



**TESTIMONY OF MARK HEESEN**  
**President, National Venture Capital Association**  
**Before the Senate Committee on Commerce**  
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Thank you for the opportunity to share the views of the National Venture Capital Association (“NVCA”). NVCA represents the interests of more than 470 venture capital firms in the United States, which together account for more than 85% of venture funding. As the only national trade group for the venture community, the NVCA’s mission is to foster public awareness of the vital role that venture funding plays in driving the United States economy and to advocate public policies that stimulate entrepreneurship and innovation.

While the importance of venture capital firms and the companies they fund to the United States economy is difficult to quantify, recent studies estimate that, in 2003, venture-backed businesses were responsible for more than 10.1 million American jobs and accounted for more than \$1.8 trillion of the United States Gross Domestic Product (“GDP”)<sup>1</sup>. Such economic mainstays as Intel, Federal Express, Home Depot, Genentech, Google, and Starbucks were incubated with venture funding. Each year, venture firms invest more than \$18 billion in start-up companies across the country, which accounts for an estimated 72% of all venture investment worldwide. A decidedly American phenomenon, venture capital funds and the companies they back provide a key differentiator animating American economic growth.

The NVCA’s members invest with a particular emphasis on emerging companies in the information technology, communications, and life sciences industries. In addition to providing early funding to young businesses unable to secure capital from more traditional sources, NVCA’s member firms take an active role in guiding nascent businesses through their start-up and middle

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<sup>1</sup> See Global Insight, *Venture Impact 2004: Venture Capital Benefits to the U.S. Economy* 1 (2004).

phases. They work with the entrepreneurs and management, lending their experience and expertise while developing long-term partnerships.

NVCA's member firms accordingly have a unique perspective on the hurdles that emerging businesses confront and the background conditions that promote or stifle growth and innovation. Prior to the Supreme Court's decision in *MGM v. Grokster*, NVCA's member firms were deeply concerned that any erosion of the bright-line protection provided in *Sony Corporation of America v. Universal City Studios, Inc.* for products that are "capable of substantial noninfringing uses" would have a chilling effect on innovation and product design by developers of multiple-use technologies and services.

We believe that the Supreme Court's decision is favorable to the venture capital industry in so far as the Supreme Court rejected the studios' strong efforts to cut back on the protections for innovative technologies that have the potential for substantial non-infringing uses. With this bright line rule intact, hopefully only those players who willfully promote copyright infringement will be subject to -- and should be subject to -- potential liability for secondary infringement of copyrights. A company or a venture capital firm that brings to market technologies that have the potential for legitimate, non-infringing uses, and that markets the technologies based on those non-infringing uses, should remain protected from secondary liability, even though other third parties might discover ways with the technologies to infringe on copyrights.

NVCA's members are pleased that a new standard for contributory infringement as proposed by the petitioners in *Grokster* was not created. Such a standard would have been virtually impossible for venture capital firms to accommodate in making their initial investment decisions, when the potential commercial applications of a promising concept are still far in the future. Having said this, NVCA is concerned that *Grokster's* long-term impact could still be very problematic for technology advancement in general and the VC community specifically. Such malleable standards — vague in their formulation and unpredictable in their application — could invite courts to second-guess design decisions and expose venture firms to potentially ruinous litigation.

### **Attacking Innovation**

Any technology or service that makes it possible to copy or distribute information can be used for copyright infringement. The list of such technologies — which today includes computers, the Internet, and e-mail, as well as CD burners, iPods, and peer-to-peer file sharing — is extensive, as is the range of their legitimate uses. Modern life would be impossible to envision without such

“dual use” technologies. Indeed, these “technologies of freedom” — which allow the rapid spread of information free of decentralized control — are critical to our modern democracy, as well as to our productivity and economic well-being.

Freedom, however, is sometimes abused. There are, and always have been, those who would abuse the power afforded them by new technologies to copy and distribute works that belong to others. Existing copyright laws provide severe penalties for such direct infringement, recognizing that the few who are caught must provide an example and deterrent for others.

But the entertainment industry has never been satisfied with attacking *direct* instances of infringement. For more than a century, when it first claimed that the player piano spelled the death of American music, the industry has attacked in turn each new development that facilitates copying and distribution, from phonographs to mimeographs, from audiotape players to VCRs, from compact disks to mp3 players. As each new technology has developed, the industry has sought to destroy or control it, often extending their attacks to the inventors who created and *the investors who funded the product or service*.

Fortunately, these attacks have been largely unsuccessful. (And their failure, ironically, has been good for the entertainment industry itself, which has in the long run benefited hugely from the new methods of distribution.) Under the bright-line rule established by the Court in *Sony*, technologies and services that are “capable of substantial noninfringing uses” are protected from secondary copyright liability, regardless of whether (or how many) others use those technologies and services for direct infringement of copyrights. Responsibility for copyright infringement rests where it belongs: on the shoulders of those who abuse products to infringe copyrights, not on those who create or invest in products capable of substantial non-infringing uses.

This bright-line protection has been critical to technological progress. Entrepreneurs have been able to develop novel products without worrying that illegitimate uses could impose ruinous liability. Because markets take time to develop, and because the future uses to which a product may one day be put (both legitimate and illegitimate) are not necessarily evident in its early phases, *Sony* allows an innovation to incubate without fear that third-party infringement (present or future) will invite litigation.

## ***Sony* Bright-Line Rule Critical To Capital Investment**

“[E]very invention is born into an uncongenial society, has few friends and many enemies.”<sup>2</sup> In *Sony*, the Supreme Court fashioned a margin of protection for such nascent technologies. The Court articulated a bright-line rule for determining liability under the doctrine of contributory infringement that armed inventors and product developers — and those who fund them — with the knowledge that a technology or service with legitimate uses would not be driven out of the market because some or even most customers may use the product to infringe copyrights.

The Court’s bright-line rule in *Sony* has been the midwife for the technological revolution of the past two decades. It is not by chance that the *Sony* decision coincided with a period of unprecedented innovation and technological progress. By establishing a bright-line rule that protects new products and services – and the investors - provided they are “capable of substantial noninfringing uses,” *Sony* has provided critical assurance to entrepreneurs that they could develop novel ideas and products without worrying that some unforeseen future use could impose ruinous liability.

Entrepreneurs frequently invent new products without any clear picture of their potential uses, secure in the belief that a good idea will eventually find a market. That others could use the invention for copyright infringement is and should be irrelevant to the question whether the product or process can be placed in service of alternative, legitimate ends. One cannot even begin to count the staples of modern life — radios, typewriters, tape recorders, cameras, photocopiers, computers, fax machines, cassette players, cell phones, CD burners, DVD players, e-mail, cable modems and DSL for high-speed Internet access, Internet search engines such as Google and Yahoo, TiVos, and mp3 players such as the iPod — that can be used to infringe copyrights and yet have perfectly legitimate uses that we increasingly could not do without. Peer-to-peer networks are another such innovation, whether used to share photos among family and friends, to promote the music of a new band, or to share research among scholars.

The *Sony* case itself provides the best illustration of the fact that products often arrive before their primary markets emerge. At the time that case was decided, the Betamax was used primarily for copying shows from over-the-air broadcasts, either to build a library of such shows or simply to

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<sup>2</sup> Joel Mokyr, *The Lever of Riches: Technological Creativity and Economic Progress* 183 (1990) (internal quotation marks omitted).

engage in time-shifting<sup>3</sup>. The primary dispute between the majority and the dissent concerned whether time-shifting was itself a fair use of the copyrighted material.<sup>4</sup> But the Betamax and its ultimately more successful competitor, the VHS VCR, quickly evolved into something quite different: a means of viewing lawfully rented movies. A whole industry grew up to provide legitimate materials for a product that the entertainment industry sought to crush in its infancy. That was possible only because the Court in *Sony* provided a protected space in which these legitimate uses could grow. In that case, as in many others, the product created its own legitimate market.

The entertainment industry in its Supreme Court brief on *Grokster* suggested that the *Sony* test encourages bad behavior by inventors and product designers who hide behind its protections in order to make money off infringement.<sup>5</sup> That is certainly possible but, as we argued in our Amicus Curiae brief, that it is not a reason to change the *Sony* bright-line test established by the Supreme Court. The Justices agreed with our line of thinking in *Grokster*. As long as a product is capable of substantial, non-infringing uses, it is a socially useful product, whose development should be encouraged. **Abuse of the product should be attacked, not the product itself, nor the inventor behind it, nor the venture capitalist who funded the venture.** If a company materially assists or encourages specific acts of infringement — whether through customer support mechanisms or other communications — secondary liability might well be appropriate.<sup>6</sup> But the mere acts of developing, advertising, marketing, upgrading, and supporting a multi-use product that is capable of substantial non-infringing uses should be protected, without necessitating a fact-specific, inherently amorphous inquiry into the motivations and incentives of the inventor.<sup>7</sup>

It is critical to understand that the threat of secondary liability from copyright suits is qualitatively different from most other sorts of business risk that investors can insure against or build into their risk calculations. The mandatory mechanism of statutory damages — designed to

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<sup>3</sup> See 464 U.S. at 423 (surveys by both respondents and Sony “showed that the primary use of the machine for most owners was ‘time-shifting,’ ” although surveys also showed “that a substantial number of interviewees had accumulated libraries of tapes”).

<sup>4</sup> *Id.* at 442, 447-56; *id.* at 477-86 (Blackmun, J., dissenting).

<sup>5</sup> See Motion Picture Studio Pet. Br. 9-11, 27-29; U.S. Br. 17; Am. Tax Reform Br. 13-15.

<sup>6</sup> See, e.g., *Cable/Home Communication*, 902 F.2d at 837-39 (active promotion of television signal descrambling chips); *Sega Enters. Ltd. v. MAPHIA*, 948 F. Supp. 923, 933 (N.D. Cal. 1996) (Internet bulletin board operator actively encouraged users to upload copyrighted games).

<sup>7</sup> NVCA takes no position on whether, on the record here, the defendants in *Grokster* materially assisted or encouraged specific acts of infringement.

discourage *direct* infringement — has crushing implications for vendors of multi-purpose technologies, where damages from unforeseen users can quickly mount in the millions and even billions of dollars. And the indeterminate reach of such secondary liability means that not merely start-up capital is at risk, but also the personal wealth of start-up’s officers, directors, and investors.<sup>8</sup> The litigation risk in such circumstances is wholly one-sided: minimal attorneys’ fees for the plaintiffs versus financial annihilation for the defendants. It would be impossible to create a more chilling environment for creativity and product development.<sup>9</sup>

### **Standards Proposed By Entertainment Industry Would Deter Investment And Innovation**

In their *Grokster* briefs before the Supreme Court, both the petitioners and the United States asked the Court to replace *Sony*’s clear rule of law with malleable legal standards that would trade certainty for legal risk. Moving from the bright-line *Sony* rule to any sort of malleable standard — with its attendant loss of certainty — would undermine investment in innovative technology.

The evolution of the business model for the VCR at issue in *Sony* demonstrates the danger of predicting a future pattern of use. While the studios predicted on the basis of early experience that the VCR would destroy the movie business, video and DVD rentals and sales currently generate substantially more revenue than movie theaters<sup>10</sup>. When industry executives cannot accurately predict the direction of the market, a legal standard that asks the federal courts to engage in such predictions has little to recommend itself.

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<sup>8</sup> The prospect of such litigation is far from theoretical. In addition to suing Napster, for example, the recording industry has brought suit against venture capital firms and other investors that provided early funding. See *In re Napster, Inc. Copyright Litig.*, Nos. C-MDL-00-1369-MHP & C-04-1166-MHP, 2005 WL 273178, at \*1 (N.D. Cal. Feb. 03, 2005) (discussing suit versus venture capital firm Hummer Winblad Venture Partners); *UMG Recordings, Inc. v. Bertelsmann AG*, 222 F.R.D. 408, 413-14 (N.D. Cal. 2004) (discussing suit against investor Bertelsmann). Indeed, after driving mp3.com into bankruptcy and acquiring its assets, the studios have even brought suit against the lawyers that performed corporate work for mp3.com in its start-up phase. Jon Healey, *MP3.com Sues Former Copyright Counsel*, L.A. Times, Jan. 19, 2002, at C2. These scorched-earth litigation tactics are expressly designed to discourage the development of any product that is capable of infringing uses — a complete inversion of the *Sony* rule.

<sup>9</sup> See Mark A. Lemley & R. Anthony Reese, *Reducing Digital Copyright Infringement Without Restricting Innovation*, 56 Stan. L. Rev. 1345, 1388 (2004) (discussing how the threat of liability has deterred innovation among computer programmers); Joseph P. Liu, *The DMCA and the Regulation of Scientific Research*, 18 Berkeley Tech. L.J. 501 (2003) (discussing ways in which threat of liability under the Digital Millennium Copyright Act deters innovation in field of encryption); Assaf Hamdani, *Who’s Liable for Cyberwrongs?*, 87 Cornell L. Rev. 901 (2002) (demonstrating that threat of secondary liability has led to over-deterrence); Matthew Fagin, Frank Pasquale & Kim Weatherall, *Beyond Napster: Using Antitrust Law to Advance and Enhance Online Music Distribution*, 8 B.U. J. Sci. & Tech. L. 451, 500 (2002) (“Innovation in the technologies of distribution will decline markedly if potential new innovators are chilled by a threat of legal action”).

<sup>10</sup> See note 8, *supra*.

The iPod, which has been responsible for the resurgence of Apple, has a similar story line. Apple first invited customers to “rip, mix, and burn” their favorite music when releasing its iTunes software in January 2001 and then embedding it on the latest version of the iMac personal computer.<sup>11</sup> The iPod followed later that year, with an initial 5 gigabit version that could hold up to 1,000 songs. Apple was immediately attacked by the major studios and accused of inciting theft.<sup>12</sup> But it was not until April 2003 that Apple launched its iTunes online music store, after reaching agreements with all of the major studios to sell the ability to download individual songs or entire CDs. In the first quarter of 2005 alone, Apple reported licensed online music sales of roughly \$275 million, and it is now selling 1.25 million songs *per day*. Just as licensed video sales and rentals have eclipsed movie theaters in revenues, it appears clear that licensed online downloads will eclipse CDs. But neither could do so without the protection afforded by *Sony* for mixed-use technologies.

Peer-to-peer sharing is likely to provide yet another example if permitted to develop. Thanks to a file-sharing technology called BitTorrent, millions of users were able to quickly download and view “lengthy amateur videos documenting the devastation of the December tsunami in the Indian Ocean, helping to spur an outpouring of charitable aid.<sup>13</sup>” BitTorrent’s main use, however, appears to be among those who want to trade Hollywood movies and TV shows, thus “putting it in the cross hairs of the entertainment industry.<sup>14</sup>” The technology obviously is capable of substantial non-infringing uses; subjecting the inventor to ruinous liability would deprive the marketplace and consumers of the opportunity to develop a legitimate market for those uses.<sup>15</sup>

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<sup>11</sup> See Dennis Sellers, *Jobs: iTunes Is New, Free Jukebox Software* (Jan. 9, 2001), available at <http://www.macworld.com/news/2001/01/09/itunes/index.php>. The first mp3 commercial players were developed several years earlier, and the music industry immediately filed suit to enjoin their sale. See *Recording Indus. Ass’n of Am. v. Diamond Multimedia Sys., Inc.*, 180 F.3d 1072 (9th Cir. 1999) (suit against Rio portable mp3 music player). It is only because of the legal protection afforded by this Court’s *Sony* decision that the iPod could be developed, marketed, and released.

<sup>12</sup> See Brooks Boliek, *Mouse Grouse: Dis Boss Lays Into Computer Biz*, *The Reporter.com*, Mar. 1, 2002, available at [http://www.larta.org/pl/NewsArticles/02Marc01\\_HR\\_Eisner.htm](http://www.larta.org/pl/NewsArticles/02Marc01_HR_Eisner.htm).

<sup>13</sup> Jonathan Krim, *High-Tech Tension Over Illegal Uses*, *Wash. Post*, Feb. 22, 2005, at E1, available at <http://www.washingtonpost.com/wp-dyn/articles/A42401-2005Feb21.html?sub=AR>.

<sup>14</sup> *Id.*

<sup>15</sup> While the United States and petitioners contend that it would be more efficient for users seeking publicly available material to go directly to the website that houses it than to use peer-to-peer file-sharing software, neither has offered any evidence to support this factual assertion. The Ninth Circuit, by contrast, found that peer-to-peer arrangements “significantly reduc[ed] the distribution costs of public domain and permissively shared art and speech.” Pet. App. 16a. While legitimate arguments may support these competing conclusions, the prior question that the United States fails to address is whether the federal courts have the institutional capabilities to weigh the competing evidence in such complex areas as computer software and the life sciences. The marketplace performs this same function automatically.

## Conclusion

The clear rule of law that the Supreme Court articulated in *Sony* has provided the backdrop for an unprecedented period of technological growth and innovation. That revolution in informational technology, in turn, has been responsible for the creation of millions of jobs in the United States, directly and indirectly contributing billions of dollars to the GDP. Replacing the *Sony* rule with a more amorphous, fact-specific standard, as advocated by many in the entertainment industry in *Grokster*, would have placed these industries, and the nascent businesses that are their life blood, at risk. The Supreme Court refused to go down this path. Supreme Court Justice Stephen Breyer along with Justices Sandra Day O’Conner and John Paul Stevens argued that “*Sony*’s rule is strongly technology protecting....*Sony* thereby recognizes that the emergence of new technologies, including (perhaps especially) those that help disseminate information and ideas more broadly or more efficiently.”

The market, rather than the federal courts, should drive investment decisions. Unfortunately, the Supreme Court left many liability questions unanswered in *Grokster*, and those issues will now have to again be addressed by the lower courts in continuing litigation. For venture capital firms, the additional layer of legal uncertainty — a risk that can be neither measured nor managed — will discourage investment in critical information technologies in the near term post *Grokster*. We have now an opportunity for a breathing space, one in which technologies can continue to emerge and further answers emerge from the courts without a rush to judgment from any sector, whether it is the entertainment industry, Congress or investors. However, if the entertainment industry decides to initiate even greater volumes of litigation against inventors and investors, Congress may need to return its focus to this issue.

Thank you again for the opportunity to testify here today on these critical issues. I look forward to answering any questions.