09-55093

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FEDERAL TRADE COMMISSION,
Plaintiff - Appellee,
v.

NEOVI, INC., d/b/a NEOVI DATA CORP. and QCHEX.COM;
G7 PRODUCTIVITY SYSTEMS, INC., d/b/a QCHEX.COM;
JAMES M. DANFORTH; and THOMAS VILLWOCK,
Defendants - Appellants.

BRIEF OF PLAINTIFF - APPELLEE FEDERAL TRADE COMMISSION
(On appeal from the United States District Court for the
Southern District of California)

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JURISDICTION

The Federal Trade Commission ("Commission" or "FTC"), an agency of the United States government, initiated this action in the United States District Court for the Southern District of California seeking relief under Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), for deceptive acts or practices that violated Section 5 of the FTC Act, 15 U.S.C. §§ 45. The district court's jurisdiction over this matter derives from 28 U.S.C. §§ 1331, 1337(a), and 1345; and from 15 U.S.C. §§ 45, and 53(b).

This Court's jurisdiction to review the permanent injunction entered against appellants derives from 28 U.S.C. § 1291. The district court entered the Final Order for Permanent Injunction and Other Equitable Relief on January 7, 2009, thereby disposing of all the Commission's claims. On the same day, the court denied the defendants' motion for reconsideration. The defendants filed their notice of appeal on January 16, 2009, and that notice was timely, pursuant to Fed. R. App. P. 4(a)(1)(B).

STATEMENT OF THE ISSUES PRESENTED

1. Whether appellants' operation of a check creation and delivery system constituted an unfair practice in violation of the FTC Act where the predictable and natural consequence of the system was that a substantial portion of the checks created and delivered by that system were used for fraudulent purposes, and where appellants

failed to verify that consumers who used the system were authorized to draw the checks that appellants were creating and delivering.

2. Whether the district court abused its discretion when it imposed injunctive relief and ordered appellants to disgorge the profits they received as a result of operating their service.

STATEMENT OF THE CASE

A. Nature of the Case, the Course of Proceedings, and the Disposition Below

In this appeal, appellants Neovi, Inc. (which does business as Neovi Data Corp., or as Qchex.com), G7 Productivity Systems, Inc. (which also does business as Qchex), James M. Danforth, and Thomas Villwock (appellants are hereinafter referred to as "Qchex"), challenge a permanent injunction that was entered against them. The Commission initiated the underlying action in September 2006 by filing a complaint alleging that Qchex had violated Section 5 of the FTC Act, 15 U.S.C. § 45, through its operation of a service that created and delivered checks.[1] Qchex did not provide adequate account verification, and as a result, its service allowed a user to draw checks on any bank account so long as that user provided the account number, regardless of whether the user was authorized to access that account. From 2000 through 2006,

[1] Section 5 prohibits, *inter alia*, "unfair or deceptive acts or practices in or affecting commerce."

Qchex created and delivered more than 150,000 checks for users of the Qchex service whose Qchex accounts were marked by Qchex as "frozen for fraud." The face amount of these fraudulent checks totaled at least $402 million, which was more than half of total value of all the checks created and delivered by Qchex during this time period.

The district court held that Qchex had committed an unfair act or practice, in violation of the FTC Act, because its service caused substantial injury to consumers, consumers could not reasonably avoid that injury, and that injury was not offset by benefits to consumers or to competition. The court entered a permanent injunction that, *inter alia*, prohibited Qchex from operating its check service unless it implemented an appropriate verification procedure to assure that each user of Qchex's service was authorized to withdraw funds from the bank account designated by that user. The injunction also required Qchex to disgorge $535,000, the proceeds of its online check creation and delivery service. In this appeal, Qchex argues that its operation of its service was not unfair, and that the court abused its discretion by ordering injunctive relief and disgorgement.

B. Facts and Proceedings Below

1. The Qchex system

Beginning in 2000, Qchex used its qchex.com website to offer a check creation and delivery service. D.89, Att. 2 at Fact 46.[2] According to Qchex's website, this service provided "a convenient system to deliver and manage checks and payments online." D.4, Ex. 14 at Att. A, p.39.[3] Qchex claimed that users would "save money, time and enjoy the convenience." *Id.* The Qchex system worked as follows: first, from the Qchex website, a user would set up a Qchex account by entering a name, an e-mail address, and creating a password. D.89, Att. 2 at Fact 47.[4] Once this account was activated, the user would go to the Bank Account Setup Wizard portion of the website. D.89, Att. 2 at Fact 49. This portion of the website prompted the user to provide the information necessary to create a check: the user's name and address, the bank code line,[5] the name and address of the bank, and the number of the check. D.4, Ex. 14 at Att. B, pp. 71-88. A blank check with the MICR line in place would then

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[2] Items in the district court's docket are referred to as "D.xx."

[3] D.4, Ex. 14 is the Declaration of Roberto Menjivar.

[4] D.89, Att. 2 is the Commission's Statement of Material Facts as to Which There Exists No Genuine Issue to be Tried.

[5] The bank code line, which appears at the bottom of every check, starting at the left edge, is part of the Magnetic Ink Character Recognition ("MICR") technology that was adopted in 1956. The MICR line on each check includes digits and characters that identify the bank against which the check is drawn, and the account from which it will be debited. These digits and characters, which are printed in a special type of magnetic ink and in a distinctive futuristic-looking font known as EB-13, can be read by high-speed check processing equipment. Note, *Computerized Check Processing and a Bank's Duty to Use Ordinary Care*, 65 Tex. L. Rev. 1173, 1173-78 (1987).

appear on the user's computer screen. D.4, Ex. 14 at Att. B, p. 92. Accordingly, the Qchex system would create a check on any account for which the user provided the account number.

Once the user had completed the necessary steps so that the Qchex system could generate a check, the user could use the Qchex system to make a payment by check. To do this, the user would go to the Payee Setup Wizard portion of the website, which would prompt the user to provide the name of the payee, the amount of the check, and an address for the payee. D.4, Ex. 14, pp. 22-23. The Qchex system would then generate an image of the completed check, which would appear on the user's screen. *See, e.g.*, D.4, Ex. 14 at Att. B, p. 104. Qchex included its own language on the line where a signature would normally appear so that the check could be negotiated without an actual signature. D.4, Ex. 14 at Att. A, p.41.

A user could direct Qchex to send a check either by e-mail or by U.S. Postal Service. D.89, Att. 2 at Fact 51. If the user had directed that the check be sent by e-mail, Qchex would send the recipient an e-mail directing the recipient to the Qchex website. D.89, Att. 2 at Fact 54. Because Qchex maintained all the checks and account information on its computer system, the recipient of an e-mailed Qchex check was required to obtain a Qchex account, and to download a program known as "Check Messenger" from the Qchex website. D.89, Att. 2 at Facts 55, 56, 93. Once this had been done, the recipient could print the check. D.89, Att. 2 at Fact 57. If the user had requested that the check be delivered by the U.S. Postal Service, Qchex would print the check in its warehouse, using check paper and magnetic ink for the MICR line. Qchex would then mail the check to the recipient at the designated address. D.89, Att. 2 at Facts 53, 59, 108, 109.

Qchex charged fees for its services. From 2000 until the spring of 2006, Qchex required users to create a Qchex payment account, and to fund an initial prepayment balance of at least $10. *See* D.4, Ex. 15, p.7.[6] Thereafter, every time the Qchex service created and delivered a check for the user, the charge for that check was deducted from that balance. During the 2000-2006 time period, the charge for creating and delivering a check ranged from $0.25 to $0.50. There were additional charges if the user wanted Qchex to generate a paper check and have that check delivered by the U.S. Postal Service. D.4, Ex. 15, p.9. For a short period of time in 2006, Qchex provided a free membership to users: it would create and deliver (by e-mail) up to 1000 checks per month for those users. D.4, Ex. 14 at Att A, p.34. Even during this period, Qchex imposed charges for mail delivery. *Id.* In mid-2006, Qchex again modified its charge structure, imposing a monthly membership charge on all users regardless of whether they requested e-mail or U.S. Postal Service delivery.

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[6] D.4, Ex. 15 is the Declaration of Linda Henry.

D.4, Ex. 14 at Att. T, 8-9. In addition to the check charges, Qchex made money by selling software, paper, and supplies that allowed recipients of e-mailed Qchex checks to print the checks they had received. D.89, Att. 2 at Fact 411. In fact, its website directed check recipients to a portion of its website where it advertised these items. D.4, Ex. 14 at 2.

When Qchex began operating in 2000, it expected that its system would be used for fraudulent purposes, D.89, Att. 2 at Fact 13 (statement of appellant Thomas Villwock, president and owner of appellant Neovi), but it took no steps to assure that users actually had the authority to withdraw funds from the checking accounts that they were registering on the Qchex system, D.89, Att. 2 at Fact 120. Soon after it began operating, Qchex received complaints both from consumers, whose accounts had been accessed by fraudulent Qchex checks, and from law enforcement agencies. D.89, Att. 2 at Facts 184, 188. Nonetheless, Qchex touted the Qchex system itself as a means of fraud protection: once a checking account was registered with Qchex, then Qchex would not allow any other Qchex user to register that same checking account, thereby shielding the initial registrant. D.89, Att. 2 at Fact 123. (Of course, Qchex had no means of assuring that the initial registrant was the legitimate account holder of the account that was being registered.) However, it was not until 2005 that Qchex took any serious steps to protect account holders whose checking accounts were being fraudulently accessed by Qchex checks.[7]

Although Qchex did not protect the public from fraudulent Qchex checks, it attempted to protect itself. In March 2001, Qchex set up a procedure whereby, if a Qchex user wanted to pay for Qchex goods or services with a Qchex check, that user was required either to provide a back-up credit card number, or to wait at least 10 days to receive the goods or services. D.89, Att. 2 at Fact 273. But Qchex did not provide the same degree of protection to other recipients of Qchex checks: even during the 10-day waiting period, Qchex would create and deliver checks by e-mail for that user because there was no charge for e-mailed checks and Qchex would not lose money if such e-mailed checks were fraudulent. D.89, Att. 2 at Fact 128.

In 2003, Qchex received five to ten complaints daily regarding a fraudulent scheme based in Indonesia that used Qchex checks. D.89, Att. 2 at Facts 30-31. (Such an offshore scheme benefited from the use of the Qchex system, because Qchex checks, which originated in the United States, would not arouse the same level of suspicion that would be raised by checks originating in Indonesia.) Qchex took no steps to halt the scheme. D.89, Att. 2 at Fact 32. In late 2004 through 2005, the

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[7] Prior to 2005, Qchex employed what it called the "Qchex Monitor," which could have been used, *inter alia*, to identify suspicious Qchex usage. *See* Brief of Appellants ("Br.") at 7-8. However, no employees (and no resources) were assigned to the Monitor, and it was ineffective. D.105 at 5 (Appellants' Excerpts of Record ("AER") at 35).

number of complaints received by Qchex increased to as many as 1000 per day. D.89, Exh. Vol. III at p. 702. Qchex simply ignored many of these complaints because it believed it had no responsibility to consumers whose accounts were debited by fraudulent Qchex checks. D.89, Att. 2 at Facts 193, 195. When Qchex received complaints from bank account owners who claimed that their accounts had been fraudulently accessed by Qchex checks, Qchex would evaluate the complaints, and, would, on a case-by-case basis, freeze the Qchex accounts of the users for whom it had generated and delivered the checks. D.89, Att. 2 at Fact 122. Although consumers and small businesses who had amounts withdrawn from their accounts by fraudulent Qchex checks were usually able to get those withdrawals reversed, the account owners often had to devote many hours to rectifying their accounts. D.89, Att. 2 at Fact 176. Those who received fraudulent Qchex checks in payment, and deposited those checks in their personal accounts, were often less lucky. Because those checks initially cleared, check recipients provided services based on the assumption that the Qchex checks were valid, only to learn, too late, that the checks were fraudulent. D.89, Att. 2 at Fact 175.

In 2005, MSNBC published two articles warning readers regarding fraudulent Qchex checks, D.89, Att. 2 at Fact 37. In July 2005, the FDIC issued a Special Alert, warning its member banks about Qchex, D.89, Att. 2 at Fact 38.

Shortly after issuance of the FDIC Alert, Qchex began the implementation of the Qchex Verification System ("QVS"), which was supposed to verify that users were entitled to draw checks on the accounts they registered with Qchex. D.89, Att. 2 at Fact 40. QVS worked as follows: when a new user registered a checking account on Qchex's system, Qchex's contractor would post two tiny deposits (each less than one dollar) into the account. To open a Qchex account, the user was required to correctly identify the amounts deposited, thereby indicating that the user had access to the account into which the deposits were made. D.89, Att. 2 at Fact 132. In fact, more than 50% of the deposits were rejected, indicating that the users of the Qchex service were attempting to have Qchex create and deliver checks on accounts that the users did not control. D.89, Att. 2 at Fact 147.

There were many loopholes in QVS. D.89, Att. 2 at Facts 137-139. Most important, QVS was activated only when the user attempted to make a payment to Qchex for a service. D.89, Att. 2 at Fact 137. If a user instructed Qchex to deliver checks only by e-mail, QVS would never be activated. D.89, Att. 2 at Fact 138. Also, QVS did not apply to preexisting users who had funded their Qchex accounts prior to the implementation of QVS. D.89, Att. 2 at Fact 137. Qchex continued to deliver checks by mail for those preexisting users until their accounts ran out. *Id.* And, if a user registered more than one checking account with Qchex, tiny deposits would be made to only one of those accounts. D.89, Att. 2 at Fact 139. Thus, if a Qchex user could pass QVS scrutiny with one account, Qchex would create and deliver checks on any other checking account registered by that user without attempting to determine whether the user was entitled to access that account.

Qchex began the implementation of QVS in September 2005, D.89, Att. 2 at Fact 135, but terminated it in May 2006, D.89, Att. 2 at Fact 155. After the termination, Qchex proposed several other methods to verify accounts, but no method was ever fully implemented. D.89, Att. 2 at Facts 156, 161, 162. Qchex ceased offering the Qchex service in October 2006, but offered a similar service that lacked verification, GoChex, until appellant Neovi declared bankruptcy in October 2007. D.89, Att. 2 at Facts 163, 164, 323.

During the period that it operated a check creation and delivery service, Qchex froze the Qchex accounts of more than 18,000 users for fraud. D.89, Ex. 278 at p.9. These users had registered to create checks on more than 37,000 bank accounts. D.89, Att. 2 at Fact 174. During the period that it operated, Qchex created and delivered more than 700,000 checks, and more than 150,000 of those were from Qchex accounts that were frozen for fraud. D.89, Att. 2 at Fact 204. The face amount on all checks created and delivered by Qchex totaled approximately $803 million, but more than half of that amount, at least $402 million, was drawn on accounts that were frozen for fraud. D.89, Att. 2 at Fact 205. From 2000 through 2005, Qchex had gross revenues of $535,358. D.117 at 13-15 (AER at 27-29).

2. Proceedings below

On September 19, 2006, the Commission filed its complaint in the United States District Court for the Southern District of California. D.1. The complaint alleged that Qchex had created and delivered checks without verifying that the person requesting the check had the authority to draw a check on the designated account. The complaint further alleged that this practice caused substantial injury to the rightful owners of the bank accounts on which the checks were drawn, and to the recipients of unauthorized checks; that this injury could not be reasonably avoided; and that the injury was not outweighed by benefits to consumers or competition. Accordingly, the complaint alleged the Qchex's practices were unfair, and violated Section 5 of the FTC Act, 15 U.S.C. § 45.

On the same day that the Commission filed its complaint, it also moved for entry of a temporary restraining order. D.4. Three days later, the court (per Judge Hayes) entered a stipulated TRO. D.8. The TRO, *inter alia*, prohibited Qchex from creating or delivering any check for any person until it had first taken reasonable steps to verify that the person using the Qchex service had the authority to withdraw funds from the account on which the check was to be drawn. The TRO described two methods that would satisfy the verification requirement: Qchex could use a system similar to QVS and require the user to confirm the amounts of two tiny deposits made to each and every account designated by that person. As an alternative, Qchex could obtain written consent from the user to contact the financial institution that holds the account on which the check was to be drawn, and then verify with that institution that the user was authorized to withdraw funds from that account.

On November 17, 2006, the court held a hearing on the Commission's motion for a preliminary injunction, and on January 18, 2007, the court denied that motion, D.32 (AER at 52). It concluded that Qchex users, not Qchex, created and delivered the fraudulent checks. Thus, the court held, Qchex did not cause any consumer injury. Also, because the court believed that Qchex provided the only service that allowed consumers to create and deliver checks online, it concluded that this service could save consumers money, and, as a result, the benefits of the Qchex system outweighed any harm the system caused. Accordingly, the court held that the Commission was unlikely to succeed on the merits of its case, and it denied the preliminary injunction.

Following a year of discovery, both the Commission and Qchex moved for summary judgment. On September 16, 2008, the Court (per Judge Sammartino, to whom the case had been reassigned) denied Qchex's motion and granted the Commission's motion in part. D.105 (AER at 31). First, the court reversed the conclusion it reached when it denied the preliminary injunction, and held that Qchex caused consumer injury because it facilitated fraudulent activity. *Id.* at 13 (AER at 43). The court found that Qchex created and delivered checks without a reasonable level of verification, and as a result, the Qchex system became "a 'dinner bell' for fraudsters." *Id.* The court also found that Qchex knew of the high level of fraud, but continued to operate "without sufficient verification measures." *Id.* In addition, the court concluded that Qchex caused substantial harm: consumers who had unauthorized funds withdrawn from their bank accounts "often spent a considerable amount of time and resources contesting the checks at their banks, protecting their accounts, and attempting to get their money back." *Id.* at 14 (AER at 44). Also, some consumers, who had to open new accounts to protect themselves from fraudulent Qchex checks, incurred considerable expense. *Id.* The court held that consumers could not reasonably avoid the injury because they frequently learned of the fraudulent Qchex checks only after their accounts had been looted. Further, Qchex made it difficult for consumers to investigate and stop fraudulent access to their accounts. *Id.* Based on an unrebutted expert report, the court also held that the purported benefits to consumers or competition from the Qchex system did not outweigh the injury that Qchex caused. *Id.* at 15 (AER at 45). Thus, the court held that Qchex business practices were unfair, in violation of the FTC Act. *Id.* at 10 (AER at 40).

The court next held that defendants Neovi and G7 Productivity Systems operated as a common enterprise because they shared office space, employees, payroll funds, and other expenses. *Id.* at 16 (AER at 46). Finally, the court held that defendants Villwock and Danforth were liable for the illegal practices of the corporate defendants because they had the authority to control the corporations, they knew of the corporations' illegal conduct, and participated in that conduct. *Id.* at 17 (AER at 47).

Qchex moved for reconsideration, and on January 7, 2009, the court denied that motion and imposed injunctive relief. The court enjoined Qchex, *inter alia*, from creating or delivering checks unless it either 1) employed an independent person to verify both the identity of any Qchex user, and the authority of that user to withdraw funds from the account that the user had registered; or 2) hired a monitor, who was agreed to by both the Commission and Qchex, and who would oversee Qchex's performance of identity and account verification. In addition, the court ordered Qchex to pay equitable monetary relief in the amount of $535,358, the proceeds it received from operating the Qchex system. D.117, D.118 (AER at 1-30).

STANDARD OF REVIEW

This Court reviews the district court's grant of summary judgment *de novo*.

This Court must determine, "viewing the evidence in the light most favorable to the nonmoving party, whether there are any genuine issues of material fact and whether the district court correctly applied the relevant substantive law." *Johnson v. Columbia Properties Anchorage, LP*, 437 F.3d 894, 898 (9th Cir. 2006). This Court reviews the district court's choice of remedies for abuse of discretion. *Nat'l Wildlife Fed. v. Nat'l Marine Fisheries Serv.*, 524 F.3d 917, 936 (9th Cir. 2008). That is, this Court should not disturb the district court's choice unless either that court failed to apply the correct law, *United States v. Comprehensive Drug Testing, Inc.*, 513 F.3d 1085, 1102 (9th Cir. 2008), or this Court has "a definite and firm conviction that the court committed a clear error of judgment in the conclusion it reached upon a weighing of the relevant factors," *Coleman v. Quaker Oats Co.*, 232 F.3d 1271, 1297 (9th Cir. 2000).

SUMMARY OF ARGUMENT

The Qchex system allowed any user to write a check on any account, regardless of whether that user was entitled to access that account. From its inception, this system was, in the district court's words, "a 'dinner bell'" for fraud. Little wonder, a substantial portion of the checks that Qchex generated and delivered for its users were fraudulent. As a result, Qchex's operation of its system satisfied all the statutory criteria of an unfair practice under the FTC Act: consumers and businesses suffered substantial injury, Qchex caused that injury, those who were injured could not reasonably avoid the injury, and the injury was not offset by benefits to consumers or competition. (Part I.A, *infra*.)

The Qchex system produced two types of substantial injury. Those who received fraudulent Qchex checks in payment for goods or services were injured when they discovered that the checks were fraudulent. Also, ample evidence shows that rightful account holders were injured when their accounts were accessed by fraudulent Qchex checks: those account holders had to devote considerable time and resources to getting their accounts recredited. It was neither possible, nor necessary, for the court to quantify the full amount of the injury that resulted from Qchex's operation of the Qchex system. However, undisputed evidence showed that Qchex generated and delivered more that $400 million in checks that were drawn on accounts that were later frozen for fraud. (Part I.A.1, *infra*.)

Qchex caused the injury that resulted from Qchex checks because that injury was the predictable and natural result of Qchex's operation of its Qchex system. Since the 1920s, cases interpreting the FTC Act have held that someone who creates a mechanism that is predictably used by wrongdoers is responsible for the harm that results. The Qchex system that Qchex created was such a mechanism. Qchex is not absolved by the fact that many of the users of its system were fraud-feasors. Indeed, a violation of the FTC Act may have more than one perpetrator. Finally, it is simply irrelevant that Qchex did not receive a direct financial benefit from the consumers who were injured by the Qchex system: direct financial benefit is not an element of an FTC Act violation. (Part I.A.2, *infra*.)

Consumers and businesses could not reasonably have avoided either of the types of harm caused by the Qchex system. Consumers whose accounts were wrongfully accessed by Qchex checks did not know in advance, and could not have known, that their accounts would be looted using Qchex checks. Although many were able to get their money back, the time and expense necessary to get accounts recredited constituted injury that could not be avoided. And those consumers and businesses who accepted Qchex checks, checks that appeared to be legitimate, could not have avoided injury because it might be many months after such a check would initially clear before the withdrawal would be reversed. (Part I.B, *infra*.)

Qchex satisfied the final criterion for unfairness because the harm caused by the Qchex system provided benefits primarily to those seeking to commit fraud, not to legitimate consumers, who had a variety of other payment options available. Qchex sought to rebut evidence presented by the Commission's expert witness with the uncorroborated declarations of its corporate officer (and defendant/appellant) Danforth. But this Court has held that such declarations are not sufficient to create a genuine issue of material fact sufficient to defeat summary judgment. (Part I.C, *infra*.)

Qchex complains that district court lacked authority to enter a mandatory injunction, but a statutory provision that authorizes the entry of "permanent injunctions," such as the provision pursuant to which the district court acted, encompasses authority to enter either prohibitory or mandatory injunctions. In any event, the injunctive provision that Qchex challenges is a prohibitory injunction, since it prohibits Qchex from operating the Qchex system, but does not mandate any conduct. (Part II.A, *infra*.)

It is also well settled that, when a court holds that the FTC Act has been violated, it may order the violator to disgorge the proceeds of its illegal conduct. That is what the district court did: it required Qchex to disgorge the proceeds of its operation of the Qchex system. Qchex mistakenly contends that this authority was limited by *FTC v. Verity Int'l, Ltd.*, 443 F.3d 48 (2d Cir. 2006). But this Court has rejected the limit imposed by *Verity*. In any event, that case involved a court's authority to award restitution, a monetary remedy that is distinct from disgorgement. Further, not only is this argument meritless, but the argument was also waived by Qchex because it was not properly raised before the district court. Finally, even though the district court speculated that there might have been some legitimate users of the Qchex system (but Qchex offered no evidence that such users existed), the court properly ordered Qchex to disgorge its entire proceeds of operating the system.

Qchex violated the FTC Act by operating the Qchex system, a system that, without adequate account verification, generated and delivered checks. Because Qchex's operation of the Qchex system, not merely its generation and delivery of specific fraudulent checks, violated the FTC Act, the district court properly required that it disgorge the entire proceeds of the system. (Part II.B, *infra*.)

ARGUMENT

I. THE DISTRICT COURT CORRECTLY HELD THAT THE QCHEX CHECK SERVICE WAS AN UNFAIR PRACTICE, IN VIOLATION OF THE FTC ACT

This Court should affirm the district court's conclusion that Qchex committed an unfair practice, in violation of Section 5 of the FTC Act, 15 U.S.C. § 45, through its operation of its Qchex system. Pursuant to Section 5(n) of the FTC Act, 15 U.S.C. § 45(n), an act or practice is unfair if it "causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition." The district court correctly determined that the Qchex system satisfies all the elements of this test.

A. The Qchex system caused substantial injury to consumers

The first element of the unfairness test has two components: substantial injury and causation. The district court correctly held that Qchex's operation of the Qchex system satisfied both components.

1. Substantial injury

There is no dispute as to what Qchex did: it developed a computerized system that allowed any user with access to the internet to ask Qchex to create and deliver to unsuspecting recipients apparently genuine checks drawn on any account the user designated. The user provided the account number, identified the bank name, and designated a payee. The Qchex system then generated a check that included a MICR line and could be read by check processing equipment. Qchex also provided the user with delivery options. Because, most of the time, Qchex had no mechanism to assure that its system was creating checks on accounts that users of its system were authorized to access, users routinely requested that Qchex generate fraudulent checks on the accounts of others.

Consumers and businesses suffered two types of injury as a result of the Qchex system. First, those who received Qchex checks in payment for goods or services were injured when they discovered that those checks were fraudulent. Qchex does not dispute that this type of injury occurred routinely.

Second, consumers and businesses whose accounts were wrongfully accessed by Qchex checks were also injured.[8] Such account holders were required to spend

[8] Appellants provide no explanation whatsoever for their contention that the injury that is at issue in this case somehow occurred before Qchex users employed the Qchex system. *See* Br. at 9.

time and resources to have amounts recredited to their accounts. There is no merit to any of the arguments that Qchex raises with respect to this type of injury. It mistakenly contends that there was no support for court's finding that consumers "'often spent a considerable amount of time and resources contesting the checks at the banks, protecting their accounts and attempting to get their money back.'" Br. at 20, quoting D.105 at 14 (AER at 44). It is peculiar that Qchex makes this argument because all four of the consumer declarations cited by Qchex in its Brief (*see* Br. at 20) and included in its Excerpts of Record specifically indicate that the declarants devoted considerable time and resources to resolving problems caused by Qchex checks. Bobowski Dec., AER at 158-159; Burles Dec., AER at 137; Merkley Dec., AER at 149-150; Segal Dec., AER at 154.[9]

Qchex contends that the district court's conclusion that injury occurred to rightful account holders was "based on speculation, not evidence," Br. at 19, but this argument relies on a quote taken out of context. As Qchex notes, the court stated that "there is not sufficient information in the record to definitively quantify the number

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[9] Qchex also speculates that, if users of Qchex checks had not had access to the Qchex system, they would have found some other means to defraud consumers. Thus, Qchex suggests that the court should have offset the harm that Qchex users actually caused against the harm that Qchex speculates the users might have caused. *See* Br. at 20. This argument, which was never raised below, is absurd. If it were the law, then no practice, no matter how harmful, could ever be considered unfair so long at the wrongdoer could imagine some worse harm that could have resulted.

of fraudulent items Defendants fraudulently created." Br. at 19, quoting D.105 at 8 (AER at 38); *see also* Br. at 18 n.3 ("court acknowledged that not all Qchex transactions were 'bogus' or 'fraudulent'). However, what the court actually said was:

> According to the Qchex database, from 2000 to 2006, Qchex sent nearly 155,000 checks from 13,770 Qchex accounts that later were frozen for fraud. Those 13,770 frozen Qchex accounts had supplied 37,369 discrete bank account numbers on which these checks were drawn. Those checks represented $402,753,276 of value, more than half of the entire $803,565,391 worth of Qchex produced overall. However, there is not sufficient information in the record to definitively quantify the number of fraudulent items Defendants fraudulently created.

D.105 at 8 (AER at 38). That is, although there was evidence that at least half of the funds transferred using the Qchex system represented fraudulent transactions, the court could not evaluate the remaining transactions because Qchex presented no evidence to show that there were *any* legitimate users of its system. Thus, it is possible that even more Qchex checks were fraudulent, but it was impossible for the court to determine the full extent of the harm caused by Qchex checks.

In any event, to establish that a practice is unfair, the Commission must show that it causes, or is likely to cause, substantial injury, but it is not necessary that the injury be precisely quantified. *See American Fin. Serv. Ass'n v. FTC*, 767 F.2d 957, 975 (D.C. Cir. 1985) (holding that practices that may result in "potential deprivations of [consumers'] legal rights" caused substantial injury sufficient to satisfy the unfairness criterion). Indeed, health and safety risks, which are inherently unquantifiable, may support a holding of unfairness. *In re Int'l Harvester Co.*, 104 F.T.C. 949, 1061 (1984). Plainly, consumers and businesses who received Qchex checks in payment, and consumers who had their accounts wrongfully accessed by Qchex checks, suffered substantial injury, and that is sufficient to satisfy this component of the unfairness test.

2. Causation

As the district court correctly held, Qchex caused the substantial injury suffered by consumers and businesses:

> Defendants [*i.e.*, Qchex] used their website and check creation expertise to convert [users'] raw data into a negotiable instrument that matched US banking regulations when printed. Defendants also e-mailed the checks, printed the checks using Neovi's "print service center," and mailed the checks. Further, as the FTC alleged, they created and delivered checks without a reasonable level of verification at the request of Qchex customers -- in many instances, fraudsters. The evidence shows that the launch of Qchex.com was a "dinner bell" for fraudsters and resulted in a high number of accounts frozen for fraud, and the large number and high value of checks (about fifty percent of the value of all Qchex checks) written on those accounts. Defendants knew of the high level of fraud from their own files and the complaints, and * * * they chose to continue to operate without sufficient verification measures. Therefore, * * * the Court finds that the FTC has satisfied the element of causation.

D.105 at 13 (AER at 43). That is, Qchex operated the Qchex.com website, and the injury suffered by consumers and businesses was the predictable and natural consequence of the system Qchex developed. Indeed, the mechanism that Qchex created was essential to the fraud committed by Qchex users because it was Qchex's check creation services that enabled users to obtain checks that were compatible with check processing equipment (*i.e.*, had the MICR line printed in magnetic ink), and that originated in the United States (making it easier for offshore users to commit fraud).[10]

1. Qchex mistakenly contends that "there were no FTC cases on point" supporting the district court's conclusion with respect to causation. *See* Br. at 17. In fact, however, Qchex has overlooked an unbroken line of cases dating back to the 1920s that holds that, when an entity creates a mechanism that is predictably used by others to commit fraud, that entity is responsible for the resulting harm and thereby violates the FTC Act. That is, it "causes" that harm.[11] In *FTC v. Winsted Hosiery Co.*, 258 U.S. 483, 494 (1922), Justice Brandeis explained for the Court "[t]hat a person is a wrongdoer who so furnishes another with the means of consummating a fraud has

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[10] Not only was the fraud the predictable and natural consequence of Qchex's actions, but also Qchex knew that the website was used to effectuate fraud. The most damning evidence of this knowledge is that Qchex did not trust its own checks: shortly after commencing operations, Qchex implemented a policy whereby users were precluded from paying for Qchex's products or services with Qchex checks unless they provided additional security. D.89, Att. 2 at Fact 273.

[11] As Judge Posner explained in *HK Systems, Inc. v. Eaton Corp.*, 553 F.3d 1086, 1090 (7th Cir. 2009):

> [t]he term "intervening [or superseding] cause," like "proximate cause," "legal cause," "chain of causation" (the "chain" that the "intervening cause" "breaks"), and "but for" cause belongs to an old-fashioned tort vocabulary. It would be clearer to speak in terms of responsibility, because the object of "causal" analysis is merely to determine who shall be responsible for some untoward event * * *.

long been a part of the law of unfair competition." At issue in *Winsted* was the labeling on cartons of undergarments that a clothing manufacturer sold to independent retailers. Although the labeling was, for the most part, not misleading to retailers, the labeling would mislead consumers. Even though consumers were defrauded by the retailers, the manufacturer was also liable under the FTC Act for providing unscrupulous retailers with the means whereby they could commit that fraud.

In *FTC v. R.F. Keppel & Bro., Inc.*, 291 U.S. 304 (1934), the Court upheld a Commission order that was entered against a candy manufacturer that sold penny candy to retailers, and packaged that candy in display boxes that retailers could use to encourage children to gamble with respect to the price of the candy. Even though it was the retailer who independently conducted the gambling transaction, the manufacturer was also held to have committed an unfair practice in violation of the FTC Act. In *Regina Corp. v. FTC*, 322 F.2d 765 (3d Cir. 1963), Regina, a vacuum manufacturer, supplied its retailers with a document describing so-called suggested list prices. Regina knew that its retailers customarily did not sell the vacuum cleaners at the suggested prices. Regina also knew that its retailers included the list prices in their advertising, thereby creating the false impression that Regina vacuum cleaners were being sold at special sale prices. The court held that, even though Regina did not itself deceive consumers, and even though Regina may not have intended that there be any deception, it was nonetheless liable because "[o]ne who places in the hands of another a means of consummating a fraud is himself guilty of a violation of the [FTC] Act." 332 F.2d at 768 (quotation marks and citation omitted).

In *FTC v. Magui Publishers, Inc.*, 1991-1 Trade Cas. (CCH) ¶ 69,425 (C.D. Cal. 1991), *aff'd* 9 F.3d 1551 (9th Cir. 1993), Magui published etchings and lithographs that purported to be the work of artist Salvador Dali, and sold them, along with accompanying certificates of authenticity, to various dealers and galleries. The galleries and dealers knew that the etchings and lithographs were published by Magui after Dali's death, but they sold them to consumers as original works of art by Dali. The court found that Magui had placed the etchings and lithographs (and the certificates of authenticity) in the hands of the retailers knowing that they would be used to deceive consumers. Accordingly, the court held that Magui had violated the FTC Act. *Id.* at p.65,726.

Most recently, in *FTC v. Accusearch*, 2007 WL 4356786 (D. Wyo. Sept. 28, 2007), *appeal docketed*, No. 08-8003 (10th Cir., Jan. 10, 2008), the court held that Accusearch, which used the internet to sell confidential consumer telephone records, had engaged in an unfair practice in violation of the FTC Act. The confidentiality of the phone records sold by Accusearch was protected by law, and, as a result, the records could be obtained only by engaging in theft, deception, or other illegal means.

Accusearch did not, itself, engage in theft or deception, but instead obtained the information from independent vendors, whom Accusearch knew (or should have known) were engaging in illegal conduct. The court concluded that, "the 'unfair business practice' * * * is Defendants' obtaining and selling of confidential consumer phone records where that practice was necessarily accomplished through illegal means." *Id.* at *6.

Qchex mischaracterizes the holding of *Accusearch* (a case on which the district court relied, *see* D.105 at 11 (AER at 41)) when it contends that it "illustrates that a defendant must take an active role in the business activity that creates the alleged consumer injury to be held liable for that activity." *See* Br. at 13; *see also* Br. at 15. In fact, the defendant in Accusearch did not take an active role in theft or deception through which its vendors obtained protected telephone records. What Accusearch did, however, was to create a mechanism that effectively invited others to engage in theft or deception. That is also what Qchex has done.

The district court also relied on *FTC v. Windward Marketing, Ltd.*, 1997 WL 33642380 (N.D. Ga. 1997). In that case, several of the defendants used deceptive practices to sell magazines to consumers. Those defendants obtained bank drafts from the defrauded consumers and sent those drafts to defendant Wholesale, who maintained commercial bank accounts and was, as a result, able to deposit the drafts obtained from the consumers. The court in *Windward* held that, even though Wholesale had not made deceptive sales, it nonetheless engaged in unfair practices in violation of the FTC Act because it sent drafts for collection that it knew were not authorized by consumers. Qchex argues that, unlike Wholesale, it never cooperated directly with its users who committed fraud. Br. at 16. But, as explained above, what is crucial is that it provided the mechanism that was predictably used to commit fraud.

These authorities belie Qchex's unwarranted assertion that there is a "dearth [of] federal case law under the FTC Act" relevant to the causation issue presented here. *See* Br. at 15. Clearly, this Court should reject Qchex's suggestion that it rely on ostensible analogies from cases under California's "Little FTC Act," Ca. Bus. & Prof. Code § 17200. *See* Br. at 17-19. Although courts in many states (including California) that have their own consumer protection statutes rely on federal authorities when interpreting those statutes, there is no authority for the reverse approach. That is, federal courts do not rely on state law cases when interpreting the federal FTC Act. Indeed, were a court to do so, it would create great confusion, given the multitude of state laws and potentially inconsistent rulings interpreting those laws. In any event, the cases Qchex relies on are inapposite, in that the claimed causal connections between the actions in question and subsequent consumer injuries were far more attenuated. None involved the situation presented here, in which Qchex created a mechanism that was routinely employed by users, and that defendants knew was routinely used, to commit fraud.[12]

2. Thus, the pertinent case law shows that, when an entity provides others with a mechanism that is predictably used by others to commit unfair or deceptive practices, the entity bears responsibility under the FTC Act for resulting injuries. Qchex provided its users with a mechanism that was naturally and predictably used to commit fraud. Its provision of the Qchex system was, accordingly, "likely to cause substantial injury to consumers * * * ." 15 U.S.C. § 45(n) (defining "unfair" acts or practices).

Qchex's various efforts to evade responsibility for the inevitable consequences of its acts are unavailing. For example, its arguments that it did not "create" checks in the sense of being the "drawer" as defined by the Uniform Commercial Code (*see*

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[12] *See Perfect 10, Inc. v. Visa Int'l Serv. Ass'n*, 494 F.3d 788 (9th Cir. 2007) (credit card companies not liable under § 17200 for copyright and trademark violations committed by websites that accepted credit cards in payment); *In re: Deep Vein Thrombosis*, 356 F. Supp. 2d 1055 (N.D. Cal. 2005) (aircraft manufacturer held not liable to passengers who suffered circulatory problems from jet travel where the manufacturer neither manufactured nor installed the seats in which the passengers sat); *In re Firearm Cases*, 126 Cal. App. 4th 959 (Cal. Ct. App. 2005) (firearm manufacturers were held not liable under § 17200 for crimes committed by the ultimate purchasers of guns they manufactured (but court did not dismiss case against two dealers who sold a large number of guns that were used to commit crimes, *id.* at 970 n.8)); *Emery v. Visa Int'l Serv. Ass'n*, 95 Cal. App. 4th 952 (Cal. Ct. App. 2002) (Visa was not liable under § 17200 for sales of illegal lottery tickets where the company that sold the tickets accepted payment by credit card).

Br. at 9, 11, 12, 18) are entirely beside the point. The Commission made no such allegation, nor is it pertinent to the legal basis for liability for unfair acts under the FTC Act.[13] It was defendants' creation and marketing of the Qchex system -- a system that irresponsibly and without safeguards put the bank accounts of innocent businesses and consumers at high risk -- that constituted an unfair practice.

Nor is there any merit to Qchex's attempt to shift all blame to its users. The fact that users *also* had to take certain actions before checks could not be generated and delivered -- *i.e.*, provide Qchex with account number and other information, and advise Qchex of the means of delivery destination -- does not detract in any way from the unfair nature of Qchex's own actions, in setting this system in motion.

Qchex also claims that it is no more blameworthy than traditional printing houses that provide checks to consumers by mail. *See* Br. at 11. In fact, however, unlike Qchex, those printing houses use verification procedures to guard against unauthorized use, and, as a result, checks printed by those companies are rarely used for the sort of fraud that was routine for Qchex checks. *See* D.89, Att. 2 (unredacted version) at Facts 240-248 (describing the account verification procedures used by a direct-to-consumer check printing company); *see also* D.89, Att. 2 at Facts 231-237

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[13] Qchex's unwarranted assumption that the Commission's allegations that it "created" checks meant that Qchex itself carried out *all* of the necessary steps to effectuate payment (*see* Br. at 13) is contradicted by paragraph 13 of the complaint, which accurately describes Qchex's *modus operandi*. See D.1 at 4 (AER at 259).

(describing the account verification method used by PayPal, a service that allows consumers to use the internet to make payments from their bank accounts, and which had fraud losses on fewer than 0.35% per cent of its transactions).

Finally, Qchex mistakenly suggests that, to show that it caused an unfair practice, the Commission must establish that it "received direct financial benefit from consumer loss." *See* Brief of Appellants ("Br.") at 16. In fact, there is nothing in the FTC Act's definition of unfairness that requires the Commission to make such a showing (although, as discussed below, a defendant's profit may be relevant to the appropriate remedy). Moreover, a defendant commits an unfair practice that violates the FTC Act if that practice "causes *or is likely to cause* substantial injury to consumers." Accordingly, the Commission is not required to wait until consumers have actually been injured, but may put a halt to unfair practices in their incipiency.

Thus, under the FTC Act, Qchex bears responsibility for, and thus caused, the harm that predictably resulted from its operation of the Qchex system. *See HK Systems v. Eaton*, *supra*.

B. Consumers could not reasonably avoid the harm caused by the Qchex system

As explained above, each of the many Qchex checks used fraudulently caused two types of harm: 1) the account holder whose account was fraudulently accessed was injured; and 2) the recipient of a Qchex check was injured when a payment made by such a check turned out to be invalid. The district court correctly held that consumers and businesses could not have reasonably avoided either of the types of harm caused by the Qchex system, and that there was no material issue of fact with respect to this issue. D.117 at 7 (AER 21).

As to those consumers and businesses whose accounts were wrongfully accessed by users of Qchex checks, the court observed that they had no chance to avoid the injury before it occurred. Qchex does not dispute this. *See* Br. at 20-21. It argues, however, that the court "did not assess whether consumers mitigated damage afterward." Br. at 21. In particular, it contends that consumers could take steps to have their accounts recredited. *Id.* But Qchex ignores that mitigation of harm does not constitute avoidance of that harm. Indeed, even when consumers' accounts were recredited, those consumers were still harmed because they were required to spend "a considerable amount of time and resources contesting the checks at their banks, protecting their accounts, and attempting to get their money back." D.105 at 14 (AER at 44). Moreover, Qchex exacerbated this harm because it "provided minimal information to injured consumers who complained about Qchex fraud, and thereby made it difficult for them to investigate and stop fraudulent activity on their bank accounts." *Id.*

Of course, Qchex caused a second type of harm, harm to recipients of Qchex checks who changed their position as a result of fraudulent Qchex checks. Qchex has not argued that such harm can be reasonably avoided. *See* Br. at 20-21. Indeed, it is hard to see how this sort of harm could be avoided since, pursuant to § 4-406 of the Uniform Commercial Code, it may be months after a check has initially cleared before an account holder takes the steps that lead to reversing the withdrawal.

C. The injury caused by the Qchex system is not outweighed by benefits to consumers or to competition

The district court correctly held that the harm caused by the Qchex system was not outweighed by benefits to consumers or to competition, and that Qchex had failed to raise any genuine issue of material fact with respect to this issue. In particular, the court concluded that the declaration of expert witness Dr. Mann (AER 77-105) established that the Qchex system "did not provide any advantage over other payment options[,] * * * did not have a positive impact in the marketplace[,] and did not benefit competition.". D.105 at 15 (AER at 45).

Qchex contends that the declarations of defendant James Danforth (AER 238, 244-245) create a genuine issue regarding the benefits of the Qchex system. Br. at 21-22. But the district court concluded that these declarations did not create a genuine issue of fact because "[t]he Ninth Circuit 'has refused to find a "genuine issue" where the only evidence presented is "uncorroborated and self-serving testimony,'" quoting *Villiarimo v. Aloha Island Air, Inc.*, 281 F.3d 1054, 1061 (9th Cir. 2002). That is precisely what the Danforth declarations are: uncorroborated and self-serving. Danforth claims that Qchex provides the only means whereby consumers can send checks by e-mail and have them printed at the destination. AER at 238, 244. Danforth did not explain why this was a benefit, and, as Dr. Mann pointed out, the vast majority of Qchex checks were sent by U.S. mail, not e-mail, because recipients of Qchex checks did not have the specialized equipment necessary to print Qchex checks. When Qchex checks were sent by mail, this resulted in higher costs to consumers and more use of resources. AER at 93.

Danforth also contends that Qchex users benefited because they could print checks on paper that is less expensive than the paper traditionally used for checks. AER at 238, 245. But as Dr. Mann explained, not only does Qchex require recipients to have the specialized printer, paper, and ink necessary to print checks, but also "[i]ncreased use of Qchex would involve continued use of the paper check-processing system, stemming the beneficial trend away from paper-based to electronic payments." AER at 96. Danforth also contends that the use of the Qchex system would enhance checking system security. AER at 238. Given the widespread abuse of the checking system fostered by Qchex, this contention not only fails to raise a material issue of fact, it is also ridiculous.

Finally, as Dr. Mann explained, consumers have numerous alternatives to traditional checks (such as PayPal, internet checking provided by most banks, and automated clearing house transfers), all of which provide greater security than Qchex. Thus, Qchex provided no benefit to legitimate competition. Indeed, as Dr. Mann concluded:

> [t]o the extent Qchex had any effect on competition, the most likely effect was to foster entry by small actors into the check fraud business. * * * Qchex substantially lowered the up-front costs of equipment and software required to generate high-quality forged checks.

AER at 96. This is hardly the sort of benefit to competition that could justify the Qchex system. Thus, Qchex raised no genuine issue of material fact regarding the benefits of the Qchex system to consumers or competition.

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Qchex raised no genuine issue of material fact with respect to any of the elements of unfairness. The district court correctly held that Qchex's operation of the Qchex system constituted an unfair practice in violation of the FTC Act.

II. THE RELIEF ENTERED BY THE DISTRICT COURT WAS NOT AN ABUSE OF DISCRETION

A. The FTC Act provided the district court with ample authority to enjoin Qchex from operating the Qchex system

It is well settled that Section 13(b) of the FTC Act, 15 U.S.C. § 53(b), provides a district court with authority to grant permanent injunctions and other equitable relief for violations of the FTC Act. *FTC v. Pantron I Corp.*, 33 F.3d 1088, 1102 (9th Cir.

1994), citing *FTC v. H.N. Singer, Inc.*, 668 F.2d 1107, 1113 (9th Cir. 1982). After having concluded that Qchex violated Section 5 of the FTC Act, the district court used this injunction authority to prohibit Qchex from operating the Qchex system. In particular, in Part I of the Injunction, the court "permanently restrained and enjoined [Qchex] from creating or delivering any check for a customer, unless [Qchex] perform[s] the verification procedures" set forth in that part of the Injunction. D.118 at 4 (AER at 4).

Qchex's argument that the court lacked authority to enter a mandatory injunction is both convoluted and wrong. *See* Br. at 24-25. It notes that Section 5(*l*) of the FTC Act, 15 U.S.C. § 45(*l*), provides that district courts may "grant mandatory injunctions and such other and further equitable relief as they deem appropriate in the enforcement" of the Commission's administrative cease and desist orders. Qchex further observes that, under Section 13(b) of the FTC Act, which was the source of the remedial authority in this case, the court is authorized to grant "a permanent injunction." From this, Qchex jumps to the conclusion that, because mandatory injunctions are mentioned in Section 5(*l*), but not in Section 13(b), a court in an action brought pursuant to Section 13(b) lacks authority to grant mandatory injunctions and can enter only prohibitory injunctions.

In fact, the term "injunction" encompasses orders commanding or preventing an action, *i.e.*, both mandatory and prohibitory injunctions. *Blacks Law Dictionary* 800 (8th ed. 2004); *see Gilmore v. California*, 220 F.3d 987, 1001 (9th Cir. 2000) ("'when a decree commands or prohibits conduct, it is called an injunction'"), quoting *Gates v. Shinn*, 98 F.3d 463, 468 (9th Cir. 1996). It may be that, in an action brought under Section 5(*l*), the court would be limited to mandatory injunctive relief (but for the further language in that section permitting the court to grant such other equitable relief as it deems appropriate). However, any limitation that may exist in Section 5(*l*) has no application to this case, which was brought pursuant to Section 13(b), not pursuant to Section 5(*l*).[14]

Even if there were some merit to Qchex's statutory argument, this would not advance its cause because the injunctive provision that it complains about is prohibitory, not mandatory. A prohibitory injunction is an injunction "that forbids or restrains an act." *Blacks Law Dictionary* 800; *see Legal Aid Soc. of Hawaii v. Legal*

[14] Qchex contends that mandatory injunctions are an extraordinary remedy. Br. at 24 n.4, 25 n.5. But all the cases it cites involve preliminary injunctions, whose purpose is to preserve the status quo *pendente lite*. In cases brought by the Commission, courts routinely grant mandatory *permanent* injunctions. *See, e.g.*, *FTC v. Stefanchik*, 559 F.3d 924 (9th Cir. 2009) (affirming order that required the defendants to maintain records, file reports, and deliver the court's order to employees); *FTC v. Gill*, 71 F. Supp. 2d 1030 (C.D. Cal. 1999), *aff'd*, 265 F.3d 944 (9th Cir. 2001) (ordering defendants, *inter alia*, to notify all their clients that their contracts were rescinded); *FTC v. Publishing Clearing House, Inc.*, 104 F.3d 1168 (9th Cir. 1997) (affirming order that required a receiver to manage an interest-bearing redress account, and required defendants to permit Commission employees to access their offices, and to file reports).

Serv. Corp., 961 F. Supp. 1402, 1408 (D. Haw. 1997) ("a prohibitory injunction prohibits the performance of certain acts"). That is exactly what Part I of the injunction does: it prohibits Qchex from operating its Qchex system. It does, of course, permit Qchex to continue the system if it adds appropriate verification procedures to prevent fraud. However, there is nothing in the injunction that mandates that Qchex take any affirmative action. Accordingly, the injunctive is prohibitory, not mandatory.

B. The disgorgement ordered by the district court was an appropriate monetary remedy[15]

Finally, there is absolutely no merit to Qchex's contention that the district court somehow lacked authority to award monetary relief. As Qchex recognizes, *see* Br. at 26, in an action (such as this one) brought by the Commission pursuant to Section 13(b) of the FTC Act, the court has the authority to grant not only injunctive relief, but also other equitable relief, including disgorgement. *FTC v. Pantron*, 33 F.3d at 1102; *FTC v. QT, Inc.*, 512 F.3d 858, 862 (7th Cir. 2008); *FTC v. GEM*

[15] Qchex contends that it raised issues of fact with respect to the monetary remedy ordered by the district court and that, as a result, the court should have held an evidentiary hearing. Br. at 23. It is mistaken because neither of the issues it raised before the district court involved an issue of fact. It challenged the admissibility into evidence of its tax returns, but this merely raised a question of law. *See* D.108 at 2-3 (AER 67-68). It also argued that any award of disgorgement should be offset by Qchex's expenses. But this also raises an issue of law, not of fact. These issues (neither of which Qchex has raised before this Court) did not merit an evidentiary hearing.

Merchandising Corp., 87 F.3d 466, 469 (11th Cir. 1996). Disgorgement is an equitable remedy that is intended to prevent a wrongdoer from unjust enrichment. *Eckard Brandes, Inc. v. Riley*, 338 F.3d 1082, 1088 (9th Cir. 2003). Thus, "[d]isgorgement wrests ill-gotten gains from the hands of a wrongdoer." *SEC v. Huffman*, 996 F.2d 800, 802 (5th Cir. 1993). The equitable monetary relief imposed by Part II of the court's Final Order, D.118 at 6 (AER at 6), which requires Qchex to pay an amount equal to the gains of its illegal activity, constitutes disgorgement. *See* D.117 at 14 (AER at 28) ("[t]he Court finds that Plaintiff has offered sufficient justification for the requested disgorgement * * *").

Qchex is not helped by *FTC v. Verity Int'l, Ltd.*, *supra*. *See* Br. at 27-30. Indeed, Qchex misunderstands the holding of that case. In *Verity*, the consumers who were deceived by the defendants made payments to the phone company, not directly to the defendants. The phone company, which was not a defendant, remitted only a portion of that amount to the defendants. The district court ordered the *Verity* defendants to pay restitution in the full amount lost by consumers. *FTC v. Verity Int'l, Ltd.*, 335 F. Supp. 2d 479, 501-502 (S.D.N.Y. 2004), *aff'd in part and rev'd in part*, 443 F.3d 48 (2d Cir. 2006).[16] That is, it required the defendants to pay more than they

[16] Although the district court in *Verity* referred to the monetary relief as both "disgorgement" and "restitution," in fact the relief was actually restitution because the court was seeking "to restore the injured person to the situation that prevailed before the wrong was committed." *Texas American Oil Corp. v. Dep't of Energy*, 44 F.3d

actually received. The Second Circuit reversed the monetary remedy in part. It imposed a strict interpretation on the district court's authority to award restitution in an action brought by the Commission under Section 13(b). It held that, regardless of the amount of harm the defendants caused, the restitution they could be required to pay was limited to the amount of money that they received from injured consumers.[17] 443 F.3d at 66-67. Thus, *Verity* held that defendants' obligation to pay restitution was capped at the portion of the payments they had received from the phone company.[18]

Verity is irrelevant to this case, however, because the remedy imposed on Qchex was disgorgement, not restitution. The very purpose of disgorgement is to

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1557, 1569 (Fed. Cir. 1995), citing *Restatement of Restitution*, §§ 150-159, Introductory Note (1937).

[17] Just like the district court, the Second Circuit in *Verity* also referred to the monetary relief as both "restitution" and "disgorgement." *See* 443 F.3d at 67.

[18] This Court, quite properly, has rejected the narrow interpretation of the Commission's remedial authority that the Second Circuit imposed in *Verity*. "Equity may require a defendant to restore his victims to the status quo where the loss suffered is greater than the defendant's unjust enrichment." *FTC v. Stefanchik*, 559 F.3d at 931. This is consistent with the Supreme Court's admonition that, when, as here, "the public interest is involved in a proceeding * * *, [the court's] equitable powers assume an even broader and more flexible character than when only a private controversy is at stake." *Porter v. Warner Holding Co.*, 328 U.S. 395, 398 (1946). Qchex notes that, in *Stefanchik*, the Commission's action was based not just on Section 13(b), but also on Section 19, 15 U.S.C. § 57b, which authorizes the court to award damages. Br. at 27 n.8. However, in *Stefanchik*, this Court was clearly relying on the court's equitable authority, not Section 19, when it held that a defendant could be required to make full restitution.

deprive a wrongdoer of ill-gotten gains -- to take back money the wrongdoer received. Thus, the issue that concerned the court in *Verity*, where the district court sought to require the defendants to pay out more than they took in, simply does not arise in this case, where the district court required Qchex to disgorge the amount that it received.

In any event, Qchex waived its argument based on *Verity* because it did not properly present that argument to the district court. The first time that Qchex challenged the court's authority to award disgorgement was in its reply in support of its motion for a stay pending appeal. *See* D.133. An argument that is first presented in a reply is waived. *Rik-Mik Enters. Inc. v. Equilon Enters.,* LLC, 532 F.3d 963, 976 (9th Cir. 2008); *Docusign, Inc. v. Sertifi, Inc.*, 468 F. Supp. 2d 1305, 1307 (W.D. Wash. 2006). Because the argument was not properly presented to the district court, this Court should not consider it. *In re E.R. Fegert, Inc.*, 887 F.2d 955, 957 (9th Cir. 1989) ("[t]he rule in this circuit is that appellate courts will not consider arguments that are not 'properly raise[d]' in the trial courts").

Qchex mistakenly contends that, because the Commission did not establish that the money awarded by the court is "money 'lost by consumers,'" the award constitutes damages. *See* Br. at 26. Qchex is wrong because, as explained above, the goal of disgorgement is to deprive a wrongdoer of ill-gotten gains, not to redress injured consumers. Thus, the measure of disgorgement is not the injury that Qchex caused, *i.e.*, the money lost by consumers, but the money Qchex received.[19]

Nor is there any merit to the arguments that Qchex raises regarding the amount of the disgorgement awarded by the district court. *See* Br. at 29-30. Qchex complains that the Commission did not present evidence regarding the amount of money that consumers and businesses lost as a result of Qchex's operation of the Qchex system. Br. at 29. But again, as explained above, the district court imposed a disgorgement remedy, not restitution, and the measure of disgorgement is Qchex's ill-gotten gains. Evidence of those gains comes directly from Qchex's tax returns. Indeed, as the district court found, these tax returns "constitute a reasonable approximation of profits causally connected to the violation." D.117 at 14 (AER at 28) (internal quotation marks and citation omitted).

Finally, although the district court speculated that there might have been some legitimate users of the Qchex system, *see* D.117 at 14 (AER at 28), this does not undermine its disgorgement award. *See* Br. at 29. As the court held, Qchex committed an unfair practice in violation of the FTC Act by operating the Qchex system, a system that, as a whole, lacked adequate verification. Because Qchex's unfair practice consisted of its operation of the Qchex system, the court required it to

[19] Of course, a court may choose to require that disgorged funds be used to compensate injured victims, but this does not alter the nature of the remedy. *SEC v. First Pacific Bancorp.*, 142 F.3d 1186, 1193 (9th Cir. 1998).

disgorge the entire revenue that resulted from the system. In any event, Qchex did not present any evidence demonstrating any legitimate use whatsoever of the Qchex system. Plainly, the district court did not abuse its discretion by requiring it to disgorge its entire revenue from the Qchex system.

CONCLUSION

For the reasons set forth above, this Court should affirm the decisions of the district court granting the Commission's motion for summary judgment, denying Qchex's motion for summary judgment, and imposing injunctive and monetary relief.

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CERTIFICATE OF SERVICE

I hereby certify that on June 18, 2009, I electronically filed the Brief of Plaintiff-Appellee Federal Trade Commission with the Clerk of the Court of the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system. I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

s/ Lawrence DeMille-Wagman

CERTIFICATE OF COMPLIANCE

I certify that this brief complies with Fed. R. App. P. 32(a)(7)(B). It is proportionally spaced and contains 11,405 words, as counted by the WordPerfect word processing program.

s/Lawrence DeMille-Wagman

STATEMENT OF RELATED CASES

There are no related cases.