

Calculation of Loss Amount and Restitution for Criminal IP Infringement

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I. INTRODUCTION

Criminal prosecution of intellectual property crimes is on the rise. There are now CHIP (Computer Hacking and Intellectual Property) units in 25 United States Attorney's Offices, with federal prosecutors who specialize in enforcing criminal trademark, copyright, and theft of trade secret statutes. The major federal law enforcement agencies also have specialized units charged with investigating these offenses. It is no wonder that prosecutions of IP crimes have risen. In 2007, there were 199 convictions nationwide for IP crimes, an increase of 80% as compared to 2006.²

This article focuses on the following factors in these federal prosecution: calculating loss amount pursuant to the Sentencing Guidelines and establishing the appropriate amount of restitution to be ordered. The loss amount drives the determination of the Sentencing Guidelines in criminal IP prosecutions. While recent Supreme Court cases arguably undermine the importance of that calculation (by underscoring the power of district courts to depart from the Guidelines calculation),³ it nevertheless will be a common battleground for most defense attorneys and prosecutors in most criminal IP cases.

Restitution poses another contested battleground in IP cases, and the case law and Sentencing Guidelines require a different analysis from the determination of loss amount. As a general proposition, restitution is supposed to make the victim whole. That calculation can—

and often is—quite different from calculating the loss amount of the offense, as described more fully below.

II. APPLICABLE STATUTES

18 U.S.C. §§ 2318–2320 make criminal the trafficking in counterfeit labels, packaging, goods and services (i.e., Sections 2318, 2320) and the criminal infringement of copyright (Section 2319).

18 U.S.C. §§ 1831–1832 make criminal the theft of trade secrets. Section 1831 applies when the target intended to benefit a foreign government, foreign instrumentality, or foreign agent. Section 1832 applies to all other theft of trade secret scenarios (as, for example, an individual who steals trade secrets from one U.S. company to sell to another U.S. company).

III. SENTENCING GUIDELINES: LOSS CALCULATION FOR COPYRIGHT AND TRADEMARK CASES

The calculation of loss amount in IP cases is frequently a complicated process due to the valuation of the property at issue. For copyright and trademark infringement cases, the starting point is Sentencing Guidelines § 2B5.3. Calculating loss amount can vary widely, depending upon whether the loss amount is based on the retail value of the infringing item (the counterfeit product), or the infringed item (the genuine product).

According to Guideline § 2B5.3(2), the loss amount is based on the retail value of the infringed item, if one of a number of scenarios are involved, including:

- the infringing item appears to a reasonably informed person to be “identical or substantially equivalent to the infringed item”;
- the retail value of the infringing item is not less than 75% of the retail price of the infringed item;
- the retail value of the infringed item “provides a more accurate assessment of the pecuniary harm to the copyright or trademark owner than does the retail value of the infringing item.”

Implicit in the Sentencing Guidelines construct is a requirement that the district court engage in a thorough analysis of the appropriate loss amount. Indeed, a loss calculation that is not supported by the evidentiary record is subject to reversal on appeal, not surprisingly. See *United States v. Zheng Xiao Yi* (district court’s sentence using the value of the infringed item not supported by evidentiary record, and reversed for resentencing; the victim companies did not submit victim impact statements prior to the sentencing, and the court had precluded the defendant from questioning the government’s pricing specialist on the retail value of the counterfeit items).⁴

Even when a court determines that the retail price for the infringed item should be used, there may be a question about which retail price to use. In *United States v. Lozano*, the defendants were convicted of trafficking in counterfeit cell phone parts. The defendants argued that loss amount should be based on the retail value for the products in Latin America (the defendants claimed that the products were being transshipped through Florida for sale in Latin America), which was “drastically” lower than the retail price for the identical products in the United States. The district court rejected this valuation and used the higher U.S. prices to calculate loss amount, because, *inter alia*, the defendants sold some of the goods

in the U.S. and the counterfeit products were seized from the defendants’ warehouse in Miami. The Eleventh Circuit affirmed the District Court use of the higher U.S. prices.⁵

Until 2006, there was some ambiguity regarding how to treat counterfeit labels that could be applied to a counterfeit product, but which were not in fact already on the counterfeit product. That loophole was closed with the enactment of the Stop Counterfeiting in Manufactured Goods Act in March 2006 and the amendment of 18 U.S.C. Section 2320. Now, it is clear that such labels can be the basis for criminal charges. Moreover, the loss amount attributable to counterfeit labels will be based on the retail value of the product to which the counterfeit label would have been applied. See Sentencing Guidelines § 2B5.3, Application Note 2(A)(vii).

In many cases, courts will not be faced with the difficult task of deciding between conflicting positions and calculations for loss amount, because prosecutors and defendants often include agreed-upon loss calculations in plea agreements. The amount that is finally agreed to in the negotiation with a particular defendant may reflect multiple risk factors of proceeding to trial and other policy considerations. Without question, however, debate over the calculation of the loss amount serves as the main area of contention when negotiating possible plea agreements, as the loss amount will heavily determine the Guidelines calculated sentence.

IV. SENTENCING GUIDELINES: LOSS CALCULATION FOR THEFT OF TRADE SECRET CASES

Sentences for convictions under the Economic Espionage Act are governed by Sentencing Guidelines § 2B1.1. See U.S.S.G. App. A. As such, calculation of the loss amount pursuant to 2B1.1 will drive the sentence calculation.

There are few cases discussing the proper calculation of loss amount for a trade secret case. But the cases that have been reported frequently base the calculation on the trade secret’s research and development cost, as a proxy for the value of the secret to the victim. See *United States v. Ameri*.⁶ See also *United States v. Wilson*.⁷

The district court need only make a “reasonable estimate” of the loss. U.S.S.G. § 2B1.1, Application Note 3(C). Thus, evidence that the theft of the trade secret represents loss to the victim beyond research and development costs should be permitted. For example, if the trade secret has lost its value as a “secret” due to the publication by the defendant or the unfair competition by a defendant who illegally used the stolen secret, the pecuniary loss to the victim may entail the lost sales and the diminution in value of the trade secret. Again, these calculations are highly fact-intensive, and are the subject of hard negotiation in connection with possible plea agreements.

V. RESTITUTION CALCULATION

Restitution is mandatory for a Title 18 “offense against property.”⁸ Section 2320 now explicitly provides that the trafficking in counterfeit goods is an offense against property⁹, and it is likely that Section 2319, the criminal copyright infringement statute, would be interpreted the same way.¹⁰ For an offense resulting in “damage” or “loss” to property, the order of restitution shall require the defendant to pay the “value of the property” on the date of the loss, or the date of sentencing, whichever is greater.¹¹ Since criminal trademark and copyright cases involve damage to intangible rights, measuring the value of the “damaged” property for the purposes of restitution may prove more challenging.

Notwithstanding the challenges in measuring restitution in criminal trademark and copyright matters, courts typically order restitution in furtherance of the strong policy in favor of compensating crime victims for their actual losses. Indeed, the government has the burden of demonstrating the amount of the victim’s loss only by a preponderance of the evidence.¹² Thus, in practice, if the government provides some evidence allowing the court to make a reasonable estimate of the victim’s losses, restitution will be ordered.¹³

To be sure, if the government does not provide a reliable estimate of the victim’s loss, the court need not enter a restitution order. In *United States v. Foote*¹⁴, the court did exactly that. In *Foote*, the

defendant was convicted of trafficking in counterfeit goods in violation of Section 2320.¹⁵ The district court held that, because the government had proposed no reliable estimate of the victim’s losses, the calculation of restitution would be unduly complicated and a restitution order need not be entered.¹⁶ In so ruling, the court relied on cases holding that restitution requires real or actual loss to the victim, and that a victim’s lost profits must be proved with some certainty.¹⁷

In general, however, and so long as some reasonable proxy for the victim’s loss is provided by the government, courts have been willing to enter restitution orders on behalf of trademark and copyright crime victims. To date, courts have applied four different approaches in awarding restitution to rights holders: (1) Victim’s net lost profits, (2) Victim’s lost gross revenue, (3) Defendant’s gross revenue, and (4) Civil statutory damages.

A. Net Lost Profits

Some courts have held that the lost profit to the victim from the sales that it would have otherwise made absent the defendant’s infringement is the appropriate measure of restitution. In *U.S. v. Martin*,¹⁸ the defendant pled guilty to trafficking in counterfeit Microsoft Office 2000 CDs in violation of Section 2320. The district court awarded restitution by taking the total retail value of the infringed CD’s, and applying Microsoft’s overall profitability for the year in question to that total value.¹⁹ Similarly, in *United States v. Beydoun*,²⁰ the defendant pled guilty to trafficking in counterfeit cigarettes in violation of Section 2320. The district court ordered restitution based upon the retail value (described by the court as “gross profits”) of the infringed items.²¹ The Fifth Circuit reversed the district court and remanded the case, holding that lost net (not gross) profits from the lost sales is the appropriate measure of the victim’s losses.

Lost net profits to the rights holder is a principled way to estimate the loss caused by the infringement. There are two issues to consider, however, with respect to this approach. First, to the extent that the goal is to measure the “actual loss” to the rights holder, a defendant may argue

that the government must provide some evidence that the customers would have paid for the legitimate items if the infringing items had not been available. Where the price differential between the infringing and infringed items is substantial, the defendant may argue that the government cannot make this showing.

Second, this approach may prove problematic for certain rights holders. To calculate the net lost profits for the lost sales of an infringed product, companies may be required to disclose proprietary cost of goods sold information for the infringed item, and if unwilling to do so, risk an order of no restitution. In *Martin*, this problem was apparently avoided by using the overall profitability figure for Microsoft, a figure that presumably was available from Microsoft's public filings. Victim companies and the government need to be sensitive to this issue, and either seek to use publicly available cost of goods sold information as in *Martin* or, if that is not possible, seek safeguards (e.g. sealed filings, sealed courtrooms, protective orders) to protect their proprietary information.

B. Lost Gross Revenue

One district court has awarded restitution based upon the lost gross revenue to the rights holder that would have been generated absent the sales of the infringing items. In *United States v. Milstein*,²² the defendant was convicted for distributing counterfeit pharmaceuticals in violation of Section 2320. The district court ordered the defendant to pay \$3.5 million in restitution to the drug manufacturers whose trademarks were misappropriated, on the basis that this is what the defendant would have paid had he purchased these products from these manufacturers for distribution in the United States.²³ In affirming the district court's restitution order as a "reasonable" estimate of the victims' lost sales, the Second Circuit relied upon the fact that lost sales was an appropriate damages measure in a civil Lanham Act trademark infringement case, and therefore an appropriate "value of the property" taken under the criminal restitution statute.²⁴

Lost gross revenue to the victim is the most favorable restitution approach for the victim employed to date. Like the net profits approach discussed above, however, a defendant would likely argue that the government would have to demonstrate that the defendant's customers would have purchased the legitimate items if the infringing items had not been available. A defendant might also argue that this approach overstates the actual loss to the victim because it does not account for the cost to the victim to manufacture the legitimate items. However, as in *Milstein*, the government may persuade the court that gross revenue meets the reasonable estimate threshold in measuring a victim's losses for the purposes of restitution.

C. Defendant's Gross Revenue

Some courts have held that gross revenue to the defendant from the sales of the infringing items is a reasonable proxy for the victim's losses. In *U.S. v. Chay*,²⁵ the defendant pled guilty to trafficking in counterfeit documents and packaging for pirated computer programs in violation of Section 2318, and agreed to pay restitution for "all losses" caused by his crimes. The district court ordered the defendant to pay restitution to the 52 victim copyright holders based upon the defendant's gross sales of the pirated computer games.²⁶ The defendant argued that the restitution order should have been reduced by his "costs," and therefore that his "net profit" was the appropriate measure of restitution.²⁷ The Seventh Circuit rejected this argument, reasoning that a copyright holder ought not be required to "subsidize the cost of [the defendant's] illegal activity," and therefore that the district court had not abused its discretion by awarding restitution on the basis of the defendant's gross sales.²⁸

In *United States v. Hicks*,²⁹ the defendant modified satellite descrambling boards to allow customers to view satellite channels for which they had not paid, and pled guilty to copyright infringement under Section 2319. The district court first sought to calculate restitution on the basis of how much lost revenue to the service providers the

additional fifteen channels would have represented.³⁰ But because this could not be established with certainty, the court recurred to the amount that the defendant had earned for modifying the boards, which was \$20,000.³¹ On appeal, the defendant argued that the \$20,000 restitution award was excessive, because it represented his gain, instead of the victim's loss.³² The 4th Circuit rejected this argument, and noted that although the restitution was based upon the defendant's revenue, "the court's real aim was to have him make restitution of the amount lost by the victim."³³

These holdings teach that, although restitution is designed to compensate a victim for its actual losses, courts will look to other measures of restitution if necessary to provide compensation to the victim. Thus, while the defendant's gain from the infringing activity may differ significantly from the actual loss to the victim, some courts view it as a reasonable (and indeed, conservative) proxy for the victim's losses, and will order restitution on that basis.

D. Civil Statutory Damages

In *U.S. v. Manzer*,³⁴ the defendant was convicted of copyright infringement for the modification of descrambling devices to permit the unauthorized decryption of cable satellite transmissions. The district court ordered restitution in the amount of \$2.7 million, based upon its finding that the defendant had sold 270 modified descrambling devices, and then estimating that each package was worth \$10,000 by reference to the minimum statutory damage award authorized in a civil copyright infringement case.³⁵ In affirming the award of restitution, the Eighth Circuit, noting the wide discretion afforded district courts in ordering restitution, reasoned that it was appropriate for the district court to look to the civil statutory remedy for guidance and that, in any event, the actual loss was far greater than the amount of restitution awarded.³⁶

Manzer confirms the wide latitude given the district court's in fashioning orders of restitution. Moreover, where the restitution order understates the amount of actual loss as it did in *Manzer*,

and as it likely will in the cases using the defendant's gross revenue as the measure of restitution, appellate courts are not likely to disturb the restitution order.

VI. VICTIM'S RIGHT TO ALLOCUTION

Victims of crime have certain rights in connection with criminal proceedings, including the right to "be reasonably heard" during sentencing. 18 U.S.C. § 3771(a)(4). Many of the issues addressed above directly affect the victims of IP crimes. For example, a victim of IP crime may disagree with the government's loss calculation—such as preferring to use the higher retail value of the infringed item rather than the infringing item—in order to maximize the deterrent value of the prosecution by an increased sentence. Similarly, the victim may prefer a more aggressive restitution calculation than that advanced by the defendant, or even by the government.

Because the victim has the statutory right to be heard at sentencing, differences in approach advanced by the victim from that taken by the government may be highlighted and may be source of some friction. Victims need to weigh the value of sending the maximum deterrent message from the individual prosecution, with the potential that taking a position that is contrary to the government may lead to difficulties in the event that additional criminal cases arise in the same jurisdiction involving different defendants. As such, maintaining maximum credibility with the individual agents and prosecutors may, in certain cases, be more valuable to the IP victim.

VII. CONCLUSION

Calculating loss amount and restitution continue to be at the forefront of criminal IP cases—certainly at the sentencing phase, but also earlier in plea negotiations. Prosecutors and defense counsel must tackle sophisticated analyses, including whether a infringing product was being passed off as a legitimate article, treatment of valuation of labels, or the value of a trade

secret. Restitution faces similar questions that require additional analysis and provide room for argument for a properly prepared defense counsel. These battles will inevitably be fought—even though procedurally they may not “crop up” until later in the case—and counsel would be well advised to be considering these issues at the outset of the criminal IP case.

ENDNOTES

1. Jeffrey C. Hallam and Richard J. Nelson are partners with Sideman & Bancroft LLP, in San Francisco, California. They are both members of the firm’s business crimes practice group.
2. Statement of Kevin J. O’Connor, Chairman of the Task Force on Intellectual Property, Department of Justice, Before the Committee on the Judiciary, United States Senate, November 7, 2007, at 2.
3. *Gall v. United States*, 128 S. Ct. 586; 169 L. Ed. 2d 445; 76 U.S.L.W. 4009 (Dec. 10, 2007) (rejecting a requirement for district court to identify “extraordinary” circumstances to justify a sentence outside the Guidelines range, and also rejecting using a “rigid mathematical formula” to justify a departure); *Kimbrough v. United States*, 128 S. Ct. 558; 169 L. Ed. 2d 481; 76 U.S.L.W. 4023 (Dec. 10, 2007) (no abuse of discretion for sentencing court to depart downward for sentence involving crack cocaine, where court conducted a reasoned appraisal of facts involving the defendant to be sentenced).
4. 460 F.3d 623, 636–638 (5th Cir. 2006).
5. 490 F.3d 1317 (11th Cir. 2007).
6. 412 F.3d 893, 900 (8th Cir. 2005) (theft of software as trade secret; district court based sentencing calculation on loss of \$1.4 million, where evidence that development of software cost \$700,000, and approximate fair market value of one copy of the software was \$1 million). See also *United States v. Four Pillars Enterprise Co.*, 2007 U.S. App. LEXIS 26001 at *24–26, 2007 FED App. 0775N (6th Cir. 2007) (affirming district court calculation of loss amount for theft of trade secret conviction, based on cost of research and development of stolen secret) (unpublished opinion).
7. 900 F.2d 1350, 1355–56 (9th Cir. 1990) (mail fraud conviction based on attempted sale of stolen trade secrets; affirming sentencing calculation that valued trade secret as a percentage of research and development costs).
8. 18 U.S.C. § 3663A(c)(1)(A)(ii).
9. 18 U.S.C. § 2320(b)(4).
10. See *U.S. v. Milstein*, 481 F.3d 132, 137 (2nd Cir. 2007) (“[I]ntellectual or intangible property falls within the purview of criminal statutes designed to protect property”).
11. 18 U.S.C. § 3663A(b)(1).
12. 18 U.S.C. § 3664(e).
13. *U.S. v. Milstein*, 481 F.3d at 137.
14. 2003 U.S. Dist. LEXIS 19312 (D. Kan. 2003).
15. *Id.* at *2.
16. *Id.* at *20 (citing to Section 5E1.1(b)(2)(B) of the United States Sentencing Guidelines).
17. *Id.* (citations omitted).
18. 64 Fed Appx. 129 (10th Cir. 2003), cert. denied 540 U.S. 906.
19. *Id.* at 131.
20. 469 F.3d 102 (5th Cir. 2006).
21. *Id.* at 107–08.
22. 481 F.3d 132 (2nd Cir. 2007).
23. *Id.* at 135.

24. *Id.* at 137, n.3. Notably, the court did not consider whether the victim's *net* sales was the more appropriate measure of restitution because the defendant had not raised that issue on appeal. *Id.*

25. 281 F.3d 682 (7th Cir. 2002).

26. *Id.* at 684.

27. *Id.* at 685.

28. *Id.* at 686–87.

29. 1995 U.S. App. Lexis 1215 (4th Cir. 1995).

30. *Id.* at *4.

31. *Id.* at *4–5.

32. *Id.* at *7.

33. *Id.* at *7–8.

34. 69 F.3d 222 (8th Cir. 1995).

35. *Id.* at 228.

36. *Id.* at 228–30.