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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

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

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 bankcode 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.

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.

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 9.9600 0.0000

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

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 Appel 0.0000 TD (oyed w)Tj 4.if

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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.

fraud. D.89, Att. 2 atFact

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

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 verificat

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. *Id.* at 18 (AER at 48).

This Court must determine,

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 than \$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 debited 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 wrongful conduct.

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.

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 is a mistake.

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 as 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 transactons were ‘bogus’ or ‘fraudulent’). However, what the court actually said was:

According to the Qchex da

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

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")Tj 25.3200 0.000t1 25.31200 0.0000 TD (")T

long been a part of the law of unfair competition.” At issue in *Winsted* was the labeling on cartons of underwear 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 *F*

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 (quot

Accusearch did not, itself, engage in theft or deception, but instead obtained the information from independ

See

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 daims 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

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

by such a beek turned out to be invalid. The district court correc

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

precisely what the Danforth declarations are: uncorroborated and self-serving.

Danforth daims that Qc

traditional checks (such as PayPal, internet chec

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

¹⁴ Qchexcontendsthatmandabry injunctionsareanextraordinaryremedy. Br. at 24 n.4, 25 n.5. But all the casesticites involve preliminary injunctions, whose purpose is to preserve the status quo *pe111.04j3.840d*

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 remedy¹⁵

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 defendant. The district court ordered the *Verity* defendants to pay restitution in the full amount lost by consumers. *FTC v. Verity Int’l,*

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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

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 rais[ed]’ 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

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 Commis

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 0 related cases.