IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 09-15684

FEDERAL TRADE COMMISSION,
Plaintiff–Appellee,

v.

NETWORK SERVICES DEPOT, INC.; NETWORK MARKETING LLC;
NETWORK SERVICES DISTRIBUTION, INC.; CHARLES V. CASTRO;
ELIZABETH L. CASTRO; GREGORY HIGH;
AND SUNBELT MARKETING, INC.,
Defendants–Appellants,

and

PHYLLIS WATSON,
Relief Defendant.

BRIEF OF PLAINTIFF–APPELLEE FEDERAL TRADE COMMISSION

(On appeal from the United States District Court for the
District of Nevada (No. 2:05-CV-00440-LDG-LRL))

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JURISDICTION

The Federal Trade Commission ("FTC" or "Commission"), filed a complaint on March 31, 2005 in the United States District Court for the District of Nevada, seeking equitable relief under Sections 13(b) and 19 of the Federal Trade Commission Act (FTC Act), 15 U.S.C. § 53(b) and 57b. AE:1-106.[1] The district court had subject matter jurisdiction over this matter pursuant to 28 U.S.C. §§ 1331, 1337(a), 1345, and Sections 5(a) and 13(b) of the FTC Act, 15 U.S.C. §§ 45(a), 53(b).

On March 5, 2009, the district court entered the final judgment against all Defendants. AE:1562-82. The notice of appeal was timely filed on April 3, 2009, pursuant to Fed. R. App. P. 4(a)(1)(B). AE:1583-1611. This court has jurisdiction pursuant to 28 U.S.C. § 1291.

STATEMENT OF ISSUES

1. Whether the district court properly granted summary judgment for the FTC on the question of individual Defendants' liability for equitable monetary

[1] "AE" refers to pages contained in Defendants–Appellants' Excerpts of Record. Unless otherwise indicated, the number(s) following "AE" reflects pagination. In addition, "Br." refers to the Defendants' opening brief. The number(s) following refers to the pagination in the electronic version posted on the Court's PACER site as of December 9, 2009. That pagination varies somewhat from the electronic version served on the FTC on October 14, 2009.

relief given their knowledge of, participation in and control over corporate Defendants' deceptive marketing and sales of Internet kiosks.

2. Whether the district court abused its discretion when it impressed a constructive trust on consumer funds received by Defendants through unlawful conduct and ordered Defense Counsel Jeffrey S. Benice to return $283,300 in attorney's fees that Defendants had paid from those funds.

STATUTES AND REGULATIONS

Pertinent statutes and regulations are set forth in the attached Addendum.

STATEMENT OF THE CASE

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

This appeal arises from an action by the FTC, pursuant to Sections 5 and 13(b) of the FTC Act, 15 U.S.C. §§ 45 and 53(b), and the FTC's Trade Regulation Rule titled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," formerly codified at 16 C.F.R. Part 436 (2005) ("Franchise Rule),[2] seeking preliminary and permanent injunctive relief, as well as equitable monetary relief, for Defendants' misrepresentations in the sale and

[2] The Rule has been replaced by two separate rules governing franchises and business opportunities which are now codified at 16 C.F.R. Parts 436 and 437. Citations herein are to the 2005 codification, which is set forth in the Addendum.

promotion of Internet kiosk business opportunities. Finding no genuine issues of material fact for trial, the district court granted summary judgment for the FTC on both the FTC Act and Franchise Rule counts and ordered permanent injunctive relief. The district court also concluded that the FTC had shown that individual Defendants Castro and High had the requisite knowledge to hold them personally liable for equitable monetary relief. AE:1280-81.[3]

The district court also determined that Defendants had paid Benice $375,000 in attorney's fees with funds derived from Defendants' unlawful Internet kiosk sales, thus subjecting those funds to a constructive trust, and ordered Benice to return $238,300 in consumer funds to the FTC. The district court rejected Defendants' claim that Benice was a purchaser for value and should be permitted to retain the funds, but ruled that it would, as an equitable matter, permit payment of Benice's reasonable attorney's fees through March 24, 2006. AE:1516. (March 24, 2006 is the date of an order (SER:27-30)[4] in which the district court indicated that the funds may be subject to consumer redress.) The district court subsequently

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[3] The FTC sought only injunctive relief with respect to defendant Elizabeth Castro.

[4] "SER" refers to pages contained in Plaintiff–Appellee's Supplemental Excerpts of Record. Unless otherwise indicated, the number(s) following "SER" reflects pagination.

accepted a stipulation between Benice and the FTC setting the equitable fee recovery at $136,700 while requiring him to return $238,300, assuming the district court was otherwise affirmed on appeal. AE:1558-59.

The present appeal attempts to challenge the district court's rulings on just two issues: (1) whether Castro and High had the requisite knowledge to be held personally liable for equitable monetary relief for corporate Defendants' violations of Section 5(a), and (2) whether Benice should return any consumer funds. Defendants do not challenge the district court's granting summary judgment that corporate Defendants violated the FTC Act and the Franchise Rule, that corporate Defendants formed a common enterprise, that Castro and High be subject to injunctive relief, or that they be personally liable for equitable monetary relief for corporate Defendants' Franchise Rule violations.

B. Facts and Proceedings Below

1. The Defendants and Their Deceptive Conduct

Four California companies owned by Defendants Charles and Elizabeth Castro were involved in an Internet kiosk business opportunity scheme that bilked consumers out of millions of dollars. The Internet kiosk was a stand-alone computer, placed in a public space such as an airport or hotel lobby, at which a user could log onto the Internet for a fee charged to the user's credit card. AE:4-5, 120; SER:1346. The lead company, Network Services Depot, Inc. (NSD), began marketing and selling Internet kiosk business opportunities to the public in 2001. AE:2-3; SER:742-44, 938, 1346.

A second company owned and run by Castro, Network Services LLC, d/b/a Network Services Marketing (NSM), began marketing and selling public payphones in 1998. AE:3, 108; SER:823. It became involved in Internet kiosks, among other ways, by acting as a primary intermediary in the "Diamond Program," SER:715, 776, 778-79, 793-94, 1054-55, a program which enabled consumers who initially had invested in unprofitable payphone business opportunities to roll over their investment into essentially worthless NSD kiosk business opportunities. SER:372, 473-74, 776, 778-79, 1054-55. Similarly, a third Castro company, Sunbelt Marketing, Inc. (Sunbelt), which had marketed and sold payphone business opportunities starting in 2000, AE:3, 108; SER:790-91, 824, helped market the Diamond Program to its customers as well. SER:793-94, 1055. A fourth Castro company, Network Services Distribution, Inc. (NSDist), began marketing and selling juke box business opportunities to the public in 2000, AE:3, 108; SER:766-67, 824, and, on at least one occasion, was involved in a transaction in which a purchaser exchanged his jukebox business opportunities for kiosk business opportunities. SER:234-36, 462.

The four companies formed a single enterprise. They shared ownership and management, AE:3, 109, 117, 119; SER:936, office space, AE:2-3, 108, 117, 119; SER:286, telephone numbers, SER:766, 790, 826-27, 1301-02, email addresses, SER:232, 571-74, 826, and employees, SER:436-37, 439-40, 790, 824-26. They were operated jointly. SER:263-67. Directly or indirectly, all were involved in the sale of Internet kiosks to consumers, as described above. SER:233-36, 776-779. Finally, they routinely transferred funds among themselves, SER:703-06, and in numerous instances one company paid the expenses of another, SER:704-05.

Defendant Charles Castro, president and an owner of each corporate Defendant, AE:3, 109, 117, 119; SER:1308, 1316-20, 1347, admitted that he controlled these companies and was active in their business affairs, SER:936, including participation in marketing and selling of kiosk business opportunities. His wife, Defendant Elizabeth Castro, was an owner, officer, and director of NSD and was also an owner of NSM, exercising control over its finances. SER:258, 262, 287, 1300, 1326, 1332-33.

Defendant Gregory High was the Vice President of Operations and general manager of NSD, SER:258, 276, 293, 437, 1267, as well as an employee of the other corporate defendants, SER:289, 438, 440. NSD specifically identified High as an NSD officer. SER:289. High was second in command at NSD, SER:1135, 1255-57, 1372, had authority to control NSD, SER:262, and participated in marketing and selling kiosk business opportunities. AE:602.

From 2001 through early 2004, NSD marketed and sold kiosk business opportunities. NSD offered to secure locations and arrange for installation and activation of Internet kiosks. SER:1308. It promoted the business opportunities through independent sales agents located nationwide, SER:1127, 1134, 1165, 1308, 1372, 1379-82, providing them and prospective customers with marketing and promotional materials, SER:490-563, 651, 664-87, 719-34, 753, as well as a disclosure document fashioned to look like an offering circular compliant with the Franchise Rule. SER:435, 442, 828. The offering circular included statements such as: "We will sell you one or more publicly-accessible Internet access terminal businesses, fully installed at a specific location selected by you from among available Sites we have identified . . . or at a Site which you own or lease or have secured yourself," SER:1351, and "Once you notify us of the Site you have chosen . . ., we will . . . install an Internet Access terminal at that site." SER:1354-55. The circular also represented that the kiosks would be operational, barring unforeseen circumstances, "no later than 60 days after the Effective Date of your Sales Agreement, or 30 days after you have submitted a Site Acceptance Notice for each Business, whichever is later." SER:1355.

In late 2001, NSD entered into a working arrangement with Mr. Ed Bevilacqua and his Internet kiosk companies, including Bikini Vending Corp., MyMart, Inc., Kiosk USA, and 360 Wireless Corp. (collectively referred to as "BVC"), whereby BVC agreed to purchase, find locations for, install, and manage Internet kiosks, and NSD agreed to promote and sell the business opportunities. AE:5; SER:939. NSD publicly offered each business opportunity for $4,400 to $7,000. SER:1063, 1328. As part of its management of kiosks, BVC said it would pay owners a fixed-minimum monthly payment, based upon the price paid for the business opportunity, plus a percentage of revenue above certain thresholds. SER:1309.

Under agreements between or among NSD, BVC, and purchasers, SER:1063-86, 1309, purchasers paid NSD for rights in specific Internet kiosks at designated locations, SER:827, 1061-86, and NSD promised to install the kiosks. SER:307. Although NSD had delegated the tasks of securing locations for and installing kiosks to BVC, NSD – not BVC – was contractually obligated to purchasers for these services. AE:5; SER:307, 939.

From at least late 2001, NSD made four false representations concerning kiosk business opportunities (SER:279-82, 664-87, 1282, 1308-09, 1327-31):

First, NSD misrepresented that the Internet kiosks would generate substantial revenues in the form of the fixed-minimum monthly payment (tied to the price paid for the business opportunity), plus a percentage of revenue above a certain threshold, SER:283-84, 754-55, 1309, amounting to an annual return of approximately 12 percent. SER:754-55. NSD's promotional material stated that kiosk purchasers could earn far more, ranging from $1,000/month to possibly as much as $1,000/day. SER:447-48, 535, 552, 680, 755. These representations were untrue and unsubstantiated. Actual revenues amounted to no more than $2,000/month for all installed kiosks combined. SER:959, 1007-53. Based upon the approximated installation of no more than 300 kiosks as of early 2004, SER:958, 1058, 1151, 1163, 1252, 1310, kiosks were "generating" less than $7.00/per month in revenue, not the $1,000/month (or more) promoted. In fact, consumers never received from BVC more than the fixed-minimum monthly payments, SER:959, 1061-62, 1169-70, 1310, and received those only because of the infusion of money from new purchasers. SER:959-60, 1086, 1310. Castro knew that the representations were reckless, if not false, testifying that he expected a typical kiosk would generate only $300- $400/month and that a kiosk generating $50/day was atypical. SER:298-99.

Second, NSD falsely represented that it found or would find profitable locations for kiosks. AE:9; SER:940, 1349. It did not find profitable locations and did not have rights to install kiosks at most locations designated on agreements with purchasers. SER:740-41, 829-33, 962, 1322-24. It also did not take steps to ensure that kiosks were located and installed. SER:323-29, 348-49, 359-60.

Third, NSD falsely claimed that purchasers would receive monthly payments representing revenue generated by their kiosk business opportunities. AE:9; SER:940. Rather than such monthly payments, kiosk purchasers received payments each month from funds that NSD had sent to BVC as a result of new purchases of kiosk business opportunities. SER:959-60, 1007-53, 1086, 1310. It was a classic Ponzi scheme.

Finally, NSD falsely claimed that consumers would acquire ownership of a working Internet kiosk business. AE:9; SER:940. By early 2004, consumers had purchased thousands of kiosk business opportunities from NSD, SER:958-60, 964-1053, 1310, but BVC, to whom NSD had delegated the installation task, had installed fewer than 300 units. SER:695, 958, 1058, 1151, 1163, 1252, 1310.

As seen above, Defendants marketed and sold Internet kiosk business opportunities using unsubstantiated claims and representations. To make matters worse, NSD and BVC erected a firewall between the two companies under which NSD did not intrude into BVC's installation and maintenance activities:

Ed's favorite saying was, 'Charlie and I have, like, a Chinese wall

> built between us.' That was his – and to some degree that was true. My role was to sell the machines. His role was to install, maintain, service, et cetera, the machinery, submit payments to the client of the machines. We were very careful not to cross those boundaries.

SER:334-35.

Despite promising purchasers to locate and install kiosks, and to do so within as little as 60 days, NSD received no written confirmation verifying that BVC had installed kiosks, SER:323-29, 348-49, 359, as Castro admitted:

> We never got anything in writing from them that would verify that there was a machine deployed. Generally, it was when the first check went out to the client. That's how it was verified, which is why you have invoices that reference invoices.

SER:328-29. In addition, NSD did not request photographs of kiosks as they were deployed, SER:327, did not generally visit sites outside of its immediate vicinity, SER:312-13, did not request location agreements between BVC and the specific locations that NSD assigned or customers chose, SER:310-11, 350-51, 353, 829, and did not request information from BVC relating to kiosk usage or profitability. SER:333-34, 742.

Defendants continued to market and sell kiosks, using the misleading offering circulars and PowerPoint presentations, until the house of cards came crashing down in March 2004. SER:340, 407, 680, 682. By early 2004, more than 450 consumers had purchased thousands of kiosk business opportunities directly from NSD, AE:6, SER:939, 1310, and more than 350 consumers purchased between 800 and 1,300 kiosks through the Diamond Program. SER:376, 473, 479-87, 621-47, 979-1006, 1266. These consumers paid an aggregate of more than $18 million to NSD and its affiliates. SER:702. In many cases, individual consumers invested thousand of dollars of retirement savings, which they largely lost, and suffered non-monetary injury. SER:1246-49.

2. Castro's and High's Participation in and Knowledge of Defendants' Deceptive Conduct

a. Castro

Castro participated in NSD's deceptive activities, representing to agents that their clients would receive monthly payments based on kiosk usage, SER:363-64, 448, 451, 1376, 1383, approving and delivering PowerPoint presentations that contained the $1,000/day claim, SER:447-48, 535, 651-52, 680, representing that NSD found or would find profitable kiosk locations, SER:445, 447-48, 493, 522, and boasting that NSD had contracts with national companies for kiosk installations. SER:1377-78. Castro signed documents warranting to purchasers that a kiosk, which a purchaser would own, SER:654, 692, 827, 1097-1108, 1236-45, was currently operating or soon would be operating at a contractually specified location, SER:1093-1109, 1171-86, and transferring rights to operate the kiosk at particular locations. SER:827, 1093-94, 1145-46.

Castro was deeply involved in NSD's internal operations. He trained NSD's sales agents, SER:743-44, supervised NSD employees, SER:293, and had editorial control over NSD's and its agents' advertisements and written presentations. SER:341-43, 367-68, 431, 663, 744-45, 757. Castro was responsible for approving the sites NSD provided to purchasers for their kiosk business opportunities. SER:295-96, 738. He purportedly ensured that NSD's operation was legally compliant. SER:343-46.

Castro also frequently communicated with Bevilacqua, with and for whom he often marketed the program, and NSD's agents. SER:240-45, 275, 278, 281, 309-10, 314-15, 356-57, 1258-65, 1281-84. As one purchaser with routine contact with Castro and Bevilacqua put it:

> it always seemed to me that [Charlie] and Ed were quite close and knew the internal details of the other's business. Every time that I called one of them to ask a question, he would need to check with the other before getting back to me. I cannot fathom that Charlie did not know that something was wrong with the program.

SER:716. Castro, however, recklessly did not breach the firewall to substantiate his own firm's representations in its offering circulars and marketing materials.

At least as early as October 2003, Castro was aware that people were going to locations where BVC had supposedly installed kiosks and finding none.

SER:322-23, 348-49, 401-05, 428-29, 471. In November 2003, one purchaser informed Castro that Bevilacqua had told him that only ten percent of the machines that he had purchased six months earlier had been installed. SER:268-71, 395-400, 412-14, 421-22, 426-27, 715-18. Emailing Bevilacqua in December 2003, Castro described the problem of clients visiting sites where no kiosk existed as becoming a "huge" issue. SER:428-30. Furthermore, on December 5, 2003, Bevilacqua informed Castro that BVC was behind in installing kiosks. SER:320-21. Castro, however, took no steps to determine whether BVC eventually installed these or any other kiosks. SER:324-29, 348, 359-60, 377, 407-09, 412-15.

Castro knew that BVC's obligations to install kiosks jumped dramatically in 2003. SER:307-08, 314, 323. While BVC had to install more than 1,300 kiosks in bowling centers, SER:465-66, 575-615, Castro visited only two sites. SER:351-52. He was aware that, during the first half of 2003, SER:374-75, BVC was obligated to install between 800 and 1,300 kiosks for Diamond clients, while telling Diamond consumers that it would take "4-6 months to get all the kiosks installed" because the number of kiosks to be transferred had grown and BVC could install only 200 to 300 kiosks per month. SER:375-76, 1266. Castro took no steps to ensure that kiosks were being installed at this rate. SER:377. Nor did he wait for BVC to install kiosks for the Diamond clients before continuing to sell more kiosks. SER:340.

Castro also received complaints from agents about BVC's failure to provide purchasers with an accounting of the revenues generated by their machines, SER:242-43, 247-52, 656-59, and its failure to provide agents with BVC's financial statements in a timely manner. SER:649-50. He also heard complaints about difficulties agents had communicating with BVC. SER:338-39.

Despite his awareness of problems with NSD's kiosk program, Castro continued aggressively marketing and selling kiosks using NSD's misleading offering circular and promotional materials. SER:340, 407, 680, 682. NSD made more than half of its gross sales for the entire four years that it operated in the six months leading to March 2004. SER:323, 464, 699-700. NSD also took in more than $5 million in the first few months of 2004 alone. SER:410-11.

b. High

High was actively involved in the marketing and selling of the kiosk business opportunities, as well. He was in charge of, among other things, "compliance issues, legal questions, document questions, offering circulars, and program descriptions" at NSD. SER:433-34, 1374. He helped create NSD's marketing material for its agents and clients. SER:144-52, 294, 450, 488-89, 564, 745. He disseminated these materials along with sales and management agreements. SER:153-76, 452-54. He also sent approved advertising to agents and reviewed advertisements that they proposed. SER:455-57, 565-70, 808.

High regularly communicated with BVC and Bevilacqua. SER:177-79, 294, 337. He was in charge of assigning NSD's clients sites for their kiosk business opportunities, SER:293-95, 801, and consulted with BVC regarding what sites to offer. SER:180, 463, 467-68, 616. To speed the process of assigning sites, in January 2004 Bevilacqua gave High permission to sign BVC notices of assignment, which assigned to NSD BVC's rights to operate kiosks. SER:181-82. High was the "primary person responsible for monitoring Bikini's site installation and location data" and had access to BVC's Intranet site "to keep [NSD] updated as to kiosk installation." AE:501.

High continued to assign locations even though he was aware of occasions where kiosks were not installed where they were supposed to be and that BVC was behind in installation. SER:186-87, 461. Agents contacted him when clients inquired about their installed kiosks but found none. SER:328-39, 425, 460, 618-20. He was aware that Diamond Program customers, who had agreed as early as 2002 to payphone-for-kiosk exchanges, were still waiting to receive kiosks as late as June 2003. SER:189, 192-229, 474, 477-78, 571-74. To discourage customers' visiting supposed installed kiosk locations, in October 2003 he purposely assigned kiosks in locations far from where purchasers and their agents resided. SER:470, 617. On at least one occasion, High visited several locations and found that the kiosks had not been installed. SER:467-68, 616. While he confronted Bevilacqua, who conceded that the kiosks were not installed and probably had not been reassigned to new locations, SER:616, High did not take steps to discover if BVC eventually installed purchased kiosks, SER:469, despite having the means to do so.

3. Defendants' Retention of Counsel

While Defendants ran the above-described Internet kiosk business opportunity scam, Castro regularly and frequently transferred funds that his companies took from consumers among numerous accounts held in the companies', his own, and his family members' names. AE:127-39. At least $888,000 of funds traceable to corporate Defendants ended up in accounts in the name of Castro's mother-in-law, Phyllis Watson, as "trustee," for the benefit of his children ("Custodial Accounts"). AE:136, 172; 185; SER:852, 899. These funds were eventually transferred to Defense Counsel. *See infra*.

In November 2004, FTC counsel met with then counsel for Defendants, Peter Spivack, and expressed their belief that Defendants were liable for violations of the FTC Act and the Franchise Rule. SER:890, 933. Shortly thereafter, FTC counsel provided Spivack with a draft complaint so alleging. SER:9-24, 934. The next month, Castro signed a sworn financial disclosure statement stating that the Custodial Accounts held $839,494, SER:899, and that he had roughly $25,000 in personal accounts. SER:898

On January 6, 2005, Phyllis Watson withdrew $888,112 from the Custodial Accounts in the form of a cashier's check, which she then signed over to the Castros. AE:129; SER:915, 925. That same day, Castro and Spivack participated in a phone interview with FTC staff during which FTC staff questioned Castro about the funds in the Custodial Accounts. SER:890-91, 919, 934. Castro asserted that the Custodial Accounts contained the funds of a revocable trust set up years earlier. SER:891. He did not disclose that he had depleted the accounts earlier that day, *id.*, nor did he respond to follow-up requests for information about the formation and funding of the "trust." SER: 919, 922-24.

On January 14, 2005, while settlement negotiations with the FTC were ongoing, Castro signed a retainer agreement with Benice and paid him $375,000 for future legal services. AE:255-259. The agreement designated all fees as "earned on receipt," earmarking them as follows (not including contingency fees): $85,000 for FTC proceedings; $35,000 to pursue a private action against Bevilacqua; $220,000 for any pending state regulatory matters; and $35,000 for the forfeiture action. *Id.* Castro explained that he "negotiated these retainer agreements in good faith for the purpose of preserving [his] assets and professional reputation." AE:176. According to his sworn financial disclosures, at the time of the transfers the funds in the Custodial Accounts constituted more than 90% of the Castros' liquid assets. SER:892-913. Castro earlier had also engaged Marc Forsythe as co-Defense Counsel, paying him a $500,000 "earned upon receipt" fee. AE:250-54.[5]

On February 2, FTC counsel notified Spivack that the FTC was terminating settlement discussions with Castro because of his failure to comply with requests for information regarding the "trust" funds. SER:919-20, 934. Castro never informed FTC staff that he had transferred the funds to his counsel, SER:919-20, and later explained that "I didn't 'surreptitiously' tell Ms. Watson to withdraw funds to pay my new counsel. I simply did not tell the FTC . . . of my business and legal strategy." AE:178. Spivack also notified FTC counsel that Benice and Forsythe would be representing Castro going forward. SER:934.

On April 7, the district court froze Defendants' assets, including assets that

[5] On February 7, 2005, Forsythe's firm returned some retainer funds, writing a check for $270,000 made out to "Phyllis I. Watson, trustee of Castro's Children's Trust," a newly formed, allegedly irrevocable trust. SER:854-55, 918, 932.

third parties held on behalf of, or for the benefit of, Defendants. SER:953-55. Meanwhile, Castro submitted a sworn statement to the FTC representing that the $839,494 still remained in (*i.e.*, had not been transferred from) the Custodial Accounts. SER:913a. In fact, those funds had been dissipated, and Defendants failed to disclose that they had transferred the funds to Defense Counsel. SER:950-51. Benice also admitted that he believed that a substantial portion of the Custodial Account funds had been used to pay attorney's fees. SER:920-21. On April 27, FTC counsel notified Defense Counsel that they believed the Retainer Funds were subject to the district court's asset freeze and requested copies of the retainer agreements. SER:926-31.

4. Proceedings Below

a. Liability Under the FTC Act and Franchise Rule

On November 29, 2005, the FTC moved for summary judgment on the question of Defendants' liability under Section 5(a) of the FTC Act, 15 U.S.C. § 45(a), and the Franchise Rule, 16 C.F.R. Part 436 (2005). The district court readily found that the FTC's evidence that NSD misrepresented the amount of income that purchasers would earn, the availability and existence of profitable kiosk locations, the source of monthly payments, and the very existence of the kiosks amounted to material conduct that misled reasonable consumers. AE:1278-

83.

In particular, the district court found that NSD raised no genuine issue of fact regarding NSD's misrepresentations about locating and installing kiosks, finding "pivotal" NSD's obligation to locate and install kiosks, despite the delegation of the task to BVC. AE:1278. "NSD's sales agreement and offering circular, however, incontrovertibly obligated NSD to locate and install the kiosks, and it was a misrepresentation of NSD to so promise given defendants' knowledge that the installations were not being done, or their reckless disregard for why." *Id.* The district court found that the Defendants had not raised a genuine issue of material fact regarding their false earnings claims. AE:1281-82. The court also rejected Defendants' argument that their profit claims were not false because they were based on a viable business model, finding actual, not theoretical, profitability to be material. AE:1282. The court also ruled that Defendants "failed to adequately contest . . . that the corporate defendants formed a common enterprise." AE:1283.

The court concluded that Defendants had also violated the FTC's Franchise Rule. AE:1283-84. It held that there was "no genuine issue of fact regarding defendants' violation of the Franchise Rule," because the court had rejected Defendants' claim that they engaged in no improper conduct. AE:1284. It said that the Franchise Rule "provide[d] an alternative basis for the court's judgment." *Id.*

The district court also concluded that Castro and High were individually liable for equitable monetary relief for NSD's violations of the FTC Act and the Franchise Rule, because they "were recklessly indifferent to the truth or falsity of the representations [NSD] was making to consumers." AE:1279. "The facts put Castro and High, as sophisticated businessmen in the field, on notice of installation and other problems, and they recklessly disregarded those warnings." AE:1281. The district court found that the individual defendants knew that kiosks were not being installed and should have verified BVC's performance. "Instead, not only did Castro take a hands-off approach to Bevilacqua's operation, but he complied with and perpetuated a 'Chinese Wall' between NSD and BVC regarding installation and maintenance activities." AE:1279. The court found that Castro's own incredulity in the face of BVC's exaggerated claims about the pace at which BVC could locate and install Internet kiosks reflected his "awareness of a high probability of fraud" as well "intentional avoidances of the truth." AE:1280. The court also rejected Defendants' claims that they were duped by BVC and did not become aware of BVC's failure to install kiosks until March 2004. AE:1280-81.

b. Defense Counsel's Return of Consumer Funds

On June 23, 2005, the FTC filed a motion for an order freezing funds transferred from the Custodial Accounts to Defense Counsel. SER:858-89. When the district court granted the FTC's summary judgment motion, it ruled that a constructive trust should be impressed on $270,000 from the Custodial Accounts that had been paid to Forsythe, but subsequently returned. AE:1283. Following supplemental briefing, the district court on September 17, 2007, ruled that the FTC had "established by clear and convincing evidence that the fee funds derive from corporate defendants' proceeds, that defendants' acquisition of the funds was wrongful, and that the FTC is entitled to the proceeds for consumer redress." AE:1515. Because it impressed the constructive trust, the court did not address "whether the transfer was fraudulent or violated the asset freeze." *Id.* It permitted Defense Counsel to seek equitable fee recovery through March 24, 2006, the date when the court had previously indicated that funds from the Custodial Accounts might be set aside for consumer redress. AE:1515-16.[6]

On January 7, 2009, the district court rejected Benice's request for attorney's fees calculated based upon a $475 hourly rate, finding it unsupported, and instead

[6] The FTC and Forsythe settled Forsythe's obligation to return consumers funds to the FTC. SER:3-7.

ordered him to re-file his request using a $300 hourly rate. SER:1-2. Benice filed a revised request for $194,382 on February 4, 2009, and on February 26, 2009, the district court accepted the FTC's and Benice's stipulation that he would receive $136,700 in fees and costs, if the district court's order requiring return of attorney's fees were not otherwise overturned. AE:1557-61. The district court entered final judgment on March 5, 2009, in which it ordered Benice to segregate $238,300 and return that money within 10 days of Benice's receiving actual notice of the final judgment. AE:1572-73.

Benice did not seek a stay of the final judgment, nor has he complied with it. On September 15, 2009, the FTC filed a "Motion for an Order to Show Cause Why Jeffrey S. Benice and Jeffrey S. Benice, a Professional Law Corporation Should Not Be Held in Civil Contempt and Memorandum in Support," which is now pending in the court below.

SUMMARY OF THE ARGUMENT

The Court should affirm the district court's granting summary judgment to the FTC regarding Castro's and High's liability for equitable monetary relief for NSD's unlawful marketing and sales of Internet kiosk business opportunities. The FTC alleged and the district court determined that Defendants had violated Section 5(a) of the FTC Act, as well as the Franchise Rule. Defendants do not challenge the district court's conclusion that Castro and High had the requisite knowledge of NSD's failure to disclose information required by the Franchise Rule, so the district court's ordering Castro and High to pay consumers redress for the Franchise Rule violations should not be reversed. In any event, Defendants' claim that Castro and High did not know about problems with NSD's Internet kiosk program until March 2004 does not negate their knowledge of or reckless disregard for NSD's Franchise Rule disclosure failures. The Court, thus, may affirm the district court without reaching Castro's and High's liability for the Section 5(a) violations.

If it reaches Defendants' Section 5(a) argument, the Court should still affirm. The record is replete with evidence, such as complaints about non-existent kiosks and revenues, that Castro and High participated in and knew about NSD's deceptive marketing of Internet kiosks. As participants in NSD's deception, they personally wooed consumers nationwide with promises of profitable kiosk locations, monthly payments generated by kiosk usage, and substantial annual returns, all the while knowing that the claims were untrue or unsubstantiated. The FTC's substantial and specific evidence showed that Castro and High had actual knowledge of NSD's kiosk problems and its continued misrepresentations. At a minimum, the evidence showed that they were recklessly indifferent to these problems and whether their representations regarding the kiosks were true, and they had awareness of the high probability of fraud. The district court correctly granted summary judgment for the FTC, because Defendants did not offer evidence putting the issue of their knowledge in dispute.

The district court correctly concluded that "there is no room for defendants to claim that Castro was being duped by Bevilacqua about there being no significant problems with installation of kiosks." AE:1280-81; *see also* 1283 (High). The firewall behind which Castro and High hid from performing due diligence for NSD's kiosk program did not shield them from knowledge of the program's problems. They had actual knowledge and both worked closely with BVC to promote kiosk sales and coordinate kiosk locations. They had the means to pursue kiosk problems, even if they chose to look the other way. Defendants' general denials of knowledge could not overcome this detailed and specific evidentiary record proving their knowledge.

The district court did not abuse its discretion when it impressed a constructive trust on consumer funds received by corporate Defendants as a result of their deceptive conduct and used by Castro to pay Benice. Whether using a tracing method that favors Defendants or one that favors consumers, the FTC proved with clear and convincing evidence, which Defendants did not rebut, that funds in those accounts traced to Defendants' unlawful conduct. The district court's conclusion was also supported by its finding that Defendants formed a common enterprise, as well as unrefuted evidence that all corporate Defendants directly or indirectly participated in and benefitted from the unlawful conduct. Accordingly, the Defendants' commingling of the consumer funds with other revenues did not immunize funds in the Custodial Accounts from impression of the constructive trust.

Nor did the district court err in ordering Benice to return $283,300 to the FTC for consumer redress. Benice had notice that the funds used to pay his "earned upon receipt" retainer could be tainted, because the FTC had already communicated to Defendants its intent to file suit alleging FTC Act violations by the time they retained him. Nevertheless, he failed to discharge his duty to determine that the funds, in fact, came from lawful activities. The steps Benice claims to have taken, such as considering whether Internet kiosks were a viable business model, did not suffice to discharge his duty. As a result, Benice was not a purchaser for value, and the constructive trust remained on the consumer funds after Defendants transferred them to Benice. The district court correctly ordered Benice to return those funds.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY DETERMINED THAT THERE WERE NO GENUINE ISSUES OF MATERIAL FACT FOR TRIAL

A. Standard of Review

This Court reviews a grant of summary judgment *de novo, Dias v. Elique*, 436 F.3d 1125, 1128 (9th Cir. 2006); *Qwest Comm'ns, Inc. v. Berkeley*, 433 F.3d 1253, 1256 (9thCir. 2006), and may affirm on any ground supported by the record. *Applied Info. Sciences Corp. v. eBay, Inc.*, 511 F.3d 966, 973 (9th Cir. 2007). The appellate court's review is governed by the same standard used by the trial court. *Qwest Comm'ns*, 433 F.3d at 1256. On review, the appellate court must determine, viewing the evidence in the light most favorable to the non-moving party, whether there are any genuine issues of material fact and whether the district court correctly applied the relevant substantive law. *See Olsen v. Idaho State Bd. of Medicine*, 363 F.3d 916, 922 (9th Cir. 2004); *Balint v. Carson City*, 180 F.3d 1047, 1054 (9th Cir. 1999). Summary judgment is proper when a rational trier of fact would not be able to find for the non-moving party on the claims at issue. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986).

B. Because Defendants Do Not Challenge Castro's and High's Personal Liability for Franchise Rule Violations, the Court May Affirm Without Reaching Their Liability for Defendants' Section 5(a) Violations

At the outset, the FTC urges the Court to affirm the district court without reaching Defendants' claim (Br. 21, 28) that, because of BVC's alleged concealment, Castro and High were ignorant of BVC's failure to locate and install kiosks and so should not be personally liable for equitable monetary relief under Section 5(a) of the FTC Act. The district court held that the Franchise Rule violations "provided an alternative basis for the court's judgment." AE:1584. Defendants, however, have neither raised nor briefed Castro's and High's monetary liability for the Franchise Rule violations, and so the issue is not before the Court. *See Entertainment Research Group, Inc. v. Genesis Creative Group, Inc.*, 122 F.3d 1211, 1217 (9th Cir. 1997) (Court will not consider claims not argued in defendants' opening brief).[7] Even if, despite the FTC's arguments, the Court were to reverse the district court's rulings regarding Castro's and High's

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[7] The Court in *Entertainment Research*, quoting *Greenwood v. FAA*, 28 F.3d 971, 977 (9th Cir. 1994), stated: "We review only issues which are argued specifically and distinctly in a party's opening brief. We will not manufacture arguments for an appellant, and a bare assertion does not preserve a claim, particularly when, as here, a host of other issues are presented for review. As the Seventh Circuit in *Dunkel* stated aptly: "judges are not like pigs, hunting for truffles buried in briefs." 122 F.3d at 1217; *see also Principe v. Ukropina (In re Pac. Enters. Sec. Litig.*, 47 F.3d 373, 379 n.6 (9th Cir. 1995).

personal liability for Defendants' Section 5(a) violations, the district court's rulings regarding Castro's and High's liability for Franchise Rule violations would remain unchallenged.

The Franchise Rule requires franchisors and franchise brokers to provide a complete and accurate disclosure document. AE:1283-84. The FTC showed that Defendants (1) failed to provide prospective franchisees with accurate and timely disclosures, in violation of 16 C.F.R. § 436.1(a) (2005), regarding the time lapse between business opportunity purchase and operation, as well as the number of operational kiosks and the financial condition of BVC from whom NSD obtained the kiosks; (2) made earnings claims to prospective franchisees that lacked a reasonable basis, failed to inform prospective franchisees that material that constituted a reasonable basis was available to them, and were not supported by a proper earnings claim document, all in violation of 16 C.F.R. § 436.1(b)-(c) (2005); and (3) generally disseminated earnings claims, in violation of 16 C.F.R. § 436.1(e) (2005), without timely disclosing information required by the Franchise Rule, including the number and percentage of prior purchasers known to Defendants to have achieved the same or better results. AE:10-12; SER:119-21, 125, 129. Pursuant to 15 U.S.C. § 57b(b), the FTC could seek "such relief as the court finds necessary to redress injury to consumers . . . resulting from the rule violation." The district court agreed with the FTC that Defendants violated the Franchise Rule, AE:1281-82, 1284, 1563-64, and accordingly ordered Castro and High to pay consumer redress. AE:1569-70. Defendants do not challenge these rulings, limiting their appeal to Castro's and High's knowledge of the Section 5(a) violations. Br. 4, 28-30.

In any event, Defendants' claim (Br. 21, 28) that Castro and High were ignorant of problems with the kiosk program would not shield them from consumer redress liability for the Franchise Rule violations. NSD's Franchise Rule disclosure violations were independent of BVC's failure to install kiosks. The kiosks that *were installed* failed to generate the revenues NSD represented, thus violating the Rule's earnings claims requirements. 16 C.F.R. § 436.1(b)-(c) (2005). Even with installed kiosks, NSD violated the Rule's advertising disclosure requirements, 16 C.F.R. § 436.1(e) (2005), by misrepresenting information about earnings achieved by prior kiosk purchasers. NSD's offering circular also did not accurately describe BVC's financial condition, in violation of 16 C.F.R. § 436.1(a) (2005). Castro's and High's knowledge and responsibility for these disclosure violations, SER:343-46, 433-34, 1374, which Defendants do not challenge, would remain. Accordingly, the Court can affirm the district court's ordering Castro and High to pay monetary redress for Franchise Rule violations without reaching the issue of their liability for Section 5(a) violations.

C. The District Court Correctly Concluded That the Individual Defendants Failed to Controvert the Commission's Showing That They Had Knowledge of the Corporate Defendants' Deception

1. Individual Defendants' Knowledge of Deceptive Conduct Creates Personal Liability

An individual may be held liable for *injunctive* relief for a corporation's violations of the FTC Act, if a court finds that the individual (1) participated in the deceptive practices or (2) had authority to control them. *FTC v. Publishing Clearing House*, 104 F.3d 1168, 1170 (9th Cir. 1997); *FTC v. Amy Travel Servs., Inc.*, 875 F.2d 564, 573 (7th Cir. 1989). Authority to control can be evidenced by "active involvement in business affairs and the making of corporate policy, including assuming the duties of a corporate officer." *Amy Travel*, 875 F.2d at 573; *see also FTC v. NCH, Inc.*, 1995-2 Trade Cas. (CCH) ¶ 71,114 at 75,351 (D. Nev. 1995), *aff'd*, 106 F.3d 407 (9th Cir. 1997); *FTC v. American Standard Credit Sys., Inc.*, 874 F. Supp. 1080, 1089 (C.D. Cal. 1994); *FTC v. Jordan Ashley, Inc.*, 1994-1 Trade Cas. (CCH) ¶ 70,570 (S.D. Fla. 1994).

To obtain *equitable monetary relief* from an individual for corporate misconduct, the FTC must also show that the individual had knowledge of the deception. *Publishing Clearing House*, 104 F.3d at 1171. Knowledge can be demonstrated by showing actual knowledge of material misrepresentations, reckless indifference to the truth or falsity of the misrepresentations, or an awareness of a high probability of fraud along with an intentional avoidance of the truth; the Commission need not show intent to defraud. *Id.; FTC v. Wolf*, 1997-1 Trade Cas. (CCH) ¶ 71,713 at 79,080 (S.D. Fla. 1996). The extent of an individual's participation in the unlawful conduct may alone be sufficient to establish the requisite knowledge. *FTC v. Affordable Media, LLC*, 179 F.3d 1228, 1235 (9th Cir. 1999) (*citing FTC v. Sharp*, 782 F. Supp. 1445, 1450 (D. Nev.1991)); *Amy Travel*, 875 F.2d at 574.

Castro and High do not challenge the district court's granting summary judgment for the FTC on the issue of their (as well as Elizabeth Castro's) liability for injunctive relief. The issue is not raised in their brief's Statement of Issues, Defendants Br. 1-7, or the portion the Statement of Facts that serves as the brief's legal argument, *id.* at 28-30. While their brief's factual recitation denies High's corporate officer and management roles, as well as his participation in NSD's deception, Br. 14, Defendants present no arguments that his (or Castro's) level of participation and control did not suffice for individual liability for injunctive relief.[8] The sole issue before this Court regarding the Defendants' individual liability is whether they possessed the requisite knowledge for equitable monetary relief. As shown below, they have failed to put that issue in dispute.

2. The District Court Correctly Concluded That Individual Defendants Had Knowledge of NSD's Deceptive Conduct

Defendants assert that, because they "presented unequivocal evidence that they had no knowledge of Bikini's and Bevilacqua's scheme and did not participate with Bikini and Bevilacqua in the scheme, the District Court could not grant summary judgment for the FTC." Br. 14. They also claim that the district court ignored their evidence in opposition to the FTC's request for summary judgment on the Section 5(a) claim. Br. 12. Assuming it reaches this issue, the Court should find that Defendants have failed to identify genuine issues of material fact precluding summary judgment for the FTC.

Defendants' belief that they were victims of BVC's fraud should not cause the Court to lose sight of the FTC's allegations and evidence, as well as the district court's assessment of the summary judgment record. Defendants marketed and

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[8] In any event, the assertions regarding High's level of participation in and control over the activities of corporate Defendants were made in unsubstantiated affidavits, which were not an adequate basis to place the issue in dispute given the Commission's overwhelming evidence proving High's control and participation. *Publishing Clearing House*, 104 F.3d at 1171.

sold their Internet kiosk business opportunity using offering circulars and promotional materials that contained material misrepresentations about the amount of income that purchasers would earn, the availability and existence of profitable kiosk locations, the source of monthly income and the very existence of the kiosks. Rather than taking steps to substantiate their marketing claims and to ensure that NSD's kiosk program ran as represented, Defendants delegated their responsibilities to BVC and erected a firewall between themselves and BVC.

That firewall did not keep Castro and High in the dark about problems with NSD's kiosk program. Evidence mounted that BVC was not locating and installing kiosks, not communicating with customers, and not paying them the substantial sums promoted by Defendants. Castro and High knew about, yet ignored, these problems and continued selling. In so doing, they defrauded consumers out of millions of dollars. Defendants are mistaken when they claim that the district court ignored or disbelieved their claims that they were duped by BVC. Br. 29. Rather, the district court concluded that Defendants' claims lacked evidentiary support and were belied by overwhelming record evidence to the contrary.

The district court concluded that Castro and High had notice of kiosk installation and other problems, recklessly disregarded the truth or falsehood of those problems and had awareness of the high probability of fraud coupled with intentional avoidance of the truth. AE:1280, 1281. These determinations were supported by direct evidence of their knowledge of problems with the kiosk program, as well as by their personal involvement and control over NSD's, and purposeful avoidance of BVC's, activities. *Affordable Media,* 179 F.3d at 1235.

a. Castro and High had direct knowledge

There is substantial evidence of Castro's direct knowledge of NSD's Internet kiosk problems and its continued deceptive conduct. He knew that purchasers were going to supposed kiosk locations and finding none installed. SER:322-23, 348-49, 401-05, 428, 471. Castro acknowledged the existence of the missing kiosks in a December 2003 email to Bevilacqua, calling it a "huge" issue, SER:428, 430, and Bevilacqua confirmed that BVC was behind in installations. SER:320-21. He also received complaints from agents about BVC's failure to provide purchasers with an accounting of the revenues generated by their machines, SER:242-43, 247-52, 656-58, about BVC's failure to provide agents with BVC's financial statements, SER:649-50, and about difficulties agents had communicating with BVC. SER:338-39. Still, Castro continued marketing and selling kiosks until March 2004. SER:340.

Likewise, High knew about the kiosk problems and that NSD's kiosk activities were deceptive. Agents contacted High about non-existent kiosks, SER:230-31, 238-39, 425, 460, 618-20, and he admitted to having received as many as 30 complaints. AE:604. He visited several locations and found that kiosks had not been installed. SER:467-68, 616. When he asked Bevilacqua about missing kiosks, Bevilacqua conceded that they had not been installed or reassigned to other locations. SER:616. Despite his knowledge of uninstalled kiosks, High continued to assign kiosks to purchasers, including strategically selecting (at BVC's request) locations far from where agents and purchasers resided. SER:470, 617.

b. Castro and High were reckless

Even if Castro and High did not have direct knowledge of problems with NSD's kiosk program and continued deception, there is overwhelming evidence of their recklessness and their awareness of a high probability of fraud. Despite the fact that NSD remained contractually bound to locate and install kiosks, Castro agreed to a firewall between NSD's and BVC's operations, SER:334-35, and NSD took no steps to ensure that kiosks were being located and installed by BVC. SER:324-25, 328-29, 359-60, 377, 406-09, 412-15, 423-24. NSD also did not request information from BVC relating to kiosk usage or profitability. SER:333-34, 741-42.

Further evidence of Castro's recklessness is his continued lack of due diligence in the face of a dramatic rise in kiosk purchases in 2003 and early 2004. Despite his awareness of growing kiosk sales, Castro took no steps to ensure that kiosks were being installed at a sufficient rate. SER:377-78. Nor did he wait for BVC to install kiosks for the Diamond Program before continuing to sell more NSD kiosk business opportunities. SER:340.

Castro's recklessness is all the more evident given his own incredulity at Bevilaqua's kiosk claims.

> Castro also testified that the estimates that Bevilacqua gave for installing machines (20,000 over eighteen months, or even thirty months) "made [Castro] want to choke." Castro was therefore not only aware of such exaggerations, but indifferently accepted Bevilacqua's words and excuses even though he knew Bevilacqua to stretch the truth.

AE:1280. Nonetheless, Castro agreed to a firewall and continued selling. SER:323-25, 328-29, 340, 347-50, 377-78, 407-09, 412-15, 423-24.

Castro's recklessness is also demonstrated by the exaggerated earnings claims made by NSD. NSD promotional material stated that a kiosk would generate as much as $1,000/month, SER:754-55, and possibly as much as $1,000/day. SER:447-48, 535, 680. There was no substantiation for such revenue levels, and actual revenues from *installed kiosks* averaged only $7.00/month.

Further evidence of Castro's recklessness regarding the $1,000/month claim was his awareness that a typical kiosk would generate only $300 to $400/month and that kiosks generating as much as $50/day were atypical. SER:298-99.

Like Castro, High ignored evidence of NSD's deception. Although he had the means to determine whether and where kiosks were being installed, such as responsibility for assigning kiosk locations and access to BVC's database of supposedly installed kiosks, AE:501; SER:293-95, 801, he did not take steps to discover if BVC had, in fact, installed kiosks on behalf of NSD's clients, SER:469, even in the face of numerous complaints.

c. Castro and High were deeply involved

Castro's and High's extensive participation in NSD's activities further supports the conclusion that they had knowledge sufficient for personal monetary liability. *Affordable Media*, 179 F.3d at 1235. Castro was an NSD officer and owner. AE:3, 119; SER:286-87, 1316-20, 1347. As detailed above, Castro helped develop NSD's marketing and promotional materials and communicated with agents and customers. SER:334, 336-37, 448, 518-63. Through these activities, he misrepresented the existence, profitability and locations of kiosks. SER:445, 447-48, 493, 521, 1129, 1377-78. He misrepresented that purchasers would own kiosks and receive revenues from their use. SER:448, 451, 543, 654, 689, 692-93, 1093-

1109, 1171-86, 1373, 1383.

High's control over and involvement in NSD's activities were also extensive. Besides being an officer of NSD and manager, SER:257-58, 276, 286, 289, 293, 437, 1267, he had responsibility for legal compliance, SER:433-34, 1374, created and disseminated promotional material, SER:144-52, 294, 450, 488-89, 564, 745, and communicated with agents and customers. SER:179, 183-89, 229, 237, 276-77, 805-07, 1268-80. He also promoted the Diamond Program. SER:189, 192-228, 474, 477-78, 571-74.

In short, Castro's and High's participation in NSD's activities are "strong evidence" of their knowledge of problems with NSD's kiosk program and its continued misrepresentations. *See Affordable Media*, 179 F.3d at 1235. The district court correctly held them personally liable for equitable monetary relief.

3. Defendants' Claims of Ignorance of Uninstalled Kiosks and Other Problems Lacked Support and Did Not Create Genuinely Disputed Facts

The Commission's overwhelming evidentiary submission satisfied its burden to prevail on summary judgment. *See Celotex Corp. v. Catrett*, 477 U.S. 317, 323 (1986). The burden then shifted to Defendants to show that genuine issues remained for trial. *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 250 (1986). Defendants needed to "do more than simply show that there [was] some metaphysical doubt as to the material facts." *Matsushita*, 475 U.S. at 586. Rather, Rule 56(e) provides that "an opposing party may not rely merely on allegations or denials in its own pleadings," but must come forward with "specific facts showing a genuine issue for trial." Fed. R. Civ. P. 56(e); *See also Matsushita*, 475 U.S. at 587; *FTC v. Gill*, 265 F.3d 944, 954 (9th Cir. 2001) (*quoting Liberty Lobby*, 477 U.S. at 249-50)); *see also Publishing Clearing House*, 104 F.3d at 1170 (defendant cannot rely on general denials, but must produce significant probative evidence demonstrating a genuine issue of material fact for trial); *SEC v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980) (evidence must be "significantly probative") (internal citations omitted).

Defendants failed to meet their burden. They claim that "material triable fact issues existed regarding whether the Defendants had" the knowledge required for individual liability, Br. 28, and that if their allegations about BVC's concealment efforts were true, it would create disputed material facts regarding their liability for NSD's conduct. Br. 29-30. The district court, however, found that Defendants had not supported their ignorance claims, stating that "there is no room for defendants to claim that Castro was being duped by Bevilacqua about there being no significant problems with the installation of kiosks." AE:1280.

The court's conclusion was supported not only by the evidence detailed above that Castro and High knew about problems with the kiosk program, or should have known given their extensive participation in it, but also by their frequent contact with BVC. The record bristles with unrefuted evidence of Castro and Bevilacqua's working closely together. SER:240-45, 275, 278, 281, 309-10, 314-15, 356-57, 1258-65, 1281-84. One NSD purchaser stated that, given Castro's and Bevilacqua's closeness, he could not "fathom that Charlie did not know that something was wrong with the program." SER:716. Similarly, High regularly communicated with BVC, SER:177-79, 294, 337. He consulted with BVC regarding site assignments, SER:18-, 463, 467-68, 616, and even had access to BVC's Intranet site "to keep [NSD] updated as to kiosk installation." AE:501. Despite their access to BVC, Castro and High never verified kiosk installations, even in the face of NSD's obligations to locate and install the kiosks and their notice of growing problems.

Rather than refute the foregoing evidence, Defendants proffered Castro's and High's conclusory declarations that generally denied knowledge of BVC's alleged fraudulent concealment. AE:500-04, 603-04. These general denials, however, so lacked specificity and substantiality that they could not suffice to raise a genuine issue of material fact regarding Castro's and High's knowledge,[9] especially given the FTC's evidence that Castro and High knew about the kiosk problems but continued selling anyway. *Publishing Clearing House*, 104 F.3d at 1170.

Defendants attempt in their brief to buttress these self-serving declarations but to no avail. They claim they undertook due diligence before NSD entered into a relationship with BVC, Br. 17, but, if there was any due diligence, it was missing once the kiosk program began. Defendants do not cite, because they do not exist, documents showing that NSD engaged in any due diligence during the 3-year period that BVC was the sole supplier and installer of NSD kiosks. Meanwhile, Defendants' assertion that in December 2001 Castro "was presented with daily revenue reports from Bevilacqua showing revenue history on approximately 72 machines," Br. 19, is undermined by Castro's own statements that Bevilacqua prohibited him from seeing revenue data once the kiosk program began. SER:333-34, 741-42. For similar reasons, their claim to have relied on Bevilacqua's computer demonstrations in the BVC office and purported "verbal statements," Br.

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[9] To be sure, Defendants' submissions to the district court included many pages of documents, but these were not significantly probative of Castro's and High's claimed ignorance of problems with NSD's Internet kiosk program and NSD's continued misleading marketing and sales efforts.

20 (citing AE:899), is unpersuasive.

Defendants also boast that BVC's 2001 white paper claimed that BVC was going to install 20,000 units in 18 months. Br. 18. That white paper could not have provided Castro and High assurance about BVC's future performance given Castro's own reaction that Bevilacqua's assertions "made [Castro] want to choke." SER:317. As the district court concluded (AE:1280), the white paper should have put Castro and High on high alert. Defendants also explain that Bevilacqua *claimed* to have relationships with national chains (Br. 18-19), but fail to identify any steps they took to verify that Bevilacqua was telling the truth. Indeed, Castro admitted that he knew that BVC did *not* have an agreement at the corporate level that allowed NSD or BVC to install kiosks at particular locations but rather, at best, had a "preferred vendor" status which would require negotiation of individual agreements with specific locations. SER:32-33.

Defendants also allege that BVC had installed a webcam that purportedly allowed people to watch the kiosks being built and shipped via the Internet. Br. 20. Again, they offer no specific evidence to support this claim other than assertions in Castro's declaration. *Id.* Even assuming there was such a webcam, it was "common for [it] to not be working properly," SER:72, and Defendants never asserted that anyone from NSD looked at the webcam.

Defendants state that, when following up on customer complaints about kiosk installations, they "promptly inquired of Bikini and Bevilacqua as to the sites" and were told that (1) "the kiosk had been moved to another location" or (2) "because of unforeseen technical problems, such as lack of a DSL line at a particular site, Bikini had encountered a delay in installation." Br. 22. Castro apparently found the explanations "both rational and believable," *id.*, yet they should have prompted him to dig deeper, suspend NSD's kiosks sales, or both. The first explanation made no sense given that NSD received complaints that the assigned locations had never had a kiosk installed in the first place, SER:36-41, 59-60, 70, 238, which meant there were no kiosks to re-locate. The second explanation should have been a cause for concern not relief, given that NSD had represented that kiosks would have DSL lines, SER:149, 1346-49, 1354-55, 1375, and given that the delays were inconsistent with NSD's offering circular's promise to have kiosks installed and operating within two months of purchase. SER:1355. Moreover, Defendants' unsubstantiated claim that they followed up with BVC is refuted by their numerous admissions not to have taken measures to ensure that the complained-about kiosks actually were installed. SER:323-25, 328-29, 348, 359-60, 377-78, 408-09, 412-15, 469.

Finally, Defendants assert that NSD agents "did their own, similar due diligence and "[n]one ever reported to Castro any abnormalities in his business practices or gave any general sense of concern." Br. 20 (citing AE No. 9 at 899; Castro opposition Dec., ¶ 14). This conclusory statement in Castro's declaration pales in contrast to record evidence showing that NSD was deluged with expressions of concern from agents about BVC. SER:36-52, 55-56, 58-60, 64-67, 184, 187-88, 246-48, 253-56, 348-49, 401-05, 412-14, 421-22, 428-29. As for Defendants' claim that "[b]y February, 2004, Bevilacqua had indicated to Defendant Castro that he was caught up on installation," Br. 21, Defendants again fail to offer any substantiating evidence. Even if Bevilacqua did make such a claim, contemporaneous complaints received by Castro in February 2004 put him on notice that BVC was *not* in fact caught up. SER:51-52, 57, 187, 412-14, 421-22.

In sum, Defendants' claim that they were duped by BVC lacked the evidentiary support necessary to raise a genuine fact dispute. The district court correctly granted summary judgment for the FTC, and this Court should affirm.

II. THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN IMPOSING A CONSTRUCTIVE TRUST AND ORDERING BENICE TO RETURN CONSUMER FUNDS

A. Abuse of Discretion Is the Proper Review Standard

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); *see also FTC v. Stefanchik*, 599 F.3d 924, 931 (9th Cir. 2009) ("We review the district court's grant of equitable monetary relief for an abuse of discretion."); *Grosz-Salomon v. Paul Revere Life Ins. Co.*, 237 F.3d 1154, 1163 (9th Cir. 2001) (same). Similarly, the Court reviews the district court's attorney's fees determinations for abuse of discretion with underlying factual findings reviewed for clear error. *Berkla v. Corel Corp.*, 302 F.3d 909, 917 (9th Cir. 2002); *see also Ting v. AT&T*, 319 F.3d 1126, 1134-35 (9th Cir. 2003); *FTC v. Assail, Inc.*, 410 F.3d 256, 262 (5th Cir. 2005).

B. The District Court Correctly Impressed a Constructive Trust

Constructive trust is a remedy "flexibly fashioned in equity to provide relief where a balancing of interests in the context of a particular case seems to call for it." *Torres v. Eastlich (In re North Am. Coin & Currency, Ltd.)*, 767 F.2d 1573, 1575 (9th Cir. 1985). "In a constructive trust, a person who has engaged in fraud or other wrongful conduct holds only bare legal title to the property subject to a duty to reconvey it to the rightful owner." *FTC v. Crittenden*, 823 F.Supp. 699, 703 (C.D. Cal. 1993), *aff'd*, 19 F.3d 26 (9th Cir. 1994). "[T]he holder of legal title to property is deemed to be trustee of that property for the benefit of another who is entitled to it." *SEC v. Elmas Trading Corp.*, 683 F.Supp. 743, 747 (D. Nev. 1987).

State law governs whether a constructive trust exists, *In re North American Coin*, 767 F.2d at 1575, and the district court appropriately applied California law. AE:1283. The elements of constructive trust under California law are: "(1) the existence of a res; (2) the plaintiff's right to the res; and (3) the defendant's acquisition of the res by some wrongful act." *Crittenden*, 823 F. Supp. at 703.[10] A finding that "the acquisition of property was wrongful and that the keeping of the property by the defendant would constitute unjust enrichment" suffices to establish a constructive trust. *Id.* (quoting *Calistoga Civic Center v. City of Calistoga*, 191 Cal. Rptr. 571, 576 (Cal. Ct. App. 1983)); *see also United States v. Pegg*, 782 F.2d 1498, 1499-1500 (9th Cir. 1986); *GHK Assocs. v. Mayer Group, Inc.*, 274 Cal. Rptr. 168, 182 (Cal. Ct. App. 1990); *David Welch Co. v. Erksine & Tulley*, 250 Cal. Rptr. 339, 344 (Cal Ct. App. 1988). A showing of fraud or intentional

[10] A constructive trust also exists under Nevada law. *Locken v. Locken*, 98 Nev. 369, 372, 650 P.2d 803, 805 (1982).

misrepresentation is not required. *Crittenden*, 823 F. Supp. at 703.

All three constructive trust elements were satisfied here. First, the FTC's expert, Dr. Kenneth Kelly, traced the res, that is, the funds in the Custodial Accounts used to pay Benice, to corporate Defendants, which Defendants admit. AE:136-37, 172. Second, the district court properly found that the funds in the Custodial Accounts came from consumers. AE:1283. Third, the district court properly found that the Defendants acquired the funds through acts that violated the FTC Act and the Franchise Rule. AE:1284, 1285. Accordingly, "the acquisition of [the funds] was wrongful" and "the keeping of [the funds] by the defendant would constitute unjust enrichment." *See Crittenden*, 823 F. Supp. at 703.

To challenge the district court's impression of the constructive trust, Defendants claim that (a) the FTC used the wrong methodology to trace the funds in the Custodial Accounts to corporate Defendants, and (b) a constructive trust cannot be impressed on this group of corporate Defendants. Br. 44-50. They have not shown that the district court abused its discretion.

1. The FTC Proved That Defendants Paid Benice With Tainted Funds

The district court concluded that "the FTC has established by clear and convincing evidence that the [attorney's] fees funds derived from corporate defendants' proceeds, that defendants' acquisition of the funds was wrongful, and that the FTC is entitled to the proceeds from consumer redress." AE:1515. Only the FTC submitted credible, substantiated evidence on the tracing issue. This evidence included five expert declarations tracing funds in the Custodial Accounts to corporate Defendants. AE:127-39; SER:77-78, 697-712, 850-52, 1389-1402 (under seal). Using the "lowest intermediate balance" or "LIB" rule the Defendants claim should be used (Br. 48-49), the FTC traced 100% of the $875,000 paid to Defense Counsel to corporate Defendants (SER:1390-91, 1396 (under seal)), 100% to NSD and NSM (SER:1390-91, 1398 (under seal)), and 90% ($795,711) to NSD alone (SER:1390-91, 1401 (under seal)). By contrast, Defendants submitted no evidence that traced the funds using the LIB rule or that refuted the FTC's LIB-based tracing results. On this record, the district court would have abused its discretion had it *not* ruled for the FTC.

Nonetheless, the Defendants maintain that the FTC failed to trace using the LIB rule, Br. 44-46, 48-50, an obviously erroneous contention. The Defendants' position is also puzzling, because the LIB rule proved even more conclusively than the FTC's initial tracing submission that the funds used to pay Benice came from corporate Defendants, especially NSD. LIB tracing essentially makes assumptions in favor of trust beneficiaries each time a defendant withdraws funds from the account where funds held in trust are commingled with funds claimed not to be held in trust. *United States v. Daniel (In re R & T Roofing Structures & Commercial Framing, Inc.)*, 887 F.2d 981, 987 (9th Cir. 1989). Consistent with analogous cases involving multiple, commingled accounts, *see, e.g., Tex. Comptroller of Pub. Accounts v. Megafoods Stores, Inc. (In re Megafoods Stores, Inc.)*, 163 F.3d 1063, 1068 (9th Cir. 1998) (discussing *In re Copeland Enterprises, Inc.*, 133 B.R. 837 (W.D. Tex. 1991) (applying LIB rule to "combined cash balances"), *aff'd*, 991 F.2d 233 (5th Cir. 1993)), the FTC did not look at any single bank account, but rather applied LIB to the various accounts that the Castros established, which eventually funded the Custodial Accounts used to pay Benice. SER:1393-94 (under seal).

In its original tracing, the FTC did not follow the LIB rule, because the FTC sought to be as conservative as possible by making assumptions *favoring* Defendants for each withdrawal from the commingled accounts. SER:1390 (under seal). In other words, the FTC assumed that when Defendants, prior to paying

Defense Counsel, withdrew from the commingled accounts, the funds withdrawn were tainted (*i.e.*, traceable to the scam), rather than untainted *Id.* This initial tracing still definitively traced $675,000 to corporate Defendants. SER:852. The LIB rule flips the assumption.

Defendants critique the FTC's initial tracing (while ignoring the LIB-based one) by focusing on statements that the FTC's expert could not "definitely establish" that 100% of the funds traced to corporate Defendants using a tracing method that favored them. Br. 47-48. Even if the FTC had not corroborated this initial tracing with the LIB-based one, Defendants' critique would remain unsupported. First, Castro (not a tracing expert) opined that only $425,000 in the Custodial Accounts came from NSD. AE:173-74. The FTC showed, however, that Castro's numbers ignored funds that originated with NSD but came into the Custodial Accounts indirectly due to Castro's penchant for shuffling funds among accounts. SER:852. Second, the critique relies on the counter-factual assumption that funds from NSM, Sunbelt and NSDist were not tainted. The record evidence proves that all corporate Defendants, directly or indirectly, participated in and benefitted from deceptive kiosk sales.

Defendants also challenge the reliability of the FTC's evidence by claiming that the FTC failed to analyze whether the $300,000 returned by Forsythe in

February 2005 and used by the Castros to set up a new trust came from NSD or from the other corporate Defendants' lawful activities. Br. 48. Defendants are wrong. Castro *admitted* that this money "was likely derived from NSD." AE:185. Moreover, Defendants did "not contest the [FTC's] allegations relating to these specific monies." AE:1283. Thus, there is no basis to claim that the district court abused its discretion by imposing a constructive trust on the funds held in Custodial Accounts and used to pay Defense Counsel.

2. Funds from All Corporate Defendants Were Properly Impressed with the Constructive Trust

Defendants also claim that the "FTC's argument in the district court that a constructive trust can be imposed by tracing funds to a 'common enterprise' was meritless." Br. 46. The claim seems to have three elements, each unfounded.

First, Defendants may be arguing that there was no common enterprise among corporate Defendants or that a constructive trust could not be imposed on it. To determine whether a common enterprise exists, courts look at various factors, such as "whether there is common control of the entities, whether the entities are distinct and operate at arms-length from one another, and whether the entities commingle funds." *CFTC v. Wall St. Underground, Inc.*, 281 F. Supp. 2d 1260, 1271 (D. Kan. 2003) (*citing Sunshine Art Studios, Inc.*, 481 F.2d 1171, 1175 (1st

Cir. 1973); *FTC v. Think Achievement Corp.*, 144 F. Supp. 2d 993, 1011 (N.D. Ind. 2000)). Here, the four Castro companies shared ownership and management, AE:3, 109, 117, 119; SER:936, office space, AE:2-3, 108, 117, 119; SER:286, telephone numbers, SER:766, 790, 826-27, 1301-02, email addresses, SER:232, 571-74, 826, employees, SER:436-37, 439-40, 790, 824-26, and operations, SER:263-67. Directly or indirectly, all were involved in the sale of Internet kiosks to consumers, as described above. SER:233-36, 776-779. They routinely transferred funds among themselves, SER:703-06, and in numerous instances one company paid the expenses of another, SER:704-05.

Based on this evidence, the district court concluded that the corporate Defendants formed a common enterprise, AE:1283, 1514, and Defendants' conclusory denial on brief does not suffice to challenge the court's conclusion. In any event, to the extent Defendants' claim is that the district court could not have impressed a constructive trust on their common enterprise, they cite no authority. In fact, courts have rejected efforts by corporate defendants to shield themselves, on grounds that they were innocent bystanders, from liability for their affiliates' wrongdoing. *See Assail*, 410 F.3d at 263 (finding no clear error in court's freezing assets of both named and unnamed defendants where companies transferred funds in and out of one another's accounts and had joint operation center); *see also*

Delaware Watch Co. v. FTC, 332 F.2d 745, 746 (2nd Cir. 1964); *Sunshine Art Studios*, 481 F.2d at 1175; *Wall Street Underground*, 218 F. Supp. 2d at 1271.

Second, Defendants may be arguing that the Sunbelt and NSM funds in the Custodial Accounts came from lawful activities and should not have been impressed with the constructive trust. In fact, all corporate Defendants participated in and profited from the Internet kiosk scheme. Numerous documents confirm NSM's involvement in NSD's deceptive kiosk activites. SER:372-74, 473-74, 476, 776, 778-79, 1054-55. In addition, NSM induced consumers to exchange their payphones for kiosks by repeating the NSD sales pitch that kiosks would be installed at profitable locations and would generate a substantial monthly income stream. SER:1054-55, 1154, 1158. Some of these clients had purchased payphone business opportunities from Sunbelt, but many of these payphones did not exist. SER:849. By substituting kiosks for payphones, Sunbelt and Castro did not need to return money that consumers paid for these non-existent payphones and thereby profited from the switch. Thus, the constructive trust properly included funds from Sunbelt payphone purchasers who were rolled into the kiosk program and non-Sunbelt payphone purchases who were rolled into the kiosk venture through NSM.

Finally, Defendants may be arguing that the commingling of NSD monies with monies from other corporate Defendants somehow shields the money from a constructive trust. Under California law, however, the act of commingling does not destroy the constructive trust. *Mitchell v. Dunn*, 211 Cal, 129, 136, 294 P. 386, 389 (1930). Further, in an analogous context this Court rejected a claim that a debtor's commingling of sales tax collections with other revenues prevented creation of a statutory trust. *In re Megafoods Stores, Inc.*, 163 F.3d at 1067-68 (applying Texas law); *see also Begier v. IRS*, 496 U.S. 53, 60-61 (1990) (debtor cannot avoid trust by refusing to segregate). It would be grossly inequitable to allow Defendants to shield revenues from their unlawful activities through their own act of commingling.

C. The District Court Did Not Abuse Its Discretion in Rejecting Benice's Claim to Consumer Funds

1. Benice Had a Duty of Inquiry, Which He Failed to Discharge

The district court's having properly impressed a constructive trust on the Custodial Accounts, the issue becomes whether the court abused its discretion in concluding that Benice was not a good faith purchaser for value. "[T]hat a transferee was not the original wrongdoer does not insulate him from liability for restitution." *Harris Trust & Sav. Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 251 (2000) (internal quotations omitted). A constructive trust can "reach the property either in the hands of the original wrongdoer, or in the hands of any subsequent holder, until a purchaser of it in good faith and without notice acquires a higher right and takes the property relieved from the trust." *Id.* As articulated in the Restatement of Restitution, this defense of "bona fide purchaser" applies to a transferee only if he gives value for the property without notice of the facts giving rise to a constructive trust. RESTATEMENT (FIRST) OF RESTITUTION § 172 (1937). A transferee has notice of the facts giving rise to a constructive trust if he "knows the facts or should know them." *Id.* at § 174. Because Benice knew or should have known that the funds were tainted, he was not a bona fide purchaser.

Benice had a heightened duty of inquiry with respect to the source of his retainer funds. *CFTC v. Co Petro Mktg. Group, Inc.*, 700 F.2d 1279, 1284-85 (9th Cir. 1983); *see also Assail*, 410 F.3d at 263-66. This duty arose from several sources. First, Benice is an officer of the court. *Co Petro Mktg.*, 700 F.2d at 1285; *Assail*, 410 F.3d at 264. Second, the fees were paid from consumer funds derived from Defendants' fraudulent scheme. *Assail*, 410 F.3d at 263-64 (comparing fees for defending against allegations of FTC Act violations to fees for defending against allegations of criminal activity). Third, statutes which subject the proceeds of criminal activity to forfeiture allow an attorney who has been paid with the criminal proceeds to keep them only upon showing that he "conducted an inquiry sufficient to allow him to be 'reasonably without cause to believe that the property was subject to forfeiture,'" which by analogy applies to the FTC Act. *Id.* at 265 (quoting Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1963(l)(6)(B) (2000)). Fourth, "a party cannot be a bona fide purchaser where the circumstances surrounding the conveyance would lead a reasonable person to doubt the validity of the transfer." *Assail*, 410 F.3d at 264-265 (citing *McGraw v. Connelly*, 838 F.2d 844, 849 (6th Cir. 1988)). In short, "an attorney is not permitted to be willfully ignorant of how his representation is funded" and, thus, has a duty to inquire as to the source of those fees if the attorney is objectively on notice that the funds may be tainted. *Assail*, 410 F.3d at 265.

Because Benice had notice that the funds used to pay him may have come from Defendants' unlawful activities, he had a duty of inquiry which he failed to discharge. When he accepted the funds, the FTC already had provided Defendants with a proposed complaint that charged all of Castro's businesses, including Sunbelt and NSM, with violating the FTC Act and Franchise Rule, as well as a letter describing those conclusions. AE:1514; SER:9-24, 934. Although Benice does not admit to having read the FTC's draft complaint and letter, or any other documents sent by the FTC to Defendants through their prior counsel, AE:1445-48, 1514-15, he does concede that he "understood Defendants were in a dispute with the FTC and that the FTC *could* eventually take action against them."

AE:1448 (emphasis in original). Notice of Defendants' potential liability destroyed Benice's bona fide purchaser status. *See Assail*, 410 F.3d at 266 ("[T]he mere fact that an attorney has read the indictment against his client is enough to put him on notice that his fees are potentially tainted and to destroy his status as a bona fide purchaser for value.").

Moreover, even a quick review of Castro's sworn FTC financial disclosure form signed prior to his retention (SER:892-913) would have shown that the Custodial Accounts contained an overwhelming majority of Castro's liquid assets and that Defendants would need to use these funds to pay Benice. AE:1445-47. Benice also knew that the funds came from the very Custodial Accounts that were the subject of settlement negotiations with the FTC. SER:920-21. Moreover, Castro did not hide his concern about the fact that the funds in the Custodial Accounts were reachable by creditors like the FTC. SER:855-56. Especially given Defendants' claim that Benice reviewed Defendants' financials, Benice should have realized that the Custodial Accounts did in fact derive from Defendants' common enterprise in which all corporate Defendants participated, directly or indirectly. On this record, the district court did not abuse its discretion in finding that Benice had notice that his fees likely came from tainted funds. AE:1514-15.

Given the foregoing, Defendants' contentions that Benice "properly exercised" his duty (Br. 38) fail. They claim that he determined that the Internet kiosk business was a viable business model. Br. 38-39. The Defendants, however, did not violate the FTC Act because their business model was not viable, but because they marketed and sold their business opportunities in a deceptive manner. *See, e.g.*, *FTC v. Tashman*, 318 F.3d 1273, 1277 (11th Cir. 2003) (finding liability for deceptive sales of phone cards); *FTC v. Minuteman Press*, 53 F. Supp. 2d 248 (E.D.N.Y. 1998) (liability for deceptive marketing of "basically sound product"). Next, Defendants claim that Benice learned that they had paid another law firm to ensure that NSD's operating circulars and promotional materials were compliant with applicable law and that Benice reviewed these documents to satisfy himself of compliance. Br. 39. He also allegedly talked to these other lawyers about NSD's operations and their legitimacy. *Id.* Even if advice of counsel were a legitimate defense, which it is not, *see FTC v. Pioneer Enterprises*, *Inc*, 1992-2 Trade Cas. (CCH) ¶ 70,043 at 69,156 (D.Nev. 1992) (citing *Amy Travel*, 875 F.2d at 575), the FTC had already determined by the time Benice was retained that Defendants' activities were likely unlawful, rendering reliance on the prior legal review suspect.

Benice's knowledge of Defendants' cooperation with the FBI (Br. 40) also did not discharge his duty. This cooperation was not evidence of Defendants' innocence but rather, as the district court concluded, merely served their self-interest once they realized that the house of cards was collapsing. AE:1283. Learning that Castro was not an FBI suspect (Br. 40) also does not discharge the duty of inquiry given that Castro was the subject of an FTC investigation, as well as a state regulatory investigation for which Benice had also been retained. AE:256, 316-317. Finally and as the district court concluded (AE:1283), there is no evidence in the record, other than Defendants' unsubstantiated declarations, that NSD ever refunded $5,000,000 of consumer funds (see Br. 40).

Defendants next claim that Benice discharged his duty by asking Phyllis Watson about the funds' source. Br. 41. Especially given the surrounding circumstances, Benice's taking Ms. Watson's word that the funds may have come from Sunbelt and NSM was not sufficient to satisfy his duty. *See Assail*, 410 F.3d at 266 (once on notice, attorney "needed to do more than simply take his client at his word that the fees were not tainted"). Further, Ms. Watson admitted that she was not involved in the Castro's business, SER:817-18, making her an unreliable source of information about the origins of the money in the Custodial Accounts.

In addition, the fact that money came from Sunbelt and NSM (Br. 41) strongly suggests taint given those Defendants' involvement in the fraudulent scheme. AE:3, 108; SER:372, 473-74, 476, 776, 778-79, 790-91, 824, 1054-55.

To the extent Sunbelt's and NSM's business activities were legitimate when they began depositing funds into those accounts in 1999, Defendants did not demonstrate that untainted money remained in those accounts by the time Benice was paid in 2005. In fact, under LIB tracing, 100% of the funds can be traced to NSD and NSM, SER:1390-91, 1398 (under seal), meaning that no "untainted" Sunbelt funds remained to pay Benice, and 90% of funds can be traced to NSD alone. SER:1390-91, 1401 (under seal).

Accordingly, the district court did not abuse its discretion in finding that Benice was paid from consumer funds subject to a constructive trust and that Benice did not accept the fees in good faith. AE:1514-15. Having failed to discharge his duty of inquiry, Benice cannot be a good faith purchaser for value. *See McGraw*, 838 F.2d at 849. The appropriate remedy is the return of consumer funds paid to him as fees. *Assail*, 410 F.3d at 265.

2. Defendants Fail to Prove that Benice Is Otherwise Entitled to Retain $375,000

Defendants' other contentions for why Benice should be permitted to keep $375,000 in consumer funds are readily disposed of.

First, Defendants insist that the consumer funds used to pay Benice became his property upon his receipt of the fee payment. Br. 35-38 (citing *In re Heritage*

Mall Assocs., 184 B.R. 128 (Bankr. Ore. 1995)).[11] Regardless of whether the "earned upon receipt" retainer was reasonable or legal, the consumer funds in the Custodial Accounts could become Benice's property only if he were a good faith purchaser for value without notice of the funds' origins, because the funds were already subject to the constructive trust by the time Defendants transferred them to Benice. *Harris Trust*, 530 U.S. at 251.

Second, Defendants claim that the district court could not order Benice to return consumer funds without finding that their transfer to him was fraudulent or in violation of the court's April 6, 2005 asset freeze order. Br. 34-35, 42-43. Fraudulent conveyance and asset freeze were alternative bases by which the FTC sought return of consumers' money. They are not part of the legal standard for impression of a constructive trust or determining whether Benice may retain funds from the trust. Because the district court relied on constructive trust, AE:1514-15,

[11] In any event, the case is inapposite, because it does not address an attorney's entitlement to consumer funds that are subject to a constructive trust at the time of payment. The debtors in *Heritage Mall* sought approval from a bankruptcy court to retain counsel under a proposed retention agreement, while here Defendants defend Benice's retainer as *fait accompli*. 184 B.R. at 129. *Heritage Mall* concerned the permissibility of "earned upon receipt" fee arrangements under *Oregon* law, but the present case concerns a *California* attorney's retention agreement with his California clients. SER:316, 945b. *Heritage Hall* also does not hold that "earned upon receipt" retainers are *per se* lawful, as Defendants suggest (Br. 43), but rather provides that such agreements must be judged for reasonableness. 184 B.R. at 134.

there was no need for the court to make findings regarding the fraudulent-transfer or asset-freeze grounds for return of the funds.

Finally, Defendants disagree with the district court's using a $300 hourly rate to set attorney's fees. Br. 50. On January 7, 2009, the district court rejected a higher rate, finding that Defendants he had not supported Benice's claimed $475 hourly rate. AE:1553-1554. While on appeal Defendants renew Benice's claim for an hourly rate higher than $300, they continue to provide no factual or legal support. The Court should affirm the district court's findings and permit Benice to retain $136,700 as an equitable fee allowance.

CONCLUSION

For the foregoing reasons, the district court's decisions should be affirmed in their entirety.

Respectfully submitted,

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December 9, 2009

STATEMENT OF RELATED CASES

U. S. Court of Appeals Docket Number(s): 09-15684

Pursuant to Circuit Rule 28-2.6, Plaintiff–Appellee Federal Trade Commission is not aware of any related cases pending in this Court.

STATUTORY ADDENDUM

15 U.S.C. § 45(a)

(a) Declaration of unlawfulness; power to prohibit unfair practices; inapplicability to foreign trade.

(1) Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.

(2) The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations, except banks, savings and loan institutions described in section 18(f)(3), Federal credit unions described in section 18(f)(4), common carriers subject to the Acts to regulate commerce, air carriers and foreign air carriers subject to the Federal Aviation Act of 1958, and persons, partnerships, or corporations insofar as they are subject to the Packers and Stockyards Act, 1921, as amended, except as provided in section 406(b) of said Act, from using unfair methods of competition in or affecting commerce and unfair or deceptive acts or practices in or affecting commerce.

(3) [omitted]

(4) [omitted]

15 U.S.C. § 53(b)

(b) Temporary restraining orders; preliminary injunctions.

Whenever the Commission has reason to believe -

(1) that any person, partnership, or corporation is violating, or is about to violate, any provision of law enforced by the Federal Trade Commission, and

(2) that the enjoining thereof pending the issuance of a complaint by the Commission and until such complaint is dismissed by the Commission or set aside by the court on review, or until the order of the Commission made thereon has become final, would be in the interest of the public -

the Commission by any of its attorneys designated by it for such purpose may bring suit in a district court of the United States to enjoin any such act or practice. Upon a proper showing that, weighing the equities and considering the Commission's likelihood of ultimate success, such action would be in the public interest, and after notice to the defendant, a temporary restraining order or a preliminary injunction may be granted without bond: Provided, however, That if a complaint is not filed within such period (not exceeding 20 days) as may be specified by the court after issuance of the temporary restraining order or preliminary injunction, the order or injunction shall be dissolved by the court and be of no further force and effect: Provided further, That in proper cases the Commission may seek, and after proper proof, the court may issue, a permanent injunction. Any suit may be brought where such person, partnership, or corporation resides or transacts business, or wherever venue is proper under section 1391 of title 28, United States Code. In addition, the court may, if the court determines that the interests of justice require that any other person, partnership, or corporation should be a party in such suit, cause such other person, partnership, or corporation to be added as a party without regard to whether venue is otherwise proper in the district in which the suit is brought. In any suit under this section, process may be served on any person, partnership, or corporation wherever it may be found.

15 U.S.C. § 57b

(a) Suits by Commission against persons, partnerships, or corporations; jurisdiction; relief for dishonest or fraudulent acts.

(1) If any person, partnership, or corporation violates any rule under this Act respecting unfair or deceptive acts or practices (other than an interpretive rule, or a rule violation of which the Commission has provided is not an unfair or deceptive act or practice in violation of section 5(a)), then the Commission may commence a civil action against such person, partnership, or corporation for relief under subsection (b) in a United States district court or in any court of competent jurisdiction of a State.

(2) If any person, partnership, or corporation engages in any unfair or deceptive act or practice (within the meaning of section 5(a)(1)) with respect to which the Commission has issued a final cease and desist order which is applicable to such person, partnership, or corporation, then the Commission may commence a civil action against such person, partnership, or corporation in a United States district court or in any court of competent jurisdiction of a State. If the Commission satisfies the court that the act or practice to which the cease and desist order relates is one which a reasonable man would have known under the circumstances was dishonest or fraudulent, the court may grant relief under subsection (b).

(b) Nature of relief available.

The court in an action under subsection (a) shall have jurisdiction to grant such relief as the court finds necessary to redress injury to consumers or other persons, partnership, and corporations resulting from the rule violation or the unfair or deceptive act or practice, as the case may be. Such relief may include, but shall not be limited to, rescission or reformation of contracts, the refund of money or return of property, the payment of damages, and public notification respecting the rule violation or the unfair or deceptive act or practice, as the case may be; except that nothing in this subsection is intended to authorize the imposition of any exemplary or punitive damages.

(c) [omitted]

(d) [omitted]

(e) Availability of additional Federal or State remedies; other authority of Commission unaffected.

Remedies provided in this section are in addition to, and not in lieu of, any other remedy or right of action provided by State or Federal law. Nothing in this section shall be construed to affect any authority of the Commission under any other provision of law.

PART 436—DISCLOSURE REQUIREMENTS AND PROHIBITIONS CONCERNING FRANCHISING AND BUSINESS OPPORTUNITY VENTURES

AUTHORITY: 38 Stat. 717, as amended, 15 U.S.C. 41–58.

SOURCE: 43 FR 59614, Dec. 21, 1978, unless otherwise noted.

§ 436.1 The Rule.

In connection with the advertising, offering, licensing, contracting, sale, or other promotion in or affecting commerce, as ‘‘commerce’’ is defined in the Federal Trade Commission Act, of any franchise, or any relationship which is represented either orally or in writing to be a franchise, it is an unfair or deceptive act or practice within the meaning of section 5 of that Act for any franchisor or franchise broker:

(a) To fail to furnish any prospective franchisee with the following information accurately, clearly, and concisely stated, in a legible, written document at the earlier of the ‘‘time for making of disclosures’’ or the first ‘‘personal meeting’’:

(1)(i) The official name and address and principal place of business of the franchisor, and of the parent firm or holding company of the franchisor, if any;

(ii) The name under which the franchisor is doing or intends to do business; and

(iii) The trademarks, trade names, service marks, advertising or other commercial symbols (hereinafter collectivelyreferred to as ‘‘marks’’) which identify the goods, commodities, or services to be offered, sold, or distributed by the prospective franchisee, or under which the prospective franchisee will be operating.

(2) The business experience during the past 5 years, stated individually, of each of the franchisor’s current directors and executive officers (including, and hereinafter to include, the chief executive and chief operating officer, financial, franchise marketing, training and service officers). With regard to each person listed, those persons’ principal occupations and employers must be included.

(3) The business experience of the franchisor and the franchisor’s parent firm (if any), including the length of time each: (i) Has conducted a business of the type to be operated by the franchisee; (ii) has offered or sold a franchise for such business; (iii) has conducted a business or offered or sold a franchise for a business (A) operating under a name using any mark set forth under paragraph (a)(1)(iii) of this section, or (B) involving the sale, offering, or distribution of goods, commodities, or services which are identified by any mark set forth under paragraph

(a)(1)(iii) of this section; and (iv) has offered for sale or sold franchises in other lines of business, together with a description of such other lines of business.

(4) A statement disclosing who, if any, of the persons listed in paragraphs (a) (2) and (3) of this section:

(i) Has, at any time during the previous seven fiscal years, been convicted of a felony or pleaded nolo contendere to a felony charge if the felony involved fraud (including violation of any franchise law, or unfair or deceptive practices law), embezzlement, fraudulent conversion, misappropriation of property, or restraint of trade;

(ii) Has, at any time during the previous seven fiscal years, been held liable in a civil action resulting in a final judgment or has settled out of court any civil action or is a party to any civil action (A) involving allegations of fraud (including violation of any franchise law, or unfair or deceptive practices law), embezzlement, fraudulent conversion, misappropriation of property, or restraint of trade, or (B) which was brought by a present or former franchisee or franchisees and which involves or involved the franchise relationship; *Provided, however,* That only material individual civil actions need be so listed pursuant to paragraph (4)(ii) of this section, including any group of civil actions which, irrespective of the materiality of any single such action, in the aggregate is material;

(iii) Is subject to any currently effective State or Federal agency or court injunctive or restrictive order, or is a party to a proceeding currently pending in which such order is sought, relating to or affecting franchise activities or the franchisor-franchisee relationship, or involving fraud (including violation of any franchise law, or unfair or deceptive practices law), embezzlement, fraudulent conversion, misappropriation of property, or restraint of trade.
Such statement shall set forth the identity and location of the court or agency; the date of conviction, judgment, or decision; the penalty imposed; the damages assessed; the terms of settlement or the terms of the order; and the date, nature, and issuer of each such order or ruling. A franchisor may include a summary opinion of counsel as to any pending litigation, but only if counsel's consent to the use of such opinion is included in the disclosure statement.

(5) A statement disclosing who, if any, of the persons listed in paragraphs (a) (2) and (3) of this section at any time during the previous 7 fiscal years has:

(i) Filed in bankruptcy;

(ii) Been adjudged bankrupt;

(iii) Been reorganized due to insolvency; or

(iv) Been a principal, director, executive officer, or partner of any other person that has so filed or was so adjudged or reorganized, during or within 1 year after the period that such person held such position in such other person. If so, the name and location of the person having so filed, or having been so adjudged or reorganized, the date thereof, and any other material facts relating thereto, shall be set forth.

(6) A factual description of the franchise offered to be sold by the franchisor.

(7) A statement of the total funds which must be paid by the franchisee to the franchisor or to a person affiliated with the franchisor, or which the franchisor or such affiliated person imposes or collects in whole or in part on behalf of a third party, in order to obtain or commence the franchise operation, such as initial franchise fees, deposits, downpayments, prepaid rent, and equipment and inventory purchases. If all or part of these fees or deposits are returnable under certain conditions, these conditions shall be set forth; and if not returnable, suchfact shall be

disclosed.

(8) A statement describing any recurring funds required to be paid, in connection with carrying on the franchise business, by the franchisee to the franchisor or to a person affiliated with the franchisor, or which the franchisor or such affiliated person imposes or collects in whole or in part on behalf of a third party, including, but not limited to, royalty, lease, advertising, training, and sign rental fees, and equipment or inventory purchases.

(9) A statement setting forth the name of each person (including the franchisor) the franchisee is directly or indirectly required or advised to do business with by the franchisor, where such persons are affiliated with the franchisor.

(10) A statement describing any real estate, services, supplies, products, inventories, signs, fixtures, or equipment relating to the establishment or the operation of the franchise business which the franchisee is directly or indirectly required by the franchisor to purchase, lease or rent; and if such purchases, leases or rentals must be made from specific persons (including the franchisor), a list of the names and addresses of each such person. Such list may be made in a separate document delivered to the prospective franchisee with the prospectus if the existence of such separate document is disclosed in the prospectus.

(11) A description of the basis for calculating, and, if such information is readily available, the actual amount of, any revenue or other consideration to be received by the franchisor or persons affiliated with the franchisor from suppliers to the prospective franchisee in consideration for goods or services which the franchisor requires or advises the franchisee to obtain from such suppliers.

(12)(i) A statement of all the material terms and conditions of any financing arrangement offered directly or indirectly by the franchisor, or any person affiliated with the franchisor, to the prospective franchisee; and

(ii) A description of the terms by which any payment is to be received by the franchisor from (A) any person offering financing to a prospective franchisee; and (B) any person arranging for financing for a prospective franchisee.

(13) A statement describing the material facts of whether, by the terms of the franchise agreement or other device or practice, the franchisee is:

(i) Limited in the goods or services he or she may offer for sale;

(ii) Limited in the customers to whom he or she may sell such goods or services;

(iii) Limited in the geographic area in which he or she may offer for sale or sell goods or services; or

(iv) Granted territorial protection by the franchisor, by which, with respect to a territory or area, (A) the franchisor will not establish another, or more than any fixed number of, franchises or company-owned outlets, either operating under, or selling, offering, or distributing goods, commodities or services, identified by any mark set forth under paragraph (a)(1)(iii) of this section; or (B) the franchisor or its parent will not establish other franchises or company-owned outlets selling or leasing the same or similar products or services under a different trade name, trademark, service mark, advertising or other commercial symbol.

(14) A statement of the extent to which the franchisor requires the franchisee (or, if the franchisee is a corporation, any person affiliated with the franchisee) to participate personally in the direct operation of the franchise.

(15) A statement disclosing, with respect to the franchise agreement and any related

agreements:

(i) The term (i.e., duration of arrangement), if any, of such agreement, and whether such term is or may be affected by any agreement (including leases or subleases) other than the one from which such term arises;

(ii) The conditions under which the franchisee may renew or extend;

(iii) The conditions under which the franchisor may refuse to renew or extend;

(iv) The conditions under which the franchisee may terminate;

(v) The conditions under which the franchisor may terminate;

(vi) The obligations (including lease or sublease obligations) of the franchisee after termination of the franchise by the franchisor, and the obligations of the franchisee (including lease or sublease obligations) after termination of the franchise by the franchisee and after the expiration of the franchise;

(vii) The franchisee's interest upon termination of the franchise, or upon refusal to renew or extend the franchise, whether by the franchisor or by the franchisee;

(viii) The conditions under which the franchisor may repurchase, whether by right of first refusal or at the option of the franchisor (and if the franchisor has the option to repurchase the franchise, whether there will be an independent appraisal of the franchise, whether the repurchase price will be determined by a predetermined formula and whether there will be a recognition of goodwill or other intangibles associated therewith in the repurchase price to be given the franchisee);

(ix) The conditions under which the franchisee may sell or assign all or any interest in the ownership of the franchise, or of the assets of the franchise business;

(x) The conditions under which the franchisor may sell or assign, in whole or in part, its interest under such agreements;

(xi) The conditions under which the franchisee may modify;

(xii) The conditions under which the franchisor may modify;

(xiii) The rights of the franchisee's heirs or personal representative upon the death or incapacity of the franchisee; and

(xiv) The provisions of any covenant not to compete.

(16) A statement disclosing, with respect to the franchisor and as to the particular named business being offered:

(i) The total number of franchises operating at the end of the preceding fiscal year;

(ii) The total number of company owned outlets operating at the end of the preceding fiscal year;

(iii) The names, addresses, and telephone numbers of (A) The 10 franchised outlets of the named franchise business nearest the prospective franchisee's intended location; or (B) all franchisees of the franchisor, or (C) all franchisees of the franchisor in the State in which the prospective franchisee lives or where the proposed franchise is to be located, *Provided, however,* That there are more than 10 such franchisees. If the number of franchisees to be disclosed pursuant to paragraph (a)(16)(iii) (B) or (C) of this section exceeds 50, such listing may be made in a separate document delivered to the prospective franchisee with the prospectus if the existence of such separate document is disclosed in the prospectus;

(iv) The number of franchises voluntarily terminated or not renewed by franchisees within, or at the conclusion of, the term of the franchise agreement, during the preceding fiscal year;

(v) The number of franchises reacquired by purchase by the franchisor during the term of the franchise agreement, and upon the conclusion of the term of the franchise agreement, during the preceding fiscal year;

(vi) The number of franchises otherwise reacquired by the franchisor during the term of the franchise agreement, and upon the conclusion of the term of the franchise agreement, during the preceding fiscal year;

(vii) The number of franchises for which the franchisor refused renewal of the franchise agreement or other agreements relating to the franchise during the preceding fiscal year; and

(viii) The number of franchises that were canceled or terminated by the franchisor during the term of the franchise agreement, and upon conclusion of the term of the franchise agreement, during the preceding fiscal year.

With respect to the disclosures required by paragraphs (a)(16) (v), (vi), (vii), and (viii) of this section, the disclosure statement shall also include a general categorization of the reasons for such reacquisitions, refusals to renew or terminations, and the number falling within each such category, including but not limited to the following: failure to comply with quality control standards, failure to make sufficient sales, and other breaches of contract.

(17)(i) If site selection or approval thereof by the franchisor is involved in the franchise relationship, a statement disclosing the range of time that has elapsed between signing of franchise agreements or other agreements relating to the franchise and site selection, for agreements entered into during the preceding fiscal year; and

(ii) If operating franchise outlets are to be provided by the franchisor, a statement disclosing the range of time that has elapsed between the signing of franchise agreements or other agreements relating to the franchise and the commencement of the franchisee's business, for agreements entered into during the preceding fiscal year.

With respect to the disclosures required by paragraphs (a)(17) (i) and (ii) of this section, a franchisor may at its option also provide a distribution chart using meaningful classifications with respect to such ranges of time.

(18) If the franchisor offers an initial training program or informs the prospective franchisee that it intends to provide such person with initial training, a statement disclosing:

(i) The type and nature of such training;

(ii) The minimum amount, if any, of training that will be provided to a franchisee; and

(iii) The cost, if any, to be borne by the franchisee for the training to be provided, or for obtaining such training.

(19) If the name of a public figure is used in connection with a recommendation to purchase a franchise, or as a part of the name of the franchise operation, or if the public figure is stated to be involved with the management of the franchisor, a statement disclosing:

(i) The nature and extent of the public figure's involvement and obligations to the franchisor, including but not limited to the promotional assistance the public figure will provide to the franchisor and to the franchisee;

(ii) The total investment of the public figure in the franchise operation; and

(iii) The amount of any fee or fees the franchisee will be obligated to pay for such involvement or assistance provided by the public figure.

(20)(i) A balance sheet (statement of financial position) for the franchisor for the most recent fiscal year, and an income statement (statement of results of operations) and statement of changes in financial position for the franchisor for the most recent 3 fiscal years. Such statements are required to have been examined in accordance with generally accepted auditing standards by an independent certified or licensed public accountant.

Provided, however, That where a franchisor is a subsidiary of another corporation which is permitted under generally accepted accounting principles to prepare financial statements on a consolidated or combined statement basis, the above information may be submitted for the parent if (A) the corresponding unaudited financial statements of the franchisor are also provided, and (B) the parent absolutely and irrevocably has agreed to guarantee all obligations of the subsidiary;

(ii) Unaudited statements shall be used only to the extent that audited statements have not been made, and provided that such statements are accompanied by a clear and conspicuous disclosure that they are unaudited. Statements shall be prepared on an audited basis as soon as practicable, but, at a minimum, financial statements for the first full fiscal year following the date on which the franchisor must first comply with this part shall contain a balance sheet opinion prepared by an independent certified or licensed public accountant, and financial statements for the following fiscal year shall be fully audited.

(21) All of the foregoing information in paragraphs (a) (1) through (20) of this section shall be contained in a single disclosure statement or prospectus, which shall not contain any materials or information other than that required by this part or by State law not preempted by this part. This does not preclude franchisors or franchise brokers from giving other nondeceptive information orally, visually, or in separate literature so long as such information is not contradictory to the information in the disclosure statement required by paragraph (a) of this section. This disclosure statement shall carry a cover sheet distinctively and conspicuously showing the name of the franchisor, the date of issuance of the disclosure statement, and the following notice imprinted thereon in upper and lower case bold-face type of not less than 12 point size:

Information for Prospective Franchisees Required by Federal Trade Commission

* * * * *

To protect you, we've required your franchisor to give you this information. *We haven't checked it, and don't know if it's correct.* It should help you make up your mind. Study it carefully. While it includes some information about your contract, don't rely on it alone to understand your contract. Read all of your contract carefully. Buying a franchise is a complicated investment. Take your time to decide. If possible, show your contract and this information to an advisor, like a lawyer or an accountant. If you find anything you think may be wrong or anything important that's been left out, you should let us know about it. It may be against the law.

There may also be laws on franchising in your state. Ask your state agencies about them.

FEDERAL TRADE COMMISSION,
Washington, D.C.

Provided, That the obligation to furnish such disclosure statement shall be deemed to have been met for both the franchisor and the franchise broker if either such party furnishes the prospective franchisee with such disclosure statement.

(22) All information contained in the disclosure statement shall be current as of the close of the franchisor's most recent fiscal year. After the close of each fiscal year, the franchisor shall be given a period not exceeding 90 days to prepare a revised disclosure statement and, following such 90 days, may distribute only the revised prospectus and no other. The franchisor shall, within a reasonable time after the close of each quarter of the fiscal year, prepare revisions to be attached to the disclosure statement to reflect any material change in the franchisor or relating to the franchise business of the franchisor, about which the franchisor or franchise broker, or any agent, representative, or employee thereof, knows or should know. Each prospective franchisee shall have in his or her possession, at the ''time for making of disclosures,'' the disclosure statement and quarterly revision for the period most recent to the ''time for making of disclosures'' and available at that time. Information which is required to be audited pursuant to paragraph (a)(20) of this section is not required to be audited for quarterly revisions, *Provided, however,* That the unaudited information be accompanied by a statement in immediate conjunction therewith that clearly and conspicuously discloses that such information has not been audited.

(23) A table of contents shall be included within the disclosure statement.

(24) The disclosure statement shall include a comment which either positively or negatively responds to each disclosure item required to be in the disclosure statement, by use of a statement which fully incorporates the information required by the item. Each disclosure item therein must be preceded by the appropriate heading, as set forth in Note 3 of this part.

(b) To make any oral, written, or visual representation to a prospective franchisee which states a specific level of potential sales, income, gross or net profit for that prospective franchisee, or which states other facts which suggest such a specific level, unless:

(1) At the time such representation is made, such representation is relevant to the geographic market in which the franchise is to be located;

(2) At the time such representation is made, a reasonable basis exists for such representation and the franchisor has in its possession material which constitutes a reasonable basis for such representation, and such material is made available to any prospective franchisee and to the Commission or its staff upon reasonable demand.

Provided, further, That in immediate conjunction with such representation, the franchisor shall disclose in a clear and conspicuous manner that such material is available to the prospective franchisee; and *Provided, however,* That no provision within paragraph (b) of this section shall be construed as requiring the disclosure to any prospective franchisee of the identity of any specific franchisee or of information reasonably likely to lead to the disclosure of such person's identity; and *Provided, further,* That no additional representation as to a prospective franchisee's potential sales, income, or profits may be made later than the ''time for making of disclosures'';

(3) Such representation is set forth in detail along with the material bases and assumptions therefor in a single legible written document whose text accurately, clearly and concisely discloses such information, and none other than that provided for by this part or by

State law not preempted by this part. Each prospective franchisee to whom the representation is made shall be furnished with such document no later than the ‘‘time for making of disclosures’’; *Provided, however,* That if the representation is made at or prior to a ‘‘personal meeting’’ and such meeting occurs before the ‘‘time for making of disclosures’’, the document shall be furnished to the prospective franchisee to whom the representation is made at that ‘‘personal meeting’’;

(4) The following statement is clearly and conspicuously disclosed in the document described by paragraph (b)(3) of this section in immediate conjunction with such representation and in not less than twelve point upper and lowercase boldface type:

CAUTION

These figures are only estimates of what we think you may earn. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

(5) The following information is clearly and conspicuously disclosed in the document described by paragraph (b)(3) of this section in immediate conjunction with such representation:

(i) The number and percentage of outlets of the named franchise business which are located in the geographic markets that form the basis for any such representation and which are known to the franchisor or franchise broker to have earned or made at least the same sales, income, or profits during a period of corresponding length in the immediate past as those potential sales, income, or profits represented; and

(ii) The beginning and ending dates for the corresponding time period referred to by paragraph (b)(5)(i) of this section, *Provided, however*, That any franchisor without prior franchising experience as to the named franchise business so indicate such lack of experience in the document described in paragraph (b)(3) of this section.

Except, That representations of the sales, income or profits of existing franchise outlets need not comply with paragraph (b) of this section.

(c) To make any oral, written or visual representation to a prospective franchisee which states a specific level of sales, income, gross or net profits of existing outlets (whether franchised or company-owned) of the named franchise business, or which states other facts which suggest such a specific level, unless:

(1) At the time such representation is made, such representation is relevant to the geographic market in which the franchise is to be located;

(2) At the time such representation is made, a reasonable basis exists for such representation and the franchisor has in its possession material which constitutes a reasonable basis for such representation, and such material is made available to any prospective franchisee and to the Commission or its staff upon reasonable demand, *Provided, however,* That in immediate conjunction with such representation, the franchisor discloses in a clear and conspicuous manner that such material is available to the prospective franchisee; and *Provided, further,* That no provision within paragraph (c) of this section shall be construed as requiring the disclosure to any prospective franchisee of the identity of any specific franchisee or of information reasonably likely to lead to the disclosure of such person’s identity; and *Provided, further*, That no additional representation as to the sales, income, or gross or net profits of

existing outlets (whether franchised or company-owned) of the named franchise business may be made later than the ‘‘time for making of disclosures’’;

(3) Such representation is set forth in detail along with the material bases and assumptions therefor in a single legible written document which accurately, clearly and concisely discloses such information, and none other than that provided for by this part or by State law not preempted by this part. Each prospective franchisee to whom the representation is made shall be furnished with such document no later than the ‘‘time for making of disclosures’’, *Provided, however*, That if the representation is made at or prior to a ‘‘personal meeting’’ and such meeting occurs before the ‘‘time for making of disclosures,’’ the document shall be furnished to the prospective franchisee to whom the representation is made at that ‘‘personal meeting’’;

(4) The underlying data on which the representation is based have been prepared in accordance with generally accepted accounting principles;

(5) The following statement is clearly and conspicuously disclosed in the document described by paragraph (c)(3) of this section in immediate conjunction with such representation, and in not less than twelve point upper and lower case boldface type:

CAUTION

Some outlets have [sold] [earned] this amount. There is no assurance you’ll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

(6) The following information is clearly and conspicuously disclosed in the document described by paragraph (c)(3) of this section in immediate conjunction with such representation:

(i) The number and percentage of outlets of the named franchise business which are located in the geographic markets that form the basis for any such representation and which are known to the franchisor or franchise broker to have earned or made at least the same sales, income, or profits during a period of corresponding length in the immediate past as those sales, income, or profits represented; and

(ii) The beginning and ending dates for the corresponding time period referred to by paragraph (c)(6)(i) of this section, *Provided, however*, That any franchisor without prior franchising experience as to the named franchise business so indicate such lack of experience in the document described in paragraph (c)(3) of this section.

(d) To fail to provide the following information within the document(s) required by paragraphs (b)(3) and (c)(3) of this section whenever any representation is made to a prospective franchisee regarding its potential sales, income, or profits, or the sales, income, gross or net profits of existing outlets (whether franchised or company-owned) of the named franchise business:

(1) A cover sheet distinctively and conspicuously showing the name of the franchisor, the date of issuance of the document and the following notice imprinted thereon in upper and lower case boldface type of not less than twelve point size:

Information for Prospective Franchisees About Franchise [Sales] [Income] [Profit] Required by the Federal Trade Commission.

To protect you, we've required the franchisor to give you this information. *We haven't checked it and don't know if it's correct.* Study these facts and figures carefully. If possible, show them to someone who can advise you, like a lawyer or an accountant. Then take your time and think it over.

If you find anything you think may be wrong or anything important that's been left out, let us know about it. It may be against the law.

There may also be laws on franchising in your State. Ask your State agencies about them.

FEDERAL TRADE COMMISSION,
Washington, D.C.

(2) A table of contents.

Provided, however, That each prospective franchisee to whom the representation is made shall be notified at the ''time for making of disclosures'' of any material change (about which the franchisor, franchise broker, or any of the agents, representatives, or employees thereof, knows or should know) in the information contained in the document(s) described by paragraphs (b)(3) and (c)(3) of this section.

(e) To make any oral, written, or visual representation for general dissemination (not otherwise covered by paragraph (b) or (c) of this section) which states a specific level of sales, income, gross or net profits, either actual or potential, of existing or prospective outlets (whether franchised or company-owned) of the named franchise business or which states other facts which suggest such a specific level, unless:

(1) At the time such representation is made, a reasonable basis exists for such representation and the franchisor has in its possession material which constitutes a reasonable basis for such representation and which is made available to the Commission or its staff upon reasonable demand;

(2) The underlying data on which each representation of sales, income or profit for existing outlets is based have
been prepared in accordance with generally accepted accounting principles;

(3) In immediate conjunction with such representation, there shall be clearly and conspicuously disclosed the number and percentage of outlets of the named franchise business which the franchisor or the franchise broker knows to have earned or made at least the same sales, income, or profits during a period of corresponding length in the immediate past as those sales, income, or profits represented, and the beginning and ending dates for said time period;

(4) In immediate conjuction with each such representation of potential sales, income or profits, the following statement shall be clearly and conspicuously disclosed:

CAUTION

These figures are only estimates; there is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

Provided, however, That if such representation is not based on actual experience of existing outlets of the named franchise business, that fact also should be disclosed;

(5) No later than the earlier of the first ''personal meeting'' or the ''time for making of

disclosures,'' each prospective franchisee shall be given a single, legible written document which accurately, clearly and concisely sets forth the following information and materials (and none other than that provided for by this part or by State law not preempted by this part):

(i) The representation, set forth in detail along with the material bases and assumptions therefor;

(ii) The number and percentage of outlets of the named franchise business which the franchisor or the franchise broker knows to have earned or made at least the same sales, income or profits during a period of corresponding length in the immediate past as those sales, income, or profits represented, and the beginning and ending dates for said time period;

(iii) With respect to each such representation of sales, income, or profits of existing outlets, the following statement shall be clearly and conspicuously disclosed in immediate conjunction therewith, printed in not less than 12 point upper and lower case boldface type:

CAUTION

Some outlets have [sold] [earned] this amount. There is no assurance you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

(iv) With respect to each such representation of potential sales, income, or profits, the following statement shall be clearly and conspicuously disclosed in immediate conjunction therewith, printed in not less than 12 point upper and lower case boldface type:

CAUTION

These figures are only estimates. There is no assurance that you'll do as well. If you rely upon our figures, you must accept the risk of not doing as well.

(v) If applicable, a statement clearly and conspicuously disclosing that the franchisor lacks prior franchising experience as to the named franchise business;

(vi) If applicable, a statement clearly and conspicuously disclosing that the franchisor has not been in business long enough to have actual business data;

(vii) A cover sheet, distinctively and conspicuously showing the name of the franchisor, the date of issuance of the document, and the following notice printed thereon in not less than 12 point upper and lower case boldface type:

Information for Prospective Franchisees About Franchise [Sales] [Income] [Profit] Required by the Federal Trade Commission

To protect you, we've required the franchisor to give you this information. *We haven't checked it and don't know if it's correct.* Study these facts and figures carefully. If possible, show them to someone who can advise you, like a lawyer or an accountant. If you find anything you think may be wrong or anything important that's been left out, let us know about it. It may be against the law. There may also be laws about franchising in your State. Ask your State agencies about them.

FEDERAL TRADE COMMISSSION,
Washington, D.C.

(viii) A table of contents;

(6) Each prospective franchisee shall be notified at the ''time for making of disclosures'' of any material changes that have occurred in the information contained in this document.

(f) To make any claim or representation which is contradictory to the information required to be disclosed by this part.

(g) To fail to furnish the prospective franchisee with a copy of the franchisor's franchise agreement and related agreements with the document, and a copy of the completed franchise and related agreements intended to be executed by the parties at least 5 business days prior to the date the agreements are to be executed.

Provided, however, That the obligations defined in paragraphs (b) through (g) of this section shall be deemed to have been met for both the franchisor and the franchise broker if either such person furnishes the prospective franchisee with the written disclosures required thereby.

(h) To fail to return any funds or deposits in accordance with any conditions disclosed pursuant to paragraph (a)(7) of this section.

§ 436.2 Definitions.

As used in this part, the following definitions shall apply:

(a) The term *franchise* means any continuing commercial relationship created by any arrangement or arrangements whereby:

(1)(i)(A) a person (hereinafter ''franchisee'') offers, sells, or distributes to any person other than a ''franchisor'' (as hereinafter defined), goods, commodities, or services which are:

(*1*) Identified by a trademark, service mark, trade name, advertising or other commercial symbol designating another person (hereinafter ''franchisor''); or

(*2*) Indirectly or directly required or advised to meet the quality standards prescribed by another person (hereinafter ''franchisor'') where the franchisee operates under a name using the trademark, service mark, trade name, advertising or other commercial symbol designating the franchisor; and

(B)(*1*) The franchisor exerts or has authority to exert a significant degree of control over the franchisee's method of operation, including but not limited to, the franchisee's business organization, promotional activities, management, marketing plan or business affairs; or

(*2*) The franchisor gives significant assistance to the franchisee in the latter's method of operation, including, but not limited to, the franchisee's business organization, management, marketing plan, promotional activities, or business affairs; *Provided, however,* That assistance in the franchisee's promotional activities shall not, in the absence of assistance in other areas of the franchisee's method of operation, constitute significant assistance; or

(ii)(A) A person (hereinafter ''franchisee'') offers, sells, or distributes to any person other than a ''franchisor'' (as hereinafter defined), goods, commodities, or services which are:

(*1*) Supplied by another person (hereinafter ''franchisor''), or

(*2*) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly required to do business by another person (hereinafter ‘‘franchisor’’); or

(*3*) Supplied by a third person (e.g., a supplier) with whom the franchisee is directly or indirectly advised to do business by another person (hereinafter ‘‘franchisor’’) where such third person is affiliated with the franchisor; and

(B) The franchisor:

(*1*) Secures for the franchisee retail outlets or accounts for said goods, commodities, or services; or

(*2*) Secures for the franchisee locations or sites for vending machines, rack displays, or any other product sales display used by the franchisee in the offering, sale, or distribution of said goods, commodities, or services; or

(*3*) Provides to the franchisee the services of a person able to secure the retail outlets, accounts, sites or locations referred to in paragraphs (a)(1)(ii)(B) (*1*) and (*2*) of this section; and

(2) The franchisee is required as a condition of obtaining or commencing the franchise operation to make a payment or a commitment to pay to the franchisor, or to a person affiliated with the franchisor.

(3) Exemptions. The provisions of this part shall not apply to a franchise:

(i) Which is a ‘‘fractional franchise’’; or

(ii) Where pursuant to a lease, license, or similar agreement, a person offers, sells, or distributes goods, commodities, or services on or about premises occupied by a retailer-grantor primarily for the retailer-grantor’s own merchandising activities, which goods, commodities, or services are not purchased from the retailer-grantor or persons whom the lessee is directly or indirectly (A) required to do business with by the retailer-grantor or (B) advised to do business with by the retailer- grantor where such person is affiliated with the retailer-grantor; or

(iii) Where the total of the payments referred to in paragraph (a)(2) of this section made during a period from any time before to within 6 months after commencing operation of the franchisee’s business, is less than $500; or

(iv) Where there is no writing which evidences any material term or aspect of the relationship or arrangement.

(4) Exclusions. The term *franchise* shall not be deemed to include any continuing commercial relationship created solely by:

(i) The relationship between an employer and an employee, or among general business partners; or

(ii) Membership in a bona fide ‘‘cooperative association’’; or

(iii) An agreement for the use of a trademark, service mark, trade name, seal, advertising, or other commercial symbol designating a person who offers on a general basis, for a fee or otherwise, a bona fide service for the evaluation, testing, or certification of goods, commodities, or services;

(iv) An agreement between a licensor and a single licensee to license a trademark, trade name, service mark, advertising or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to that trademark, trade name, service mark, advertising, or other commercial symbol.

(5) Any relationship which is represented either orally or in writing to be a franchise (as defined in this paragraphs (a) (1) and (2) of this section) is subject to the requirements of this

part.

(b) The term *person* means any individual, group, association, limited or general partnership, corporation, or any other business entity.

(c) The term *franchisor* means any person who participates in a franchise relationship as a franchisor, as denoted in paragraph (a) of this section.

(d) The term *franchisee* means any person (1) who participates in a franchise relationship as a franchisee, as denoted in paragraph (a) of this section, or (2) to whom an interest in a franchise is sold.

(e) The term *prospective franchisee* includes any person, including any representative, agent, or employee of that person, who approaches or is approached by a franchisor or franchise broker, or any representative, agent, or employee thereof, for the purpose of discussing the establishment, or possible establishment, of a franchise relationship involving such a person.

(f) The term *business day* means any day other than Saturday, Sunday, or the following national holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans' Day, Thanksgiving, and Christmas.

(g) The term *time for making of disclosures* means ten (10) business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement or any other agreement imposing a binding legal obligation on such prospective franchisee, about which the franchisor, franchise broker, or any agent, representative, or employee thereof, knows or should know, in connection with the sale or proposed sale of a franchise, or (2) the payment by a prospective franchisee, about which the franchisor, franchise broker, or any agent, representative, or employee thereof, knows or should know, of any consideration in connection with the sale or proposed sale of a franchise.

(h) The term *fractional franchise* means any relationship, as denoted by paragraph (a) of this section, in which the person described therein as a franchisee, or any of the current directors or executive officers thereof, has been in the type of business represented by the franchise relationship for more than 2 years and the parties anticipated, or should have anticipated, at the time the agreement establishing the franchise relationship was reached, that the sales arising from the relationship would represent no more than 20 percent of the sales in dollar volume of the franchisee.

(i) The term *affiliated person* means a person (as defined in paragraph (b) of this section):

(1) Which directly or indirectly controls, is controlled by, or is under common control with, a franchisor; or

(2) Which directly or indirectly owns, controls, or holds with power to vote, 10 percent or more of the outstanding voting securities of a franchisor; or

(3) Which has, in common with a franchisor, one or more partners, officers, directors, trustees, branch managers, or other persons occupying similar status or performing similar functions.

(j) The term *franchise broker* means any person other than a franchisor or a franchisee who sells, offers for sale, or arranges for the sale of a franchise.

(k) The term *sale of a franchise* includes a contract or agreement whereby a person obtains a franchise or interest in a franchise for value by purchase, license, or otherwise. This term shall not be deemed to include the renewal or extension of an existing franchise where there is no interruption in the operation of the franchised business by the franchisee, unless the new contracts or agreements contain material changes from those in effect between the franchisor and franchisee prior thereto.

(l) A *cooperative association* is either (1) an association of producers of agricultural products authorized by section 1 of the Capper-Volstead Act, 7 U.S.C. 291; or (2) an organization operated on a cooperative basis by and for independent retailers which wholesales goods or furnishes services primarily to its member-retailers.

(m) The term *fiscal year* means the franchisor's fiscal year.

(n) The terms *material*, *material fact*, and *material change* shall include any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee.

(o) The term *personal meeting* means a face-to-face meeting between a franchisor or franchise broker (or any agent, representative, or employee thereof) and a prospective franchisee which is held for the purpose of discussing the sale or possible sale of a franchise.

§ 436.3 Severability.

If any provision of this part or its application to any person, act, or practice is held invalid, the remainder of the part or the application of its provisions to any person, act, or practice shall not be affected thereby.

NOTE 1: The Commission expresses no opinion as to the legality of any practice mentioned in this part. A provision for disclosure should not be construed as condonation or approval with respect to the matter required to be disclosed, nor as an indication of the Commission's intention not to enforce any applicable statute.

NOTE 2: By taking action in this area, theFederal Trade Commission does not intend to annul, alter, or affect, or exempt any person subject to the provisions of this part from complying with the laws or regulations of any State, municipality, or other local government with respect to franchising practices, except to the extent that those laws or regulations are inconsistent with any provision of this part, and then only to the extent of the inconsistency. For the purposes of this part, a law or regulation of any State, municipality, or other local government is not inconsistent with this part if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by this part. Examples of provisions which provide protection equal to or greater than that provided by this part include laws or regulations which require more complete record keeping by the franchisor or the disclosure of more complete information to the franchisee.

NOTE 3: [As per § 436.1(a)(24) of this part]:

DISCLOSURE STATEMENT

Pursuant to 16 CFR 436.1 et seq., a Trade Regulation Rule of the Federal Trade Commission regarding Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, the following information is set forth on [name of franchisor] for your examination:

1. Identifying information as to franchisor.
2. Business experience of franchisor's directors and executive officers.
3. Business experience of the franchisor.
4. Litigation history.
5. Bankruptcy history.
6. Description of franchise.
7. Initial funds required to be paid by a franchisee.
8. Recurring funds required to be paid by a franchisee.
9. Affiliated persons the franchisee is required or advised to do business with by the franchisor.
10. Obligations to purchase.
11. Revenues received by the franchisor in consideration of purchases by a franchisee.
12. Financing arrangements.
13. Restriction of sales.
14. Personal participation required of the franchisee in the operation of the franchise.
15. Termination, cancellation, and renewal of the franchise.
16. Statistical information concerning the number of franchises (and company-owned outlets).
17. Site selection.
18. Training programs.
19. Public figure involvement in the franchise.
20. Financial information concerning the franchisor.

CERTIFICATE OF COMPLIANCE

U. S. Court of Appeals Docket Number(s): 09-15684

I hereby certify that this brief complies with Fed. R. App. P. 32(a)(7)(B). It is proportionally spaced and contains 13,882 words, as counted by the WordPerfect word processing program.

Signature /s/ *Mark S. Hegedus*
Mark S. Hegedus

CERTIFICATE OF SERVICE
When Not All Case Participants are Registered for the
Appellant CM/ECF System

U. S. Court of Appeals Docket Number(s): 09-15684

I hereby certify that I electronically filed the Brief for Plaintiff-Appellee Federal Trade Commission with the Clerk of the Court for the United States Court of Appeals for the Ninth Circuit by using the appellate CM/ECF system on December 9, 2009.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid, or have dispatched it to a third party commercial carrier for delivery within 3 calendar days, to the following non-CM/ECF participants:

Matthew L. Johnson
Matthew L. Johnson & Associates PC
Lakes Business Park
8831 W. Sahara Ave.
Las Vegas, NV 89117

Signature /s/ *Mark S. Hegedus*
Mark S. Hegedus