

## Investors Face Potential Liability for Napster's Copyright Infringement

In a recent decision rejecting a motion to dismiss, the U.S. District Court for the Northern District of California raised the possibility that venture capital and private equity firms and their partners may be sued directly for contributory and vicarious copyright infringement as a result of investments in portfolio companies that are themselves liable for copyright infringement.

On July 14, 2004 in UMG Recordings, Inc. v. Bertelsmann AG, Judge Marilyn Hall Patel rejected a motion to dismiss brought by the primary investors in the music file sharing company, Napster, Inc. (the venture capital firm Hummer Winblad Venture Partners and Bertelsmann AG) in a lawsuit brought by various record companies alleging that the two investors and two partners of Hummer Winblad should be held liable for contributory and vicarious copyright infringement. The U.S. Court of Appeals for the Ninth Circuit had previously found Napster liable for contributory and vicarious copyright infringement arising from the operation of its music file sharing service. Although this decision relates only to copyright infringement, one can envision creative plaintiffs' attorneys using similar arguments with respect to a claim of patent infringement.

### Lessons from the Case

While this decision is not the final resolution of the case, if it were sustained after trial, it could have important consequences for venture capital and private equity funds:

- Funds could be held directly liable for their portfolio companies' infringing activities, although it is not yet clear what level of involvement or control is necessary for liability to attach. The plaintiffs in the case alleged that Hummer Winblad and Bertelsmann had a great deal of control over Napster's infringing activities, but the court explicitly reserved the question of what degree of control was sufficient to state a claim.
- Intellectual property and litigation due diligence would be of even greater importance in venture capital and private equity transactions to assess the risk of intellectual property claims, not only to the business that is being invested in, but also risk to the investing funds themselves. Creative plaintiffs could increase their chances of recovery by involving as many potentially-liable defendants as possible, and funds are particularly attractive deep-pocket defendants.
- Copyright holders continue to aggressively enforce their copyrights in a number of well-publicized actions, including music industry challenges to file sharing services like Grokster and Kaazaa, and actions against universities, students, and other individuals for sharing music files. A decision against the investors in this case could accelerate this sort of litigation against a new class of defendants.

### No Discussion of Corporate Limitation of Liability

A particularly interesting aspect of this case is that the court allowed for liability of investors strictly as a matter of copyright law, without any discussion of corporate law considerations. The court's decision did not address whether, as

shareholders of Napster, Hummer Winblad and Bertelsmann were entitled to limited liability for the actions of the corporation, or whether this was a situation where piercing of the corporate veil was appropriate.

### Level of Requisite Control Unclear

Although Judge Patel ruled that it is possible to state a claim for contributory and vicarious copyright infringement against investors in a company found liable for copyright infringement, the court's ruling expressly reserved the question of what level of investment or control would give rise to such a claim. In the case at issue, the plaintiffs' complaints alleged that Hummer Winblad and its partners Barry and Hummer controlled Napster's board, while Barry also served as Napster's CEO. They also alleged that Bertelsmann, as Napster's only remaining available source of funding, effectively controlled the company, and at one time relatively late in the company's history convened an internal Bertelsmann task force to decide whether Napster should continue its operations.

In explaining its decision, the court reasoned that the plaintiffs did not allege that Hummer Winblad and Bertelsmann merely "aided and abetted" the vicarious and contributory infringement of Napster, (i.e., providing Napster with funding that allowed it to continue to operate). In the Napster litigation, the court had previously rejected claims it termed as "tertiary infringement," where the defendants were accused of vicarious or contributory assistance to a vicarious or contributory infringer. Rather, in this case the plaintiffs had alleged that, in addition to providing funding, both Hummer Winblad and Bertelsmann had assumed control of Napster's operations and directed the infringing activities that gave rise to the original Napster litigation. The court, however, refused to determine whether it was necessary to allege such a significant degree of control in order to state a claim for contributory and vicarious copyright infringement against investors.

### Contributory and Vicarious Copyright Infringement

The music companies' theories of liability against Hummer Winblad and Bertelsmann are that they each engaged in *contributory copyright infringement* by maintaining and facilitating Napster's system for unauthorized copying, and alternatively that it engaged in *vicarious copyright infringement* by virtue of its potential financial gain from the Napster investment, combined with its failure to exercise its authority to curtail the company's infringing activities. These judicially-created theories of liability for copyright infringement are not new, but by suing Napster's investors, the plaintiffs are seeking to extend liability to a new class of defendants. Until the court reaches a decision on the merits providing guidance for avoiding liability is difficult. Investors should assume, however, that exercise of control may expose them to more risk than they may have previously assumed.

### Contact Information

If you are interested in learning more about this evolving area of the law, please call or email your regular Ropes & Gray attorney.

