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Ronald H. Schmidt with Richard Siegel and Michael F. Kelleher

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Commentary

Grokster — New Forms Of Liability At The Doorstep Of VCs And Advertisers?

By
Ronald H. Schmidt
Richard Siegel
and
Michael F. Kelleher

[Editor's Note: Ronald Schmidt is a Principal at LECG, Inc. Dr. Schmidt is a Principal at LECG where he is an expert in quantifying antitrust, commercial, and personal damages. He was formerly a Senior Economist with the Federal Reserve Bank of San Francisco. Richard Siegel is Managing Director at Navigant Consulting, Inc. and has more than 25 years of senior-level experience at a number of international technology companies, including telecommunications, Internet, consumer electronics, computing systems, and industrial automation. Michael Kelleher is a partner at the law firm Folger Levin & Kahn LLP and head of its intellectual property group. Mr. Kelleher's practice involves intellectual property litigation and counseling, complex commercial litigation, and electronic discovery. The views expressed are those of the authors and do not represent positions of LECG, Navigant Consulting, or Folger Levin & Kahn LLP. *Copyright 2007 by authors.* *Replies to this commentary are welcome.]*

On June 27, 2005, the U.S. Supreme Court sharply turned up the heat around copyright issues with its decision in *Metro-Goldwyn-Mayer Studios Inc., et al., v. Grokster, LTD., et al.,* 125 S. Ct. 2764 (2005) ("*Grokster*"). One novel aspect of the decision is a new role for business model evidence: by looking to the business models of Grokster and Streamcast as evidence of contributory copyright infringement, the Court potentially expanded the avenues for copyright liability of venture capitalists and advertisers dealing in the high tech marketplace. By adding the business model to the contributory infringement test, *Grokster* may require firms who fund on-line content and services not directly paid for by the consumer to monitor usage of those services closely. If the service has the *potential* to abuse copyrights, awareness of that possibility by those investing in the venture could be enough to bring a complaint for contributory infringement to their doorstep. This new role for business model evidence may provide plaintiffs another way to try to reach into the deep pockets of VCs and advertisers.

Background

The development of intellectual property law can be described as a tug of war. On one side are the producers of the intellectual property — the writers, musicians, artists, inventors, and the music and film production companies. Pulling on the other end of the rope are the consumers of that intellectual property — consumers and technology firms. The courts have attempted to maintain a fine balance between rewarding the producers who create content, and maximizing distribution of the content to the consumers. The *Grokster* decision shifts the balance in favor of the content producers.

Revisions to the scope of copyright protection are inevitable as technology, products and services evolve. The digital era has dramatically changed the landscape. Before the advent of digital recording and storage media, copying a record or movie onto analog tape was time consuming and required physical media for each copy (i.e., the tape). In addition, the duplica-

tion process resulted in a reduction in quality for each "generation" of copying. Consequently, there were real impediments and costs associated with copyright infringement that reduced those activities.

Now, a song once recorded in digital format can be duplicated without any loss of quality for virtually no cost and transmitted around the globe with almost no investment of time by the person copying that song. This, combined with the ease of conducting peer-to-peer commerce via eBay, PayPal and other channels, has removed the impediments that kept copyright infringement within more reasonable bounds in the past.

This digital revolution has brought tremendous advances to consumers, and at the same time raised major concerns to content producers. Consumers now have the ability to store entire music libraries in their iPOD, incorporate songs into presentations and slide shows, and store and backup movies. In the case of music, movies, and other digital content that is legally obtained, such uses for personal consumption are typically protected by copyright's fair use defense. However, the ease with which the material can be duplicated and transferred makes it very easy for users to duplicate and transfer digital material to others, potentially harming the ability to sell the materials. For example, the number of Napster subscribers exceeded 70 million at its peak in 2001.[1] Consequently, new legal interpretations and technological innovations have become necessary to properly reward innovation and artistic creation.

Public vs. Private Goods

The difficulties facing protection of intellectual property in digital products and services are not unique. Economists have written extensively about "public goods." The distinguishing characteristic of a public good is that it is "non-rival" in consumption, i.e., if one person listens to a song it does not prevent another person from listening to the same song at the same time. This contrasts with most "normal" goods, where if one person consumes it, the other cannot — at least not the same unit.

Digital products, because they can be replicated at virtually zero marginal cost, also exhibit this non-rival characteristic. Consequently, unless there is some way to artificially exclude some customers, market prices for the products would approach zero and there would be little, if any, incentive to produce them. Examples of this exact behavior are prevalent with the worldwide distribution of counterfeit DVD's (the latest movie available in China for $1-2 within hours of release in theaters) and the millions of files "shared" by consumers via peer-to-peer networks such as Kazaa.

'Solving' The Public Goods Problem

Solutions to this problem of under-provision of non-rival goods have emerged in three basic forms. First, government has undertaken provision of some of these products — parks and libraries are examples of this type of provision. In fact, one can point to government sponsorship of the Internet's development as a further example of such public investment.[2]

But in addition to direct provision by the government, two other avenues have been pursued in trying to increase rewards to content creators: technological exclusion and vigorous legal enforcement of copyrights. In both cases, it has been a struggle to find the right balance between rewarding the creator of the intellectual property and providing the greatest access to and benefit of that IP to consumers.

Technological Exclusion

Copy protection has evolved from the early days of video tapes to the introduction of computer software and media to the current panoply of content available in digital form. Providing original content (encompassing audio, video, software applications and games) and ensuring the control of its distribution has been one of the most difficult challenges in building and sustaining a content distribution business.

Historically, copy protection and user rights limitations (that allow a limited number of copies, accesses, or uses of media or applications) have protected the producer of the content. However, the protection system usually introduces some level of complexity or adds steps to the acquisition and use of the media. In early video tape systems, this led to problems playing copy protected tapes on certain players, and interfered with the revenues of legitimate video rental businesses. In more modern systems, stories abound of copy-protected CDs, DVDs, and games causing problems for authorized users. Microsoft, Apple, and hundreds of media and software giants have

found that building a workable content protection system that is "transparent" to the consumer is one of the most difficult challenges in their development environment.

And it has become a war of escalation. As each new digital rights management (DRM) solution is created, an army of hackers is waiting to crack it and publish the exploit to the public, or find ways to derive lucrative revenue streams. Growing sophistication of "uncrackable" encryption systems, user authorization servers (such as Microsoft's Windows Activation process) and proprietary data formats (such as Apple's iTunes AAC audio format) are bringing a bewildering set of challenges to legitimate users who just want to listen to music, watch video or play games.

The balance that designers of modern DRM systems face is how to allow "transparent" access for legitimate users (and uses) of media and applications, while building an impenetrable barrier to those that seek to violate the fair use of the content.

Copyright Enforcement

Unfortunately for copyright owners, it may not be feasible to pursue the individuals who directly infringe copyrighted works. For example, the individual infringers may be too numerous or the infringers may lack assets to pay a judgment. Thus, copyright owners have often targeted companies that facilitate copyright infringement by others. Such lawsuits have a long history, and the defendants charged with aiding copyright infringement by others have included dance hall operators, landlords, swap meet organizers, credit card companies, and the manufacturers of recording equipment.

The Copyright Act does not include a provision for indirect liability, but court decisions have recognized two theories of indirect liability: vicarious and contributory infringement. Vicarious infringement arises when a defendant has the right and ability to supervise the infringing activity and also has a direct financial interest in such activities. Contributory infringement is knowing assistance to an infringer and arises from: (1) direct infringement by a third party; (2) actual or constructive knowledge by the defendant that third parties were directly infringing; and (3) a material contribution by the defendant to the infringing activities.

As technology has developed, courts have struggled to define the scope of indirect liability as applied to new technologies. For example, in its landmark 1984 decision in *Sony Corp. of America v. Universal City Studios,* 464 U.S. 417 (1984), the Supreme Court added the issue of "substantial non-infringing use" to the contributory infringement inquiry. The *Sony* case involved claims that Sony's VCR equipment allowed owners to copy and distribute material, and thus it was liable for contributory infringement. The Supreme Court found that knowledge of infringement by users could not be imputed to Sony because there were substantial non-infringing uses of the technology (i.e., time shifting, where users taped shows to watch later) that were protected by the fair use doctrine. The substantial non-infringing uses of the recorders meant that Sony had not intentionally induced or encouraged infringement.

The *Napster* litigation further defined the boundaries of indirect liability after *Sony*. In its *Napster* decisions, *A&M Records v. Napster*, 239 F.3d 1004 (9th Cir. 2001) and 284 F.3d 1091 (9th Cir. 2002), the Ninth Circuit Court of Appeals affirmed an injunction against Napster on both contributory and vicarious copyright infringement grounds. Napster's claim that there were substantial non-infringing uses under *Sony* — that some of the data transmitted was not violating copyright protection — did not carry the day. In its decisions, the Ninth Circuit agreed with the district court that contributory infringement existed because Napster knew or had reason to know of copyright infringement on its system, and that Napster materially contributed to the infringement by providing a central web site and server. As to vicarious infringement, the Ninth Circuit affirmed the district court's findings that Napster financially profited from the presence of infringing materials on its site due to increased revenues from advertisers, and that Napster had the ability to supervise materials on its site.

Napster's legal problems also snagged its investors. In July 2004, a district court judge ruled that plaintiffs could pursue claims of vicarious and contributory infringement against Bertelsmann and Hummer Winblad, investors who were alleged to have controlled Napster and allowed it to continue providing infringing copies to users.

The *Grokster* case arose from services that tried to fill the gap created when Napster was shut down. The

new services, Grokster and Streamcast, mimicked Napster's functionality by allowing users to search for and copy files from the computers of other users, but attempted to avoid Napster's fate by not maintaining a central server. These differences allowed Grokster and Streamcast to prevail in the Ninth Circuit, where the court found the defendants not liable for contributory or vicarious copyright infringement. 380 F.3d 1154 (9th Cir. 2004).

The Supreme Court, in overturning the Ninth Circuit's *Grokster* decision, found that the lower court's application of the *Sony* principle was overbroad, and that defendants were potentially liable for contributory copyright infringement. The Supreme Court declined to further define *Sony's* substantial non-infringing use test, instead holding that the test was inapplicable in light of evidence that Grokster and Streamcast had actively encouraged and induced copyright infringement by their users.

In deciding *Grokster*, the Supreme Court relied only upon the theory of contributory infringement and expressly declined to reach vicarious infringement. However, despite forswearing vicarious infringement and its test of whether defendants profited from infringement, the Supreme Court nevertheless looked to the business model of the services in considering contributory infringement. The Court observed that the business model supported a finding of knowledge of infringement because the profitability of the venture depended on volume of use, and the volume was driven largely by infringing uses.

The *Grokster* Court's examination of the business model potentially expands the scope of contributory infringement liability by importing the "profit" element of the vicarious liability test without the corresponding "control" limitations of that test. Before the *Grokster* decision, business models were examined by courts only as part of the test for vicarious copyright infringement, i.e., in deciding whether a defendant profited from a third party's infringement. Vicarious infringement liability required a further showing, however, that defendant had the right and ability to supervise or control the third party's activity. This second part of the test, control, is missing from the *Grokster* analysis. In effect, the Supreme Court created a hybrid test for third party liability by marrying the business model/profit examination from vicarious liability with the material contribution test of contributory liability. The result is the potential for more liability for investors and advertisers.

Implications Of Grokster For Third Party Liability

In its *Grokster* opinion, the Supreme Court gave new prominence to the role of the business model used to distribute the content.

A wide variety of business models are emerging in the digital world. We distinguish between two basic types — user-pay, and third-party-pay systems.

User-Pay Business Models

- Traditional pay-per-use, involving providing limited access to specific digital content for a specific amount of usage (number of plays, views, uses). Here exclusion is made possible because of the mechanisms incorporated into either the media itself (for example, embedding "tags" into the content that carry the licensed usage information, associated with players that read and track usage) or within a software application that may have a limited use window (e.g. "30-day free trial" versions of software that will be disabled unless the activation code is purchased and entered into the application).

- Pay for download, where the user pays a fee to download the data or content, which may include technological features preventing or limiting copying. Examples include legitimate MP3 audio files, iTunes music, stock photography, fonts, and e-books. These pay-per-download items may contain embedded copy protection to ensure that the original downloader is the only possible user of the media.

- Subscription services, where the user has limited or unlimited access to the content or applications, and must pay to continue to maintain access and usage. Examples include Anti-Virus subscriptions (Norton Anti-Virus, McAfee, etc.), Internet Service Providers (AOL, Yahoo, etc.), media content (iTunes, satellite radio, news websites, Yahoo!Music, pornography websites, etc.). Even conventional software vendors of products such as Microsoft Office

and Autodesk AutoCAD are embracing the possibilities of subscription-based "application services."

Third-Party-Pay Business Models

- Direct advertising, where third-party advertisers supply ads and provide the revenue stream for the service provider. Similar to newspapers and magazines, which are subsidized by advertising revenues, these business models charge little or nothing to the consumer for access to the content, but depend on indirect sales of advertised products or services to generate revenues for their advertisers. Examples include Yahoo, AOL, and MSN websites.

- Indirect advertising, where the service provider captures addresses and preferences to sell to advertisers who might then directly contact the users. Examples of this model include most services that collect the user's email address and personal information for legitimate uses of a service or information source, then (either legitimately via the use of "opt-in" or "opt out" user selection or illegitimately through direct resale of the information) can monetize the use of this information to third-party advertisers who promote their goods or services.

Infringing And Non-Infringing Uses

This taxonomy of business models provides a roadmap in applying *Grokster*. In the user-pay cases, the seller is either the creator of the content, or would pay royalties to the content creator or provider. Moreover, the seller has the incentive to minimize copyright infringement resulting from transfers by the buyers to other potential users, since that reduces the seller's potential profit. Consequently, in the user-pay business models, the sellers strive to erect barriers to downstream copying and transferring of the digital material, whether by technological (e.g. DRM) solutions or by issuing threats of lawsuits against users identified as transferring the material. These mechanisms, while imperfect, have proven to be increasingly effective in providing both fair use and high levels of copy protection (for example, Apple iTunes).

The major problems arise, therefore, in the business models that rely on third-party payers. In such cases, where profits are generated by advertising or selling the information on preferences and buying habits to other parties, defendants have always faced an argument that they could be vicariously liable because they profit from infringement. In facing this argument, a defendant would likely try to argue that it had no ability to control or supervise the service, so that the second prong of vicarious infringement is absent.

Now, defendants involved in third-party payer model business will also face a strengthened contributory infringement argument as plaintiffs argue that the business model is evidence that defendants actively encouraged copyright infringement. This will force such defendants to present other evidence that infringement was not encouraged,[3] or that they did not "materially contribute" to infringement.

A New Way To Reach 'Deep Pockets'

Recovery of damages in copyright infringement can be difficult, particularly in third-party-payer business models where the assets of the service provider being sued are limited. With the *Grokster* decision's new emphasis on the business model as evidence of contributory infringement, however, plaintiffs have another argument for looking upstream from the service performing the transfer to the advertisers and investors in that service for further compensation.

Advertisers

A primary potential target for plaintiffs is the advertisers supporting these businesses. In cases such as *Grokster*, advertisers who actively support a file transfer service that can involve substantial infringement may themselves be liable. Particularly, if the types of advertisements can be reasonably shown to attract or correlate with users most likely to infringe, such evidence would be presented as an indication that the advertisers knowingly supported a service and benefited indirectly from copyright infringement. Marketing plans developed by the agencies that target users who can be linked to copyright infringement would provide such evidence.

Advertisers in a business using a third party payer model must now consider how to avoid claims for both vicarious and contributory infringement. For vicarious infringement, the third party payer model could arguably be evidence that advertisers financially benefit from the infringing activity because the volume

of ad viewers may increase as the volume of copyrighted works increases. To avoid vicarious infringement, the advertiser will want to develop evidence that it has no right or ability to supervise the infringing activity. For contributory infringement, the advertiser should consider developing proof that infringement is not encouraged in order to countervail the use of the business model as evidence of knowledge of infringement. Moreover, the advertiser should consider whether it "materially contributes" to the infringement, perhaps by the volume of its ad buys.

VCs / Investors

In a similar vein, venture capitalists and investors who fund businesses that facilitate copyright infringement may also be liable. As discussed above, some of the investors in Napster currently face such claims due to their alleged control of pre-shutdown operations. In the wake of *Grokster*, allegations are likely to point to the business model and exit strategy for investors — to what extent does the business success depend on volume generated by infringing uses to succeed? If such volume is significant, and the service/business would not be likely to succeed in its absence, such investors may face allegations for contributory infringement.

As discussed above with respect to advertisers, investors should consider strategies to avoid both vicarious and contributory infringement claims. As to vicarious infringement, a third party payer model may mean that investors profit from infringing activity. Thus, investors should try to avoid the second prong of vicarious liability by either avoiding control of a third party payer business (which could increase the risk of the investment), or if investors assume control, exercising such control to avoid infringement by users.

As to contributory infringement, an investor in the post-*Grokster* world should consider whether a business encourages or discourages copyright infringement by its users by due diligence consideration of the operation of the technology, advertising, technical support and public statements. Investors should also consider the *Sony* question of whether knowledge of infringement can be imputed in the absence of substantial non-infringing uses for the technology. Finally, investors should also consider whether they materially contribute to infringement, perhaps through control of the business as alleged in the litigation against the Napster investors.

Conclusions

The *Grokster* decision provides a new threat to entities that help fund a business model where infringement by customers and users is likely. If the business model can be shown to depend to some extent on volume driven by infringing uses, the liability conferred on the funding sources — advertisers and investors — is likely to be addressed.

Footnotes

1. Sherry, Edward F., "The Napster Controversy: Intellectual Property and Economic Analysis," *LECG Perspectives*, Vol 2, No. 4, LECG, Inc., October 2001.

2. The Internet remains essentially a public provision resource today – along the lines of "open source" – it is owned and operated in a collaborative fashion by a number of both private and government resources, worldwide.

3. The Supreme Court's *Grokster* opinion lists other factors beyond the business model that led to a finding that Grokster and Streamcast induced infringement. For example, Grokster's employees routinely responded to questions asking how to perform various actions involving copyright infringement and were given instructions to allow this. Grokster and Streamcast also encouraged the downloading and distribution of copyrighted material by targeting former Napster users and planning for advertising that featured the availability of copyrighted works. ■