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Unfair Business Practices Update

Software Download Is Not "Goods or Services" under CLRA, but Third Party Payments Constitute "Restitution" under the UCL: *Ferrington v. McAfee*.

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Software now joins insurance and credit services on the list of intangible "goods or services" that fall outside the scope of California's Consumer Legal Remedies Act (CLRA). The recent news from the Northern District, however, is not all good. *Ferrington* also involved a claim under the Unfair Competition Law (UCL)[1] and held that "restitution" for purposes of a UCL claim encompasses monies paid to third parties so long as it is "reasonable to infer that the defendant indirectly received that money from the third party." This decision marks a departure from the California Supreme Court's decision in *Korea Supply Co. v. Lockheed Martin*, which essentially defined "restitution" under the UCL as the return of a direct, out-of-pocket loss. While a handful of courts have found room in *Korea Supply* for the recovery of indirect losses where the lost funds can be fairly traced back to the plaintiff, none have gone as far as *Ferrington*.

The Download

In *Ferrington v. McAfee*, 2010 WL 3910169 (N. D. Cal. Oct. 5, 2010), the Northern District confirmed some settled points and made some new ones:

- Pleading Requirements: The pleading requirements of Rule 9(b) apply to UCL/CLRA claims brought in federal court when the allegations either expressly or implicitly constitute the elements of fraud;
- UCL Standing: A plaintiff who pays money to a third party has standing under the UCL to recover that money from a defendant whose unlawful business practice caused the plaintiff to pay the money;
- Picking Off: Refunding the plaintiff's money will not moot a claim unless the money is repaid with interest;
- "Unfair" Test: Because the California Supreme Court has not yet decided which test is appropriately applied to consumer actions, federal courts may use either the *Cel-Tech* tethering test or the traditional balancing test, but may not use the Federal Trade Commission (FTC) test.

The Facts

Plaintiffs purchased McAfee anti-virus software on-line. After plaintiffs had completed their purchase, but before they downloaded the McAfee software, a pop-up ad sponsored by Arpu appeared inviting plaintiffs to click a “Try it Now” button. Because of its position in the purchase flow and the text in the box, plaintiffs believed that clicking on the “Try it Now” button was necessary to download the McAfee software, so they did. Subsequently (i.e., when the charge appeared on their credit card statement), they discovered that by clicking the “Try it Now” button, plaintiffs had enrolled in a 30-day free trial of Arpu’s software, and that a monthly fee of $4.95 would be charged to the credit card that they had used to purchase the McAfee software if they did not cancel the subscription at the expiration of the free 30-day trial. Behind the scenes, McAfee allegedly had an agreement with Arpu through which it automatically transferred its customers’ credit card numbers to Arpu when a customer clicked on the “Try it Now” button. Plaintiffs alleged violations of the UCL and the CLRA, as well as common law claims for unjust enrichment, declaratory judgment, and the violation of several New York laws.

The Holdings

Ferrington is significant in several respects: it confirms established pleading standards in federal court, clarifies the test for “unfair” in federal courts, removes software from the CLRA, and interprets UCL standing requirements and the definition of “restitution” for purposes of the UCL.

Rule 9(b)

The Court confirmed that Rule 9(b) applies to allegations grounded in fraud regardless of whether the plaintiff asserted a claim for fraud. Rejecting plaintiffs’ argument that the elements of common law fraud need not be pleaded to state a UCL claim, the Court found that Rule 9(b) is appropriately applied not only when fraud is alleged expressly, but also when the allegations, taken as a whole, necessarily constitute the elements of fraud.[2]

CLRA “Goods or Services”

Software, or a software license, is not a “good or service” covered by the CLRA. Recognizing that it was a close call, the Court found that software, like insurance and credit, is considered an “intangible” chattel under California law.[3] The Court, however, sustained the demurrer with leave to amend, inviting plaintiffs to allege facts about the specific software that may affect the Court’s analysis.[4]

UCL Standing

Probably the most important aspect of *Ferrington* is its interpretation of the UCL standing requirement. Plaintiffs did not pay McAfee money as a result of the pop-up ad. Instead, they unwittingly paid a small sum to Arpu when their credit cards were automatically charged after clicking the “Download Now” button. The Court found that this payment was sufficient to confer standing on plaintiffs to seek restitution from *McAfee.*

Relief under section 17200 is limited to injunctive relief and restitution. The California Supreme Court defined “restitution” for purposes of the UCL in *Korea Supply Co. v. Lockheed Martin Corp.*, 29 Cal. 4th 1134 (2003). There, the Court explained that restitution for purposes of the UCL is an out-of-pocket loss or the loss of money in which a plaintiff had an ownership interest.[5] *Korea Supply* drew a distinction between restitution and the broader remedy of “disgorgement,” defining the latter as the return of all money obtained from any source through an unfair business practice, such as profits earned through an unfair business practice. *Korea Supply* confirmed that “disgorgement” is available under the UCL only to the extent that it is also “restitutionary,” i.e., that it represents the return of money that the plaintiff lost directly. *Korea Supply* thus concluded that only money that a defendant takes directly from a plaintiff can be ordered returned as “restitution” under the UCL.[6]

Korea Supply has been largely interpreted as requiring the return of funds from the person to whom the funds were paid. *Ferrington* arrives at a different conclusion, holding that the plaintiffs could recover from McAFee the money they paid to Arpu. The Court’s conclusion was based on a curious interpretation of a recent appellate court decision: *Troyk v. Farmers Group, Inc.*, 171 Cal. App. 4th 1305 (2009). *Ferrington* recognized *Korea Supply’s* holding that “an award is not ‘restitutionary’ if it would not replace money that defendants took directly from

Plaintiffs."[7] However, the *Ferrington* Court found that statement to be limited to the particular facts at issue in *Korea Supply*, those facts being that plaintiffs were seeking to disgorge profits earned from a third party transaction and thus profits in which plaintiffs never had an ownership interest.[8] Relying on *Troyk, Ferrington* found that *Korea Supply* left room for a plaintiff to seek restitution under the UCL from a defendant whose unlawful business practice caused the plaintiff to pay money to the third party.[9]

While *Ferrington's* definition of "restitution" was inconsistent with the black letter of *Korea Supply*, particularly in light of the facts alleged there, it was not necessarily inconsistent with general jurisprudence surrounding "restitution." It is not unusual for terms to have different meanings in different contexts, and because *Korea Supply* represents the Supreme Court's word on 'restitution" for purposes of the UCL, *Ferrington* erred in failing to adhere to it. In *Ferrington's* defense, however, the existing case law has not been clear about distinguishing between restitution under the UCL and restitution for other purposes. *Ferrington*, relying almost entirely on *Troyk*, concluded that "the UCL permits restitution from a defendant whose unfair business practices caused plaintiff to pay money to a *third party*, as long as it is reasonable to infer that the defendant indirectly received that money from the third party."[10] This conclusion is not wholly incorrect because case law does allow restitution of "indirect" funds under the UCL so long as those funds can be directly traced back to the plaintiff. It cannot, however, be money that plaintiff never paid, as that would be the disgorgement that *Korea Supply* denounced.

The *Ferrington* Court's error was its failure to recognize a critical fact present in *Troyk* that was not present in the case before it: *Troyk* did not involve an arm's length business relationship like the alleged revenue-sharing agreement between McAfee and Arpu. Rather, *Troyk* involved a series of interrelated companies intertwined sufficiently to constitute alter egos as a matter of law. In *Troyk,* plaintiff purchased a monthly automobile insurance policy from Farmers Insurance Exchange ("Farmers"). Through his suit, plaintiff sought return of a $5 service charge that was not disclosed in his policy. Farmers Underwriters Association ("FGI") was Farmers' attorney-in-fact and performed all policy administration services, including drafting and issuing policies and collecting premium. The Court found that it was acting as Farmers' agent. Prematic Service Corporation was a wholly owned subsidiary of FGI and collected the premiums for Farmers' monthly policies, including plaintiff's. The Court found that because of the relationship between Prematic, FGI, and Farmers, Prematic was the alter ego of FGI. Accordingly, plaintiff could recover his $5 from Farmers or FGI even though he paid it to Prematic because the three companies were in effect operating as a single enterprise under established California law to collectively transact the business of insurance.[11]

Notwithstanding that the facts of *Troyk* were a far cry from those in *Ferrington,* there is language in *Troyk* and other California cases indicating that both parties to a revenue-sharing agreement may be liable under the UCL or an unjust enrichment theory regardless of to whom the plaintiff actually paid the money. While *Ferrington's* third party theory was certainly wrong as it was applied to its facts, a tracing theory, such as that used in the context of constructive trust, finds some support in the case law. While California law has kept relatively tight reigns on the restitution of money paid initially to a third party post-*Korea Supply,* there are a handful of cases that have allowed "indirect" restitution. Courts have allowed indirect purchaser type recovery, for example against a manufacturer, even though the plaintiff purchased the product from a retailer.[12] Courts have also allowed recovery against a restaurant corporation that allegedly misappropriated plaintiffs' tips and paid those tips to the bartenders.[13] Two factors are consistently present in all of these decisions: (1) plaintiff paid money to someone and thus was out-of-pocket; and (2) the specific out-of-pocket funds were directly traceable to the defendant, akin to a constructive trust situation.

Hirsch, one of the cases upon which *Ferrington* relied, is instructive because it involved recoverable "indirect" charges to the plaintiff as well as non-recoverable third-party payments, and thus highlights the distinction. *Hirsh* involved an alleged kick-back scheme between the defendant banks and title insurance and escrow companies. In exchange for the deposit of escrow funds into demand deposit accounts, the banks paid the title companies disguised interest payments that the title companies then converted to their own use. Federal law prohibited interest on demand deposit accounts. California law, in turn, required that interest be paid to the depositing party.[14] Plaintiffs' theory was that they were entitled to recover the kick-back payments because they were really interest payments to which they were entitled under the California statute. Plaintiffs also sought recovery of allegedly excessive “management services” fees that were passed on to them through the escrow process.

The Court sustained the banks’ demurrers to the interest claim, finding that because federal law prohibited interest on the deposit accounts, plaintiffs never had any interest in that money and thus could not recover it through the UCL.[15] In other words, the funds were not traceable back to the plaintiffs, either directly or indirectly—it simply was not their money. With respect to the excessive charges passed through to plaintiffs, however, plaintiffs survived demurrer—that was their money. Importantly, however, the Court did not find that the overcharges were recoverable under the UCL. Instead, the Court found that plaintiffs were entitled to restitution under the independent legal theory of *unjust enrichment*, noting that under that theory, “to confer a benefit, it is not essential that money be paid directly to the recipient by the party seeking restitution.”[16]

Ferrington was decided on a pleading motion, so its ultimate outcome remains to be seen. It may be that the plaintiffs will be unable to show that they had a direct ownership interest in any funds that Arpu paid to McAfee. The take-away is that the question will turn on the specific terms of the payment provisions in the agreement between McAfee and Arpu. And, even though restitution under the UCL does not fit, restitution under another legal theory may.

Endnotes

1 (Business & Professions Code §§ 17200 *et seq.*)

2 *Id*. at *5.

3 *Id*. at *18, *citing, Fairbanks v. Sup. Ct.,* 46 Cal. 4th 56 (2009); Cal. Commercial Code § 9102(a).

4 *Id.,* n. 6.

5 *Id*. at 1149.

6 *Korea Supply* at 1149.

7 *Ferrington* at *7, citing, *Korea Supply* at 1149.

8 *Id.*

9 *Id.*, citing, *Troyk* at 1305.

10 *Id*., emphasis added.

11 *Troyk*, 171 Cal. App. 4th at 1319.

12 *Shersher v. Sup. Ct.,* 154 Cal. App. 4th 1500 (2007)(holding plaintiff entitled to restitution from Microsoft based on misrepresenting data transmission rates on various wireless products even though plaintiff purchased the products from a retailer rather than from Microsoft directly).

13 *Matoff v. Brinker Restaurant Corp.*, 439 F. Supp. 2d 1035, 1038 (C. D. Cal. 2006); *see also, Hirsch v. Bank of America*, 107 Cal. App. 4th 708 (2003) (allowing recovery of excessive fees ultimately paid by plaintiffs through unjust enrichment theory).

14 *Hirsch* at 711-12.

15 *Id*. at 718 (holding that in order to recover under the UCL, “appellants must have been deprived of something to which they had an interest…”).

16 *Id*. at 722.

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