ACCOUNTING FOR PROFITS IN A COPYRIGHT INFRINGEMENT ACTION: A RESTITUTIONARY PERSPECTIVE

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INTRODUCTION

Claims of copyright infringement have become ubiquitous in modern society as we have moved toward an information-based, technologically advanced, media-driven economy. Many corporations carry a substantial portion of their value in intellectual property and will aggressively seek to protect it from misappropriation. To this end, a key component of a copyright infringement suit, once liability is established, is the calculation of the plaintiff's actual damages and the profits of the defendant attributable to the infringement.[1] Although calculating the defendant's "net" profit from the infringement sounds simple enough,[2] it invariably provokes further argument between the plaintiff and defendant.

This argument usually revolves around which expenses the defendant may deduct from his gross revenue attributable to the infringement to arrive at his net profit. The more expenses the defendant is allowed to deduct, the less money goes into the plaintiff's pocket. The tension is obvious. Two types of infringer expenses that have provoked a good deal of argument over the years are (1) federal income taxes paid on the profits from the infringing item, and (2) various overhead expenses ostensibly associated with the production of the infringing item. There have been sharp disagreements among the federal courts concerning the propriety of deducting these expenses in arriving at net profit.

Much of the discourse among the federal courts concerning whether to deduct these expenses centers around high rhetoric, absolutism, and blind justification by reference to precedents established nearly a century ago under a different statutory regime. The goal of this Note is to step back, return to the underlying principles of a copyright infringement action, and discuss how these principles can be used to understand the disagreements within the federal courts. Specifically, this Note aims to reach a principled resolution of these disagreements while staying true to both the underlying principles and the actual statutory language that govern remedies for copyright infringement.

This Note posits that the principles of the law of restitution underlie a copyright infringement action and can be used to give both a context and a resolution to the common disputes over the infringer's claimed expenses. Part I explores the current case law regarding the deductions for federal income taxes paid and overhead. Part II explains the basics of the law of restitution and how it is relevant to copyright law. Part III presents a restitutionary approach to the dispute over an infringer's deduction for federal income taxes paid, and Part IV does the same with respect to overhead expenses.

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[1] *See* 17 U.S.C. § 504(b) (2000) ("[T]he copyright owner is entitled to recover the actual damages suffered by him or her as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages.").

[2] *See id.* (defining the infringer's profits as the excess of gross revenue over deductible expenses).

I. RECOVERY OF THE INFRINGER'S PROFITS IN COPYRIGHT

A. *The Statutory Framework*

Today, 17 U.S.C. § 504 governs the recovery of damages and profits in a copyright infringement action. In the typical scenario, the plaintiff will file an action in federal district court alleging that the defendant has infringed the plaintiff's exclusive rights granted by the Copyright Act.[3] Assuming the plaintiff prevails on liability, he will then seek injunctive and/or compensatory relief for the defendant's infringement.[4] This Note focuses on the compensatory, rather than the injunctive, remedies available to an aggrieved plaintiff. Once the plaintiff has elected to pursue compensatory remedies, he then has another choice: he may elect to recover (1) actual damages and profits,[5] or (2) statutory damages.[6]

Should the plaintiff elect to recover actual damages and profits, § 504(b) entitles him to the actual damages he suffered as a result of the infringement *and* any profits attributable to the infringement that were not taken into account when calculating actual damages.[7] Furthermore, § 504(b) establishes a dual-burden framework for establishing the proper measure of the infringer's profits: the plaintiff must prove the defendant's gross revenue, while the defendant must prove his deductible expenses and any element of profit not attributable to the infringement.[8] Once the defendant's net profits are established via this procedure, he must pay them over to the plaintiff.

Should the plaintiff elect to recover statutory damages, § 504(c)(1) grants the plaintiff damages within a statutorily prescribed range.[9] Section 504(c)(2) allows a plaintiff who has been the victim of "willful" infringement to recover enhanced statutory damages.[10] Although § 504(b) makes no similar allowance for the enhancement of actual damages and profits,[11] willfulness has nevertheless also become a fixture in the calculation of the defendant's profits in a § 504(b) accounting. When a court deems an infringement willful, it is less likely to allow the defendant to deduct federal income taxes paid[12] or

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[3] *See id.* § 501 (defining copyright infringement); *id.* §§ 106-122 (delineating the exclusive rights protected by copyright).

[4] *See id.* § 502 (injunctive remedies); *id.* § 504 (compensatory remedies).

[5] *Id.* § 504(b).

[6] *Id.* § 504(c).

[7] *Id.* § 504(b).

[8] *Id.*

[9] *Id.* § 504(c)(1) (establishing a range of $750 to $30,000).

[10] *Id.* § 504(c)(2) (increasing the maximum award to $150,000 upon a finding "that infringement was committed willfully").

[11] *See id.* § 504(b).

[12] *Compare* In Design v. K-Mart Apparel Corp., 13 F.3d 559, 566-67 (2d Cir. 1994) (holding that an innocent infringer may deduct income taxes), *with* Sheldon v. Metro-Goldwyn Pictures Corp., 106 F.2d 45, 53 (2d Cir. 1939) (*Sheldon I*) (holding that a willful

overhead expenses.[13] Thus the willful defendant will be found to have higher profits and will be forced to pay the plaintiff more. As an example, assume that a plaintiff proves, under § 504(b), that a defendant's gross revenue from an infringement is $1 million. The burden then shifts to the defendant to prove his deductible expenses. Now further assume that the defendant paid $125,000 in federal income taxes, incurred $200,000 in various overhead expenses, and had a $350,000 expense for cost of sales. The defendant will claim each of these expenses as a deduction from gross revenue. Even though § 504(b) makes no mention of willfulness, the amount that the defendant is allowed to deduct hinges on whether the infringement was willful. If it was not, the court will allow all three deductions (totaling $675,000) and the plaintiff will receive $325,000. If it was, at least some courts will deny the deductions for taxes and overhead; the defendant will only be allowed to deduct the $350,000 expense for cost of sales, and the plaintiff will receive $650,000. Unsurprisingly, both the deduction of federal income taxes paid and overhead expenses have proved to be fertile ground for contention when it comes to the treatment of "willful" versus "innocent" infringers.

B. *The Infringer's Deduction for Federal Income Taxes Paid*

Initially, it is important to remember the context in which we are discussing this deduction. The plaintiff has already prevailed on liability; the defendant has been found guilty of infringing one or more of the plaintiff's exclusive rights under the Copyright Act. The plaintiff now seeks the defendant's profits from the infringement as a remedy. Section 504(b), however, does not entitle the plaintiff to the defendant's gross revenues; it only entitles the plaintiff to the defendant's gross revenues *less* the deductible expenses the defendant can prove. One expense that the defendant will often claim is the amount of federal income taxes paid on his income arising from the production of the infringing item. As the argument goes for the defendant, his *true* profit from the infringing activity is his post-tax profit. For example, if the defendant has a profit of $450,000 after deducting his ordinary and necessary business expenses, $153,000 of that profit will line Uncle Sam's pocket, assuming a

infringer may not deduct income taxes), *aff'd*, 309 U.S. 390 (1940) (*Sheldon II*). *But see* Schnadig Corp. v. Gaines Mfg. Co., 620 F.2d 1166, 1169-71 (6th Cir. 1980) (stating that a deduction for income taxes should *never* be allowed); Matthew McNicholas & John P. McNicholas, *Non-Deductibility Is a Wonderful Thing: Federal Income Taxes Should Not Be Deductible When Calculating Net Profits in a Copyright Infringement Suit*, 5 UCLA ENT. L. REV. 71 (1997) (same).

[13] *Compare* Frank Music Corp. v. Metro-Goldwyn-Mayer, Inc., 772 F.2d 505, 515 (9th Cir. 1985) (holding that an innocent infringer may deduct overhead expenses), *with* Saxon v. Blann, 968 F.2d 676, 681 (8th Cir. 1992) (holding that a willful infringer may not deduct overhead expenses). *But see* Hamil Am., Inc. v. GFI, 193 F.3d 92, 107 (2d Cir. 1999) (stating that a deduction for overhead expenses should be allowed under certain circumstances even when an infringement *is* willful); ZZ Top v. Chrysler Corp., 70 F. Supp. 2d 1167, 1168 (W.D. Wash. 1999) (same).

34% corporate tax rate.[14] Thus, in reality, the defendant has only profited $297,000 from the infringement, and should only be required to disgorge that amount to the plaintiff. Life, however, is never this simple.

It has become a nearly universal rule that "innocent" copyright infringers may deduct the federal incomes taxes they have paid on profits arising from their infringement as an expense in a § 504(b) accounting, but that "willful" copyright infringers may *not*.[15] The effect for willful infringers, at first blush, is to force them to pay over their *pre*-tax profit to the plaintiff under § 504(b). In this sense, courts must have a punitive design in mind, since "omitt[ing] an item from the defendant's side of the ledger would overstate net enrichment, resulting in a liability that, to the extent of the excess, might fairly be described as punitive."[16] Certainly the infringer has not reaped the benefit of this excess, because it has been paid over to the government. Disallowing the infringer to deduct the amount he paid in federal income tax operates as a kind of tax subsidy in favor of the plaintiff, who will now receive a "profit" award that is greater than the actual profit he would have kept had he earned it himself.

The troubling aspect of this draconian rule is that it bases the deductibility of an ostensibly legitimate expense not on the infringer's ability to prove that expense, but on whether the infringer acted "willfully" or "innocently" in the course of his infringement. Willfulness, however, is only permitted as a *determinative* criterion for assessing liability under § 504(c) (statutory damages), *not* under § 504(b) (profit disgorgement).[17] Thus, the more appropriate route would be either to allow *all* infringers to deduct income taxes paid (subject, of course, to the individual infringer's ability to "prove" that

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[14] *See* I.R.C. § 11(b) (2000) (detailing corporate tax rates).

[15] *See* cases cited *supra* note 12. There have been several other cases in which the court has granted an income tax deduction to an innocent infringer, *see, e.g.*, Three Boys Music Corp. v. Bolton, 212 F.3d 477, 488 (9th Cir. 2000); New Line Cinema Corp. v. Russ Berrie & Co., 161 F. Supp. 2d 293, 302, 304 & n.5 (S.D.N.Y. 2001), or denied a deduction to a willful infringer, *see, e.g.*, L.P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co., 277 U.S. 97, 100 (1928) (trademark context); Alfred Bell & Co. v. Catalda Fine Arts, Inc., 191 F.2d 99, 106 (2d Cir. 1951). Moreover, courts that grant an income tax deduction to an innocent infringer tend to dutifully recite the rule that a willful infringer would not be entitled to such a deduction. *See, e.g.*, *Three Boys Music Corp.*, 212 F.3d at 487; *In Design*, 13 F.3d at 566. Treatise authors Melville and David Nimmer have described the proposition that willful infringers are not entitled to income tax deductions as "settled law." 4 MELVILLE B. NIMMER & DAVID NIMMER, NIMMER ON COPYRIGHT § 14.03[C][2] (2006).

[16] Andrew Kull, *Restitution's Outlaws*, 78 CHI.-KENT L. REV. 17, 27 (2003).

[17] *See ZZ Top*, 70 F. Supp. 2d at 1168 (pointing out that § 504(b), in contrast to § 504(c), "makes no distinction between willful and innocent infringers"); 2 PAUL GOLDSTEIN, GOLDSTEIN ON COPYRIGHT § 14.1.2.1(d) (3d ed. 2005) ("If willfulness is to be penalized, statutory damages represents the appropriate route."); *see also* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42, reporter's note to cmt. i (Tentative Draft No. 4, 2005) (stating that the distinction between innocent and willful infringers "import[s] a punitive component that has no basis in [§ 504(b)]").

expense as required by § 504(b)), or to allow *no* infringers to take such a deduction on the theory that taxes paid are not really "expenses" under § 504(b).

The Sixth Circuit and some commentators have argued that no infringers should be allowed a deduction for federal income taxes paid.[18] This argument is principally premised on the notion that income taxes paid are not an expense: if an infringer were allowed to deduct income taxes paid, the economic realities of the federal income tax system would allow him to "reap a net gain from his infringing activity."[19] Various hypothetical examples have been suggested to demonstrate this, but for continuity's sake, let us return to the hypothetical defendant who made a $450,000 profit from his infringement.[20]

Let us assume that 100% of the defendant's profits are attributable to the infringement. If we allow the defendant to deduct the income taxes paid on his $450,000 profit, and if we assume a 34% corporate tax rate, the defendant will be able to work the system to ensure a $100,980 net gain for himself. Let me explain. The defendant will take a deduction of $153,000 (34% of $450,000), and will ultimately pay $297,000 to the plaintiff. The Internal Revenue Code, however, allows businesses to deduct, as ordinary and necessary business expenses, those amounts paid as damages.[21] Thus, after paying $297,000 to the plaintiff, our infringer will deduct it on his tax return. This deduction is worth $100,980 (34% of $297,000), and represents a net gain to the infringer. The infringer made a $450,000 profit, paid some of it to the government ($153,000 of tax), paid the rest to the plaintiff ($297,000 of damages), and received a $100,980 tax deduction as a result. The $100,980 is, "in essence, free money."[22]

Such an analysis holds true even in the face of different tax situations for different taxpayers. The Sixth Circuit recognizes that "offsetting losses could conceivably bar use of the deduction or negate any tax effect of the award."[23] Nevertheless, the net operating loss provision of the Internal Revenue Code allows infringers to hold on to the deduction and apply it against their gross

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[18] *See* Schnadig Corp. v. Gaines Mfg. Co., 620 F.2d 1166, 1169-71 (6th Cir. 1980); McNicholas & McNicholas, *supra* note 12, at 101.

[19] *Schnadig*, 620 F.2d at 1170.

[20] The methodology that follows is based on hypotheticals presented in *Schnadig*, 620 F.2d at 1169, and McNicholas & McNicholas, *supra* note 12, at 81-83.

[21] *See* I.R.C. § 162(a) (2000) (allowing the deduction of "ordinary and necessary" business expenses); Treas. Reg. § 1.162-21(c)(1) (1975) (indicating that payment of a damage award is a deductible business expense); *see also Schnadig*, 620 F.2d at 1169 n.7 (noting that "amounts paid as damages are deductible"). To be clear, although the Copyright Act makes a distinction between "actual damages" and "profits" in § 504(b), the "damages" concept as an "ordinary and necessary business expense" in tax law encompasses them both. *See id.*

[22] McNicholas & McNicholas, *supra* note 12, at 82.

[23] *Schnadig*, 620 F.2d at 1169-70.

income as a carry-forward for twenty years or as a carry-back for two years.[24] Therefore, the defendant's use of the deduction is not merely speculative.[25]

The same analysis can be used to demonstrate the inherent equity of a rule denying the deduction across the board. Under such a rule, the infringer would pay over his entire profit of $450,000 to the plaintiff. He would then deduct that $450,000 as a "damage" payment on his tax return, producing a net tax savings of $153,000 (34% of $450,000). "Consequently, the infringer has been fully reimbursed for all income tax liability yet has taken nothing by way of its infringement. Further, the plaintiff copyright holder has received all of the infringing profits attributable to its original work."[26] As the Sixth Circuit concludes, "[D]isallowing consideration of the immediate tax consequences to the infringer does not penalize; it merely assures that the profit to the wrongdoer is fully extracted."[27]

Even in the face of this analysis, however, other circuits hold fast to the willful-innocent dichotomy to determine the deductibility of federal income taxes paid.[28] These circuits certainly have the weight of precedent in their favor,[29] but we should not ignore the fact that such precedent is antiquated and disregards both the textual realities of the current Copyright Act[30] and the economic realities of the current Internal Revenue Code.[31] One of the principal objectives of this Note is to provide some contextual background to this approach, which has been sorely lacking in contemporary discussions. First, however, this Note will highlight another deduction that has sparked a similar row.

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[24] I.R.C. § 172(b)(1)(A); *see also Schnadig*, 620 F.2d at 1170 & n.10 (highlighting the possibility of carry-forwards and carry-backs); McNicholas & McNicholas, *supra* note 12, at 86-87 (same).

[25] McNicholas & McNicholas, *supra* note 12, at 86-90.

[26] *Id.* at 81.

[27] *Schnadig*, 620 F.2d at 1171.

[28] *See* In Design v. K-Mart Apparel Corp., 13 F.3d 559, 567 (2d Cir. 1994) (dismissing the court's analysis in *Schnadig* as "[h]ypothetical"); Three Boys Music Corp. v. Bolton, 212 F.3d 477, 487-88 (9th Cir. 2000) (acknowledging the circuit split between the Second and Sixth Circuits and ultimately deciding to "uphold the district court's decision to allow non-willful infringers to deduct income taxes").

[29] *See, e.g.*, L.P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co., 277 U.S. 97, 99-100 (1928) (applying the willful-innocent dichotomy in a trademark infringement case); Sheldon v. Metro-Goldwyn Pictures Corp., 106 F.2d 45, 53 (2d Cir. 1939) (*Sheldon I*) (applying the willful-innocent dichotomy in a copyright infringement case), *aff'd*, 309 U.S. 390 (1940) (*Sheldon II*); *see also* Christine Ballard, Note, *Not All Copyright Infringers Are Created Equal: Why Federal Income Tax Is a Proper Deductible Expense for Non-Willful Copyright Infringers*, 8 VAND. J. ENT. & TECH. L. 585, 600-05 (2006) (detailing precedent in favor of the willful-innocent dichotomy).

[30] *See supra* note 17 and accompanying text.

[31] *See supra* notes 18-27 and accompanying text.

C. *The Infringer's Deduction for Overhead Expenses*

Courts considering the deductibility of overhead expenses[32] have split into three separate camps. The first employs the same draconian rule that we saw in the tax context: the innocent infringer receives a deduction and the willful infringer does not.[33] This has the same effect as in the tax context – it makes "willfulness" or "innocence" the *determinative* inquiry in allowing a deduction – and it is similarly unsupported by the text of the Copyright Act.[34] The second camp would prohibit any inquiry into willfulness or innocence when determining the infringer's profits; advocates of this position principally rely on a strict textual interpretation of § 504.[35] A third camp, however, has carved out a rough middle ground: willfulness or innocence is *relevant* to the calculation of the infringer's profits, but it is not *determinative*. Courts implement this position by heightening the willful infringer's burden of proof, rather than executing a per se denial of the deduction.[36] The alluring aspect of this theory is that it permits consideration of willfulness or innocence, yet acknowledges that the ultimate question of fact in each case is whether a particular item of overhead "assist[ed] in the production of the infringement."[37]

A principal concern of this Note is to examine whether the law of restitution can shed light on the relative merits of these three camps. First, however, I think it appropriate to trace the historical development of the draconian rule that the first camp espouses, and demonstrate how it is grounded in a fundamental misinterpretation of *Sheldon v. Metro-Goldwyn Pictures Corp.*,[38] the seminal case on calculating an infringer's profits in a copyright suit. I will then follow up this analysis with an explanation of how the third camp's position (the rough middle ground) is consistent with both *Sheldon* and the text

[32] Overhead expenses of a business are quite varied. They can include, for example, rent, entertainment expenses, personnel expenses, general business expenses, and public relations expenses. Hamil Am., Inc. v. GFI, 193 F.3d 92, 105 (2d Cir. 1999). On the slightly more exotic end, they can also include "continuities scrapped" and "completed pictures never exhibited" when dealing with the motion picture industry. *Sheldon I*, 106 F.2d at 54.

[33] *See* cases cited *supra* note 13; *see also* Jarvis v. A & M Records, 827 F. Supp. 282, 294 (D.N.J. 1993) ("[I]f defendant's conduct is willful, overhead may not be deducted.").

[34] *See supra* note 17 and accompanying text.

[35] *See, e.g.*, ZZ Top v. Chrysler Corp., 70 F. Supp. 2d 1167, 1168 (W.D. Wash. 1999) ("[T]here is no statutory basis for denying a deduction of overhead costs as a punishment to willful infringers.").

[36] *See Hamil*, 193 F.3d at 107 ("When infringement is found to be willful, the district court should give extra scrutiny to the categories of overhead expenses claimed by the infringer to insure [sic] that each category is directly and validly connected to the sale and production of the infringing product.").

[37] *Sheldon I*, 106 F.2d at 54; *see also Hamil*, 193 F.3d at 106 ("[W]e are not prepared to abandon the teachings of *Sheldon* in favor of a hard and fast rule denying all overhead deductions to willful infringers.").

[38] 106 F.2d 45 (2d Cir. 1939) (*Sheldon I*), *aff'd*, 309 U.S. 390 (1940) (*Sheldon II*).

of § 504 of the Copyright Act, thus answering the textualist objections of the second camp.

1. The Fundamental Misinterpretation of *Sheldon*

Initially, it is important to understand what *Sheldon* says and what it does not. *Sheldon* involved Metro-Goldwyn's infringement of Edward Sheldon's play, "Dishonored Lady," when Metro-Goldwyn released the movie "Letty Lynton."[39] Judge Learned Hand described Metro-Goldwyn's infringement as "deliberate plagiarism,"[40] and Sheldon naturally sued Metro-Goldwyn for copyright infringement and sought Metro-Goldwyn's profits.[41] While discussing the parties' various objections to the district court's accounting for Metro-Goldwyn's profits, Judge Hand made two separate holdings. First, "[A] plagiarist may not charge for his labor in exploiting what he has taken."[42] Second, "'Overhead' which does not assist in the production of the infringement should not be credited to the infringer; that which does, should be; it is a question of fact in all cases."[43]

These two holdings make it clear that Judge Hand did not see overhead expenses as a component of labor costs. Under the first holding, labor costs are categorically prohibited to a "plagiarist" (or, to use the term this Note has adopted, a "willful infringer"). Under the second holding, however, overhead costs must be allowed to the extent that they assisted in the production of the infringing item – a standard far from outright denial. Moreover, Judge Hand contemplated the allowance of overhead costs as a "question of fact" to be decided on a case-by-case basis – again, hardly a prohibitory statement. Thus, although *Sheldon* draws a distinction between innocent and willful infringers when it comes to deducting the cost of "labor" – innocent infringers can and willful infringers cannot – it draws no such distinction with regard to overhead expenses. Subsequent courts have nevertheless conflated these two concepts to create a doctrine whereby *Sheldon* is authority for allowing innocent infringers, but not willful infringers, to deduct overhead expenses.[44]

The only way to understand this perversion of *Sheldon*'s holdings is to trace its development in case law. The starting point is *Kamar International, Inc. v. Russ Berrie & Co.*[45] The plaintiff, Kamar International, cited *Sheldon*'s first holding ("a plagiarist may not charge for his labor") for the proposition that a willful copyright infringer may not deduct overhead expenses.[46] The court made two points in response to this argument. First, it found that Russ Berrie's

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[39] *Sheldon II*, 309 U.S. at 396.

[40] *Sheldon I*, 106 F.2d at 51.

[41] *Sheldon II*, 309 U.S. at 396.

[42] *Sheldon I*, 106 F.2d at 51.

[43] *Id.* at 54.

[44] *See infra* notes 50-55 and accompanying text.

[45] 752 F.2d 1326 (9th Cir. 1984).

[46] *Id.* at 1331.

infringement was not willful.[47] Next, it observed that *Sheldon*'s first holding was never meant to apply to overhead expenses.[48] The *Kamar* court understood that Judge Hand did not consider overhead expenses to be a component of the "labor" for which "a plagiarist may not charge." The court therefore crafted an "actual assistance" test, which allows even a willful infringer to deduct an overhead expense if he can show that the overhead "was of actual assistance in the production, distribution or sale of the infringing product."[49] Despite this intellectually honest reading of *Sheldon*, other courts have used *Kamar* as a launching pad for the development of a dichotomous doctrine allowing innocent infringers, but not willful infringers, to deduct overhead expenses.

The first principal offender was *Frank Music Corp. v. Metro-Goldwyn-Mayer, Inc.*[50] While *Frank Music* ultimately applied *Kamar*'s "actual assistance" test to a case of innocent infringement,[51] it added an important caveat. Before applying the "actual assistance" test, the court asserted that *Kamar* stands for the absolute proposition that "[a] portion of an infringer's overhead properly may be deducted from gross revenues to arrive at profits, *at least where the infringement was not willful, conscious, or deliberate*."[52] This is a disingenuous reading of *Kamar*. After all, *Kamar* requires an infringer to demonstrate "actual assistance," and does not look to whether the infringement was "willful, conscious, or deliberate."[53] Moreover, *Kamar* expressly recognizes that *Sheldon* never intended for the deductibility of an overhead expense to depend on the infringer's willfulness or innocence.[54] Nevertheless, *Frank Music* is on the books and has provided additional justification for courts that have decided to go the route of denying the overhead expense deduction to willful infringers while allowing it for innocent infringers.[55]

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[47] *Id.* ("[T]he district court's finding that Russ Berrie's infringements were not willful is not clearly erroneous.").

[48] *Id.* (observing that *Sheldon* "does . . . not disallow all overhead" even in the case of willful infringement).

[49] *Id.* at 1332 (citing Sheldon v. Metro-Goldwyn Pictures Corp., 106 F.2d 45, 54 (2d Cir. 1939) (*Sheldon I*)).

[50] 772 F.2d 505 (9th Cir. 1985).

[51] *See id.* at 515-16.

[52] *Id.* at 515 (emphasis added).

[53] *See supra* note 49 and accompanying text.

[54] *See supra* note 48 and accompanying text.

[55] *See, e.g.*, Saxon v. Blann, 968 F.2d 676, 681 (8th Cir. 1992) ("Overhead may not be deducted from gross revenues to arrive at profits when an infringement was deliberate or willful." (citing *Frank Music*, 772 F.2d at 515)).

2. Interpreting *Sheldon*: A Return to Reason

Despite the bumbling of its sister circuits, the Second Circuit has adhered to a faithful interpretation of *Sheldon*. In *Hamil America, Inc. v. GFI*,[56] a federal district court ruled that GFI could not deduct overhead expenses because it was a willful copyright infringer.[57] The Second Circuit reversed, stating that it refused to follow *Frank Music*, *Saxon v. Blann*,[58] and *Jarvis v. A & M Records*,[59] cases in which the court "abandon[ed] the teachings of *Sheldon* in favor of a hard and fast rule denying all overhead deductions to willful infringers."[60] Instead, the *Hamil* court crafted a test that did not outright deny willful infringers a deduction for overhead, but instead imposed a heightened burden of proof upon willful infringers to show a "direct and valid nexus between each claimed overhead expense category and the production of [the infringing item]."[61] The court termed this test the "strong nexus" test, which it contrasted with the "sufficient nexus" test for innocent infringers.[62]

In applying the "strong nexus" test, a court is supposed to "give extra scrutiny to the categories of overhead expenses claimed by the infringer to insure [sic] that each category is directly and validly connected to the sale and production of the infringing product."[63] If a willful infringer fails to meet this test for a particular category of overhead, the category may not be deducted.[64] This approach, unlike that of *Frank Music*, *Saxon*, and *Jarvis*, is consistent with *Sheldon*.

Foremost, *Hamil* retains the notion that whether an overhead expense is deductible is ultimately a question of fact to be decided based on the overhead item's assistance in producing the infringing item. Unlike the absolutist doctrine of *Frank Music*, *Saxon*, and *Jarvis*, which truncates the analysis at the infringer's innocence or willfulness, *Hamil*'s "strong nexus" test does not destroy the ultimate inquiry into whether a particular item of overhead expense actually helped to produce the infringing item. If it did, it will still be allowed as a deduction even if the defendant's infringement was willful. Moreover, *Hamil* expresses fidelity to the original, and correct, interpretation of *Sheldon* contained in *Kamar*.[65] Just as *Kamar* retains "actual assistance" as the ultimate determinant of whether an overhead expense is deductible,[66] *Hamil*'s "strong nexus" and "sufficient nexus" tests retain "connect[ion] to the sale and

[56] 193 F.3d 92 (2d Cir. 1999).
[57] *Id.* at 106.
[58] 968 F.2d 676 (8th Cir. 1992).
[59] 827 F. Supp. 282 (D.N.J. 1993).
[60] *Hamil*, 193 F.3d at 106.
[61] *Id.* at 107.
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *See id.* (citing *Kamar* as support for the "strong nexus" test).
[66] *See supra* note 49 and accompanying text.

production of the infringing product" as their ultimate inquiry.[67] In neither case is willfulness or innocence considered the *determinative* factor in allowing the infringer an expense deduction.

Likewise, the *Hamil* test also retains fidelity to the language of the current Copyright Act. Textualist courts and commentators (the second camp) have aptly pointed out that § 504(b) does not call on courts to take an infringer's willfulness or innocence into account. However, even these expositors ground their criticism in an assumption that willfulness or innocence is being used to truncate the actual assistance inquiry, rather than augment it as *Hamil* does.[68] Section 504(b) simply requires that an infringer "prove his or her deductible expenses" in an accounting for profits.[69] But the statute does not specify the quantum of proof or define an "expense." The furthest a textual interpretation of § 504 could take us is to the conclusion that a finding of willfulness or innocence may not be used as a per se determinant of what expenses may be deducted. This is as far those in the second camp can legitimately claim their theory extends.[70]

The House Report accompanying the current Copyright Act lends support to the above view; it states that one basic aim of § 504 is "to provide the courts with reasonable latitude to adjust recovery to the circumstances of the case."[71] Thus, in the case of overhead expenses, Congress may have intended for the quantum of proof referred to in § 504(b) to be malleable based upon the circumstances of the case – which is precisely what happens under *Hamil*'s "strong" and "sufficient" nexus tests. Similarly, if courts are to be given "reasonable latitude," there may be room to interpret not only what constitutes "proof" but also what constitutes an "expense" – an inquiry directly relevant to the practice of allowing or disallowing an infringer to deduct federal income taxes paid.[72] But where do we go from here?

Even given how far we have pushed this analysis, it is still unsatisfying. From where are courts deriving this willful-innocent dichotomy? What legal theory has consistently led courts to strive to consider willfulness or innocence in some form when conducting an accounting for profits? The reasons for such a strained theory of inquiry are by no means obvious. Consequently, some

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[67] *See supra* note 63 and accompanying text.

[68] For example, in *ZZ Top v. Chrysler Corp.*, 70 F. Supp. 2d 1167 (W.D. Wash. 1999), Judge Lasnik criticized courts that "authoriz[e] different remedies depending on the infringer's culpability." *Id.* at 1168. In contrast, *Hamil*'s test allows a willful infringer to obtain the same remedy as an innocent infringer – a result consonant with the statutory language of § 504.

[69] 17 U.S.C. § 504(b) (2000).

[70] *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 cmt. i (Tentative Draft No. 4, 2005) ("[T]he decision to disallow a provable deduction, logically relevant to a determination of the net profit attributable to infringement, can be justified only if the court claims the authority to impose an overtly punitive sanction.").

[71] H.R. REP. NO. 94-1476, at 161 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 5659, 5777.

[72] *See supra* Part I.B.

other set of legal norms must be influencing this area of the law. This set of legal norms is contained in the law of restitution.

II. RESTITUTION AND ITS RELEVANCE TO COPYRIGHT REMEDIES

A. *The Law of Restitution: A Primer*

Before turning to the relationship between copyright remedies and restitution, a short description of the general law of restitution is in order. Liability in restitution is succinctly described as follows:

> The source of a liability in restitution is the receipt of an economic benefit under circumstances such that its retention without payment would result in the unjust enrichment of the defendant at the expense of the plaintiff. The consequence of a liability in restitution is that the defendant must either restore the benefit in question (or its traceable product), or else pay money in the amount necessary to eliminate unjust enrichment.[73]

For example, suppose Andy owes Barb $100 on account and Andy pays Barb $200 by mistake. There is no contract between Andy and Barb establishing a duty to refund the overpayment; Barb's obligation to do so is a liability in restitution.[74] Restitution is a simple concept, but can quickly become complicated.

The principal complication that concerns this Note involves restitutionary counterclaims asserted by "disfavored" defendants.[75] I will explain the concept of the restitutionary counterclaim with an example. Assume that plaintiff Paul has sued defendant David for willfully trespassing on his property.[76] Further assume that David's trespass involved an ongoing business activity that produced substantial profits, and that Paul's claim for relief involves disgorging David of a percentage of those profits. David must now account for his profits. But what if the court does not allow David to deduct one of his legitimate expenses? This would force David to overstate his net profits, thus resulting in the unjust enrichment of Paul.[77] David therefore has a restitutionary counterclaim against Paul, based on the unjust enrichment that would occur if the legitimate expense were denied.

However, courts often pass over, ignore, or deny a defendant's restitutionary counterclaim when the defendant is "disfavored" in some respect.[78] This is a

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[73] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. a (Discussion Draft 2000).

[74] *Id.* § 1 illus. 6.

[75] *See generally* Kull, *supra* note 16.

[76] This example is based on *Edwards v. Lee's Adm'r*, 96 S.W.2d 1028 (Ky. 1936).

[77] *See* Kull, *supra* note 16, at 27 ("An accounting that omitted an item from the defendant's side of the ledger would overstate net enrichment, resulting in a liability that, to the extent of the excess, might fairly be described as punitive.").

[78] *Id.*

fairly surprising result. After all, "actions of restitution are not punitive."[79] A primary purpose of restitution is to "tak[e] from the defendant and restor[e] to the plaintiff something to which the plaintiff is entitled"[80] – not to force the defendant to give the plaintiff *more* than he is entitled. Such forfeiture would no doubt constitute a punitive sanction. Why, then, would a court reject a restitutionary counterclaim brought by a disfavored defendant who simply seeks to avoid overpaying a plaintiff? The answer has to do with a second purpose of restitution (which sometimes runs counter to the first): preventing forced exchanges.

A draft version of the *Restatement (Third) of Restitution and Unjust Enrichment* squarely identifies the remedy of nonconsensual transfers ("forced exchanges") as one of restitution's objectives.[81] (The term "forced exchange" is a term of art in restitution and represents a situation in which "the defendant has neglected a duty to contract with the owner for the property or its use.")[82] Restitution is principally concerned with remedying forced exchanges when they are brought about by a consciously tortious defendant:

> If a conscious wrongdoer were able to make profitable, unauthorized use of the claimant's property, then pay only the objective value of the assets taken or the harm inflicted, the anomalous result would be to legitimate a kind of private eminent domain (in favor of a wrongdoer) and to subject the claimant to a forced exchange.[83]

Restitution therefore attempts to prevent forced exchanges by conscious wrongdoers. However, one can easily imagine a situation in which the countervailing policies of "no punitive restitution remedies" and "no forced exchanges by conscious wrongdoers" lock horns.

For example, assume Jim B. knowingly trespasses on Jack D.'s property, removes some corn, and distills that corn into whiskey.[84] Further assume that Jack D. discovers Jim B.'s consciously tortious act and sues him, seeking a return of the corn (which has now been converted into whiskey). If we are concerned about preventing "forfeitures" and "punitive" restitution remedies, we have no choice but to allow Jim B. some sort of compensation for his costs in converting the corn into whiskey. On the other hand, if we are concerned about preventing a forced exchange by a conscious wrongdoer, we should require Jim B. to disgorge the whiskey to Jack D. with no compensation whatsoever, since Jim B. obviously neglected to contract with Jack D.

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[79] RESTATEMENT OF RESTITUTION, introductory note to ch. 8, Topic 2, at 596 (1937).

[80] *Id.* at 595-96.

[81] *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. d (Discussion Draft 2000).

[82] *Id.*

[83] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT, introductory note to ch. 5, Topic 1, cmt. 3 (Tentative Draft No. 4, 2005).

[84] This example is based on *Silsbury v. McCoon*, 3 N.Y. 379 (1850).

In reality, the settled rule of law is that Jim B. must disgorge the whiskey (the entire finished product) to Jack D. without any compensation as a result of his consciously tortious act.[85] The object of preventing a forced exchange has prevailed over the object of preventing a punitive restitutionary remedy, at least where a "disfavored" defendant is involved.[86] This statement, however, is not always entirely accurate; "wiggle room" will play a substantial role in the pages that follow. This Note will now turn to the direct and substantial relationship between the law of restitution and the remedial copyright claim for an infringer's profits.

B. *Restitution and Copyright*

Even before the first major codification of U.S. copyright law in the Copyright Act of 1909,[87] a restitutionary theory informed a copyright plaintiff's right to recover an infringer's profits.[88] Such a recovery was considered an equitable remedy, imposed "not to inflict punishment but to prevent an unjust enrichment."[89] This language should sound familiar; it is the language of restitution.[90] One court elaborated on the rationale behind the plaintiff's right to recover the infringer's profits, explaining that it would be "unconscionable for an infringer to retain a benefit which he had received by the appropriation and use of the plaintiff's property right."[91] Thus, in equity, a copyright infringer was disgorged of his profits, but only to the extent necessary to prevent unjust enrichment. Congress did not change the restitutionary theory upon which profit recovery was premised when it codified the remedies for copyright infringement in 1909.

The Copyright Act of 1909 contained a provision for the recovery of the infringer's profits: § 25(b).[92] Section 25(b) provided, in relevant part: "[I]f any person shall infringe [a] copyright . . . such person shall be liable . . . [t]o pay to the copyright proprietor . . . all the profits which the infringer shall have made from such infringement . . . ."[93] More importantly, courts recognized that, as a result of this codification, "there was no change in the principle upon

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[85] *McCoon*, 3 N.Y. at 392-93; *see also* Wooden-ware Co. v. United States, 106 U.S. 432, 433-35 (1882) (requiring full disgorgement of profits from a conscious trespasser who felled timber without permission, transported it to town, and sold it for fourteen times the amount it would have cost before being transported).

[86] *See* Kull, *supra* note 16, at 28-30.

[87] Ch. 320, 35 Stat. 1075.

[88] *See* Sheldon v. Metro-Goldwyn Pictures Corp., 309 U.S. 390, 399-400 (1940) (*Sheldon II*) (recognizing the influence of restitution on the development of copyright law).

[89] *Id.* at 399.

[90] *See supra* note 73 and accompanying text (providing a general definition of a restitution claim).

[91] Sammons v. Colonial Press, Inc., 126 F.2d 341, 345 (1st Cir. 1942).

[92] § 25(b), 35 Stat. at 1081.

[93] *Id.*

which such relief had theretofore been granted by courts of equity."[94] Hence, Congress retained the basic restitutionary theory behind the "profits remedy" in its 1909 codification of the federal copyright law.

Thirty-one years ago, Congress overhauled the federal copyright law, supplanting the 1909 Act with the Copyright Act of 1976.[95] However, Congress left intact the restitutionary theory underpinning the recovery of profits in a copyright infringement action. Two pieces of evidence confirm this conclusion. The first is the uncanny similarity between the language used in the old § 25(b) and in the new § 504(b).[96] This provides a strong indication that the Congress that passed the 1976 Act intended to retain the same theory of recovery contemplated by the Congress that passed the 1909 Act.

The second piece of evidence comes from the House Report accompanying the 1976 Act. According to the Report, "section 504(b) recognizes . . . [that] profits are awarded to prevent the infringer from unfairly benefiting from a wrongful act."[97] This, of course, echoes the language of restitution, and is further indication that Congress intended for the profits remedy to be imposed, as it had been in the past, "not to inflict punishment but to prevent an unjust enrichment."[98]

Thus, we can fairly say that the plaintiff's recovery of a defendant's profits in a copyright infringement action continues to be based upon a theory derived from the law of restitution. Modern commentary also supports this view. For example, the draft *Restatement (Third) of Restitution and Unjust Enrichment* devotes an entire section to "Interference with Intellectual Property and Similar Rights."[99] The inclusion of this section suggests that the theory behind providing *any* remedy, not just the recovery of profits, for the infringement of copyright and similar property rights is rooted in the common law concept of restitution. This idea is not surprising when we think about what constitutes the core of a copyright claim. A copyright infringer is someone who makes

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94 *Sammons*, 126 F.2d at 346 (citing *Sheldon II*, 309 U.S. at 399-400).

95 Pub. L. No. 94-553, 90 Stat. 2541 (codified at 17 U.S.C.).

96 *Compare* § 25(b), 35 Stat. at 1081 ("[I]f any person shall infringe . . . copyright . . . such person shall be liable . . . [t]o pay to the copyright proprietor . . . all the profits which the infringer shall have made from such infringement, and in proving profits the plaintiff shall be required to prove sales only and the defendant shall be required to prove every element of cost which he claims . . . ."), *with* 17 U.S.C. § 504(b) (2000) ("The copyright owner is entitled to recover . . . any profits of the infringer that are attributable to the infringement . . . . In establishing the infringer's profits, the copyright owner is required to present proof only of the infringer's gross revenue, and the infringer is required to prove his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work.").

97 H.R. REP. NO. 94-1476, at 161 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 5659, 5777.

98 *Sheldon II*, 309 U.S. at 399; *see also* 4 NIMMER & NIMMER, *supra* note 15, § 14.03[D][1] ("*Sheldon*'s result has now won express adoption in the 1976 Act . . . .").

99 RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 (Tentative Draft No. 4, 2005).

unauthorized use of another's property to reap a profit he does not deserve; it is conceptually the same as Jim B. trespassing on Jack D.'s property and making unauthorized use of Jack's corn to produce whiskey.[100] In both cases the plaintiff claims that the defendant has been unjustly enriched at his expense; in both cases restitution provides the basis for recovery. But what is the most appropriate way to use this theoretical basis when construing a modern statute such as the Copyright Act of 1976?

The draft *Restatement (Third) of Restitution and Unjust Enrichment* provides some guidance on how to use restitutionary principles in construing modern statutory law. It recognizes that a restitution claim based on copyright infringement will "rarely be asserted without reference to statute."[101] However, restitution can "serve to illuminate legislative purpose . . . and as an aid to interpretation in a doubtful case. . . . A judge who believes the statute has incorporated underlying restitutionary principles may look to [restitution] for additional guidance on the content of those principles."[102] Thus, the general common law of restitution is relevant to the interpretation of statutory law insofar as it (1) aids in the interpretation of ambiguous statutory terms, and (2) does not supplant the plain text of the statute. With these principles in mind, this Note will now turn to its two original quandaries: first, what to do with the infringer's deduction for federal income taxes paid on his ill-gotten profits, and second, why courts are so insistent on considering willfulness when faced with an infringer's claimed deduction for overhead expenses.

III. THE DEDUCTION FOR FEDERAL INCOME TAXES PAID: A RESTITUTIONARY PERSPECTIVE

Before delving into the substance of this section, let us first ground ourselves in some of the restitutionary characteristics that have been discussed. First, recall the nature of the claim here: the plaintiff has sued the defendant for copyright infringement and prevailed on the issue of liability. Further, the plaintiff has elected to recover actual damages and profits from the defendant under § 504(b), and has proven the defendant's gross revenue. The defendant must therefore prove his deductible expenses; these will be deducted from his gross revenue to arrive at the net profit that he must disgorge to the plaintiff. One of the expenses that the defendant will invariably claim is the federal income taxes paid on income arising from the production of the infringing item. As the defendant's argument goes, his *true* profit from the infringing activity is his *post*-tax profit.

If we accept the defendant's contention that taxes paid are a legitimate item of expense that should be deducted, then the restitutionary principles discussed in Part II are implicated. If the court were to deny the deduction, it would

[100] *See supra* notes 84-86 and accompanying text.

[101] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 cmt. a (Tentative Draft No. 4, 2005).

[102] *Id.*

remove an item from the defendant's side of the accounting ledger, overstate the defendant's net enrichment, and result in a punitive forfeiture. The plaintiff would recover "more than the defendant's net enrichment because the court decline[d] to recognize the defendant's implicit claim for his own contribution to the assets in dispute."[103] This, of course, is precisely what several courts do when a defendant's infringement is deemed "willful." Without so much as asking if the taxes paid represent a legitimate item of expense, courts simply deny the deduction to willful infringers and allow it to innocent ones. Thus the question I pose is twofold. First, is there something in the background law of restitution that justifies such a dichotomy? Second, is the use of the background law of restitution appropriate in this particular instance?

A. *The Restitutionary Etiology of the Tax Dichotomy*

To fully understand the context of this so-called "tax dichotomy," we must understand its origins. We can trace its first mention in a copyright law context to Judge Learned Hand's opinion in *Sheldon v. Metro-Goldwyn Pictures Corp.*[104] Judge Hand cited *L.P. Larson, Jr., Co. v. Wm. Wrigley, Jr., Co.*[105] as authority for an absolute rule allowing the federal income tax deduction to innocent, but not willful, infringers.[106] *Larson*, a trademark infringement case, in turn cited nothing for this proposition. Justice Holmes, writing for the Court in *Larson*, stated, "[I]n a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction [of income taxes paid] should not be allowed."[107] The dichotomy that has subsequently developed sprang from this statement, as well as the statement earlier in the opinion that "[n]o doubt there are cases in which such a deduction would be proper."[108] Thus, we can see that the tax dichotomy, as a rule of law, arose from trademark infringement and was later imported to copyright infringement. However, we still should ask what legal principles drive this rule, especially in light of its original pronouncement in *Larson* – a pronouncement our generation would likely condemn as blatant "judicial activism." Common law principles underlying restitution provide the critical missing context.

Of the many things that can be said about Justice Holmes, one undeniable fact is that he was an astute student of the common law.[109] The tax dichotomy

[103] Kull, *supra* note 16, at 29; *see also supra* notes 75-86 (identifying the restitutionary principles implicated by a defendant's claim for his contribution to assets in dispute).

[104] 106 F.2d 45 (2d Cir. 1939) (*Sheldon I*), *aff'd*, 309 U.S. 390 (1940) (*Sheldon II*).

[105] 277 U.S. 97 (1928).

[106] *See Sheldon I*, 106 F.2d at 53.

[107] *Larson*, 277 U.S. at 100.

[108] *Id.* at 99.

[109] *See generally* OLIVER WENDELL HOLMES, JR., THE COMMON LAW (Little, Brown & Co. 1990) (1881).

is simply one instance in which he turned to common law principles to solve a difficult statutory question. Traditionally, the common law drew a distinction between tortious conduct committed in good faith and consciously tortious conduct, such as fraud, theft, and deceit.[110] Conscious torts received harsher treatment than torts committed in good faith.[111]

The law of restitution, at the time *Larson* and *Sheldon* were decided, employed an identical distinction between consciously tortious wrongdoers and innocent wrongdoers. (This is particularly relevant because, as we have seen, claims for infringement of intellectual property, whether copyright or trademark, are grounded in a restitutionary theory.)[112] The distinction between consciously tortious and innocent wrongdoers can be seen in the juxtaposition of two sections of the 1937 *Restatement of Restitution*. Section 151 deals with the value of property acquired by a consciously tortious act,[113] whereas section 154 deals with the value of property innocently converted.[114] The difference in the treatment of defendants under these two sections is readily apparent.

For example, under section 151, if a conscious wrongdoer makes additions or improvements to the property he has converted, the original owner "is entitled to the full value of such things after the additions have been made."[115] The *Restatement* specifically identifies this as "a form of penalty imposed upon a person who has done a consciously wrongful act."[116] Similarly, Holmes' language in *Larson* suggests that the Court denied the deduction for federal income taxes paid as a penalty for a consciously wrongful act.[117]

Conversely, under section 154, an innocent wrongdoer who makes additions or improvements to the property he has converted is not subject to the same penalty. He is "not liable to the owner for the increased value where he retains [the property], and if he returns it, he may be entitled to credit for the value of his services."[118] This is the situation that Holmes contemplated when he acknowledged that deduction of federal income taxes paid "would be proper" in at least some cases.[119]

Thus, it appears that Holmes not only imported a general common law distinction between conscious and innocent torts, but also incorporated a specific characteristic of the law of restitution into the accounting for profits in

[110] *Compare id.* at lecture III (discussing trespass and negligence), *with id.* at lecture IV (discussing fraud, malice, and intent).

[111] *See, e.g.*, Wooden-ware Co. v. United States, 106 U.S. 432, 433-34 (1882) (importing this common law doctrine from English common law).

[112] *See supra* note 99 and accompanying text.

[113] RESTATEMENT OF RESTITUTION § 151 (1937).

[114] *Id.* § 154.

[115] *Id.* § 151 cmt. d.

[116] *Id.*

[117] *See supra* note 107 and accompanying text.

[118] RESTATEMENT OF RESTITUTION § 154 cmt. a (1937).

[119] *See supra* note 108 and accompanying text.

Larson. This characteristic has since passed from trademark into copyright law, and ultimately into modern jurisprudence regarding a copyright defendant's claimed deduction for federal income taxes paid in a § 504(b) accounting. Regardless of its original propriety under the Copyright Act of 1909, we must critically inquire whether it is still appropriate to use this restitutionary gloss under our current statutory regime.

B. *The Propriety of Using a Restitutionary Gloss Under the 1976 Act*

The answer to the question of whether it is proper, under the Copyright Act of 1976, to resort to a restitutionary gloss – one that denies willful infringers a deduction for taxes paid on their ill-gotten profits, yet grants such a deduction to innocent infringers, without considering anything else – must unequivocally be "no." The answer must be no for three reasons. First, the meaning of the 1976 Act is abundantly clear: willfulness or innocence may only be determinative when the copyright owner claims statutory damages, *not* when he seeks to disgorge the infringer's profits. It is precisely because the Act is so unambiguous that the draft *Restatement (Third) of Restitution and Unjust Enrichment* counsels against any reference to the background law of restitution in such cases. Second, and related to the first point, our modern jurisprudential thinking regarding statutory interpretation does not allow for "common law glosses" to be placed on statutes whose meaning is clear. Third, the fact that the willfulness-innocence dichotomy is derived from trademark law suggests that it should not be used in a copyright law context, given the obvious textual differences between the statutorily allowed profit remedies in trademark law and copyright law. I will discuss each of these points in turn.

1. The *Restatement (Third)* Prohibition

The text and legislative history of the Copyright Act of 1976 make it clear that willfulness or innocence may be determinative when the plaintiff claims statutory damages under § 504(c), but *not* when the plaintiff seeks actual damages and profits under § 504(b). Section 504(c) explicitly allows for an award to be enhanced to a maximum of $150,000 (instead of a maximum of $30,000) when the plaintiff proves that the infringement was willful.[120] In contrast, § 504(b) makes no mention of innocence or willfulness: the copyright infringer is allowed to deduct all appropriate expenses in the accounting for profits, subject *only* to his ability to prove those expenses.[121] Similarly, the House Report accompanying the 1976 Act states that "courts should be given discretion to increase *statutory damages* in cases of willful infringement,"[122] but counsels no such discretion to increase awards based on willfulness when the plaintiff seeks actual damages and profits. Thus, as one judge has noted,

[120] 17 U.S.C. § 504(c)(2) (2000).

[121] *Id.* § 504(b).

[122] H.R. REP. NO. 94-1476, at 162 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 5659, 5778 (emphasis added).

"Where Congress intended to punish willful infringement by authorizing different remedies depending on the infringer's culpability, it clearly knew how to do so."[123] It did so in § 504(c). In § 504(b), it did not.

This conclusion finds support not only in judicial opinions[124] and legal treatises,[125] but also in the draft *Restatement (Third) of Restitution and Unjust Enrichment*: "The fact that the statute[] make[s] express provision for enhanced damages in particular cases makes it harder to justify the manipulation of the profits-based remedy to inflict a punishment not specified by statute."[126] This recognition, coupled with the draft's express warning against turning to restitutionary principles where the letter of a statute is not "doubtful,"[127] counsels strongly against imposing the age-old common law distinction between conscious and innocent torts when determining the deductibility of a copyright infringer's federal income taxes in a § 504(b) accounting.

2. The Current Theory of Statutory Interpretation

The modern zeitgeist surrounding statutory interpretation also counsels against applying a common law gloss to the express text of § 504(b). We see this modern approach embodied in the draft *Restatement (Third)*, which cautions that general restitutionary principles are only relevant in intellectual property cases "to the extent they do not modify or displace [statutory remedies]."[128] The Reporter's Note in the draft *Restatement* further confirms this view: it presents the tax dichotomy as an example of judicial discretion run amok, in light of statutory language that clearly points in a different direction.[129]

Perhaps the most eloquent statement of this modern approach to statutory interpretation is contained in Justice Scalia's *A Matter of Interpretation: Federal Courts and the Law*.[130] Scalia points out that we live in an age of democratically enacted legislation, and criticizes "the mind-set that asks, 'What is the most desirable resolution of this case, and how can any

[123] ZZ Top v. Chrysler Corp., 70 F. Supp. 2d 1167, 1168 (W.D. Wash. 1999).

[124] *See id.* ("Section 504(b) . . . makes no distinction between willful and innocent infringers.").

[125] *See* 2 GOLDSTEIN, *supra* note 17, § 14.1.2.1(d) ("If willfulness is to be penalized, statutory damages represents the appropriate route.").

[126] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42, reporter's note to cmt. i (Tentative Draft No. 4, 2005).

[127] *See supra* notes 101-02 and accompanying text.

[128] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 cmt. a (Tentative Draft No. 4, 2005).

[129] *See id.* at reporter's note to cmt. i.

[130] ANTONIN SCALIA, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW (1st paperback prtg. 1998).

impediments to the achievement of that result be evaded?'"[131] This mind-set, in Scalia's view, is inappropriate for "most of the work" of statutory interpretation that federal judges do.[132] Yet it is precisely this mind-set that federal judges appear to be embracing when they use an infringer's willfulness or innocence to truncate the factual analysis contemplated by the express text of § 504.

A Matter of Interpretation even seems to consider the tacit justification that may be driving those judges who insist on looking to an infringer's willfulness or innocence in the tax expense context. Scalia notes that one "canon" or "presumption" sometimes used in statutory interpretation is that "statutes in derogation of the common law will be narrowly construed."[133] This presumption suggests that statutes ought to be consistent with the common law in some manner. Perhaps some judges view the tax dichotomy as a way to impose common law principles on a statute "in derogation" of those principles. Nevertheless, given our modern, democratically enacted copyright legislation, turning to such a justification "seems like a sheer judicial power-grab."[134] Imposing (or continuing to impose) a common law gloss on § 504(b) is simply not appropriate in our modern era of democratically enacted legislation.

3. The Trademark Law Etiology

Finally, we must remember that the tax dichotomy was originally derived from trademark law, not copyright law.[135] This is particularly significant because today's statutory schemes governing copyright law and trademark law differ in an important respect. The statutory scheme governing trademark law, unlike that governing copyright law, expressly grants courts the discretion to adjust an infringer's liability for actual damages and profits based on the infringer's willfulness. The relevant trademark provision, 15 U.S.C. § 1117(a), provides that "[i]f the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may *in its discretion* enter judgment for such sum as the court shall find to be just, *according to the circumstances of the case*."[136] One of these circumstances, identified earlier in § 1117(a), is the establishment of a "willful violation" of another's trademark.[137] Thus, the statute governing remedies for trademark infringement expressly allows a willfulness-based profit adjustment where the Copyright Act of 1976 does not. A direct analogy between trademark infringement

[131] *Id.* at 13.

[132] *Id.* For a general discussion of how judges ought to approach statutory interpretation, see *id.* at 9-14.

[133] *Id.* at 29.

[134] *Id.*

[135] *See supra* notes 104-08 and accompanying text.

[136] 15 U.S.C. § 1117(a) (2000) (emphasis added).

[137] *Id.*

remedies and copyright infringement remedies is therefore misplaced in the current statutory scheme.

C. *Tax Deduction or No Tax Deduction?*

The current practice of allowing an innocent infringer to deduct his federal income taxes paid in an accounting for profits, while disallowing an identical deduction to a willful infringer, cannot withstand modern jurisprudence. Consequently, assuming a defendant proves the amount of federal income taxes he paid that are attributable to his infringing profits, do we allow him to deduct them or not? The answer must not turn on the defendant's willfulness or innocence, but on whether his taxes are properly considered an "expense" within the meaning of § 504(b). When one considers the practical consequences that undeniably flow from allowing a tax deduction, one cannot help but conclude that federal income taxes should not be considered an "expense" within the meaning of § 504(b), and consequently should not be deductible. The economic realities of the current tax code simply obviate the need to consider income taxes paid on profits arising from copyright infringement an "expense." Because damage payments are tax deductible, the infringer will receive a tax savings equal to the amount of taxes he paid on his ill-gotten profits. His taxes paid are not an "expense" because he is not out of pocket a single cent. In fact, treating his taxes paid as an "expense" and deducting them in a § 504(b) accounting for profits would enable him to reap a net *gain* from his infringement.[138]

The consideration of such practical consequences represents a pragmatic, principled weight to consider in interpreting the necessarily ambiguous reference to "expenses" in § 504(b). Justice Breyer's pragmatic approach, best known for its application to constitutional texts, is equally applicable to the interpretation of statutory texts.[139] "Since law is connected to life, judges, in applying a text in light of its purpose, should look to *consequences,* including contemporary conditions, social, industrial, and political, of the community to be affected."[140] Here, the contemporary social and political consequences that would flow from allowing an infringer to deduct income taxes include an unwarranted windfall whereby the infringer would profit from his wrongdoing. To allow such a result would "undermine the very human activity that the law seeks to benefit"[141] – namely, the grant of an exclusive property right. Therefore, the proper resolution of the tax dichotomy is to forbid *any* infringer,

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[138] *See supra* notes 18-27 and accompanying text.

[139] *See generally* STEPHEN BREYER, ACTIVE LIBERTY: INTERPRETING OUR DEMOCRATIC CONSTITUTION 85-101 (2005).

[140] *Id.* at 18 (internal quotation marks omitted).

[141] *Id.* at 100.

regardless of culpability, from deducting his federal income taxes paid in a § 504(b) accounting for profits.[142]

IV. THE DEDUCTION FOR OVERHEAD EXPENSES: A RESTITUTIONARY PERSPECTIVE

As in Part III, it will be useful to ground ourselves again in the issue at hand and its appurtenant restitutionary characteristics. To reiterate, our procedural posture is that the plaintiff has sued the defendant for copyright infringement, prevailed on the issue of liability, and has elected to recover actual damages and profits. Section 504(b) thus requires an accounting where the defendant must prove his expenses; these will be deducted from his gross revenue to arrive at the ultimate net profit that he must disgorge to the plaintiff. Just as the defendant invariably claims income taxes paid as an expense, he will also claim that he should be able to deduct his overhead costs. As the defendant's argument goes, his *true* profit is his gross revenue less all monies expended in order to generate that revenue.

As with the tax expense, if we accept the defendant's contention that his overhead costs are a legitimate item of expense that should be deducted, we implicate the restitutionary characteristics discussed in Part II. If the court denied this expense, it would remove an item from the defendant's side of the ledger, overstate the defendant's net enrichment, and result in a punitive forfeiture by denying the defendant's implicit restitution claim for his own contribution to the assets in dispute.[143] The same result would occur if the court truncated the analysis and never even reached the question of whether the defendant's overhead costs were a legitimate expense. This, however, is precisely what courts do when they deny a defendant a deduction for overhead costs solely by characterizing his infringement as "willful" and ending the inquiry.

We have already seen that the "truncating" approach is inappropriate to apply to § 504(b); the decision to allow a deduction should not hinge on a defendant's innocence or willfulness alone.[144] But some courts that do *not* truncate still use willfulness or innocence as a bellwether to determine what level of proof to demand, rather than as an ultimate determinant of whether the expense will be allowed. The *Hamil* court, for example, allows a willful infringer to deduct overhead costs if he can meet a heightened standard of

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142 *But see* Ballard, *supra* note 29, at 600-05 (arguing that the differential treatment of willful and innocent infringers is appropriate). Ballard, however, rests her argument on "precedential support" and circuit counting rather than an effort to explore the real differences between the language of the copyright and trademark statutes, or the origins of the tax dichotomy and the propriety of applying a common law gloss in light of modern statutory interpretation and the plain language of § 504.

143 *See supra* notes 75-86 (identifying the restitutionary principles implicated by a defendant's claim for his contribution to assets in dispute).

144 *See supra* Part III.B.

proof, showing that "each category [of overhead] is *directly* and *validly* connected to the sale and production of the infringing product."[145] We have seen that this approach can be squared with the text and history of § 504(b).[146] Nevertheless, we have yet to see a coherent theory that can shed some light on the judiciary's insistence on considering willfulness or innocence in some form when deciding whether to deduct overhead costs. The law of restitution can act as a useful spotlight.

A. *Countervailing Restitutionary Principles: Forfeitures and Forced Exchanges*

1. "Equity Abhors Forfeitures"[147]

Liability in restitution has historically been regarded as an equitable claim.[148] Consequently, restitutionary remedies are typically not punitive; the object of a claim in restitution is not to punish but to "tak[e] from the defendant and restor[e] to the plaintiff something to which the plaintiff is entitled."[149] Thus, in the case of a defendant who misappropriates a plaintiff's property, restitution will typically do its damnedest to ensure that a proper accounting is conducted and the defendant disgorges no more than his *net* profit to the plaintiff. Restitution makes this meticulous effort because any misstep that overstated the defendant's net enrichment would result in a punitive forfeiture.[150] Restitution does not seek this result.

Several well-known restitution cases illustrate this "no forfeiture" principle. The clearest example is *Tlapek v. Chevron Oil Co.*[151] In this case, Chevron employed Tlapek as a geologist and furnished him with confidential information that he used to formulate a theory that a large quantity of oil could be found in a particular location in Arkansas.[152] When Chevron dragged its feet on the issue of drilling, Tlapek resigned, leased the land in question, and

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[145] Hamil Am., Inc. v. GFI, 193 F.3d 92, 107 (2d Cir. 1999) (emphasis added); *see also supra* notes 56-67 and accompanying text (describing *Hamil*'s "strong" and "sufficient" nexus tests).

[146] *See supra* notes 68-72 and accompanying text (explaining how *Hamil*'s "strong" and "sufficient" nexus tests are consistent with § 504(b)). Moreover, no one has ever seriously suggested that overhead costs are not a legitimate "expense" under § 504(b).

[147] Jones v. Guar. & Indem. Co., 101 U.S. 622, 628 (1879) ("A court of equity abhors forfeitures, and will not lend its aid to enforce them.").

[148] *See* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmts. b, f (Discussion Draft 2000).

[149] RESTATEMENT OF RESTITUTION, introductory note to ch. 8, Topic 2, at 595-96 (1937); *see also* Kull, *supra* note 16, at 17 ("Restitution . . . is not supposed to be punitive in purpose or effect.").

[150] *See* Kull, *supra* note 16, at 29.

[151] 407 F.2d 1129 (8th Cir. 1969).

[152] *Id.* at 1130-31.

secured drilling resources, all without any effort to conceal his activities.[153] The trial court found Tlapek's actions to be a violation of his fiduciary duties to Chevron, since he used confidential information provided by Chevron to formulate his theory and acquire the necessary land.[154] However, despite Tlapek's blatant breach of fiduciary duty, the Eighth Circuit reversed and remanded the trial court's award of damages, finding it "clear that [Tlapek] was not given credit in the findings for all of the original cost of acquisition of the leases."[155] Specifically, the trial court failed to take account of various borrowed funds, "the reasonable value of [Tlapek's] services in the acquisition of the leases," and "miscellaneous additional fees for recording, tax stamps, drafts, notaries, and costs for lease forms, maps, materials, and minor expenses."[156] *Tlapek* presents the classic fact pattern of a so-called "faithless fiduciary."[157] In such cases, "[A] fiduciary held as constructive trustee of assets acquired in breach of the duty of loyalty will almost invariably be allowed to recover out-of-pocket acquisition costs, no matter how cynical the disloyalty."[158] *Tlapek* is the perfect example of this principle in practice. The defendant's breach of loyalty was both cynical and blatant, yet the court took pains to ensure that he would not have to forfeit anything to Chevron as the result of an overstatement of his net enrichment. The result is that "[t]he disloyal fiduciary is . . . protected from forfeiture."[159] Thus we can see that the abhorrence of forfeitures is a characteristic principle of restitution.

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[153] *Id.* at 1131-32.

[154] *Id.* at 1132.

[155] *Id.* at 1136. In fact, the Eighth Circuit found that "either the finding of the total acquisition costs was clearly and erroneously low as a matter of fact, or . . . an erroneous equitable standard was applied which limited [Tlapek] to credit only for his out-of-pocket cash expended in acquisition of the leases." *Id.*

[156] *Id.*

[157] *Tlapek* is merely one example of a common fact pattern in restitution. For example, *Hunter v. Shell Oil Co.*, 198 F.2d 485 (5th Cir. 1952), and *Beatty v. Guggenheim Exploration Co.*, 122 N.E. 378 (N.Y. 1919), both had facts similar to *Tlapek*: a company employed an agent to investigate and acquire desirable parcels of land, and the agent subsequently breached his fiduciary duty by acquiring parcels for himself. *See Hunter*, 198 F.2d at 486-88; *Guggenheim*, 122 N.E. at 380. In *Hunter*, the court spoke of the defendant's entitlement to the "original cost of such [land] interests" and noted a "lengthy period of accounting." *Hunter*, 198 F.2d at 488. In *Guggenheim*, Judge Cardozo spoke of the defendant's duty to "transfer the [land] claims at cost." *Guggenheim*, 122 N.E. at 380. Thus, each of these decisions took for granted that the costs specifically enumerated in *Tlapek* would be taken account of. *Hunter* and *Guggenheim* likely made no further mention of the costs because their inclusion was neither in dispute nor erroneously ignored by the trial court.

[158] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT, introductory note to ch. 5, Topic 1, cmt. 5 (Tentative Draft No. 4, 2005).

[159] *Id.* § 43 cmt. h (referring the reader to illustrations based on *Tlapek*, 407 F.2d at 1129, *Hunter*, 198 F.2d at 485, and *Guggenheim*, 122 N.E. at 378).

2. Restitution Abhors a Forced Exchange with a Conscious Wrongdoer

Despite restitution's characteristic abhorrence of forfeitures, it nevertheless sometimes requires a conscious wrongdoer to disgorge an amount that exceeds his net profit. I will discuss three such cases in which forfeiture was required, and then consider the common thread that runs between them: an aversion to forced exchange with a conscious wrongdoer so powerful that it overwhelms the "no forfeiture" principle. The first of these cases, and perhaps the most paradigmatic, is *Wooden-ware Co. v. United States.*[160] This was one of several cases that grappled with the question of how to handle a timber thief. The typical fact pattern was this: a thief knowingly and wrongfully took timber from another person's land, improved the timber (by chopping, sawing, finishing, transporting, etc.), and then was sued by the owner of the land.[161] The question was whether the defendant would have to pay the owner the value of the timber *as improved*, or the value of the timber when it was stolen.[162] The *Wooden-ware* Court's answer was complete forfeiture: the timber thief would receive no allowance for the time and money that he spent improving his misbegotten timber.[163] This harsh result was premised on the fact that the thief's trespass onto the plaintiff's land was conscious; the Court indicated that complete forfeiture would not have been required from an innocent trespasser.[164]

In another famous restitution case, the court similarly refused to take account of a conscious wrongdoer's expenses in accounting for his profits. In *Ward v. Taggart*,[165] Taggart agreed to purchase a seventy-two-acre parcel of land for $4000 per acre and, under the guise of a real estate agent, extracted a price of $5000 per acre from Ward.[166] The court upheld a judgment against Taggart of $72,000, which represented his secret profit from the fraud, and explicitly refused to deduct $25,563 from the judgment, which represented various expenses that Taggart "incurred to accomplish his fraud."[167] Taggart had insisted that these expenses were not incurred to accomplish the fraud, but

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[160] 106 U.S. 432 (1882).

[161] *Id.* at 433. As a matter of fact, it was not the timber thief who was sued in *Wooden-ware*, but rather a third party who innocently purchased the timber from the original thief. However, the Court found it necessary to the resolution of the case to determine how it would have treated the original thief. Thus, the original thief's physical absence from the case is not particularly relevant for our purposes.

[162] *Id.*

[163] *Id.* at 434.

[164] *Id.* ("[W]here the trespass is the result of inadvertence or mistake, and the wrong was not intentional, the value of the property when first taken must govern . . . .").

[165] 336 P.2d 534 (Cal. 1959).

[166] *Id.* at 535-36. Note that this is *not* a "faithless fiduciary" case. The court explicitly found that Taggart did not stand in a fiduciary relationship to Ward. *Id.* at 537.

[167] *Id.* at 539. These expenses included various commissions and fees that Taggart paid, as well as the cost of escrow accounts. *Id.*

Justice Traynor disagreed, holding that it was "entirely speculative" whether these expenses would have been incurred in a "legitimate [transaction]."[168] Once again, a consciously tortious defendant was made to pay the plaintiff more than his net enrichment; once again, the court refused to recognize the defendant's own claim for his contribution to the assets in dispute.[169]

In a third famous restitution case, a conscious wrongdoer was also denied certain allowances for his contributions to the assets in dispute. In *Edwards v. Lee's Administrator*,[170] Edwards discovered a cave under his property, exploited it as a tourist attraction, and made a substantial profit, all the while knowing that he was trespassing under land owned by his neighbor, Lee.[171] Lee sued Edwards, and in the accounting for profits that ensued, the court held that the proper measure of Edwards' profits was "net profits" and not "gross profits."[172] The court, however, seemingly contemplated allowances to Edwards only for certain out-of-pocket expenditures such as electric light, and not for Edwards' tireless labor and enterprise which made his cave a profitable success.[173] This refusal to consider labor and enterprise stands in stark contrast to the Eighth Circuit's decision in *Tlapek*. Recall that in *Tlapek*, the court remanded for a new accounting because the original accounting failed to make allowances for, among other things, "the reasonable value of [Tlapek's] services."[174]

In *Edwards*, we see a different manner in which a court can impose a negative restitution sanction. Rather than explicitly denying the defendant's claim for his own contribution to the assets in dispute, the court simply ignores it.[175] The negative sanction embodies itself as a "failure to perform a full accounting of the transactions between claimant and defendant for which defendant is liable in restitution,"[176] whether such a failure is explicit (as in *Wooden-ware* and *Taggart*) or implicit (as in *Edwards*).

But what distinguishes *Wooden-ware*, *Taggart*, and *Edwards* from *Tlapek*? Why was the court willing to perform a complete accounting in *Tlapek*, but not in the other three cases? Culpability alone cannot provide the explanation. One cannot seriously contend that faithless fiduciaries (such as Tlapek) are any

[168] *Id.*

[169] To be clear, the $25,563 that the court refused to allow Taggart to deduct represents the *extra* money that Taggart had to disgorge. Taggart was in no way enriched by this extra amount; it is money that he never saw. Taggart's net enrichment was only $46,437 ($72,000 minus $25,563), yet he was forced to pay over $72,000 to the plaintiff.

[170] 96 S.W.2d 1028 (Ky. 1936).

[171] *Id.* at 1028-30.

[172] *Id.* at 1032.

[173] Kull, *supra* note 16, at 29 (citing *Edwards*, 96 S.W.2d at 1032).

[174] Tlapek v. Chevron Oil Co., 407 F.2d 1129, 1136 (8th Cir. 1969); *see also supra* notes 151-59 and accompanying text (discussing *Tlapek*).

[175] *See* Kull, *supra* note 16, at 27.

[176] *Id.*

less culpable, in either an objective or subjective sense, than timber thieves, conscious trespassers, and defrauders. Justice Cardozo recognized as much in his famous statement regarding the duty of a fiduciary: “Not honesty alone, but the punctilio of an honor the most sensitive, is . . . the standard of behavior.”[177] Thus, something other than the defendant’s culpability must account for the harsh results in *Wooden-ware*, *Taggart*, and *Edwards*.

The common thread that runs through these cases – and is not present in faithless fiduciary cases like *Tlapek* – is that the court could not have allowed all of the defendant’s expenses without the end result being a forced exchange between the plaintiff and defendant. Just as the abhorrence of forfeiture is characteristic of restitution, so too is an aversion to forced exchanges with a conscious wrongdoer.[178]

In *Wooden-ware*, the timber thief “neglected a duty to contract with the owner for the property”[179] and instead stole it.[180] Requiring the plaintiff to pay the thief for his improvements to the timber would be forcing a contractual arrangement upon the plaintiff. In *Taggart*, the real estate price defrauder similarly neglected a duty to contract with the plaintiff. The defrauder admittedly did not fail to “contract” in the same sense as the timber thief, but he certainly went beyond an arm’s length transaction and entered the realm of fraudulent misrepresentation.[181] Forcing a fraudulently obtained price (or any price above the fair market value of the property as represented by what the defrauder paid for it) upon the plaintiff would indeed be sanctioning a perverse conception of “contracting.”[182] Lastly, in *Edwards*, the conscious trespasser neglected his duty to contract with his neighbor for the use of the portions of cave under his neighbor’s property.[183] This falls into the same mold as our timber thief; the conscious trespasser did not contract with his neighbor at all. Thus, requiring the neighbor to pay for the trespasser’s labor and entrepreneurial skill would be forcing the neighbor to accept a contractual arrangement that he might have rejected.

In *Tlapek*, on the other hand, the faithless fiduciary was required to forfeit nothing, even though he was just as culpable as the converters, defrauders, and conscious trespassers of *Wooden-ware*, *Taggart*, and *Edwards*. This is because there was no danger of a forced exchange: a forced exchange results from

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177 Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

178 *See supra* notes 81-83 and accompanying text.

179 RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. d (Discussion Draft 2000).

180 *See* Wooden-ware Co. v. United States, 106 U.S. 432, 433 (1882).

181 *See* Ward v. Taggart, 336 P.2d 534, 539 (Cal. 1959).

182 *See* JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 1.6 (rev. ed. 1993) (recognizing that contracts induced by fraud are voidable).

183 *See* Edwards v. Lee’s Adm’r, 96 S.W.2d 1028, 1028-30 (Ky. 1936).

neglecting a duty to contract,[184] and here the fiduciary *actually contracted* with the owner of the misappropriated property (i.e., his employer). Rather than appropriating certain property for his employer's use, as the contractual understanding with his employer contemplated, Tlapek appropriated the property for his own use. When his employer called on the court to recover this misappropriated property, the court was doing no more than enforcing an existing contractual obligation arising out of the defendant's employment. Therefore, no danger of a forced exchange existed, and the restitutionary principle left to control was that of abhorring forfeitures.

To sum up, restitution abhors forfeitures, but abhors forced exchanges with conscious wrongdoers even more.[185] In cases such as *Wooden-ware*, *Taggart*, and *Edwards*, the court required the defendant to forfeit certain costs incurred, because to do otherwise would have resulted in a forced exchange between the plaintiff and a conscious wrongdoer. In cases where the potential for a forced exchange was not present, such as *Tlapek*, or where the wrongdoing was innocent rather than conscious, the court honored the "no forfeiture" principle. This restitutionary concept – the harsher treatment of conscious wrongdoers attempting to force exchanges – can help provide the vital missing context explaining different courts' approaches to the copyright infringer's attempt to deduct overhead costs.

B. *Restitution and the Deduction for Overhead Expenses*

1. Restitution and Copyright Infringement Revisited

As we have already seen, the disgorgement of profits as a remedy for copyright infringement has its roots in the law of restitution. Furthermore, it is appropriate for courts to refer to the background law of restitution when construing malleable statutory provisions.[186] (For example, a court might look to restitution to help determine what quantum of proof to require when a defendant proves his expenses in a § 504(b) accounting for profits.)[187] With regard to the deductibility of overhead expenses, a particularly relevant concept from the law of restitution is its aversion to forced exchanges.

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[184] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. d (Discussion Draft 2000).

[185] To be clear, restitution's abhorrence of forced exchanges *only* prevails over its abhorrence of forfeitures when the defendant is a *conscious* wrongdoer. In contrast, "'when . . . inadvertence has been the cause of the misfortune, then the simple course is to make every just allowance for outlay on the part of the person who has so acquired the property.'" *Wooden-ware*, 106 U.S. at 434 (quoting Livingstone v. Rawyards Coal Co., (1880) 5 App. Cas. 25, 35 (H.L.) (appeal taken from Scot.)); *see also* RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. b (Discussion Draft 2000).

[186] *See supra* notes 101-02 and accompanying text.

[187] *See supra* notes 68-72 and accompanying text.

Recall that a "forced exchange" occurs when a "defendant has neglected a duty to contract with the owner for the property or its use."[188] Copyright ownership is no less a property right than the ownership of land or chattel.[189] As a result, one's failure to obtain a license to use another person's copyright is no less a failure to contract than one's failure to obtain a license, easement, or lease to use another person's land. A defendant who has misappropriated a plaintiff's copyright has therefore "neglected a duty to contract" with the copyright owner for a license to use the copyright. The draft *Restatement (Third) of Restitution and Unjust Enrichment* acknowledges this dynamic in a comment explaining the restitutionary rationale behind an infringer's liability to disgorge ill-gotten profits: "[L]iability limited [only] to the use value of the claimant's property would provide inadequate incentive to bargain over the rights at issue . . . ."[190] Thus, we can fairly say that copyright infringement is a characteristic "forced exchange" – a conclusion that again provides a solid basis for looking at restitutionary principles to make sense of the remedies that courts grant in cases of copyright infringement.

2. Understanding the Infringer's Deduction for Overhead Expenses in a Restitutionary Context

As in the tax dichotomy context, considering the basic restitutionary nature of a copyright infringement claim can provide a framework for evaluating the case law that has arisen around the § 504(b) accounting in the overhead expense context. As discussed earlier, the *Hamil* court's insistence that willful infringers meet a heightened standard of proof when claiming a deduction for overhead expenses is in line with the text and legislative history of § 504(b).[191] This, however, does not explain *why* culpability (willfulness or innocence) has come to play the role that it does under the *Hamil* approach, or why other courts, in the face of clear statutory language to the contrary, insist that they can use the infringer's culpability to truncate an inquiry into the legitimacy of a claimed expense and deny it outright. To an extent, the common law history of

[188] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 cmt. d (Discussion Draft 2000).

[189] *See* 4 NIMMER & NIMMER, *supra* note 15, § 16.02 (acknowledging a property theory of copyright); Michael A. Carrier, *Cabining Intellectual Property Through a Property Paradigm*, 54 DUKE L.J. 1, 8-12, 10 n.13 (2004) (describing the "propertization of intellectual property" and noting its analogy to trespass law).

[190] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 cmt. g (Tentative Draft No. 4, 2005); *see also id.* § 39 cmt. f ("The purpose of the disgorgement remedy for breach of contract is to eliminate the possibility that an intentional and opportunistic breach will be more profitable to the performing party than negotiation with the party to whom performance is owed. . . . If the defaulting promisor's liability in restitution were limited to the amount that might have been paid to obtain the necessary contractual modification in a voluntary transaction, there would be inadequate incentive to bargain over the entitlement in question.").

[191] *See supra* notes 68-72 and accompanying text.

restitution discussed in the tax expense context can answer this question.[192] But the other principle of restitution that this Note has discussed – its aversion to forced exchange with a conscious wrongdoer – can provide a more concrete answer.

In the restitution context, we saw that conscious wrongdoers received harsher treatment than innocent wrongdoers in accountings for profits where the plaintiff was put at risk of suffering a forced exchange. Copyright infringement, of course, raises the specter of a forced exchange for the plaintiff. Thus, the restitutionary urge to make a conscious wrongdoer forfeit *more* than his net enrichment to guard against a forced exchange, while ensuring that an innocent wrongdoer forfeits *no more* than his net enrichment, has bled into the case law governing the overhead expense deduction.

This restitutionary urge has its most obvious manifestation in cases such as *Frank Music*, *Saxon*, and *Jarvis*, where the courts have taken the truncation approach: innocent infringers may take the expense deduction for overhead costs, and willful infringers may not.[193] I refer to this as the truncation approach because it cuts off the inquiry into whether a particular overhead expense actually helped to produce the infringing item – the key inquiry that the plain text of § 504(b) requires the court to make. The court judges the propriety of allowing the expense on the infringer's level of culpability instead of the quantum of evidence that he can marshal to prove the legitimacy of his expense. This approach, while supported by its restitutionary etiology,[194] is too extreme given the text of the democratically enacted Copyright Act,[195] and thus a more measured approach is likely desirable.

This more measured approach, however, is by no means the *other* extreme: refusal to consider culpability in any manner whatsoever.[196] While refusing to consider culpability at all would comport with the literal text of § 504, it would ignore the very restitutionary principles upon which § 504(b) and much of copyright law are based. This consideration, moreover, is meaningful in the overhead expense context in a way that it was not in the income tax context.

The pertinent question in the tax expense context was whether taxes paid on profits from infringement are properly considered "expenses" within the meaning of § 504(b). This issue can be determined without reference to the

192 *See supra* Part III.A (discussing the common law distinction between conscious and innocent wrongdoers, its incorporation into trademark law in *Larson*, and its subsequent application to copyright law in *Sheldon*).

193 *See* Frank Music Corp. v. Metro-Goldwyn-Mayer, Inc., 772 F.2d 505, 515 (9th Cir. 1985); Saxon v. Blann, 968 F.2d 676, 681 (8th Cir. 1992); Jarvis v. A & M Records, 827 F. Supp. 282, 294 (D.N.J. 1993).

194 *See supra* Part IV.A.2 (discussing multiple instances of "truncation" in classic restitution cases).

195 *See supra* Part III.B.

196 *See, e.g.*, ZZ Top v. Chrysler Corp., 70 F. Supp. 2d 1167, 1168 (W.D. Wash. 1999).

law of restitution. Restitution is only relevant in the tax expense context insofar as it demonstrates the etiology of an old legal rule that is inappropriate to apply under a new statutory scheme. Conversely, in the overhead expense context, restitution not only shows us *why* an old legal rule should no longer be applied, but is also relevant to the determination of *what* the current legal rule should be. Given that overhead costs are legitimately considered an "expense," the law of restitution can help determine the appropriate quantum of proof to require of a defendant who claims such an expense. (If one were to accept the proposition that income tax should be considered an "expense" within the meaning of § 504(b) – a proposition that this Note does not accept[197] – then restitution would be relevant to the quantum of proof inquiry in the same way as in the overhead expense context.) Thus, the critical conundrum is to craft an approach to overhead expenses that both comports with the literal text of § 504 and retains the basic restitutionary principles that § 504(b) (and the rest of copyright law) are based on. *Hamil* crafts this approach.

Hamil effectively combines a retention of the restitutionary willfulness-innocence consideration with the literal text of § 504. *Hamil* retains the notion that the allowance of any particular overhead cost is ultimately a question of fact to be decided based on the overhead item's assistance in producing the infringing item. *Hamil*'s "strong" and "sufficient" nexus tests for willful and innocent infringers, respectively, retain "connect[ion] to the sale and production of the infringing product" as their ultimate inquiry,[198] and consequently comport with the language and history of § 504(b).[199] These tests, moreover, are consistent with the precedent they purport to interpret (*Sheldon*), unlike the courts espousing the truncation approach.[200] But most importantly, while retaining fidelity to the text of § 504, *Hamil* is also able to incorporate a consideration of the infringer's culpability – his willfulness or innocence – and maintain the critical ties to the accounting's restitutionary roots.

Thus, it is in this manner that the willfulness-innocence dichotomy is incorporated in *Hamil*. The infringer's culpability is not used to truncate an analysis of the legitimacy of the claimed overhead expense. Rather, the infringer's culpability is used as a guide for properly adjusting the infringer's burden of proof. Innocent infringers must only show a "sufficient" nexus between the claimed overhead expense and the production of the infringing item, while willful infringers must show a "strong" nexus, and prove that the claimed overhead expense is "directly and validly connected to the sale and production of the infringing product."[201] This manner of incorporation, moreover, is appropriate notwithstanding the fact that it is not the *exact* manner

[197] *See supra* Part III.C.

[198] Hamil Am., Inc. v. GFI, 193 F.3d 92, 107 (2d Cir. 1999).

[199] *See supra* notes 68-72 and accompanying text.

[200] *See supra* notes 56-67 and accompanying text.

[201] *See Hamil*, 193 F.3d at 107.

in which the law of restitution classically approached the willful-innocent dichotomy in accountings for profits.

In many instances, restitution indeed truncated the analysis at culpability and never reached the legitimacy of the claimed expense. *Hamil* does not do this, but *Hamil* is nevertheless the most prudent approach to incorporating the underlying restitutionary principles of copyright remedies into a § 504(b) accounting. The realities of modern statutory law, and even those of the draft *Restatement (Third) of Restitution and Unjust Enrichment*, dictate the prudence of this approach. The draft *Restatement* acknowledges that the federal statutory scheme that governs copyright, along with much of the rest of intellectual property, must be given primacy. The "generally applicable principles of unjust enrichment" are only valid "to the extent they do not modify or displace [statutory law]."[202] Adopting a truncation approach in the § 504(b) context would do just that: "modify or displace" the plain language of § 504. The quantum of proof approach that *Hamil* takes, however, does not ignore § 504.

Instead of ignoring § 504, *Hamil* embraces it. Under *Hamil*'s approach, the ultimate inquiry will always be: has the defendant met his burden of proof regarding his claimed overhead expenses? This is the inquiry that § 504(b) requires. What makes *Hamil* unique from a restitutionary perspective, however, is its recognition that this burden of proof is malleable and its subsequent turn to restitutionary principles, which § 504(b) has incorporated, "as an aid to interpretation in [this] doubtful case."[203] Thus, all considered, *Hamil* strikes the appropriate balance between the restitutionary principles that underlie accountings for profits in copyright infringement and the text of the statute governing those accountings, which the courts cannot ignore.

CONCLUSION

Sharp disagreements exist among the various federal courts regarding which expenses a copyright infringer may deduct in an accounting for his ill-gotten profits. Two principal areas of disagreement involve the infringer's claimed deduction for federal income taxes paid on his profits and the infringer's claimed deduction for various overhead expenses associated with producing the infringing item. Since the remedies for copyright infringement have their roots in the law of restitution, restitutionary principles can provide a unique lens though which to view both the context and resolution of these conflicts. When considering the invariable disputes that will arise concerning a copyright infringer's expense deductions in an accounting for his ill-gotten profits, the courts should be mindful of the restitutionary etiology of the claim at hand and endeavor to use these restitutionary principles to arrive at a just result.

[202] RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 42 cmt. a (Tentative Draft No. 4, 2005).

[203] *Id.*