UMG Recordings, Inc. v. Veoh Networks, Inc.: The Future of Investor Liability for User-Generated Content

Liz Brodzinski

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UMG RECORDINGS, INC. V. VEOH NETWORKS, INC.:

THE FUTURE OF INVESTOR LIABILITY FOR USER-GENERATED CONTENT

I. INTRODUCTION

Since the fame and subsequent explosive demise of Napster as an illicit peer-to-peer file sharing phenomenon, global use of the internet for media storage and retrieval has continued to skyrocket.1 Never far from the front page, intellectual property issues in web media content were brought once again to the forefront of the nation’s consciousness with Viacom and Google’s recent battle over YouTube content.2 As the online market continues to expand, and websites hosting user-generated content continue to crop up at a rate surpassed only by the increasing numbers of users, intellectual property liability is becoming a growing concern for those providing users the online space with which to store and share their media.

Recently, in UMG Recordings, Inc. v. Veoh Networks, Inc.,3 the Central District of California in the Ninth Circuit made a statement about the limits of liability for investors. This note will advocate


2. Greg Sandoval, Viacom, YouTube Inch Toward Courtroom Showdown, CNET News, Jan. 7, 2010, http://news.cnet.com/8301-31001_3-10429617-261.html (“Viacom accuses YouTube of encouraging copyright and profiting when users upload unauthorized TV and movie clips. That the two sides are preparing for summary judgment is a sign that the nearly 3-year-old and closely-watched copyright fight is finally nearing some kind of closure.”) (emphasis added).

that, while the legal support behind that statement could be stronger, continuing to limit liability for investors is the correct decision for a number of policy reasons. However, because policy is always open to varying interpretations, Congress should amend existing copyright law in order to create a more predictable investment environment in terms of infringement liability.

Part II of this article covers the background leading up to *UMG v. Veoh*, including: (a) a foray into the various theories of secondary copyright infringement liability; (b) a discussion of the current issues for those who invest in websites hosting user-generated content, with a brief description and history of the Digital Millennium Copyright Act’s “safe harbor” provisions; and (c) a discussion of the *Napster-Grokster-Aimster* trilogy and resulting developments in the changing landscape of user-generated content. Part III features a brief history of the legal skirmishes between Universal Music Group and Veoh, followed by a summary of the most recent substantive investor-related opinion in *UMG v. Veoh*; and Part IV will analyze the *Veoh* opinion in light of the recent history of litigation involving websites hosting user-generated content and public policy. Finally, Part V of this article will forecast the future of investor liability for websites hosting user-generated content and endorse the need for further Congressional consideration of the investor liability question in the form of an amendment to the Digital Millennium Copyright Act.

II. BACKGROUND

A. Theories of Secondary Liability

1. Contributory Infringement Liability

Contributory infringement liability is derived from the concept of enterprise liability in tort law. The accepted standard for

4. See Demetriades v. Kaufman, 690 F. Supp. 289, 292 (S.D.N.Y. 1988) ("In delineating the contours of this third-party liability, and because copyright is
contributory infringement dictates that liability will arise if the defendant "(1) has knowledge of the infringing conduct and (2) 'induces, causes, or materially contributes to the infringing conduct.'" There are two general types of actions that yield such liability: "(a) personal conduct that forms part of or furthers the infringement; or (b) the contribution of machinery or goods that provide the means to infringe."6

Recently, A&M Records, Inc. v. Napster, Inc. (Napster II)7 demonstrated that a system operator is liable for the infringing material put on his system by others only when he learns about specific infringing material. Without actual or constructive knowledge of the specific infringing activities, the system operator "cannot be liable for contributory infringement merely because the structure of the system allows for the exchange of copyrighted material."8

2. Vicarious Infringement Liability

This rationale for holding a party liable for another's infringing acts has roots in the doctrine of respondeat superior.9 Modern cases such as Fonovisa, Inc. v. Cherry Auction, Inc.10 show that vicarious liability is no longer confined to the traditional limits of


10. Id.
respondeat superior." A defendant is vicariously liable after direct infringement takes place when that defendant "(1) had 'the right and ability to supervise the infringing activity,' and (2) had an obvious and direct financial interest in such activities." Neither intent to infringe, nor knowledge of infringement, is required.

In Fonovisa, the defendant, Cherry Auction, operated a flea market, or "swap meet," in which third-party vendors sold counterfeit copies of music, infringing the plaintiff's copyrights and trademarks. The United States Court of Appeals for the Ninth Circuit reversed the district court's dismissal of Fonovisa’s complaint, finding, inter alia, that Cherry Auction would likely be held liable under the doctrine of vicarious liability, both for having a right to supervise its vendors – due to Cherry Auction’s broad contractual right to police its vendors – and for knowingly benefitting from its vendors’ infringement. While Cherry Auction did not obtain a direct commission from the vendors’ receipts, "the sale of pirated recordings at the Cherry Auction swap meet was a 'draw' for customers," from which Cherry Auction derived concession sales, as well as admission and parking fees.

Thus, Fonovisa demonstrates that, although the right and ability to supervise may be most apparent in the employer-employee relationship, it can extend to other supervisory relationships when the supervisory and financial interest elements are fulfilled. The policy behind vicarious liability is to prevent genuine infringers from hiding behind "dummy" entities; however, the actual standard of oversight required to create liability in these cases does not require such a high level of intent. As the Second Circuit

11. Henning, supra note 5, at 179.
12. Id. at 180.
14. Fonovisa, 76 F.3d at 261.
15. Id. at 263.
16. Id.
17. Henning, supra note 7, at 181.
18. See Shapiro, Bernstein & Co. Inc., v. H. L. Green Co., 316 F.2d 304, 309 (2d Cir. 1963). The Second Circuit reached the conclusion that "in many cases, the party found strictly liable is in a position to police the conduct of the 'primary' infringer" adding "[w]here we to hold otherwise, we might foresee the
once articulated in the context of the use of copyrighted music at a dance hall, vicarious liability can be found "whether or not the proprietor has knowledge of the compositions to be played or any control over their selection."\textsuperscript{19}

This application of this policy was demonstrated by the Ninth Circuit in \textit{Napster II}, when the court concluded that the file-sharing company Napster was vicariously liable for its users' infringement because it met the classical elements for vicarious liability: (1) Napster, Inc.'s users directly infringed the copyrights; (2) Napster had the right and ability to supervise its users' conduct and failed to do so; and (3) Napster's "future revenue was directly dependent upon increases in user base."\textsuperscript{20} Thus, as Napster derived no significant revenue from its business model, it appears that, under \textit{Napster II}, the promise of future revenue is an adequate benefit upon which to base the imposition vicarious liability.\textsuperscript{21}

\textbf{3. Inducement to Infringement Liability}

A third form of secondary liability was introduced in \textit{Metro-Goldwyn-Mayer Studios, Inc. v. Grokster, Ltd.},\textsuperscript{22} when the United States Supreme Court adopted an inducement test for contributory infringement liability, declaring that, "one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties."\textsuperscript{23} In order to create this new rule, the Court looked to patent law for guidance and found a suitable solution in the prospect -- not wholly unreal -- of large chain and department stores establishing 'dummy' concessions and shielding their own eyes from the possibility of copyright infringement, thus creating a buffer against liability while reaping the proceeds of infringement". \textit{Id.}

\textsuperscript{19} \textit{Id.} at 307.

\textsuperscript{20} \textit{Napster II}, 239 F.3d 1004, 1023-24 (9th Cir. 2001) (noting that the element of financial benefit can be proven with infringement that "enhances the attractiveness of a venue" (citing \textit{Fonovisa}, 76 F.3d 259, 263-64 (9th Cir. 1996))).

\textsuperscript{21} Henning \textit{supra} note 5, at 182.

\textsuperscript{22} 545 U.S. 913 (2005).

\textsuperscript{23} \textit{Id.} at 936-37.
patent law theory of intentional inducement of infringement liability. 24 The Court explained that, under the theory of intentional inducement, a party is liable when it engages in “purposeful, culpable expression and conduct” that promotes and encourages the infringing uses of its product, not when it has “mere knowledge” of infringement. 25 Intent can be derived from “active steps . . . taken to encourage direct infringement,” such as advertising. 26

As the need has arisen, courts have continued to refine the standards for assessing secondary liability in copyright cases, and Congress has pursued statutory codification of many standards. The Digital Millennium Copyright Act is an example of one such Congressional action.

B. The Digital Millennium Copyright Act

Congress enacted the Digital Millennium Copyright Act (DMCA) 27 in 1998 in response to the increased availability of illegal file-sharing methods on the web and the unprecedented legal issues associated with the litigation begotten by such methods. 28 The two principal reasons the DMCA was promulgated were: (1) to appease copyright owners’ fears that their material would be spread across the entire digital community; and (2) to affirm the ratification of the World Intellectual Property Organization (WIPO) treaties. 29

Title II of the DMCA, the “Online Copyright Infringement Liability Limitation Act,” 30 addresses the liability of Internet
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Service providers (ISPs) for copyright infringement. By acting in accordance with certain prerequisites, an ISP will avoid liability for monetary damages for various copyright infringement claims. ISP compliance with the Act further limits equitable and injunctive relief.

Title II specifically enumerates four limitations on ISP liability. These four parts of Section 512 are commonly referred to as the "DMCA Safe Harbor Provisions." Section 512(a) applies to ISP liability for the transmission of infringing material over its network. Section 512(b) covers liability for system caching, which refers to "the intermediate and temporary storage of material on a system or network" controlled by the ISP. Section 512(c) addresses liability for copyrighted information that "resides on a system or network" controlled by the ISP. Finally, section 512(d) deals with liability for providing information location tools, such as directories, indices, references, pointers, or hypertext links.

To qualify for these safe harbor provisions, the ISP must have a policy for terminating repeat offenders, and must notify account holders of this policy. The ISP also must not interfere with standard technical measures used by copyright owners to identify or protect copyrighted works. Some of the specific safe harbors have additional requirements. For example, to be free from liability under sections 512(c) and 512(d), the ISP cannot have actual knowledge of the infringement or be "aware of facts or circumstances from which infringing activity is apparent." In

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31. Fitzdam, supra note 28, at 1089.
33. Id. § 512(j).
35. Id. § 512(a).
36. Id. § 512(b)(1).
37. Id. § 512(c).
38. Id. § 512(d).
40. Id. § 512(i)(1)(B).
41. Id. §§ 512(c)(1)(A)(i)-(ii), (d)(1)(A)-(B).
addition, the ISP must not receive direct financial benefits from the infringing activity.\textsuperscript{42} Further, to avoid liability under sections 512(b), 512(c), and 512(d), upon receiving notice, the ISP must respond "expeditiously to remove, or disable access to, the material that is claimed to be infringing or to be the subject of infringing activity."\textsuperscript{43} Shortly after its adoption in 1998, a number of courts across the country began to rely on the DMCA as file-sharing sites such as Napster sprang up.

\textbf{C. The Napster-Grokster-Aimster Trilogy}

In the fall of 1998, Northeastern University freshman Shawn Fanning developed MusicShare, the peer-to-peer file-sharing software that was publicly released in the summer of 1999 and formed the basis of Napster, Inc.\textsuperscript{44} Over fifty million people were using MusicShare by the time the Ninth Circuit issued its injunction.\textsuperscript{45} "Faced with a vast amount of allegedly infringing activity taking place by the software's users, A&M Records and seventeen other record companies sued Napster for vicarious and contributory copyright infringement liability in December 1999 . . .\textsuperscript{46}"

The Northern District of California concluded "that facilitating the unauthorized exchange of copyrighted music was a central part of Napster, Inc.'s business strategy from the inception."\textsuperscript{47} The court granted the plaintiffs' motion for a preliminary injunction and enjoined Napster from operating as a facilitator of copyrighted music exchange.\textsuperscript{48} The Court of Appeals for the Ninth Circuit affirmed the "district court's conclusion that plaintiffs had demonstrated a likelihood of success on the merits of their contributory copyright infringement claim."\textsuperscript{49} The court further

\textsuperscript{42} Id. §§ 512(c)(1)(B), (d)(2).
\textsuperscript{43} Id. §§ 512(b)(2)(E), (c)(1)(C), (d)(3).
\textsuperscript{44} Henning supra note 5, at 167-68.
\textsuperscript{45} Id. at 168.
\textsuperscript{46} Id. at 169 (citing A & M Records, Inc. v. Napster, Inc. (\textit{Napster I}), 114 F. Supp. 2d 896 (N.D. Cal. 2000).
\textsuperscript{47} \textit{Napster I}, 114 F. Supp. 2d at 918.
\textsuperscript{48} Id. at 927.
\textsuperscript{49} \textit{Napster II}, 239 F.3d 1004, 1022 (9th Cir. 2001).
concluded that Napster had materially contributed to its users' infringing activities by providing and monitoring the "site and facilities" for direct infringement.\(^50\) A number of peer-to-peer file-sharing software companies rushed to fill the file-sharing void left by the fallen Napster, and studios and media conglomerates hastened to follow in the successful legal footsteps of A&M Records and its peers.

Grokster was one such peer-to-peer file-sharing software company. In *Grokster*, a bevy of entertainment companies jointly filed a complaint against Grokster for contributory and vicarious copyright infringement.\(^51\) The entertainment plaintiffs alleged that, like Napster before it, Grokster distributed peer-to-peer file-sharing software to end-users who then employed the software to illegally share the plaintiffs' copyrighted material with others.\(^52\) The litigation went through a number of iterations, until the United States Supreme Court unanimously vacated the Ninth Circuit's judgment in its 2005 decision.\(^53\) The decision upheld a grant of partial summary judgment in favor of Respondents, Grokster and StreamCast.\(^54\) In doing so, the Court adopted an inducement liability rule that holds the distributor of a product contributorily liable for users' infringing activities when the distributor promotes the use of the product to infringe copyrights—as demonstrated by clear expression or affirmative steps to cultivate infringement—regardless of the product's lawful uses.\(^55\)

In *In re Aimster Copyright Litigation*,\(^56\) the Seventh Circuit employed five factors to gauge contributory copyright liability: (1) the ongoing relationship between the vendor and the users; (2) the balance between infringing and noninfringing uses; (3) any willful blindness on the part of the vendor; (4) the cost to the vendor to

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50. *Id.* ("[W]ithout the support services defendant provides, Napster users could not find and download the music they want with the ease of which defendant boasts." (quoting *Napster I*, 114 F. Supp. 2d at 919-20).
51. MGM Studios, Inc. v. Grokster, Ltd. 545 U.S. 913, 941 (2005); see also Henning, *supra* note 5, at 167.
53. *Grokster*, 545 U.S. at 941.
54. *Id.*
55. *Id.* at 936-37.
56. 334 F.3d 643 (7th Cir. 2003).
avoid the infringement; and (5) the probability of actual noninfringing uses. In concluding that, in copyright law, “willful blindness is knowledge,” Judge Posner treated the encryption built into Aimster’s system as purposeful shielding from the infringement Aimster knew to be occurring. Thus Judge Posner adopted a “knowledge rule” that holds distributors liable if they knew or should have known of infringing activity. The court ultimately affirmed an injunction against Aimster, concluding that at trial Aimster would likely be liable for contributory infringement.

While the litigious history of secondary liability had been expanding, the three concepts of secondary copyright liability had never been applied on a tertiary level when UMG v. Veoh was decided.

III. SUBJECT OPINION: UMG RECORDINGS, INC. V. VEOH NETWORKS, INC.

A. Facts

Universal Music Group (UMG) is a company comprised of two core businesses: recorded music and music publishing. “The company discovers, develops, markets, and distributes recorded music through a network of subsidiaries, joint ventures and licensees in 77 countries, representing 98% of the music market.” UMG also sells, distributes, and licenses music videos, DVD products, and recordings. UMG’s music publishing company, Universal Music Publishing Group, owns and acquires rights to

58. In re Aimster Copyright Litig., 334 F.3d at 650.
59. Id. (emphasis added).
60. In re Aimster Copyright Litig., 334 F.3d at 653.
62. Id.
63. Id.
musical compositions and licenses them for use in recordings, films, and advertisements.  

Veoh is an online video service that gives users with a broadband connection free access to a substantial amount of TV and film studio content, independent productions, and user-generated videos on the Web. Content ranges from series on CBS, ABC, and MTV Networks to Warner Bros., Sony Pictures and ESPN, to “your favorite YouTube clips.” Veoh’s search capabilities and recommendations engine help users find videos that they choose to search for as well as discover recommended content based on user preferences.

**B. Procedural History**

On August 9, 2007, Veoh Networks, Inc. commenced a declaratory judgment action against UMG Recordings and other UMG-affiliated companies seeking a declaration of non-infringement of UMG’s copyrights, principally under § 512(c) of the Digital Millennium Copyright Act (DMCA). The United States District Court for the Southern District of California granted UMG’s motion to dismiss the complaint, citing the lack of an adequately defined controversy to support federal jurisdiction. The court noted that Veoh’s lack of specificity about what copyrights UMG owned and which of Veoh’s material was infringing meant that Veoh was essentially seeking to preempt any possible future suits for infringement of any of UMG’s materials—a rather far-reaching holding in light of the increasing probability of infringement on the internet. However, Veoh’s complaint was

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64. *Id.*  
66. *Id.*  
67. *Id.*  
69. *Id.* at 1268-69.  
70. *Id.* at 1269-70. (The court further noted that “because Plaintiff does not reference any specific copyright, even by way of example, the relief requested would necessarily take the form of an advisory opinion. Succinctly, the Court
dismissed without prejudice—an acknowledgement by the court of the likely continuation of litigation between UMG and Veoh.\textsuperscript{71}

Indeed, Veoh executives' fears of a future infringement suit from UMG were substantiated almost immediately when UMG sued Veoh for direct, contributory, and vicarious copyright infringement, and for inducement to copyright infringement in early September 2007.\textsuperscript{72} Veoh responded by asserting an affirmative defense under the DMCA's "safe harbor" provisions.\textsuperscript{73} UMG filed for partial summary judgment on the issue that Veoh was not entitled to an affirmative defense under one of the safe harbors, codified at 17 U.S.C. § 512(c).\textsuperscript{74} The defense at issue precluded imposing monetary liability on a "service provider . . . for infringement of copyright by reason of the storage at the direction of a user of material that resides on a system or network controlled or operated by or for the service provider," but only if the service provider fulfills a number of statutory requirements.\textsuperscript{75}

UMG challenged four specific software functions performed by Veoh as infringing its copyrights: "(1) automatically creating 'Flash-formatted' copies of video files uploaded by users; (2) automatically creating copies of uploaded video files that are comprised of smaller 'chunks' of the original file; (3) allowing users to access uploaded videos via a technology called 'streaming;' and (4) allowing users to access uploaded videos by downloading whole video files."\textsuperscript{76} The California district court concluded that each of these functions was "narrowly directed toward providing access to material stored at the direction of users," and affected only the form, and not the content, of the videos.\textsuperscript{77} The court thus denied UMG's motion for partial summary judgment on Veoh's safe harbor defense in December

\textsuperscript{71} Id. at 1270.

\textsuperscript{72} Veoh III, 2009 U.S. Dist. LEXIS 14955, at *2.

\textsuperscript{73} UMG Recordings, Inc. v. Veoh Networks, Inc. (Veoh II), 620 F. Supp. 2d 1081, 1082 (C.D. Cal. 2008).

\textsuperscript{74} Id.

\textsuperscript{75} Id.

\textsuperscript{76} Id. at 1083.

\textsuperscript{77} Id. at 1092.
UMG made short work of continuing its litigious saga with Veoh, and filed its First Amended Complaint (FAC) on August 26, 2008, naming three of Veoh’s investors as defendants ("Investor Defendants") on all of the secondary liability theories included in the original complaint against Veoh.79

C. Motion to Dismiss UMG’s First Amended Complaint

The United States District Court for the Central District of California granted Veoh’s Rule 12(b)(6) motion to dismiss UMG’s FAC on February 2, 2009.80 The court considered each of UMG’s theories of liability as separate issues, the first being whether the investor defendants were liable for contributory copyright infringement.81 The second issue was whether the investor defendants were vicariously liable for copyright infringement,82 and the third issue was whether the investor defendants were liable for inducing copyright infringement.83

1. The District Court’s Analysis in Veoh III

In its analysis, the court noted that all of the causes of action against the Investor Defendants were based on theories of secondary liability premised on thus far unproven allegations that Veoh and its users directly infringed UMG’s copyrighted works.84 The Court went on to analyze each theory of secondary liability separately.85

78. Id.
79. Veoh III, 2009 U.S. Dist. LEXIS 14955, at *2. The original complaint alleged the defendants were liable for contributory and vicarious copyright infringement, as well as inducement of copyright infringement. Veoh II, 620 F. Supp. 2d 1081, 1082 (C.D. Cal. 2008).
81. Id. at *8-9.
82. Id. at *14-17.
83. Id. at *17-18.
84. Id. at *8.
85. Id. at *9-19.
a. Contributory Copyright Infringement

The Court cited the rule from *Napster* that “[t]o be liable for contributory copyright, the defendant must have knowledge or reason to have knowledge of direct infringement *and* must provide material assistance to the infringer.”86 According to the court, the FAC alleged that the Investor Defendants had actual knowledge of direct infringement, but did not sufficiently allege that they gave material assistance in achieving it.87 Essentially, UMG attempted unsuccessfully to allege that the Investor Defendants sought and obtained control of Veoh “knowing full well that the site displayed and distributed copyrighted works without appropriate licenses, and knowing full well that Veoh’s users used Veoh to engage in massive copyright infringement.”88 However, Judge A. Howard Matz was unpersuaded by this argument, citing UMG’s lack of specific allegations of the Investors’ significant involvement in Veoh’s workings.89

Judge Matz was not convinced by UMG’s various assertions regarding the Investor Defendants’ control over the company as members of the board of directors, or UMG’s attempts to analogize *Veoh* to *UMG Recordings, Inc. v. Bertelsmann AG, et al.*,90 in which investors in Napster were held liable for contributory copyright infringement.91 In holding that there were no sufficient allegations of contributory copyright infringement in the present case, the Judge distinguished *Bertelsmann*, noting that in that case, Bertelsmann was Napster’s “only available source of funding,” Napster had already been found guilty of copyright infringement, and Senior Bertelsmann management directed Napster to stay operational while infringing in order to preserve its

88. *Id.* at *9* (citing UMG’s First Am. Compl. 5, Aug. 26, 2008).
90. 222 F.R.D. 408 (N.D. Cal. 2004).
customer base.\textsuperscript{92}

\textit{b. Vicarious Copyright Infringement}

The court took its cue from \textit{Napster} again, stating that “[a] party may be vicariously liable if it has the right and ability to supervise the infringing activity, and has a direct financial interest in the infringing activities.”\textsuperscript{93} Here, the court did not address whether the FAC sufficiently alleged that Investor Defendants had the right and ability to supervise Veoh’s directly infringing conduct, because the court found that UMG failed to establish that the Investor Defendants had a direct financial interest in the allegedly infringing activities.\textsuperscript{94}

UMG cited \textit{Fonovisa, Inc. v. Cherry Auction, Inc.},\textsuperscript{95} as its only binding authority; however, in that case, the revenue from the flea-market of infringing goods flowed directly from customers to the flea-market’s owners.\textsuperscript{96} In contrast, the court in \textit{Veoh} concluded that any alleged financial benefit the Investor Defendants might someday hope to obtain would not come directly from Veoh’s users or from Veoh’s advertisers, but rather from a potential future sale of Investors’ stock in the company.\textsuperscript{97} Since the financial benefit was “too far removed to be considered a ‘direct’ financial interest,” the court held that allegations of vicarious copyright infringement were insufficient to withstand a motion to dismiss.\textsuperscript{98}

\textit{c. Inducement to Infringe Copyright}

The inducement to infringe copyright standard was first articulated in \textit{Grokster}, and was used again by the court in \textit{Veoh III}: “Inducement to infringe copyright requires distribution of a

\begin{footnotes}
\item[92] Id. at *12 (citing UMG Recordings, Inc. v. Bertelsmann AG, 222 F.R.D. 408, 412-13 (N.D. Cal. 2004)).
\item[93] \textit{Veoh III}, 2009 U.S. Dist. LEXIS 14955, at *14 (quoting \textit{Napster}, 239 F.3d 1004, 1022 (9th Cir. 2001)).
\item[95] 76 F.3d 259 (9th Cir. 1996).
\item[96] \textit{Veoh III}, 2009 U.S. Dist. LEXIS 14955, at *15.
\item[97] Id. at *17.
\item[98] Id.
\end{footnotes}
device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement." Regarding this theory of secondary liability, Judge Matz found that UMG failed to allege that the Investors had encouraged infringement by Veoh or by Veoh's users at all. Furthermore, the court pointed out once again that Veoh had yet to be found liable for copyright infringement.

Judge Matz granted the Investor Defendants' motion to dismiss without prejudice, but with a stern warning that should UMG choose to file a Second Amended Complaint, it "should reflect carefully what is likely to result if [it does] so. The Court's existing scheduling requirements and the near-certain additional costs and complications that will flow from attempting to go after deep pockets whose potential liability could entail vexing issues of corporate governance caution that 'less may be more.'"

D. Motion to Dismiss UMG's Second Amended Complaint

True to the warning concluding his previous opinion, Judge A. Howard Matz considered and dismissed UMG's Second Amended Complaint (SAC) as efficiently as he did their first.

1. New Allegations Against Investor Defendants

The court began its analysis by asserting that it was incorporating its opinion granting the dismissal of the FAC, and reviewing the allegations in order to highlight the similarities between the FAC and the SAC. After reviewing his prior opinion, Judge Matz briefly summarized the new allegations against the Investor Defendants, which can be summed up as: (1) investors had extensive control over Veoh; (2) investors were the

99. Id. at *17-18 (citing Grokster, 545 U.S. 913, 936-37, (2005)).
101. Id.
102. Id. at *19.
104. Id. at *4-5.
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“public face” of Veoh; (3) investors considered and were aware of copyright matters; (4) investors participated in decisions to eschew filtering technology; (5) investors participated in the decision not to initiate a manual filtering policy; (6) investors had actual knowledge of direct infringement; (6) and investors decided to allow infringing traffic to attract users to the site.\footnote{105}

The court took the time to discuss each new allegation individually, but in the end asserted that:

[T]hey boil down to allegations that overlap almost entirely with the allegations of the FAC: the Investor Defendants knew that infringing activity was occurring on Veoh’s site; as board members and financial supporters of Veoh the Investor Defendants could have done more to prevent this activity, such as implementing filtering software or hiring employees to ferret out infringing content; and the Investor Defendants hoped to eventually profit from their investment in Veoh, and thus sought to attract more users to Veoh by providing funding and by implementing policies that “facilitated more infringement.”\footnote{106}

The court then evaluated each of UMG’s allegations in relation to the three theories of secondary liability under which Investor Defendants were being sued—all the while noting with distaste the similarities to the FAC.\footnote{107}

2. The District Court’s Analysis in Veoh II

\textit{a. Contributory Copyright Infringement}

UMG again relied on Fonovisa in the SAC, this time asserting that Investor Defendants provided the “site and facilities” for

\footnotesize
\begin{itemize}
\item \textbf{105.} \textit{Id.} at *5-13.
\item \textbf{106.} \textit{Id.} at *12-13.
\item \textbf{107.} \textit{Id.} at *15-28.
\end{itemize}
direct infringement. 108 Fonovisa held that “providing the site and facilities for known infringing activity is sufficient to establish contributory liability.” 109 “Site and facilities” as articulated by the Fonovisa court included “space, utilities, parking, advertising, plumbing, and customers” for defendants’ infringing flea-market, and was extended to the domain of the internet in Napster. 110 The Ninth Circuit in Napster held that the defendant provided the “site and facilities” for direct infringement because it operated “an integrated service designed to enable users to locate and download MP3 music files.” 111 Judge Matz distinguished Veoh’s situation, asserting that the “site and facilities” analysis did not apply because Veoh’s Investors merely provided funding. 112

b. Vicarious Copyright Infringement

The Court held in its previous opinion that it did not need to address the question of Investor Defendants’ right and ability to supervise the infringing activity because the FAC failed to allege that the Investor Defendants had a direct financial interest in the infringing activities, and the SAC did not do much to supplement the FAC in that regard. 113

c. Inducement to Copyright Infringement

The court was again unimpressed with any extra boost the new allegations against Investor Defendants were supposed to provide to UMG’s claims that they induced anyone to infringe UMG’s copyrights. 114 Judge Matz pointed out that there were no allegations present in the SAC that defendants, as either Investors or Board members, “distributed” any device, and therefore he

108. Id. at *17 (relying on the “site and facilities” test that was established in the Ninth Circuit (citing Fonovisa, 76 F.3d 259 (9th Cir. 1996)).
110. Id. at *17-18 (citing Napster, 239 F.3d 1004, 1022 (9th Cir. 2001)).
111. Veoh IV, 2009 U.S. Dist. LEXIS 70553, at *18 (quoting Napster, 239 F.3d at 1022).
113. Id. at *25.
114. Id. at *27.
could not find them liable for inducement to copyright infringement.\textsuperscript{115}

In his conclusion, Judge Matz was careful to pronounce that his decision was a result not only of defects in UMG’s SAC, but that "[i]n the absence of clear precedent, this Court is not willing to expand the scope of copyright liability in a manner that presents a substantial risk of upending well-established concepts of corporate governance."\textsuperscript{116} He goes on to point out that secondary copyright liability principles are important, however, UMG’s proposed expansion of those principles would weaken the corporate form, which is meant to protect investors from liability.\textsuperscript{117} Lastly, Judge Matz brings home the public policy point that seems to be a large factor in his decision: "[t]he vast and rapid expansion of software technology in telecommunications is generally beneficial to our economy and society, and we should not erect obstacles to that growth in the absence of sound legal and policy-based reasons."\textsuperscript{118}

\section*{IV. Analysis}

In the conclusion of his last substantive opinion on the subject,\textsuperscript{119}

\begin{itemize}
\item[\textsuperscript{115}] Id. (explaining that inducement to infringe copyright requires "distribution of a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement." (quoting Grokster, 545 U.S. 913, 936-37 (2005) (emphasis added)).
\item[\textsuperscript{116}] Id. at *28 (emphasis added).
\item[\textsuperscript{117}] Id.
\item[\textsuperscript{118}] Veoh IV, 2009 U.S. Dist. LEXIS 70553, at *29.
\item[\textsuperscript{119}] Judge Matz issued two subsequent procedural opinions. First, he denied Investor Defendants’ motion for costs and fees because plaintiffs’ claims were not frivolous as "[t]here was no clear appellate precedent upholding (or rejecting, for that matter) the validity of UMG's claims." UMG Recordings, Inc. v. Veoh Networks, Inc., No. CV 07-5744 AHM (AJWx), 2010 U.S. Dist. LEXIS 9082 (C.D. Cal. Jan. 15, 2010). Second, he denied Veoh’s motion for costs and fees, after citing the same lack of frivolousness that was found in Investor Defendants’ motion, and discussing the policy considerations that "what UMG sought to do here was consistent with the kind of vigorous advocacy that can lead to clarification and more predictable application of principles of secondary copyright liability, [additionally,] Veoh advanced a meritorious defense and awarding it fees would encourage it (and other
Judge Matz did not reiterate any of his earlier legal conclusions regarding Veoh investors' alleged contributory infringement, but instead chose to focus almost entirely on policy justifications for his ruling. Judge Matz's policy arguments are indeed sound, and the court reached the correct policy decision; however, that decision was not adequately supported with law. This is a problem that will continue to occur until a clear line marking the bounds of secondary and tertiary copyright liability is drawn, either by the Supreme Court or Congress—preferably the latter.

A. Law and Precedent

In *Veoh*, Judge Matz did not offer a concrete legal analysis of the issues presented so much as a scattered list of various loosely-related and quickly presented arguments. In his assessment of the contributory copyright liability allegations, Judge Matz focused on the idea that the Investor Defendants only provided funding for Veoh and declared that it would be far too over-inclusive to allow liability to attach to any defendants who provide "any essential element of a business—from electricity to courier service." However, this exaggerated assertion makes light of the fact that Veoh Investors not only funded Veoh's operations but also sat on the board of directors and helped make decisions about the direction the company would take. Being mere board members is perhaps not, in the end, a substantial enough source of defendants) to litigate such important defenses 'to the same extent that plaintiffs are encouraged to litigate meritorious claims of infringement.' UMG Recordings, Inc. v. Veoh Networks, Inc., No. CV 07-5744 AHM (AJWx), 2010 U.S. Dist. LEXIS 44430, Copy. L. Rep. (CCH) P29902 at *6 (C.D. Cal. April 6, 2010) (citation omitted).

122. In Judge Matz's defense, there were a high number of allegations, none of which seem to have been backed by a substantial amount of evidence. Unfortunately, although the structure of the allegations may have lent itself to a scattered analytical approach, such an arrangement does not provide the opportunity for inclusion of much legal support, and, rather, it appears as though Judge Matz provides mostly unsubstantiated assertions to support his positions.
124. Id. at *10.
control to yield contributory copyright liability, but it remains a fact that should be discussed, not tossed away with a comparison of Investor Defendants to computer display, storage, and software companies, or "even utility companies that provide electricity to the Internet."\(^{125}\)

In his vicarious copyright infringement analysis, Judge Matz concentrated on the lack of dividends or other direct financial benefits to the Investor Defendants, taking as almost a given that future returns on investment potentially derived from the sale of the company were "too remote to constitute a 'direct' benefit from the allegedly infringing activities of that company."\(^{126}\) However, no cases were cited by the Court in support of this assertion. Judge Matz merely stated that the case at bar was distinguishable from cases like *Napster* and *Fonovisa*. Unfortunately, it is unclear how the potential future sale of the company is any more remote a financial benefit to Investor Defendants than the potential charging of "fees for a premium or commercial version of its software" was for *Napster*.\(^{127}\)

It is true that potential future benefits derived from increased traffic perhaps resulting from infringing content is difficult to measure, but a strong argument in logic could be made that, were there no financial benefit to be derived, Investor Defendants would not have knowingly allowed infringement to continue, thus opening themselves up to litigation. As this case was only about the liability of the investors and not about the infringing or noninfringing nature of Veoh's content, it seems that little legal harm would have been done in allowing Veoh's investors to remain defendants under the vicarious liability theory. After all,

\(^{125}\) *Id.* at *19-20* (citing *Perfect 10, Inc. v. Visa Int'l Serv. Ass'n*, 494 F.3d 788 (9th Cir. 2007)). In *Perfect 10*, the Ninth Circuit rejected an allegation of contributory liability for a credit card company that provided payment processing services to alleged infringers, because "[a]ny conception of 'site and facilities' that encompasses [such companies] would also include a number of peripherally-involved third parties, such as computer display companies, storage device companies, and software companies that make the software necessary to alter and view the pictures and even utility companies that provide electricity to the Internet." 494 F.3d at 800.


\(^{127}\) *Napster I*, 114 F. Supp. 2d at 902.
had Veoh been found secondarily liable for vicarious copyright infringement,\textsuperscript{128} there would be a strong argument that Veoh's investors—who apparently knew full-well about the infringing activity,\textsuperscript{129} and logically expected to benefit from it—had the right and ability to supervise through membership on the board of directors, and chose not to stop the infringement.\textsuperscript{130}

Inducement to infringe copyright is the one theory of secondary liability that plainly did not apply to the Investor Defendants. Judge Matz strongly backed up his decision regarding this theory with the clear precedent in \textit{Grokster} that "only the one who \textit{distributes} a device can be liable under an inducement theory."\textsuperscript{131} UMG never alleged that any of the defendants, "as either investors or board members, 'distributed' any device."\textsuperscript{132} However, of the three theories of secondary (or in this case, tertiary) liability under which the Investor Defendants were sued, only the decision regarding Inducement to Infringe was strongly supported by law. The contributory and vicarious infringement decisions were both couched in somewhat ambiguous language and occasionally questionable logic.

\textbf{B. Policy}

Nonetheless, as previously stated, Judge Matz reached the best decision in this relatively unprecedented case. The public policy

\begin{itemize}
\item \textsuperscript{128} Veoh was later granted summary judgment that it was entitled to the section 512(c) safe harbor, and was thus free from liability. UMG Recordings, Inc. v. Veoh Networks, Inc., No. CV 07-5744 AHM (AJWx), 665 F. Supp. 2d 1099 (C.D. Cal. 2010)
\item \textsuperscript{129} "[I]n October 2006, Eisner, the principal of Tomante and its designee to Veoh's Board, corresponded with Mark Cuban, owner of Landmark Theaters and the Dallas Mavericks basketball franchise, about Veoh. Cuban pointed out . . . in an email that the site had '[l]ots of potential, but you got a bunch of full length movies up there. Im [sic] watching Tokyo Drift right now from there....You saved me 20 bucks, but be careful.'" \textit{Veoh IV}, 2009 U.S. Dist. LEXIS 70553, at *9-10.
\item \textsuperscript{130} A question not reached by the court, "because the FAC failed to allege that the Investor Defendants had a direct financial interest in the infringing activities." \textit{Veoh IV}, 2009 U.S. Dist. LEXIS 70553, at *23.
\item \textsuperscript{131} \textit{Id.} at *28.
\item \textsuperscript{132} \textit{Id.} at *27.
\end{itemize}
arguments that Judge Matz made at the conclusion of his opinion are highly relevant, and strongly controvert a finding of tertiary liability in cases such as *Veoh*. Two of the main policy arguments espoused by Judge Matz regard maintenance of the sanctity of the corporate form and derivation of societal benefits from "the vast and rapid expansion of software technology in telecommunications." Both arguments are determinative, and should continue to drive the direction of legal development in many areas of internet and technology law.

The first important policy reason that investor liability should be precluded is the maintenance of the sanctity of the corporate form. Of particular concern throughout the legal history of derivative copyright liability has been the extent to which liability can progress from the primary infringer to the business or businesses that provide the context for the infringement. Historically, while corporations have suffered the financial repercussions of legal and contractual disputes, their investors have enjoyed a fair amount of insulation from those same consequences.

Judge Matz cites "well-established concepts of corporate governance" in the conclusion of his analysis, but fails to elaborate on the exact nature of those "well-established concepts," leaving future litigants without clear guidance. A subsequent reference to the corporate form leads one to deduce that Judge Matz is referring to the limited liability afforded to corporate shareholders, the exception to which is labeled "piercing the corporate veil."

It is generally acknowledged that one of the most critical features of corporate law is the safety net of limited liability, which insulates a corporation's owners (its shareholders) from the debts of the corporation beyond the value of their investment. "Piercing the corporate veil is the single exception to the limited liability principle." Traditionally, it was thought that the rigid

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133. *Id.* at *29.
134. *Id.* at *28.
135. *Id.*
137. *Id.* at 199.
legal rules of limited liability needed a safety valve to escape unacceptable results and supervise limited liability, and so the concept of piercing the corporate veil was born. 138

Most states will disregard the corporate fiction of limited liability and hold a shareholder liable for the debts of the corporation only under a restricted set of circumstances. 139 Although the prongs of the piercing test vary from jurisdiction to jurisdiction, generally, the plaintiff must show that: (1) the corporate shareholder exercised dominion or control over the corporation, such that the separate personalities no longer factually existed; 140 and (2) the shareholder engaged in conduct that suggests that, in the absence of piercing, an injustice will be perpetrated using the corporate form. 141

Veil piercing has been the subject of intense debate stemming from the irregularity with which it is applied, 142 as well as its benefits—which are key to policy arguments in decisions like Veoh and should continue to be so in the formulation of future copyright legislation. Such benefits include, most importantly in the context of the internet, facilitation of capital formation. If liability were not limited in cases like Veoh, “even a small investment could render an investor liable for a substantial corporate obligation,” and investors would be reluctant to assume the risk. 143

Maintenance of the sanctity of the corporate form is important because without such protection from liability, investment—

139. Dearborn supra note 136, at 203.
140. Note that, although the phrase “piercing the corporate veil” is never used, a very similar test is applied by Judge Matz in determining if Veoh’s investors deserved liability for the alleged infringement of Veoh’s copyrights.
141. See Dearborn supra note 136, at 204.
142. See id.
143. David Millon, Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability, 56 EMORY L.J. 1305, 1312 (2007); see also Adam Lashinsky, The Boom is Back, FORTUNE, Apr. 19, 2006, available at http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/01/8375405/index.htm (indicating that investors are already hesitant in the online market as a result of the so-called ‘dot-com bust’).
especially the already-risky venture capital needed to fund internet startups—will be chilled. Copyright holders pursuing secondary parties, such as cash-poor internet start-ups, will often seek injunctive relief. However, as here, if the opportunity presents itself, those same copyright holders will turn to tertiary parties for compensation. Granted, nothing prevents the copyright holder from seeking compensation solely from secondary infringers or seeking injunctive, rather than compensatory, relief from tertiary parties, but the former seems more likely. For example, in the context of the internet and "widespread infringement enabled by cash-poor start-up companies, investors are more likely to have deep pockets, and are therefore more likely to be pursued for compensatory damages." "

Exacting huge compensatory damages from investors in online service providers would be detrimental to maintaining a national policy that fosters innovation. In today’s rapidly changing technological environment, the United States is at clear risk of losing its position as a leader in science and industry. Bipartisan legislative history on the subject demonstrates an undeniable Congressional intent to promote innovation in order for the United States to stay competitive on a global scale.


146. Id.

147. Id.

148. Gompers & Lerner, supra note 144, at 19 ("[V]enture funding does have a strong positive effect on innovation. The estimated coefficients vary according to the techniques employed, but on average a dollar of venture capital appears to be three to four times more potent in stimulating patenting than a dollar of traditional corporate R&D.").


150. See Task Force on American Innovation, http://www.innovation
C. Future Directions

The importance of maintaining the corporate form for generating capital, especially venture capital, combined with the stated and necessary national policy of increasing and encouraging technological innovation, is ample justification for Judge Matz’s decision in *Veoh*. However, the question remains: what now? Public policy alone is not often a sufficient base upon which to support judicial decisions, and can lead to any number of unpredictable and irregular results in differing jurisdictions—or even different judges in the same jurisdiction.

1. Potential Direction of Investor Liability Within Existing Framework

Potentially, investors could require a declaratory judgment of non-infringement before investing, but as *Veoh* shows, courts are loath to grant such judgments in copyright infringement cases without a very specific controversy to address. It has further been asserted that the requirement of a declaratory judgment “would be an ideal response from an efficiency point of view”; however, it seems quite clear that this would be a most inefficient solution from the courts’ perspective—courts’ already low desire to grant a declaratory judgment in these types of cases would be
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further antagonized by what could amount to daily requests by startups seeking funding.

A convenient—and at first glance, ideal—solution would be to inflict copyright liability only on such investors as would already be susceptible to veil-piercing. The problem, as previously discussed, is that piercing the veil is no more an exact science than the method already employed for determining copyright liability. If the policy is to avoid chilling innovation by discouraging investment, replacing the current three theories of secondary copyright liability with an older and more complicated but no less unpredictable method of determining liability will not help the situation. It does not appear that the current framework for establishing tertiary copyright liability will be workable in the long run, as it does not provide investors with any security regarding the possibility of future litigation or the outcome of such litigation. As development of online service providers continues to rise, lack of security will be unfortunately demonstrated by a growing number of unclear opinions that differ unpredictably between jurisdictions.

2. Potential Changes to Existing Framework

Compelling arguments can be made in defense of investor liability, but those arguments rarely, if ever, consider the potential need for change in copyright law—either in substance or in enforcement. That is, all arguments for investor liability rest on a foundation of copyright law as it stands today, with no mention of the direction copyright law may need to take in the future.

variable and fact-intensive treatment of the reasonable apprehension requirement.

154. In fact, the three theories of secondary copyright liability each contain pieces of a ‘piercing the corporate veil’ analysis: for example, the ‘right and ability to supervise’ requirement for vicarious copyright liability is fairly close to the ‘dominion or control over the corporation’ requirement for veil piercing, and as Judge Matz applied the factors to Veoh, it was plain that he intended not to impose tertiary liability to the investors unless they were so attached to Veoh that “separate personalities no longer factually existed.” See supra pp. 2-5, 9.

155. See generally Dearborn supra note 136.

156. See Glatstein supra note 145.
Perhaps, then, it is time once again for Congress to make some changes to the existing framework, as it did with the Digital Millennium Copyright Act in 1998. Congress could limit the remedies that can be sought against investors and other tertiary parties to mostly injunctive relief, unless there is a showing of bad faith, in which case compensatory damages could be sought.

It stands to reason that it would be to the benefit of society if investors, service providers, and even websites that host infringing content (but have substantial non-infringing use) were not responsible for bearing the cost of constantly monitoring the potentially infringing action of an increasingly tech-savvy population with a steadily growing quantity of methods for uploading infringing content. Perhaps the real cost/benefit analysis ought to be performed from the perspective of the copyright holder. If the cost to the copyright holder himself is greater than the benefit he derives from pursuing infringers, how can a third party (or the venture capitalists that fund that third party) realistically be expected to shoulder that cost? It is further unrealistic to assert that if no one hosts infringing content, the infringement will stop.

The “Pandora’s Box” argument may seem evasive, and it is certainly not a valid argument in every instance; however, cases like Veoh highlight the practical impossibility of damming the flood of user-generated content. That impossibility combined with the sound policy of promoting innovation and the international exchange of ideas and cultures to the benefit of all make this an instance where Pandora’s Box should be left open.

158. Id.
159. See Mark Walsh, Forrester: Smartphone U.S. Market Share Reaches 17%, Media Post News, Jan 5, 2010, http://www.mediapost.com/publications/?art aid=120085&fa=Articles.showArticle (“The proportion of adult U.S. subscribers owning smartphones jumped to 17% last year from 11% in 2008 and 7% in 2007, according to new data from Forrester Research. The growth rate has held steady from 2008 even as the user base has expanded . . . .”).
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V. CONCLUSION

The UMG v. Veoh saga highlights the fact that investors will be targets in what is sure to be an ongoing trend of litigation in the area of user-generated online content. The contributory, vicarious, and inducement theories of secondary liability will continue to be directed at these investors—technically tertiary infringers—with varying results. While the decision in Veoh provides a relatively weak legal model for future litigants in this area, the policy used to guide the decision was sound, and, thus, the correct result was achieved.

However, because policy is often open to varying interpretations, it is important that Congress amend current copyright law in order to create a stable, lower liability environment for content-hosting sites, which are a necessary step on current technological advancement, and the investors that make such sites possible.

Such a reduction in the restrictiveness of copyrights would not mean an end to authorial prosperity, but would rather be an opportunity to profit in new ways, and would allow more freedom for the investment that drives innovation. After all, it may be that when Pandora gave in to her curiosity and finally opened the box, all of the evils, ills, diseases, and burdensome labor that mankind had not known previously escaped therefrom. However, it is said, at the very bottom of her box, there lay hope.

Liz Brodzinski
