

IP/Technology Transfer

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▼ Napster case spills into biotech sector

Aaron Bouchie¹

Aaron Bouchie is a news editor for Nature Biotechnology

If Napster's investors are found guilty of assisting copyright infringement, then venture capitalists will begin to practice more caution before dropping money into any high-risk technology firm.

A July decision in a copyright infringement lawsuit involving Napster's investors is causing great anxiety in the world of technology venture capitalists (VC). Depending on how the lawsuit plays out, VCs could be found guilty of infringement if a portfolio company commits a crime, but only in rare circumstances. The Napster case is unlikely to trigger a downturn in investment for biotech startups, but instead will persuade VCs to perform more in-depth due diligence on a company's intellectual property (IP) before investing.

Mountain View, California-based Napster began making waves in May 1999, when it launched software that enabled personal computer users to share music files. Many major record labels, including UMG Recordings, sued Napster for so-called "secondary infringement"; the company did not commit any actual copyright infringement, but—according to a judge's ruling in 2000 and an appeal in 2001—it "had engaged in contributory and vicarious infringement" by enabling others to download copyrighted songs without paying the copyright owner.

After Napster went bankrupt in 2001, UMG filed suit against Hummer Winblad, a VC firm that invested \$13.5 million in the company in May 2000, when legal trouble was already brewing. UMG accuses Hummer Winblad of "tertiary infringement," contributory or vicarious assistance to a contributory or vicarious infringer, in this case Napster. On July 14, US District Court Judge Marilyn Hall Patel refused to dismiss the lawsuit, potentially leaving the door open for VCs to be found guilty of such infringement. In this case, Hummer Winblad could be liable for sales that the plaintiffs lost because of Napster.

Michael Cohen, attorney for Heller Ehrman White & McAuliffe in Washington, DC, explains that although this case concerns copyright law, the concept of secondary infringement also exists in patent law. Therefore, this case may have a "little spillover" into the biotech sector in some circumstances, for example, when manufacturing materials such as reagents that have no substantial use other than to enable another party to create a product that is protected by a third-party's patent.

The main concern of the National Venture Capital Association is that this case, as well as a bill currently in the US Senate (see [Box 1](#)), could prompt investors to shy away from companies that have a high risk of potential IP infringement, such as biotech R&D firms.

“UMG Recordings v. Hummer Winblad Venture Partners should force startups to question the involvement of their own investors”

But Judge Patel's ruling sidestepped the issue of tertiary infringement, according to Dan Primack, editor of Thomson Venture Economic's *PE Week Wire* newsletter in Boston. Instead, he says she focused on the investors' control of the company, pointing out that when Hummer Winblad made its investment, it also received two board seats, and one partner took the helm as CEO. "Patel was more concerned with the VC partners allegedly being directly responsible for Napster's operations, more than merely investing in the company," says Primack.



Napster

For years, the Napster cat logo has symbolized copyright infringement for song downloaders. It may also soon symbolize infringement for VCs.

Most VC firms do not take this level of control when they make an investment, and therefore the case "is worth keeping an eye on, but not freaking out over," says Primack. He also says that the case should force startups to question the involvement of their own investors. "If you have VCs, how involved are they? How involved do you want them to be?" asks Primack.

Cohen agrees that the Napster case is at a very early stage, and observers shouldn't "overstate the Judge's statement." He points out that the case has not yet begun the "discovery" stage where both plaintiff and defendants present their evidence, so no charges have been proven. "Patel's decision should not hinder investment into new and innovative technologies," says Cohen. "But it should create a heightened sense of awareness to investors' roles in companies that perform potentially illegal activities. Increased due diligence is never a bad thing."

Web links

Inducing Infringement of Copyrights Act of 2004

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s2560is.txt.pdf

US District Court Northern District of California

<http://www.cand.uscourts.gov/>

Private Equity Week

<http://www.privateequityweek.com/>

Heller Ehrman McAuliffe & White LLP

<http://hewm.com>

Box 1: Induce Act induces nervousness among tech developers

On June 22, six US Senators introduced the "Inducing Infringement Copyrights Act of 2004" or the "Induce Act." This bill is intended to broaden the definition of "intentionally induce" in the copyright law concerning infringement, to make some peer-to-peer (P2P) network software, such as the original Napster, illegal. But some developers and investors of high tech products fear that the bill is too broad and will stifle innovation.

Mark Heesen, president of the National Venture Capital Association, sent a letter to Senator Orrin Hatch, a cosponsor of the bill, asking for "a full and thorough process of [public] comment and hearing." Heesen is worried that the Induce Act could make investors liable of tertiary infringement, and "even the mere threat of a legal action can drive investment decisions away from what could turn out to have been important technology advances."

Michael Cohen, and attorney for Heller Ehrman McAuliffe & White in Washington, DC, says the bill is not intended to link to investment issues in the way that *UMG Recordings v. Hummer Winblad Venture Partners* does. He says that the Induce Act specifically targets the behavior of P2P companies, such as Morpheus, that promoted themselves as Napster's replacement once it went bankrupt. Cohen believes that Congress will leave the wording of the bill and allow courts to decide on secondary and tertiary infringement on a case-by-case basis, rather than changing the wording to give blanket protection to all technologies and investors.

When judges need to interpret laws, they often look at the statements made by the legislators when introducing the bill to gauge the true intent of the law. In this case, Senators Hatch, Leahy and Frist repeatedly state that the Induce Act does not target technology, and that the makers of equipment and vendors of software "should rest easy."

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