ARNOLD & PORTER LLP

ADVISORY

April 2010

NINTH CIRCUIT REJECTS TAX WITHHOLDING AS LITMUS TEST FOR COPYRIGHT "FOR HIRE" STATUS

In *JustMed, Inc.* v. *Byce,* announced on April 5, 2010, the United States Court of Appeals for the Ninth Circuit determined that an individual who did not receive a regular salary, chose his own hours and place of work, did not receive employee benefits, and was not subjected to tax withholding was nonetheless an "employee" who created a "work for hire" under the US Copyright Law. The ruling, which does not necessarily predict the law in the other circuits, can mitigate uncertainty in licensing and acquisition transactions with emerging technology companies. It is particularly relevant to computer software ventures that may have started up with less than comprehensive intellectual property protocols. However, it should not be a prescription for less rigorous intellectual property discipline in start-up companies.

Under the US Copyright Act, a copyrighted "work for hire" automatically belongs to the person who "hired" the work. Unless a work is "for hire," the person for whom the work is prepared (and who pays for it) cannot establish ownership of the work without formal, written assignments executed and delivered after completion of the work by the individuals who created the works. The absence of adequate proof of ownership can interfere with the company's ability to consummate licenses, raise financing, or even sell the company. It can be difficult, time-consuming and expensive after the fact to secure those assignments; therefore, a company that can rely confidently on "for hire" status of all of its internally developed copyrightable material will be in a much better position than one with a more tenuous chain of title to its copyrights.

"For hire" treatment, however, is not always available. While any work prepared by an employee within the scope of his or her employment is automatically a work for hire, works prepared by independent contractors are only works for hire if (a) they fall into a small number of categories; and (b) are specially commissioned pursuant to an agreement made before the work is created. If either the work does not fit into one of the designated categories, or there is no advance agreement, the copyright in a work created by an independent contractor is

Brussels
+32 (0)2 290 7800

Denver
+1 303.863.1000

London
+44 (0)20 7786 6100

Los Angeles
+1 213.243.4000

New York
+1 212.715.1000

Northern Virginia
+1 703.720.7000

San Francisco
+1 415.356.3000

Washington, DC
+1 202.942.5000

arnoldporter.com

owned by the contractor, even if the contractor was paid to create the work. The problem is particularly critical in the case of computer software created by independent contractors, which seldom falls into any of the categories eligible for the employer-favorable treatment.

The US Copyright Act provides no definition of "employee". The United States Supreme Court, in *Community for Creative Nonviolence* v. *Reid,* 490 U.S. 730 (1989) held the definition to be that of a common law employee, enumerating a list of factors to be weighed. The factors almost completely overlap the regulations adopted by the US Department of the Treasury for determining whether an employer is required to pay employment taxes and/or withhold income tax from payments made to the individual for his or her services. It is not surprising, then, that several federal appellate cases have held that the failure of an employer to pay payroll taxes or withhold income taxes is highly persuasive, if not fully dispositive of the individual's status as an independent contractor. In one case, *Aymes* v. *Bonelli,* 980 F.2d 857 (2d. Cir. 1992), the court weighed in that a company "should not in one context be able to claim that [the individual] was an independent contractor and ten years later deny him that status to avoid a copyright infringement suit."

The Ninth Circuit has now rejected the use of a bright-line test based only on tax reporting and formal documentation. In the case of *JustMed,* the company was more or less a startup. When one of its founders left the company to take a job elsewhere, the brother-in-law of the remaining founder indicated an interest in joining the company and completing the work of the founder who had moved. As a startup and somewhat of a sideline enterprise for all, the Company had very little money and could not pay the new man initially on an ongoing basis. Instead, it proposed to issue him stock over time. Eventually, however, it paid a portion of his compensation in cash. Even though it eventually started paying the programmer a salary and taking withholding, during the time that most of the work was done, the employee was being paid primarily in stock and was issued a Form 1099, the method used for reporting payments to contractors. Until *JustMed,* the common wisdom was that the copyrighted program could not be treated as a work for hire.

The opinion in *JustMed* specifically distinguishes the rational from the *Aymes* case. It reasons that the "inherent unfairness" of permitting a company to avoid payroll taxes while claiming the individual to be an independent contractor is simply not applicable to a small startup company. It reasons that the start-up "naturally conducted its business more informally than an established enterprise might," and that using the simpler approach "should not make the company more susceptible to losing control over software integral to its product." It also focuses on how the process of writing and testing computer software does not require the same kind of management infrastructure of another type of business and thus, the fact that the employee lived in another state, had his own computer equipment, and chose when and where to work, was essentially irrelevant to the determination.

This is good news for startup companies, particularly those involved in creating computer software, which for one reason or another have not complied in the past with tax requirements or have not formally documented contractor relationships. Potential purchasers and sources of financing for computer software businesses may now be able to look at the substance of the formative years of a startup venture, rather than be concerned solely with whether every programmer received a W-2. Was the programmer doing a single task, or involved on an ongoing basis? Was he or she paid regularly, or only on completion of an agreed deliverable? Was he or she involved in business planning, marketing, or other activities typical of the multiple roles played by employees in early stage companies?

It remains an open question as to whether the new case should give comfort to start-ups outside the computer software industry. There is no "work for hire" doctrine for patents; patent assignments are required from both employees and contractors. Other businesses that are

heavily dependent on copyright protection might not meet the same fairness test that *JustMed* applies to computer software development.

All that said, the case should only be used to reduce anxiety in due diligence investigations of a recent start-up. It should not be an excuse for a start-up to avoid documenting copyright ownership rigorously from the start. It is unlikely it will be applied to individuals who are not intimately involved in the day to day business of the company and it is clear that it will not apply to any contractor other than an individual. There is simply no substitute for a comprehensive intellectual property assignment agreement with every person who creates intellectual property for a company.

We hope you find this advisory helpful. If you would like more information, please feel free to contact your Arnold & Porter attorney or:

Ira Moskatel
+1 213.243.4223
Ira.Moskatel@aporter.com

Monty Agarwal
+1 415.356.3042
Monty.Agarwal@aporter.com

John C. Ulin
+1 213.243.4228
John.Ulin@aporter.com

Ryan M. Nishimoto
+1 213.243.4158
Ryan.Nishimoto@aporter.com