AMENDMENT 1 - IMPLEMENTATION OF THE NO ELECTRONIC THEFT ACT: Staff Analysis

The No Electronic Theft (NET) At of 1997, Pub. L. 105-147, directs the Commission to: (1) ensure that the applicable guideline range for a crime against intellectual property (including offenses set forth at section 506(a) of title 17, United States Code, and sections 2319, 2319A, and 2320 of title 18, United States Code) is sufficiently stringent to deter such crime; and (2) ensure that the guidelines provide for consideration of the retail value and quantity of the items with respect to which the intellectual property offense was committed.

The NET Act gave the Commission emergency amendment authority to promulgate temporary amendments necessary to implement the Act's directives. The recently enacted Digital Theft Deterrence and Copyright Damages Improvement Act of 1999 requires the Commission to promulgate the emergency amendments within 120 days of the enactment of that Act, *i.e.*, by April 6, 2000.

The Commission currently is considering two options for implementing the congressional directives, previously designated as Option 3 and Option 4. Both options implement the directives by changing the monetary calculation currently found in the copyright and trademark infringement guideline, §2B5.3, to provide for consideration of the retail value of the infringed item. (Currently, §2B5.3(b)(1) contains an enhancement based on a calculation of the retail value of the infringing item multiplied by the quantity of infringing items.) In addition, a number of other modifications to the infringement guideline, including some mitigating and aggravating factors, are incorporated into both options as an additional means of providing sufficient deterrence.

Implementing the second directive (providing consideration of the retail value of the infringed item) has proven to be the most challenging aspect of responding to the NET Act. The most direct and straightforward manner of implementing that directive is to amend §2B5.3(b)(1) to provide a sentencing enhancement based on a calculation of the retail value of the infringed item multiplied by the quantity of infringing items for all intellectual property offenses (except § 2319A violations). The problem with this approach is that it likely would overstate the pecuniary harm caused to copyright and trademark owners in the majority of cases currently sentenced under the guideline because it presumes (1) a one-to-one correlation between the sale of infringing items and the displaced sale of legitimate infringed items, which is unlikely in most cases, and (2) that the pecuniary harm resulting from each lost sale is equal to the retail value of the infringed item. Option 3 and Option 4 address this potential overstatement of pecuniary harm in different ways as described below.

OPTION 3 - CHANGE IN THE MONETARY CALCULATION

How it works: Option 3 addresses the potential overstatement of pecuniary harm caused by using the retail value of the infringed item by attempting to carve out from the universe of intellectual property offenses only those categories of offenses for which the infringed value may be the most appropriate. In other words, for some cases, instead of using the infringed value in all cases and

making adjustments (or departures) from that calculation to account for overstatement of pecuniary harm, it uses the infringed value only in those cases in which it appears to be the most appropriate. The infringing value would be used in all other cases.

Option 3 directs the court to use the retail value of the infringed item in any case in which:

(i) the infringing item is identical to, or substantially equivalent to, or the infringing item is a digital or electronic reproduction of, the infringed item;

(ii) the retail price of the infringing item is not less that [75%] of the retail price of the infringed item;

(iii) the retail value of the infringing item is difficult or impossible to determine without unduly complicating or prolonging the sentencing proceeding;

(iv) the offense involves the illegal interception of a satellite cable transmission in violation of 18 U.S.C. § 2511;

Option 3 further implements the directive (to provide for consideration of the retail value of the infringed item) and adds an element of judicial discretion by permitting the government to show, for any intellectual property offense, that such value is the more accurate assessment of pecuniary harm to the copyright or trademark owner than does the retail value of the infringing item.

Pros and Cons: The advantage of Option 3 is that by using the retail value of the infringing item in some cases, such as those involving obviously inferior counterfeited goods, it reduces the likelihood that the pecuniary harm would be overstated when the sale of a counterfeit item is not likely to displace the sale of a legitimate item on a one-to-one basis.

The disadvantages of Option 3 are that it is somewhat more complicated than Option 4 and, on its face if not in principle, appears to meet the directive less clearly and directly than Option 4.

Public Comment: The copyright industry endorsed Option 3 in its initial round of public comment, but in its most recent public comment changed its endorsement to Option 4. The copyright industry commented, however, that it would find Option 3 acceptable with minor modifications (which are not germane to the monetary calculation). In large part, the copyright industry dropped its written endorsement of Option 3 because the trademark industry opposed it. The trademark industry in its first round of public comment complained that the Option 3 in essence would treat trademark offenses as "second class offenses" to copyright offenses because the infringed value would be used in almost all copyright cases, but the infringing value would be used in a majority of trademark offenses. The trademark industry also contended that Option 3 failed to take into account the substantial harm to the reputation of a trademark that is caused by counterfeiting, regardless of the quality of the infringing item. In order to address this concern of the trademark industry, an upward departure consideration is provided for cases in which the offense involved "substantial harm to the reputation of the copyright or trademark owner."

The Department of Justice, in its written testimony, criticizes Option 3 as being very complex and possibly requiring a sentencing mini-trial concerning the quality and performance of the infringing item. The Practitioners' Advisory Group and the Federal Public and Community Defenders favor Option 3 as "more focused" and the most "sharply-focused . . . and best accounts for the harm that is not readily quantifiable. Option 3, although nuanced, is straightforward and not difficult to apply."

OPTION 4 - CHANGE IN THE MONETARY CALCULATION

How it works: Option 4 is built upon a proposal (previously identified as Option 2) submitted by the Department of Justice. Option 4 amends the infringement guideline to provide an enhancement based on a calculation of the retail value of the infringed items multiplied by the quantity of infringing items for all intellectual property offenses (except for § 2319A violations). Option 4 addresses the potential overstatement of pecuniary harm resulting from this calculation in two ways. First, it provides a 2-level reduction in offense level (but not less than the base offense level) for offenses involving (i) "greatly discounted merchandise" infringing goods with a price less than [25%] of the retail price of the infringed item, or (ii) infringing goods with a quality and performance "substantially inferior" to the quality and performance of the infringed item. In addition, a downward departure provision is provided for cases in which the 2-level reduction is inadequate to account for the overstatement of pecuniary harm. However, in such a case, the court may not reduce the offense level below the offense level that would result if the retail value of the infringing item were used in the calculation under subsection (b)(1). Like Option 3, Option 4 contains an upward departure provision for cases involving "substantial harm to the reputation of the copyright or trademark owner".

Pros and Cons: Option 4 was developed in response to public comment from the International AntiCounterfeit Coalition concerning Option 3. This trademark organization suggested that the Commission develop an option that uses the infringed value in all cases, regardless of the quality of the infringing item, and provide a 2-level reduction in cases in which the infringing item is obviously inferior to the infringed item. Option 4 also attempted to address the Department of Justice's proposal for a 2-level reduction in cases involving "greatly discounted merchandise".

The advantages of Option 4 are that on its face it appears to more clearly and directly meet the directive to provide for consideration of the retail value of the infringed item and may do so in a less complicated manner. However, the primary disadvantage of Option 4 is that, with respect to the greatly discounted merchandise prong, it has multiple layers of arbitrariness. First, the Commission would have to decide at what percent to set the cut-off point for the 2-level reduction, and there is little credible evidence as to where that point should be. Second, it is unclear that the 2-level reduction would be sufficient to account for any overstatement of pecuniary harm in a particular case (and, in fact, depending where on the loss table the monetary calculation lies, it may overcompensate in some cases).

Option 4 takes two steps to reduce the apparent arbitrariness of this prong. First, it adds an alternative prong to provide the same 2-level reduction if the infringing item is "substantially

inferior" to the infringed item. Second, it provides a departure provision if the 2-level reduction is insufficient. As described in more detail directly below, however, the public comment has been negative toward both of these provisions.

Public Comment: The Department states that Option 4 is a "clear improvement over the status quo and over Options 1 and 3," but asserts that the "substantially inferior" prong of the 2-level reduction will create many of the same litigation problems as Option 3. The Department adds that this prong will put the parties in the odd position of having the infringer contend that his product was of poor quality, while the victim must argue that the infringing item was of high quality. Thus, the Department reasserts that for purposes of the sentencing guidelines, the price differential between the legitimate and counterfeit items remains the best indicator of whether a counterfeit item displaced the sale of a legitimate item. Accordingly, the Department continues to support prior Option 2.

Industry, however, opposes relying solely on the price differential as a means of triggering the 2-level reduction, as Option 2 did. Both the copyright and trademark industries have criticized the "greatly discounted merchandise" reduction as creating "perverse incentives" to counterfeiters to sell their wares at very low prices, which in turn results in their capturing an even greater share of the market.

The International AntiCounterfeit Coalition proposes remedying the problems created by these prongs by requiring *both* greatly discounted merchandise and substantially inferior goods in order to trigger the 2-level reduction. In their latest comment, the copyright industry proposes modifying Option 4 by dropping the greatly discounted merchandise prong, and clarifying that electronic or digital reproductions are exempt from the substantially inferior prong.

In either event, both the copyright and trademark industries are likely to oppose the recently added downward departure provision in Option 4. This provision invites a departure in cases in which the 2-level reduction is insufficient to account for substantial overstatement of pecuniary harm caused by the use of the infringed value in the monetary calculation. It also prohibits the court from reducing the offense level on this basis below that which would have resulted had the infringing value been used in the calculation. In prior Option 1, which also used the infringed value in all cases (except § 2319A violations), there was a similar departure provision for substantial overstatement of pecuniary harm. The industry representatives commented very strongly against this provision as abdicating the role of the Commission in establishing guidelines that provide certainty and uniformity in sentencing, particularly because it is anticipated that the provision could be used in a number of cases. In its testimony, the Department also criticized the downward departure provision in prior Option 1 because it "will provide scarce guidance to the courts and entail the risk of great sentencing disparity through the frequent use of departures from the applicable guideline range."

OTHER PROPOSED MODIFICATIONS TO THE INFRINGEMENT GUIDELINE

Option 3 and Option 4 both contain a number of other modifications to the infringement guideline, §2B5.3, that take into account aggravating and mitigating factors that may be present in an

infringement case. The possible additional enhancements and adjustments are as follows:

(1) Increase the base offense level from level 6 to level 8. A 2-level increase in the base offense level would bring the infringement guideline more in line with the fraud guideline, §2F1.1. Both guidelines have a base offense level of level 6; however, the fraud guideline contains a 2-level enhancement for more than minimal planning, which applies to the great majority of fraud offenses. A similar enhancement does not exist in the infringement guideline, but, based on a review of cases sentenced under the guideline, if a more than minimal planning enhancement did exist, it similarly would apply in the majority of infringement cases. Thus, the majority of fraud offenses effectively start at an offense level of level 8, whereas infringement cases start at an offense level of level 6.

The copyright and trademark industries have commented in favor of this change. The Practitioners' Advisory Group and Federal Public Defenders oppose multiple grounds. First, they point out that the more than minimal planning concept has been troublesome for some time. Incorporating it into the base offense level would serve to overpenalize offenders who do not engage in more than minimal planning. Second, they contend that many of the other proposed adjustments to the infringement guideline more directly address important concerns about infringement. Finally, they question whether the analogy to fraud is apt, given that few consumers of infringing items are actually deceived into believing they are purchasing the legitimate item.

(2) Provide an enhancement of 2 offense levels, and a minimum offense level of level 12, if the offense involved the manufacture, importation, or uploading of infringing items. The Commission estimates that this enhancement would apply in approximately 2/3 of the cases currently sentenced under §2B5.3. The rationale for this enhancement is that defendants who manufacture, import, or upload infringing items are more culpable because they initially place infringing items in the stream of commerce, thereby enabling others to infringe the copyright or trademark.

This proposed enhancement received wide support in public comment.

(3) Provide a downward adjustment of 2 offense levels, but not less than the base offense level, if the offense was not committed for commercial advantage or private financial gain. This proposed adjustment stands alone in Option 3, but is one of three alternative prongs for the 2-level downward adjustment described above in Option 4. This adjustment takes into account the statutory penalty structures established for these offenses under the NET Act as well as the possibility that such offenders may have reduced culpability. The Commission has been unable to determine the frequency with which such a downward adjustment would apply because the statutory change criminalizing such conduct was enacted in December 1997, and has formed the basis for a very limited number of prosecutions.

The copyright industry opposes this downward adjustment because the harm caused by such offenses is in no way reduced by the fact that the offense was not committed for commercial advantage or private financial gain. The trademark industry has not commented on this particular provision. The Department included the same reduction as an alternative mechanism to "greatly discounted merchandise" for triggering the 2-level reduction in prior Option 2.

(4) Provides a suggested upward departure provision if the offense involved the conscious or reckless risk of serious bodily injury. This provision could apply, for instance, if a case involved counterfeit automobile parts or imitation soda. The Commission's review of cases sentenced under the guideline suggests that this offense characteristic rarely occurs, which is why this factor is proposed to be taken into account as a departure provision.

The copyright and trademark industries have commented that this factor should be included as an enhancement instead of a departure provision. The Department agrees, but would have it apply if the offense "involved a reasonably foreseeable risk to public health or safety." The Department also would include a minimum offense level of level 13. The current version is limited to the conscious or reckless risk of serious bodily injury to track similar language in the fraud guideline, §2F1.1.

(5) Provide an application note that expressly provides that §3B1.3 (Abuse of Position of Trust or Use of Special Skill) will apply if the defendant de-encrypted or otherwise circumvented some technological security measure in order to gain initial access to copyrighted material. As stated in the background commentary to §3B1.3, persons who use a special skill to facilitate or commit a crime generally are viewed as more culpable. Based on the Commission's review of cases sentenced under the copyright and trademark infringement guideline, it is anticipated that this adjustment would rarely apply.

This proposed application note received wide support in public comment.

WHAT'S MISSING FROM THE FEDERAL REGISTER PUBLICATION

A number of proposed modifications published in the *Federal Register* are no longer part of proposed Option 3 or Option 4. They are:

(1) An enhancement of 2 offense levels if the infringing item was distributed by the offender before the copyright or trademark owner commercially released the item. The copyright industry has commented that it strongly supports this enhancement because if the infringing item is substantially inferior, the harm is exacerbated by damaging the reputation of the copyright or trademark owners. However, the proposed departure provision for substantial harm to reputation should cover this situation. Industry also states that if the infringing item is a close substitute for the infringed item, the harm is exacerbated by denying the copyright or trademark owner the front end of the market. To address this harm, the copyright industry proposed adding a departure provision if the offense involves "substantial harm to the market of the infringing item". This industry suggestion has not been incorporated into the options because it appears redundant with the monetary calculation, is vague and ambiguous, and may result in double counting against offenders who already will receive an enhancement for manufacturing, importing, or uploading.

(2) An enhancement of 2 offense levels if purchasers of the infringing item were deceived to believe that they were purchasing the legitimate infringed item. The enhancement takes into account harm to the consumer who is actually deceived, over and above the harm to the copyright or trademark owner. However, the enhancement presents significant proof problems. An attempt

to ameliorate those problems by lowering the standard for triggering the enhancement to something less than actual deception, such as the reasonable likelihood of deception, risks promulgating an enhancement that is triggered merely by an element of the offense (see, 18 U.S.C. § 2320(e)). For these reasons, the enhancement is not including in either Option 3 or Option 4. Neither the Department nor industry has pushed for this enhancement.