New York Law Journal

SERVING THE BENCH AND BAR SINCE 1888

Web address: http://www.nylj.com

VOLUME 235—NO. 65 WEDNESDAY, APRIL 5, 2006 ALM

OUTSIDE COUNSEL

BY JONATHAN S. SACK AND THOMAS M. KEANE

Potential Defense Counsel Responses to Consumer Fraud Enforcement

New York's Attorney General, Eliot Spitzer, has received considerable attention in recent years for his aggressive enforcement efforts aimed at a range of business activities, including the sale and marketing of securities, mutual funds, insurance, and music.

The attorney general's traditional role in the realm of consumer protection is less publicized but no less important, as recently demonstrated on March 15, 2006, when the attorney general filed suit against H&R Block Inc. for allegedly fraudulent marketing of individual retirement accounts.

Both substantive legal standards and procedural rules confer enormous power on the attorney general when he claims that advertising is false and deceptive. Indeed, the law is so favorable to the attorney general on liability that the most important litigation in such cases will often concern the appropriate remedies. Because the remedies in a consumer enforcement proceeding turn on broad equitable principles, defense counsel have the opportunity to develop arguments to mitigate the impact of an adverse decision on the merits.

Attorney General's Power

Section 63(12) of the New York

Jonathan S. Sack, *former chief of the criminal division of the U.S. Attorney's Office for the Eastern District of New York, is a principal at Morvillo, Abramowitz, Grand, Iason & Silberberg PC.* **Thomas M. Keane** *is an associate at the firm. The firm represented National Collector's Mint Inc. in a case discussed in this article.*

Jonathan S. Sack *Thomas M. Keane*

Both legal standards and procedural rules confer enormous power on the attorney general when he claims advertising is false and deceptive.…[M]ost litigation concerns appropriate remedies.

Executive Law and Article 22-A of the General Business Law give the Attorney General considerable power to bring actions against businesses and individuals for allegedly fraudulent, illegal or deceptive business practices and false advertising. Applicable case law goes a step further by relaxing the standard that the attorney general must meet to establish liability. A private plaintiff suing under Article 22-A of the General Business Law must prove that the conduct at issue would deceive a "reasonable consumer." In contrast, under §63(12) of the Executive Law, the attorney general need only show conduct having "the capacity or tendency to deceive" consumers, including "the ignorant, the unthinking and the credulous."[1] Moreover, the attorney general is not required to prove such typical elements of fraud as intent to deceive and injury.[2]

A streamlined procedure also favors the attorney general. Actions brought by the attorney general under §63(12) of the Executive Law may be brought as special proceedings, governed by Article 4 of the Civil Practice Law and Rules, in order to expedite the case. Thus, the case proceeds rapidly to a hearing, possibly in as little time as eight days from service of the notice of petition which commenced the proceeding. See N.Y. Civil Practice Law and Rules (CPLR) §403(b). At the hearing, the court will "make a summary determination upon the pleadings, papers and admissions to the extent that no triable issues of fact are raised," N.Y. CPLR §409(b), applying the same standard applicable to motions for summary judgment under §3212 of the CPLR.[3] Thus, unless the court finds that there are issues of fact with respect to the tendency of the respondent's conduct to deceive ignorant, unthinking, and credulous consumers, the case can advance to a determination of the appropriate remedies within weeks of commencement.

The Remedial Phase

In light of the attorney general's strong hand in consumer fraud cases, counsel representing respondents in such proceedings would do well to anticipate the possible remedies, even while addressing the issue of liability. The attorney general is authorized to seek injunctive relief, restitution and civil penalties. While any injunction granted will generally track the findings of fact on liability, the two remaining forms of relief—restitution and civil penalties—present particular challenges, and opportunities, for defense counsel.

• ***Restitution.*** Section 63(12) of the Executive Law authorizes the attorney general to seek restitution on behalf of defrauded consumers. Restitution is not mandatory, however; it is subject to the court's discretion. The court may order restitution when it finds that (i) there has been unjust enrichment and (ii) the advantages of fashioning a restitution remedy outweigh the burdens. The key issue for the court is fashioning a method of restitution that returns the parties to the position they were in before any unjust enrichment occurred.[4]

Case law suggests an important distinction between (a) cases in which, despite the alleged fraud, consumers received something of value (as when advertising is found to have made exaggerated claims, for example) and (b) cases in which consumers paid money and received nothing of value in return (as when money is collected for the sale of goods or services which are illegal, do not exist, or are not delivered). In cases where customers received nothing of value, restitution will typically be a mechanical process of paying refunds to those customers, to the extent that respondent has sufficient funds to make refunds.[5]

In cases in which customers have received something of value, and it is conceded that some customers may not want to return their purchases, the respondent should be required to pay restitution only to those customers who indicate they have been injured by returning the product and requesting a refund. A restitution mechanism often will include a letter to the customers containing information intended to correct any misrepresentations made about the product or services purchased and offering to refund customers who return their purchases. Customers who, upon being informed of the alleged fraud upon them, nevertheless wish to keep the product or service at issue, rather than get their money back, are not entitled to restitution. Such customers may not have been deceived to begin with or, upon having received both the product or service at issue and information intended to correct any deception practiced upon them, may simply conclude that the product or service was worth what they paid for it.[6]

This distinction—between cases in which consumers receive something of value and cases in which consumers receive nothing of value —is likewise relevant to another issue that may arise: whether the respondent should be required to set aside a fund to secure the payment of refunds. Although such a fund is not addressed by statute or case law, the attorney general sometimes seeks, and courts sometimes require, creation of restitution funds.[7] In such cases, the size of the fund may be a vital issue for a respondent with limited means.

In a situation in which a seller has received money from consumers but has provided nothing of value in return, the amount of restitution— essentially the seller's gross proceeds—is readily quantifiable, and a court's ordering a security fund in that amount is more likely, especially if the respondent's willingness or ability to make refunds is in question.[8]

Regarding false advertising, the attorney general may seek civil penalties, which courts have held as appropriate even when full restitution has been made.

In contrast, in *State v. Princess Prestige Co.*, 42 NY2d 104, 108, 397 NYS2d 360, 362 (1977), the respondent had not been marketing valueless products. Rather, it had sold and delivered legitimate merchandise but had violated statutory provisions affording customers a "cooling-off" period and right of cancellation. Rather than direct restitution or establish a restitution fund, the Court of Appeals directed the respondent to "take affirmative action necessarily preliminary to establishment of the consumers' rights to restitution to give notice of that right and, thus, in practical effect, to implement restitution." While not squarely or explicitly deciding whether a restitution fund was appropriate, the court presupposed an identification of the persons entitled to a refund and a determination of the amount of money that would be paid out to refund claimants in advance of the creation of any such restitution fund.

As these cases suggest, a respondent can reasonably argue that a fund is appropriate, if at all, only after the amount of restitution is ascertained. Taking this view, in cases where the product at issue had value, and the amount of restitution cannot be known until those customers who want refunds identify themselves, a restitution fund should not be ordered or, alternatively, should be ordered only in an amount reasonably expected to be claimed by consumers as part of a restitution process.

Civil Penalties

In cases involving false advertising, the attorney general may seek imposition of civil penalties, which courts have held to be appropriate to punish and deter wrongdoing even when full restitution has been made. See *People v. National Collector's Mint, Inc.*, Index No. 6355-04, at *6 (N.Y. Sup. Ct., Albany County, Oct. 12, 2005). Section 350-d of the General Business Law provides that acts or practices proscribed as unlawful in Article 22-A are subject to a civil penalty "of not more than five hundred dollars for each violation[.]"

The statute provides no rule or formula, however, by which to assess civil penalties. Additionally, the statute offers no guidance concerning what amount per violation, short of $500, constitutes an appropriate penalty; nor does it explain what constitutes an individual "violation." As a result, the statute merely sets an outer limit on the civil penalty that may be levied in such an action, while giving the court discretion as to whether to impose a penalty and, if so, in what amount below that outer limit.

Courts have held that they must first determine the number of violations, before assessing a civil penalty. As a result, judicial discretion is particularly relevant in cases involving advertising in mass media and on the Internet, which can involve enormous numbers of violations. In mass marketing cases, the number of violations has been determined by reference to various factors, including the number of: (i) individuals who received the deceptive advertising; (ii) individual acts of publication of the deceptive advertising; and (iii) consumer transactions that resulted from the deceptive advertising.[9]

In light of the potentially massive penalty that might result from the application of any of these approaches to cases involving mass marketing, courts have recognized that they must explore the relevant facts and circumstances and "balance the equities" in order to arrive at a proper decision as to civil penalties.[10] Thus, imposition of civil penalties under N.Y. Gen. Bus. Law §350-d reduces to a broad exercise of discretion.

To guide that discretion, courts have looked to federal case law developed under the Federal Trade Commission Act, 15 USCA §45 (the FTCA). In *People v. National Collector's Mint, Inc.*, Index No. 6355-04, at *4 (N.Y. Sup. Ct., Albany County, Oct. 12, 2005), the court held that it should take into account such factors as: (i) the injury to the public from the respondent's conduct; (ii) the respondent's good or bad faith; (iii) the respondent's ability to pay; and (iv) whether the amount of the penalty is sufficient to deter future violations and deprive the respondent of any unlawfully obtained benefit, while not being so excessive as to shock one's sense of fairness.[11]

Under this standard, counsel defending a respondent in a proceeding under N.Y. Gen. Bus. Law §350 should recognize that some penalty will likely be required, if liability is established, in recognition of the injury done to the public and in order to deter similar conduct. Nevertheless, counsel should be prepared to argue, if applicable, that respondent has no history of prior violations.[12] Moreover, if the attorney general seeks imposition of a penalty so large that it threatens respondent's ability to continue in business, counsel should point out that the applicable standard requires consideration of the respondent's ability to pay.

The *National Collector's Mint* case provides an example of how these factors are applied. The court determined the number of violations at issue by reference to the number of orders placed by potentially deceived customers. The court then confronted the question of the appropriate penalty for each of more than 184,000 violations. The attorney general conceded that the statutory maximum penalty of $500 per violation would yield an excessive penalty of over $92 million. Instead, the attorney general sought a penalty of $2 million. Based on the respondent's lack of a prior history of violations of the statute, its limited ability to pay (as determined based on evidence of its net profits from the transactions at issue), and the need to impose a penalty larger than a mere cost of doing business so as to deter future violations, the court instead imposed a penalty of $369,510, or $2 per violation.

Balancing the Equities

In light of the courts' extremely broad discretion to order restitution and impose civil penalties, counsel may find it useful to direct that the court be best advised to turn to basic equitable principles. A bedrock principle of equity jurisprudence is that "[a] court of equity will not do an inequitable thing" and an equitable remedy should not be granted that "would impose great hardship upon [the defendant] and cause little or no benefit to the plaintiff." *McClure v. Leaycraft*, 183 NY 36, 41-42, 75 NE 961, 962-63 (1905). By focusing the court on these principles, defense counsel may be able to convince the court to fashion remedies that make consumers whole without driving respondents out of business or otherwise imposing undue hardships on them.

While courts will be unsympathetic to businesses found to have deceived consumers, they will also hesitate before imposing remedies that defeat the public interest by needlessly harming innocent employees and reducing the chance of a full refund to injured consumers.

1. *People by Spitzer v. General Elec. Co.*, 302 A.D.2d 314, 314-15, 756 N.Y.S.2d 520, 523 (1st Dept. 2003); *Guggenheimer v. Ginzburg*, 43 N.Y.2d 268, 273, 401 N.Y.S.2d 182, 184 (1977).

2. *People v. Apple Health and Sports Clubs, Ltd.*, 206 A.D.2d 266, 267, 613 N.Y.S.2d 868, 869 (1st Dept. 1994) (Attorney general need not prove intent to deceive); *State by Abrams v. Ford Motor Co.*, 136 A.D.2d 154, 158, 526 N.Y.S.2d 637, 639-40 (3d Dept. 1988) (same); *Guggenheimer*, 43 N.Y.2d at 272-73 (Attorney general may state a cause of action without proof "that consumers are being or were actually injured").

3. See *Lefkowitz v. McMillen*, 57 A.D.2d 979, 394 N.Y.S.2d 107, 108 (3d Dept. 1977).

4. *People by Vacco v. Appel*, 258 A.D.2d 957, 958, 685 N.Y.S.2d 504, 505 (4th Dept. 1999); *State by Abrams v. Ford Motor Co.*, 136 A.D.2d 154,158, 526 N.Y.S.2d 637, 639 (3d Dept. 1988); *D.U. Fourth Realty Co. v Meredith*, 119 Misc.2d 423, 425, 463 N.Y.S.2d 374, 376 (N.Y. City Civ. Ct. 1983).

5. See, e.g., *Ford Motor Co.*, 136 A.D.2d at 154, 526 N.Y.2d at 640 (warranty deductible held illegal and ordered refunded); *People by Vacco v. Lipsitz*, 174 Misc.2d 571, 663 N.Y.S.2d 468 (Sup. Ct. N.Y. County 1997) (restitution ordered of money collected for magazine subscriptions that were not delivered).

6. See *State v. Princess Prestige Co.*, 42 N.Y.2d 104, 108, 397 N.Y.S.2d 360, 362 (1977) (ordering respondent to take action to determine whether customers wanted to return home appliances sold and delivered to them, rather than ordering "across-the-board" restitution). Note that any restitution mechanism ordered in cases involving goods that must be returned should provide a procedure for handling returns and refunds. In this regard, while the court may require the respondent to contact customers to advise them of the availability of restitution, the respondent may properly urge that customers be required to respond in order to be included in the restitution process. See *People by Spitzer v. Condor Pontiac, Cadillac, Buick and GMC Trucks, Inc.*, 2003 WL 21649689, at *1 (Sup. Ct. N.Y. County July 2, 2003) (holding restitution would be provided to consumers who demonstrated the bona fides of their claims). The burden is on customers "to come forward and make their claim," and to do so within a specified time. *State by Lefkowitz v. Scottish-American Ass'n, Inc.*, 52 A.D.2d at 528, 529, 381 N.Y.S.2d at 671, 672 (1st Dept. 1976).

7. See, e.g., *State v. Midland Equities of N.Y., Inc.*, 117 Misc.2d 203, 208, 458 N.Y.S.2d 126, 129-30 (Sup. Ct. N.Y. County 1982); *State by Lefkowitz v. Bevis Indus., Inc.*, 63 Misc.2d 1088, 1092, 314 N.Y.S.2d 60, 66 (Sup. Ct. N.Y. County 1970). Alternatively, courts may in certain cases require the respondent to take out a performance bond in order to continue to do business. See, e.g., *People v. Allied Mktg. Group, Inc.*, 220 A.D.2d 370, 633 N.Y.S.2d 137 (1st Dept. 1995); *Scottish-American Assoc., Inc.*, 52 A.D.2d 528, 381 N.Y.S.2d 671.

8. See, e.g., *Midland Equities of N.Y., Inc.*, 117 Misc.2d at 208, 458 N.Y.S.2d at 129-30 (finding that the services rendered by the defendant were valueless and creating a fund to insure repayment of the exact amount of money defendant admitted having received for valueless services). In addition, compare *State by Lefkowitz v. Hotel Waldorf-Astoria Corp.*, 67 Misc.2d 90, 323 N.Y.S.2d 917 (Sup. Ct. N.Y. County 1971) (ordering restitution of a relatively small and undisputed specified amount via refunds to customers, without creation of a restitution fund) with *People v. Life Science Church*, 113 Misc.2d 952, 970-71, 450 N.Y.S.2d 664, 676-77 (Sup. Ct. N.Y. County 1982) (requiring creation of a restitution fund after finding defendant was guilty of civil and criminal contempt for violating previously issued preliminary injunction).

9. See, e.g., *People v. Allied Marketing Group, Inc.*, 220 A.D.2d 370, 633 N.Y.S.2d 137, 137-38 (1st Dept. 1995); *People v. National Collector's Mint, Inc.*, Index No. 6355-04, at *3 (N.Y. Sup. Ct., Albany County, Oct. 12, 2005).

10. See *People v. Record Club of Am.*, 51 A.D.2d 709, 380 N.Y.S.2d 26, 27 (1st Dept. 1976).

11. Cf. 15 USC §45(m) (courts exercising discretion to assess penalties under the FTCA "take into account the degree of culpability, any history of prior such conduct, ability to pay, effect on ability to continue to do business, and such other matters as justice may require.") Courts have interpreted this statute as creating essentially four criteria: (i) respondent's conduct; (ii) injury to the public; (iii) respondent's financial resources (in particular, its ability to pay); and (iv) the need to provide deterrence for future violations. *United States v. Alpine Indus., Inc.*, 352 F.3d 1017, 1030 (6th Cir. 2003).

12. *FTC v. Bonnie & Co. Fashions, Inc.*, 1992 WL 314007, at *7 (D.N.J. Sept. 28, 1992); *United States v. T.C.A., Inc.*, 1997 WL 542683, at *1 (N.D. Cal. Sept. 2, 1997) (in assessing a penalty for a violation of the Fair Debt Collections Practices Act, which has a penalty provision similar to the FTCA, the court took into consideration that the defendant had no prior history of misconduct).