195. *See* BARTLETT, *supra* note 9, § 9.2.

196. *See* Baker & Kirsch, *supra* note 138.

197. *See* Smith, *supra* note 182, at 141 ("Venture capitalists exert substantial control over the entrepreneur because of the staged financing that characterizes most venture capital relationships.").

198. *See* BARTLETT, *supra* note 9, § 9.2.

vestors can wield significant economic power over their ventures, especially ESVs with little capital.¹⁹⁹ Secondary liability can extend to investors through their economic relationships with ventures in two broad ways. One is the power of the purse: the affirmative decision to invest and how much to invest.²⁰⁰ The second is through the contractual relationship: the rights and benefits that are written into the financing documents.²⁰¹ Thus, when investing in DCIs that are heavily dependent on UGC, investors should think about how the decision to invest and the structure of an investment might implicate liability on their part.

Even simply the decision to invest may implicate liability for investors. For example, a pre-money valuation communicated to a venture may implicate knowledge of the venture's liability.²⁰² To the extent that a pre-money valuation is based on a sophisticated look into the venture's business model and finances, it will arguably constitute constructive knowledge of infringing activity.²⁰³ The decision to proceed with the investment would likely implicate the facilitation prong of contributory liability to the extent that the investment constitutes a "substantial participation" or encouragement in the infringing activity.²⁰⁴ Thus, perhaps a significantly inflated valuation or a very small equity stake would provide investor protection to the extent that it would fail to constitute substantial participation or material facilitation.²⁰⁵

The structure of the security—whether it be preferred stock, convertible debt, or otherwise—can also implicate liability. For example, preferred stock entitles the investor to certain control rights designed to protect the investor's interests, such as preemptive rights.²⁰⁶ These control rights provide the investor leverage to approve major business decisions and demand a board seat,²⁰⁷ thus giving them the right and ability to supervise infringing activity.²⁰⁸ VCs should also structure their investments in ways that minimize the relationship between the infringing activity and a financial benefit.²⁰⁹ Preferred stock also entails financial benefits:

199. *See id.*

200. *Id.* at 92.

201. *Id.*

202. *See* UMG Recordings, Inc. v. Shelter Capital Partners, 718 F.3d 1006 (9th Cir. 2011) (stating that knowledge can be implied from investors communication to ventures).

203. *See* Arista Records v. Lime Grp., 784 F. Supp. 2d. 398, 432 (S.D.N.Y. 2011).

204. *See* Religious Tech. Center v. Netcom On-Line Commc'n Servs., 907 F. Supp. 1361, 1375 (N.D. Cal. 1995); *see also* Arista Records, 784 F. Supp. 2d. at 425.

205. *Cf.* Perfect 10, Inc. v. Visa Int'l Serv. Ass'n, 494 F.3d 788, 797 (9th Cir. 2007).

206. John F. Coyle & Joseph M. Green, *Contractual Innovation In Venture Capital*, 66 HASTINGS L.J. 133, 150 (2014); *see also* Bratton, *supra* note 183, at 929.

207. *See* Coyle & Green, *supra* note 206, at 150.

208. *See* MGM v. Grokster, 545 U.S. 913, 930 (2005).

209. *See* UMG Recordings, Inc. v. Veoh Networks Inc., No. CV 07-5744 AHM, 2009 WL 334022, at *6 (C.D. Cal. Feb. 2, 2009); *see also* Marshall, *supra* note 166 (considering structuring any investment initially as a loan rather than equity).

a preferred dividend and liquidation preference.²¹⁰ Convertible debt similarly may implicate a financial benefit insofar as it allows the creditor to participate in the upside of the venture with little risk.²¹¹ Also, more complex securities, such as bridge loans and warrants, often contain extra financial benefits compared to more traditional investment contracts, which may implicate the financial benefit prong of vicarious liability.²¹²

VCs also may be subject to secondary liability by virtue of the overall structure and disbursement of their investments. VCs often structure their investments in ways that provide incentives for entrepreneurs to advance the company, while also allowing the VCs to jump ship if things start to go sour.²¹³ Structuring investments in this manner ostensibly means that VCs have control over their ventures' business models.²¹⁴ Thus, this kind of milestone-based staged financing may implicate both the facilitation and right and ability to supervise prongs of secondary liability.²¹⁵ Similarly, vesting schedules are often viewed as control mechanisms, insofar as they put strong incentives on entrepreneurs to continue with the venture and, correspondingly, the business model approved by investors.²¹⁶

iii. Control Provisions

Through the terms of their investments, VCs implement strong control rights as a means both of protecting themselves and monitoring entrepreneurs.²¹⁷ One of the most fundamental forms of control that VCs seek is the board seat.²¹⁸ As a legal matter, a venture's board of directors runs

210. Coyle & Green, *supra* note 206, at 150.

211. *See id.* at 151. (“[C]onvertible notes may be converted into common stock or preferred stock, thereby giving the holder a chance to participate in the upside if a company ultimately achieves a successful exit.”); *see also* Smith, *supra* note 182, at 148 (“[T]he use of convertible securities allows a [VC] to salvage some value from failing ventures and usually specifies that the [VC] may sell its shares at the same time and on the same terms as the entrepreneurs.”).

212. *See Arista Records*, 784 F. Supp. 2d., at 435 (benefits associated with bridge loans or warrant may create a causal connection between the infringing activity and investors); *see also* FELD & MENDELSON, *supra* note 165, at 38 (“Since the bridge loan investor took additional risk, he generally gets either a discount on the price of the equity . . . or warrants that effectively grant a discount . . .”).

213. *See* Smith, *supra* note 182, at 141 (“Venture capitalists usually provide money to entrepreneurs in stages to give entrepreneurs an incentive to advance the company.”); *see also id.* at 148 (“[T]he structure of venture capital investments, particularly the staging of such investments, provides performance incentives to entrepreneurs and allows venture capitalists to abandon investments that are failing.”).

214. Coyle & Green, *supra* note 206, at 151.

215. *See* Smith, *supra* note 182, at 141.

216. *See* FELD & MENDELSON, *supra* note 165, at 50 (“[M]any entrepreneurs view vesting as a way for VCs to control them, their involvement, and their ownership in a company”).

217. *See* Darian M. Ibrahim, *Debt as Venture Capital*, 2010 U. ILL. L. REV. 1169, 1193.

218. BARTLETT, *supra* note 9, § 9.2 (“In negotiating the term sheet, the struggle for power concerns who sits on the board.”); *see also* Coyle & Green, *supra* note 206, at 150.

the business.²¹⁹ In turn, if a board of directors is under the control of a VC or group of VCs, the business is ostensibly “controlled” by the VC or group of VCs. Board control allows VCs to act in their own interest provided, however, that such action is in the interest of the company.²²⁰ Board control by investors is not unheard of; in fact, one empirical study found VC board-control in 25% of cases,²²¹ a percentage that is likely higher in late-stage financings.²²² Most early-stage boards have five board members comprising two VCs, two entrepreneurs, and one outside representative.²²³ Even the ability to add another VC member or to actively influence the outside board member could constitute outright control of the board.²²⁴ Contracting for visitation or attendance rights, which allow VCs to attend but not vote at board meetings, might also imply knowledge of infringing activity.²²⁵

Investor control of the board was the basis of UMG’s claim in *Shelter Capital Partners*. Citing the rather expansive interpretation of contributory liability found in *Fonovisa*, UMG claimed that three VCs made up the majority of a five-person board of directors, which in turn “provided the ‘site and facilities’ for direct infringement by wielding their majority power to direct spending.”²²⁶ The claim failed because there was no allegation that the investors acted in concert to form a majority, but the court also pointed out that “joint control [is] not typically an element of contributory infringement.”²²⁷ Still, *Shelter Capital Partners* stands for the proposition that control of a DCI’s board, whether attributed to a single VC or a syndicate acting in concert, can increase exposure to potential liability.²²⁸ Giving up a board seat might be hard, but investors in DCIs are advised to avoid maintaining control of the board or arranging for control through a syndicate in a way that could be characterized by particularly

219. BARTLETT, *supra* note 9, § 9.2. Among other things, a board of directors has the power to make decisions regarding investment policy, dividend policy, exit strategy, or amending the firm’s charter. See Bratton, *supra* note 183, at 926.

220. When acting on behalf of the company, directors are subject to fiduciary duties. See Ibrahim, *supra* note 217, at 1193.

221. See Bratton, *supra* note 183, at 899 (“One or the other party, VC or E, has control of the board in only 38% of their cases. In this subset, the VC takes control in two-thirds of the cases . . .”).

222. See *id.*

223. FELD & MENDELSON, *supra* note 165, at 62.

224. The ability to add another VC or to influence an outside board member may be considered acting in concert to form control of the board. Cf. UMG Recordings, Inc. v. Shelter Capital Partners, 718 F.3d 1006, 1032 (9th Cir. 2013).

225. See BARTLETT, *supra* note 9, § 9.2.

226. UMG Recordings, Inc. v. Shelter Capital Partners, 718 F.3d 1006, 1032, 1047 (9th Cir. 2013).

227. *Id.* at 1032.

228. Gasner & Miksch, *supra* note 22 (“[T]here is a ‘safety in numbers’.”).

aggressive plaintiffs as cooperation or conspiracy to control the company.²²⁹

Voting rights are another control mechanism that may implicate liability for investors. One study has shown that VCs control a majority of the votes in their ventures in over 70% of cases.²³⁰ VC voting control also tends to be higher in ventures that have yet to become profitable.²³¹ Therefore, because DCIs often take a long time to extract profits from UGC,²³² it is reasonable to assume that VCs investing in DCIs tend to have more voting control. The ability to vote on substantive business issues likely constitutes a direct connection to the venture's activities.²³³ To the extent that VCs exercise their voting control to support business models that facilitate the distribution of infringing material, or fail to exercise their voting control to prevent it, they may be considered to have "control" for purposes of vicarious liability.²³⁴ Similarly, voting may constitute "engag[ing] in personal conduct that encourages or assists infringement."²³⁵

Protective provisions also raise liability concerns. Protective provisions constitute veto rights that investors have on certain actions by the company and are common expectations in term sheet negotiations.²³⁶ Some provisions give VCs veto power over major transactions, such as issuing dividends or selling the company.²³⁷ Other provisions provide VCs with preemptive rights that help guarantee them consistent ownership stakes.²³⁸ Protective provisions have the potential to implicate every element of the secondary liability tests. If VCs are vetoing business decisions but the infringing activity is continuing, they will likely be seen as facilitating and controlling the ventures sufficiently for both secondary liability tests.²³⁹

229. *Id.*

230. Bratton, *supra* note 183, at 899.

231. *Id.*

232. *See, e.g.*, Rob Lever, *10 Years Later, YouTube is a Hit But Faces Challenges*, BUSINESSINSIDER (Apr. 23, 2015, 11:53 AM), <http://www.businessinsider.com/afp-10-years-later-youtube-is-a-hit-but-faces-challenges-2015-4> (discussing the fact that despite a \$1.6 billion acquisition by Google and cultural ubiquity, 90 percent of analysts agree that YouTube is not profitable).

233. *See* Perfect 10, Inc. v. Visa Int'l Serv. Ass'n, 494 F.3d 788, 796 (9th Cir. 2007).

234. *See id.* at 802–03; *see also* MGM v. Grokster, 545 U.S. 913, 930 (2005).

235. A&M Records, Inc. v. Napster Inc., 239 F.3d 1004, 1019 (9th Cir. 2001).

236. FELD & MENDELSON, *supra* note 165, at 64.

237. Ibrahim, *supra* note 217, at 1193.

238. Coyle & Green, *supra* note 206, at 150.

239. *See* Religious Tech. Ctr. v. Netcom On-Line Commc'n Services, 907 F. Supp. 1361, 1374 (N.D. Cal. 1995) (stating that failure to stop infringing conduct from being distributed constitutes substantial participation); *see also* Arista Records v. Lime Grp., 784 F. Supp. 2d 398, 435 (S.D.N.Y. 2011).

Control stakes can be conditioned upon ventures meeting, or failing to meet, certain milestones.²⁴⁰ For example, a term sheet may provide that VCs start out with limited control, but upon the failure to meet certain benchmarks, a larger control stake “flips” back to them.²⁴¹ Similarly, sometimes VCs will start out with significant control that recedes as ventures become more profitable. VCs should negotiate these change-of-control provisions in the financing documents with the secondary liability tests in mind. Thus, VCs should avoid contracting for provisions that give them the legal and practical ability to prevent infringing activity. For example, if a venture’s business model is sufficiently dependent on UGC, a change-of-control provision contingent upon furthering that business model to a certain extent or reaching certain performance benchmarks could imply that the VCs are “facilitating” infringement.

iv. Defensive Maneuvers

VCs can also use the venture financing negotiation process to implement defensive mechanisms that actively shift liability risk away from them. Indemnification provisions, for example, are powerful tools for investors to limit their liability exposure. In *Shapiro*, the court stated that secondary liability was “not unduly harsh or unfair as a third party could have obtained an indemnity agreement.”²⁴² VCs can obtain indemnification on two separate levels: the individual (director) level and the fund level. Director indemnification provisions are commonplace in term sheets, whereas fund indemnification remains optional.²⁴³ Given the potential for expansive DCI liability, VCs are strongly encouraged to negotiate aggressively to obtain the venture’s agreement to indemnify it against any and all losses suffered as a result of copyright infringement.²⁴⁴ Especially if a venture is operating in dangerous territory, they can expect their bargaining position with regards to indemnification to be fairly weak. Still, investors should keep an eye out for carve-outs that block indemnifi-

240. See LEE R. PETILLON ET AL., REPRESENTING START-UP COMPANIES § 7.12 (Supp. 2015) (“One of the thorniest issues in negotiating start-up financing arrangements is a provision for change of control in the event that certain performance benchmarks (e.g., successful development of a prototype, commencement of production, customer acceptance of the product or turning profitable) are not met, or the company defaults in its obligations under the financing agreement.”).

241. BARTLETT, *supra* note 9, at § 9.2 (“Further, the term sheet may provide for a control ‘flip,’ meaning that the investors are content with a minority of the board as long as everything is going well; they succeed to outright control of the board when and as the company gets in trouble, allowing them to tie a can to the founder.”); see also PETILLON ET AL., *supra* note 240 (“Often venture investors will require that the control of the company, normally vested in the founder/management group, switch and vest in the investor group upon occurrence of such a triggering event.”).

242. See *Shapiro*, *Bernstein & Co. v. H. L. Green Co.*, 316 F.2d 304, 308 (2d Cir. 1963).

243. FELD & MENDELSON, *supra* note 165, at 93.

244. Foley, *supra* note 133, at 127.

cation if investors “knowingly” supported or encouraged the infringement.²⁴⁵

Representations and warranties are also a crucial way to shift liability risk away from the investors and towards the financing targets. In the case of unknown infringement, prospective investors should obtain representations and warranties from financing targets specifying that the target both has no knowledge of copyright infringement and that they do not intend to infringe in the future.²⁴⁶ A warranty of no knowledge can help investors avoid liability under a contributory infringement claim by providing evidence that they did not have actual knowledge of infringing activity.²⁴⁷ In the case of known infringing activity, the VC should demand a representation of full disclosure of all known infringements.²⁴⁸ Ideally, the investors would have full knowledge of any infringing activity from their due diligence process, but they should still obtain a contractual representation that the financing target has done its own thorough due diligence to determine whether it is actively contributing to the infringement of third party copyrights.²⁴⁹

Avoiding knowledge of infringing activity is a particularly thorny issue for VCs in negotiating financing contracts. On the one hand, it is reasonable to say that VCs should minimize overt acknowledgments of infringing activity prior to investing. However, VCs have a strong incentive to be fully aware of infringing activity to help encourage monitoring and notice systems in order to prevent future liability issues from flaring up. If a venture is in a position to make changes to its business strategy or product design to reduce liability, VCs should encourage that. Additionally, willful blindness of infringing activity constitutes knowledge for purposes of contributory liability.²⁵⁰ A VC that has a subjective belief of infringing activity occurring and then chooses to avoid learning more about such infringement while moving forward with an investment would be considered willfully blind.²⁵¹ However, negotiating for less control rights in the financing documents may reduce the likelihood of a finding of constructive knowledge. Thus, VCs should understand that affirmatively avoiding awareness of infringing activity is likely not a solution; rather VCs should get representations and warranties from entrepreneurs addressing known and unknown infringement. VCs can instead rely on reduced control to

245. Blevins, *supra* note 105, at 1855.

246. *See* Marshall, *supra* note 166.

247. *See* Proctor, *supra* note 172, at 230.

248. *Id.* at 229–30.

249. Foley, *supra* note 133, at 126–27.

250. *Luvdarts v. AT&T Mobility*, 710 F.3d 1068, 1073 (9th Cir. 2013).

251. *See id.*

limit their liability and should encourage notification and monitoring systems to help establish good faith.²⁵²

Insurance is also a powerful protection device. In the same way that it relied on the availability of indemnification, the court in *Shapiro* justified vicarious liability in situations where a defendant could easily have obtained insurance.²⁵³ VCs are strongly encouraged to obtain insurance coverage for copyright infringement liability prior to engaging in financing transactions.²⁵⁴ Insurance coverage should be on multiple levels: the company level, the fund level, and personal level. Also, VCs should make sure the coverage is broad enough to cover known and unknown copyright infringement liability as well as prior infringement. Potential investors should be aware, however, that insurance can tie their hands: having adequate insurance may make it more difficult to turn down settlement offers from plaintiffs with weak claims.²⁵⁵

Defensive mechanisms such as insurance are useful, but they can only do so much in situations of expansive liability. Expansive insurance coverage may worry limited partners, indemnification agreements will be useless against ESVs that have little capital, and representations and warranties will provide little protection when infringing activity is a known and fundamental aspect of the company's business model. In the clear cases, then, such as Napster and YouTube, the best answer is not to invest.²⁵⁶ In most cases, however, the aforementioned transactional maneuvers should encourage VCs to move forward.

v. Post-Investment Conduct

Once the decision to invest is made and the term sheet negotiations are complete, VCs should continue to adjust their conduct to help reduce the likelihood of finding a causal connection between them and infringing activity.²⁵⁷ VCs should be especially cautious in all communications with entrepreneurs to avoid acknowledging infringing activity.²⁵⁸ VCs should also encourage prompt action in response to notices of infringement and encourage DMCA compliance.²⁵⁹ It is equally important for VCs to stay up to date on the venture's business, monitoring product and business strategy changes so as to be aware when such changes increase or decrease

252. See John T. Williams & Craig W. Mandell, *Winning the Battle, But Losing the War: Why the Second Circuit's Decision in Viacom Int'l, Inc. v. YouTube, Inc. Is a Landmark Victory For Internet Service Providers*, 41 AIPLA Q.J. 235, 274 (2013).

253. *Shapiro, Bernstein & Co. v. H. L. Green Co.*, 316 F.2d 304, 308 (2d Cir. 1963).

254. See Foley, *supra* note 133, at 128.

255. See Carrier, *supra* note 6, at 937.

256. See generally Foley, *supra* note 133, at 126.

257. See Proctor, *supra* note 172, at 230.

258. See Foley, *supra* note 133, at 126.

259. See *id.*; see also Latham, *supra* note 19, at 9.

liability concerns.²⁶⁰ For example, the more UGC becomes integrated with a venture's strategy and revenue model, the more likely that liability will exist.²⁶¹ VCs should also take part in a certain degree of legal positioning. They should work with counsel to stay on top of legal developments regarding investor and DCI liability and should seek advice as to how to best frame their conduct as independent of infringing activity, which may help a court determine that the VC is too tangential a party to be held liable.²⁶²

V. CONCLUSION

The continuing growth of UGC presents enormous opportunity for VCs. Unfortunately, as the prevalence of UGC grows so does the prospect for copyright infringement liability. Investors are not immune from this liability, and current precedent makes the scope of investor liability conspicuously unclear. But the lack of legal clarity should not act as a deterrent to future investment. The traditional tests of secondary liability can form the basis of cautious term-sheet negotiating which can shield investors from implicating themselves in infringing conduct. This approach will help encourage continued investment and innovation in UGC, and will avoid repeating the ramifications of *Napster*.

260. See Marshall, *supra* note 166 (“[I]t will be equally important to continually monitor product changes and business strategies . . .”).

261. See Ginsburg, *supra* note 21, at 579 (“The more infringement becomes integrated into the innovator's business plan, however, the less likely the entrepreneur is (or should be) to persuade a court of the neutrality of its venture.”).

262. See *In re Napster, Inc. Copyright Litig.*, No. C 00-1369 MHP, 2001 WL 36593841, at *2 (N.D. Cal. July 9, 2001).