NO ELECTRONIC THEFT ACT

Policy Development Team Report

February 1999

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I. Introduction

This Final Report is submitted pursuant to Section V(B) of the No Electronic Theft Act Policy Development Team charter. The Team was formed in October 1998, to assist Commissioners in developing and evaluating possible responses to two congressional directives contained in the No Electronic Theft Act, Pub. L. 105-147 ("the Act"). The Act directs the Commission to ensure that:

(1) the applicable guideline range for a crime committed against intellectual property (including offenses set forth at 17 U.S.C. § 506(a), and 18 U.S.C. §§ 2319, 2319A, and 2320) is sufficiently stringent to deter such a crime; and

(2) the guidelines provide for consideration of the retail value and quantity of the items with respect to which the intellectual property offense was committed.

As discussed below, the current sentencing guideline, §2B5.3, provides for increasing offense levels solely based on a monetary adjustment using the retail value of the *infringing* item. Therefore, in order to satisfy the directives, particularly the second, it would appear that the Commission must make some modification to the sentencing guideline.

Congress passed the Act in December, 1997 (attached as Appendix B). In January, 1998, the Commission published in the Federal Register a proposal from the Department of Justice ("DOJ") on the implementation of these directives as well as a general issue for comment on how to address the directives. *See* Appendix F. In March 1998, the Commission received public comment and heard testimony at a public hearing from a number of interested outside groups. *See* Appendix C.

In April 1998, the Commission staff, in consultation with DOJ and representatives of interested outside groups, developed additional options for amending §2B5.3, the offense guideline pertaining to intellectual property offenses. On April 23, 1998, the Commission voted to publish three options (including two submitted by DOJ) for additional public comment, which was received through August 31, 1998. *See* Appendices D and E.

Building on the work performed during the spring of 1998, the Team (i) analyzed the legislative history of the Act, (ii) reviewed the history of §2B5.3, (iii) reviewed the public comments the Commission received through August 1998, (iv) conducted an empirical analysis of cases sentenced under §2B5.3, (v) conducted a literary review, and (vi) researched relevant state law and federal regulation for guidance. Perhaps most important, the Team conducted a lengthy series of meetings with economists and representatives of industries most affected by intellectual property offenses in order to learn more about the harms they cause and how to quantify these harms. Specifically, the Team consulted with Economists Stephen E. Siewek and Kent W. Mikkelsen of Economists, Inc., Professor Bruce Kobayashi, an economist at the George Mason University School of Law, Professor Thomas Hardy, of the William & Mary School of Law, the Software Publishers Association, the Business Software Alliance, the Motion Pictures Association, the Interactive Digital Software Association, the Recording Industry Association of America, the International

AntiCounterfeiting Coalition, the Electronic Frontier Foundation, and the United States Customs Department, among others.

II Legislative History

Representative Robert W. Goodlatte (R-VA) introduced the NET Act on July 25, 1997,[1] in direct response to United States v. LaMacchia, 871 F.Supp. 535 (D. Mass. 1994) (hereinafter LaMacchia). LaMacchia involved a defendant who encouraged lawful purchasers of copyrighted computer games and other software to upload these works via a special password to an electronic bulletin board on the Internet. The defendant then transferred the works to another electronic address and urged other persons with access to a second password to download the materials for personal use without authorization by or compensation to the copyright owners. LaMacchia never benefitted financially or otherwise from any of these transactions.

The court dismissed the case holding that criminal sanctions available under Titles 17 and 18 of the United States Code for copyright infringement do not apply to cases in which a defendant does not realize a commercial advantage or private financial gain. In dismissing the case, the court stated that criminal copyright infringement law, from its origin in the Copyright Act of 1897 through the passage of the Copyright Felony Act of 1992, always required proof that the defendant acted willfully and for commercial advantage or private financial gain.

The NET Act reverses the practical consequences of LaMacchia and criminalizes computer theft of copyrighted works, whether or not the defendant derives a direct financial benefit or commercial advantage from the act(s) of misappropriation. *See* 17 U.S.C. §506(a)(2). The Act further provides that such offenses are punishable by up to three years of imprisonment for a first offense, and by up to six years for subsequent offenses (for offenses consisting of ten or more illegal copies of copyrighted works, which have a total retail value of $2,500 or more).
18 U.S.C. §2319(c). Offenses involving copyrighted works which have a retail value of more than $1,000 are punishable by up to one year of imprisonment. *Id.*

The NET Act, however, did not criminalize copyright infringements by *non-electronic* means that are not committed for private financial gain or commercial advantage. *See* 17 U.S.C. §506(a)(2). Nor did it increase penalties for criminal copyright infringements committed by non-electronic means. Such offenses generally are punishable by up to five years of imprisonment for a first offense, and by up to ten years for a second offense. 18 U.S.C. §§ 2319(b), 2319A(a). The NET Act also did not increase the penalties for trademark infringements or further criminalize such conduct. Trafficking in counterfeit goods or services are punishable by up to ten years of imprisonment for a first offense, and by up to 20 years for subsequent offenses.
18 U.S.C. §2320(a).

All of the testimony – and the entire body of the House Report – is devoted to the effects of copyright infringement. The Judiciary Committee's Subcommittee on Courts and Intellectual Property heard testimony from the Recording Industry Association of America, the Motion Picture Association of America, the Business Software Alliance, the United States Telephone Association,

[1] Representative Howard Coble, Chairman of the House Judiciary Subcommittee on Courts and Intellectual Property, Representative Barney Frank, Ranking Member of that Subcommittee, and Representative Chris Cannon of the Subcommittee were cosponsors of the Act.

the Software Publishers Association, Microsoft, and the Register of Copyrights, however, the vast majority concerned software piracy. Trademark offenses are not mentioned in the legislative history. This may suggest that although the directive to the Commission applies to "intellectual property offenses," the Commission's implementation of the directive could be limited to copyright violations.

Regardless of how broadly or narrowly the directive is interpreted, the legislative history of the Act does not indicate how Congress desires the Commission to amend the guideline to "provide for consideration" of the retail value of the infringed upon item. However, subsequent to its enactment, Representatives Goodlatte and Coble wrote to the Commission and stated that "the purpose of the directive was to replace the current Guideline's 'retail value of infringing items' standard with a 'retail value of infringed-upon items' standard. In so doing, it was Congress' intention to increase the potential criminal liability of infringers because it is the view of Congress that the current standard fails to offer an appropriate and effective level of deterrence." *See* Representative Goodlatte and Representative Coble Letter to the Commission dated August 28, 1998 (attached at E-1). Nonetheless, the fact that the language of the statute is not clear and unambiguous, coupled with the legislative history, suggests the Commission has a great deal of discretion in implementing the directive.

Subsequent to the enactment of the NET Act, Congress passed the Digital Millennium Copyright Act, Pub. L. 105-304 (hereinafter "the DMCA"), which became law on October 29, 1998. The DMCA does not contain any directive to the Commission, but it does contain criminal provisions relevant to the Team's consideration of §2B5.3 that prohibit the "circumvention of copyright protection systems" (§ 1201) and the "removal or alteration of copyright management information" (§ 1202). The former involves decryption or other means of accessing copyrighted material without authorization. The latter involves falsifying or distorting copyrighted material to facilitate or conceal its infringement. The DMCA provides for fines of up to $500,000 and imprisonment of up to five years for first offenders, and fines of up to $1,000,000 and imprisonment of up to ten years for subsequent offenses. The legislative history of the DMCA indicates that Congress was particularly concerned that "because digital works can be copied and distributed worldwide virtually instantaneously, copyright owners will hesitate to make their works available on the Internet without reasonable assurance that they will be protected against massive piracy.**"**

The DMCA also is, in large measure, a response to and the implementing legislation for the World Intellectual Property Organization Treaty (hereinafter "WIPO"), which the United States and 150 other signatory nations ratified in December 1996. WIPO establishes international reciprocity for copyrighted works, particularly motion pictures and sound recordings. Signatory nations are obliged to afford the same protection to foreign copyrighted works as they afford domestic ones.

III. Introduction to §2B5.3

A. Guideline History and Rationale

Section 2B5.3 (Criminal Infringement of Copyright or Trademark) was adopted with the initial set of guidelines in 1987 and largely retains its original form.[2] Like the guidelines for other

[2] The Commission promulgated two amendments to §2B5.3 in 1993. Amendment 481 was a technical and conforming amendment to reflect statutory changes and add "trademark" to the guideline's title. Amendment 482 added Application Note 1, which clarifies that "infringing

economic crimes, §2B5.3 aims to achieve proportionate punishment by setting the offense level according to the seriousness of the crime and, thus, largely mirrors the treatment of fraud offenses under §2F1.1 (Fraud and Deceit). Specifically, §2B5.3 provides for a base offense level of 6, which, like all base offense levels, is designed to reflect a minimal, general harm caused by the offense. In addition, if the value of the infringing items exceeds $2,000, the offense level is adjusted upward by the corresponding number of levels from the loss table in §2F1.1.[3]

The original Commission was persuaded that pecuniary loss to the primary victim(s) is generally the best basis for assessing the seriousness of all economic and property crimes, including infringement of intellectual property.[4] However, defining loss and determining appropriate offense level adjustments for different amounts of loss have proven difficult. In the fraud and theft context, the Commission is currently developing alternative approaches to defining and calculating loss. *See* 63 Fed. Reg. 65980 (Nov. 30, 1998).

The guideline for intellectual property offenses calls for offense level increases based on the value of the *infringing item.* Because this calculation more closely estimates the gross gain to the offender than the loss to the victim, at first glance §2B5.3 appears to depart from the loss-based approach to sentencing. However, former and current staff who participated in these discussions and material published contemporaneously indicate that the Commission adopted "retail value of the infringing items" not because they were trying to use gross gain as a measure of the seriousness of the offense, but because it was a clear and easily applied *proxy* for loss to the victim.

The original Commission was particularly concerned that proxies for loss be easy to calculate even if not precise. Indeed, Application note 8 in the original §2F1.1 stated that "the amount of loss need not be precise." This concern seemed particularly justified in infringement cases because alternative approaches either were too complicated,[5] or did not necessarily more accurately account for the economic harm to the victim. An example from the contemporaneous literature illustrates some of the concerns of the original Commission.[6] Using the value of the infringed *upon* item seemed

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items means the items that violate the copyright or trademark laws (not the legitimate items that are infringed upon)." The basic form of the guideline, and the rationale underlying it, remain that of the original Commission.

[3] The base offense level of 6 is the same as for fraud offenses, but 2 levels greater than the base offense level for theft. The loss table for theft, however, begins at $100 instead of $2,000. Thus, both tables yield the same offense level for thefts involving more than $2,000.

[4] Jeffrey Parker, *Criminal Sentencing Policy for Organizations: The Unifying Approach of Optimal Penalties*, 26 AM. CRIM L. REV. 513 (1989)(former Deputy General Counsel for the U.S. Sentencing Commission describes economic justification for loss-based sentencing, particularly for organizations).

[5] Economists on the research staff of the early Commission developed proposals for "optimal penalties" in infringement cases, but they were viewed as too complicated and impracticable. *See U.S. Sentencing Commission Discussion Materials on Organizational Sanctions, July 1988*, at 8.9-8.13.

[6] Mark Cohen, *Corporate Crime and Punishment: A Study of Social Harm and Sentencing Practice in the Federal Courts, 1984-1987*, 26 AM. CRIM L. REV. 605, at 640

to overestimate the harm because the sale of a counterfeit product, such as a fake Rolex, does not necessarily displace a sale of a real one. A consumer who purchases the fake Rolex for $20 on the street is unlikely to have the desire and/or financial means to purchase a genuine Rolex at its retail price. Further, the infringed-upon value fails to account for the production costs of the legitimate manufacturer, and thus overestimates its lost profits. In fact, the Commission believed that the retail value of the *infringing* items "will generally exceed the loss or gain due to the offense" for the very reason that the fake Rolex sale most likely does *not* displace a genuine Rolex sale – and, therefore, Rolex suffers no lost sale. *See* Background Commentary to §2B5.3.

Finally, the guidelines for other economic crimes contain other specific offense characteristics (SOCs) independent of the loss calculation that reflect additional harms to the victim, or to society as a whole, that are not as quantifiable as pecuniary loss. Both the fraud (§2F1.1) and theft (§2B1.1) guidelines contain numerous SOCs, although many of these were added after the drafting of the original guidelines (some in response to legislative directives). For example, §2F1.1 increases the offense level if the crime involved more than minimal planning, was committed through mass marketing, or jeopardized the safety of a financial institution, to name just a few of the SOCs. By contrast, §2B5.3 has no offense level adjustments other than the adjustment based on the value of the infringing items. The relative paucity of SOCs in §2B5.3 apparently reflects the lack of discernible distinguishing factors found by the original Commission in its foundation database and the heretofore relative lack of attention to the guideline.[7]

B. The Guideline in Practice

Section 2B5.3 covers a variety of infringement crimes. The harm to the copyright or trademark holder can vary widely depending on the type of item infringed, the method of infringement, and the quality of the infringing item. Therefore, it is important to consider what types of cases are currently sentenced under the guideline, as well as how the composition of types may change in the years ahead. Accordingly, Commission staff analyzed all cases sentenced under §2B5.3 in FY1996 and in the first six months of FY1998 — a total of 232 cases. Cases were categorized using a specially-developed coding scheme, which described the types of infringing items and other characteristics of the offense and offender.

Staff compared the mix of cases in FY1996 with the first six months of FY1998 to assess whether there has been any change in the types of cases sentenced over the past two years. We found that there has been a substantial increase in the *number* of cases sentenced under the guideline; more cases were sentenced in the first half of FY1998 (125) than in all of FY1996 (107). But the *composition* of case types has not changed. In particular, no increase in the portion of cases involving copyright as opposed to trademark infringement, or involving software, digital music, or online distribution was detected. Consequently, for purposes of further analysis the groups of cases

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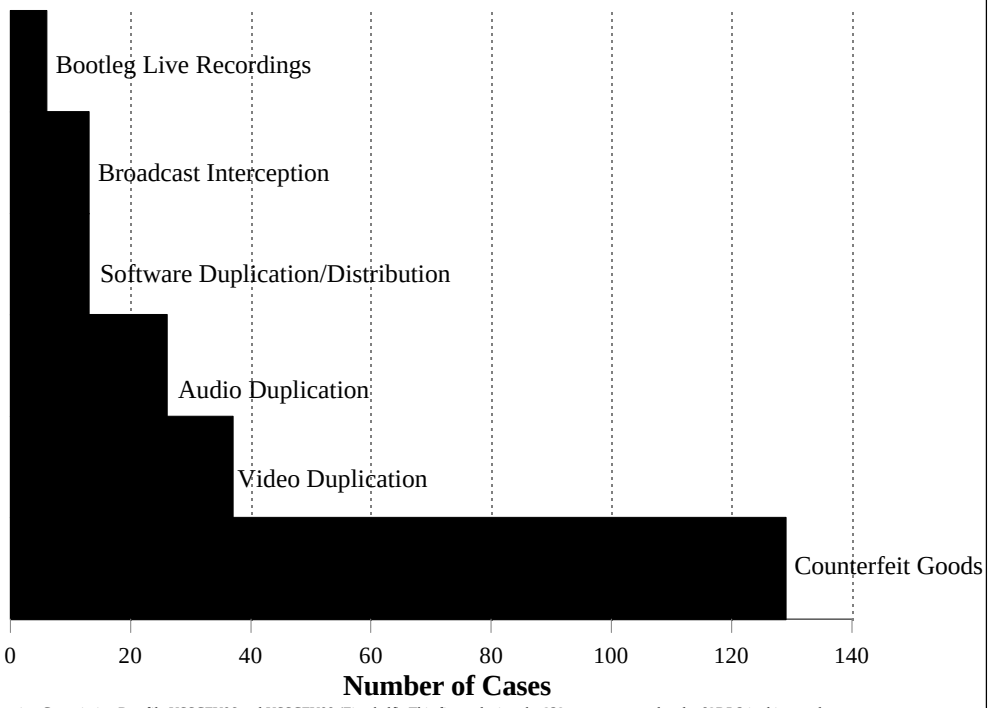
(1989)(describing difficulties in determining loss in infringement cases and reviewing past court practices in sentencing these offenses).

[7] *See* U.S.S.G., Ch. 1, Pt. A, 3 (describing generally the empirical approach used in drafting the guidelines).

for the two years were combined because there were no immediately discernible substantive differences them.

Figure 1
Copyright and Trademark Infringement Case Types



SOURCE: U.S. Sentencing Commission Datafile USSCFY96 and USSCFY98 (First half). This figure depicts the 232 cases sentenced under §2B5.3 in this sample.

Figure 1 displays the distribution of cases according to the primary type of infringing item. The statistical heartland of cases sentenced under the guideline consists of trademark infringement cases involving the manufacture and distribution of counterfeit goods. Overwhelmingly, these goods consist of clothing (NFL jerseys, tee-shirts with Disney characters, Levi's jeans, etc.). Offenses involving the distribution of counterfeit clothing often include accessories such as counterfeit handbags, watches, and pens as well. Copyright violations of videos and recordings comprise a significant minority. Software piracy and online infringements
are rare, but they could comprise a greater portion of cases in the future if the NET Act is enforced or other factors change the mix of cases prosecuted. All of the offenses apparently were motivated by a desire for financial gain, either personally or commercially.

Staff also analyzed the types of sentences that were imposed under the guideline. Because the offense level is driven by increases from the monetary calculation used in the loss table of the fraud guideline (§2F1.1), staff determined the number of cases falling at each level of the table. Table 1 shows that ninety percent of cases receive some offense level increase, with the majority having increases of three to six levels. (On average, each offense level increase raises the midpoint of the imprisonment range in the sentencing table approximately 12 percent.)

Table 1
Monetary Distributions for §2B5.3 Cases
(FY96 and first half of FY98)

Loss Amount	Offense Level Increase	N	%
Total		**232**	**100.0**
$0-$2,000	+0	24	10.3
More than $2,000	+1	6	2.6
More than $5,000	+2	17	7.3
More than $10,000	+3	31	13.4
More than $20,000	+4	33	14.2
More than $40,000	+5	21	9.1
More than $70,000	+6	28	12.1
More than $120,000	+7	15	6.5
More than $200,000	+8	14	6.0
More than $350,000	+9	7	3.0
More than $500,000	+10	12	5.2
More than $800,000	+11	4	1.7
More than $1,500,000	+12	8	3.5
More than $2,500,000	+13	9	3.9
More than $5,000,000	+14	2	0.9
More than $10,000,000	+15	0	0.0
More than $20,000,000	+16	0	0.0
More than $40,000,000	+17	0	0.0
More than $80,000,000	+18	0	0.0

The effects of these offense level increases, however, do not place most offenders in Zones D of the sentencing table, where some term of imprisonment is required by the guidelines, absent some reason for departure. Although the guidelines provide the option of imprisonment for all offenders, most offenders (69%) receive sentences of probation or probation with confinement conditions. Table 2 shows the types of sentences imposed for cases falling within each sentencing zone. Most cases received the least restrictive option available for their zone. For example, 89% of the cases in Zone A received probation sentences. In fact, 14.6% received sentence types less restrictive than required by their sentencing zone. Substantial assistance departures account for over two-thirds of these cases. The remaining one-third received other downward-departures.

For cases sentenced under §2B5.3 that received imprisonment only, Figure 2 shows where within the guideline range they were sentenced as well as the percentage that were sentenced above or below the guideline range. Figure 2 also compares this guideline range data for §2B5.3 cases with all cases sentenced under the guidelines in fiscal year 1996. The majority of prison sentences imposed under §2B5.3 were sentenced at or below the midpoint of the sentencing guideline range, and

approximately 40% were sentenced at the guideline range minimum. This finding is consistent with cases sentenced under the sentencing guidelines generally. (It should be noted, however, that the findings for all guidelines are dominated by drug offense cases, which account for approximately 40% of guideline cases.) What conclusions, if any, can be drawn from this data are not clear because a number of variables, such as criminal history or guilty pleas, may affect final sentencing decisions. For this reason, interpretations of the data in this figure should be made with caution.

TYPE OF SENTENCE IMPOSED ON §2B5.3 OFFENDERS IN EACH SENTENCING ZONE[8]

Sentencing Zone	Total	Prison Only		Split Sentence		Probation with Confinement		Probation Only	
		Number	Percent	Number	Percent	Number	Percent	Number	Percent
All Zones	**211**	50	23.7	15	7.1	50	23.7	96	45.5
Zone A	**91**	5	5.5	0	0.0	5	5.5	81	89.0
Zone B	**51**	6	11.8	1	1.9	35	68.6	9	17.7
Zone C	**27**	7	25.9	8	29.7	7	25.9	5	18.5
Zone D	**42**	32	76.2	6	14.3	3	7.1	1	2.4

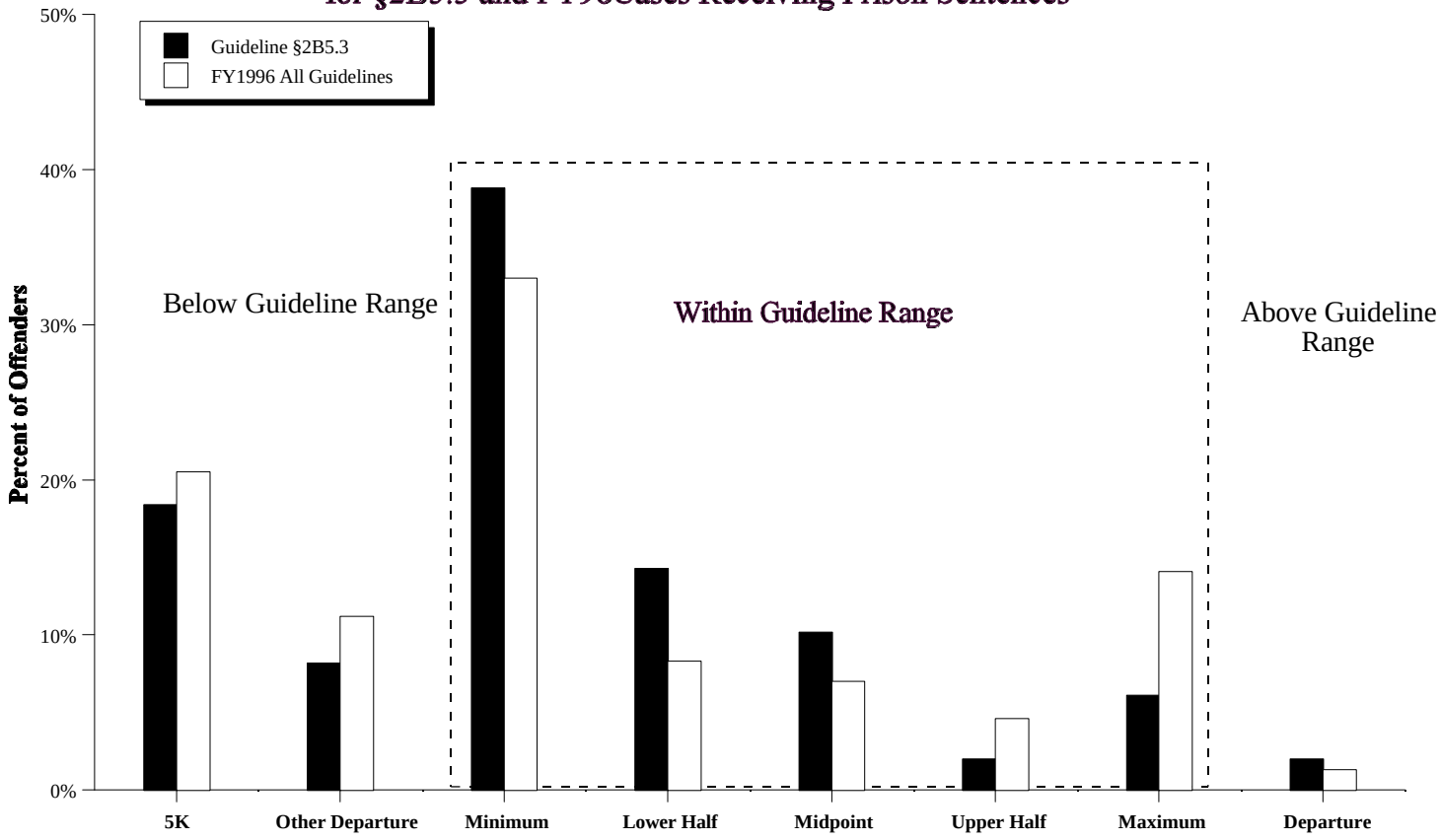
15.6% of §2B5.3 offenders received sentences greater than required by their sentencing zones.
(Compared to 12% of all offenders in FY96)

14.6% of §2B5.3 offenders received sentences less than required by their sentencing zones.
(Compared to 7.7% of all offenders in FY96**)**

◆ 68% of these §2B5.3 offenders received a substantial assistance departure
◆ 29% of these §2B5.3 offenders received other downward departures

[8]SOURCE: U.S. Sentencing Commission, 1996 Datafile, USSCFY96 and 1998 Datafile (first six months), USSCFY98. Of the 232 cases sentenced under §2B5.3, the Commission received complete guideline information for 211 cases. Of these, 21 were excluded for one or more of the following reason: missing zone, missing sentencing information, multiple guideline ranges, or no imprisonment or probation was ordered. The zones indicated correspond to the offense levels and criminal history categories established by the court and do not indicate the impact of mandatory minimums or statutory maximums constricting the sentence.

Figure 2
Use of Departures and Imprisonment Range for §2B5.3 and FY96Cases Receiving Prison Sentences



SOURCE: U.S. Sentencing Commission, 1996 Datafile, USSCFY96 and 1998 Datafile, USSCFY98 (first half) . Of the 232 cases sentenced under §2B5.3, 50 were sentenced to prison only and appear in this figure. Of the 42,436 cases sentenced in FY96, 27,598 received prison sentences and are represented in this figure.

IV. The Role of the Guidelines in Deterring Infringement Crimes

The Sentencing Reform Act charges the Commission with evaluating how effectively federal sentences accomplish the four purposes set forth at 18 U.S.C. 3553(a)(2).[9] The NET Act specifically directs the Commission to ensure that punishment for crimes against intellectual property is "sufficiently stringent to deter" such crimes. In addition, industry representatives expressed as one of their key concerns the deterrence of criminal copyright and trademark infringement. The Team focused largely on identifying the range and relative seriousness of harms resulting from infringement crimes.

A. A Lack of Swift and Certain Punishment

Industry representatives provide both anecdotal reports and data suggesting that intellectual property offenses are damaging American industry and that currently such crimes are not deterred adequately. Standard criminological theory posits that the deterrent value of criminal sanctions depends on the *certainty* and *swiftness* of punishment as well as its *severity*. While the NET Act focuses only on the latter, discussions with industry representatives made clear that the uncertainty of any punishment also plays a significant role in the widespread failure of deterrence.

Industry representatives repeatedly complained that infringement cases were not prosecuted frequently, and that when prosecuted, the penalties were not sufficiently severe. U.S. Attorneys' offices may be reluctant to prosecute intellectual property offenses for a number of reasons. First, U.S. Attorneys' offices simply may choose to allocate prosecutorial resources to crimes they perceive as more serious and demanding more attention. Second, prosecutors could not press criminal charges against infringers who did not personally or commercially gain from the infringement before the passage of the NET Act. Industry representatives report some prosecutors may not be fully aware of the NET Act or its implications because some prosecutors recently have informed them that no crime has been committed if the infringer did not personally or commercially gain from the infringement. With the enactment of the NET ACT, such assertions are no longer correct.

Third, and most important for our purposes, the current guideline structure may affect prosecutorial decisions. Industry representatives report that U.S. Attorneys' offices claim that the current guideline structure provides insufficient incentive to bring these cases because they rarely result in imprisonment and, therefore, are not worth allocating the resources to prosecute. This suggests that some offices may have monetary thresholds beneath which they will not prosecute. It also could signal confusion over the calculation of the applicable monetary amount. Industry representatives report that prosecutors interpret the retail *value* of the infringing item to mean the retail *price* of the infringing item. In the copyright context, however, the two figures can be quite different. In the case of pirated software given away on the Internet, for example, the price of the

[9] 28 U.S.C. 991(b)(1)(A). Two of these purposes – incapacitation and rehabilitation of offenders – are addressed in guideline provisions that lie beyond the scope of the Policy Team's charter. Chapter Four addresses the need to incapacitate an offender through determination of the criminal history score. Chapter Five addresses treatment and training needs through conditions of probation and supervised release.

infringing item is zero, but the value of the infringing item is identical to the retail value of the legitimate software (less the value of any accompanying documentation and support). Finally, prosecutors may be unwilling to bring cases in which the monetary amount is difficult to determine because the sentence is so dependent on that amount. In any event, industry representatives expressed a desire that the guidelines be amended to provide the U.S. Attorneys' offices with greater incentive to prosecute these cases.

U.S. Attorneys' offices are not the only parties reluctant to prosecute intellectual property offenses. The intellectual property owners themselves rarely press charges. Industry representatives reported a few cases in which an employee of the intellectual property owner was the initial source of the infringement, but the employer declined to seek criminal penalties.

B. Industry Desire for Incentives and Examples

The industry representatives look to the Commission to send a signal to both the public and prosecutors via heightened guideline penalties that these crimes are serious and that their prosecution is important in the hope that this will deter intellectual property offenses. Several suggested that a few well-publicized prosecutions yielding severe penalties would have a significant deterrent effect. At the same time, there is no data to show whether the current penalties might provide a sufficient deterrent if more cases were prosecuted. Nor is there data to show whether increasing the penalties will provide the desired incentive for increased prosecutions or greater use of imprisonment.

Industry representatives believe an additional important reason to increase penalties for intellectual property offenses is to provide a model for overseas law enforcement. The Software Publishers Association, for instance, asserts that software piracy is seen by some nations as an easy way to bring themselves into the new technology-based global economy (specifically citing Singapore, Hong Kong, France, Italy, Greece, Argentine, Brazil and Israel as key offending nations).[10] Industry representatives report difficulty in persuading foreign countries to prosecute infringement cases and that foreign representatives sometimes cite lax enforcement in the United States as an excuse. Consequently, many industries, with the support of the U. S. government, are engaged in a campaign to increase international recognition and enforcement of intellectual property rights. Industry representatives seek federal penalties that can provide a model for other countries to treat copyright and trademark violations severely.

V. Harms Caused by Copyright and Trademark Infringement

A. Proportionate Punishment and Types of Harm

[10] Software Publishers Association, *Software Piracy and Global Competitiveness, 1998 Report on Global Software Piracy,* at 3.

The original Commission made proportionate punishment — matching the relative severity of punishment to the seriousness of the crime — a primary purpose of the guidelines. Proportionate penalties are assumed to help control crime[11]. A crime's seriousness is determined in part by the *harms* it causes, particularly to the primary victim, but also to society as a whole. See §1B1.3 and the definition of harm. Pecuniary *loss* is an important type of harm, which the loss table adjustment in many guidelines attempts to capture. But there are other harms, which are not always quantifiable, and which are taken into account in other guidelines by SOCs. Understanding the different types of harm resulting from infringement crimes, and how §2B5.3 might account for them, became a primary objective of the Team.

Proponents of the "just desserts" sentencing philosophy assert that a defendant's *culpability*–including his or her intentions and motivation for the offense and control over the crime's consequences–are also important considerations in determining a crime's seriousness.[12] The NET Act was intended to ensure the *criminal liability* of offenders, even if their infringement was not committed for the purpose of commercial gain or advantage. However, a defendant's motivation may still be a relevant consideration for sentencing purposes.

B. Harm to the Owners of Intellectual Property

1. Global Estimates

The legislative history surrounding the NET Act makes clear that a primary concern of Congress was the harm to U. S. corporations of copyright violations, particularly piracy of computer software, compact discs, and movie videos. Several congressional representatives and witnesses in hearings on the bill cited a study by International Planning and Research (IPR) which estimated that global losses to the business software applications industry alone exceeded $11 billion in 1996, of which about $2 billion was in the United States. It should be noted that, for purposes of this study, the loss caused by an infringement was assumed to be the retail value of the legitimate software, a figure which may overstate the harm, as discussed in more detail below. IPR estimated that, of the 523 million new business software applications used globally during 1996, 225 million – nearly one in every two – were pirated. This represents a 20% increase in the number of units estimated to have been pirated in 1995 (187 million). IPR estimated that more than one in four (27%) computer programs are pirated in the United States. Although this figure compares favorably with international statistics — in some countries 80-90% of business software applications are pirated — it represents the largest single-country loss because of the size of the U.S. market.[13]

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[11] *See* Guidelines Manual, Chapter 1, Part A, Section 3, discussing the general compatibility of just desserts and crime control objectives.

[12] *See* Andrew Von Hirsch, DOING JUSTICE: THE CHOICE OF PUNISHMENTS (1976), Chapter 9, for the original and influential argument in favor of this approach to sentencing.

[13] IPR Piracy Study, 1997. This survey can be found at http:www.bsa.org/piracy.

There is little doubt that American companies, entertainers, and artists suffer significant losses through piracy of movie videos, musical recordings, and video games. Estimates in the 1980s were that five to ten percent of the nation's video inventory was pirated, costing the home video business even then $600 million domestically and millions more worldwide.[14]

In the area of counterfeiting and trademark infringements, the International Trademark Association sponsored a study by the econometric firm WEFA of losses to a wide range of industries, including apparel, shoes, and sports franchises. WEFA found that participating companies lost an estimated 22 percent of their total sales worldwide, or $2 billion, as a result of trademark infringement.[15]

2. Losses Due to Particular Infringements

Global estimates of industry-wide losses help underscore the seriousness of copyright and trademark infringement generally, but loss estimation for sentencing purposes is somewhat different. If penalties were tied directly to the amount of harm caused, factual findings somewhat analogous to determining compensatory damage awards in civil cases of copyright or trademark violations would be required.[16] Economists interviewed by the Team identified three categories of harm to property holders caused by infringements: 1) lost sales, 2) price erosion, and 3) reputation damage.

Lost sales are the most apparent, and most often cited, harm caused by infringement. In the area of copyright infringement, in particular -- where digital copies of software or musical recordings may be virtually identical to the original -- distribution of pirated copies plausibly replace sales of the legitimate item. The growth of the Internet and the creation of websites devoted to the distribution of pirated software and recordings, as described in greater detail below, have created a need to prevent the black market from overwhelming legitimate producers and suppliers.

The economists and industry representatives with whom we spoke agreed, however, that a one-to-one correspondence between pirated or counterfeit copies and the displaced sale of a legitimate item cannot be assumed and, in fact, would be highly unlikely in the vast majority of infringements. A product-by-product or even case-by-case analysis would be needed to determine how many legitimate sales of, Windows 98, for example, would be displaced by a certain number of pirated copies. Several examples of how distribution of an infringing item may *not* displace a sale of a legitimate product were noted. First, counterfeit products – such as Gucci bags or Hermes scarves,

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[14] Jayachri Srikantiah, *The response of copyright to the enforcement strain of inexpensive copying technology,* 71 N.Y.U. L. Rev. 1634 (1996) (citing Motion Picture Association of America estimates).

[15] International Trademark Association, *The economic impact of trademark counterfeiting and infringement* (April, 1998)(available at http://www.inta.org/tmctrftg.htm).

[16] For an introduction to issues in the civil arena, see Roger D. Blair & Thomas F. Cotter, *An Economic Analysis of Damages Rules in Intellectual Property Law*, 39 WM & MARY L. REV. 1585 (1998).

especially when sold at prices well below the legitimate good – may be purchased by consumers who are unwilling or unable to purchase the genuine product at its full price. The infringing items thus supply a low end of the market, which presumably would otherwise go unfilled by the trademark owner. Second, some persons collect "trophy" copies of software or video games simply to "prove they can do it" and to add to their collection; they would not otherwise purchase the legitimate item.

Price erosion occurs in two ways. First, if the infringing item is a close substitute for the legitimate product, it effectively increases supply which, in turn, decreases price. Second, the counterfeit or pirated items may depress demand for the legitimate product either by reducing its exclusivity or by tainting its reputation, thereby creating pressure to lower prices. The infringement thus affects not only the lost sales replaced by the counterfeit or pirated item, but also the sale price of the legitimate items.

Reputation damage was consistently cited in our interviews as an important concern of copyright and trademark holders, and it can arise in several ways. Counterfeit items of inferior quality, if "palmed off" on unwary consumers, constitute misrepresentations of the legitimate manufacturer and can obviously damage its reputation for quality. One area in which this is of particular concern is the illegal distribution of pre-release products, such as a developmental "beta" version of a video game or software application. The quality of these pre-release versions often is inferior to the final product that the copyright owner plans to release, usually because pre-release versions still have "bugs." As word of the inferior quality spreads, consumer demand for the legitimate software often decreases. In cases not involving pre-release items, the process of copying, especially of videotapes but also of software, may produce low quality or corrupted copies or even introduce computer viruses. Even products of comparable quality can dilute the value of a mark by reducing its exclusivity or cache.

It should be noted, however, that some economists contend that infringement can sometimes benefit trademark and copyright holders, as well as consumers and the economy as a whole.[17] Copyright holders have been urged to engage in "selective enforcement" of their rights, because copying can have benefits by fostering exposure and commitment to a product among consumers who might not otherwise enter its market.[18] The economic model of "optimal penalties" also identifies ways that some types of infringement can be good for the economy, and excessive punishment bad for it.[19]

C. Harms to the Public and to Society at Large

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[17] See discussion in William R. Johnson, *The economics of copying*, 93 J. Pol. Econ. 158 1985)(citing among others Stephen Breyer, *The uneasy case for copyright: A study of copyright in books, photocopies, and computer programs*, 84 Harv. L. Rev 281 (1970)).

[18] Kathleen Conner & Richard Rumelt, *Software piracy: An analysis of protection strategies*, 37 Management Sci. 125 (1991); Lisa Takeyama, *The intertemporal consequences of unauthorized reproduction of intellectual property*, 40 J. of Law & Econ. 511 (1997).

[19] Parker, *supra* note 4.

1. Consumer Losses

Industry representatives report a number of ways that consumers can be harmed by copyright or trademark violations. At the extreme are unwitting consumers of inferior counterfeit goods. These consumers are additional victims of a crime that is part fraud perpetrated against them, and part theft from the mark-holder. Persons who purchase "palmed-off" merchandise may pay the same or nearly the same price as a purchaser of a legitimate product. In many cases the product is of inferior quality. In rare cases it may represent a health or safety hazard. For example, our case review revealed a few cases involving the manufacture and sale of counterfeit soft drinks and cleaning solution and the mislabeling of automobile brake parts. Although the record did not indicate that any actual physical harm occurred in those cases, the potential for such harm exists.

Even consumers of pirated digital products such as software, where the product is often an exact copy of the legitimate software, may suffer some harm. Software companies do not provide technical support for pirated copies (as the consumer may discover when asked to provide proof of purchase). They are not eligible for free upgrades that the company may provide, and documentation for the program often is not available.

Most infringements, however, do not involve consumer deception. *Knowing* purchasers of infringing items raise entirely different issues. By knowingly buying a counterfeit product, the consumer promotes the violation and is more akin to an accomplice in the crime than a victim of it. Determining whether deception is involved in a particular offense is sometimes impossible because of the role the infringer plays in the distribution chain. For instance, in a police raid on a factory sewing counterfeit designer labels into clothing it may not be possible to discern whether the goods would be sold on the street at a fraction of the retail value of the legitimate good, in which case consumer deception is unlikely, or through a legitimate retail outlet, where the likelihood of consumer deception seems greater. The sale of counterfeit goods at reasonable prices through a legitimate channel seems suspicious. But only a naive consumer would believe that Chanel No. 5 can be bought on New York's Canal Street for a small fraction of the suggested retail price. In many cases in our sample, only circumstantial evidence relating to the consumer deception issue was available.

In addition to unwitting *purchasers* of *counterfeit* items, the *owners* of limited-number *genuine* items, such as a collector of numbered art prints by Salvatore Dali, may suffer loss due to an erosion of the value of their property if counterfeits are widely available.

2. General Societal Harm

In addition to the direct harms to property owners and consumers, infringement crimes have secondary effects throughout the economy. The IPR study cited above estimated that software piracy alone resulted in 130,000 lost jobs, $5.6 billion in lost wages, and $1 billion in lost tax revenues. Many industry representatives described powerful disincentives to entrepreneurs created by

widespread piracy. Companies forego investing in research and development and fail to introduce new products for fear that they will not be able to recoup their investment.[20]

Several industry representatives and some published accounts have pointed to the connections between piraters, counterfeiters, and organized crime.[21] Traffickers in pirated software or videos tend to establish criminal distribution networks, often with connections to international gangs. Law enforcement personnel have said that high-level syndicates are behind some of the counterfeiting operations in the Los Angeles area. They cite cases in which money from counterfeiting and piracy can be used to fund other criminal operations involving drugs, gambling, prostitution, or even terrorism.

3. The Unique Challenge of Online Electronic Infringement

The growth of the information and entertainment industries, the expansion of the Internet, and the digitalization of intellectual property present unique challenges to the enforcement of copyright law. These developments were clearly part of the motivation for passage of the NET Act. Copyright-protected industries, especially software companies, are the fastest-growing sector of the U. S. economy and an integral part of America's economic prospects in the global economy.[22]

The Software Publishers Association's 1998 Report on Global Software Piracy perhaps best describes the challenge:

> Software piracy can be committed in a wide variety of ways, including softlifting, counterfeiting, hard disk loading, rental, OEM unbundling and Internet. This factor, combined with the ease of duplication and high quality of pirated software presents a unique problem to the software industry. Unlike other products . . . , there is little or no degradation in the quality of software from copy to copy. Even worse, a program that reflects unprecedented technology, years of effort and millions of development dollars can be duplicated in minutes with the touch of a button. Any PC user can duplicate a product priced from $20 to $20,000 for no more than the cost of a few blank diskettes or at no cost, and that user can make one, a dozen or a thousand perfect copies.[23]

The computer equipment needed to engage in Internet piracy or infringement is affordable, readily obtainable, and common to homes and offices worldwide. One report found that even by 1993, piracy

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[20] Software companies spend on average between 10-15% of their revenues on research and development. Members of the Business Software Alliance spent $9.3 billion in 1995, which accounted for almost 9% of research and development spending by all U.S. companies.

[21] Christina Wood, *Is your software stolen?* PC World (December 15, 1998).

[22] Stephen E. Siwek and Gale Mosteller, Economists, Inc., *Copyright Industries in theU.S. Economy, 1998* (prepared for the International Intellectual Property Alliance).

[23] SPA Report, *supra* note 10, at 4.

from Internet bulletin boards accounted for $1.5 billion in potential lost software sales.[24] The Interactive Digital Software Association reports that on any given day there are over 200,000 web sites with illegal copies of video games available for unauthorized downloading, and often these games are made available at no cost. The Business Software Alliance showed the Team numerous websites devoted exclusively to the distribution of illegal software.

Industry representatives report that the ease of copying and distributing infringing items over the Internet threatens the healthy development of these crucial industries. Morever, this is a problem faced not only by large companies who, some would argue, can absorb these costs. Of the Software Publishers Association's 1,200 members, for example, 885, or 75%, have annual revenues less than $2 million. Piracy in the United States and abroad seriously damages these companies' ability to compete successfully in the global marketplace and to develop the next generation of cutting-edge technology. Software pirates can single-handedly interrupt their revenue stream and cause economic instability for them.[25]

Compounding the problem of infringement via the Internet is the difficulty of detection. Because one's Internet address is not a location in the geographical sense, investigators may be aware of infringing web sites but unable to locate their creators. Further complicating detection is the fact that individuals who maintain infringing sites frequently change their Internet service providers so that they are constantly avoiding detection. Once identified, determining the number of illegal copies downloaded from a particular site often is difficult or impossible, either because such records are purposely destroyed by the offender on a daily basis, or because the Internet service providers are unwilling to provided them.

Of the cases in our sample, only five involved online electronic infringement. Three of the cases involved trading of software on an electronic bulletin board, and the other two involved the illegal sale of software via the Internet. However, given the rapid growth of the Internet and the passage of the NET Act, it is reasonable to expect more of these cases in the future.

VI. The Difficulty of Accurately Measuring Total Harm

The review above illustrates the variety of pecuniary losses and social harms that result from copyright and trademark infringement. It should be clear that it is difficult to establish a simple, generally applicable rule that will accurately and fully measure the harm caused by the wide variety of offenses sentenced under guideline §2B5.3. The economists with whom the Team spoke agreed that, even in the context of civil litigation concerning the narrower issue of pecuniary damage to a particular property holder, measuring the amount of damage is an inexact science. No simple formulas exist, and courts routinely hear time-consuming, conflicting and highly technical expert testimony. The practical realities of the sentencing process necessitate a simpler, more easily workable approach.

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[24] Cited in Srikantiah, *supra* note 13.

[25] SPA Report, *supra* note 10, at 4.

By focusing on the number of infringing items and the proper measure of their value, the present guideline and the directive in the NET Act channel attention to one type of the harm (perhaps intended to approximate lost sales). However, at best this is an incomplete measure of the different types of harm that arise in different types of infringement crimes. Further, it may encourage a false sense that the seriousness of a particular offense has been measured precisely, thereby diverting attention from other aspects of the crime that justify a more or less severe sentence. The challenge for the Commission is to develop a reasonable proxy for loss in the heartland of cases sentenced under the guideline, and to the extent that discrete additional harms or mitigating factors can be identified, SOCs might be considered to reflect them.

VII. Proposed Methods for Estimating Economic Harm.

The logical starting place for the Commission to implement the second directive in the NET Act – that is, to provide for consideration of the retail value and quantity of the items with respect to which the crime against intellectual property was committed – is to change the application of §2B5.3(b)(1), the SOC that references the fraud loss table. As explained above, this SOC currently increases the offense level based on a monetary amount calculated using the retail value of the *infringing* items. The Team has identified three methods by which the Commission could incorporate the retail value of the *infringed-upon* item:

1. Use the retail value of the infringed-upon item for all intellectual property violations,

2. Use the retail value of the infringed-upon item for copyright violations, but use the retail value of the infringing item for trademark violations, and

3. Use the retail value of the infringing item as the starting point for all intellectual property offenses but make some modifications to the guideline to provide for consideration of the retail value of the infringed-upon item.

This section addresses each method in turn.

A. Method One: Use Infringed-Upon Value as Default.

The most direct method of providing for consideration of the retail value of the infringed item is to base the monetary adjustment of §2B5.3(b)(1) on the retail value of the *infringed-upon* item instead of the retail value of the *infringing* item, as is currently the case. For example, if an offender sells 100 counterfeit Gucci purses with a retail value of $15, under the current guideline the monetary adjustment would be $1,500 ($15 multiplied by 100). Basing the adjustment on the retail value of the infringed-upon product – in this case the retail value of a *genuine* Gucci purse – would result in a higher monetary adjustment: 100 multiplied by the retail value of a genuine Gucci purse. The three proposals drafted by DOJ staff for the Commission's consideration in 1998 use this method. *See* Appendix D, at D-3, D-6; Appendix E, at E-34.

1. Analysis.

Using the retail value of the infringed-upon item has some features that, on its face, make it an attractive alternative to the current method of calculating harm. However, upon further analysis, the Team concludes that this method most likely would overestimate the harm in the majority of cases currently sentenced under §2B5.3. Its most obvious advantage is that it most clearly and directly responds to the second directive of the NET Act because it directly uses the infringed-upon value to calculate the guideline offense level in every intellectual property offense.

Overstates Harm Because No One-To-One Lost Sales Correlation

If an infringement deprives an intellectual property owner of sales, the infringed upon value arguably more accurately accounts for the gross lost revenue — one of the three economic harms suffered by intellectual property owners — than the infringing value.[26] Thus, if there were a finding that in most cases the sale of infringing items causes a one-to-one loss in sales to the intellectual property owner, then adopting the infringed-upon value might make more sense than the current guideline measurement.

The Team, however, found no evidence of a one-to-one correlation between sales of infringing items and lost sales to the intellectual property owners. The economists and industry representatives with whom the Team consulted uniformly agreed that one cannot credibly claim that such a relationship generally exists. Moreover, in the civil context (particularly patent infringement cases), very detailed and protracted expert testimony is generally required to prove *any* lost sales.

The Team's review of FY 1996 and FY 1998 cases sentenced under §2B5.3 also suggests that the sale of infringing items does *not* cause a one-to-one displacement of legitimate sales. The majority of cases involve consumers who purchase counterfeit designer trademarked goods at a fraction of the price of their legitimate counterparts and/or in settings that suggest that the purchasers know they are not buying the genuine article (*e.g.,* a flea market). In other words, consumers generally know they are buying illegally trafficked articles and yet do so anyway (one would presume because of the price disparity). The consumer's complicity and the large disparity between the retail price of the infringed-upon item and the infringing item suggest that the consumer would *not* (or could not) have purchased the legitimate good if the infringing item had not been available.

Of course, the composition of guideline cases may change. But even in cases that do not involve counterfeit designer goods, a one-to-one lost sales correlation cannot be shown. As described above, industry representatives report that software, for example, that retails for thousands of dollars routinely is distributed on the Internet at no cost. The same is true for audio materials and soon will be true for videos. It is uncertain that someone who downloads thousands of dollars worth of software at no cost has (i) the desire and (ii) the financial means to purchase the legitimate software

[26] At least the infringed-upon value would appear to have a stronger correlation to lost revenue than the infringing value.

in the absence of the availability of the illegal copy; therefore, it is questionable whether a lost sale has occurred in this kind of case. [27]

There is a minority of cases in which a one-to-one correlation in lost sales may reasonably be assumed: those in which the consumer actually believes he is purchasing the legitimate item when in fact he is not. The fact that the consumer thought he was buying the legitimate article by itself suggests that the consumer *may* have purchased the legitimate article if the infringing article had not been presented instead. This is particularly true if the price of the infringing item approximates the price of the infringed-upon item because it evidences not only the consumer's desire to purchase the genuine article, but also the financial means to do so. Moreover, the consumer presumably would have preferred to purchase the legitimate item if he had known the truth.

Note, however, that in cases of actual consumer deception, whichever base method the Commission adopts (*i.e.*, infringing value or infringed-upon value) would have little practical effect because the likelihood of consumer deception increases as the price difference between the infringing and infringed good decreases. A consumer who purchases a "Rolex" watch for $15 cannot reasonably believe that he has purchased the legitimate article, but one who purchases a counterfeit Rolex for $500 very well may. Thus, the price of the infringing article usually will approach more closely the price of the infringed-upon article in cases of consumer deception than in cases of consumers who knowingly purchase counterfeit items. Given that the difference between the two values will be less, the significance of choosing one method of valuation over the other also is diminished for this class of cases.[28]

Even if a one-to-one correlation in lost sales can be shown, the infringed-upon value overstates the harm from a lost sale because it does not account for costs associated with developing, producing and distributing the legitimate item. For example, Ralph Lauren may sell a Polo shirt for $50, but after deducting labor, material, and marketing expenses, the company may earn only $10, for example, from each sale. Thus, if a consumer who otherwise would have purchased the genuine article purchases a counterfeit Polo shirt, Ralph Lauren suffers a net loss of only $10, not the infringed-upon value of $50.

May Capture Other Economic Harms.

Although the infringed-upon value may overstate the harm caused by lost sales, one may argue that it is still a more complete measure of economic harm. For instance, in the Polo shirt example just cited, the infringed-upon value overstates the monetary harm caused to Ralph Lauren from the lost

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[27] Indeed, this method arguably overstates the harm the most for those offenders who personally gain the least, such as those who give away illegal copies at no cost.

[28] Of course, some percentage of consumers who are not deceived might have bought the genuine article if an infringing copy was not made available by the offender. Unfortunately, economists and industry representatives agree that determining this percentage is a near-impossible task within the confines of a sentencing hearing.

sale, but it may account for harm to other parties in the legitimate article's distribution chain. Even though Ralph Lauren net profits are only $10 on the sale of the $50 shirt, the other $40 represents payments by Ralph Lauren to legitimate suppliers of material, labor and other services, as well as payments by consumers to legitimate retailers — payments that may be diverted in the absence of a legitimate sale.

Moreover, one might argue that any overstatement of harm from lost sales that results from using the infringed-upon value can be viewed as an attempt to account for other economic harms, such as price erosion and reputational damage. However, the economists and industry representatives with whom the Team consulted uniformly agreed that there is no reasonably practicable method for measuring these other economic harms from individual violations, much less for entire categories of offenses. As a result, the Team has identified other adjustments to §2B5.3 that the Commission may want to consider as a way to account for these other incalculable, but nonetheless real, economic harms.

Practical Concerns

One advantage of using the infringed-upon value, at least in some cases, is that it may be easier for courts to determine that value than it is to determine the infringing value. The retail price of an infringed-upon item is a legitimate market figure, whereas the infringing value depends on gray- or black-market information that may not be readily available. How often this distinction is relevant in practice is a matter of debate. The infringing value most likely will be readily discernable from the investigation of the offense; law enforcement officers usually know exactly how much the infringing goods were being (or are typically) sold for.

Using the infringed-upon value, however, also presents its own challenges. The same legitimate good may be sold at different prices at different retailers, and courts may find it difficult to choose which price to use. The Commission could direct the court to use the Manufacturer's Suggested Retail Price (MSRP), however, goods usually sell at a discount from the MSRP. Thus, such a decision would further exacerbate the overstatement of harm.

2. Counterbalancing Downward Adjustment

When DOJ proposed the infringed-upon value in the spring of 1998, the Department apparently recognized the criticisms discussed above. Specifically, DOJ stated that "[a] sentencing calculation based on the retail value of the infringed items may lead to an unfair result" when the retail price of the infringing item is significantly less.[29] DOJ then suggested compensating for the overstatement of harm through a downward adjustment. Its April 17 proposal included an SOC that subtracts 2 offense levels when the price of the infringing item is between 30% and 50% of the price of the infringed-upon item, and subtracts 4 levels when the price of the infringing item is less than 30% of the price of the infringed-upon item. Its April 15 proposal encouraged a downward departure when the price of the infringing item is less than 30% of the retail value of the infringed-upon item. The

[29] Department of Justice Letter dated August 31, 1998. Attached at Appendix E, at E-27.

latest DOJ proposal, submitted in August, provides a 2-level reduction if the price of the infringing item is less than 10% of the retail price of the infringed-upon item.[30]

The solutions to this problem, however, present a number of problems themselves. First, the choice of a percentage cut-off point appears to be arbitrary—as evidenced by the fact that the DOJ proposals varied from targeting the downward adjustment to infringing items that retail 50% to 30% to 10% of the infringed-upon item, and from 4 to 2 levels. There is no empirical basis for the conclusion that the infringed-upon value never overstates economic harm when the infringing price is 35% of the infringed-upon price, for instance, but always overstates harm when the figure is, for example, 5%. As discussed above, as the difference between the infringing value and the infringed-upon value increases, there is a decreased likelihood of harm through lost sales, but the likelihood of harm most likely changes gradually, without such dramatic cut-off points.

Further, the downward adjustment for "greatly discounted merchandise" by its very nature may be ill-suited to compensating for monetary overestimates. If the monetary calculation overstates the harm, a more appropriate adjustment would be to the monetary calculation itself rather than to the offense level that corresponds to the monetary amount referenced in the fraud table. A specified mandatory reduction in offense level may be insufficient to compensate for the overstatement of harm in some cases, while in others it may overcompensate. One might respond that the encouraged downward departure included DOJ's April 15th proposal, therefore, is a better vehicle for addressing overestimates of harm in cases involving greatly discounted merchandise. Yet, departures are intended to be used only for atypical cases outside of the "heartland". As discussed above, the typical case sentenced under §2B5.3 involves a significant disparity between the infringed-upon price and the infringing price, frequently large enough to qualify for the proposed downward departure in the April 15 proposal (or the 2-level reduction in the August proposal).

While what comprises the "typical case" may change, any such change might exacerbate this problem, rather than reduce it. Software, audio, and video piracy lends itself to large infringed-upon/infringing price disparities because these goods cost little or no money to illegally copy and, therefore, often are given away on the Internet. Infringing counterfeit goods, even if cheaply made, cost more to manufacture and distribute and thus tend to have higher prices. In fact, the downward departure (and the suggested 2-level reduction) probably would apply most often to the very defendants that the NET Act targeted: those who distribute unauthorized copies to others without charge.

However, an offense-level reduction of this sort would complicate sentencing by requiring the court to determine two values for every infringing item: the infringed-upon value and the infringing value. Furthermore, most cases involve several different types of infringing item, but the draft guideline provides no direction to the court as to how to apply the reduction in cases involving some items that qualify under the percentage cut-off point and others that do not.

B. Method Two: Use Infringed-Upon Value for Copyright Cases and Infringing Value for Trademark Cases.

[30] *See* Appendix D, at D-3, D-6; Appendix E, at E-34.

A second method considered by the Team follows the contours of the Commission staff proposal published in the spring of 1998.[31] It would base the monetary adjustment of §2B5.3(b)(1) on the retail value of the *infringed-upon* item for cases involving *copyright* violations, but retain the current method of using the retail value of the *infringing* item for all other intellectual property violations (*i.e.*, trademark violations). The monetary adjustment in mixed cases involving both copyright and trademark violations would be calculated using the infringed-upon value.

1. Analysis

The premise behind treating copyright and trademark offenses differently is that copyright violations *may* cause lost sales more often than trademark violations. As discussed above, the infringed-upon value is not an accurate proxy for harm for all intellectual property offenses generally, but it is a reasonable proxy in cases in which the sale of the infringing item causes a lost sale. Although the Team has no empirical evidence for the proposition, it seems logical that the more similar the counterfeit and genuine article are, the more likely the sale of the counterfeit item represents a lost sale. If this is true, lost sales would occur more often in copyright than in trademark violations. In the copyright context, unauthorized copies are often *exact* duplicates of the legitimate item. Conversely, in the trademark context, counterfeit goods rarely are of comparable quality to – and certainly are not identical copies of – the genuine article.

Minimizes Impact of Overstatement of Harm

A significant advantage of Method II over Method I is that, to the extent that the retail value of the infringed-upon item overstates the harm, the impact is limited to copyright cases. In any event, the impact from any overstatement of harm caused by using the infringed-upon value is likely to be smaller in copyright cases than in trademark cases. Because many copyright violations involve infringing items that are identical to the legitimate item, the *value* of the infringing item – regardless of what price the infringer charges – should be virtually the same as the value of the infringed-upon item. Therefore, for this class of offenses, using the infringed-upon value results in little or no impact on the monetary adjustment calculation. In contrast, in trademark cases, the infringing value and the infringed-upon value tend to be very different. The actual retail value of a counterfeit Chanel handbag, for example, is only a fraction of the retail value of the genuine article. Thus, in trademark cases using the infringed-upon value would have a greater impact on the monetary adjustment, even though there is no evidence that this calculation better estimates the harm.

Palmed-Off Prong Deleted

The primary substantive difference between the Team's Method II and the staff option from last spring is that the "palmed-off" prong has been deleted. In addition to using the infringed-upon value for copyright cases, the staff option had used the infringed-upon value for articles that were "palmed-off," regardless of whether they were copyrighted or trademarked. The proposal originally contained the "palmed-off" prong because of the increased likelihood that consumers who are deceived into thinking that they are purchasing a legitimate good but in fact are not would have purchased the

[31] *See* Appendix D, at D-1.

legitimate good. Accordingly, there is an increased likelihood of a lost sale to the intellectual property owner, and the infringed-upon value better accounts for the harm of a lost sale.

Upon further analysis, however, the Team found that the definition of a "palmed-off" good in the staff option was too broad to fit this premise. "Palmed-off" goods were defined as "counterfeit goods that a consumer reasonably could believe are the legitimate items, because of price comparability and apparent substitutability." The problem is that even if consumers reasonably *could* be deceived, unless they are *actually* deceived it cannot be said with any confidence that there is an increased likelihood of a lost sale. Therefore, using the infringed-upon value merely because consumers reasonably could be deceived may not more accurately estimate the harm caused to the intellectual property owner. Furthermore, this definition is indistinguishable in any meaningful manner from the essential elements of a trademark violation: that is, that the counterfeit mark is "likely to cause confusion, to cause mistake, or to deceive." 18 U.S.C. §2320(e). Finally, even if the Commission were to limit the definition of palmed-off goods to those cases involving actual consumer deception, it may be difficult to discern whether consumers *actually* were deceived, particularly when the offender was a manufacturer and there was no evidence of the price at which the good would be sold to end-users.

Practical Concerns

Method II probably would be more complicated than either of the other two methods. The guidelines will have to define two different valuation approaches: infringing and infringed-upon. Courts and practitioners will have to become familiar with both concepts and learn when to apply each.

Legal and Constituent Concerns

Using the retail value of the infringing item for copyright cases, but not for trademark cases, may not satisfy a literal reading of the second directive in the NET Act. Although the legislative history of the Act clearly shows that Congress was principally concerned with copyright violations, the language of the directive is broader. It directs the Commission to provide consideration for the retail value of the infringed-upon item for *intellectual property offenses*, and trademark offenses are clearly intellectual property offenses. The Commission should consider whether the ambiguity inherent in the phrase "ensure that the guidelines provide for consideration" gives it enough discretion to make this distinction when implementing the directive.

Moreover, some constituents of the Commission may contend that any distinction between copyright and trademark violations in the guidelines would reflect a policy judgment by the Commission that copyrights are worthy of greater protection than trademarks, or a failure by the Commission to take into account some of the economic harms, such as damage to reputation, that tend to be of greater consequence to trademark holders. Indeed, trademark industry representatives might well lobby Congress for similar treatment.

C. Method Three: Retain the Infringing Value as the General Rule.

Method III, as conceived by the Team, would continue to use the retail value of the infringing item to calculate the adjustment for monetary loss as required by §2B5.3(b)(1). Method III reflects a hesitancy to dramactically change from the status quo to use the retail value of the infringed-upon item – and to the corresponding increase in sentences – in the absence of evidence that the latter approach more accurately would estimate the harm caused by intellectual property violations. However, if the Commission chooses this option, the Team recommends two important changes to the guideline in order to better address the second directive in the NET Act.

First, the Commission should clarify that the retail *value* of the infringing item is *not* necessarily the same as the retail *price* at which the infringing item is sold. For example, a defendant, like LaMacchia, who illegally uploads software to an Internet site and invites others to download it at no cost "sells" the infringing item for zero dollars. Thus, the retail *price* of the infringing item is zero, and the monetary adjustment also would be zero if based on price. However, assuming that the illegal software is an unauthorized copy of the legitimate software and, therefore, performs similarly, the retail *value* of the infringing software program is virtually identical to the retail value of the infringed-upon software (less the value of any documentation that would accompany the legitimate software). Therefore, the Commission should provide expressly that the infringed-upon value be used for calculating the monetary adjustment when the infringing and infringed-upon goods are virtually identical. The Commission could do this either by way of an example in an application note and/or by basing the monetary adjustment on the greater of (1) the price of the infringing good or (2) the retail value of the infringing good.

If the Commission does adopt the clarification described above, it should be noted that in practice the impact of Method III will be similar to that of Method II. In copyright cases, the infringing item often is of a quality similar to the infringed-upon item. Thus, under Method III, like Method II, the infringed-upon value would be used for the majority of copyright infringements. The same cannot be said of goods that infringe on trademarks. Because producing an infringing trademarked good has real costs associated with its manufacture and sale, counterfeit trademarked goods are usually inferior in quality comparted to the genuine item. Thus, under Method III, like Method II, the infringing value would be used for the majority of trademark cases.

Second, if the Commission retains the infringing value as the default measurement, it should permit the court to consider the value of the infringed-upon item when calculating the infringing value if (i) the retail value of the infringing item is difficult or impossible to determine, or (ii) if the prosecution is able to prove a one-to-one correlation between the sale of infringing items and lost sales to the intellectual property owner.

1. Analysis

Gain Has Some Correlation to Loss

There is a broad consensus among economists, industry representatives, and the Team that the infringing value accurately measures the illegitimate gross gain earned by the infringers. In criminal matters, it is considered appropriate by many to impose greater punishment on defendants who gain more from their illegal activity than those who gain less, and this method would further that objective.

Moreover, this measurement would somewhat parallel the civil context, in which disgorgement of profits is often sought by victims of intellectual property violations (particularly patent violations).

Furthermore, there is reason to believe that gain has some correlation to loss (although the extent of the correlation is debatable). Suppose two defendants sell the same counterfeit Hermes scarf. Defendant A sells 500 scarves on the street for $10 each. Defendant B sells the same 500 counterfeit scarves through a reputable retail establishment for $100 each. The monetary adjustment – and gross gain – for Defendant A under Method III would be $5,000, and the monetary adjustment for Defendant B would be $50,000, even though both defendants sold equal quantities of the same item. The justification for treating these two defendants differently is that Defendant A's sales probably resulted in fewer lost sales than Defendant B's. Consumers who buy "Hermes" scarves on the street for $10 are less likely to believe that they are genuine, and have made a lesser showing of ability to pay for the genuine article. Therefore, it is reasonable to assume that they are less likely to have purchased a genuine Hermes scarf.

A Cautious Approach

Even though the infringing value is a flawed measurement of harm, retaining it as the default monetary adjustment may be a prudent approach for the Commission to take in the absence of evidence that the infringed-upon value — which definitely would produce higher penalties — is a more accurate estimate of the monetary harm caused by intellectual property violations. Moreover, any shortcomings the infringing value has may be compensated by adopting some of the other adjustments proposed below.

Legal and Constituent Concerns

Unlike Method II, Method III treats all intellectual property cases the same, so the "generality of application" that the directive arguably requires is not an issue here. But the general rule under this approach focuses on the infringing value, and one might question whether the changes to §2B5.3 suggested in conjunction with this proposal are comprehensive enough to satisfy the congressional directive.

Even if Method III satisfies the NET Act directive from the standpoint of statutory construction, some constituents of the Commission may object. DOJ has submitted three proposals to date, all of which use the infringed-upon value. In addition, use of the infringed-upon value received broad-based support from industry representatives. However, if the Commission retains the infringing value but also adopts some of the other adjustments to §2B5.3 suggested below, it is possible that key constituents would find the overall package acceptable.

For instance, by expressly providing that the infringed-upon value should be used in cases involving infringing items of identical quality as the legitimate items, Method III does address the specific types of offenses that were the impetus for the NET Act: those in which the defendant does not personally gain from the offense because he has given away the infringing items. Industry representatives report that United States Attorneys' offices currently claim they would calculate the infringing value in such cases as zero, resulting in no monetary adjustment. The Team does not

believe that result was intended by the Commission when it promulgated §2B5.3. Furthermore, even though in practice the application of Method III would result in the infringed-upon value being used in most copyright cases and the infringing value in most trademark cases, the Commission would be less susceptible to criticism that it has made a policy judgment to protect trademarks less than copyrights because there is no such distinction on the face of the proposal.

D. Special Considerations

Regardless of which method the Commission adopts, certain small categories of cases may require special treatment. For example, in the case of a "bootlegged" recording of a live concert in violation of 18 U.S.C. §2319A, if there is no published authorized recording of the concert, the unauthorized recording has no infringed-upon value upon which to base this monetary adjustment. Thus, in these cases the calculation may best be based on the retail value of the infringing item.

Similarly, unauthorized compilations of individually copyrighted articles that are sold only separately in the legitimate market do not have a legitimate counterpart from which to determine an infringed-upon value. Regardless of which method for estimating loss the Commission adopts, it may want to consider using the retail value of the infringing item for these cases.

Finally, the Commission may want to consider special treatment for cases involving counterfeit components of unfinished products for purposes of valuation. For example, our analysis revealed many cases involving counterfeit labels of still-unassembled apparel. Currently, §2B5.3 does not contain an application note specifically addressing counterfeit components, and counterfeit labels typically are valued at a nominal value. Several states have statutes that value counterfeit components as if they were already utilized in a counterfeit finished product at the time of recovery. The problem with valuing components as if they were finished products is that estimating the value of the finished good is very speculative and may greatly overestimate the harm to the intellectual property owner. On the other hand, assessing counterfeit components a nominal value may underestimate the harm caused by these offenders, who are most likely manufacturers.

VIII. Other Adjustments

As a result of the universal agreement among industry representatives and economists that there is no reasonably accurate and practicable method to calculate the monetary harm caused by intellectual property offenses, the Team evaluated alternative ways to capture more adequately both the culpability of offenders and the harm. If the Commission amends §2B5.3 to provide for varying penalties based on some factor(s) other than the monetary amount (as a proxy for loss), that would reduce the influence of the this inherently inaccurate calculation on the offense level.

The Team identified the following offense characteristics that warrant consideration by the Commission for some adjustment to the base offense level under §2B5.3:

1. more than minimal planning as a factor to be built into the base offense level

2. offenders who are manufacturers or importers

3. offenders who are uploaders

4. offenders who breach security measures such as encryption

5. offenses that involve the violation of a pre-release copyrighted or trademarked article

6. offenses that involve actual consumer deception

7. offenses that involve the conscious or reckless risk of serious bodily injury or death

8. offenses that are not committed for commercial advantage or private financial gain.

The Commission risks complicating what is currently a fairly straightforward guideline if it adopts some or all of these adjustments. The Team has attempted to combine these factors in a logical manner that would not result in unreasonably severe punishment. The Commission may wish to unbundle and/or regroup these adjustments in other ways.

A. Increase Base Offense Level from 6 to [8].

The Commission should consider increasing the base offense level (BOL) in §2B5.3 to increase the punishment for intellectual property offenses and to better reflect the typical degree of sophistication and repetitive nature of these offenses.

Pros:

- Increasing the BOL may reduce disparity among similar economic crimes. As discussed above, fraud offenses receive a base offense level of 6 under §2F1.1. However, the majority of fraud offenses sentenced under §2F1.1 receive a two-level enhancement for more than minimal planning (MMP) under §2F1.1(b)(2), thereby resulting in an offense level of 8 before the loss amount is taken into account. There is no counterpart to the MMP enhancement in §2B5.3, but if there were, the Team believes it would apply to the majority of cases sentenced under §2B5.3 as well. This finding raises the question of whether an unwarranted difference in the treatment of these economic crimes exists.

- Increasing the BOL may account somewhat for the many intangible harms resulting from intellectual property offenses that appear to be (i) more significant in the intellectual property context than in other economic crimes, and (ii) cannot be measured adequately within the confines of the sentencing process.

Cons:

- Building the equivalent of the MMP enhancement into the BOL could over-punish offenders who in fact did not engage in MMP (perhaps street vendors). The review of cases the Team

conducted did not reveal any significant enforcement against offenders likely to fall into this category (e.g., street vendors), however, with the enactment of the NET Act an increase in the number of these cases is possible. An alternative approach could be to add an SOC for MMP as it exists in the other economic crime guidelines, but the former Commission seemed to be moving away from the general concept of MMP as the basis for a separate enhancement.

B. [2]-level Enhancement [and Floor] for Manufacturers, Importers, and Uploader with an Additional [2]-level Enhancement if (i) the Defended Initially Breached a Security Measure or (ii) if the Offense Involved Pre-Release Material

This SOC combines factors 2 through 5 as listed at the outset of this section. Each element will be discussed in turn.

1. [2]-level Enhancement [and Floor] if the Defendant is a Manufacturer or Importer of the Infringing Articles.

The Commission should consider an enhancement, and perhaps a floor, for manufacturers and importers.

Pros:

- Manufacturers and importers are the initial sources of illegal articles which are subsequently distributed and purchased by others. As such, they cause more harm than offenders who sell the infringing articles to end users (for example, flea market vendors). Moreover, their role in enabling others to violate intellectual property rights increases their culpability and warrants incremental punishment. This is arguably somewhat analogous to §2G2.2 (Trafficking in Material Involving the Sexual Exploitation of a Minor), in which the BOL is 17, but if the offense involved distribution, the offense level is increased by at least 5 levels. See §2G2.2(b)(2).

- Proving that an offender is a manufacturer or importer is less burdensome to prosecutors than establishing the monetary harm (or a monetary proxy for it) in any given case. Accordingly, this enhancement would address the criticism levied by industry representatives that, in part because of the current penalty structure, prosecutors are reluctant to bring cases where loss is difficult or impossible to determine.

Cons:

- Because manufacturers and importers presumably will be held accountable for a higher loss amount than small scale distributors — regardless of which method of loss calculation is adopted — some may argue that this enhancement double counts the monetary harm they cause.

- Some may argue that this enhancement would be duplicative of the role in the offense adjustment in §3B1.1. The enhancement for aggravated roles in §3B1.1 deals with leadership and control over others, however, while this proposed enhancement is intended to incrementally punish

manufacturers and importers for increasing the exposure of intellectual property owners to economic harm caused by others.

2. [2]-level Enhancement [and Floor] if the Offense Involved the Use of a Computer to Unlawfully Distribute Infringing Articles.

As discussed above, industry representatives uniformly agree that the use of computers (e.g., the Internet, World Wide Web, an electronic bulletin board, or any other online facility) greatly increases the exposure to harm for the intellectual property owner because of the ease of unauthorized duplication, the world-wide reach of these facilities, and in many instances the identical quality of the infringing item to the infringed upon good. The enhancement should be tailored to apply to the offender who illegally uploads material to an Internet site but not to end- users who subsequently download the infringing material. The reasoning for this distinction is that the uploader performs the same function as manufacturers and importers (regardless of whether he does so for financial gain), increasing the exposure to harm by enabling others to violate intellectual property rights. On the other hand, the downloader is more like the person who purchases counterfeit goods in a retail outlet or flea market. In application, for example, it would apply to an offender who illegally uploads a video game to an electronic bulletin board for others to download (whether or not for commercial advantage or financial gain), but would not apply to the person who subsequently downloads the game for personal use.

If the Commission adopts the manufacturer/importer enhancement, it may want to consider addressing the uploader through an application note that expressly makes clear that the uploader in the online context is to be considered a manufacturer for purposes of this guideline. If the Commission does not adopt a manufacturer/importer enhancement, it should consider the computer enhancement separately because of the unique exposure to harm and difficulty in calculating loss in cases involving uploading.

Pros:

- An enhancement for use of a computer is appropriate because intellectual property owners are immediately exposed to world-wide violations of their rights when protected material is uploaded to a web site.

- In the online environment, it is highly unlikely that any method of estimating loss will adequately capture the harm to intellectual property owners. Unlike most other infringements where at least the quantity of illegal items is readily calculable, there is no practicable method of determining the number of times an illegal software program, for instance, is downloaded from an illegal web site. Industry representatives report that many Internet service providers will not provide such information absent a court order, and many infringers destroy such records daily in any event. An enhancement [and floor] for the use of a computer would be based in part on a similar rationale as the "chop shop" enhancement and floor in §2B1.1(b)(5). That is, the loss calculation for chop shops is likely to understate the actual loss because of their high inventory turnover, and, there, as here, some other method of accounting for the harm is necessary.

- The ease with which the use of a computer makes protected material illegally available to those who otherwise might have purchased the genuine article increases the possibility of a direct lost sale. In addition, the easy availability of a perfect copy of the genuine article via a computer also may increase the likelihood of a lost sale when compared to, for instance, a cheap imitation of a trademarked designer purse.

- An enhancement for use of a computer would address criticism raised by industry representatives that prosecutors are reluctant to bring cases involving on-line infringement because of either the difficulty in determining the monetary harm or the misperception that there is no such adjustment under the guideline when material is illegally downloaded at no cost. Although our statistical analysis confirms that few online cases are brought, that may be a result of the recency of the passage of the NET Act. In addition, the Commission could address the misperception about the value of items downloaded at no cost by adding an application note clarifying that infringing items do have value even if they are given away.

- As discussed above, the United States economy is becoming increasingly dependent on electronic commerce and, therefore, the Commission may want to add additional deterrent measures to protect this growing segment of the economy. In any event, the legislative history of the NET Act and the DMCA clearly indicate Congress's concern in this area. Industry representatives have indicated broad-based support for such an enhancement.

  Cons:

- If the Commission adds an enhancement for the use of a computer, it risks targeting for increased penalties some offenders who do not commit the offensesfor commercial advantage or personal pecuniary gain. It is precisely these offenders (e.g., college students uploading and downloading video games or recordings just for the sport of it) who may be adequately deterred by increased enforcement of existing penalties. This criticism could be addressed by providing a reduction for offenses that are not committed for commercial advantage or private financial gain as discussed below, but the Commission may not want one SOC to cancel the other out.

- If the Commission adopts the use of a computer enhancement but rejects the manufacturer/importer enhancement, there may be a proportionality concern over the different penalty structures for on-line distributors and non-online (or traditional) distributors.

3. An Additional [2]-level Increase if the Offense Involved Breaching A Security Measure or Engaging in De-Encryption to Gain Access to Protected Software.

In addition to any enhancement for use of a computer, the Commission should consider an additional enhancement if the offender engaged in de-encryption or some other breach of security measures to gain initial access to protected software.

Alternatively, the Commission may want to consider an application note that expressly provides that the 2-level enhancement for use of a special skill under §3B1.3 applies in cases involving de-encryption or other breaches of software security measures.

Pros:

- The offender who first "cracks" the code and exposes previously protected software is the initial source for subsequent illegal distribution and use by others. In other words, he is the point of the pyramid in the illegal distribution of copyrighted material via the Internet. Accordingly, an enhancement for de-encryption makes an appropriate distinction in culpability because the original de-encryptor creates the risk of subsequent exposure to harm.

- The de-encryption through the use of special skills enables other less skilled offenders to access protected material that they otherwise would not have had the means to do.

- An enhancement for de-encryption would be akin to the sophisticated means enhancement in §2F1.1(b)(5).

Cons:

- It may be impracticable to identify the initial source of de-encrypted software.

- The difference in culpability between an uploader who uses de-encryption and one who does not may not be sufficiently significant to warrant a difference in penalty.

4. An Additional [2]-level Enhancement if the Offense Involved a Pre-Released Copyrighted or Trademarked Article.

Industry representatives report that infringements involving pre-release versions of protected material, particularly copyrighted works, cause economic harm to the intellectual property owner that are not captured adequately by any of the options for calculating loss. Moreover, this is the case whether the pre-release infringing item is of identical or inferior quality to the released product. If the pre-release version is of equal quality, then the premature sale into the commercial market causes greater lost sales because the infringer is able to capture the high end of the demand curve. Even more problematic is the case where the pirated pre-release version is of an inferior quality to that which would otherwise ultimately be released by the intellectual property owner, which industry representatives report often to be the case. For instance, if a video game is pirated before it is released and has "bugs" in it that cause it to perform poorly, reports of its poor performance quickly spread via the Internet and trade publications, which in turn significantly damage the market for the product even before it is released. Because this effect, which is both a harm to reputation and a direct loss of sales, is impracticable to calculate, the Commission may want to consider an enhancement in these cases.

Pros:

- Offenses involving pre-release protected items seem particularly unfair because the rightful owner has not had the opportunity to avail itself of the commercial market.

- An enhancement for pre-release infringements would capture some of the intangible harms (e.g., damage to reputation) and direct economic harms (e.g., lost sales) that are particularly serious in such cases but are nonetheless difficult to quantify.

- Pre-release offenses often involve some other improper activity such as a misappropriation by someone in a position of trust (e.g., an employee of the intellectual property owner) as the initial source of the illegal copy. However, industry representatives report that it is sometimes difficult to determine the initial source of the pirated pre-release item. Moreover, these sources indicated that even when the initial source of the pirated pre-release item is discovered, intellectual property owners usually do not press criminal charges and sometimes do not even fire the employee.

Con:

- Some may argue that the reputational damage caused in offenses involving pre-release items is more akin to a consequential damage, which currently is not included in the loss calculation in §2F1.1 (except in product substitution, defense procurement and certain computer crime cases).

C. [2]-level Enhancement if the Offense Involved Actual Consumer Deception with an Additional [2]-level Enhancement [and Floor] if the Offense Involved the Conscious or Reckless Risk of Serious Bodily Injury or Death.

This proposed enhancement has two elements. The first is a [2]-level enhancement if the offense involved actual consumer deception. The second is an additional [2]-level enhancement [and floor] if the offense involved the conscious or reckless risk of serious bodily injury or death. These two enhancements are combined into one SOC under the theory that an infringement is unlikely to cause serious bodily injury or death unless consumers are actually deceived. The Commission could choose to adopt only one of these enhancements, or to have separate SOC's for each.

1. [2]-level Increase if the Offense Involves Actual Consumer Deception.

This proposed enhancement is an outgrowth of the staff option published last spring, which used the infringed-upon value if the goods were "palmed-off." The staff version defined palmed-off goods as "counterfeit goods that a consumer reasonably would believe are the legitimate items, because of price comparability and apparent substitutability." As discussed above, the Team concluded that if the Commission desires to address separately the distinct harms to consumers caused by intellectual property offenses, ***actual*** consumer deception must be the standard.

If the Commission declines to adopt an SOC for actual consumer deception, it may wish to recommend it as a ground for an upward departure.

Pros:

- Consumers who are deceived suffer harm that is separate and distinguishable from that suffered by the intellectual property owner which may not be accounted for by any of the proposed

methods for calculating loss. Moreover, these cases are unlike most infringements where the consumer is patently aware that the article is infringing and, therefore, akin to a co-conspirator..

- The fact that the consumer actually believed he was purchasing a legitimate (or infringed upon) item increases the likelihood of an actual lost sale.

Cons:

- An enhancement to account for actual consumer deception suffers the same drawbacks as the "palmed-off" prong of the staff option for estimating loss set forth this spring. Even if the SOC is tailored to apply only to cases involving actual consumer deception, prosecutors may find that proving actual consumer deception is too difficult. This is most likely to be the case with an offender who is high in the distribution chain because it is less clear in what manner or at what price the infringing goods ultimately would have been sold to the consumers. For instance, consumers who purchase an infringing item at a flea market for a deep discount are less likely to be actually deceived than consumers who purchase the same infringing good at a legitimate retail outlet for a smaller discount. If the offender is a manufacturer or distributor, it may not be clear how or for how much money the goods ultimately would have been sold to retail customers.

- Actual consumer deception already may be penalized sufficiently through the loss calculation, regardless of which option is adopted by the Commission. Presumably, for a consumer to purchase an infringing item and actually believe that it is the legitimate item, the difference in price between the infringing and infringed-upon items cannot be so great as to arouse suspicion. Thus, the infringing value is closer to the infringed upon value in cases of actual consumer deception than in cases where the consumer is aware that the infringing article is infringing. As a result, even under Option 3 for the loss calculation, the loss amount will be higher in cases of actual consumer deception which, in turn, may sufficiently increase the offense level to account for the separate harm to consumers.

2. An Additional [2]-level Enhancement [and Floor of [13]] if the Offense Involved the Conscious or Reckless Risk of Serious Bodily Injury or Death.

This proposed enhancement is an outgrowth of the DOJ proposals presented last spring and could be adopted by the Commission separately if it chooses not to adopt an enhancement for actual consumer deception. It would apply, for instance, in cases involving counterfeit drugs, cosmetics, and auto parts. The option of a floor with an offense level of 13 is presented because the same floor is provided in §2F1.1(b)(6).

Pros:

- Offenders who consciously or recklessly risk serious bodily injury are more culpable than other offenders inasmuch as they put their victims at risk for more serious harm than mere economic loss and, therefore, deserve an increase in offense level.

- This enhancement received broad-based support this spring (although no specific language gained a consensus).

Cons:

- Intellectual property offenses that risk serious bodily injury or death occur so rarely that they could be considered out of the heartland and better handled as upward departures. Our analysis revealed no cases in FY 1998 where it could apply and only two in FY 1996 where it could potentially apply (one a case of imitation Diet Coke and the other counterfeit auto parts). The departure provision in chapter 5 of the guidelines (*i.e.*, §5K2.14 (Public Welfare) already could apply to such cases.

D. [2]-level Reduction if the Offense was not Committed for Commercial Advantage or Private Financial Gain.

Last spring the Electronic Frontier Foundation (EFF) initially proposed a reduction in offense level if the offense was not committed for commercial advantage or private financial gain, and it was included in all three proposals published this summer.

Pros:

- Defendants who commit economic crimes but who do not personally or commercially gain from their offenses typically are viewed as being less culpable than those who do. Indeed, under the LaMacchia holding, individuals were not subject to criminal prosecution for copyright violations absent such benefit, a result that directly led to passage of the NET Act.

- Defendants in this category of offenses may be deterred adequately by greater enforcement of existing penalties because they receive no benefit from their actions, other than perhaps notoriety within their counterculture.

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Cons:

- This reduction probably would apply so rarely that these cases may be considered as outside the heartland and, therefore, better considered as a factor for a downward departure. There were no cases in FY 1996 or FY 1998 in which this reduction could have applied, due in great part to the fact that such conduct was not criminalized until the recent enactment of the NET Act.

- To the extent that the Commission believes that the penalty for intellectual property offenses should increase in correlation to the harm caused, this reduction undermines that premise because the potential harm is no less because the defendant does not benefit. This is particularly true in

the on-line environment, where there is no correlation to the economic gain to the defendant and the potential harm to the intellectual property owner.

- This reduction may not be politically wise in light of the fact that the crux of the NET Act was specifically aimed at this type of conduct. Moreover, the reduction could negate any sentencing impact that the proposed uploading enhancement would have (unless the Commission excludes its application in cases involving uploading or adopts a floor for uploading). On the other hand, the Commission may conclude that this canceling-out effect is appropriate.

IX. Recommendations for Going Forward

The Team recommends the following:

- Upon evaluating the options presented herein, that draft language be prepared for those options considered most meritorious.

- After the number of options have been reduced, that the Team conduct an impact analysis on the effect of the proposed SOCs. Such an analysis has not been performed for purposes of this report because it cannot be done meaningfully until the range of options is narrowed substantially. However, once the number of options is more manageable, the Team thinks that only modest resources would be required to perform an impact analysis on the effect of the proposed SOCs. It should be noted that an impact analysis for the three methods of estimating loss is not practicable because the presentence reports typically do not include the retail value of the infringed-upon item as that figure currently is not a relevant factor in determining the sentence.