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3rd Annual Computer & Technology Law Institute

Office of Continuing Legal Education at the University of Kentucky College of Law

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**UK
CLE**

3rd Annual
**COMPUTER
&
TECHNOLOGY
LAW INSTITUTE**

March 2001

**UK
CLE**

3rd Annual

**Computer &
Technology Law
Institute**

March 2001

**Presented by the
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW**

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3RD ANNUAL COMPUTER & TECHNOLOGY LAW INSTITUTE

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FEDERAL E-SIGN LEGISLATION AND UETA

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FEDERAL E-SIGN LEGISLATION AND UETA

Presented at the
3RD Annual

COMPUTER & TECHNOLOGY LAW INSTITUTE

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Lexington, Kentucky

by Charles R. Keeton¹ and David A. Cornett²

1. What is UETA?

UETA is the Uniform Electronic Signatures Act, approved by the National Conference of Commissioners on Uniform State Laws ("NCCUSL") at its annual meeting in July, 1999 as a body of legislation validating the use of electronic records and electronic signatures.³

NCCUSL is a 109 year old nonprofit, unincorporated association of commissioners on uniform laws from the 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands. NCCUSL's primary task is to determine which areas of the law would benefit from uniformity, and to write and recommend uniform laws to state legislatures for enactment. NCCUSL has written more than 200 uniform laws, including its most famous (and successful) product, the Uniform Commercial Code,⁴ the Uniform Partnership Act, the Uniform Trade Secrets Act, the Uniform Probate Code and the Uniform Limited Partnership Act.⁵

UETA is procedural in nature, not substantive. It does not require anybody to use electronic signatures or to rely upon electronic records and signatures. It does not prohibit paper records and manual signatures. Basic rules of law, like the general and statutory rules of contracts, continue to apply.⁶

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³ Fry, Patricia B., "A Preliminary Analysis of Federal and State Electronic Commerce Laws," Chair of the UETA Drafting Committee, July 7, 2000, accessed online at <http://www.jetaonline.com/docs/pfry700.html> on January 24, 2001.

⁴ NCCUSL sponsors the UCC jointly with the American Law Institute.

⁵ <http://www.webcom.com/legaled/ETAForum/bkgd.html>, accessed February 14, 2001.

⁶ http://www.nccusl.org/uniformact_summaries/uniformacts-s-ueta.htm, "Uniform Electronic Transactions Act," accessed January 24, 2001.

UETA applies only to transactions in which each party has agreed by some means to conduct them electronically. Agreement is an essential element. Parties that are subject to UETA may also opt out. They may vary, waive or disclaim most of the provisions of UETA by agreement, even if it is agreed that business will be transacted by electronic means. The rules in UETA are almost all default rules that apply only in the event that the terms of an agreement do not govern.⁷

Section 7 of UETA provides its four basic rules: (1) a record or signature may not be denied legal effect or enforceability solely because it is in electronic form; (2) a contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation; (3) any law that requires a writing will be satisfied by an electronic record; and (4) any signature requirement in the law will be met if there is an electronic signature.⁸

(a) Background and History

UETA is a response to NCCUSL's recognition that electronic commerce transcends both state and national boundaries, that non-uniform legislation passed by various individual states is not an optimal method for the development of such commerce, and that there is a need for a uniform law validating electronic commerce. Prior to the drafting of UETA, some states had already enacted laws dealing with electronic technologies. Legislation of Utah, California and Illinois, while varying significantly from the final product, was relied upon as models by the drafters of UETA.⁹

A good summary of the reasons behind the drafting of UETA is provided in the Reporter's Memorandum for the first submitted draft of UETA:

"On July 1, 1997, President Clinton announced the Administration's 'Framework for Global Electronic Commerce.' The Framework indicates that global commerce via Internet transactions is anticipated to reach 'tens of billions of dollars by the turn of the century.' That estimate does not include electronic commerce being conducted today over so-called 'closed systems' such as electronic data interchange. Clearly the magnitude of the economic activity being conducted electronically is huge, and growing rapidly. This activity is currently being conducted amid legal uncertainty regarding the validity and efficacy of the electronic records and documents being used to evidence the commercial transactions and relationships being created.

⁷ *Id.*

⁸ *Id.*

⁹ Fry, Patricia B., "The Medium Shall Not Be The Message: Securing Legal Certainty For Electronic Transactions With The Uniform Electronic Transactions Act," <http://www.abanet.org/buslaw/mo/premium-cl/programs/spr00/abc.asp>, accessed January 30, 2001.

- Supportive, not Prescriptive – The law was to be supportive of electronic commerce, enabling it to grow and mature in a sound legal environment, but should not be prescriptive or regulatory.
- Minimalism – The law was to not impose any greater restrictions on electronic communications than it imposes on paper-based communications.
- Technology Neutral – The law was to adopt provisions that accommodated existing technologies and allowed new technology. No technology was to be favored over another, nor inhibit development of new technologies.
- Implementation Neutrality – The law was to not favor one business implementation over another.
- Non-Interference with Substantive Rules – The law was to not restate substantive legal rules but was to assure, as much as possible, that there were no barriers because of the form in which messages or records were communicated or stored in transactions.
- Freedom of Contract – Participants in electronic commerce were to be given the freedom to structure their transactions and relations among themselves contractually, with a minimum of interference from the law.¹¹

(b) Enactment of UETA by States

As of February 6, 2001, UETA has been adopted in 23 states and has been introduced in 10 others, it has also been introduced in the U.S. Virgin Islands.¹² The first state to adopt UETA was California, however, they are now in the process of adopting a conforming version of UETA.

(c) Kentucky's UETA Enactment

Kentucky's enactment of UETA became effective August 1, 2000. A full copy of the text of the bill of enactment (HB 571),¹³ the amendments, and the time-line for its enactment is attached to this document as Appendix A. Appendix B of this document contains Chapter 369 of the Kentucky Revised Statutes, the statutorily enacted version of UETA. Salient provisions of HB 571 provide that it:

..

electronic media should be treated as the equal of written media.
 ...”¹⁰ (Emphasis added.)

The guiding principles for the drafting of UETA included the following:

¹⁰ Reporter's Memorandum (Ben Beard), Introducing the First Draft of UETA, August 15, 1997.

Recognizing this void, the Framework calls for the creation of a 'Uniform Commercial Code' for Electronic Commerce.'

This draft has been prepared to address that uncertainty and fill the legal void by creating a basic legal structure recognizing and effectuating records and signatures generated electronically. *The fundamental policy running throughout this Act is to establish the legal equivalence of electronic records and signatures with paper writings and manually signed signatures.* At its most basic, this policy focuses on overcoming perceived bias against electronic records and signatures because of their ethereal nature and lack of concrete substance. The concern in this regard relates to the sense that something as seemingly fleeting as electronic 'beeps and chirps' is insufficient to support and evidence commercial activities involving potentially large sums of money.

Whether the concern manifests itself in the context of existing writing and signature requirements such as the Statute of Frauds, or evidentiary requirements to prove the existence and terms of a transaction, the concerns are real for many. Notwithstanding these concerns, however, the economic benefits of electronic commercial activity, e.g. time, efficiency and storage savings, have caused many commercial actors to proceed with implementing electronic commerce in the face of these concerns. This is largely due to the recognition among commercial actors that electronic commerce is generally as reliable and safe as paper, and justifies the risks inherent in the legal uncertainty.

The legal uncertainties surrounding electronic commerce relate principally to the media in which these transactions are conducted, i.e., electronic records as opposed to paper and ink writings. For most commercial activity, once electronic media are recognized, the substantive body of commercial law, whether derived from statutes such as the Uniform Commercial Code or the common law as reflected in *Restatement (Second) Contracts*, provides the applicable and appropriate rule of law. ...

Part 2 reflects the fundamental premise of this Act that

¹¹ Boss, Amelia K., "Uniform Electronic Transaction Act," accessed at the Business Law Home Page at <http://www.abanet.org> on January 30, 2001.

¹² <http://www.uctaonline.com/hapstate.html>, accessed February 14, 2001. States enacting UETA include Arizona, California, Delaware, Florida, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Nebraska, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Utah, and Virginia. States introducing UETA include Arkansas, California (conforming version), Connecticut, Mississippi, Montana, New Jersey, New Mexico, North Dakota, Oregon, Texas, and Vermont.

¹³ <http://www.lrc.state.ky.us/record/00rs/HB571.htm>, accessed February 14, 2001.

- creates new sections of KRS Chapter 369 to adopt UETA to provide uniform rules to govern transactions in electronic commerce;
- defines “electronic signature” as an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record;
- defines “transaction” as an action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs;
- directs that UETA apply to electronic records and electronic signatures relating to a transaction;
- provides that UETA apply to electronic records or electronic signatures created, generated, sent, communicated, received, or stored on or after the effective date [August 1, 2000] of this Act;
- directs that UETA does not require the creation or use of an electronic record or electronic signature;
- directs that UETA apply only to transactions in which each party has agreed by some means to conduct them electronically;
- allows a party who agrees to conduct a transaction by electronic means to refuse to conduct other transactions electronically;
- permits the provisions of UETA to be varied by agreement;
- describes how UETA is to be construed and applied;
- provides that a record or signature may not be denied legal effect or enforceability solely because it is in electronic form;
- provides that a contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation;
- directs that any law that requires a record to be in writing will be satisfied by an electronic record;
- directs that any signature requirement in the law will be satisfied by an electronic signature;
- describes the relationship between UETA and other law;

- creates new sections of KRS Chapter 369 to adopt UETA to provide uniform rules to govern transactions in electronic commerce;
- defines “electronic signature” as an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record;
- defines “transaction” as an action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs;
- directs that UETA apply to electronic records and electronic signatures relating to a transaction;
- provides that UETA apply to electronic records or electronic signatures created, generated, sent, communicated, received, or stored on or after the effective date [August 1, 2000] of this Act;
- directs that UETA does not require the creation or use of an electronic record or electronic signature;
- directs that UETA apply only to transactions in which each party has agreed by some means to conduct them electronically;
- allows a party who agrees to conduct a transaction by electronic means to refuse to conduct other transactions electronically;
- permits the provisions of UETA to be varied by agreement;
- describes how UETA is to be construed and applied;
- provides that a record or signature may not be denied legal effect or enforceability solely because it is in electronic form;
- authorizes the Governor's Office for Technology to specify the manner and format;
- authorizes governmental agencies to specify the type of electronic signature required, the manner and format in which it is affixed to a record, and the identity of, or criteria that must be met by, any third party used by a person filing a document;
- allows a governmental agency to specify any other required attributes for electronic records;
- directs that UETA does not require a governmental agency to use or permit the use of electronic records or electronic signatures;

- designates the Governor's Office for Technology to set standards for the use of electronic records and signatures that promote consistency and interoperability between governmental agencies; and
- directs that UETA applies to contracts created or renegotiated on and after the effective date of this Act.

Kentucky's enactment of UETA also contained amendments that are not a part of the uniform version of UETA. HB 571 amendments include the following:

- Exempts certain consumer protection statutes from application of the Act;
- regarding consumer contracts entered for personal, family, or household reasons, establishes circumstances by which an electronic agent provides an opportunity for the prevention or correction of an error;
- establishes rules that apply to a transaction entered into by an individual for personal, family, or household purposes.¹⁴

(i) Differences Between Kentucky UETA Enactment And Uniform UETA

The differences between the Kentucky UETA enactment and the uniform version of UETA as drafted by NCCUSL in 1999 are found in Section 3 (KRS § 369.103). The uniform version of UETA provides in pertinent part that:

“(b) This [Act] does not apply to a transaction to the extent it is governed by:

- (1) a law governing the creation and execution of wills, codicils, or testamentary trusts;
- (2) [The Uniform Commercial Code other than Sections 1-107 and 1-206, Article 2, and Article 2A];
- (3) [the Uniform Computer Information Transactions Act]; and
- (4) [other laws, if any, identified by State].”

The Kentucky enactment of UETA, however, provides the following (KRS 369.103(2)):

¹⁴ *Id.*

“(2) KRS 369.101 to 369.120 does not apply to a transaction to the extent it is governed by:

- (a) A law governing the creation and execution of wills, codicils, or testamentary trusts;
- (b) KRS Chapter 355 other than KRS 355.1-107 and 355.1-206, and Articles 2 and 2A of KRS Chapter 355;
- (c) *A law governing the conveyance of any interest in real property; and*
- (d) *A law governing the creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title.”* (Emphasis added.)

The Official Comments to Section 3 of the NCCUSL uniform version of UETA specifically discusses the exemption of real estate transactions from UETA’s scope (KRS 369.103(2)(c)). It provides that:

“**Real Estate Transactions.** It is important to distinguish between the efficacy of paper documents involving real estate between the parties, as opposed to their effect on third parties. As between the parties it is unnecessary to maintain existing barriers to electronic contracting. There are no unique characteristics to contracts relating to real property as opposed to other business and commercial (including consumer) contracts. Consequently, the decision whether to use an electronic medium for their agreements should be a matter for the parties to determine. Of course, to be effective against third parties state law generally requires filing with a governmental office. *Pending adoption of electronic filing systems by States, the need for a piece of paper to file to perfect rights against third parties, will be a consideration for the parties.* In the event notarization and acknowledgment are required under other laws, Section 11 provides a means for such actions to be accomplished electronically.” (Emphasis added.)

It appears likely that the Kentucky legislature has heeded the advice of the Drafting Committee and considered the lack of an electronic filing system for real estate transactional documents and the need for a piece of paper for enforcement.

KRS 369.103(2)(d) is somewhat more problematic. Although this section of the statute exempts “[a] law governing the creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title” from Kentucky’s UETA enactment, Section 16 of UETA (KRS 369.116) specifically includes a “transferable record,” which is defined as an electronic record that “[w]ould be a note under Article 3 of KRS Chapter 355 or a document

under Article 7 of KRS Chapter 355 if the electronic record were in writing;” subject to the requirements that (1) “[t]he issuer of the electronic record expressly has agreed it is a transferable record,” and (2) a person has “reliably established” control of the transferable record. Section 16 (KRS 369.116) further defines how a person is deemed to have reliably established control of the transferable record.

2. UETA Requirements

(a) Limited to Transactions

UETA applies only to electronic records and electronic signatures relating to a transaction. In the absence of these elements, UETA does not apply.¹⁵

An “electronic record” is one created, generated, sent, communicated, received or stored by electronic means including facsimile, e-mail, voice mail, audio records, internet transmissions, or any other technology with electromagnetic or similar capability.¹⁶

An “electronic signature” is any electronic sound, symbol or process attached to or logically associated with a record which is executed or adopted by a person with the intent to sign the record. It must include three elements: (1) an affirmative act; (2) an intention to sign a record; and (3) logical association with the signed record.¹⁷

UETA defines a “transaction” as “an action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs.”¹⁸

(b) Agreement/Consent

UETA § 5(b) provides that “[t]his Act applies only to transactions between parties each of which has agreed to conduct transactions by electronic means. Whether the parties agree to conduct a transaction by electronic means is determined from the context and surrounding circumstances, including the parties’ conduct.”

The parties do not have to enter into a formal written agreement to utilize electronic transactions. The term “agreement” is to be given broad construction under UETA. The Official Comments to UETA provide the following examples of where the parties are found to have agreed to conduct business transactions electronically:

¹⁵ See UETA § 3(a).

¹⁶ See UETA §§ 2(5), (7), (13).

¹⁷ See UETA § 2(8).

¹⁸ See UETA § 2(16).

"A. Automaker and supplier enter into a Trading Partner Agreement setting forth the terms, conditions and methods for the conduct of business between them electronically.

B. Joe gives out his business card with his business e-mail address. It may be reasonable, under the circumstances, for a recipient of the card to infer that Joe has agreed to communicate electronically for business purposes. However, in the absence of additional facts, it would not necessarily be reasonable to infer Joe's agreement to communicate electronically for purposes outside the scope of the business indicated by use of the business card.

C. Sally may have several e-mail addresses - home, main office, office of a non-profit organization on whose board Sally sits. In each case, it may be reasonable to infer that Sally is willing to communicate electronically with respect to business related to the business/purpose associated with the respective e-mail addresses. However, depending on the circumstances, it may not be reasonable to communicate with Sally for purposes other than those related to the purpose for which she maintained a particular e-mail account.

D. Among the circumstances to be considered in finding an agreement would be the time when the assent occurred relative to the timing of the use of electronic communications. If one orders books from an on-line vendor, such as Bookseller.com, the intention to conduct that transaction and to receive any correspondence related to the transaction electronically can be inferred from the conduct. Accordingly, as to information related to that transaction it is reasonable for Bookseller to deal with the individual electronically.

The examples noted above are intended to focus the inquiry on the party's agreement to conduct a transaction electronically. Similarly, if two people are at a meeting and one tells the other to send an e-mail to confirm a transaction - the requisite agreement under subsection (b) would exist. In each case, the use of a business card, statement at a meeting, or other evidence of willingness to conduct a transaction electronically must be viewed in light of all the surrounding circumstances with a view toward broad validation of electronic transactions."

(c) Attribution

Attribution involves the methods involved to attribute electronic communications to their senders.

UETA § 9 provides that an electronic record or electronic signature is attributable to a person if it was the act of the person. This may be proven by any means, including a showing of the efficacy of a security procedure which has been applied. UETA is technology neutral in that one form of security procedure (such as dual key encryption) is not preferred over any other. The type of security procedure utilized goes to the quality of the evidence indicating that an electronic record or signature is to be attributed to a certain person. UETA does not contradict or disturb any existing digital signature legislation.

UETA defines a "security procedure" as:

"a procedure employed for the purpose of verifying that an electronic signature, record, or performance is that of a specific person or for detecting changes or errors in the information in an electronic record. The term includes a procedure that requires the use of algorithms or other codes, identifying words or numbers, encryption, or callback or other acknowledgement procedures."

(d) Electronic Agents

UETA defines an "electronic agent" as "a computer program or an electronic or other automated means used independently to initiate an action or respond to electronic records or performances in whole or in part, without review or action by an individual."¹⁹

UETA clearly validates contracts formed by electronic agents. Section 14 of UETA provides that a person may form a contract by using an electronic agent. That means that the principal, which is the person or entity that provides the program to do business, is bound by the contract that its agent makes.²⁰

(e) Exclusions

The list of excluded transactions in the UETA is limited, although an enacting state is free (but not encouraged) to enlarge upon these exceptions. The exclusions to UETA are found in Section 3(b) and include the following:

- Laws governing the creation and execution of wills, codicils, or testamentary trusts. Because testamentary documents are intended to be effective and

¹⁹ See UETA § 2(6).

²⁰ See UETA § 14.

binding on third parties following the death of the testator, the significance of the document for the testator, and the fact that such documents are intensely personal and only incidentally of commercial value, the decision was made to exclude records governed by such statutes.²¹

- The Uniform Commercial Code other than § 1-107 (Waiver or Renunciation of Claim or Right After Breach) and § 1-206 (Statute of Frauds for Kinds of Personal Property Not Otherwise Covered) and Articles 2 and 2A.
- The Uniform Computer Information Transactions Act (“UCITA”). UCITA applies to transactions in computer information. It contains its own provisions validating the use of electronic records and transactions and are thought to be consistent with UETA.²²

3. What is E-SIGN?

(a) Federal Enactment, Background and History

The Electronic Signatures in Global and National Commerce Act (“E-SIGN”), S. 761, Pub. L. No. 106-229, 114 Stat. 464, was adopted by Congress on June 16, 2000, signed by President Clinton on June 30, 2000, and became effective on October 1, 2000. It is codified at 15 U.S.C. §§ 7001-7006, 7021 and 7031.

The fundamental purpose of the law is to establish that a signature, contract, or record relating to a transaction involving interstate or foreign commerce may not be denied legal effect or enforceability simply because it is in electronic form. Several states, but not all, have adopted their own legislation concerning electronic transactions. As a means to eliminate the obstacles to efficient interstate online transactions posed by the different states’ laws and the uncertainties created by the absence of such laws, E-SIGN prescribes uniform national standards while also allowing states to maintain their own measures if they conform to the federal standards.²³ E-SIGN is intended to preempt any state law that gives greater legal status or effect to the use of any specific technology.

E-SIGN includes four titles; Title I establishes the fundamental rules governing the use of electronic signatures and the rights and obligations attendant to those rules, particularly as they affect consumers; Title II sets forth specific provisions regarding electronic negotiable instruments or “transferable records;”

²¹ Fry, Patricia B., “The Medium Shall Not Be The Message: Securing Legal Certainty For Electronic Transactions With The Uniform Electronic Transactions Act,” <http://www.abanet.org/buslaw/mo/premium-cl/programs/spr00/abc.asp>, accessed January 30, 2001.

²² *Id.*

²³ Perkins, Nancy L., “New Electronic Signature Legislation Validates Online Contracting,” *The Computer & Internet Lawyer*, Vol. 17, No. 12, December 2000, pp. 1-7.

Title III prescribes principles for the promotion of international electronic commerce; and Title IV amends the Child Online Protection Act.²⁴

4. E-SIGN Requirements²⁵

(a) Electronic Legal Validity

A signature, contract, or other record relating to a transaction in or affecting interstate or foreign commerce may not be denied legal effect, validity, or enforceability solely because it is in electronic form.

(b) Consent

Electronic records may be substituted for records otherwise required to be in writing only if the consumer has affirmatively consented to receive an electronic record and such consent has not been withdrawn; and prior to consenting the consumer is provided with a clear and conspicuous statement informing the consumer of rights or options to have the record provided or made available on paper, and the right of the consumer to withdraw the consent to electronic records and of any conditions, consequences (which may include termination of the parties' relationships) or fees in the event of withdrawal of consent.

(c) Notice

If the consumer has consented to the receipt of electronic records and a change in the hardware or software needed to access or retain the records creates a risk that the consumer will not be able to access or retain a record that was the subject of the consent, the person providing the electronic record must provide the consumer with a statement of the revised hardware and software requirements for access to and retention of the electronic records, and the right to withdraw consent without the imposition of any fees for such withdrawal and without the imposition of any condition or consequence that was not disclosed.

(d) Preemption of State Law

E-SIGN preempts state law *unless* such law: (1) constitutes an adoption or enactment of the UETA as approved and recommended by NCCUSL in 1999; or (2) specifies alternative procedures or requirements for the use or acceptance of electronic signatures or records for establishing the legal effect, validity, and enforceability of contracts or records, and those alternative procedures or requirements are (a) consistent with Titles I and II of E-SIGN, and (b) do not require, or give greater legal status or effect to use or application of a specific

²⁴ Nimmer, Raymond T., "Electronic Signatures and Records: The New US Perspective," *The Computer & Internet Lawyer*, Vol. 17, No. 12, December 2000, pp. 8-28.

²⁵ *Id.*

technology or technological specification for creating, storing, generating, receiving, communicating, or authenticating electronic signatures or records.

(e) Exemptions

(i) Transactions Covered by Certain Other Laws

E-SIGN does not apply to:

- a statute, regulation, or rule of law governing the creation and execution of wills, codicils, or testamentary trusts;
- a statute, regulation, or other rule of law governing adoption, divorce, or other matters of family law; or
- the Uniform Commercial Code as in effect in any state, other than § 1-107 and § 1-206 and Articles 2 and 2A.

(ii) Legal Orders and Certain Notices

E-SIGN also does not apply to:

- court orders, notices, or official court documents required to be executed in connection with court proceedings;
- notices of cancellation or termination of utility services; or
- notices of default, acceleration, repossession, foreclosure or eviction, or the right to cure under a credit agreement secured by, or a rental agreement for, a primary residence of an individual or the cancellation or termination of health insurance, benefits, or life insurance benefits (excluding annuities).

(f) Federal and State Agency Implementing Authority

A federal or state regulatory agency, or a self-regulatory organization, may specify standards or formats for the filing of records with that agency or organization, including requiring paper filings or records. Further, a federal or state regulatory agency that is responsible for rulemaking under any other statute may interpret E-SIGN with respect to such statute through the issuance of regulations, orders, or guidance if the agency finds that: (1) there is a justified purpose for the regulation, order, or guidance; (2) the methods selected to carry out that purpose are substantially equivalent to the requirements imposed on records that are not electronic records and will not impose unreasonable costs on the use and acceptance of electronic records; and (3) the methods selected to carry out that purpose do not require the implementation or application of a specific

technology or technological specification for creating, storing, generating, receiving, communicating, or authenticating electronic signatures or records.

(g) Transferable Records

Defined as electronic records that would be promissory notes or documents if in written form, may be executed using an electronic signature. A person is deemed to have control of a transferable record if a single authoritative copy of the transferable record exists and identifies the person to whom the transferable record was issued or most recently transferred and copies and revisions are properly identifiable and authorized.

(h) Promotion of International Electronic Commerce

The Secretary of Commerce is directed to "take all actions" necessary to eliminate impediments to electronic commerce on a global scale.

(i) Studies

The Department of Commerce must conduct a study of the effectiveness of the delivery of electronic records to consumers via e-mail as compared to postal mail, and together with the Federal Trade Commission, must conduct a study on the benefits and burdens of specific elements of the consumer consent requirements of E-SIGN.

5. Uniform UETA and E-SIGN's Exemption to Preemption.²⁶

Generally, federal law preempts overlapping state law under the Supremacy Clause of the United States Constitution. E-SIGN specifically provides that if state has adopted the uniform version of UETA §§ 1 – 16 as promulgated by NCCUSL in 1999, then such state's law is not preempted. The pertinent language of E-SIGN providing for this exemption to preemption is found in E-SIGN § 102(a):

"(a) IN GENERAL- A State statute, regulation, or other rule of law may modify, limit, or supersede the provisions of section 101 with respect to State law only if such statute, regulation, or rule of law--

(1) constitutes an enactment or adoption of the Uniform Electronic Transactions Act as approved and recommended for enactment in all the States by the National Conference of Commissioners on Uniform State Laws in 1999, except that any exception to the scope of such Act enacted by a State under section 3(b)(4) of such Act shall be preempted to the extent such exception is inconsistent with this title or

²⁶ Fry, Patricia B., "A Preliminary Analysis of Federal and State Electronic Commerce Laws," accessed online at <http://www.uetaonline.com/docs/pfry700.html> on January 24, 2001.

title II, or would not be permitted under paragraph (2)(A)(ii) of this subsection; or

(2)(A) specifies the alternative procedures or requirements for the use or acceptance (or both) of electronic records or electronic signatures to establish the legal effect, validity, or enforceability of contracts or other records, if--

(i) such alternative procedures or requirements are consistent with this title and title II; and

(ii) such alternative procedures or requirements do not require, or accord greater legal status or effect to, the implementation or application of a specific technology or technical specification for performing the functions of creating, storing, generating, receiving, communicating, or authenticating electronic records or electronic signatures; and

(B) if enacted or adopted after the date of the enactment of this Act, makes specific reference to this Act.”

There are two important caveats to this exemption, the first being that if a state has accepted the invitation in UETA § 3(b)(4) to exclude bodies of state law other than those listed by the drafters, E-SIGN § 102(a)(1) specifies that those exclusions are preempted to the extent that they are inconsistent with Title I (electronic contracting) and Title II (transferable records) of E-SIGN. E-SIGN does not affect a state's uniform enactment of UETA §§ 1-16. This caveat prevents states from enacting UETA while simultaneously undermining the key goals of E-SIGN. Because UETA § 3(b)(4) enables a state to prevent the use or acceptance of electronic signatures or records for a variety of transactions, some states have used this “loophole” to exclude important transactions, such as insurance transactions. Congress has closed this “loophole” through E-SIGN § 102(a)(1) by preempting any exception that is “inconsistent” with E-SIGN.

The second caveat is that any state's other laws or non-uniform provisions of UETA are to be evaluated under E-SIGN § 102(a)(2)'s two-part test. If the other law or non-uniform UETA provision is consistent with Titles I and II of E-SIGN and does not favor any specific technology it will survive federal preemption. Existing federal preemption doctrine prescribes that any inconsistent, non-uniform provision of a state's enactment of UETA or other law that violates the E-SIGN § 102(a)(2) two-part test will be ineffective but the remainder of such enactment or law will be enforceable to the extent not inconsistent with E-SIGN.

E-SIGN has other provisions to limit the authority of a state to override its provisions. UETA § 8(b) provides that if a state law requires records to be posted or displayed, sent or communicated, or provides for specific formatting for stated information, the method provided in that state law must be followed. E-SIGN § 102(c) states that this UETA provision may not be used by the state to circumvent E-SIGN by imposing "nonelectronic delivery means" which would be enforced under UETA § 8(b).

It is important to note that E-SIGN's § 102 exemption to preemption provision applies only to the electronic contracting provisions of E-SIGN. To the extent that any other titles of the statute overlap state law, the federal law will prevail.

6. Comparison of UETA and E-SIGN²⁷

(a) UETA is More Comprehensive Than E-SIGN

(i) Attribution

E-SIGN contains no provisions dealing with the attribution of electronic records or electronic signatures. UETA § 9 provides that an electronic record or electronic signature is to be attributed to a person if it was the act of the person, which can be shown by any relevant evidence.

(ii) Effect of Other State Law

UETA is procedural in nature and explicitly defers to the provisions of other state law for most substantive determinations. Questions of authority, agency, forgery, contract formation, etc. are to be determined by other state law. E-SIGN states that it does not affect any legal requirement beyond requirements for writings, signatures, and the like.

(iii) Agreement of the Parties

UETA recognizes that the parties are free to enter into agreements concerning their use of electronic media and applies only when the parties have agreed to transact electronically. UETA § 5(d) provides that parties have the power to vary its provisions by contract. E-SIGN confines itself to the legal effect, validity and enforceability of electronic records and signatures. It contains no provisions on variation by agreement. Any mandatory provisions of E-SIGN, such as the consumer notice provisions of § 101(c), are not susceptible to variation by agreement, even in cases where state law might otherwise have permitted the parties to define or specify matters in their contracts.

²⁷ *Id.*

(iv) The “e-Mailbox Rule”

UETA § 15 ties the determination as to whether an electronic record is sent or received to the communications system used by the parties and, unless otherwise agreed, they are sent or received from the parties’ principal place of business or residence, regardless of the actual location of the computer, server or other communications equipment. E-SIGN does not address time and place of receipt or transmission of an electronic record.

(v) Mistake or Error

UETA § 10 contains specific provisions governing the effect of the failure to use an agreed security procedure, the impact of mistakes made by an individual while dealing with an electronic agent, and specifies that, except as specifically provided, the rules of mistake otherwise apply. E-SIGN does not contain provisions dealing with mistakes or errors in electronic communications.

(vi) Admissibility into Evidence

UETA § 13 specifies that electronic records are not to be denied admissibility into evidence solely because the records are in electronic format. E-SIGN does not address the admissibility of electronic records.

(vii) Transferable Records

UETA would allow all documents which would, if on paper, be either a promissory note under UCC Article 3 or a document of title under UCC Article 7. E-SIGN provides only for electronic negotiable notes in transactions secured by real property. Both, UETA and E-SIGN condition the application of the statutory provisions on (1) express consent by the issuer of the note, and (2) the existence of a system which will “reliably establish” the person in “control” of the electronic transferable record. Furthermore, because the UETA and E-SIGN provisions do not overlap here, the federal statute will not preempt UETA.

(b) Differences between UETA and E-SIGN

(i) Consumer Protection

A. UETA Focuses on Parties’ Compliance With State Consumer Protection Rules

- UETA does not apply to electronic records in the absence of an agreement to transact electronically. Agreement is not required to be explicit but can be determined from the context and surrounding circumstances of the transaction.

- UETA § 8 specifies that the legal requirements to provide, send or deliver information in writing may be satisfied with an electronic record capable of retention at the time of receipt. Such a record is not capable of retention if the sender, or its information processing system, inhibits the ability of the addressee to print or store the record.
- UETA preserves the requirements of other state law concerning the manner of sending, posting, displaying and formatting of information.

B. E-SIGN Emphasizes Regulating the Manner of Consumer Assent to Deal Electronically

- E-SIGN does not require consumer consent before all electronic dealings.
- E-SIGN § 101(c) applies only where the law requires information to be provided or made available to the consumer in writing.
- The consumer must be notified of any right or option to receive paper.
- The consumer must be notified of the right to withdraw consent to receive electronic notice and of any consequences (including termination of the relationship) and fees upon termination.
- The consumer must be notified whether the consent is to the specific transaction or to notices during the course of the parties' relationship.
- The consumer must be informed how to obtain a paper copy of an electronic record and of any fee to be charged.
- The consumer must be furnished, prior to obtaining consent, with a statement of hardware and software needed for access to and retention of the records.
- The consumer must consent electronically or confirm the assent electronically "in a manner that reasonable demonstrates that the consumer can access information in the electronic form that will be used ..."
- The consumer must be provided with another statement of hardware and software requirements and be given the right to withdraw the consent without any fees being imposed or any other conditions if a system change raises a material risk that the consumer will not be able to access or retain an electronic record. The consumer must also consent once again electronically or confirm the assent electronically.

- E-SIGN § 101(c)(3) provides that the failure to obtain consent in compliance with its terms does not, of itself, affect the effectiveness, validity or enforceability of any contract entered into with the consumer.

(ii) Record Keeping

UETA merely requires that the record remain accessible for later reference. E-SIGN requires that the record remain accessible to “all persons who are entitled to access by statute, regulation, or rule of law” for the time specified in such a rule.

(iii) Automated Transactions

UETA § 14 provides that the use of one or more electronic agents will not defeat the formation of contracts, even in cases where no individual is aware of or reviews the operations of the agents or resulting terms and that a contract may be formed by the interaction of an individual and an agent, including actions in which the individual performs voluntarily, having knowledge or reason to know that such action will cause the agent to complete the performance (*e.g.* clicking an “I Agree” button).

UETA also addresses errors in the transmission of electronic records and failure to use available security procedures to detect changes and/or errors and contains a special provision for mistakes made by individuals dealing with electronic agents. There are no comparable E-SIGN provisions.

E-SIGN § 101(h) provides that a contract or other record may not be denied effect, validity or enforceability solely because an electronic agent was involved in its formation, creation or delivery, provided that the agent is attributable “to the person to be bound.” E-SIGN does not provide that a contract may be formed by the interaction between an individual and an agent.

(iv) Exclusions

E-SIGN contains additional exclusions that are not found in UETA. These exclusions include:

- Statutes, regulations or other rules of law governing adoption, divorce or other matters of family law.
- Court orders, notices, and items required to be executed in connection with judicial proceedings. (UETA does not consider these as “transactional documents.”)
- Cancellation or termination of utility services, health insurance and health insurance benefits, or life insurance benefits.

- Default, acceleration, repossession, foreclosure, eviction, or right to cure a credit agreement or a rental agreement relating to a primary residence and notice of recall or material failure of a product which might endanger health or safety.
- Any document required to accompany the shipping or handling of hazardous or toxic materials.

Unlike UETA, however, E-SIGN contains no exception for UCITA.

7. Digital Signatures, Negotiable Instruments, UETA and E-SIGN

(a) Digital Signatures, What Are They?

Digital signatures are, in their most basic form, mathematical algorithms. They are electronic substitutes for manual signatures that serve the same functions as manual signatures.²⁸ The main functions of digital signatures are signer authentication, non-alteration, and non-repudiation which correspond to the requirements of a written signature; namely, evidentiary, cautionary, deterrent and channeling functions.²⁹ More specifically, a digital signature is "the sequence of bits that is created by running an electronic message through a one-way hash function and the encrypting the resulting message digest with the sender's private key."³⁰ Therefore, a digital signature is unique to each document signed, but not necessarily unique to the signer. However, because each signature is unique to a document, it can provide additional security as to the authenticity and integrity (*i.e.* non-alteration) of the communication. A digital signature is not a digitized image of a handwritten signature or a typed signature.

(b) UETA, E-SIGN and Digital Signatures

Neither UETA nor E-SIGN are digital signature legislation. The use of dual key encryption, Secure Socket Layer™, or a personal identification number is not mandated or prescribed by UETA or E-SIGN. This is consistent with their drafting philosophies of technology neutrality and minimalism. The use of specific technology is relevant where the attribution or accuracy of a record is disputed.

UETA allows other state law concerning digital signatures. It does not contradict or disturb such laws. The UETA drafting committee considered state laws requiring the use of specific technology as useful experiments for the future

²⁸ Cocco, Anthony, "Digital Signatures, Effects on Marketplace & Technology," *The Lawyer's PC*, Vol. 17, No. 23, September 1, 2000.

²⁹ Dorney, Maureen S., "Digital Signature Legislation," (Derived from an article funded by CommerceNet), June, 1997.

³⁰ Cocco, Anthony, "Digital Signatures, Effects on Marketplace & Technology," *The Lawyer's PC*, Vol. 17, No. 23, September 1, 2000.

legal treatment of security techniques and did not wish to alter such existing legislation.³¹

E-SIGN, however, is intended to preempt any mandatory state digital signature legislation.³² The primary motivation for such preemption is to prevent barriers to electronic commerce that are perceived to be erected by individual states' legislation regarding digital signatures. The result under Section 101(a) of E-SIGN is that electronics using the "state mandatory technology" and electronics using any other technology are enforceable under law as altered by E-SIGN.³³

(c) Negotiable Instruments Under UETA and E-SIGN

UETA Section 16 provides that notes under Article 3 and documents under Article 7 of the UCC are "transferable records" when in electronic form. These are negotiable instruments.³⁴ UETA provides that a transferable record which meets certain requirements for "control," as found in Section 16, is enforceable and that the person in "control" has the same rights as a holder of a note under the UCC.³⁵ The Official Comments to UETA § 16 provide that "Section 16(b) allows control to be found so long as 'a system employed for evidencing the transfer of interests in the transferable record reliably establishes [the person claiming control] as the person to which the transferable record was issued or transferred.'" The Official Comments go on to state that "[t]he key point is that a system, whether involving third party registry or technological safeguards, must be shown to reliably establish the identity of the person entitled to payment" and that "[g]enerally, the transferable record must be unique, identifiable, and except as specifically permitted, unalterable."

Presently, a system "... which dates, encrypts, and stores all the electronic information in the transferable record in a manner which lender can demonstrate reliably establishes lender as the person to which the transferable record was issued"³⁶ is apparently not commercially available on a cost-effective basis.³⁷

³¹ Fry, Patricia B., "The Medium Shall Not Be The Message: Securing Legal Certainty For Electronic Transactions With The Uniform Electronic Transactions Act," <http://www.abanet.org/buslaw/mo/premium-cl/programs/spr00/abc.asp>, accessed January 30, 2001.

³² Fry, Patricia B., "A Preliminary Analysis of Federal and State Electronic Commerce Laws," Chair of the UETA Drafting Committee, July 7, 2000, accessed online at <http://www.jetaonline.com/docs/pfry700.html> on January 24, 2001.

³³ Nimmer, Raymond T., "Electronic Signatures and Records: The New US Perspective," *The Computer & Internet Lawyer*, Vol. 17, No. 12, December 2000, pp. 8-28.

³⁴ http://www.nccusl.org/uniformact_summaries/uniformacts-s-jeta.htm, "Uniform Electronic Transactions Act," accessed January 24, 2001.

³⁵ Stern, Sandra, "The Future Is Here: The Electronic Closing In 2000," *Banking Law Journal*, October, 2000.

³⁶ UETA Section 16 Official Comment 3.

³⁷ Stern, Sandra, "The Future Is Here: The Electronic Closing In 2000," *Banking Law Journal*, October, 2000.

Many of the "technological safeguards" required by Section 16 for transferable records are found in digital signature technology. However, as described above, digital signature technology aids in signer authentication and non-alteration, but non-repudiation (because a digital signature is not unique to the "signer") is troublesome. Dual-key encryption, the present most popular form of digital signature technology, utilizes a public-private key pair.³⁸ The sender of a transferable record transmits the public key along with the message to the recipient. The recipient, however, must be able to know, in fact, that the public key he or she has received belongs to the sender in order to avoid repudiation problems. Certification Authorities are one possible solution to this problem. Certification Authorities are trusted third-party entities that ascertain the identity of a person, called a subscriber, and certify that the public key of a public-private key pair used to create digital signatures belong to that person.³⁹ Such systems are currently in place with regard to the transfer of security entitlements under Article 8 of the UCC and in the transfer of cotton warehouse receipts under the program sponsored by the US Department of Agriculture.⁴⁰ Such systems are also being developed for electronic commerce by IBM, Verisign, GTE's CyberTrust and, the U.S. Post Office has announced plans to begin acting as a Certification Authority.⁴¹ The use of electronic negotiable instruments, while theoretically allowable under the uniform version of UETA, is possible, albeit a complicated and expensive proposition involving third-parties at this time.

Another hurdle in the use of electronic negotiable instruments is, as now exists, the situation where UETA has not been enacted in each jurisdiction of the United States. A court sitting in a non-UETA state, which has established jurisdiction over a dispute among the parties, may hold an electronic negotiable instrument non-enforceable.⁴² This situation may be somewhat alleviated by E-SIGN. E-SIGN provides for an "electronic negotiable instrument," but it applies only to promissory notes secured by real property that the issuer has expressly agreed is covered by E-SIGN.⁴³ E-SIGN's other "transferable record" provisions are modeled after UETA and so long as any such security provisions "reliably

³⁸ A complete description of dual-key encryption and public-private key pairs is beyond the scope of this paper. Please refer to Stern, Sandra, "The Future Is Here: The Electronic Closing In 2000," *Banking Law Journal*, October, 2000; Dorney, Maureen S., "Digital Signature Legislation," (Derived from an article funded by CommerceNet), June, 1997; and Cocco, Anthony, "Digital Signatures, Effects on Marketplace & Technology," *The Lawyer's PC*, Vol. 17, No. 23, September 1, 2000, for a more in-depth analysis of this technology.

³⁹ Cocco, Anthony, "Digital Signatures, Effects on Marketplace & Technology," *The Lawyer's PC*, Vol. 17, No. 23, September 1, 2000.

⁴⁰ UETA Section 16 Official Comment 3.

⁴¹ Stern, Sandra, "The Future Is Here: The Electronic Closing In 2000," *Banking Law Journal*, October, 2000, EN 15.

⁴² *Id.*

⁴³ See E-SIGN § 201 and Wittie, Robert A., Winn, Jane K., "E-SIGN of the Times," published in the August, 2000 issue of *E-Commerce Law Report*, accessed at <http://www.kl.com/practiceareas/technology/pubs/page20.stm> on February 14, 2001.

establish" the person under "control" of the instrument, the electronic version of the promissory note will be treated as equivalent to a paper note.⁴⁴

It remains to be seen how Kentucky's enactment of UETA, providing that it does not apply to a transaction to the extent it is governed by "[a] law governing the creation or transfer of any negotiable instrument . . .,"⁴⁵ is affected by, or will affect, the "transferable records" provision of UETA Section 16 (KRS 369.116) or whether it will be considered to be contradictory to E-SIGN as a "non-uniform enactment" of UETA and thus preempted.

8. Going Forward With Both, UETA and E-SIGN

E-SIGN includes provisions in its Title III to encourage international recognition of electronic signatures and records in accordance with principles outlined in E-SIGN § 301(a). It directs the Secretary of Commerce to take an active role in bilateral and multilateral talks to promote the use and acceptance of electronic signatures and electronic records worldwide. The E-SIGN § 301(a) principles are as follows:

- Remove paper based obstacles to electronic transactions by adopting relevant principles from the Model Law on Electronic Commerce adopted in 1996 by the United Nations Commission on International Trade Law.
- Permit parties to a transaction to determine the appropriate authentication technologies and implementation models for their transactions, with assurance that those technologies and implementation models will be recognized and enforced.
- Permit parties to a transaction to have the opportunity to prove in court or in other proceedings that their authentication approaches and their transactions are valid.
- Take a nondiscriminatory approach to electronic signatures and authentication methods from other jurisdictions.

E-SIGN requires two federal agency studies. First, it requires the Department of Commerce to conduct a study of the delivery of electronic records to consumers via e-mail as compared with delivery of written records via US Postal Service. This study is due June 30, 2001. The second study is to be conducted jointly with the Commerce Department and the Federal Trade Commission and is to analyze the effectiveness of the consumer consent provisions of E-SIGN. This study is also due on June 30, 2001. Furthermore the Commerce Department is required to report by June 30, 2003, whether the E-SIGN exclusions are necessary to protect consumers.

Congress has made provisions for E-SIGN to interface harmoniously with a state's enactment of the uniform version of UETA. Furthermore, there are incentives for

⁴⁴ *Id.*

⁴⁵ Kentucky Revised Statutes 369.103(2)(d).

a state to enact UETA because of the more comprehensive scope of UETA and its differences from E-SIGN.

Charles R. Keeton
David A. Cornett
February 28, 2001

LOUIMDMS/18204.2

APPENDIX A

Kentucky Enactment of UETA

"HB 571/FN (BR 841) - C. Geveden, J. Richards, S. Riggs

AN ACT adopting the Uniform Electronic Transactions Act, and making changes incidental thereto.

Create new sections of KRS Chapter 369 to adopt the Uniform Electronic Transactions Act (UETA) drafted by the National Conference of Commissioners on Uniform State Laws to provide uniform rules to govern transactions in electronic commerce in every state; define "electronic signature" as an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record; define "transaction" as an action or set of actions occurring between two or more persons relating to the conduct of business, commercial, or governmental affairs; define various additional terms; direct that UETA apply to electronic records and electronic signatures relating to a transaction; provide exemptions; provide that UETA apply to electronic records or electronic signatures created, generated, sent, communicated, received, or stored on or after the effective date of this Act; direct that UETA does not require the creation or use of an electronic record or electronic signature; direct that UETA apply only to transactions in which each party has agreed by some means to conduct them electronically; allow a party who agrees to conduct a transaction by electronic means to refuse to conduct other transactions electronically; permit the provisions of UETA to be varied by agreement; describe how UETA is to be construed and applied; provide that a record or signature may not be denied legal effect or enforceability solely because it is in electronic form; provide that a contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation; direct that any law that requires a record to be in writing will be satisfied by an electronic record; direct that any signature requirement in the law will be satisfied by an electronic signature; describe the relationship between UETA and other law; prescribe attribution and effect of an electronic record or electronic signature; establish rules regarding errors and changes in messages; provide for notarization and acknowledgment by electronic signature under certain conditions; set forth rules for retention of electronic records; allow a governmental agency to specify additional requirements for record retention subject to the agency's jurisdiction; prohibit, in a proceeding, exclusion of evidence of a record or signature solely because it is in electronic form; prescribe rules for automated transactions; establish when and from what place information is legally sent or received in electronic form; prescribe rules for transferable records, as defined in the Uniform Commercial Code;

direct each governmental agency to determine whether, and the extent to which it will create electronic records and direct the Department of Libraries and Archives to determine whether, and the extent to which, the Commonwealth will retain electronic records and convert written records to electronic records; allow each governmental agency, in compliance with standards established by the Governor's Office for Technology, to determine its use of sending and accepting electronic records; authorize the Governor's Office for Technology to specify the manner and format; authorize governmental agency to specify the type of electronic signature required, the manner and format in which it is affixed to a record, and the identity of, or criteria that must be met by, any third party used by a person filing a document; allow a governmental agency to specify any other required attributes for electronic records; direct that UETA does not require a governmental agency to use or permit the use of electronic records or electronic signatures; designate the Governor's Office for Technology to set standards for the use of electronic records and signatures that promote consistency and interoperability between governmental agencies; provide severability clause; direct that UETA applies to contracts created or renegotiated on and after the effective date of this Act; provide that contracts based on the repealed KRS 369.010 to 369.030 shall continue under their terms until those contracts expire or are renegotiated and direct that the application of the repealed electronic signature statutes to those contracts shall continue as if the specified statutes had not been repealed; make technical amendment; repeal KRS 369.010 (Legislative intent of KRS 369.010 to 369.030), 369.020 (Definitions for KRS 369.010 to 369.030), and 369.030 (Use of electronic record or electronic signature--Construction and scope of); establish August 1, 2000, as the effective date of this Act.

HB 571 - AMENDMENTS

SFA(1, W. Blevins) - Exempt certain consumer protection statutes from application of the Act; regarding consumer contracts entered for personal, family, or household reasons, establish circumstances by which an electronic agent provides an opportunity for the prevention or correction of an error; establish rules that apply to a transaction entered into by an individual for personal, family, or household purposes.

Feb 3-introduced in House

Feb 4-to State Government (H)

Feb 9-posted in committee

Feb 22-reported favorably, 1st reading, to Calendar

- Feb 23-2nd reading, to Rules
- Feb 25-recommitted to Appropriations and Revenue (H)
- Mar 1-posted in committee
- Mar 9-reported favorably, to Rules
- Mar 10-posted for passage in the Regular Orders of the Day for Monday,
March 13, 2000
- Mar 13-3rd reading, passed 95-0
- Mar 14-received in Senate
- Mar 16-to Economic Development, Tourism & Labor (S)
- Mar 20-reported favorably, 1st reading, to Calendar
- Mar 21-2nd reading, to Rules; floor amendment (1) filed
- Mar 22-posted for passage in the Regular Orders of the Day for Thursday,
March 23, 2000
- Mar 24-3rd reading; floor amendment (1) withdrawn ; passed 34-0
- Mar 27-received in House; enrolled, signed by each presiding officer,
delivered to Governor
- Apr 3-signed by Governor (Acts ch. 301).

APPENDIX B

Kentucky's Enacted Version of UETA Kentucky Revised Statutes Chapter 369

369.101 Short title for KRS 369.101 to 369.120.

KRS 369.101 to 369.120 may be cited as the Uniform Electronic Transactions Act.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 1, effective August 1, 2000.

369.102 Definitions for KRS 369.101 to 369.120.

As used in KRS 369.101 to 369.120, unless the context requires otherwise:

- (1) "Agreement" means the bargain of the parties in fact, as found in their language or inferred from other circumstances and from rules, regulations, and procedures given the effect of agreements under laws otherwise applicable to a particular transaction;
- (2) "Automated transaction" means a transaction conducted or performed, in whole or in part, by electronic means or electronic records, in which the acts of records of one (1) or both parties are not reviewed by an individual in the ordinary course in forming a contract, performing under an existing contract, or fulfilling an obligation required by the transaction;
- (3) "Computer program" means a set of statements or instructions to be used directly or indirectly in an information processing system in order to bring about a certain result;
- (4) "Contract" means the total legal obligation resulting from the parties' agreement as affected by KRS 369.101 to 369.120 and other applicable law;
- (5) "Electronic" means relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities;
- (6) "Electronic agent" means a computer program or an electronic or other automated means used independently to initiate an action or respond to electronic records or performances in whole or in part, without review or action by an individual;
- (7) "Electronic record" means a record created, generated, sent, communicated, received, or stored by electronic means;

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- (8) "Electronic signature" means an electronic sound, symbol, or process attached to or logically associated with a record and executed or adopted by a person with the intent to sign the record;
- (9) "Governmental agency" means an executive, legislative, or judicial agency, department, board, commission, authority, institution, or instrumentality of the federal government or of a state or of a county, municipality, or other political subdivision of a state;
- (10) "Information" means data, text, images, sounds, codes, computer programs, software, databases, or the like;
- (11) "Information processing system" means an electronic system for creating, generating, sending, receiving, storing, displaying, or processing information;
- (12) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, governmental agency, public corporation, or any other legal or commercial entity;
- (13) "Record" means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form;
- (14) "Security procedure" means a procedure employed for the purpose of verifying that an electronic signature, record, or performance is that of a specific person or for detecting changes or errors in the information in an electronic record. The term includes a procedure that requires the use of algorithms or other codes, identifying words or numbers, encryption, or callback or other acknowledgment procedures;
- (15) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States. The term includes an Indian tribe or band, or Alaskan native village, which is recognized by federal law or formally acknowledged by a state; and
- (16) "Transaction" means an action or set of actions occurring between two (2) or more persons relating to the conduct of business, commercial, or governmental affairs.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 2, effective August 1, 2000.

369.103 Scope of KRS 369.101 to 369.120.

- (1) Except as otherwise provided in subsection (2) of this section, KRS 369.101 to 369.120 applies to electronic records and electronic signatures relating to a transaction.
- (2) KRS 369.101 to 369.120 does not apply to a transaction to the extent it is governed by:
 - (a) A law governing the creation and execution of wills, codicils, or testamentary trusts;
 - (b) KRS Chapter 355 other than KRS 355.1-107 and 355.1-206, and Articles 2 and 2A of KRS Chapter 355;
 - (c) A law governing the conveyance of any interest in real property; and
 - (d) A law governing the creation or transfer of any negotiable instrument or any instrument establishing title or an interest in title.
- (3) KRS 369.101 to 369.120 applies to an electronic record or electronic signature otherwise excluded from the application of KRS 369.101 to 369.120 under subsection (2) of this section to the extent it is governed by a law other than those specified in subsection (2) of this section.
- (4) A transaction subject to KRS 369.101 to 369.120 is also subject to other applicable substantive law.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 3, effective August 1, 2000.

369.104 Prospective application of KRS 369.101 to 369.120.

KRS 369.101 to 369.120 applies to any electronic record or electronic signature created, generated, sent, communicated, received, or stored on or after August 1, 2000.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 4, effective August 1, 2000.

369.105 Use of electronic records and electronic signatures - Variation by agreement.

- (1) KRS 369.101 to 369.120 does not require a record or signature to be created, generated, sent, communicated, received, stored, or otherwise processed or used by electronic means or in electronic form.

- (2) KRS 369.101 to 369.120 applies only to transactions between parties each of which has agreed to conduct transactions by electronic means. Whether the parties agree to conduct a transaction by electronic means is determined from the context and surrounding circumstances, including the parties' conduct.
- (3) A party that agrees to conduct a transaction by electronic means may refuse to conduct other transactions by electronic means. The right granted by this subsection may not be waived by agreement.
- (4) Except as otherwise provided in KRS 369.101 to 369.120, the effect of any of its provisions may be varied by agreement. The presence in certain provisions of KRS 369.101 to 369.120 of the words "unless otherwise agreed," or words of similar import, does not imply that the effect of other provisions may not be varied by agreement.
- (5) Whether an electronic record or electronic signature has legal consequences is determined by KRS 369.101 to 369.120 and other applicable law.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 5, effective August 1, 2000.

369.106 Construction and application of KRS 369.161 to 369.120.

KRS 369.101 to 369.120 must be construed and applied:

- (1) To facilitate electronic transactions consistent with other applicable law;
- (2) To be consistent with reasonable practices concerning electronic transactions and with the continued expansion of those practices; and
- (3) To effectuate its general purpose to make uniform the law with respect to the subject of KRS 369.101 to 369.120 among states enacting it.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 6, effective August 1, 2000.

369.107 Legal recognition of electronic records, electronic signatures, and electronic contracts.

- (1) A record or signature may not be denied legal effect or enforceability solely because it is in electronic form.
- (2) A contract may not be denied legal effect or enforceability solely because an electronic record was used in its formation.

- (3) If a law requires a record to be in writing, an electronic record satisfies the law.
- (4) If a law requires a signature, an electronic signature satisfies the law.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 7, effective August 1, 2000.

369.108 Provision of information in writing - Presentation of records.

- (1) If parties have agreed to conduct a transaction by electronic means and a law requires a person to provide, send, or deliver information in writing to another person, the requirement is satisfied if the information is provided, sent, or delivered, as the case may be, in an electronic record capable of retention by the recipient at the time of receipt. An electronic record is not capable of retention by the recipient if the sender or its information processing system inhibits the ability of the recipient to print or store the electronic record.
- (2) If a law other than KRS 369.101 to 369.120 requires a record to be posted or displayed in a certain manner, to be sent, communicated, or transmitted by a specified method, or to contain information that is formatted in a certain manner, the following rules apply:
 - (a) The record must be posted or displayed in the manner specified in the other law.
 - (b) Except as otherwise provided in subsection (4)(b) of this section, the record must be sent, communicated, or transmitted by the method specified in the other law.
 - (c) The record must contain the information formatted in the manner specified in the other law.
- (3) If a sender inhibits the ability of a recipient to store or print an electronic record, the electronic record is not enforceable against the recipient.
- (4) The requirements of this section may not be varied by agreement, but:
 - (a) To the extent a law other than KRS 369.101 to 369.120 requires information to be provided, sent, or delivered in writing but permits that requirement to be varied by agreement, the requirement under subsection (1) of this section that the information be in the form of an electronic record capable of retention may also be varied by agreement; and

- (b) A requirement under a law other than KRS 369.101 to 369.120 to send, communicate, or transmit a record by United States mail may be varied by agreement to the extent permitted by the other law.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 8, effective August 1, 2000.

369.109 Attribution and effect of electronic record and electronic signature.

- (1) An electronic record or electronic signature is attributable to a person if it was the act of the person. The act of the person may be shown in any manner, including a showing of the efficacy of any security procedure applied to determine the person to which the electronic record or electronic signature was attributable.
- (2) The effect of an electronic record or electronic signature attributed to a person under subsection (1) of this section is determined from the context and surrounding circumstances at the time of its creation, execution, or adoption, including the parties' agreement, if any, and otherwise as provided by law.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 9, effective August 1, 2000.

369.110 Effect of change or error.

If a change or error in an electronic record occurs in a transmission between parties to a transaction, the following rules apply:

- (1) If the parties have agreed to use a security procedure to detect changes or errors and one (1) party has conformed to the procedure, but the other party has not, and the nonconforming party would have detected the change or error had that party also conformed, the conforming party may avoid the effect of the changed or erroneous electronic record.
- (2) In an automated transaction involving an individual, the individual may avoid the effect of an electronic record that resulted from an error made by the individual in dealing with the electronic agent of another person if the electronic agent did not provide an opportunity for the prevention or correction of the error and, at the time the individual learns of the error, the individual:
 - (a) Promptly notifies the other person of the error and that the individual did not intend to be bound by the electronic record received by the other person;
 - (b) Takes reasonable steps, including steps that conform to the other person's reasonable instructions, to return to the other person or, if instructed by the

other person, to destroy the consideration received, if any, as a result of the erroneous electronic record; and

- (c) Has not used or received any benefit or value from the consideration, if any, received from the other person.
- (3) If neither subsection (1) of this section nor subsection (2) of this section applies, the change or error has the effect provided by other law, including the law of mistake, and the parties' contract, if any.
- (4) Subsections (2) and (3) of this section may not be varied by agreement.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 10, effective August 1, 2000.

369.111 Notarization and acknowledgment.

If a law requires a signature or record to be notarized, acknowledged, verified, or made under oath, the requirement is satisfied if the electronic signature of the person authorized to perform those acts, together with all other information required to be included by other applicable law, is attached to or logically associated with the signature or record.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 11, effective August 1, 2000.

369.112 Retention of electronic records -- Originals.

- (1) If a law requires that a record be retained, the requirement is satisfied by retaining an electronic record of the information in the record which:
 - (a) Accurately reflects the information set forth in the record after it was first generated in its final form as an electronic record or otherwise; and
 - (b) Remains accessible for later reference.
- (2) A requirement to retain a record in accordance with subsection (1) of this section does not apply to any information the sole purpose of which is to enable the record to be sent, communicated, or received,
- (3) A person may satisfy subsection (1) of this section by using the services of another person if the requirements of that subsection are satisfied.
- (4) If a law requires a record to be presented or retained in its original form, or provides consequences if the record is not presented or retained in its original

form, that law is satisfied by an electronic record retained in accordance with subsection (1) of this subsection.

- (5) If a law requires retention of a check, that requirement is satisfied by retention of an electronic record of the information on the front and back of the check in accordance with subsection (1) of this subsection.
- (6) A record retained as an electronic record in accordance with subsection (1) of this section satisfies a law requiring a person to retain a record for evidentiary, audit, or like purposes, unless a law enacted after August 1, 2000, specifically prohibits the use of an electronic record for the specified purpose.
- (7) This section does not preclude a governmental agency of this state from specifying additional requirements for the retention of a record subject to the agency's jurisdiction.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, see. 12, effective August 1, 2000.

369.113 Admissibility in evidence.

In a proceeding, evidence of a record or signature may not be excluded solely because it is in electronic form.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, see. 13, effective August 1, 2000.

369.114 Automated transaction.

In an automated transaction, the following rules apply:

- (1) A contract may be formed by the interaction of electronic agents of the parties, even if no individual was aware of or reviewed the electronic agents' actions or the resulting terms and agreements.
- (2) A contract may be formed by the interaction of an electronic agency and an individual, acting on the individual's own behalf or for another person, including by an interaction in which the individual performs actions that the individual is free to refuse to perform and which the individual knows or has reason to know will cause the electronic agent to complete the transaction or performance.
- (3) The terms of the contract are determined by the substantive law applicable to it.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, see. 14, effective August 1, 2000.

369.115 Time and place of sending and receipt.

- (1) Unless otherwise agreed between the sender and the recipient, an electronic record is sent when it:
 - (a) Is addressed properly or otherwise directed properly to an information processing system that the recipient has designated or uses for the purpose of receiving electronic records or information of the type sent and from which the recipient is able to retrieve the electronic record;
 - (b) Is in a form capable of being processed by that system; and
 - (c) Enters an information processing system outside the control of the sender or of a person that sent the electronic record on behalf of the sender or enters a region of the information processing system designated or used by the recipient which is under the control of the recipient.
- (2) Unless otherwise agreed between a sender and the recipient, an electronic record is received when:
 - (a) It enters an information processing system that the recipient has designated or uses for the purpose of receiving electronic records or information of the type sent and from which the recipient is able to retrieve the electronic record; and
 - (b) It is in a form capable of being processed by that system.
- (3) Subsection (2) of this section applies even if the place the information processing system is located is different from the place the electronic record is deemed to be received under subsection (4) of this section.
- (4) Unless otherwise expressly provided in the electronic record or agreed between the sender and the recipient, an electronic record is deemed to be sent from the sender's place of business and to be received at the recipient's place of business. For purposes of this subsection, the following rules apply:
 - (a) If the sender or recipient has more than one (1) place of business, the place of business of that person is the place having the closest relationship to the underlying transaction.
 - (b) If the sender or the recipient does not have a place of business, the place of business is the sender's or recipient's residence, as the case may be.
- (5) An electronic record is received under subsection (2) of this section even if no individual is aware of its receipt.

- (6) Receipt of an electronic acknowledgment from an information processing system described in subsection (2) of this section establishes that a record was received but, by itself, does not establish that the content sent corresponds to the content received.
- (7) If a person is aware that an electronic record purportedly sent under subsection (1) of this section, or purportedly received under subsection (2) of this section, was not actually sent or received, the legal effect of the sending or receipt is determined by other applicable law. Except to the extent permitted by the other law, the requirements of this subsection may not be varied by agreement.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 15, effective August 1, 2000.

369.116 Transferable records. (Effective until July 1, 2001)

- (1) In this section, "transferable record" means an electronic record that:
 - (a) Would be a note under Article 3 of KRS Chapter 355 or a document under Article 7 of KRS Chapter 355 if the electronic record were in writing; and
 - (b) The issuer of the electronic record expressly has agreed is a transferable record.
- (2) A person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred.
- (3) A system satisfies subsection (2) of this section, and a person is deemed to have control of a transferable record, if the transferable record is created, stored, and assigned in such a manner that:
 - (a) A single authoritative copy of the transferable record exists which is unique, identifiable, and, except as otherwise provided in paragraphs (d), (e), and (f) of this subsection, unalterable;
 - (b) The authoritative copy identifies the person asserting control as:
 - 1. The person to which the transferable record was issued; or
 - 2. If the authoritative copy indicates that the transferable record has been transferred, the person to which the transferable record was most recently transferred;

- (c) The authoritative copy is communicated to and maintained by the person asserting control or its designated custodian;
 - (d) Copies of revisions that add or change an identified assignee of the authoritative copy can be made only with the consent of the person asserting control;
 - (e) Each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
 - (f) Any revision of the authoritative copy is readily identifiable as authorized or unauthorized.
- (4) Except as otherwise agreed, a person having control of a transferable record is the holder, as defined in KRS 355.1-201(20), of the transferable record and has the same rights and defenses as a holder of an equivalent record or writing under KRS Chapter 355, including, if the applicable statutory requirements under KRS 355.3302(l), 355.7501, or 355.9-308 are satisfied, the rights and defenses of a holder in due course, a holder to which a negotiable document of title has been duly negotiated, or a purchaser, respectively. Delivery, possession, and indorsement are not required to obtain or exercise any of the rights under this subsection.
- (5) Except as otherwise agreed, an obligor under a transferable record has the same rights and defenses as an equivalent obligor under equivalent records or writing under KRS Chapter 355.
- (6) If requested by a person against which enforcement is sought, the person seeking to enforce the transferable record shall provide reasonable proof that the person is in control of the transferable record. Proof may include access to the authoritative copy of the transferable record and related business records sufficient to review the terms of the transferable record and to establish the identity of the person having control of the transferable record.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 16, effective August 1, 2000.

369.116 Transferable records. (Effective July 1, 2001)

- (1) In this section, "transferable record" means an electronic record that:
- (a) Would be a note under Article 3 of KRS Chapter 355 or a document under Article 7 of KRS Chapter 355 if the electronic record were in writing; and
 - (b) The issuer of the electronic record expressly has agreed is a transferable record.

- (2) A person has control of a transferable record if a system employed for evidencing the transfer of interests in the transferable record reliably establishes that person as the person to which the transferable record was issued or transferred.
- (3) A system satisfies subsection (2) of this section, and a person is deemed to have control of a transferable record, if the transferable record is created, stored, and assigned in such a manner that:
 - (a) A single authoritative copy of the transferable record exists which is unique, identifiable, and, except as otherwise provided in paragraphs (d), (e), and (f) of this subsection, unalterable;
 - (b) The authoritative copy identifies the person asserting control as:
 - 1. The person to which the transferable record was issued; or
 - 2. If the authoritative copy indicates that the transferable record has been transferred, the person to which the transferable record was most recently transferred;
 - (c) The authoritative copy is communicated to and maintained by the person asserting control or its designated custodian;
 - (d) Copies of revisions that add or change an identified assignee of the authoritative copy can be made only with the consent of the person asserting control;
 - (e) Each copy of the authoritative copy and any copy of a copy is readily identifiable as a copy that is not the authoritative copy; and
 - (f) Any revision of the authoritative copy is readily identifiable as authorized or unauthorized.
- (4) Except as otherwise agreed, a person having control of a transferable record is the holder, as defined in KRS 355.1-201(20), of the transferable record and has the same rights and defenses as a holder of an equivalent record or writing under KRS Chapter 355, including, if the applicable statutory requirements under KRS 355.3302(1), 355.7-501, or 355.9-330 are satisfied, the rights and defenses of a holder in due course, a holder to which a negotiable document of title has been duly negotiated, or a purchaser, respectively. Delivery, possession, and indorsement are not required to obtain or exercise any of the rights under this subsection.

- (5) Except as otherwise agreed, an obligor under a transferable record has the same rights and defenses as an equivalent obligor under equivalent records or writing under KRS Chapter 355.
- (6) If requested by a person against which enforcement is sought, the person seeking to enforce the transferable record shall provide reasonable proof that the person is in control of the transferable record. Proof may include access to the authoritative copy of the transferable record and related business records sufficient to review the terms of the transferable record and to establish the identity of the person having control of the transferable record.

Effective: July 1, 2001

History: Created 2000 Ky. Acts ch. 301, sec. 16, effective July 1, 2001.

Legislative Research Commission Note (7/14/2000). Effective July 1, 2001, the reference to former KRS 355.9-308 in subsection (4) of this statute changes to KRS 355.9-330, to reflect the location of the relevant text in Kentucky's adoption of Revised Article 9 of the Uniform Commercial Code. See 2000 Ky. Acts ch. 301, sec. 23, and ch. 408, sec. 191.

**369.117 Creation and retention of electronic records by governmental agencies
Conversion of written records by governmental agencies.**

Each governmental agency of this Commonwealth shall determine whether, and the extent to which, it will create electronic records. The Kentucky Department for Libraries and Archives shall determine whether, and the extent to which, the Commonwealth will retain electronic records and convert written records to electronic records.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 17, effective August 1, 2000.

369.118 Acceptance and distribution of electronic records by governmental agencies.

- (1) Except as otherwise provided in KRS 369.112(6), each governmental agency of this state, in compliance with standards established by the Governor's Office for Technology, shall determine whether, and the extent to which, it will send and accept electronic records and electronic signatures to and from other persons and otherwise create, generate, communicate, store, process, use, and rely upon electronic records and electronic signatures.
- (2) To the extent that a governmental agency uses electronic records and electronic signatures under subsection (1) of this section:
 - (a) The Governor's Office for Technology, giving due consideration to security, may specify the manner and format in which the electronic

records must be created, generated, sent, communicated, received, and stored and the systems established for those purposes;

- (b) If electronic records must be signed by electronic means, each governmental agency, giving due consideration to security, may specify the type of electronic signature required, the manner and format in which the electronic signature must be affixed to the electronic record, and the identity of, or criteria that must be met by, any third party used by a person filing a document to facilitate the process;
 - (c) The Governor's Office for Technology and the Department for Libraries and Archives, giving due consideration to security, may specify control processes and procedures as appropriate to ensure adequate preservation, disposition, integrity, security, confidentiality, and auditability of electronic records; and
 - (d) Each governmental agency, giving due consideration to security, may specify any other required attributes for electronic records which are specified for corresponding nonelectronic records or reasonably necessary under the circumstances.
- (3) Except as otherwise provided in KRS 369.112(6), KRS 369.101 to 369.120 does not require a governmental agency of this state to use or permit the use of electronic records or electronic signatures.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 18, effective August 1, 2000.

369.119 Interoperability.

The Governor's Office for Technology, which adopts standards pursuant to KRS 369.118(2)(a), may encourage and promote consistency and interoperability with similar requirements adopted by other governmental agencies of this and other states and the federal government and nongovernmental persons interacting with governmental agencies of this state. If appropriate, those standards may specify differing levels of standards from which governmental agencies of this state may choose in implementing the most appropriate standard for a particular application.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 19, effective August 1, 2000.

369.120 Severability of provisions.

If any provision of KRS 369.101 to 369.120 or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or

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applications of KRS 369.101 to 369.120 which can be given effect without the invalid provision or application, and to this end the provisions of KRS 369. 101 to 369.120 are severable.

Effective: August 1, 2000

History: Created 2000 Ky. Acts ch. 301, sec. 20, effective August 1, 2000.

CYBER-BUSINESS START UP ISSUES

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**III. COMPARISON CHART OF KENTUCKY LLCs AND
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SECTION B

Overview of Factors Involved in Choosing the Entity

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What Is a Limited Liability Company?

A limited liability company (LLC) is a new non-corporate entity. It combines features of corporations, and general and limited partnerships. Owners of LLCs, called "members," receive partnership tax treatment, but are not personally liable for the LLC's debts and obligations.

Partnership Treatment

A primary advantage of the LLC is its partnership tax treatment. Until recently, under Internal Revenue Service (IRS) regulations, this meant LLCs could not have all the Internal Revenue Code (IRC) characteristics of a corporation:

- Limited liability;
- Continuity of life;
- Free transferability of interests; and
- Centralized management.

LLCs did not have to avoid all four -- only two. Since LLCs were designed to have limited liability, they had to avoid two of the other elements. The original LLC statutes addressed this problem by mandating:

- No transferability of interests, by requiring unanimous consent to admit a new member; and
- No continuity of life, again by requiring unanimous consents to avoid dissolution.

These rules were called "Bulletproof Acts," and were adopted by Colorado, Nevada, South Dakota, Virginia, West Virginia and Wyoming and approved by the IRS. By 1993, the IRS was willing to allow some flexibility. It approved what were called "Flexible Acts" that did not require unanimous consent for transfers or to avoid dissolution.

Nevertheless, early LLCs had many of the characteristics of partnerships. In addition to avoiding the above corporate characteristics, LLCs generally gave members the right to:

- Voluntarily withdraw and receive payment for their interests;
- Manage the LLC's affairs; and
- Bind the LLC by their acts.

These are similar to the rights of partners and are not generally shared by corporate stockholders.

The IRS treatment of LLCs continued to evolve. In December 1994, it issued Rev.Proc.95-10, which expanded the safe harbors that LLCs could use to avoid continuity of life and dissolution. In Notice 95-14, the IRS announced a proposal to allow business entities to select whether to be treated as a partnership or corporation for federal tax purposes. On May 13, 1996, the IRS proposed "check-the-box" regulations allowing such election. They became effective January 1, 1997. Under these regulations, LLCs no longer need to avoid two of the corporate characteristics. They simply elect how to be treated. In light of the relaxed IRS treatment, many states adjusted their statutes to allow greater flexibility in continuity, management and transferability.

Nevertheless, in most instances, an LLC will be structured as a partnership. Accordingly, partnership tax rules regarding contributions, distributions, and capital accounts, for example, will be applicable to LLCs.

Comparing it to a corporation can show the kinship of an LLC to a partnership. The closest corporate analogy to an LLC is an S corporation. Both have flow-through taxation but limited liability. Although they share these two characteristics, LLCs and S corporations are different in significant respects:

Members of an LLC usually cannot freely transfer their interests in the LLC, but are generally limited to transferring the rights to profits and distributions associated with their interests;

In many LLCs, members have the power to bind the LLC by their acts:

- Management of most LLCs will be informal and tailored to the LLC members' desires. There may be no officers, boards of directors, or annual stockholders' and directors' meetings; and
- Members of LLCs will generally have the statutory right to withdraw from the LLC and receive payment for their interests. This right is available to stockholders only by contract.

Corporate Treatment

LLC member liability, on the other hand, is comparable to that of corporate stockholders. Each member is personally liable for its individual actions, but not actions committed by it as a member or manager of the LLC. This rule applies to torts and contracts. There are several exceptions:

- Members must pay amounts they agreed to contribute;
- Some states require members to return distributions -- even though rightfully received;
- Members personally involved in the LLC may be treated as "operators" under the Comprehensive Environmental Response, Compensation and Liability Act;
- "Responsible person" in the LLC may be liable for unpaid taxes;
- Under a "piercing the veil" doctrine, the LLC may be ignored; and
- Some states impose liability on members of professional LLCs.

Apart from these areas of liability, however, LLC members are not personally liable for the LLC's debts and obligations. This liability limitation distinguishes LLCs from general and limited partnerships, and makes them similar to corporations.

Characteristics of a Limited Liability Company

In this section, we discuss the principal characteristics of an LLC. As with any new entity, LLCs are subject to a new language. Key LLC terms are printed in boldface type.

Formation

An LLC is formed by filing **articles of organization** with the secretary of state in the state where the LLC will be formed. The articles of organization are comparable to a corporation's articles of incorporation or a limited partnership's certificate of limited partnership.

Members of an LLC will generally enter into an **operating agreement**. Together with the articles of organization, the operating agreement is a contract among members of an LLC. Although similar to the bylaws of a corporation, the operating agreement is more like the partnership agreement of a general or limited partnership. An operating agreement describes the basic rules governing the LLC, including contributions, management, sharing of profits, losses and distributions, transfer of membership interests, and dissolution.

Ownership

An LLC is owned by its **members**, equivalent to the stockholders of a corporation or the partners of a partnership. Under most LLC statutes, membership interests may be represented by certificates, like stock. However, because of restrictions on transfers of ownership interests under many LLC statutes, most LLCs, like partnerships, do not issue ownership certificates.

Management

LLCs will generally be managed either by their members or by **managers**. If member-managed, the members will be comparable to general partners of a general or limited partnership. Members in a manager-managed LLC are equivalent to limited partners. Although LLC statutes allow LLC members to elect the equivalent of a board of directors and officers, most do not.

Entity Aspects of Limited Liability Companies

LLC statutes create a separate entity, much like a corporation; not an aggregate of the owners like a general partnership. LLC property is owned by the LLC. This means members' creditors can not attach LLC property for members' debts. Suits by and against LLCs must be brought in the name of the LLC, and not in the names of the members of the LLC.

Dissociation of Members; Dissolution of Limited Liability Companies

Members of an LLC generally have the right to voluntarily withdraw from an LLC and to receive payment for their LLC interests. Prior to the easing of IRS rules, withdrawal, as well as the death or bankruptcy of an LLC member, caused the dissolution of the LLC. The remaining members, however, had the right to continue the LLC after such dissolution.

Formation of Limited Liability Companies

An LLC is formed by filing articles of organization. The articles must comply with statutory requirements, and are filed with the secretary of state in the state of formation. Under several statutes, substantial compliance with statutory requirements is sufficient to create the LLC.

Generally, LLCs are formed at the time the articles of organization are filed by the secretary of state. Under a few statutes, the formation date is the date the articles of organization, in satisfactory form, are delivered to the secretary of state's office -- even if

the secretary of state approves and files the articles later. Several statutes permit articles of organization to contain an effective date later than the date of filing.

Under most statutes, an LLC may be formed, that is, the articles of organization may be executed and filed, by non-LLC members. This is similar to the filing requirements for corporations, and facilitates the formation of LLCs. In contrast, a certificate of limited partnership, the document that must be filed to form a limited partnership, must be filed by general partners of the limited partnership. Where a non-member files articles of organization, the operating agreement (or consent by the person filing the articles of organization) must transfer the LLC to the initial members or managers.

For corporations, articles of incorporation must be filed by an incorporator who is not a director, officer or stockholder. Under most statutes, the filing does not complete the organization of the corporation. Directors must be named, stock subscribed, and preliminary actions taken by the incorporator, initial stockholders and directors. Until organization is completed, the corporation does not officially exist, and in some cases there is no right to carry on business.

For LLCs, there is no case or statutory law on this point. Therefore, the authority and potential liability of a person forming an LLC before the operating agreement is signed are not clear. Under LLC statutes that do not require LLCs to have operating agreements, no other "organization" activities may be required. Nevertheless, the person filing the articles of organization should sign a statement transferring the LLC to members and managers. If members execute an operating agreement before or along with the articles of organization, they may direct someone to file the articles, and expressly reserve all other power and authority for themselves.

Under a few LLC statutes, signatures on the articles of organization must be acknowledged or verified.

Contents of the Articles of Organization

Certain information must be included in LLC articles of organization. In all states, the LLC's name, registered agent, and registered or principal office are required. In addition, one or more of the following are required under various LLC statutes: purpose, names and addresses of initial organizers, period of duration, and whether managed by members or managers.

Because of the lack of uniformity in this area, it is critical to check and comply with the applicable statute. Certain statutes require, for example, the articles to set forth any:

- Contributions required of members;

- Limitation on members' ability to bind the LLC;
- Rules for continuing the LLC after dissolution; and
- Nonstatutory events causing dissolution as agreed to by members.

Several LLC statutes permit articles of organization to include additional information. Under these statutes, an LLC can provide actual notice of information to third parties who read the articles. Under several LLC statutes and a few court interpretations, inclusion of required information is constructive notice to third parties.

Operating Agreement

LLC members may enter into an operating agreement (under some LLC statutes, "regulations," "limited liability company agreement," or "member control agreement"). The operating agreement serves the same function as a limited partnership agreement. In it, members may set out the terms governing contribution, management, distributions and allocations, fiduciary duties and indemnification, transfers of interest, dissociation and dissolution.

The terms of most LLC statutes may be varied by agreement of the LLC's members. The agreement can be in the LLC's articles of organization or operating agreement. Under some LLC statutes, an operating agreement must be in writing. Under these statutes, provisions varying the LLC from statutory default rules must be in writing to be enforceable.

Number of Members Required

An LLC must have two or more members at the time of formation. Under certain statutes, it is enough to simply state in the articles that the LLC has two or more members. Under other statutes, two or more members must exist at the time of formation, or must sign the articles of organization.

It is important to time the execution of the operating agreement and the filing of the articles of organization. Where two members are required at the time of formation, the LLC's operating agreement should be executed before or along with filing articles of organization. If the articles of organization are filed before the operating agreement is signed, the LLC may not be legally formed.

Because of lack of case law on LLCs, the effect of such a defect cannot be predicted. As with some defectively formed corporations and partnerships, members of a defectively formed LLC may be liable to third party creditors. Accordingly, it is safer for an operating agreement to be signed by two or more members before filing the articles of organization.

Some statutes permit ownership of an LLC by one member. Under these statutes, a single-member LLC will receive the benefit of limited liability and other statutory provisions applicable to LLCs. In Rev.Proc.95-10, the Internal Revenue Service indicated that a one-member LLC was not a partnership for tax purposes. This appears consistent with the Internal Revenue Code, which defines a partnership as a "syndicate, group, pool, joint venture, or other unincorporated organization" carrying on business. Multiparty entities or organizations are implicit in this definition.

Names of Limited Liability Companies

LLC statutes require that the name of every LLC contain certain words or letters identifying the entity as an LLC. The specific identifiers vary from state to state, but commonly include "limited liability company," "LLC," and "LC." The purpose of these words is to give notice to third parties of the nature (specifically the lack of owner liability) of the entity with which they are dealing.

Most LLC statutes prohibit the use of names that are deceptively similar to the names of other LLCs -- and in some cases, other corporations or limited partnerships -- formed in the jurisdiction. Under most LLC statutes, names may be reserved for a short period. Assumed or fictitious name statutes often apply to LLCs. Accordingly, LLCs may be required to comply with filing and notification requirements under applicable assumed or fictitious name statutes.

Registered Agent and Office

LLC statutes require LLCs to maintain registered offices and registered agents for service of process. Each LLC statute specifies who may serve as a registered agent. Generally, an individual residing in the applicable state, a domestic or foreign corporation, and, often, foreign and domestic LLCs may serve as registered agents.

Amendment of Articles of Organization

LLCs may amend their articles of organization. Many statutes also provide that an LLC's articles of organization must be amended if they become or are discovered to be erroneous. This amendment requirement comes from limited partnership statutes, but is not really relevant to LLCs.

Under limited partnership statutes, the certificate of limited partnership is filed with a secretary of state, and puts creditors on notice about the parties that are liable for partnership obligations. Under former statutes, the certificate also specified the amounts required to be contributed by partners.

For LLCs, creditors are aware that no party is generally liable for LLC obligations, and under only a few statutes are contributions to an LLC required to be included in the LLC's articles of organization. Accordingly, the reasons for requiring amendment of a limited partnership certificate have little application to LLCs.

Purposes of Limited Liability Companies

LLCs may engage in any lawful business, except as limited in its articles of organization or in other statutes. Many LLC statutes also prohibit LLCs from engaging in certain specified businesses. In several states, LLCs may not engage in certain professional practices. Other prohibited purposes include insurance, banking, and farming and agriculture.

Powers of Limited Liability Companies

Most LLC statutes contain a broad list of powers that LLCs have to carry out their business. The powers are usually comparable to those given to corporations. Other LLC statutes provide that LLCs have all powers necessary to effectuate their purposes.

Capital Structure

Flexibility is a hallmark of the LLC entity. The LLC's capital structure is a prime example.

An important characteristic distinguishing LLCs from S corporations is flexibility in allocations and distributions. S corporations are limited to one class of stock. This means stockholders of S corporations cannot structure their distributions and allocations in the way LLC members can.

LLC statutes contain default provisions on sharing profits and distributions. However, every operating agreement should include profit sharing and distribution rules. Unless it chooses to be treated as a corporation under the Internal Revenue Service check-the-box regulations, an LLC will be taxed as a partnership. This includes the treatment of capital accounts. To ease compliance with the regulations, it is better to borrow capital structures from limited and general partnerships rather than corporations. For example, it would be better for operating agreements to use preferential returns rather than a preferred stock equivalent, and cash percentage distributions rather than dividends.

Form and Amounts of Contributions

LLC statutes are also flexible on the form and amount of contributions that members may

make. No minimum contribution is required, and contributions may be made in many forms, including:

- Cash;
- Property;
- Services;
- Agreements to contribute cash, property or services; and
- Guarantees of LLC's obligations.

Such contribution flexibility is in line with current trends in corporate and partnership statutes. In the past, corporate and limited partnership statutes assumed that creditors in providing credit would rely on the articles of incorporation or limited partnership certificate. Accordingly, historic corporate statutes required minimum capital levels, and limited partnership statutes required descriptions of the amount of capital contributed by each partner and the circumstances under which capital could be distributed or withdrawn. In addition, issuance of stock in return for promises to contribute or promissory notes was prohibited.

Under current credit practices, however, creditors do not rely primarily on statements in articles of incorporation or certificates of limited partnership. Nor do creditors necessarily rely on amounts to be contributed by owners. Accordingly, there is no real reason for LLC statutes to require minimum contributions, nor to prohibit contributions in the form of services or property.

In calculating the amount to be contributed to the LLC, members should consider the possible application of the piercing the veil doctrine. Courts may apply this doctrine to LLCs in a way comparable to how it has been applied to corporations. Under corporate law, thin capitalization is a factor viewed by courts in determining whether a corporation is a sham, and whether corporate protection from liability should be disregarded. Failure to adequately capitalize an LLC could be viewed in a similar light.

Most LLC statutes require contribution obligations to be in writing and disclosed either in the LLC's articles of organization or in separate LLC records. A few LLC statutes contain record-keeping requirements, but do not require contribution obligations to be in writing.

There are sound policy reasons for requiring contribution obligations, and for them to be in writing. In addition to the practical importance of contributions in financing operations, contributions provide the default basis under many LLC statutes for sharing profits, losses and distributions.

Liability for Contribution Obligations

Under most LLC statutes, members are liable to the LLC for amounts they have agreed to contribute to the LLC. This liability can be enforced by the LLC, by creditors of a bankrupt LLC, and under some LLC statutes by creditors of a nonbankrupt LLC. In addition to cash and property the member agreed to contribute, the liability includes the cash equivalent of any unperformed services that the member agreed to make.

Under most LLC statutes, contribution obligations may be excused or reduced by an agreement between the obligated member and the LLC, if approved by the unanimous consent of all other members. However, such agreement can not be enforceable against creditors who relied on the contribution obligation.

Distributions by Limited Liability Companies

Unless the operating agreement provides otherwise, an LLC member has no right to receive distributions from the LLC before dissociation or dissolution. The position of LLC members is comparable to that of general partners of a general partnership, limited partners of a limited partnership, or stockholders of a corporation.

There are several reasons why members should provide in the operating agreement for ongoing distributions.

- LLCs are generally taxed as partnerships. Therefore, members are liable for federal and state taxes on their percentage of the LLC's taxable income, whether or not they receive any distributions from the LLC.
- As with close corporations and general partnerships, members will want to receive ongoing income.

Sharing of Distributions

LLC distributions are divided among members as provided in the operating agreement. In the absence of such a provision, under most LLC statutes, members allocate distributions on the basis of relative financial contributions. Under the Prototype Act, distributions are on a per capita basis.

The commentary to §601 of the Prototype Act supports per capita distributions because distributions based on financial contributions present difficulties. If members make nonfinancial contributions, the relative percentages of financial contributions may not accurately reflect ownership interests. In addition, LLCs without written operating agreements may not have sufficient records to accurately calculate distributions on the basis of capital contributions.

Restrictions on Distributions of In-Kind Property

Distributions of in-kind property by LLCs pose several problems. Most obvious is the difficulty of valuing the property. Another is the potential disproportionate postponement of recognition of gain by members receiving such property. LLC statutes address these problems in two ways.

- Members cannot be required to receive property in a greater percentage than the percentage of their contribution to the LLC; or
- Members have no obligation to receive in-kind distributions.

LLC statutes also generally provide that members have no right to demand non-cash distributions.

Wrongful Distributions

LLC statutes prohibit distributions by an insolvent LLC, or that would render an LLC insolvent. Many LLC statutes also prohibit distributions that would interfere with preferential rights. Under several LLC statutes, the definition of insolvency is the inability to pay debts as they become due.

The statutory restrictions on LLC distributions are similar to those on limited partnership distributions and corporate dividends. These restrictions supplement the creditor protection under fraudulent conveyance laws. In some cases, LLC statutes provide greater protection for creditors:

- Fraudulent conveyance statutes have an intent requirement; and
- LLC statutes have a longer statute of limitation.

Liability for Return of Wrongful Distributions

Nearly all LLC statutes require the return of wrongful distributions. The amount of liability and liable parties depend on the statute. Under most laws, members who knowingly receive wrongful distributions must return them. Under other statutes, members (and in some cases managers) who vote for wrongful distributions are also liable. Knowledge may not be required.

Creditor protection under several LLC statutes is similar to that under ULPA (Uniform Limited Partnership Act). Members of an insolvent LLC, for instance, may be forced to return distributions that are returns of their capital contributions -- even when the LLC was solvent at the time of distribution.

Management and Control of Limited Liability Companies

The first issue on management and control of an LLC is who has the power to govern it. Unless members agree otherwise, members under most statutes manage LLCs. Under a few statutes, however, unless members agree otherwise, managers manage LLCs.

Under most LLC statutes, members who desire to vary these default rules must do so in the articles of organization. Other LLC statutes allow the variance to be in the operating agreement.

Member-Managed Limited Liability Companies

Members in two cases will manage LLC:

- Under LLC statutes where member management is the default rule, unless members select manager management in the operating agreement.
- Under LLC statutes where manager management is the default rule, but members elect member management in the operating agreement.

In a member-managed LLC, there are three main governance issues:

- Matters requiring a member vote;
- Percentage of votes required on different matters; and
- Whether voting is *per capita* or *pro rata* on the basis of members' relative financial interests in the LLC.

The Prototype Act establishes clear rules for these issues. Unanimous affirmative votes are necessary to amend a written operating agreement, or authorize a manager or member to perform any act contrary to the written operating agreement. Decisions on other matters require approval of a majority of the members. Members vote *per capita*, not *pro rata* on the basis of their financial interest in the LLC. The unanimous voting provision may be overridden in a written operating agreement; the majority voting provision may be overridden in any operating agreement.

A few LLC statutes are silent on voting and management responsibility, where there is no operating agreement. Ultimately, courts may determine whether majority or perhaps unanimous approval is required in such cases. In the meantime, the lack of a default provision is a substantial gap.

For partnerships, the UPA requires unanimous partner consent for "extraordinary"

actions. This includes amendments to a written operating agreement, or to authorize an act in contravention of a written operating agreement. Defining what constitutes extraordinary actions is, of course, difficult.

For LLCs, the Prototype Act is a practical solution. Every amendment of the operating agreement and every act in contravention of it may not be material. However, given the difficulty of determining which events are important enough to require unanimity, the Prototype Act rule is clear and relatively simple to enforce. In addition, because it applies only to LLCs with written operating agreements, members can consider the unanimous rule at the time the operating agreement is executed.

A provision of the Prototype Act that may be controversial is *per capita* voting, rather than voting by percentage of financial interest. Most LLC statutes that address the issues of voting and sharing of profits, losses, and distributions have voting and sharing on a *pro rata* basis according to members' relative financial interests. The drafters of the Prototype Act believed that *per capita* voting was a better default rule, taking into account the difficulty of determining members' relative financial interests in an LLC.

Manager-Managed Limited Liability Companies

Managers in two cases will manage LLCs:

- Under LLC statutes where manager management is the default rule, unless members elect member management in the operating agreement.
- Under LLC statutes where member management is the default rule, where members have elected manager management in the operating agreement.

Election of Managers

Managers are elected by a majority of members or by members holding a majority of the financial interests, as provided in the operating agreement or governing law.

A few LLC statutes provide for corporate-type annual meetings for the election of managers and other corporate-type formal procedures. Of course, corporate-type management is an option for nearly every LLC. Many members forming LLCs come from a corporate background and are more at home in an entity governed by a board of directors and officers than one subject to partnership governance procedures.

Generally, LLC statutes permit a corporate governance type of arrangement. Parties desiring this type of arrangement, however, must carefully evaluate the statute under which the LLC is formed. They must pay close attention to whether the "board of directors" would be equivalent to managers under the statute, and whether the statute

would permit managers to name agents (i.e., “officers”) to carry on the LLC’s business.

In manager-managed LLCs, the operating agreement should cover the election, authority, and removal of managers. In addition, members may want to retain voting rights over fundamental matters, such as sales of significant assets or amendment of the operating agreement.

Ability of Members to Bind a Member-Managed Limited Liability Company

A second LLC governance issue is who has the power to bind the LLC in transactions with third parties. Under the largest number of LLC statutes, members’ ability to bind an LLC is comparable to a general partner’s in a partnership. An LLC can be bound by any member “apparently carrying on in the usual way the business” of the LLC. The LLC is not bound, however, if the member had no actual authority and the person with whom it is dealing knows there is no authority.

This rule attempts to balance the relative interests of the LLC and third parties. For acts within the LLC’s usual business, the rule encourages third parties to transact with the LLC without investigation. For acts that would appear unusual or extraordinary, the rule encourages the third party to investigate and demand evidence of the member’s authority to bind the LLC.

There will always be close questions whether a particular act was apparently within the usual business of an LLC. Because the rule is based on the UPA (Uniform Partnership Act), however, a significant body of law exists that can be applied to LLCs.

Ability of Managers and Members of a Manager-Managed Limited Liability Company to Bind the Limited Liability Company

In manager-managed LLCs, managers have the same basic authority as members in a member-managed LLC. This means any manager can bind the LLC by an act “apparently carrying on in the usual way the business” of the LLC. A manager’s act is not binding if the manager has no authority and if the person the manager is dealing with knows there is no such authority.

In an operating agreement, members may restrict the managers’ authority to bind the LLC. Such a restriction will not be effective against a third party:

- If the manager is carrying on the LLC’s usual business; and
- If the person the manager is dealing with is not aware of the restriction.

Under LLC statutes generally, members of a manager-managed LLC can not bind the

LLC -- unless the operating agreement provides otherwise. This rule places a significant burden on persons dealing with LLC members. Before dealing with an LLC member, a person must determine:

- Whether the applicable state default rule provides for management by members or managers;
- Assuming that it provides for member management, whether the articles of organization and/or operating agreement provide for manager management; and
- Whether the act taken is apparently within the usual business of the LLC.

Accordingly, persons aware of this rule but willing to deal with an LLC must incur certain transaction costs or risks that the members' act binds the LLC.

Ownership of the Limited Liability Company and Its Property

LLC property is owned by the LLC, and not by the members individually. Accordingly, LLC property is not available to satisfy creditors of individual members. In addition, the right to transfer and deal with LLC property is held by members with management rights under the operating agreement -- not with individual members -- unless the operating agreement otherwise provides.

Ownership of property by an LLC is comparable to ownership by a corporation or limited partnership. In contrast, ownership of property in a general partnership combines entity and aggregate theory. A general partnership's property is held by partners as a tenancy by the partnership. However, ownership rights of individual partners are limited.

LLC statutes generally do not define what property is owned by an LLC, although several refer to property "transferred to or otherwise acquired by" the LLC. Where records are not kept and property is not held in the name of the LLC, there may be confusion about who owns property. LLC statutes generally do not contain default provisions determining ownership of property comparable to those in the UPA and RULPA (Revised Uniform Limited Partnership Act).

Members' Interests in a Limited Liability Company

Under most LLC statutes, a member's interest is its financial interests in the LLC. Financial interests generally include interests in distributions, capital, contributions, and profits.

A member's interest does not include all rights in the LLC. It does not include, for instance, management rights. A member's interest is personal property and assignable, unless prohibited by the operating agreement. Members' rights to manage, however, are

generally not assignable.

Rights of Members' Creditors

A member's creditors generally have no right to attach LLC property to satisfy the member's obligation. However, members may assign or pledge their interests as security for personal obligations. Since a member's interest is personal property, any pledge of a member's interest would be governed by the Uniform Commercial Code. Because members have the right to transfer only their financial interests, upon foreclosure a creditor would have no rights to manage the LLC.

Most LLC statutes permit unsecured creditors to obtain a charging order (a form of garnishment or attachment) against the member's interest in the LLC. A charging order gives the creditor the right of an assignee. This means it can receive distributions and, in some cases, profits and losses.

Certification of Member's Interests

A number of LLC statutes permit LLCs to issue certificates representing membership interests, as long as other statutes do not prohibit them. Certificates can be an efficient way of managing ownership interests, especially in an LLC with many owners.

Liability of Members and Managers

The primary reason for using an LLC entity is to limit the liability of members for debts and obligations, yet receive partnership tax treatment. This liability limitation distinguishes LLCs from partnerships. In this respect, an LLC is more like a corporation.

Under all LLC statutes, LLC members and managers are not liable for the LLC's debts and obligations. However, they are only released from liability that arises from their positions as members and managers. They remain liable for their individual actions, including torts and negligence in supervising other members or managers.

In nearly all cases, since general partners are liable for the partnership's debts and obligations, the limited liability feature of LLCs means they are better choices than a general or limited partnership.

In some case, LLC members have more protection from liability than even limited partners of limited partnerships. Limited partners may be held generally liable for partnership obligations if they participate in management of the limited partnership. Statutes based on RULPA have an extensive list of actions that may be taken without participating in management. However, limited partners may go beyond the safe-harbor

provision and be held liable for partnership obligations in extreme circumstances. In contrast, LLC members do not have to worry about their degree of involvement in LLC management.

Member Liability for Unpaid Contributions and LLC Distributions

Limited liability under LLC statutes is only for LLC's debts and obligations to third parties. Members are usually liable to the LLC for unpaid contributions that they agreed to make.

The liability for unpaid contributions is an obligation to the LLC. However, under many statutes it may be enforced in a derivative action brought by other LLC members. In addition, creditors may be able to enforce the obligation if the LLC is bankrupt.

Failure to pay contributions does not mean the member becomes liable for the LLC's debts. The contribution obligation is limited to the unpaid amount. In addition, under most LLC statutes, members are liable only if the agreement to contribute is in writing.

Members are also liable to the LLC for wrongful distributions, generally defined as contributions that render the LLC insolvent. Under many LLC statutes, members and managers who approved the distributions may also be held liable for such distributions.

Application of the Doctrine of Piercing the Corporate Veil

LLC members may be liable for the LLCs debts and obligations under a piercing the veil or instrumentality theory. The doctrine is based on an "instrumentality" theory: the corporation is "so organized and controlled and its affairs are conducted so that it is a mere 'instrumentality'" of its owner.

In evaluating whether a corporation is an instrumentality of its owners, the primary factors considered are identity of interest and inadequate capitalization. They are just as likely to be present in an LLC as in a corporation. A third factor, failure to comply with corporate "formalities," is less likely to be present with LLCs, because LLC statutes require fewer formalities than corporate statutes.

At least one federal court has held that piercing-the-veil theory may be applied to an LLC. In *Abu Nassar v. Elders Futures Inc.*, the defendant sought to hold the members of a Lebanese LLC personally liable on a contract signed by the LLC under a piercing the corporate veil theory. The court denied plaintiffs' motion for summary judgment. In part, it found that summary judgment was inappropriate because factual issues existed under Lebanese and New York corporate veil theories.

The court treated the LLC as it would have treated a corporation under New York law. It did not analyze whether a corporate theory such as piercing the corporate veil should be applied to a Lebanese LLC. It is uncertain whether other courts would apply the theory to U.S. LLCs. However, LLCs are sufficiently similar to corporations that the theory is likely to be applied.

Contractual Guarantees by Members of a Limited Liability Company

Often, to obtain financing, members of an LLC must personally guarantee its debts. In many cases, the guarantee creates more liability than that of a general partner in a general or limited partnership.

Even if such a guarantee is required, however, it is better than general liability for all obligations of a partnership. Guarantees are limited to specific debts, and LLC members are not liable for other LLC debts and obligations.

Litigation Involving Limited Liability Companies

There are several instances where litigation may involve LLCs.

Suits By and Against Limited Liability Companies

Generally, suits by and against LLCs are brought in the name of the LLC and not individual members. Most LLC statutes expressly provide that suits against LLCs are brought in the LLC's name. Although other LLC statutes may not expressly state that LLCs may bring suits in the LLC's name, there is substantial support toward that result.

The clear intent of LLC statutes is that LLCs are entities. That intent should apply to litigation as it does to other aspects of LLCs.

However, without an express provision in LLC statutes permitting suits in the LLC's name, there is a possibility that suits must be brought in the names of individual LLC members. Based on the aggregate theory, the partnership laws of many states require suits to be brought in the names of **all** partners. In states where that is the law, a court could find an LLC to be an aggregate comparable to a general partnership and require suit to be brought in **all** members' names.

In a manager-managed LLC, the power to conduct lawsuits resides in the managers. This is part of their general authority to manage the business of the LLC. In member-managed LLCs, under most LLC statutes, consent of at least a majority of members (per capita or based on percentage of financial interest, depending on the statute) would be required to bring a lawsuit. However, many LLC statutes require members' unanimous consent for

actions outside the LLC's usual business. Depending on an LLC's business and the matter involved, a lawsuit may not be within the LLC's usual business. Accordingly, it could require unanimous member consent.

Derivative Lawsuits

Most LLC statutes give members the right to bring a derivative suit on behalf of the LLC. In states where derivative suits are not explicitly provided for in the statute, they may be recognized by courts -- under common law or principles of federal civil procedure -- as they have been with limited partnerships.

The rules for derivative suit in many LLC statutes are similar to those in limited partnership statutes. There are rules on who has the right to bring suit, whether demand is required, and, if required, the type of demand required.

Derivative lawsuits are an extraordinary remedy. They are also complicated and expensive. In a widely-held LLC, the extra expense may be justified. In a closely-held LLC, however, members generally can sue on their own behalf at less expense and with less disruption to the LLC.

Individual Lawsuits

As discussed above, suits on behalf of an LLC must be brought by the LLC. Usually, members may not bring suit on the LLC's behalf in their own names. LLC members, however, can make claims on their own behalf against the LLC, other members, and third parties. The more common claims are for securities violations, indemnification, and breaches of the LLC's operating agreement.

Members may also bring individual negligence and fraud claims that could be brought derivatively on the LLC's behalf. To avoid prejudice to members in a similar position and duplication of lawsuits, courts may require that a claim be brought in a derivative or class action mode.

Indemnification

Nearly every LLC statute gives members and managers the right to be indemnified by the LLC for actions taken by them on behalf of the LLC. A number of statutes have indemnification provisions similar to those in corporate statutes -- with the right to indemnity limited. The largest group, however, provides a general, express right to indemnify members or managers, and does not impose any limitations.

Indemnification does not exist under all LLC statutes. For LLCs formed under LLC

statutes that do not have indemnification, indemnification should be included in the LLC's operating agreement. In LLCs formed under such statutes without written operating agreements, indemnification will be limited to what is agreed on at the time indemnification is requested.

Fiduciary Duties of Managers and Members

Fiduciary duties are standards of conduct that are expected of, and imposed on, directors. In some cases they are also imposed on stockholders, general partners and in fewer cases limited partners. Fiduciary duties generally arise where the conduct of directors, stockholders, or partners could be:

- Harmful to the corporation or partnership; or
- Beneficial to the directors, stockholders, or partners, but to the detriment of the corporation or partnership.

Fiduciary duties of directors, stockholders, and partners are based in part on statutes, but to a greater extent have developed over time in case law.

Because of the similarity of LLCs to corporations and partnerships, courts will apply fiduciary duties to members and managers of LLCs comparable to those applied to directors, officers, stockholders, and partners. By comparing the roles of members and managers of LLCs with those of directors, officers, stockholders, and partners, the types of fiduciary duties can be anticipated.

The type and nature of fiduciary duties that will apply to LLC members and managers will depend on the type of LLC involved and who manages the LLC. An important difference is whether the LLC is member managed or manager managed.

Member-managed LLCs are closest to general partnerships. Members, therefore, will likely have fiduciary duties of general partners.

Manager-managed LLCs are comparable to corporations. Members and managers in such LLCs may have fiduciary duties equivalent to corporate stockholders and directors. Two general categories of fiduciary duties have been applied to directors, officers, stockholders, and partners:

Duty of care that must be satisfied by a director, officer, or general partner in conducting corporate or partnership affairs; and

Duty of loyalty that requires a director or general partner to act on behalf of the corporation or partnership, not on the director or general partner's own behalf, and to avoid conflicts of interest and self-dealing.

Waiver of Fiduciary Duties

Under most LLC statutes, members and managers may waive their fiduciary duties in the operating agreement. The extent to which fiduciary duties may be waived varies from statute to statute. The most common rules are:

- Full waiver of fiduciary duties is permitted, under the theory that members and managers have full power to contract;
- Waiver of all fiduciary duties permitted, except intentional misconduct, criminal acts, self-benefit, and liability for improper distributions; and
- Limited waiver of the duty of care is permitted.

Securities Law Implications of Limited Liability Companies

In this section we consider whether LLC interests are “securities” under federal and state law. There are significant implications if member interests are securities:

- Unless an exemption exists, they may not be sold without registration under federal and state securities laws;
- Sellers are subject to federal and state securities fraud laws, whether or not the interests were registered or sold under an exemption;
- Sellers may be subject to broker-dealer registration laws;
- Purchasers have a statutory right of rescission; and
- Professionals working with LLCs are exposed to greater liability.

Analysis under Federal Law

Under Section 2(1) of the Securities Act and Section 3(a)10 of the Securities Exchange Act, the definition of “security” includes a “certificate of interest or participation in any profit-sharing agreement” and an “investment contract.” Under case law interpreting this definition, membership interests in an LLC may be either a certificate of interest or an investment contract.

In *SEC v. Howey*, the Supreme Court stated that an investment contract “means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party....” Under *Howey*, an investment contract involves:

- Whether the LLC is involved in an activity in which all members may engage, or is sophisticated and specialized.

The issuance of certificates to evidence the LLC's interests may cause the interests to be a security. In *Landreth Timbercove v. Landreth*, the Supreme Court held that under the Securities Act and Securities Exchange Act stock is a security. Under a similar analysis, certificates evidencing a membership interest in an LLC may be a "certificate of interest" in a profit-sharing agreement and, thus, a security.

Whether the interest in a specific LLC is a security depends on the particular facts of the LLC:

- Interests in several LLCs will undoubtedly be securities.
- Interests in manager-managed LLCs and LLCs that are more widely held are more likely to be securities than closely-held, member-managed LLCs.
- If members' limited liability causes them to be passive investors, their interests are more likely to be securities.

In one federal case, the SEC took the position that interests in an LLC are securities. In *SEC v. Parkersburg Wireless Limited Liability Company*, the SEC charged the defendant with numerous violations of Securities Act and Exchange Act for the sale of LLC interests. The defendant was found in contempt of a temporary restraining order that had previously been granted with respect to the SEC's charges. The opinion did not analyze whether the interests in the LLC were securities, but for purposes of the temporary restraining order and contempt citation treated them as such.

The use, ownership, and management of LLCs, however, may be sufficiently diverse to preclude generalizations about whether LLC interests are securities.

Analysis under State Laws

Each state has a system of securities laws (referred to as "blue sky" laws), which are parallel to the federal securities laws. Exemption from federal securities registration or broker/dealer requirements is not an exemption from state blue sky laws. Failure to comply with blue sky laws has consequences similar to those under federal laws.

On the federal law level, there are few administrative or court interpretations on the securities aspect of LLC interests. On the state level, however, several statutes and blue sky law administrators have considered the treatment of LLC interests as securities.

Most states presume that LLC interests are securities for blue sky law purposes, although they have exceptions for smaller, member-managed LLCs. A few state statutes define

- Investment of money;
- Common enterprise;
- Expectation of profits; and
- Sole reliance on the efforts of a promoter or third party.

These factors will undoubtedly be present in most LLCs.

The general partnership is the entity most analogous to LLCs for securities law analysis. Generally, in looking at general partnerships, courts have considered whether partnership agreements are investment contracts under the *Howey* test. The outcome depends on the facts of the general partnership.

The leading case applying the *Howey* test to general partnership interests is *Williamson v. Tucker*. In *Williamson*, several joint ventures operating as general partnerships purchased and developed real-estate tracts. The promoter purchased the real estate, sold the joint venture interests, and was solely responsible for the management and sale of the real estate. The joint venturers had the power to remove and replace the promoter as manager of the property and had a veto over certain actions, including sale of the property.

The court found that the first three elements of the *Howey* test were satisfied. The joint venture interests would, therefore, be securities if the joint venturers were expecting profits solely from the promoter's efforts. The court considered three factors in determining whether this fourth element was satisfied:

- Was the joint venture structured so similarly to a limited partnership that it left little power in the hands of the investors;
- Were the investors experienced enough to be capable of exercising the powers granted to them under the joint venture agreement; and
- Were the investors dependent on the unique entrepreneurial ability of the promoter, or could he be replaced?

Under the foregoing analysis, the question of whether interests in a specific LLC are securities will depend on the facts and circumstances of the LLC, including some of the following factors:

- Whether the LLC is member-managed or manager-managed;
- Number of LLC members;
- Powers granted to members and managers under the LLC's operating agreement;
- Extent to which the LLC relies on the expertise and efforts of certain members or managers; and

LLC interests as securities, although several of them establish circumstances under which the interests may not be securities. For example, in Indiana, LLC interests are included within the definition of securities, but not if all members are actively engaged in management. In Wisconsin, interests in LLCs are securities unless the LLC has no more than fifteen members and is member managed.

Some states have limited offering exemptions for sales of LLC interests. In Kansas, for example, sales of LLC interests with 35 or fewer members are exempt from state securities registration requirements, if members are not solicited through general solicitation and advertising.

Many states have yet to address the issue by statute, and continue to rely on no action letters and interpretations.

Use of Limited Liability Companies in Particular Situations

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Professionals

In recent decades, professionals base their business form on tax considerations. Partnership tax treatment is a natural fit for professionals. The professional corporation, however, has from time to time offered certain tax advantages:

- More favorable tax rate;
- More favorable deductions for medical and health care expenses;
- More pension plan options; and
- Reduced taxes by retaining assets in the corporation.

During recent years, however, liability for malpractice has exploded. Protection from such liability is now as important as obtaining partnership tax treatment.

Cash Method of Accounting

The use of LLCs by professionals had been limited because of questions regarding the use of the cash method of accounting by professional service LLCs. Because of the nature of professional practices, the cash method of accounting has been strongly preferred. If professionals changing from a general partnership to an LLC were required to change to the accrual method of accounting, significantly accelerated recognition of income would result. While the Code exempted professional service corporations and partnerships from the requirement to use the accrual method of accounting, it was silent about LLCs.

The IRS responded to this issue in Private Letter Rulings 9321047 and 9415005. The Rulings indicated that most professional LLCs would be permitted to remain on a cash basis of accounting. The rulings were based on the facts of the specific firms seeking the rulings, however, and questions remained regarding applicability of the Service's position to other professional organizations with different factual circumstances.

Status of Professionals under Limited Liability Company Statutes

The initial question on the use of an LLC by professionals is whether the use is permitted under the applicable LLC statute. A second question is whether professional licensing authorities permit professionals to operate as LLCs.

Generally, LLC statutes permit LLCs to be used for any lawful business. Accordingly, unless the LLC statute specifically prohibits the use of LLCs by professionals, an LLC could be used for a professional practice.

A number of LLC statutes expressly authorize the use of LLCs by professionals. Several of these LLC statutes contain detailed provisions regarding governance and operation of a professional LLC, including special provisions regarding:

- Names of professional LLCs;
- Limitations on members and ownership of membership interests; and
- Required purchase of membership interest by the professional LLC upon death of a member.

The use of LLCs by professionals has been controversial in several states, and is currently restricted under a few LLC statutes.

Use of Limited Liability Companies by Accountants

The American Institute of Certified Public Accountants (AICPA) determines the entities that accountants may use. In 1992, AICPA amended the AICPA Code of Professional Conduct Rule 505 to permit accountants to use LLCs.

Use of Limited Liability Companies by Lawyers

The practice of law is generally governed by the state bar association or the highest court of the state. This means that for lawyers authority to practice as an LLC is not sufficient. The appropriate state regulatory authority must also approve the use of LLCs. Regulatory authorities in a number of states, including Colorado, Kansas, Alabama, Virginia, Louisiana, Montana, and Missouri, have authorized the use of LLCs by lawyers.

Underlying the question of whether professionals should be permitted to limit their liability are significant policy questions. There is concern that if professionals are permitted to limit their liability for their co-practitioner's malpractice, the overall quality of services will diminish. This concern is evidenced in Section 79 (Vicarious Liability) of the American Law Institute Restatement of the Law Governing Lawyers, Tentative Draft No. 7 (April 7, 1994). The restatement takes the position that a law firm (and each of its

principals) should be liable for damages caused by principals and employees acting in the ordinary course of business or with actual authority.

Others argue that limiting a professional's liability for a colleague's malpractice will not reduce the quality of services. They point out that all assets of the professional LLC are liable for members' malpractice. In addition, the LLC's reputation, arguably its most significant asset, is at risk. Protecting the LLC's assets and reputation is a significant incentive for professionals to provide quality services -- whether or not they are personally liable for colleagues' malpractice.

Real Estate Transactions

LLCs can be useful in real estate transactions. In several respects, the tax treatment of real property ownership is more favorable for partnerships than corporations. Upon sale (and certain transfers), the appreciated value of real property owned by a corporation is taxed at a corporate level; upon distribution from the corporation, it is taxed again at the stockholder level. This double taxation does not occur with a partnership. In addition, individual owners can take some deductions that corporations cannot.

On the other hand, there is significant potential liability to owning real estate ownership. This usually means the owner should be an entity with limited liability. While insurance and non-recourse financing can reduce real estate liability, there are still insurance gaps and uninsurable liabilities.

Limited partnerships were often the vehicle of choice for real estate ownership. They offer partnership tax treatment and limited liability -- at least for limited partners. The disadvantage is that a general partner is liable for partnership obligations. While many limited partnerships used a special purpose corporation as the general partner, there were three difficulties with such an approach:

- Minimal capital requirements;
- Additional administrative expense and difficulty; and
- Risk that creditors of the general partner could pierce the corporate veil and hold the owners of the corporation liable for the partnership's debts.

For real property ownership, an LLC is better than a limited partnership in several respects:

- No LLC owner is liable for company obligations, so there is no need to risk the assets of an existing entity (or create a new one) to serve as a general partner.
- Owners of an LLC have more management flexibility. While limited partners cannot be actively involved in management, all LLC members can be active without risking personal liability for LLC obligations.

Title insurance for LLCs raises additional issues. As noted earlier, there is a great deal of flexibility on who may manage and bind an LLC. This means title insurance companies must conduct a greater level of review than is required for transactions involving corporations or limited partnerships. Title insurance companies must carefully review:

- Who is authorized under the articles or incorporation, operating agreement, and applicable LLC law to bind the LLC; and
- Who is or was active in the LLC's management, and has or had apparent authority to bind the LLC.

LLC promoters should seek in their title insurance policies "Fairway" endorsements, in response to a case in Ohio by that name. In the case, the original partners of a general partnership transferred their interests (including financial interests and management rights) to new partners. The partnership was denied title insurance coverage. The court found that under Ohio law, the partnership dissolved upon transfer of the partnership interests, and was effectively reformed with the transferees as new partners. The title insurance company successfully argued that it had insured the initial dissolved entity and not the reformed entity. A similar argument could be raised for LLCs, if under the operating agreement or state law a transfer causes dissolution of the LLC.

In response, title companies have issued to partnerships Fairway endorsements, which generally provide that the policy accrues to the entity despite transfers of interests. Similarly, Fairway endorsements should be requested for LLC title policies.

Venture and Growth Businesses

Growing businesses are complicated enterprises that balance competing interests. The equity interests are typically in the hands of the original entrepreneurs, who may desire to use some equity to reward employees and keep them involved in the business as it grows. Outside investors may demand equity positions, or make loans convertible into equity positions. The company may also have conventional loans, secured by the business's assets.

The use of LLCs should be advantageous for new and growing businesses, particularly those that desire "venture capital" investment. Owners of such businesses generally desire flow-through or partnership tax treatment. In the early stages of growing businesses, owners and investors may be able to take advantage of losses incurred by the business. In

addition, the owners and investors may desire to avoid double taxation of the current income, and appreciation if the business or assets are ultimately sold.

Investors in venture and growth businesses often want to be involved in the management of the business on a regular or emergency basis. For this purpose, an LLC is a better investment vehicle than a limited partnership. Unlike a partnership, LLC investors may be involved in management without being exposed to the LLC's obligations.

An S corporation is an unwieldy vehicle for venture capital investments. A number of venture capital investors are corporations or limited partnerships, entities that cannot own S corporation stock. In addition, an S corporation may have only one class of stock, which creates difficulty in structuring venture capital investments in S corporations. In contrast, there are no restrictions on who may own interests in LLCs. In addition, LLCs may have different classes of stock.

Corporate Joint Ventures

Limited liability companies can be useful in corporate joint ventures, which are specific business activities carried on by two or more businesses. Joint ventures have typically been structured in one of two ways.

- If the joint venture involves a relatively low-risk activity, corporate participants form a general partnership, with the participants themselves acting as general partners.
- Where the business activity involves greater risk, the corporate venturers may each form a wholly owned single-purpose corporate subsidiary to act as a general partner of a general partnership carrying out the venture's activities.

Partnerships are a preferred vehicle for corporate joint ventures because they feature pass-through taxation. This avoids a layer of taxation that would be present if the joint venture was carried out by as a corporation.

If the joint venture entity was owned by or operated as a C corporation, there is a tax detriment, although it can be reduced by a dividends-received deduction. Alternatively, an S corporation could act as the joint venture or its partners and pass through taxation. Unfortunately, restrictions on ownership of S corporation stock, limits the use of an S corporation as a joint venture vehicle.

An LLC is a better vehicle for a joint venture than either a corporation or a general partnership:

- An LLC features pass-through taxation, making it superior in most cases to use of a C corporation;
- There are no limits on ownership of an LLC, unlike an S corporation; and

- Because it has limited liability, the LLC can be the joint venture. There is no need to establish special purpose corporate subsidiaries to own the joint venture, as there is with partnerships.

Estate Planning

Using a limited partnership or LLC to own and transfer interests in a family's assets can provide significant benefits:

- **Retained control:** Parents can control the assets by retaining voting or management rights, while at the same time transferring economic interests in the assets to other family members;
- **Easy transfers:** Only the general partner or LLC manager must execute the necessary documents. The signatures of all involved family members are not required;
- **Flexibility:** Interests with different attributes can be issued. Subject to limitations provided in the Internal Revenue Code, parents can maximize the appreciation of assets in the hands of their children, while retaining income for their own needs. Disproportionate transfers of interests can differentiate among children on the basis of their relative contributions to the family and its businesses; and
- **Reduced estate tax:** The value of the LLC or partnership interests may be discounted for minority ownership and limited marketability.

What Entity Should Be Used?

C corporations are generally not good choices as estate planning entities. While they have limited liability, there is a corporate-level tax imposed on C corporations, which makes them less economically viable than entities with pass-through tax treatment.

Although **S corporations** provide pass-through tax treatment and limited liability, the one class of stock restriction on S corporations limits their flexibility and use in estate planning. For example, where a family wishes to transfer appreciated assets to children while retaining the stream of income for parents, an S corporation would not work.

A **general partnership** provides pass-through taxation and flexibility in allocating interests among family members. If the family assets involve a significant risk of liability, however, all family members would be liable for the partnership's obligations. In addition, all family members would have at least the apparent authority to bind the partnership by their actions. This is generally not desired in family estate planning.

Limited partnerships and **LLCs** have the principal elements desired in a family estate planning entity. Both provide pass-through taxation and significant flexibility in allocating interests in the entity. A limited partnership, however, requires at least one

party to be generally liable for the partnership's obligations. Although this requirement can be satisfied by the creation of a general partner corporation, it involves additional expense and complication. The advantage of the LLC is that limited liability exists without having to create a separate corporate general partner.

There are several problems, however, with using LLCs for estate planning. First, under a number of statutes, members may withdraw from the LLC and demand payment of the value of their LLC interest. Where the LLC allows parents to distribute family assets while retaining control during their lifetimes, the right of their children to prematurely withdraw and demand payment is a serious defect. Because of such potential disruption, LLCs should not be used as estate planning vehicles where such withdrawal is permitted.

Second, many statutes still require unanimous consent for transfers of interests. Where parents wish to periodically make transfers to children, they may not want to seek consent from (or even inform) non-recipients. LLCs should not be used for estate planning where such consents are required.

Third, in states that prohibit free transferability of LLC interests, family relationships among partners or members may be a problem. Under the "lack of separate interests" theory, a requirement in a partnership agreement that partners consent to transfers is disregarded if the partners' relationship makes the consent likely. Under the theory, the interests would be considered to be transferable.

Comparison Chart of Kentucky LLCs and Other Business Entities — May 7, 1999

	LIMITED LIABILITY COMPANY	LIMITED PARTNERSHIP	S CORPORATION	C CORPORATION
LIMITED LIABILITY	Members enjoy limited liability	Limited partners generally enjoy limited liability	Shareholders enjoy limited liability	Shareholders enjoy limited liability
PARTICIPATION IN MANAGEMENT	No restrictions — very flexible	Participation by general partners only or limited partners lose limited liability	No restrictions	No restrictions
TRANSFERABILITY OF OWNERSHIP INTERESTS	Restrictions are imposed by LLC statute, as modified by operating agreement	Restrictions may be imposed by the partnership agreement	Restrictions may be imposed by a shareholders' agreement — less restricted as a matter of corporate law	Restrictions may be imposed by a shareholders' agreement — less restricted as a matter of corporate law
QUALIFICATION	No restrictions	A limited partnership needs a general partner (general partner may be a corporation)	There are various eligibility requirements, including a restriction on the number and type of shareholders and on the ownership of subsidiaries	None
NUMBER OF OWNERS	One or more members	At least two	1 to 75	Unlimited
TYPES OF OWNER	Any	Any	Ownership limited to U.S. residents and citizens and to certain U.S. trusts; ESOPs now permitted and certain tax exempt organizations now permitted	Any
CLASSES OF OWNERSHIP INTERESTS	Multiple classes are permitted	Multiple classes are permitted	One. However, there can be differences in voting rights. Debt Safe Harbor Rules should be reviewed. Also, there are certain rules that permit "contractual" differences among shareholders	Multiple are permitted
ABILITY TO DO BUSINESS IN OTHER STATES	Must review laws of other states — generally not a problem given spread of LLC form	Yes	Yes	Yes

Comparison Chart of Kentucky LLCs and Other Business Entities — May 7, 1999

	LIMITED LIABILITY COMPANY	LIMITED PARTNERSHIP	S CORPORATION	C CORPORATION
AFFILIATE LIMITS	None	None	Restricted — may own 80% or more of C corporation stock and 100% of QSSS	None
LEVELS OF INCOME TAX	Member level only	Partner level only	Shareholder level only, unless S election is made when corporation holds appreciated assets	Corporate level and shareholders level on distributed profits and liquidating distributions
SPECIAL ALLOCATIONS OF INCOME AND LOSS	Yes	Yes	No	No
DEDUCTIBILITY OF LOSSES	Members may deduct their allocable share of the LLC's losses only to the extent of their tax basis in their LLC interest, which includes their allocable share of LLC debt	Partners may deduct their allocable share of the partnership's losses only to the extent of their tax basis in their partnership interest, which includes their allocable share of partnership debt	Shareholders may deduct their allocable share of the S corporation's losses only to the extent of their tax basis in their S corporation shares, which does not include corporate debt	Corporate level only — no flow through
AT-RISK LIMITATIONS	Applicable to members — owners' deductions are limited to the "amount at risk" in LLC (i.e. — property or cash contributed and amounts "borrowed" with respect to the activity)	Applicable to partners — owners' deductions are limited to the "amount at risk" in partnership (i.e. — property or cash contributed and amounts "borrowed" with respect to the activity)	N/A	N/A
PASSIVE ACTIVITY LOSS RULES	Applicable to members	Applicable to partners	N/A	
FISCAL YEAR	Generally follows fiscal year of majority partner	Generally follows fiscal year of majority partner	Generally calendar	Any year permitted (with certain exceptions for personal service corporations)

Comparison Chart of Kentucky LLCs and Other Business Entities — May 7, 1999

	LIMITED LIABILITY COMPANY	LIMITED PARTNERSHIP	S CORPORATION	C CORPORATION
CASH DISTRIBUTIONS	Nontaxable to the extent of a member's tax basis in his LLC interest — basis reduced	Nontaxable to the extent of a partner's tax basis in his partnership interest — basis reduced	Generally nontaxable to the extent of the shareholder's tax basis in his stock — basis reduced. Note: Special rules apply where S corp was formerly a C corp	Dividend to the extent of earnings and profit. Note: If not a dividend, first reduces basis and then, to the extent in excess of basis, taxable as a capital gain. (Note: Dividend received deductions are available for corporate shareholders 100%/80%/70% rules)
APPRECIATED PROPERTY DISTRIBUTIONS	No gain or loss to entity. The member generally does not recognize gain or loss. Member's basis in property will be the adjusted basis of the LLC in such property	No gain or basis to entity. The partner generally does not recognize gain or loss. Partner's basis in property will be the adjusted basis of the partnership in such property	Gain recognized and passed-through to shareholders generally; however, entity level tax possible where such appreciated property was in existence at the time of conversion from C corp. Otherwise, for the shareholder, the distribution is treated similar to cash distribution rules above	Dividend treatment; gain recognition to entity
LIQUIDATION	Nontaxable to the extent of a member's tax basis in his LLC interest; appreciated assets distributed tax-free	Nontaxable to the extent of a partner's tax basis in his partnership interest; appreciated assets distributed tax-free	Generally nontaxable at corporate level and taxable at shareholder level through flow-through of corporate tax items; distribution of appreciated assets treated as taxable; capital gain on excess value received over basis. Note: basis increased by virtue of gain recognized to S Corp on appreciated property	Gain recognition to entity if appreciated property distributed. Capital gain to shareholder on excess value received over shareholder's basis in stock

Comparison Chart of Kentucky LLCs and Other Business Entities — May 7, 1999

	LIMITED LIABILITY COMPANY	LIMITED PARTNERSHIP	S CORPORATION	C CORPORATION
SALE OF INTEREST BY OWNER TO THIRD PERSON	Capital gain, subject to §751 ordinary income categorization	Capital gain, subject to §751 ordinary income categorization	Capital gain; no effect on basis of corporation's assets	Capital gain; no effect on basis of corporation's assets
DEATH OF OWNER	Estate as member subject to agreement, FMV at date of death is basis for interest	Estate as partner subject to agreement, FMV at date of death is basis for interest	Estate continues as shareholder: FMV at date of death (or alternate valuation date) is a basis for shares; no effect on basis of corporation's assets	Estate continues as shareholder: FMV at date of death (or alternate valuation date) is a basis for shares; no effect on basis of corporation's assets
REORGANIZATIONS	Tax-free transaction structures exist but are limited	Tax-free transaction structures exist but are limited	Tax-free to shareholders if qualifying under reorganization provisions (§354 and §368)	Tax-free to shareholders if qualifying under reorganization provisions (§354 and §368)
CARRYOVER OF TAX ATTRIBUTES	N/A	N/A	Carryover of tax attributes to successor entity if tax-free reorganization (limits on NOL exist)	Carryover of tax attributes to successor entity if tax-free reorganization (limits on NOL exist)

LOU-234891-1

NEGOTIATING VENTURE CAPITAL DEALS

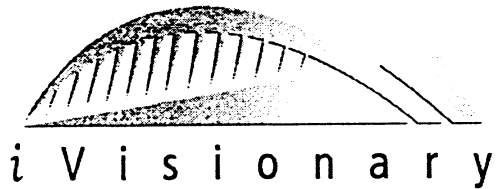
*Craig Greenberg
Chief Operating Officer & General Counsel
iVisionary
Louisville, Kentucky*

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SECTION C

NEGOTIATING VENTURE CAPITAL DEALS

- I. SAMPLE TERM SHEET - SERIES B PREFERRED STOCK DEAL C-3
- II. SAMPLE TERM SHEET - CONVERTIBLE DEBT DEAL C-13
- III. WHAT IS VENTURE CAPITAL? C-17
- IV. THE STATE OF THE VENTURE CAPITAL INDUSTRY C-25



Negotiating Venture Capital Deals

Presented By:
Craig Greenberg
Chief Operating Officer & General Counsel, iVisionary

March 16, 2001

Supplemental Materials

- Sample Term Sheet – Series B Preferred Stock Deal
- Sample Term Sheet – Convertible Debt Deal
- What is Venture Capital? (Source: National Venture Capital Association)
- The State of the Venture Capital Industry (Source: Venture One)

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TECH COMPANY, INC.

SERIES B PREFERRED STOCK FINANCING

SAMPLE TERM SHEET

March 1, 2001

The intent of this document (this "Term Sheet") is to describe, for negotiation purposes only, some key terms of the proposed agreement between VC Fund III, L.P. and/or its affiliates ("VC"), other potential investors (together, with VC, the "Investors") and Tech Company, Inc (the "Company").

Issuer: Tech Company, Inc.

Amount of Financing: Minimum of \$15,000,000. Maximum of \$25,000,000.

Type of Security: 4,285,714 to 7,142,857 shares of Series B Preferred Stock ("Series B Preferred"), initially convertible into an equal number of shares of Common Stock.

Purchase Price: \$3.50 per share (the "Purchase Price").

Use of Proceeds: The Company will use the proceeds from the Series B Preferred financing for its growth and expansion. No proceeds will be used to repurchase or cancel any securities held by any investor.

Investors: VC shall serve as the lead investor for this round of financing and shall purchase approximately \$5 million of Series B Preferred. Other Investors must be acceptable to VC and the Company.

Closing: The initial closing (the "Closing") shall be on or before April 31, 2001. There may also be a subsequent closing (the "Subsequent Closing") for the sale of up to the balance of the authorized shares of Series B Preferred not sold at the Closing. All sales made at the Subsequent Closing shall be made on the identical terms and conditions (other than the closing date) as the sales made at the Closing.

This Term Sheet will expire on March 7, 2001 unless executed by Tech Company, Inc. on or prior to that date.

Capitalization:

The capitalization of the Company on a fully-diluted basis as of March 1, 2001 is as follows:

Common Stock	4,984,740
Series A Preferred Stock	3,286,592
Series B Preferred Stock	To be determined
Warrants to purchase Series A Preferred	250,000
Options to purchase Common Stock	1,726,911
Options available for grant	433,899

Note: The Warrants to purchase Series A Preferred do not include a warrant to purchase up to 175,000 shares of Series A Preferred at the initial exercise price of \$1.25 per share, the exercise of which is contingent upon the satisfaction of certain conditions.

Rights and Preferences of Series B Preferred

Dividend Rights:

The Series B Preferred will be entitled to an annual per share dividend equal to 7% of the Purchase Price, payable when and if declared by the Board of Directors (the "Board"). The dividends will be non-cumulative and will be paid prior to the payment of any dividend with respect to the Common Stock.

Liquidation Preference:

In the event of any liquidation, dissolution or winding up of the Company, the holders of the Series B Preferred will be entitled to receive a per share amount equal to the Purchase Price (subject to anti-dilution adjustments) plus all declared but unpaid dividends, prior to any distribution to the holders of the Common Stock and Series A Preferred (the "First Preference Distribution"). If the Company has insufficient assets to permit payment in full of the preference amount to which all Series B shareholders are entitled, then the assets of the Company will be distributed ratably to the holders of the Series B shareholders in proportion to the preference amount each such holder would otherwise be entitled to receive as provided herein.

After payment of the First Preference Distribution has been made, the holders of the Series B Preferred will be entitled to receive an additional per share amount equal to the Purchase Price (subject to anti-dilution adjustments) plus all declared but unpaid dividends, *provided*, that such

This Term Sheet will expire on March 7, 2001 unless executed by Tech Company, Inc. on or prior to that date.

payment is made: (i) prior to any distribution to the holders of the Common Stock, and (ii) concurrently with any distribution to the holders of the Series A Preferred in a per share amount equal to the applicable original purchase price (subject to anti-dilution adjustments) for the Series A Preferred, plus all declared but unpaid dividends. If the Company has insufficient assets to permit payment in full of the preference amount to which all Series A and Series B Preferred shareholders are entitled, then the assets of the Company will be distributed ratably to the holders of the Series A and Series B Preferred in proportion to the preference amount each such holder would otherwise be entitled to receive as provided herein.

In the event of a sale of substantially all of the assets of the Company or a merger, acquisition or sale of voting control in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation (a "Change in Control"), the Investors may elect to treat such a transaction as a liquidation or dissolution for purposes of determining amounts to be received by the Investors and priority of such receipt.

Redemption:

The holders of the Series B Preferred shall have the option to require the Company to redeem all or any part of their Series B Preferred shares, at any time after five years from the closing, for a price equal to the greater of (a) the Purchase Price, plus all [accrued/declared] but unpaid dividends, or (b) the fair market value per share, as determined by a qualified, independent appraiser acceptable to both the Company and Investors or, if the Company and Investors cannot agree on an appraiser, the average of the fair market value per share as determined by a qualified, independent appraiser selected by the Company and the fair market value per share as determined by a qualified, independent appraiser selected by the Investors.

Conversion:

The holders of the Series B Preferred will have the right to convert the Series B Preferred into shares of Common Stock at any time. The initial conversion rate for the Series B Preferred will be on a one-for-one basis, subject to adjustments as provided herein.

This Term Sheet will expire on March 7, 2001 unless executed by Tech Company, Inc. on or prior to that date.

Automatic Conversion: The Series B Preferred will automatically be converted into Common Stock, at the then applicable conversion rate, upon the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price of at least \$7.00 per share and gross proceeds to the Company in excess of \$25,000,000 (a "Qualified IPO").

Anti-Dilution Provisions: The conversion price of the Series B Preferred is subject to proportional adjustment in the event of (i) any split or combination of the Company's capital stock, (ii) a declaration of a dividend or distribution of its capital stock, or (iii) certain consolidation, merger or exchange transactions.

The conversion price of the Series B Preferred will be adjusted on a weighted average basis upon the Company's issuance of additional shares of Common Stock (or warrants or rights to purchase Common Stock or securities convertible into Common Stock) for a consideration per share that is less than the conversion price of the Series B Preferred. The conversion price of the Series B Preferred will not be adjusted for issuances of Common Stock upon (i) the exercise or conversion of any presently outstanding securities, or (ii) the future issuance of stock options to employees, officers or directors pursuant to a stock option plan, so long as such options are granted (a) with the approval of the Board, and (b) at a fair market value.

Registration Rights: Demand, Piggyback and S-3 Rights: The holders of Series B Preferred may require, on not more than two occasions after the earlier of the second anniversary of their investment, or six months after a Qualified IPO, the Company to use its best efforts to file a registration statement covering the public sale of the Company's securities having an aggregate public offering price of at least \$5,000,000; *provided*, that the Company will have the right to delay such demand registration under certain conditions for a period not to exceed 90 days each time in any 12 month period.

The holders of Series B Preferred shall be entitled to (i) unlimited piggyback registration rights to register their shares in any registration of the shares of the Company by the Company or its management, and (ii) three registrations

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per year on Form S-3 (minus any demand registrations as described above).

Expenses: The Company will bear the registration expenses (excluding underwriting discounts and commissions but including all other expenses related to the registration) of all such registrations.

Termination: The registration rights will terminate five years after the closing of a Qualified IPO, and will not apply to any holder who can sell all of such holder's shares in any three-month period without registration pursuant to Rule 144 promulgated under the 1933 Act.

Voting Rights:

Each share of Series B Preferred will carry a number of votes equal to the number of shares of Common Stock then issuable upon its conversion into Common Stock. The Series B Preferred will generally vote together with the Common Stock and the other series of Preferred Stock, and not as a separate class, except as provided below.

Protective Provisions:

Consent of the holders of a majority of the outstanding Series B Preferred will be required for: (i) any amendment or change of the rights, preferences, privileges or powers of, or the restrictions provided for the benefit of, the Series B Preferred; (ii) any amendment of the Company's Articles of Incorporation that adversely affects the rights of the Series B Preferred differently than those of the other series of Preferred Stock; or (iii) any increase in the number of authorized shares of the Series B Preferred.

Consent of the holders of a majority of the outstanding Preferred Stock voting together as a class will be required for: (i) any purchase or redemption of any shares of Preferred Stock other than a redemption pursuant to the Company's Articles of Incorporation; (ii) repurchase or acquisition of any shares of Common Stock in an amount greater than \$25,000 in any 12 month period, other than pursuant to the terms of an equity incentive agreement with a director, employee, consultant or other service provider giving the Company the right to repurchase shares upon the termination of such services; (iii) any amendment or change of the rights, preferences, privileges or powers of, or the restrictions provided for the benefit of, the Preferred Stock, (iv) any action that authorizes, creates or issues shares of any class of stock having preferences superior to

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or on a parity with the Preferred Stock, (v) any action that reclassified any outstanding shares into shares having preferences or priority as to dividends or assets senior to or on a parity with the preference of the Preferred Stock; (vi) any merger or consolidation of the Company with one or more other corporations in which the shareholders of the Company immediately after such merger or consolidation hold stock representing less than a majority of the voting power of the outstanding stock of the surviving corporation; (vii) the sale of all or substantially all the Company's assets; (viii) the liquidation or dissolution of the Company; (ix) the declaration or payment of a dividend on the Common Stock; (x) any subsidiary to sell or otherwise transfer any shares of capital stock to any individual or entity other than the Company or any holder of Preferred Stock; or (xi) any increase or decrease in the authorized number of shares of Preferred Stock.

Right of First Refusal:

Each holder of Series B Preferred will have a right of first refusal to purchase up to its pro rata share (based on its percentage of the Company's outstanding common shares, calculated on a fully-diluted, as-converted basis) of any securities offered by the Company (other than securities issued to employees, directors or consultants or pursuant to an acquisition), on the same price and terms and conditions as the Company offers such securities to other potential investors.

Co-Sale Rights:

Until a Qualified IPO has occurred, if any founder of the Company or any member of the Company's senior management who is not a founder, proposes to sell shares to a new investor, holders of the Series B Preferred shall be offered the right to sell their shares on a pro rata basis in such sale; *provided*, that such member of senior management who is not a founder, shall be bound by this provision only until the earlier of the closing date of a Qualified IPO, or one year after his or her voluntary or involuntary termination of employment with the Company.

Additional Rights:

In the event that any of the Company's existing shareholders are entitled to any rights, privileges or protections on terms more favorable than those herein afforded to the Series B Preferred, the Series B Preferred shall be entitled to the benefits of such more favorable terms.

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Lock-Up: In connection with a Qualified IPO, all holders of Series B Preferred will agree not to sell or to offer to sell any securities of the Company for up to 180 days following the date of the Qualified IPO upon the request of the Company and its underwriters. All officers and directors, all holders of Preferred Stock, and any greater than 1.0 % shareholder will be required to enter into similar lock-up agreements.

Governance, Documentation and Closing

Board of Directors: The Articles of Incorporation and Bylaws shall provide that the number of Directors be five. Pursuant to the Articles of Incorporation, the Series B Preferred shareholders (voting as a class) shall have the right to elect two directors. Expenses of the Directors incurred in fulfilling their duties as Directors shall be borne by the Company.

Purchase Agreement: The purchase of shares of Series B Preferred will be made (i) pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, customary terms and conditions, customary representations and warranties of the Company, and covenants of the Company reflecting the provisions set forth herein, and (ii) upon the occurrence of appropriate conditions of closing, including the delivery of an opinion of counsel for the Company.

Due Diligence: The Closing of this transaction is subject to due diligence (which shall be completed prior to the Closing of this transaction) and complete satisfaction by the Investors and Company with the final terms and conditions of all documents contemplated herein, as well as complete satisfaction that there has been no material adverse change in the market, business, financial condition, prospects, management, ownership or structure of the Company from that currently perceived, understood or contemplated by the Investors.

Employment Agreements: Each key officer and employee of the Company will have entered into acceptable confidential information, noncompetition, and invention assignment agreements. The Company will use its best efforts to have the remainder of the employees and officers sign such agreements.

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Key Person Insurance: The Company shall obtain key person life insurance on selected key executives in amounts to be agreed to by Investors and the Company, with proceeds payable to the Company.

Stock Option Plan: Prior to the Closing, 10% of the Company's Common Stock shall be set aside for a management and employee stock option plan. Stock issued pursuant to the plan shall vest over a period no shorter than four years.

Information Rights: So long as shares of Series B Preferred are outstanding, the Company will deliver to each holder of Series B Preferred (i) audited annual financial statements within 120 days of the end of each fiscal year, (ii) unaudited quarterly financial statements within 45 days of the end of each fiscal quarter, (iii) unaudited monthly financial statements within 30 days of the end of each month, and (iv) an annual budget within 30 days of the end of each fiscal year and following approval of the Board.

The Company shall permit each holder of at least 250,000 shares of Series B Preferred to visit and inspect the Company's properties, to examine its books of account and records, and to discuss the Company's affairs, finances and accounts with its officers.

Exclusivity: Commencing upon the execution of this Term Sheet and continuing for 60 days thereafter, the Company shall not, and shall ensure that none of its employees, officers, directors, affiliates, agents or representatives discuss this Term Sheet, or solicit, initiate, encourage or discuss the issuance of its capital stock for capital raising purposes, or other financing transaction, or furnish any information with respect to, assist or participate in or in any other manner facilitate any such transaction, except with the prior approval of VC or upon the prompt notification by VC to the Company that it no longer plans to consummate the transactions contemplated by this Term Sheet; *provided, however,* that the foregoing shall not apply to any communications by the Company, to the extent necessary to consummate the transaction contemplated by this Term Sheet, with any of its existing shareholders and the following potential investors: Strategic Investor 1, VC Fund 2, and VC Fund 3.

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Expenses:

The Company shall reimburse the Investors for the reasonable legal fees of its counsel for this transaction, in an amount not to exceed \$25,000, plus direct, out-of-pocket, reasonable and documented expenses, and for the direct, out-of-pocket, reasonable and documented expenses incurred by the Investors in connection with this transaction, payable at Closing or payable if the Company elects not to proceed with the transactions described herein.

Except with respect to the Exclusivity and Expenses provisions above, this Term Sheet shall not constitute a legally binding agreement between us, but is intended to serve as the basis for the preparation of the agreements contemplated herein. Except for the Exclusivity and Expenses provisions, no legally binding agreement shall arise until the agreements contemplated herein, in mutually satisfactory form, have been duly authorized, executed and delivered by both parties.

Furthermore, it is the intention of both parties to consummate the transactions contemplated by this Term Sheet on those terms reflected in this Term Sheet.

If the Company is in agreement with the foregoing, it should sign the acknowledgement at the end of this letter.

VC Fund III, L.P.

By _____
John Smith, Managing Director

Acknowledged and agreed to:

Tech Company, Inc.

By _____

Name: _____

Title: _____

Date: _____

This Sample Term Sheet was prepared by:
Craig Greenberg
Chief Operating Officer & General Counsel
iVisionary
cgreenberg@ivisionary.com

This Term Sheet will expire on March 7, 2001 unless executed by Tech Company, Inc. on or prior to that date.

TERMS OF BRIDGE OFFERING FOR

Cool Company, Inc.

March 1, 2001

- Issuer:** Cool Company, Inc. (the "Company").
- Purchasers:** VC Bridge Fund II, L.P., Strategic Purchaser X, Inc., and others to be determined ("Purchasers").
- Security:** Demand Convertible Promissory Notes (the "Notes").
- Amount:** \$10,000,000 principal amount, with a minimum of \$6,000,000 for closing.
- Use of Proceeds:** Working Capital.
- Payable in Full:** On the earlier of demand by holders of 66 2/3% of the Notes or the sale of the Company.
- Interest Rate:** 10%, accrued and compounded quarterly.
- Payment upon Sale of Company:** If the Company is sold or the Notes are paid in cash before conversion of the Notes, the Purchasers will receive in payment of the Notes an amount equal to 2x principal plus all accrued interest.
- Conversion:** Purchasers shall convert principal and interest into the next Series of Preferred Stock offered by the Company, with the approval of the Purchasers as required below, without the payment of any additional consideration by Purchasers. The Notes will convert at a price equal to the price per share offered in such preferred equity offering. At the time of any such conversion, the Purchasers shall, with the cooperation of the Company, become parties to the Company's co-sale, investor rights and stockholder voting agreements with appropriate changes to reflect such preferred equity round.

- Negative Covenants:** The Notes will contain negative covenants prohibiting the following unless approved by holders of a supermajority of the outstanding Notes, such supermajority percentage to be determined in connection with negotiation of the definitive documents:
- sale or recapitalization of the Company by any method (merger, sale of substantially all assets etc.) at an enterprise valuation of less than \$250 million;
 - any issuance of equity securities or securities convertible into the Company's equity, with reasonable exceptions for employee compensation awards approved by the Board of Directors;
 - incurrence of any additional indebtedness, other than ordinary course trade payables, in an amount exceeding \$200,000 in the aggregate;
 - sale of any assets outside the ordinary course of business;
 - any acquisition of or investment in any other business;
 - any transaction, other than transactions negotiated on an arm's length basis, outside the ordinary course of the Company's business; or
 - any liquidation, dissolution or winding up of the Company.
- Warrants:** For each \$1 of Notes purchased, each Purchaser will also receive nominal warrants to purchase 2.5 shares of common stock.
- Expenses:** The Company will pay all expenses reasonably incurred by Purchasers in connection with this contemplated transaction, including, without limitation, all reasonable legal and accounting fees, subject to a cap of \$25,000.
- Conditions:** Completion of documentation for this transaction that is satisfactory to both parties, which includes a representation and closing condition that there has been no material change in the business.

Receipt of all necessary approvals, including approvals of Series A, B and C holders and any approvals required for Purchasers to purchase Notes, including any internal committee approvals.

Receipt of customary opinions of inside and outside counsel to the Company.

Completion of satisfactory due diligence by the Purchasers.

Following execution of the Notes, delivery of monthly financial statements to Purchasers within 30 days of each month end.

Following execution of the Notes, delivery of monthly pipeline reports to Purchasers within 10 days of each month end.

Board of Directors: Within 30 days of the date of the Notes, the Company shall fill the vacant seat on its Board of Directors with a person approved by Purchasers holding a majority of the Notes.

Entire Understanding: This summary of proposed Terms of Bridge Offering supersedes all prior discussions, term sheets and understandings, whether written or oral, regarding the subject matter hereof.

Non-binding: This summary of proposed Terms of Bridge Offering, other than the Company's obligation to pay all expenses reasonably incurred in connection with this contemplated transaction, shall not be binding, but shall serve as the basis for discussions toward a possible transaction and negotiations of a definitive agreement for such transaction.

ACCEPTED:

Cool Company, Inc.

By: _____

Title: _____

Date: _____, 2001

VC Bridge Fund II, L.P.

By: VC Fund Management Co., LLC
its General Partner

By: _____

Its _____

Date: _____, 2001

Strategic Purchaser X, Inc.

By: _____

Its _____

Date: _____, 2001

This Sample Term Sheet was prepared by:

Craig Greenberg
Chief Operating Officer & General Counsel
iVisionary
cgreenberg@ivisionary.com

WHAT IS VENTURE CAPITAL

The Venture Capital Industry

An Overview

Venture capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Professionally managed venture capital firms generally are private partnerships or closely-held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards;
- Have a long-term orientation

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward, they actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges.

Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund. Many times they will co-invest with other professional venture capital firms. In addition, many venture partnership will manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness. Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft and Genentech are famous examples of companies that received venture capital early in their development.

Private Equity Investing

Venture capital investing has grown from a small investment pool in the 1960s and early 1970s to a mainstream asset class that is a viable and significant part of the institutional and corporate investment portfolio. Recently, some investors have been referring to venture investing and buyout investing as "private equity investing." This term can be confusing because some in the investment industry use the term "private equity" to refer only to buyout fund investing. In any case, an institutional investor will allocate 2% to 3% of their institutional portfolio for investment in alternative assets such as private equity or venture capital as part of their overall asset allocation.

Currently, over 50% of investments in venture capital/private equity comes from institutional public and private pension funds, with the balance coming from endowments, foundations, insurance companies, banks, individuals and other entities who seek to diversify their portfolio with this investment class.

What is a Venture Capitalist?

The typical person-on-the-street depiction of a venture capitalist is that of a wealthy financier who wants to fund start-up companies. The perception is that a person who develops a brand new change-the-world invention needs capital; thus, if they can't get capital from a bank or from their own pockets, they enlist the help of a venture capitalist.

In truth, venture capital and private equity firms are pools of capital, typically organized as a limited partnership, that invests in companies that represent the opportunity for a high rate of return within five to seven years. The venture capitalist may look at several hundred investment opportunities before investing in only a few selected companies with favorable investment opportunities. Far from being simply passive financiers, venture capitalists foster growth in companies through their involvement in the management, strategic marketing and planning of their investee companies. They are entrepreneurs first and financiers second.

Even individuals may be venture capitalists. In the early days of venture capital investment, in the 1950s and 1960s, individual investors were the archetypal venture investor. While this type of individual investment did not totally disappear, the modern venture firm emerged as the dominant venture investment vehicle. However, in the last few years, individuals have again become a potent and increasingly larger part of the early stage start-up venture life cycle. These "angel investors" will mentor a company and provide needed capital and expertise to help develop companies. Angel investors may either be wealthy people with management expertise or retired business men and women who seek the opportunity for first-hand business development.

Investment Focus

Venture capitalists may be generalist or specialist investors depending on their investment strategy. Venture capitalists can be generalists, investing in various industry sectors, or various geographic locations, or various stages of a company's life. Alternatively, they may be specialists in one or two industry sectors, or may seek to invest in only a localized geographic area.

Not all venture capitalists invest in "start-ups." While venture firms will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (so called "**seed investing**"), or may provide capital to start up a company in its first or second stages of development known as "**early stage investing**." Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful ("**expansion stage financing**").

The venture capitalist may invest in a company throughout the company's life cycle and therefore some funds focus on **later stage investing** by providing financing to help the company grow to a critical mass to attract public financing through a stock offering. Alternatively, the venture capitalist may help the company attract a merger or acquisition with another company by providing liquidity and exit for the company's founders.

At the other end of the spectrum, some venture funds specialize in the **acquisition, turnaround or recapitalization** of public and private companies that represent favorable investment opportunities.

There are venture funds that will be broadly diversified and will invest in companies in various industry sectors as diverse as semiconductors, software, retailing and restaurants and others that may be specialists in only one technology.

While high technology investment makes up most of the venture investing in the U.S., and the venture industry gets a lot of attention for its high technology investments, venture capitalists also invest in companies such as construction, industrial products, business services, etc. There are several firms that have specialized in retail company investment and others that have a focus in investing only in "socially responsible" start-up endeavors.

Venture firms come in various sizes from small seed specialist firms of only a few million dollars under management to firms with over a billion dollars in invested capital around the world. The common denominator in all of these types of venture investing is that the venture capitalist is not a passive investor, but has an active and vested interest in guiding, leading and growing the companies they have invested in. They seek to add value through their experience in investing in tens and hundreds of companies.

Some venture firms are successful by creating synergies between the various companies they have invested in; for example one company that has a great software product, but does not have adequate distribution technology may be paired with another company or its management in the venture portfolio that has better distribution technology.

Length of Investment

Venture capitalists will help companies grow, but they eventually seek to exit the investment in three to seven years. An early stage investment may take seven to ten years to mature, while a later stage investment may only take a few years, so the appetite for the investment life cycle must be congruent with the limited partnerships' appetite for liquidity. The venture investment is neither a short term nor a liquid investment, but an investment that must be made with careful diligence and expertise.

Types of Firms

There are several types of venture capital firms, but most mainstream firms invest their capital through funds organized as limited partnerships in which the venture capital firm serves as the general partner. The most common type of venture firm is an independent venture firm that has no affiliations with any other financial institution. These are called "private independent firms". Venture firms may also be affiliates or subsidiaries of a commercial bank, investment bank or insurance company and make investments on behalf of outside investors or the parent firm's clients. Still other firms may be subsidiaries of non-financial, industrial corporations making investments on behalf of the parent itself. These latter firms are typically called "direct investors" or "corporate venture investors."

Other organizations may include government affiliated investment programs that help start up companies either through state, local or federal programs. One common vehicle is the Small Business

Investment Company or SBIC program administered by the Small Business Administration, in which a venture capital firm may augment its own funds with federal funds and leverage its investment in qualified investee companies.

While the predominant form of organization is the limited partnership, in recent years the tax code has allowed the formation of either Limited Liability Partnerships, ("LLPs"), or Limited Liability Companies ("LLCs"), as alternative forms of organization. However, the limited partnership is still the predominant organizational form. The advantages and disadvantages of each has to do with liability, taxation issues and management responsibility.

The venture capital firm will organize its partnership as a pooled fund; that is, a fund made up of the general partner and the investors or limited partners. These funds are typically organized as fixed life partnerships, usually having a life of ten years. Each fund is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, the partnership is closed to further investment from new investors or even existing investors so the fund has a fixed capital pool from which to make its investments.

Like a mutual fund company, a venture capital firm may have more than one fund in existence. A venture firm may raise another fund a few years after closing the first fund in order to continue to invest in companies and to provide more opportunities for existing and new investors. It is not uncommon to see a successful firm raise six or seven funds consecutively over the span of ten to fifteen years. Each fund is managed separately and has its own investors or limited partners and its own general partner. These funds' investment strategy may be similar to other funds in the firm. However, the firm may have one fund with a specific focus and another with a different focus and yet another with a broadly diversified portfolio. This depends on the strategy and focus of the venture firm itself.

Corporate Venturing

One form of investing that was popular in the 1980s and is again very popular is corporate venturing. This is usually called "direct investing" in portfolio companies by venture capital programs or subsidiaries of nonfinancial corporations. These investment vehicles seek to find qualified investment opportunities that are congruent with the parent company's strategic technology or that provide synergy or cost savings.

These corporate venturing programs may be loosely organized programs affiliated with existing business development programs or may be self-contained entities with a strategic charter and mission to make investments congruent with the parent's strategic mission. There are some venture firms that specialize in advising, consulting and managing a corporation's venturing program.

The typical distinction between corporate venturing and other types of venture investment vehicles is that corporate venturing is usually performed with corporate strategic objectives in mind while other venture investment vehicles typically have investment return or financial objectives as their primary goal. This may be a generalization as corporate venture programs are not immune to financial considerations, but the distinction can be made.

The other distinction of corporate venture programs is that they usually invest their parent's capital while other venture investment vehicles invest outside investors' capital.

Commitments and Fund Raising

The process that venture firms go through in seeking investment commitments from investors is typically called "fund raising." This should not be confused with the actual investment in investee or "portfolio" companies by the venture capital firms, which is also sometimes called "fund raising" in some circles. The commitments of capital are raised from the investors during the formation of the fund. A venture firm will set out prospecting for investors with a target fund size. It will distribute a prospectus to potential investors and may take from several weeks to several months to raise the requisite capital. The fund will seek commitments of capital from institutional investors, endowments, foundations and individuals who seek to invest part of their portfolio in opportunities with a higher risk factor and commensurate opportunity for higher returns.

Because of the risk, length of investment and illiquidity involved in venture investing, and because the minimum commitment requirements are so high, venture capital fund investing is generally out of reach for the average individual. The venture fund will have from a few to almost 100 limited partners depending on the target size of the fund. Once the firm has raised enough commitments, it will start making investments in portfolio companies.

Capital Calls

Making investments in portfolio companies requires the venture firm to start "calling" its limited partners commitments. The firm will collect or "call" the needed investment capital from the limited partner in a series of tranches commonly known as "capital calls". These capital calls from the limited partners to the venture fund are sometimes called "takedowns" or "paid-in capital." Some years ago, the venture firm would "call" this capital down in three equal installments over a three year period. More recently, venture firms have synchronized their funding cycles and call their capital on an as-needed basis for investment.

Illiquidity

Limited partners make these investments in venture funds knowing that the investment will be long-term. It may take several years before the first investments starts to return proceeds; in many cases the invested capital may be tied up in an investment for seven to ten years. Limited partners understand that this illiquidity must be factored into their investment decision.

Other Types of Funds

Since venture firms are private firms, there is typically no way to exit before the partnership totally matures or expires. In recent years, a new form of venture firm has evolved: so-called "secondary" partnerships that specialize in purchasing the portfolios of investee company investments of an existing venture firm. This type of partnership provides some liquidity for the original investors. These secondary partnerships, expecting a large return, invest in what they consider to be undervalued companies.

Advisors and Fund of Funds

Evaluating which funds to invest in is akin to choosing a good stock manager or mutual fund, except the decision to invest is a long-term commitment. This investment decision takes considerable investment knowledge and time on the part of the limited partner investor. The larger institutions

have investments in excess of 100 different venture capital and buyout funds and continually invest in new funds as they are formed.

Some limited partner investors may have neither the resources nor the expertise to manage and invest in many funds and thus, may seek to delegate this decision to an investment advisor or so-called "gatekeeper". This advisor will pool the assets of its various clients and invest these proceeds as a limited partner into a venture or buyout fund currently raising capital. Alternatively, an investor may invest in a "fund of funds," which is a partnership organized to invest in other partnerships, thus providing the limited partner investor with added diversification and the ability to invest smaller amounts into a variety of funds.

Disbursements

The investment by venture funds into investee portfolio companies is called "disbursements". A company will receive capital in one or more rounds of financing. A venture firm may make these disbursements by itself or in many cases will co-invest in a company with other venture firms ("co-investment" or "syndication"). This syndication provides more capital resources for the investee company. Firms co-invest because the company investment is congruent with the investment strategies of various venture firms and each firm will bring some competitive advantage to the investment.

The venture firm will provide capital and management expertise and will usually also take a seat on the board of the company to ensure that the investment has the best chance of being successful. A portfolio company may receive one round, or in many cases, several rounds of venture financing in its life as needed. A venture firm may not invest all of its committed capital, but will reserve some capital for later investment in some of its successful companies with additional capital needs.

Exits

Depending on the investment focus and strategy of the venture firm, it will seek to exit the investment in the portfolio company within three to five years of the initial investment. While the initial public offering may be the most glamorous and heralded type of exit for the venture capitalist and owners of the company, most successful exits of venture investments occur through a merger or acquisition of the company by either the original founders or another company. Again, the expertise of the venture firm in successfully exiting its investment will dictate the success of the exit for themselves and the owner of the company.

IPO

The initial public offering is the most glamorous and visible type of exit for a venture investment. In recent years technology IPOs have been in the limelight during the IPO boom of the last six years. At public offering, the venture firm is considered an insider and will receive stock in the company, but the firm is regulated and restricted in how that stock can be sold or liquidated for several years. Once this stock is freely tradable, usually after about two years, the venture fund will distribute this stock or cash to its limited partner investor who may then manage the public stock as a regular stock holding or may liquidate it upon receipt. Over the last twenty-five years, almost 3000 companies financed by venture funds have gone public.

Mergers and Acquisitions

Mergers and acquisitions represent the most common type of successful exit for venture investments. In the case of a merger or acquisition, the venture firm will receive stock or cash from the acquiring company and the venture investor will distribute the proceeds from the sale to its limited partners.

Valuations

Like a mutual fund, each venture fund has a net asset value, or the value of an investor's holdings in that fund at any given time. However, unlike a mutual fund, this value is not determined through a public market transaction, but through a valuation of the underlying portfolio. Remember, the investment is illiquid and at any point, the partnership may have both private companies and the stock of public companies in its portfolio. These public stocks are usually subject to restrictions for a holding period and are thus subject to a liquidity discount in the portfolio valuation.

Each company is valued at an agreed-upon value between the venture firms when invested in by the venture fund or funds. In subsequent quarters, the venture investor will usually keep this valuation intact until a material event occurs to change the value. Venture investors try to conservatively value their investments using guidelines or standard industry practices and by terms outlined in the prospectus of the fund. The venture investor is usually conservative in the valuation of companies, but it is common to find that early stage funds may have an even more conservative valuation of their companies due to the long lives of their investments when compared to other funds with shorter investment cycles.

Management Fees

As an investment manager, the general partner will typically charge a management fee to cover the costs of managing the committed capital. The management fee will usually be paid quarterly for the life of the fund or it may be tapered or curtailed in the later stages of a fund's life. This is most often negotiated with investors upon formation of the fund in the terms and conditions of the investment.

Carried Interest

"Carried interest" is the term used to denote the profit split of proceeds to the general partner. This is the general partners' fee for carrying the management responsibility plus all the liability and for providing the needed expertise to successfully manage the investment. There are as many variations of this profit split both in the size and how it is calculated and accrued as there are firms.

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**MODERATE SLOWDOWN IN FOURTH QUARTER VENTURE INVESTMENT
TEMPERED BY INCREASES IN BIOTECHNOLOGY AND INTERNET INFRASTRUCTURE**

PricewaterhouseCoopers and VentureOne release results of first joint venture capital survey

San Francisco and San Jose, Calif.—February 6, 2001—Despite a downturn in the fourth quarter, 2000 was a record-breaking year for investment in venture-backed companies, according to the first combined statistics released by the PricewaterhouseCoopers MoneyTree™ Survey in partnership with VentureOne. Total investment reached \$68.8 billion in 2000, an 80% increase over the amount invested by venture capitalists in 1999. It was a remarkable year for venture-backed Internet companies, as well. These companies raised \$56.9 billion, a 92% gain over 1999. However, fourth quarter's \$13.7 billion raised in 853 venture financing rounds constituted a 9% decrease in the number of financing rounds and an 18% drop in the amount invested compared with third quarter. This marks the third consecutive quarter of decline, driven largely by decreases in products and services investment, which comprised only 23% of the total amount invested, compared to 40% in the fourth quarter of 1999.

Tracy T. Lefteroff, global managing partner of the Venture Capital Practice of PricewaterhouseCoopers, commented, "Perspective is important here. Despite the 'dot.bombs' of 2000, and despite the turmoil in the public markets, venture capital investments were the highest in history. The quarter-to-quarter declines indicate that venture investing is settling toward a new plateau -- a plateau that will be far above historical norms."

Interestingly, the median amount raised by venture-backed companies in the fourth quarter hit a record high of \$12 million, up from \$11.15 million in 3Q'00. This is due, in part, to changes in investment by round class. John Gabbert, Director of Research at VentureOne Corp., observes, "Fourth quarter saw many later-stage deals that were smaller than what we've come to expect; conversely, many early-stage financing rounds were larger than normal." Furthermore, while many speculated that venture capitalists had pulled back from early-stage investing during the quarter, the percentage of investment by round remained remarkably consistent with the third quarter.

After five years of consistent growth, investment in Internet-related companies declined as a percentage of the total for the third consecutive quarter and now constitutes 80% of overall venture investment. As a whole, Internet companies suffered an 11% decline in the

number of financing rounds and a 19% decrease in amount raised, but those focused on infrastructure saw slight increases. While software/database investment declined only mildly from its 3Q'00 peak, the remaining Internet sectors fared poorly. Investment in e-commerce companies decreased 92% from its peak in 4Q'99 and now accounts for only 1% of Internet investment. Business services, which once attracted roughly half of the Internet dollars, continued its steady decline in the fourth quarter, and is now at half its 1Q'00 high.

Though information technology companies accounted for a record 66% of the total amount invested in 4Q'00, IT experienced a 13% decrease in amount raised, largely due to reductions in the dollars allocated to the electronics, software, and information services segments. In contrast, semiconductor investment remained relatively stable after gaining steadily throughout the year; in fact, semiconductor investment in 2000 was more than double 1999's total. Communications and networking investment declined only slightly from third quarter. Within communications, however, the fiberoptics/photonics industry experienced a 9% increase in amount raised.

Healthcare ended its record-breaking year with a moderate downturn. Nevertheless, investment increased in the medical devices and biopharmaceuticals segments. Biopharmaceuticals companies, which raised \$761.9 million in the fourth quarter, have seen an 86% increase since 4Q'99. Contributing to this gain was the astounding 70% increase in biotechnology investment. VentureOne's John Gabbert notes, "This is an exciting time for biopharmaceuticals companies, and specifically biotechnology. Their strong showing in the otherwise lukewarm fourth quarter is a testament to their growing appeal for investors." PricewaterhouseCoopers' Tracy Lefteroff summed it up: "Biotech is hot. And, we expect the momentum to continue this year."

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NOTE TO EDITORS: At first reference the survey should be termed "The PricewaterhouseCoopers MoneyTree Survey in Partnership with VentureOne." Subsequent references may quote the "MoneyTree Survey." Charts may be sourced either to the complete name of the survey or to "PricewaterhouseCoopers/VentureOne."

About PricewaterhouseCoopers

The PricewaterhouseCoopers Private Equity & Venture Capital Practice is part of the Global Technology Industry Group (www.pwcglobaltech.com). The group is comprised of industry professionals who deliver a broad spectrum of services to meet the needs of fast-growth technology start-ups and agile, global giants in key industry segments: Networking & Computers, Internet, Semiconductors, Software, Life Sciences and Private Equity & Venture Capital. PricewaterhouseCoopers is a recognized leader in each industry segment with services for technology clients in all stages of growth.

PricewaterhouseCoopers (www.pwcglobal.com) is the world's largest professional services organization. Drawing on the knowledge and skills of more than 150,000 people in 150 countries, we help our clients solve complex business problems and measurably

enhance their ability to build value, manage risk and improve performance in an Internet-enabled world.

PricewaterhouseCoopers refers to the member firms of the worldwide PricewaterhouseCoopers organization.

About VentureOne

VentureOne, the world's leading venture capital research firm, offers investors and entrepreneurs the most comprehensive and accurate information on venture-backed companies, as well as world-class events, industry analysis, and customized research. VentureOne's products help top-tier venture capital firms, corporate investors, investment banks and accounting and law firms identify private investment opportunities, perform due diligence, and evaluate market trends, including company valuations and executive compensation. VentureOne clients collectively manage close to \$175 billion in venture capital.

VentureOne's wealth of information about venture-backed companies is made available in VentureSource_4.0, an Internet database containing more than 11,000 venture-backed companies, over 4,000 investors—including more than 900 traditional and corporate venture firms with almost 2,200 funds—and more than 31,000 financing transactions and 80,000 key executives. Data on executive compensation is available online via CompensationPro, VentureOne's database of salary, bonus, and equity information.

For more information about VentureOne products and services, please visit www.ventureone.com.

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The investment figures included in this release are based on proprietary research conducted by VentureOne and PricewaterhouseCoopers in tracking thousands of U.S. venture-backed companies through in-depth interviews with company CEOs and CFOs and their investors.

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FOR IMMEDIATE RELEASE

VENTURE FUNDRAISING IN 2000 DOUBLES FROM PREVIOUS YEAR

Annual commitments to venture capital approach \$70 billion, according to VentureOne

San Francisco—February 15, 2001—The year 2000 saw the greatest amount of money in history committed to venture capital, according to the latest statistics released by VentureOne, the leading provider of venture capital information and services. Limited partners contributed a record-breaking \$69.1 billion to 249 funds, doubling from 1999's \$34.5 billion invested in 202 funds.* An astounding 18 funds hit or exceeded the billion-dollar mark in 2000, compared to only three in 1999. Five of these closed in 4Q'00, indicating that current economic uncertainty has not yet impaired the ability of venture capital firms with proven track records to attract significant sums from institutional investors.

Fundraising in the fourth quarter totaled \$18.1 billion in new funds, a 5% increase from third quarter's \$17.3 billion, and more than any quarter besides 2Q'00. The number of funds raised dropped considerably throughout 2000, with 56 funds closing in the fourth quarter, nearly a 45% plunge from the peak in 4Q'99, when venture firms closed 81 funds.

John Gabbert, Director of Research at VentureOne, commented, "Funds raised by established venture capital firms are still extremely attractive for institutional investors. These firms have repeatedly demonstrated considerable investing acumen and they adapt their strategies to suit the economic landscape, whether that means anticipating emerging technologies or looking further afield to overseas opportunities."

The number of billion-dollar-plus funds that focus on venture investment increased six-fold from 1999, including three funds that reached the \$2 billion mark. TA Associates and New Enterprise Associates, both of Menlo Park, CA, closed \$2 billion and \$2.3 billion funds, respectively, and Summit Partners of Boston, MA raised a \$2.1 billion fund. Over half of the dollars raised for venture capital funds are now in funds exceeding \$500 million, and the median fund size reached \$138 million in 2000, up marginally from \$135 million in 1999.

Despite a recent slowdown in venture investment, first-time players in the venture capital arena are not only increasing in numbers but are also collecting more money from investors. In 2000, 75 firms raised initial venture capital funds totaling \$7.6 billion, compared to \$4.5 billion raised for 54 first-time funds in 1999.

According to VentureOne's Gabbert, "The record amount raised for venture investment should provide ample funding for entrepreneurship in the near future, particularly since investors have grown more cautious over recent months."

** Totals refer to funds focused on venture investment and do not include buyout funds or capital raised for strategic corporate development investment.*

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Commitments to VC Funds (\$M) 1999-2000

	1Q1999	2Q1999	3Q1999	4Q1999	1999 Total	1Q2000	2Q2000	3Q2000	4Q2000	2000 Total
Total Amount Raised (\$M)	\$5,736.90	\$6,116.80	\$7,910.00	\$14,774.01	\$34,537.71	\$14,524.88	\$19,145.91	\$17,330.06	\$18,081.60	\$69,082.45

Number of Funds Raised 1999-2000

	1Q1999	2Q1999	3Q1999	4Q1999	1999 Total	1Q2000	2Q2000	3Q2000	4Q2000	2000 Total
Number of Funds	36	42	43	81	202	70	67	56	56	249

Median VC Fund Size (\$M)*

	1998	1999	2000
Median Amount Raised (\$M)	114.5	135	138

* Funds greater than \$20 million

State of the Market

Venture capitalists continued to pour near-record levels of capital into startup companies during the third quarter of 2000. Venture capital investment dipped slightly for the second quarter in a row, declining 6% in dollars invested and 16% in deals closed compared with the previous quarter. Venture-backed companies raised a total of \$16.12 billion in 879 financing rounds during the third quarter, down from \$17.24 billion in the second quarter, but still well above the \$8.84 billion raised in 3Q99 and every quarter preceding it. Indeed, more venture capital was committed to startup companies in the third quarter of 2000 than was raised in all of 1998, or in any other preceding year.

Financing of Internet-related companies declined noticeably, echoing the drop from the first to the second quarter. Funding of Internet startups fell 12% from the second quarter, to \$13.12 billion, and the number of deals declined 21%, to 664 rounds of financing. The Internet sector's share of overall venture investment declined as well, from 86% in the second quarter to a still-substantial 81% in the third quarter, as the decrease in Internet investment outpaced the overall drop in venture financing.

The decline in Internet investment during the third quarter was particularly pronounced in the largest Web-related sector, business services, which fell by one-third to \$4.64 billion. This drop was somewhat offset by increases in financing for Internet infrastructure and software companies. Infrastructure startups raised a record \$3.23 billion in 110 rounds, a 42% increase in dollars and a 24% increase in rounds closed compared with the previous quarter. Internet-related software startups, especially those developing business applications and communications/connectivity software, rode a surge of investor interest that netted \$3.11 billion in

187 rounds, a 9% increase in funding compared with the second quarter.

In venture capital investment overall, the combination of a small drop in funding and a larger drop in deals resulted in higher median amounts raised during the third quarter. The median amount raised by venture-backed companies rose from \$11 million in the second quarter to \$12 million in the third; for Internet-related companies, this figure rose from \$12 million to \$12.6 million.

Median premoney valuations also increased, rising from \$25.4 million in the second quarter to \$41.2 million in the third; among Internet-related startups, the median rose from \$26.8 million to \$49.5 million. Historically, however, companies have been slow to report diminished valuations, and therefore median premoney valuations may decrease substantially as more information becomes available.

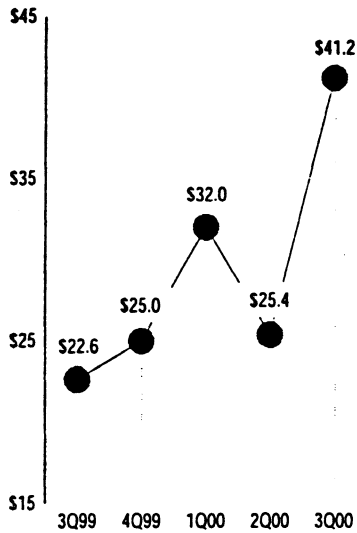
The increase in the median amount raised reflected a shift toward later-stage financings, which tend to be larger than early-stage rounds. VCs invested 73% of their cash in second and later-stage rounds in the third quarter, compared to 62% in the second quarter and

Alternative Financing Rounds Raised by Venture-Backed Companies 1998-2000 YTD (\$M)

Investment Type	1998				1999				2000			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	
Amount Raised												
Venture Capital	\$3,045.16	\$3,795.61	\$3,850.88	\$4,192.22	\$5,037.08	\$8,065.22	\$8,838.07	\$15,470.71	\$18,684.82	\$17,240.49	\$16,124.20	
Corporate	\$232.82	\$245.33	\$135.49	\$142.13	\$292.52	\$538.14	\$825.54	\$1,154.68	\$2,098.07	\$1,516.89	\$1,454.29	
Secondary Transactions	\$15.39	\$21.84	\$4.25	\$23.50	\$3.70	\$15.00	\$0.71	\$3.54	\$0.52	N/A	N/A	
Private Placement	\$39.22	\$245.73	\$300.30	\$104.52	\$254.54	\$755.26	\$730.91	\$1,456.24	\$2,947.75	\$1,107.73	\$1,772.75	
Number of Deals												
Venture Capital	411	539	527	533	570	783	804	1,028	1,112	1,045	879	
Corporate	24	21	16	22	27	40	54	55	97	87	71	
Secondary Transactions	6	6	4	3	1	1	3	3	1	1	4	
Private Placement	4	11	13	9	14	30	29	47	69	35	33	

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Median Premoney Valuations
3Q99- 3Q00* (\$M)



* See "Methodology" on page 168.

Companies providing non-financial business services secured \$3.01 billion in 190 rounds, the greatest number of dollars and deals of any sector. Fiber optics

64% in the first. Total investment in seed-stage and first rounds fell 33% from second to third quarter.

The most active sectors for venture investment in the third quarter were non-financial business services, connectivity products, connectivity/communications software, business applications software, and fiber-optics equipment.

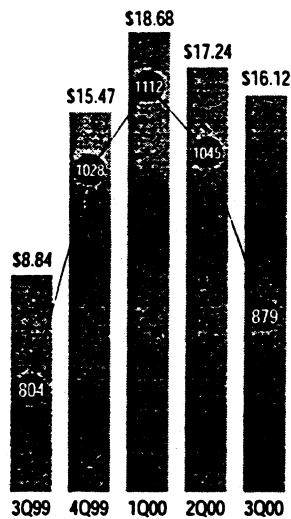
equipment makers raised \$1.74 billion in 56 rounds, business applications software providers secured \$1.21 billion in 62 rounds of financing, connectivity products raised \$1.11 billion in 35 deals, and connectivity software garnered \$885.2 million in 58 deals.

RELEERA (Denver, CO), a developer and manager of Internet data centers, received the largest round of funding among all venture-backed companies in the third quarter. The company closed a \$208 million second round in July co-led by BANK OF AMERICA CAPITAL PARTNERS and CRESCENDO VENTURES, and joined by BROADBAND VENTURE PARTNERS, CIBC CAPITAL PARTNERS, MORGAN STANLEY DEAN WITTER VENTURE PARTNERS, NAVIS PARTNERS, TELECOM PARTNERS, and COLUMBIA PARTNERS.

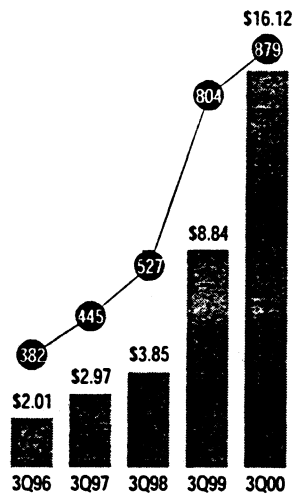
NEW ENTERPRISE ASSOCIATES was the most active venture capital firm during the quarter, closing 48 deals. CHASE CAPITAL PARTNERS was close behind with 47 deals. BESSEMER VENTURE PARTNERS and MAYFIELD FUND were the third and fourth most active venture capital firms during the quarter, closing 32 and 31 deals, respectively.

The San Francisco Bay Area retained its perennial status as the most favored region for venture investment,

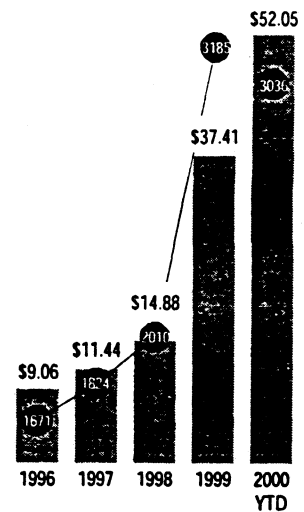
Total Amount Invested in 3Q00



3Q00 vs Previous Quarters



3Q00 vs Previous 3rd Quarters



2000 YTD vs Previous Years

■ Amount Invested (\$B) ● Number of Deals

capturing \$6.58 billion of startup capital during the quarter. Southern California attracted the second largest amount of venture dollars, with \$1.28 billion, followed by the Boston area with \$836.6 million.

Corporate venture investment fell slightly from the second quarter, to \$1.45 billion. While it was down 31% from the record first quarter, corporate investment was still well ahead of last year's pace, when \$825.5 million were deployed in 3Q99.

Industry Breakdown

The fall-off in Internet-related investments was reflected in the overall investment activity of the information technology (IT) and products and services industry

Most Active Venture Capital Investors in 3Q00

Investor Name	Deals
New Enterprise Associates	48
Chase Capital Partners	47
Bessemer Venture Partners	32
Mayfield Fund	31
Accel Partners	27
Kleiner Perkins Caufield & Byers	26
Sprout Group	24
Crescendo Ventures	23
Lightspeed Venture Partners	23
Sequoia Capital	23

groups, where Internet companies tend to be most heavily concentrated. Products and services startups raised \$4.3 billion, a 21% decrease from the second quarter. This extended a sharp decline from the first to the second quarter, when new investment in products and services dropped 25%. The total number of rounds in products and services fell to a four-quarter low of 267 deals in 3Q00.

Within the IT group, the Internet-centric information services segment fared no better: investment dollars fell by one-third to \$1.48 billion. The software, semi-conductors, and electronics and computer hardware segments experienced slight gains, but not enough to offset the sharp drop in information services. Overall,

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the IT group raised \$10.16 billion in the third quarter, down slightly from the \$10.48 billion closed in the second quarter. Still, IT remained the leading industry group, garnering 54% of all deals and 63% of all dollars in the third quarter.

Healthcare companies, led by the biopharmaceuticals sector, experienced their best quarter ever. Companies in this industry group raised \$1.63 billion in 126 deals, an impressive 32% rise in venture capital investment and a 9% increase in deals compared with the previous quarter. While the gains were significant for the healthcare group, the industry's percentage of overall venture investment advanced only modestly, to 10% of all dollars invested in the third quarter and 14% of rounds closed.

Biopharmaceuticals startups raised \$663.6 million in 40 rounds, compared with \$537.9 million in 43 rounds during the previous quarter. While biopharmaceuticals companies enjoyed the greatest amount of funding within the healthcare group, all healthcare segments attracted increased venture investment. Medical devices companies closed 46 rounds—the most of any healthcare segment—and raised \$415.3 million, second only to biopharmaceuticals. Medical information systems startups had an equally strong quarter, raising \$412.4 million in 31 deals.

Liquidity

The venture-backed IPO market returned to pre-correction levels in the third quarter, with 70 companies raising \$6.59 billion in public equity. This was more than twice the \$3.06 billion raised in 39 offerings in the second quarter. Though overall market activity rebounded, investors remained skeptical of Internet-based products and services firms. Instead, the new offerings market was dominated by biopharmaceutical companies, software vendors, and communications and networking companies, which accounted for 48 of the 70 deals completed in the quarter.

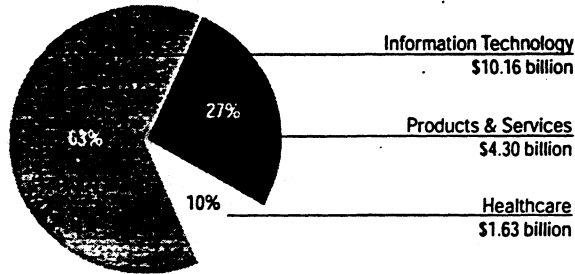
Communications and networking startups raised \$2.23 billion at IPO—the most of any industry space. Much of the segment's new capital was lavished on CORVIS (Nasdaq: CORV), a fiber optics equipment developer, which completed the largest initial offering ever of a venture-backed company in July, netting \$1.14 billion. Overall, the communications segment had its second best quarter for IPOs, matched only by the \$2.58 billion raised in the fourth quarter of 1999. Of the 11 companies in the segment that went public, two focus on fiber optics and four are wireless technology firms.

Investment in the Internet 3Q99-3Q00 (\$M)

Internet Segment	3Q99	4Q99	1Q00	2Q00	3Q00
Business Services					
Number of Deals	296	413	497	450	283
Amount Invested	\$2,683.84	\$5,878.61	\$7,886.78	\$6,916.40	\$4,643.98
% Change- Amount Invested		119%	34%	-12%	-33%
Content					
Number of Deals	35	60	59	46	35
Amount Invested	\$430.39	\$633.35	\$755.88	\$500.67	\$483.77
% Change- Amount Invested		47%	19%	-34%	-3%
Electronic Commerce					
Number of Deals	49	49	36	27	17
Amount Invested	\$1,052.49	\$1,457.44	\$879.30	\$469.07	\$378.46
% Change- Amount Invested		38%	-40%	-47%	-19%
Infrastructure					
Number of Deals	63	75	88	89	110
Amount Invested	\$1,060.19	\$1,557.66	\$1,853.52	\$2,282.84	\$3,230.83
% Change- Amount Invested		47%	19%	23%	42%
Internet Service Providers					
Number of Deals	14	29	40	27	32
Amount Invested	\$379.97	\$1,379.37	\$1,880.17	\$1,856.95	\$1,279.33
% Change- Amount Invested		263%	36%	-1%	-31%
Software/Databases					
Number of Deals	135	172	189	198	187
Amount Invested	\$1,209.37	\$1,983.72	\$2,856.30	\$2,838.10	\$3,105.74
% Change- Amount Invested		64%	44%	-1%	9%
Total Number of Deals	502	798	909	837	664
% Change- Deals Closed		57%	14%	8%	-27%
Total Amount Raised	\$5,816.24	\$12,890.14	\$16,171.94	\$14,864.02	\$13,122.11
% Change- Amount Invested		89%	25%	8%	-12%
Median Amount Invested	\$7.80	\$10.00	\$12.00	\$12.00	\$12.63
Median Premoney Valuation	\$26.31	\$25.00	\$32.80	\$26.83	\$49.50

Communications and networking companies took the greatest share of IPO revenue, but biopharmaceuticals startups experienced the greatest increase in deals, completing 20 offerings that raised \$1.53 billion. The number of biopharmaceuticals offerings completed was higher than any other industry segment in the third quarter, and the total capital raised was second only to the communications segment. Software was the only other industry segment to raise more than \$1 billion at IPO in the third quarter. Seventeen software companies went public, raising a collective \$1.08 billion.

Percentage of Total Amount Invested in 3Q00*



* Other companies raised \$37.0 million, less than 1% of the total.

Among Internet-related companies, business services startups fared better than in the second quarter, completing eight offerings that raised \$762 million. Still, this was far below the more than \$2 billion raised in 19 offerings in the first quarter. The Internet-tainted e-commerce and content sectors remained

wallflowers at the IPO ball, posting no initial offerings for the second consecutive quarter.

There were fewer mergers and acquisitions of venture-backed companies in the third quarter, but activity remained at historically high levels. A total of 79 companies merged or were acquired, investing \$16.84 billion.

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Industry Monitor 1997- 2000 YTD (\$M)

Industry	1997		1998		1999		2000 YTD			
	# of Deals	Amount Invested	# of Deals	Amount Invested	# of Deals	Amount Invested	# of Deals	% of Total	Amount Invested	% of Total
Information Technology	1,064	\$6,657.89	1,173	\$9,043.87	1,578	\$20,610.25	1,566	24%	\$30,482.01	33%
Communications & Networking	252	\$2,430.98	309	\$3,442.42	398	\$8,148.77	421	14%	\$13,208.20	25%
Electronics & Computer Hardware	83	\$495.34	82	\$477.70	73	\$780.85	51	2%	\$820.08	2%
Information Services	144	\$783.76	197	\$1,496.66	443	\$4,628.46	382	13%	\$5,872.08	11%
Semiconductors	70	\$460.65	76	\$591.21	94	\$993.52	94	3%	\$1,516.51	3%
Software	515	\$2,487.16	509	\$3,035.68	664	\$6,039.66	618	20%	\$9,075.14	17%
Other Information Technology	0	\$0.00	0	\$0.00	4	\$19.00	0	0%	\$0.00	0%
<i>% Change from Previous Year</i>			10%	36%	43%	128%				
Healthcare	411	\$2,781.31	414	\$2,819.34	412	\$3,378.76	378	12%	\$4,477.85	9%
Biopharmaceuticals	109	\$785.48	137	\$991.97	114	\$1,203.94	122	4%	\$1,775.59	3%
Healthcare Services	106	\$797.65	83	\$628.51	57	\$387.90	35	1%	\$288.46	1%
Medical Devices & Equipment	136	\$773.54	129	\$809.18	168	\$1,202.81	121	4%	\$1,026.32	2%
Medical Information Systems	60	\$424.64	65	\$389.68	73	\$584.11	100	3%	\$1,387.49	3%
<i>% Change from Previous Year</i>			1%	1%	0%	20%				
Products & Services	314	\$1,806.04	392	\$2,842.87	1,076	\$13,309.03	1,071	35%	\$16,903.61	32%
Consumer & Business Products	50	\$299.54	36	\$234.97	38	\$377.61	30	1%	\$323.30	1%
Consumer & Business Services	186	\$955.35	267	\$1,987.93	857	\$9,167.57	957	32%	\$14,769.63	28%
Retailers	78	\$551.15	89	\$619.98	181	\$3,763.85	84	3%	\$1,810.69	3%
<i>% Change from Previous Year</i>			25%	57%	174%	368%				
Other	35	\$194.36	31	\$177.99	21	\$113.04	21	1%	\$176.05	0%
<i>% Change from Previous Year</i>			-11%	-8%	-32%	-36%				
Stage - All Industries										
Startup	130	\$361.26	176	\$625.89	281	\$1,174.96	185	6%	\$1,357.06	3%
Product Development	564	\$3,408.76	601	\$4,615.73	885	\$9,094.99	944	31%	\$16,199.69	31%
Shipping Product	1,028	\$7,035.79	1,139	\$8,897.85	1,919	\$26,226.76	1,842	61%	\$33,316.36	64%
Profitable	100	\$630.30	91	\$724.90	95	\$899.21	64	2%	\$1,168.91	2%
Restart	2	\$3.50	3	\$19.50	5	\$15.16	1	0%	\$7.50	0%
Total	1,824	\$11,439.61	2,010	\$14,883.87	3,185	\$37,411.08	3,036	100%	\$52,049.52	100%
<i>% Change from Previous Year</i>			10%	30%	58%	151%				

The largest deal was Sycamore Network's (Nasdaq: SCMR) acquisition of SIROCCO SYSTEMS (Wallingford, CT) for \$3.49 billion. The total amount paid this year to date, at \$83.31 billion in 272 deals, dwarfs all previously recorded yearly totals. The decline in both deals and dollars this quarter was nonetheless significant, as the number of deals fell 10% and the total amount paid dropped 26% compared with the second quarter. The percentage of Internet-related companies completing

partnership. Other firms that successfully completed billion-dollar funds were VANTAGEPOINT VENTURE PARTNERS, MENLO VENTURES, REDPOINT VENTURES, and PATRICOF & CO. VENTURES.

Seven new funds were opened for subscription during the third quarter. Notably, none of the new funds aspires to billion-dollar status; the largest of them, INTERWEST PARTNERS' InterWest VIII, has set a "modest" goal of \$750 million.

M&A deals increased slightly during the third quarter, rising to 63% of all M&A deals, compared with 59% the previous quarter.

Fundraising

Venture capital firms raised \$16.44 billion in new commitments during the third quarter, a 19% decline from the previous quarter. Even so, the third quarter was noteworthy for the number of billion-dollar megafunds that closed. Six of the 41 funds closed during the quarter raised a billion dollars or more, and two of these—TA ASSOCIATES' TA/Advent IX fund and New Enterprise Associates' NEA 10 fund—raised \$2 billion, a record figure for a venture capital limited

**CYBERSPACE JURISDICTION
-UPDATE-**

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SECTION D

CYBERSPACE JURISDICTION

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CYBERSPACE JURISDICTION

Electronic commerce ("E-Commerce") over the Internet has become a huge business. With its rapid growth, not just in transactions between businesses and consumers (B to C transactions) but, perhaps more importantly, in transactions among businesses (B to B transactions), E-Commerce already amounts to billions of dollars annually. However, conventional commerce still dwarfs it. With the rise in volume of E-Commerce, can litigation be far behind? Of course, not. This is litigious America. Today, there already over 165 reported cases involving cyberspace jurisdictional issues.

This outline examines the more significant of these cases to expose the logic of some of the judicial decisions, to develop some fundamentals of cyberspace jurisdiction and to suggest some protective actions to avoid being haled into unanticipated and/or unwelcome forums. The attached Cyberspace Jurisdiction Case List of Cases Finding No Personal Jurisdiction and of Cases Finding Personal Jurisdiction contain their citations. The attached Cyberspace Jurisdiction Articles List discusses many of these cases and the legal concepts underlying them.

To understand these cases, it is necessary to briefly review the existing jurisprudence on personal jurisdiction. While doing so, recall that, until the arrival of the Internet, a territory that defies all boundaries, personal jurisdiction tracked somewhat closely geographical and territorial boundaries, and, indeed, was rooted in them and defined by them.

JURISDICTIONAL FUNDAMENTALS

Personal jurisdiction concerns a court's power to decide a matter in controversy before it, and the court's authority over the subject matter and the parties involved in such controversy. In federal courts, issues about personal jurisdiction may be raised at any time. Indeed, a judgment rendered by a court without proper personal jurisdiction will not be enforced when properly challenged.

Personal jurisdiction is of two types: "general jurisdiction" extends to all cases and controversies that may be brought before the court within the bounds of legal rights and remedies; "specific jurisdiction" covers only a specified case or class of cases. More limited in nature than general jurisdiction, specific jurisdiction requires less proof to establish. Thus far, most U.S. cases concerning personal jurisdiction over Internet activities have rested on specific jurisdiction.

Traditionally, the courts have considered various facts in determining whether jurisdiction, general or specific, exists. Absent a Federal statute expressly conferring jurisdiction over a given matter on a specific court, federal courts apply the law of the state where the action is brought and use a two-step analysis to determine if proper personal jurisdiction exists. In such an analysis, the court first determines if jurisdiction is proper under the State's long-arm statute. If it is, the court next determines if the exercise of personal jurisdiction over the defendant comports with due process under the U.S. Constitution. World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 289-90 (1980).

Long-arm statutes are of two types: Those that limit a court's exercise of jurisdiction in one or more ways; and those that permit the exercise of personal jurisdiction to the full extent permitted by the U.S. Constitution. In states where the statute permits full exercise, the court's analysis really consists of a single step evaluation of whether personal jurisdiction is proper under the due process clause of the U.S. Constitution.

In now familiar language, International Shoe Co. v. Washington, 326 U.S. 310 (1945), states that constitutional due process requires that the defendant have "minimum contacts such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice'". Id. at 316. Later, World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980), held the defendant's minimum contacts must be "conduct and connection with the forum State . . . such that he should reasonably anticipate being haled into court." Id. at 297. Due process does not require that the defendant have ever been physically present in the forum. Due process does require that the defendant's contacts be more than merely "random," "fortuitous" or "attenuated" ones. Burger King Corp. v. Rudzewicz, 471 U.S. 462, 476 (1985).

Under Hansen v. Denckla, 357 U.S. 235 (1958), to establish general jurisdiction over a defendant, constitutional due process requires a showing that the defendant's contacts were "substantial" or "continuous and systematic"; in short, that the defendant "purposely avail[ed] of the privilege of conducting activities within the forum state, thus invoking the benefits and protection of its laws." Id. at 253. However, for specific jurisdiction, Supreme Court decisions

require only that the defendant's efforts are directed toward the forum state. So long as a commercial actor's efforts are "purposefully directed" toward residents of another state, "jurisdiction may not be avoided merely because the defendant did not physically enter the forum state." Burger King Corp. v. Rudzewicz, supra, at 476.

What do these land mark cases tell us about jurisdiction over E-Commerce on the Internet today? In truth, although these cases supply the language of and the framework for analysis, their principles are only indirectly related to the results that the courts reach. An understanding of the function of the Internet, an ability and willingness to explain it to the court and the creativity to concoct a persuasive presentation of the facts are important additional requirements for reaching appropriate results. What emerges is the realization that the case holdings are somewhat diverse, the principles of analysis are still under development and consistent results have been (relatively) slow to develop. Unfortunately, the situation makes it difficult for lawyers for Internet merchants to advise their clients how to do business on the Internet and to avoid the jurisdictional reach of a host of states.

APPLYING JURISDICTIONAL FUNDAMENTALS TO ONLINE CONTACTS

As noted, over 165 cases exist which apply the Jurisdictional Fundamentals in litigation involving online contacts. In approximately 98 of the cases on the attached Case List, the Court found no personal jurisdiction. In another 68, the Court found personal jurisdiction. The pages which follow examine the seminal or otherwise significant federal circuit court cases to expose

the logic of the decisions, to explain the holdings of various courts and to develop some fundamentals cyberspace jurisdiction. That done, this paper suggests some safeguards for persons doing business over the Internet to attempt to avoid successful assertion of jurisdiction over them by others.

CASES FINDING NO JURISDICTION

Bensusan Restaurant Corp. v. King

One of the earliest and most widely cited cases in which a court found a web site did not provide the necessary minimum contacts is Bensusan Restaurant Corp. v. King, 937 F.Supp.2d 295 (S.D.N.Y. 1996), aff'd, 126 F.3d 25 (2d Cir. 1997). Bensusan operated "The Blue Note" jazz club in New York City. King operated "The Blue Note" club in Columbia, Missouri. Bensusan held a federally registered mark "The Blue Note" to promote his club and ticket sales. King put up a web site that advertised his Columbia Blue Note with a telephone number and ticket purchasing information. Bensusan claimed that King's web site constituted trademark infringement. At issue was whether King's web site evidenced an intent to sell merchandise in New York justifying personal jurisdiction over him.

Granting King's Motion to Dismiss For Lack of Personal Jurisdiction, the Court refused to view King's web site as "purposeful availment," because a New York resident would have to take several affirmative steps to access and utilize the web site. Further, the New York resident would actually have to go Missouri to pick up tickets he purchased because King did not mail tickets to his Columbia, Missouri club to purchasers. The Court rejected Bensusan's claim that King

should have foreseen that the web site would be viewed in New York. There were no facts indicating that King encouraged any New Yorkers to access his site.

In response to Bensusan's argument that King should have foreseen that his web site would be viewed in New York, the Court held that "mere foreseeability of an in-state consequence" was not an adequate basis to assert personal jurisdiction over King. Moreover, the Bensusan court analogized creating a web site to "placing a product in the stream of commerce," in that its effects "may be felt nationwide -- or even worldwide -- but, without more, it is not an act purposefully directed toward to forum state." 937 F. Supp.2d at 301. In short, King's Missouri web site simply did not rise to the level of doing business in New York. The Second Circuit affirmed the District Court, relying on the language of the New York Long Arm statute, thus avoiding the due process issue. The District Court in Bensusan was one of the first to pay close attention to the facts, analyze them and conclude that the online contacts did not support personal jurisdiction.

Cybersell, Inc. v. Cybersell, Inc.

In Cybersell, Inc. v. Cybersell, Inc., 130 F.3d 414 (9th Cir. 1997), the 9th Circuit concluded that a web site or other electronic contact, alone, was not "purposeful availment" of the benefits of the forum state. Cybersell, Inc., an Arizona corporate plaintiff ("Cybersell Arizona"), sued a Florida corporation (Cybersell Florida) in an Arizona court for alleged trademark infringement through a web site. Cybersell Florida had no contacts with Arizona. It did not attempt to market in Arizona. It did not sell any products or services in Arizona.

It did not solicit business in Arizona. It did not receive any telephone calls from Arizona. Even so, Cybersell Arizona claimed that its assertion of jurisdiction met due process requirements in that Cybersell Florida "should be amenable to suit in Arizona because cyberspace is without borders and a web site is necessarily intended for use on a worldwide basis."

Unpersuaded, the Court recognized that anyone could access a web site, but that fact did not compel a conclusion that the web site alone was an attempt to target anyone in any specific forum. Here, Cybersell Florida did not intentionally aim its conduct at Arizona knowing it would cause harm there. The 9th Circuit recognized that some cases found a web site to be sufficient contact for the assertion of jurisdiction, but noted there was usually "something more" to show that the defendant purposefully directed substantial activity to the forum state. In Cybersell, there were no other contacts between the Florida defendant and the State of Arizona. In short, it was simply a passive web site. Cybersell Florida did not undertake any actions that qualified as purposeful activity invoking the benefits and protections of Arizona.

The cases finding no jurisdiction include ones in which the court declined to uphold personal jurisdiction based on the mere existence of a web site without anything more. Indeed, it is now at least somewhat settled that "a mere presence on the World Wide Web does not support the minimum contacts necessary to subject a corporation to personal jurisdiction on a worldwide basis." Morantz v. Hang & Shine Ultrasonics, 79 F.Supp 2d 537, 539-540 (E.D. Pa. 1999). Nearly a

hundred other cases finding no jurisdiction appear on the attached Cyberspace Jurisdiction Case List: Cases Finding No Personal Jurisdiction.

As the Cybersell court had stated: “[S]o far as we are aware, no court has ever held that an Internet advertisement alone is sufficient to subject the advertiser to jurisdiction in the plaintiff's home state....” Cybersell, supra, 130 F.3d at 418. However, as the Morantz court observed, the jurisdictional jurisprudence of the Internet contains at least two unfortunate cases where *very* minimal contacts were sufficient to establish personal jurisdiction. Inset Systems, Inc. v. Instruction Set, Inc., 937 F.Supp 161 (D. Conn. 1996), held that maintaining a web site and telephone number was sufficient to establish personal jurisdiction in every state, including the forum state. Heroes, Inc. v. Heroes Found., 958 F.Supp. 1 (D.D.C. 1996) found a web site that explicitly solicited donations and provided a toll free number was subject to the jurisdiction of the court. Fortunately, these misguided cases have been widely criticized in other opinions and are seldom followed. However, you can expect to see them if a plaintiff is scrambling to find minimum contacts to oppose a motion to dismiss.

CASES FINDING JURISDICTION

CompuServe, Inc. v. Patterson

Another early and widely cited Internet jurisdiction case, CompuServe, Inc. v. Patterson, 89 F.3d 1257 (6th Cir. 1996) occurred close to home. CompuServe, headquartered in Columbus, Ohio, was an early “information utility.” Patterson, a Texas resident, developed software attractive to CompuServe and its customers. In 1991, CompuServe and Patterson agreed to

make Patterson's shareware available to all CompuServe subscribers. Their agreement was negotiated and consummated by e-mail. Thereafter, Patterson uploaded (from Texas) to CompuServe (in Ohio) 32 master software files which CompuServe placed on its server for access by its subscribers.

A couple of years later, CompuServe began to market and sell software similar to Patterson's. Upon learning of CompuServe's actions, Patterson e-mailed CompuServe that its efforts constituted an infringement on his common law trademark rights. CompuServe changed the name of its software. However, Patterson continued to complain and threaten suit. (Unsurprisingly, Patterson was a lawyer.) His continued complaints and demands for compensation caused CompuServe to seek a declaratory judgment in Ohio Federal Court. Patterson moved to dismiss for lack of personal jurisdiction. The trial court granted his motion. The 6th Circuit reversed.

In CompuServe, the 6th Circuit noted the crucial federal constitutional inquiry was whether, given the facts of the case, the non-resident defendant had sufficient contacts with the forum state that the District Court's exercise of jurisdiction would comport with "traditional notions of fair play and substantial justice. [Citations omitted]. The 6th Circuit employed three criteria to make this determination:

First, the defendant must purposefully avail himself of the privilege of acting in the forum state or causing a consequence in the forum state. Second, the cause of action must arise from the defendant's activities there. Finally, the acts of the defendant or consequences caused by the defendant, must have a substantial enough connection with the forum to

make the exercise of jurisdiction over the defendant reasonable. Id. at 1262.

The 6th Circuit concluded that Patterson had knowingly made an effort to market his products through CompuServe. Accordingly, the 6th Circuit believed it reasonable to subject Patterson to suit in Ohio, the state which is home to the computer network service he chose to employ.

Discussing each of the three criteria, the court found that, by his actions, Patterson took steps that created a connection with Ohio. He subscribed to CompuServe. He entered into the shareware registration agreement when he loaded his software onto the CompuServe system for others to use or purchase. He repeatedly sent his computer software electronically to CompuServe. He advertised that software on CompuServe. Finally, he initiated the events that lead to the filing of the suit by making demands of CompuServe by both electronic and regular mail.

The 6th Circuit found these contacts with Ohio “substantial” enough that Patterson could reasonably have anticipated being haled into an Ohio court. Specifically, “*although all of this happened with the distinct paucity of tangible, physical evidence, there can be no doubt that Patterson purposely transacted business in Ohio.*” Id. at 1264. (Italics supplied here and throughout). Other events showed that CompuServe and Patterson intended the relationship to be ongoing. And, Patterson deliberately set in motion an ongoing marketing relationship with CompuServe that he could have reasonably foreseen would have consequences in Ohio. Last, Patterson entered into a contract expressly stating that it would be governed by and construed in the light of Ohio law.

The 6th Circuit found that there was a substantial enough connection between Patterson and Ohio to make it reasonable for an Ohio court to assert personal jurisdiction over him. Someone like Patterson, who employed a computer network service like CompuServe to market a product, can reasonably expect disputes with that service to yield law suits in the service's home state. Finding Patterson had sufficient contact with Ohio to support the exercise of personal jurisdiction over him, the 6th Circuit reversed the District Court's dismissal and remanded the case for further proceedings consistent with its opinion.

Zippo Manufacturing Company v. ZippoDot Com, Inc.

Another seminal case, Zippo Manufacturing Company v. ZippoDot Com, Inc., 952 F.Supp. 1119 (W.D. Pa. 1997), is significant because the court offered an appealing framework to analyze personal jurisdiction in cyberspace, one of the few courts to do so. That framework has proved popular with other courts, and many have used it.

Zippo Manufacturing Co. ("Manufacturing") sued Zippo Dot Com, Inc. ("Dot Com") for several alleged violations of Federal and state trademark protection laws by use of the domain names "zippo.com," "zippo.net," and "zipponews.com." Dot Com was incorporated and based in California. Manufacturing was incorporated and based in Pennsylvania. Almost all of Dot Com's contacts with Pennsylvania occurred over the Internet. After reviewing cases and holdings cited in Jurisdictional Fundamentals, supra, the Zippo court stated:

Enter the Internet, a global 'super-network' over 15,000 computer networks used by over 30 million individuals, corporations, organizations and educational institutions worldwide. [Citations omitted.] In recent years, businesses have begun to use the Internet to provide information and products to consumers and other businesses. [Citation omitted.] The Internet makes it possible to conduct business throughout the world entirely from a desktop. With this global revolution looming on the horizon, the development of the law concerning the permissible scope of personal jurisdiction based on the Internet use is in its infant stages. The cases are scant. Nevertheless, our review of the available cases and materials reveals that the likelihood of personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the Internet. This *sliding scale* is consistent with well-developed personal jurisdiction principles. At one end of the spectrum are situations where a defendant clearly does business over the Internet. If a defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper. *E.g. CompuServe, Inc. v. Patterson*, 89 Fed.3d 1257 (6th Circuit, 1996). At the opposite end are situations where a defendant has simply posted information on an Internet web site which is accessible to users in foreign jurisdictions. A passive Web site that does little more than make information available to those who are interested in it is not grounds for the exercise of personal jurisdiction. *E.g. Bensusan Restaurant Corp. v. King*, 397 F. Supp. 295 (S.D. N.Y. 1996). The middle ground is occupied by interactive Web sites where a user can exchange information with the host computer. In these cases, *the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the web site*. *E.g. Maritz, Inc. v. CyberGold, Inc.* 397 F.Supp. 1328 (E.D. Mo. 1996). *Zippo*, supra, at 1123-1124.

The Zippo court went on to say that “. . . when an entity intentionally reaches beyond its boundaries to conduct business with foreign residents, the exercise of specific jurisdiction is proper. [Citation omitted]. *Different results should not be reached simply because business is conducted over the Internet.*” *Id.* at 1124.

The Zippo court found Dot Com's claim that its web site was not “purposeful availment” of Pennsylvania law “wholly unpersuasive”. In essence,

the court found that by receiving and processing subscription applications from Pennsylvania and then assigning passwords to applicants, Dot Com deliberately and systematically availed itself of the privileges and benefits of doing business in Pennsylvania. The court found irrelevant the fact that only 2% of Dot Com's accounts came from Pennsylvania. It is the nature and quality of forum contacts that are of primary relevance, not their quantity. Dot Com made a conscious choice to conduct business with the residents of Pennsylvania and was therefore on notice that it could be subject to suit there.

Notably, here, as in Patterson, the court was aware that the virtual contacts were buttressed by contracts and other physical, real space contacts. The court found nothing unreasonable about the exercise of jurisdiction over Dot Com here. Dot Com consciously chose to conduct business in Pennsylvania, pursuing profits from the actions that are in question. "*The Due Process clause is not a territorial shield to inter-state obligations that have been voluntarily assumed.*" Burger King, 471 US at 474.

Writing in *The Business Lawyer* in November, 2000, Jeremy Gillman aptly stated:

Zippo is significant not because of its facts, which parallel those of myriad other Internet jurisdiction cases, but because of the test devised by the court to arrive at its conclusion. That test, which has been cited like a mantra in almost every Internet jurisdiction decision that has followed *Zippo*, is notable for its simplicity and practicality; it recognizes that every web site is different and that each engages its users to varying degrees.

As will be seen, most web sites fall in the middle of the *Zippo* spectrum, leaving it up to the courts to determine on a case-by-case basis whether their interactivity level qualifies them for jurisdiction in a forum state. Given *Zippo's* flexible and non-formulaic approach, however, it is not uncommon for similar web sites to yield dissimilar jurisdictional outcomes. 56 *The Business Lawyer* 395, 399 (November 2000).

Panavision International, L.P. v. Toeppen

In Panavision International, L.P. v. Toeppen, 141 F.3d 1316 (9th Cir. 1998), another significant decision on Internet jurisdiction, Toeppen continued his "business" of obtaining Internet domain names based on the registered trademarks of various companies, including Delta Airlines, Neiman Marcus, Eddie Bauer, Lufthansa and over a hundred others. Toeppen had attempted to "sell" the domain names for other trademarks for amounts up to \$15,000.

Here, Panavision held registered trademarks to the names "Panavision" and "Panaflex" in connection with motion picture camera equipment. Panavision promoted its trademarks through motion pictures and television, not media advertising. When Panavision attempted to register a web site on the Internet with the domain name Panavision.com, it failed because Toeppen had already obtained rights to use Panavision as the domain name for his web site. (When accessed, Toeppen's web page displayed photographs of the City of Pana, Illinois.)

In December, 1995, Panavision's counsel sent a letter from California to Toeppen in Illinois informing him that Panavision held a trademark in the name Panavision and telling him to stop using that trademark and the domain name Panavision.com. Toeppen responded stating he had a right to use the name

Panavision.com on the Internet as his domain name and offered to settle the matter if Panavision would pay him \$13,000 in exchange for the domain name. Toeppen also stated that if Panavision agreed, he would not acquire any other Internet addresses which are alleged by Panavision Corporation to be its property. Panavision refused. Toeppen promptly registered Panavision's other trademark as the domain name Panaflex.com.

Panavision filed this action against Toeppen in the District Court for the Central District of California alleging dilution of its trademark under Federal and California law. Panavision claimed Toeppen was in the business of stealing trademarks, registering them as domain names on the Internet and selling the domain names to the proper trademark owners. The District Court determined it had personal jurisdiction over Toeppen and granted summary judgment in favor of Panavision on both its federal and state dilution claims. Toeppen appealed.

The Ninth Circuit held that simply registering someone else's trademark as a domain name and posting a web site on the Internet was not sufficient to subject the party domiciled in one state to jurisdiction in another. Cybersell, 130 F.3d at 418. Rather, the Cybersell court held, there must be "something more" to demonstrate that the defendant directed his activity toward the foreign state. The Ninth Circuit concluded that Toeppen engaged in a scheme to register Panavision's trademarks as his domain name for the purpose of extorting money from Panavision and that this conduct had the effect of injuring Panavision in California where it had its principal place of business and where the movie and telephone industry was centered. Accordingly, under the "effects test," the

purposeful availment requirement necessary for a specific personal jurisdiction was satisfied. The Ninth Circuit also found that Panavision's claims arose out of Toeppen's California related activities and that the exercise of personal jurisdiction over Toeppen was reasonable. Indeed, the Ninth Circuit placed on Toeppen the burden to present a compelling case that the presence of some other considerations that would render jurisdiction unreasonable. Toeppen could not. The Ninth Circuit concluded "that all of the requirements for exercise of specific, personal jurisdiction are satisfied. The District Court properly exercised personal jurisdiction over Toeppen." Toeppen at 1324.

In so holding, the Court noted that in tort cases such as this one, "jurisdiction may attach if the defendant's conduct is aimed at or has an effect in the foreign state." As Gillman observes, again aptly: "[u]nderstandably, Panavision's 'effects test' is commonly invoked by claimants eager to establish jurisdiction over non-residents. More often than not, however, courts seem inclined to apply Zippo's sliding scale approach rather than Panavision's effects test when adjudicating jurisdictional disputes." Gillman, 56 *The Business Lawyer* at 400.

GTE New Media Services Inc. v. Bellsouth Corp., Et Al.

Two other circuit court decisions also provide useful information. GTE New Media Services Inc. v. BellSouth Corp., et al., 199 F.3d 1343 (D.C. Cir. 2000), concerned GTE's suit against five regional telephone operating companies and affiliates claiming the RBOC's conspired to dominate the Internet business directories market in violation of Section 1 and 2 of the Sherman Act. To pursue

their claimed monopoly, GTE alleged the defendants obtained exclusive links on web services such as Netscape and Yahoo. Previously, GTE had had a non-exclusive contract with Netscape offering various Internet business directories including GTE's SuperPages, offering Netscape terminated by removing its links to GTE's directory.

The familiar battle over personal jurisdiction ensued. Specifically, the defendants asked the District Court to dismiss for lack of personal jurisdiction. It denied those motions, finding jurisdiction under the District of Columbia long-arm statute on the grounds that GTE had sufficiently shown that the defendants' caused tortious injury in the District of Columbia by virtue of their acts outside the District of Columbia. Because there existed a substantial ground for difference of opinion concerning this ruling, the District Court certified its Order for immediate interlocutory review.

The D.C. Circuit remanded, rejecting the District Court's finding that defendants' conduct outside the District of Columbia was designed to injure GTE within the District of Columbia by pulling D.C. based users of GTE's business directories toward their own. The Court found no evidence of record identifying this specific tortious injury that GTE allegedly suffered in the District nor did it find support for GTE's claim of lost advertising revenue. The D.C. Circuit held that just because D.C. residents could access defendants' web sites, standing alone, did not "show a persistent course of conduct by the defendants in the District. Access to web site reflects nothing more than a telephone call by District residents to the defendants' computer servers, all of which are apparently operated

outside the District." 199 F.3d at 1349-50. Labeling the contention "far-fetched," the appellate court also rejected GTE's contention that defendants were "transacting business" in the District whenever a District resident accessed their yellow pages web sites,

Specifically, the DC Circuit held:

Additionally, personal jurisdiction surely cannot be based solely on the ability of District residents to access the defendants' websites, for this does not by itself show any persistent course of conduct by the defendants in the District. Access to a website reflects nothing more than a telephone call by a District resident to the defendants' computer servers, all of which apparently are operated outside of the District. And, as this court has held, mere receipt of telephone calls outside the District does not constitute persistent conduct 'in the District' within the meaning of the long-arm statute. See Tavoulareas v. Comnas, 720 F.2d 192, 194 (D.C.Cir. 1983).

Finally, GTE appears to suggest that, when a District resident accesses the defendants' Yellow Pages websites, the defendants are somehow 'transacting business' in the District. This is a far-fetched claim on this record. Access to an Internet Yellow Page site is akin to searching a telephone book – the consumer pays nothing to use the search tool, and any resulting business transaction is between the consumer and a business found in the Yellow Pages, not between the consumer and the provider of the Yellow Pages. In short, there is nothing here to indicate that District residents actually engage in any business transactions with the defendants.

When stripped to its core, GTE's theory of jurisdiction rests on the claim that, because the defendants have acted to maximize usage of their websites in the District, mere accessibility of the defendants' websites establishes the necessary 'minimum contacts' with this forum. See Br. for Appellee at 16. This theory simply cannot hold water. Indeed, under this view, personal jurisdiction in Internet-related cases would almost always be found in any forum in the country. *We do not believe that the advent of advanced technology, say, as with the Internet, should vitiate long-held and inviolate principles of federal court jurisdiction. The*

Due Process Clause exists, in part, to give 'a degree of predictability to the legal system that allows potential defendants to structure their primary conduct with some minimum assurance as to where that conduct will and will not render them liable to suit.' World-Wide Volkswagen Corp., 444 U.S. at 297, 100 S.Ct. 559. In the context of the Internet, GTE's expansive theory of personal jurisdiction would shred these constitutional assurances out of practical existence. Our sister circuits have not accepted such an approach, and neither shall we.

Ultimately, the D.C. Circuit declined to rule on the merits of its theory of jurisdiction. Rather, it remanded the case for further jurisdictional discussion.

Once again, Jeremy Gillman gives us a sage observation:

GTE is significant in two respects in that it (i) signifies yet another federal appeals court's affirmation of the fact that the broad reach of the Internet will not defeat time-honored principles of personal jurisdiction law developed well before the dawn of the computer age, and (ii) reminds litigants that they need to rely on detailed, case-specific facts rather than conclusory assertions when presenting their jurisdictional arguments to the court. Gillman, 56 *Business Lawyer* at 408.

Intercon, Inc. v. Bell Atlantic Internet Solutions

One final appellate decision remains for discussion. In Intercon, Inc. v. Bell Atlantic Internet Solutions, 205 F.3d 1244 (10th Cir. 2000), Intercon, an Oklahoma ISP, had a domain name of Icon.net. Bell Atlantic offered Internet access through various service providers, one of whom used the domain name Iconnet.net. Here, Intercon sued Bell Atlantic, a non-resident provider of dial-up Internet service for unauthorized use of Intercon's e-mail server. For complicated reasons, defendant had to route its e-mail through other Internet service providers. However, an addressing problem caused much of that routing to go through Intercon, severely burdening the latter mail server. Even after Intercon's president

contacted Bell Atlantic to explain and complain, Bell Atlantic continued to provide Intercon's address to new subscribers for a full two months and permitted thousands of existing customers to access Intercon's server for an additional seven weeks, despite having the technological ability to prevent such access immediately upon discovering the problem. More specifically, beginning in July, 1996, defendant mistakenly routed its customers' e-mail messages to the wrong domain name, a practice that continued for many months, even after Intercon's president contacted defendant on several occasions. Defendant finally terminated its use of plaintiff's facilities in February, 1997, by completely blocking customer access to the mail server.

Plaintiff brought this action against defendant in Oklahoma seeking compensation for defendant's unauthorized use of the mail server and attendant damages. A battle of affidavits ensued in support of defendant's motion to dismiss. Finding defendant's contacts with Oklahoma were not purposely established, a district court granted the motion. Intercon appealed.

Defendant claimed that because it never intended to transmit traffic through Oklahoma, its inadvertent contacts with Oklahoma were merely "fortuitous" and, therefore, insufficient to establish personal jurisdiction. The Tenth Circuit disagreed stating:

Here, accepting plaintiff's evidence as true, we conclude that plaintiff has shown that defendant purposefully directed its conduct toward Oklahoma after the end of October 1996. At that point, defendant had notice that it was routing its customers' e-mail through the Oklahoma mail server and that the unauthorized traffic was causing problems for the Oklahoma-based company. It is possible that defendant knew this information even earlier, as it was already

providing plaintiff's phone number to its customers for technical support before plaintiff advised defendant of the problem. Defendant nonetheless continued to provide plaintiff's address to its new subscribers for a full two months, until December 31, 1996, and permitted thousands of its old customers to access the Oklahoma server for an additional seven weeks, despite having the technological ability to prevent such access immediately upon discovering the problem. Although defendant may have had a legitimate business reason for not terminating its use of the Oklahoma mail server immediately – concerns over interrupting its customers' service – this does not negate the fact that defendant purposefully availed itself of the Oklahoma server for almost four months after being notified of the erroneous address.

Having concluded that the defendant's activities and consequences had a substantial enough connection with Oklahoma to make the exercise of jurisdiction reasonable, the appellate court reversed the judgment of the district court.

Of the cases on the Case List, approximately 98 find no jurisdiction while approximately 68 find jurisdiction. In those finding jurisdiction, Patterson and Zippo have provided the analytical framework that a number of later cases have followed. Although discussion of some or even many of the cases on the Cyberspace Jurisdiction Case Lists might provide additional information, it would contribute little additional wisdom.

CYBERSPACE JURISDICTIONAL FUNDAMENTALS

As the preceding discussion shows, courts are applying traditional jurisdictional rules to determine the existence of personal jurisdiction over the parties to Internet transactions. From these cases, I submit the following jurisdictional fundamentals will be true more often than not:

1. General Jurisdiction based on Internet presence alone is extremely unlikely. Rather, the court is likely to require a significant amount of forum contact in both cyberspace and physical space before finding general jurisdiction exists.

2. In considering the role of the Internet in establishing contacts for personal jurisdiction, the courts have analogized Internet contacts to more traditional communication media. However, for all their explanatory usefulness, analogies can be quite misleading. Even so, the courts have applied a number of them, analogizing:

- a. telephone calls and mail sent to the forum to e-mail;
- b. the physical distribution of goods within the forum to the electronic distribution of goods;
- c. national print or broadcast advertisements and 1-800 numbers to web pages; and,
- d. contracts executed in the forum or entered into with its residents to "point and click" contracts.

As an exercise, think through some of the cases under discussion using these analogies to see if you feel they give satisfactory results. I submit that analogizing telephone calls to the Internet contacts is better than most.

3. Specific jurisdiction is unlikely to arise from a mostly or even predominantly passive web site.

4. Pure Internet advertising cases are unlikely to give rise to a finding of specific jurisdiction. Therefore, in cases where the defendant actively solicits

or transacts business through the web site, or provides goods and services ordered through the web site, the courts often find specific jurisdiction.

5. In many of the cases where the court found specific jurisdiction, the court considered as important factors the defendant's non-Internet contacts: such as contracts with forum residents, toll-free advertisements in forum publications, mailings into the forum and toll-free telephone numbers.

6. In any case where a defendant has purposefully directed his activity to the forum state in a substantial way, the courts have been generous in finding specific jurisdiction, even more so when there exist non-Internet contacts.

7. Last, the incidental activity that typically arises in these specific jurisdiction cases usually takes the form of either commercial activity or effects directed toward the forum state, i.e., a "targeting" the forum state or one of its residents.

Finally, in conducting your analysis, be mindful of some of Andrew Costa's well-founded distinctions in his seminal article *Minimum Contacts in Cyberspace: A Taxonomy of the Case Law*. For example, Costa points out that some courts have had difficulty separating the defendant's conduct from the medium in which it takes place. Costa believes an important distinction exists between the Internet itself, as the purposefully availing contact, and the Internet, as the *vehicle* for the purposefully availing conduct.

Costa's distinction between the Internet itself and the conduct which takes place on it illustrates the fallacy in Maritz, Inc. v. Cybergold, *supra*, where the court characterized Cybergold's web site as evidence of intent to reach all

Internet users regardless of geographical location. Similarly, in Inset Systems, Inc. v. Instruction Set, Inc., the court viewed the defendant's Internet advertising and toll free numbers as indicating it intended to avail itself of the privilege of doing business in all states. Costa correctly observes that these cases would subject those with an Internet presence to suit any of the fifty states. Costa also accurately observes that where the Internet by itself is viewed as a pervasive medium that demonstrates an intent to avail oneself of all forum states, the result cannot be harmonized with the Jurisdictional Fundamentals stated earlier.

Similar cautions are useful to insure that the court making a minimum contacts analysis does not mistake technological possibility with foreseeability. The fact that a party can reasonably foresee citizens of each of the fifty states accessing his web site is not the same thing as that same party reasonably anticipating that his Internet presence, without more, would render him amenable to suit in any jurisdiction in the United States. After all, a web site is not automatically projected to a user's computer. Rather, the user, himself, must take affirmative action to access the web site.

SAFEGUARDS AGAINST ASSERTION OF JURISDICTION

1. Operate a passive, information only, web site with little or no consumer interaction. Do not solicit or fill orders through the web site. Have the order solicitation and acceptance occur through more conventional means.
2. Limit the degree of consumer/customer interaction on the web site.

3. Restrict access to the web site to persons from "friendly" jurisdictions, and decline business from jurisdictions where you do not wish to be subject to jurisdiction.
4. Put contractual terms on the web site, call them to the attention of web site users and require web site users to accept them before undertaking significant activities on, or placing orders through, the web site.
5. The contractual terms may include, among other things,
 - a. Contractual choice of forum and choice of law clauses;
 - b. Jurisdictional disclaimers;
 - c. Non-judicial remedies in advance of, but in the event of, a dispute including arbitration or mediation clauses, credit card charge off agreements and escrow agreements.

CONCLUSION

Cyberspace jurisdiction is indeed a matter of new wine in old bottles. The new wine, of course, is the detailed case specific facts of internet usage that appear in the cases discussed here and in the Caselists. The old bottles, of course, are the time-honored principles of personal jurisdiction developed well before the dawn of the computer age. For you, as for every advocate, an understanding of the function of the internet, an ability and willingness to explain it to the court, and the creativity to concoct a persuasive presentation of the facts are all required to reach appropriate results. I wish you good luck in your efforts.

**CYBERSPACE JURISDICTION
CASE LIST**

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DOTCOM LITIGATION

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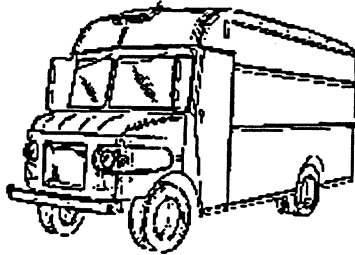
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DOTCOM LITIGATION

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A SOMEWHAT INTERESTING GUIDE TO TRADEMARKS

1. You are surrounded by trademarks. The automobile you drove to this CLE bears its manufacturer's trademark in several places. The jeans you wear on the weekends feature trademarks. So does the can of soda on your desk, the watch on your wrist, and the newspaper you are reading (when you should be paying attention to the CLE!).

2. Trademarks are among a company's most valuable assets. They distinguish that company's goods and services from those of its competitors. They are symbols of the goodwill consumers have toward the company.

3. A formal definition: A trademark is a word, phrase, symbol or design (see previous page), or combination thereof, which identifies and distinguishes the source of the goods of one party from those of others.

4. A service mark is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product.

5. Normally, a trademark appears on the product or on its packaging while a service mark appears in advertising for the services.

6. Trademark rights arise from either:
A. Actual use of the mark in commerce, or
B. The filing of an application to register a mark in the United States Patent and Trademark Office ("USPTO") stating that the applicant has a bona fide intention to use the mark in interstate commerce.

7. Federal registration is not required to establish rights in a mark. There are many valid marks which are not registered. These are called "common law" marks.

8. The owner of a common law mark may use the "TM" symbol next to his mark; the use of the "TM" symbol will warn others that you claim rights in that mark.

9. Federal registration does have certain benefits. The owner of a federal registration:

- A. is presumed to be the owner of the mark for the goods and services specified in the registration,
 - B. is entitled to use the mark nationwide,
 - C. is entitled to certain advantages and remedies in federal lawsuits,
- and
- D. gets to use the cool ® symbol next to his mark. ® ® ® ® ® ® ® ®

10. Trademarks may also be registered on a state-by-state basis. In Kentucky, the Secretary of State handles trademark registrations.

11. Unlike copyrights or patents, trademark rights can last forever if the owner continues to use the mark to identify its goods or services.

A. The term of a federal trademark registration is 10 years, with 10-year renewal terms.

B. The term of a state trademark registration will vary from state to state.

12. Many persons may use the same trademark as long as there is not a likelihood of confusion caused by their simultaneous use of the mark. Confusion is unlikely to occur if (a) the mark is not being used for the same services or goods or (b) the mark is used by different owners but in different locations.

13. Example of the same mark being used by different owners:

A. The Wyatt, Tarrant & Combs, LLP law firm uses the WYATT mark to advertise its *very reasonably priced* legal services.

B. The Wyatt Technology Corporation uses the WYATT mark in connection with its manufacture and sale of "multi-angle laser light scattering equipment" (whatever that means).

C. Both Wyatt Technologies and Wyatt, Tarrant & Combs may use the WYATT mark. They are not competitors. Aside from Florida voters, no one shopping for "laser light scattering equipment" will be confused by Wyatt, Tarrant & Comb's use of the WYATT mark.

14. The Internet is one big market without any boundaries. A California cigar dealer who uses the mark "Hotrods" to advertise his goods on the Internet may cause confusion with a New York cigar dealer who uses the same mark. The result is dotcom litigation.

A PARTIALLY INTERESTING GUIDE TO DOMAIN NAMES

15. Domain names are divided into "hierarchies." The "top-level" of the hierarchy appears after the last dot in a domain name. ".com" is the most common top level domain name, and is used to indicate that the domain name is owned by a commercial enterprise.

16. Other top level domains ("TLD") are:

A. ".org" for non-profit organizations,

B. ".net" for network and Internet related organizations,

C. ".edu" for colleges and universities,

D. ".gov" for government entities.

17. Virtually every nation also has a TLD, including the following:

- [1] ".bs" for Bahamas (though this would be appropriate for certain politicians),
- [2] ".de" for Germany (Deutschland),
- [3] ".nr" for Nauru,
- [4] ".ps" for Palestinian Territories (though this would be a great domain for certain letter writers),
- [5] ".tv" for Tuvalu (which has been soliciting registrations from various television companies),
- [6] ".uk" for the United Kingdom (England),
- [7] ".va" for the Vatican.

18. The following new TLD's will become operative sometime during the first half of this year:

- A. ".aero" for air transport businesses,
- B. ".biz" for businesses,
- C. ".coop" for cooperatives,
- D. ".info", unrestricted use,
- E. ".museum" for museums, believe it or not,
- F. ".name" for individuals,
- G. ".pro" for accountants, lawyers and physicians.

[1] The ".pro" domain will be divided into sub-domains which will allow different professionals with the same name to use that name without conflicting with others. Example: "johnstevens.cpa.pro" and "johnstevens.law.pro."

[2] The TLD may also add geographic designations within each profession so professionals with the same name and occupation may use their names. Example: "johnstevens.ky.law.pro" and "johnstevens.ny.law.pro"

19. Here is some advice. Before you sign up to register a name in any of the new TLDs, please note the following:

A. No companies have been accredited yet to register names in any of the new TLDs. Registration procedures have not yet been formalized, and there is no guarantee that any particular organization will be authorized to take registrations for any particular TLD.

B. No one has been authorized to "pre-register" domain names in the new TLDs. Persons who attempt to "pre-register" such domain names do so at their own risk and with no assurance that they will receive the pre-registered names once the TLDs become operational. The U.S. Federal Trade Commission (FTC) recently issued a consumer alert warning about "scam artists" offering services along these lines. Among other recommendations, the FTC advised consumers to protect themselves by "[a]voiding

any domain name pre-registration service that asks for up-front fees, guarantees particular top level domain names or preferential treatment in the assignment of new top level domain names."

20. The "second level" domain name appears to the left of the "dot."
A. "Yahoo" is the second-level domain name in "Yahoo.com"
B. There are now over 15 million "second-level" domain names registered worldwide.

21. There are three big problems with the domain name system.
A. Two identical second level domain names cannot coexist under the same top level domain.
B. Domain names have been registered on a first-come, first-served basis, without any regard to whether the registrant has the right to the name (though many of the new TLD registrars plan to pre-screen applicants).
C. Internet users assume that a company's domain name will contain the company's most famous trademark: "A customer who is unsure about a company's domain name will often guess that the domain name is also the company's name." Panavision Int'l, L.P. v. Toepfen, 141 F.3d 1316 (9th Cir. 1998).

22. This situation has led to "cyberpiracy" – the registration of trademarks as domain names by persons with no rights in the marks. Some cyberpirates do this in the hope of being able to sell the domain names to the owners of those marks, others are trying to take unfair advantage of the reputation attached to those marks, and others are doing it to strike at the trademark owners. Examples:

A. peta.org: an organization entitled "People Eating Tasty Animals" obtained the peta.org domain name, much to the disgust of the better known "People for the Ethical Treatment of Animals."

B. microsoftwindows.com and microsoftoffice.com: Two individuals named Kurtis Karr and Kenny Brewer registered eleven Microsoft trademarks as their domain names, including "microsoftwindows.com" and "microsoftoffice.com." Microsoft was not amused.

C. mcdonalds.com: This domain name was registered by an author from Wired magazine who was writing a story on the value of domain names and how traditional companies were slow to recognize their value. In exchange for returning the domain name to McDonalds, the author convinced the company to make a charitable contribution.

RESOLVING DOMAIN NAME DISPUTES THE CHEAP AND EASY WAY (THE ICANN DISPUTE RESOLUTION PROCEDURE)

23. In January, 2000, the Internet Corporation for Assigned Names and Numbers ("ICANN") replaced Network Solutions Inc. as the new administrator of the Internet domain name registry system. ICANN assumed responsibility for managing the registry system, coordinating new competitive domain name registries and creating new top-level domains in addition to the ".com," ".net," and ".org" domains. ICANN also established a new domain name dispute resolution policy.

24. ICANN's new dispute resolution procedure provides trademark owners with a speedy and relatively cheap mechanism to resolve domain name disputes. Trademark owners may resolve their domain name ownership disputes through an administrative process with any "dispute resolution service providers" approved by ICANN.

25. ICANN has issued the "Uniform Domain Name Dispute Resolution Policy" (a.k.a. the "UDRP") which outlines the general goals, limitations and procedures of domain name dispute resolution proceedings.

26. To be confusing, ICANN has also promulgated the "Rules for Uniform Domain Name Dispute Resolution Policy" ("UDRP Rules").

27. A trademark owner with a domain name dispute may choose from four dispute resolution providers. ICANN intends to approve many other dispute resolution service providers, but for now the choice is limited to the following organizations:

- A. The World Intellectual Property Organization ("WIPO") based in Geneva, Switzerland,
- B. The National Arbitration Forum in Minneapolis, Minnesota,
- C. The eResolution Consortium of Montreal, Canada, and
- D. The CPR Institute for Dispute Resolution.

28. A complainant does not need to have a registered trademark in order to file a proceeding with an ICANN dispute resolution provider. A complainant can base an action on his "common law" trademark rights.

29. An ICANN dispute resolution works like this:

- A. The trademark owner or his attorney picks a dispute resolution provider and checks that provider's supplemental rules.
- B. The trademark owner files a complaint and the required fee with the dispute resolution provider. The fee varies by provider and also depends on the number of persons who are going to hear the dispute. The trademark owner (now referred to

as the Complainant) can choose to have the dispute heard by one arbitrator (for approximately \$750) or by a panel of three arbitrators (for approximately \$2,200).

C. The Complainant then serves a copy of the complaint on the registrant -- the person or entity which has registered the disputed domain name.

D. The registrant (now referred to as the Respondent) has twenty days to file his response with the dispute resolution provider.

E. The arbitrator or panel of arbitrators will review the statements and documents submitted and render a decision in approximately two weeks.

F. There is a ten-day waiting period after the decision. During that period, the losing party may file a lawsuit in a court of proper jurisdiction. If no lawsuit is filed within this time period, the arbitrator's decision becomes binding and the domain name registrar will abide by the decision.

30. There is no provision in the administrative dispute resolution policy for an appeal.

31. The ICANN proceedings do not involve live testimony; decisions are based strictly on the documents submitted. The proceedings are intended to be a cost-effective alternative to the court system. Participants to the proceedings are not required to use attorneys (but they should!).

32. In order to prevail in an ICANN proceeding, the Complainant must prove each of these elements:

A. That the domain name is "identical or confusingly similar" to the Complainant's trademark;

B. That the Respondent does not have any "rights or legitimate interests" in the domain name; and

C. That the domain name "should be considered as having been registered and being used in bad faith."

33. The following may be evidence of "bad faith":

A. circumstances which indicate that the Respondent registered the domain name "primarily for the purpose of selling, renting, or otherwise transferring the domain name registration to the . . . owner of the trademark or service mark or to a competitor of [the owner], for valuable consideration in excess of the Respondent's documented out-of-pocket costs. . . ."

B. evidence that the Respondent has engaged in a "pattern of conduct" of registering domain names "in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name."

C. proof that the Respondent "registered the domain name primarily for the purpose of disrupting the business of a competitor," or

D. A showing that the Respondent "intentionally attempted to attract, for commercial gain, Internet users" to the Respondent's web site "by creating a likelihood of confusion" with the Complainant's mark.

34. The Respondent will be entitled to retain the domain name registration if he has a legitimate interest in the domain name. Here are some examples of a legitimate interest:

A. The Respondent used the domain name "in connection with a bona fide offering of goods or services" before receiving any notice of the domain name dispute; or

B. The Respondent is "commonly known by the domain name" even if the Respondent has "acquired no trademark or service mark rights"; or

C. The Respondent is making "a legitimate noncommercial or fair use of the domain name, without intent for commercial gain to misleadingly divert consumers or to tarnish the trademark or service mark at issue."

AN INCOMPLETE SAMPLING OF ICANN CASES

"THE DOMAIN NAME IS 'IDENTICAL OR CONFUSINGLY SIMILAR' TO THE COMPLAINANT'S TRADEMARK."

35. **MICKJAGGER.COM** (FA0007000095261). Complainant, Mr. Mick Jagger, asserted that he owned a "common law trademark in his famous personal name" and presented evidence of the continuous commercial use of that mark for more than thirty-five (35) years." Respondent used the domain name MICKJAGGER.COM as a link to a porno site. The arbitrator found for Complainant, noting that it was not necessary for Mr. Jagger to have a registered trademark: "The UDRP does not require that the Complainant have rights in a registered trademark or service mark. Certainly, Complainant held a common law trademark in his famous name, 'Mick Jagger,' even without registration at the United States Patent and Trademark Office." But see STING.COM, infra.

36. **CITYUTILITIES.COM** (D2000-0407). Complainant City Utilities of Springfield, Missouri was unable to wrest this domain name away from Respondent, an individual. The Complainant was commonly known as "City Utilities." The Respondent used the domain name as a link to another website which was not related to utilities. Nonetheless, the WIPO Arbitration and Mediation Center found that the Respondent won because "the term 'city utilities' describes the type of services offered by a utility company within a city, rather than the source of such services. As such, the term is generic and does not function as a mark. It is not protectable."

37. **MICROSOF.COM** (D2000-0548). The Respondent used this domain name for a site which featured Microsoft and Linux products. Complainant Microsoft Corporation argued that the domain name MICROSOFT.COM was confusingly similar to its famous trademark. The arbitrator agreed: "The term 'microsof' is very similar to 'microsoft' in its visual impression. Pronunciation of the two terms is very similar. An Internet user or consumer viewing the term 'microsof' (or 'microsof.com') is likely to confuse it with the term 'microsoft' (or microsoft.com')." "

38. **DIGITALCITYMAP.COM** (D2000-1283). Complainant Digital City, Inc. owned numerous registered "DIGITAL CITY" marks. Respondent was a land surveyor. The arbitrator found that the domain name DIGITALCITYMAP.COM was not confusingly similar to the DIGITAL CITY marks because (i) the "domain name comprises a mark and a suffix," (ii) the "mark is essentially generic within the online world and has not acquired such distinctiveness as to merit broader protection," and (iii) "the suffix . . . does not relate specifically to the business of the Complainant."

39. **32 NCAA DOMAIN NAMES** (D2000-0836). Complainant NCAA owns several registered NCAA trademarks, such as "NCAA", "NCAA Basketball" and "NCAA Football." Respondent is not associated with the NCAA but nonetheless registered 32 domain names, each containing the mark "NCAA." Many of the domain names were obviously in association with gambling, such as NCAABASKETBALLODDS.COM, NCAABASKET-BALLPICKS.COM, NCAAFOOTBALLGAMBLING.COM, NCAAFOOTBALLODDS.COM. Others appeared to be informational, such as NCAAMENSBASKETBALL.COM, NCAABASKETBALLSCHEDULE.COM, NCAABASKETBALLSCORES.COM, and NCAACOLLEGE BASKETBALL.COM. The arbitrator found that the twenty "informational" domain names must be transferred to the NCAA. However, the twelve "gambling" domain names would not be transferred. The arbitrator found that there would not be any confusion between the NCAA gambling domain names because of the NCAA's opposition to gambling: "Given the NCAA's strong opposition to gambling, it is less likely that these names could lead to any confusion."

"THE RESPONDENT DOES NOT HAVE ANY 'RIGHTS OR LEGITIMATE INTERESTS' IN THE DOMAIN NAME."

40. **DIRECTLINESUCKS.COM** (D2000-0583). The Complainant is a British group of insurance and banking companies which use the DIRECT LINE mark for their services and products. The Respondent took the names of eighteen well-known British enterprises, added the word "sucks" to each, and registered them as domain names, including DIRECTLINESUCKS. The Respondent claimed he registered the DIRECTLINESUCKS.COM name in order "to help protect enterprises against being bothered by customer sites at which grievances are aired." In the same altruistic spirit, the Respondent offered to sell the domain name to Direct Line for a "five figure sum" to be paid directly to a charity chosen by the Respondents" plus 5,000 pounds to

Respondent for its time and expense. The arbitration panel found the Registrant did not have a legitimate interest in the domain name: "The panel finds that there is no justification for the role of officious interfeerer which the Respondents have taken upon themselves" See also **STANDARDCHARTEREDSUCKS.COM** (D2000-0681) (reaching almost identical decision).

41. **Note:** According to an August 20, 2000, story published on CNET.COM, "arbitrators have sided with trademark owners in nine out of 11 domain name disputes involving '-sucks' variations on corporate names." The story noted that many corporations are registering as domain names their own trademarks in combination with "sucks" in order to protect themselves. Verizon Communications, for instance, registered "VERIZONSUCKS.COM." But that did not dissuade one protestor, who then registered "VERIZONREALLYSUCKS.COM." When Verizon contacted the registrant and demanded the transfer of the domain site, the registrant registered the following domain name: "VerizonShouldSpendMoreTimeFixingItsNetworkAndLessMoneyOnLawyers.Com"

42. **MADONNA.COM** (D2000-0847). Respondent purchased this domain name for \$20,000 and used the name in connection with a site that displayed sexually explicit photographs and text. The singer called Madonna (a.k.a. Madonna Ciccone), complained. Respondent had registered MADONNA as a trademark in Tunisia.

A. The panel of arbitrators noted that "it is possible for a Respondent to rely on a valid trademark registration to show prior rights," but noted that "it would be a mistake to conclude that mere registration of a trademark creates a legitimate interest under the Policy." The arbitrators found that Respondent's trademark registration carried no weight since both the Respondent and Complainant were Americans and "[a] Tunisian trademark registration is issued upon application without any substantive examination."

B. Respondent's case was also weakened by the fact that he "has registered a large number of other domain names . . . that matched the trademarks of others," including "wallstreetjournal.com"

C. Respondent argued that his porn site would not tarnish Madonna's reputation "because she has already associated herself with sexually explicit creative work." The arbitrators felt this argument "missed the point." He also noted that Madonna's reputation could be tarnished because Madonna did not control the Respondent's sexually explicit content and it "may be contrary to her creative intent and standards of quality."

43. **PRIORITYMAIL.COM** (FA0010000095757). The arbitrators held that the Respondent did not have a legitimate interest in PRIORITYMAIL.COM, PRIORITY-MAIL.COM, POST-OFFICE.ORG or POST-OFFICE.NET. Accordingly, they transferred the domain names to the Complainant, the U.S. Postal Service. In finding an absence of legitimate interest in these names, the panel noted that the Respondent had never used the domain names until after the complainant contacted Respondent, that Respondent

has registered over 700 domain names, and that his "decision to register multiple variations of the same name (org and net, hyphen or not) supports a conclusion that the purpose was to use the name to attract traffic, not to provide consumer services. In any event, only one such name would have been sufficient."

THE DOMAIN NAME "SHOULD BE CONSIDERED AS HAVING BEEN REGISTERED AND BEING USED IN BAD FAITH."

44. **WORLDWRESTLINGFEDERATION.COM** This domain name became the subject of the first case decided under ICANN's uniform dispute resolution policy ("UDRP"). A California resident had registered the domain name **worldwrestlingfederation.com**. He offered to sell the name at substantial profit to the pro wrestling organization. Rather than sending Hulk Hogan to forcibly retrieve the domain name, the WWF filed a Complaint with the WIPO. The arbitration panel directed that the domain name should be transferred to the WWF. It held the domain name was identical to or confusingly similar to the service marks owned by the WWF; the California dude had no legitimate interests in the domain name; and the domain name had been registered and used in bad faith -- as evidenced by the registrant's offer to sell the name to the WWF.

45. **SKUNKWORX.NET & MP3SKUNKWORKS.COM (D2000-0799):** Complainant Lockheed Martin Corporation is a large defense contractor and for many decades has operated the "Skunk Works" research facility. That facility has gained fame through production of such aircraft as the U2, the SR-71 Blackbird and the F-117 Stealth Fighter. Respondent registered SKUNKWORX.NET and MP3SKUNKWORKS.COM but "appears never to have pointed this name at any active web site." He claims that he never heard of Lockheed, he thought "Skunk Works" was a generic term for a research facility, and he was contemplating using his domain names for "a space where the collective creation of audio could take place." When Lockheed contacted him about the domain names, Respondent offered to sell them for \$5,000. The arbitrator found that Respondent registered and used the domain names in bad faith, despite the fact that they were never actually "used."

A. Bad faith registration and "use" were proved by these facts: (a) Respondent probably knew of Lockheed's trademarks, (b) he "had no bona fide intent to use that name in the generic sense, (c) by registering "SKUNKWORX.NET" the Respondent tried to capitalize on Lockheed's trademarks, (d) Respondent sought to block Lockheed from using "SKUNKWORX.NET" despite Respondent's lack of legitimate interest in the name, and (e) his conduct was consistent with an intent to engage in malicious mischief.

B. "The Policy does not define the term 'bad faith.' The examples of 'circumstances' recognized as 'evidence of bad faith' in Paragraph 4(b) of the Policy embody an eclectic group of concepts variously reminiscent of unjust enrichment, misappropriation, tortious interference with prospective economic advantage, trademark

infringement, and 'unfair' business behavior in a general sense. The examples all require that a Respondent have acted with a particular state of mind, such as 'primarily for the purpose of disrupting the business of a competitor,' or 'in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name.'

46. **MICROSOFT.COM**, supra. The arbitrator explained that the "html code for a webpage also may contain . . . its title, description and keywords which are used by some search engines to determine whether a particular webpage is relevant to an Internet user's search engine query. The arbitrator noted that the MICROSOFT.COM website had the virtually same "source code" or "html code" as that of the MICROSOFT.COM website. The only difference was that Respondent had omitted the letter "t" from the word Microsoft. Consequently, the MICROSOFT.COM site would be listed in response to searches looking for Microsoft Corporation. This was further evidence of the Registrant's bad faith.

47. **37 YAHOO DOMAIN NAMES** (D2000-0273). Mr. Eitan Zviely, the Respondent, using a variety of names and shell companies, registered 37 domain names which incorporated the name YAHOO (e.g. YAHOOUK.COM, KYAHOO, ATLANTAYAHOO.COM) or phonetic equivalents (e.g. JAHU.COM, YOUHOO.COM and YUAHOO.COM). Respondent's YAHOO-domains directed users to his own 800GO.COM site, which he advertised as "twelve search engines in one." Complainant, Yahoo! Inc., pointed to Mr. Zviely's pattern of registering trademark-related domain names, stating that he "has registered countless other domain names, misspelling at least 50 well-known trademarks owned by third parties." The arbitrator was persuaded that Respondent's practice was evidence of his bad faith: "This conclusion is reinforced by Zviely's pattern of conduct in registering 37 Yahoo-like domain names, as well as dozens of other trademark-related domain names. . . . Zviely's only purpose in registering so many trademark-related domain names must have been to trade on the good will and fame associated with those marks."

48. **STANFORDUNIVERSITY.COM** (FA0008000095543). Complainant is the world-famous Stanford University and owns several registered federal trademarks incorporating the word "Stanford." Respondent is a California surgeon who claims to have operating privileges at Stanford University medical Center. The arbitrator found Respondent's domain name was confusingly similar to Complainant's registered marks and that Respondent did not have a legitimate use for the mark. Nonetheless, the arbitrator refused to transfer the domain name because he did not find that Respondent registered and used the domain name in bad faith. This finding was based primarily on the fact that Respondent had only registered this one mark and did not have a pattern of registering marks as domain names in order to deprive the trademarks owners of the use of their marks: "Here, there is no evidence that Respondent has registered any other

domain names. Therefore, a finding of bad faith under ICANN Policy 4(b)(ii) can not be made."

49. **STING.COM** (D2000-0596): Complainant Gordon Sumner is better known as the musician "Sting." Respondent Michael Urvan is better known as Michael Urvan. Until being contacted by Complainant, Respondent was not using the domain name. He then briefly linked it to a site called "GunBroker.com" and offered to sell the domain name to Sting for \$25,000. Complainant alleged he had common law trademark rights in the name "Sting." Respondent claimed that he had used "Sting" as his e-mail name for eight years. The arbitrator found for the Respondent because the Respondent had not registered the name in bad faith-- even though the Respondent did not have any legitimate rights in "Sting." The Arbitrator also questioned whether Sting had any common law trademark rights in his name, characterizing Sting as having "personality rights." Though other panels have treated the name of a famous person as constituting an unregistered trademark, this Arbitrator pointed to the "Report of the WIPO Internet Domain Name Process", upon which ICANN based the UDRP. This Report stated that the arbitration procedure would be limited (1) "to cases of deliberate, bad faith abusive registrations" and (2) to cases involving "trademarks and service marks. Thus, registrations that violate trade names, geographical indications or personality rights would not be considered to fall within the definition of abusive registration for the purposes of the administrative procedure."

THE RESPONDENT USED THE DOMAIN NAME "IN CONNECTION WITH A BONA FIDE OFFERING OF GOODS OR SERVICES" BEFORE RECEIVING ANY NOTICE OF THE DOMAIN NAME DISPUTE.

50. **CISSELL.COM** (FA0008000095321). Respondent was a former distributor of Complainant Cissell and registered this domain name after Complainant permitted its own registration of the domain name to lapse. Respondent now uses the name to link to its site where it offers products from Complainant's competitors. Nonetheless, the arbitrator ruled in favor of the Respondent, finding that it had a legitimate interest in the domain name when it registered the name *and* that the Respondent continued to purchase Cissell products from other sources and to offer those products to its customers. "The evidence is unrefuted that Respondent's use of the domain name has been in connection with a bona fide offering of goods and services."

51. **SANDALSHONEYMOON.COM DOMAIN NAMES** (FA0005000094944). Respondent, a travel agency, registered nine domain names each containing the word "SANDAL." Complainant owns and uses the SANDAL trademark in connection with nine resort hotels in the Caribbean. Respondent had been affiliated with Complainant, had booked many tourists on trips to Sandals resorts (selling 850 rooms in the year 2000), and Complainant's top managers had encouraged Respondent's website from its inception. But after Complainant created its own site it sought to gain control over

Respondent's nine domain names. The arbitrator held the Complainant's had implicitly consented to Respondent's use of its mark and ruled in favor of Respondent on equitable grounds: "[T]he Panelist has concluded that Complainant is estopped from terminating the implied consent which, if allowed, would be inequitable because of Respondent's reasonable reliance, evaluated in the light of the long-lasting relationship between the parties."

THE RESPONDENT IS "COMMONLY KNOWN BY THE DOMAIN NAME" EVEN IF THE RESPONDENT HAS "ACQUIRED NO TRADE-MARK OR SERVICE MARK RIGHTS"

52. **PENGUIN.ORG** (D 2000-0204). Respondent Anthony Katz registered the domain names PENGUIN.ORG, PENGUINLAND.ORG, PENGUINLAND.COM, and PENGUINLAND.NET. Complainant Penguin Books Limited has registered the PENGUIN mark in connection with its book publishing business. After Penguin Books contacted Mr. Katz about the domain name PENGUIN.ORG, he offered to sell it for \$10,000. In response to the Complaint, Respondent argued that he was known by the nickname "Penguin." He also said his wife was known as "Mrs. Penguin." He also claimed that he registered the PENGUIN.ORG domain name with the intent of registering a site dedicated to penguins. The arbitration panel ruled in favor of Respondent, finding he had a legitimate interest in the domain name.

A. "It is reasonable for someone to register a domain name based on a nickname such as "Penguin" and it follows that the Respondent had legitimate interests in that name. It is not for this Administrative Panel to decide on whether such use would in any way infringe any intellectual property rights of the Complainant and this must be left to other fora."

B. The panel also noted that it had to accept Respondent's evidence regarding his nickname "in the absence of any rebuttal evidence from the Complainant."

THE RESPONDENT IS MAKING "A LEGITIMATE NONCOMMERCIAL OR FAIR USE OF THE DOMAIN NAME, WITHOUT INTENT FOR COMMERCIAL GAIN TO MISLEADINGLY DIVERT CONSUMERS OR TO TARNISH THE TRADEMARK OR SERVICE MARK AT ISSUE."

53. **32 NCAA DOMAIN NAMES**, *supra*. The Registrant was found to have a "legitimate interest" in the twelve NCAA-gambling domain names: "Complainant notes that it is lobbying the U.S. government to make Internet gambling illegal, but does not suggest that the alleged use is illegal. For purposes of this proceeding, therefore, a web site devoted to providing information or access to gambling on NCAA games qualifies as the bona fide offering of goods or services and thus constitutes a legitimate use."

54. **ROBOTCOCK.COM** (D2000-0900). The Complainant, a Swiss company, manufactured "electric devices serving the intimate self-pleasuring of women." The

Respondent, another Swiss company, was a web developer. After the Complainant refused to pay the Respondent's \$128,000 bill for services, the Respondent held the ROBOTCOCK.COM domain name hostage. The Complainant then filed this ICANN proceeding, seeking to have the name transferred. Interestingly, the Respondent never claimed any ownership of the domain name – he admitted that it belonged to the Complainant. Nevertheless, the panel refused to transfer the domain name: "Since Respondent, uncontestedly, registered the Domain Name for and on behalf of the Complainant (albeit in its own name), bad faith at the stage of registration is not apparent for the Panel. Not even Complainant contends bad faith at this stage and supplies no evidence of it."

55. **SCIENTOLOGIE.ORG** (D2000-0410): This proceeding grew out of a dispute between the "official" Scientology organization, the American "Religious Technology Center," and a renegade German group called Freie Zone e.V. ("Free Zone Association"). The Religious Technology Center filed a Complaint against Free Zone concerning the latter's registration of SCIENTOLOGIE.ORG. Complainant proved that Scientology's founder, L. Ron Hubbard, had assigned it all rights to the "SCIENTOLOGY" trademark, a trademark which it had registered in the U.S.A. and 18 other countries. Respondent was formed in 1982 by Captain Bill Robertson, L. Ron Hubbard's former "right arm." In 1995 Respondent purchased all rights to a 1934 German book entitled "Scientologie – Wissenschaft von der Beschaffenheit und Tauglichkeit des Wissens" ("Scientology – Science of the Constitution and Usefulness of Knowledge"). Respondent maintains that it uses the domain name for a website which promotes the philosophy of that book's author, Dr. Anastasius Nordenholz. Under German law, Respondent owns the word "Scientologie" as a "work title." Respondent's website has a disclaimer; it explicitly states that it is not connected with Complainant, the "official" Scientology organization. The arbitrator refused to transfer the domain name, finding that Respondent was legitimately using the domain name in connection with Dr. Nordenholz's book: "The copyrights and other rights in this book have been licensed to Respondent by Dr. Nordenholz's heirs, and these rights appear to be even older than Complainant's trademarks. Under these circumstances, it cannot be said that Respondent has no right whatsoever and no legitimate interest in the Domain Name."

MISCELLANEOUS NOTES ABOUT ICANN PROCEEDINGS

56. The ICANN rules provide for the submission of a Complaint and a Response. They do not provide for other pleadings, such as a Reply or Surreply.

57. The rules do provide that the Panel may request further documentation: "In addition to the complaint and the response, the Panel may request, in its sole discretion, further statements or documents from either of the Parties." UDRP Rule 12.

58. Many parties have filed replies and surreplies without first asking leave to file. Some of these have been considered; others have been returned unread.

A. In PENGUIN.ORG, supra, the arbitrator considered the Complaint, the Response, a Reply, and a Sur-Reply, even though the parties did not ask for permission to file the additional pleadings.

B. In SCIENTOLOGIE.ORG, supra, the arbitrator considered the Complaint, the Response, and four more unsolicited submissions. "Although not bound to do so under the Rules, the Panelist accepts and considers the Parties' further submissions after the Complaint and Response."

C. In STING.COM, supra, the arbitrator returned the numerous unsolicited pleadings which were filed after the Complaint and Response. He stated that further pleadings should not be considered except in extraordinary cases. To routinely consider other pleadings would frustrate the administrative procedure which "allows for more rapid and cost effective resolution of domain name challenges." Before filing an additional pleading, the party should request leave: "If a Party wishes to submit a further statement, the better practice under the Rules would be to first seek consent from the panel, with an explanation of why a further statement is warranted. Appropriate reasons may include the existence of new, pertinent facts that did not arise until after the submission of the complaint, or the desire to bring new, relevant legal authority to the attention of the Panel."

59. The rules do not specify the standard of proof. More than one arbitrator has stated that the Complainant bears the same burden as that of a plaintiff in a civil lawsuit: "[W]e believe the appropriate standard for fact finding is the civil standard of a preponderance of the evidence. . . . Under the 'preponderance of the evidence' standard a fact is proved for the purpose of reaching a decision when it appears more likely than not to be true based on the evidence." MADONNA.COM, supra.

60. It is a mistake to think of the "Complaint" as the equivalent of a Complaint in a civil law suit. Think of the Complaint as a motion for summary judgment. Attach sworn proof, i.e. affidavits from persons with firsthand knowledge. Otherwise, your assertions are mere argument: "In view of the contradictory contentions made by Complainant and Respondent and the failure of Complainant to support its position by declaration based on identified personal knowledge, the Panel is unable to conclude that Lockheed has proved, by a preponderance of the evidence, that Respondent registered 'SKUNKWORX.NET' primarily for the purpose of selling, renting or otherwise transferring the domain registration to the Complainant.'" SKUNKWORX.NET, supra.

61. The Respondent's failure to file a Response does not remove the Complainant's burden of proof: "Respondents' failure to respond does not relieve Yahoo! of its burden of proof on this element or on either of the two other elements of Paragraph 4(a) of the Policy." 37 YAHOO DOMAIN NAMES, supra.

62. The scope of an ICANN proceeding is limited. A panel will decide whether to cancel or transfer a domain name. That's it.

A. "The remedies available to a complainant pursuant to any proceeding before an Administrative Panel shall be limited to requiring the cancellation of your domain name or the transfer of your domain name registration to the complainant." UDRP 4(i). If you want additional relief, go to court.

B. In 37 YAHOO DOMAIN NAMES, supra, the Complainant asked the Arbitrator to compel the Respondent "to produce a full list of domain names he has registered incorporating and/or misspelling the YAHOO! mark." The arbitrator stated, "It is doubtful that the panel has authority to grant such relief." It was not doubtful – the panel clearly did not have such authority.

C. The dispute in ROBOTCOCK.COM, supra, concerned a bad debt. The Respondent refused to transfer the domain name until the Complainant paid for Respondent's services in registering the name and hosting the ROBOTCOCK.COM website for 18 months. The panel recognized it was not equipped to adjudicate the merits of this controversy: "The purpose of the Policy is to prevent the misuse of the domain name system by so-called cybersquatters, but not to handle any contractual disagreements of two parties in connection with a domain name registration. The Panel is lacking both the power and the legal means to deal with questions concerning an underlying contractual relationship, blackmailing, etc."

63. An ICANN proceeding does not limit your rights in a subsequent lawsuit.

A. "The mandatory administrative proceeding requirements . . . shall not prevent either you or the complainant from submitting the dispute to a court of competent jurisdiction for independent resolution before such mandatory administrative proceeding is commenced or after such proceeding is concluded." UDRP 4(k).

B. "[T]his decision does not bar either party from submitting the dispute to a court. Thus, if Complainant believes that registration of these domain names is a violation of U.S. AntiCybersquatting Consumer Protection Act – as cited in the Complaint – Complainant may bring such an action in U.S. court." 32 NCAA DOMAIN NAMES, supra.

64. An ICANN decision is not binding on a court. In the arbitration proceeding concerning the "eREFEREE.COM, eREFEREE.ORG, eREFEREE.NET" domain names (FA0004000094707), the Complainant owned the federally registered trademark of "REFEREE" for a magazine. It complained that the Respondent's marks were confusingly similar to REFEREE and should be transferred. The arbitrator ruled in favor of Respondent, finding that the Respondent had a legitimate interest in the domain name in view of his sports background, that Respondent had not attempted to suggest an affiliation with the Complainant, and that Complainant could not preempt all uses of the word "REFEREE." According to a Feb. 16, 2001, story on CNET.COM, a federal judge in Wisconsin, C.N. Clevert, overturned the ICANN decision and issued an injunction prohibiting Respondent from using its domain names and from using the term "referee"

at all, "either alone or with other words" in its "domain names, directory names or other such computer addresses." The judge apparently accepted Complainant's argument that Respondent's site would deceive viewers into believing it was affiliated with Complainant and that Respondent's trademark was confusing similar to Complainant's mark.

65. The ICANN dispute resolution process has proven popular because of its low cost (generally less than \$2000) and its quick turn around time (approximately three months). Here are some statistics from ICANN, current as of January 2001:

A. There have been 2,780 proceedings filed involving 4,952 different domain names.

B. In 1,537 proceedings, the arbitrators held in favor of the Complainants and transferred 2,677 names.

C. In 372 proceedings involving 476 domain names, the arbitrators ruled for the Respondents.

D. Other proceedings were settled (52), dismissed without prejudice (169), disposed of without a decision or otherwise terminated.

A DRY INTRODUCTION TO THE ANTICYBERSQUATTING CONSUMER PROTECTION ACT

66. Not to be left out of the act, Congress provided trademark owners another method of obtaining conflicting domain names when it passed the AntiCybersquatting Consumer Protection Act (the "ACPA"), 15 U.S.C. § 1125(d).

67. **ELEMENTS OF CAUSE OF ACTION:** The ACPA enables the owner of a distinctive or famous trademark (including personal names used as marks) to bring a civil action in federal court against any person who:

A. "has a bad faith intent to profit from that mark, including a personal name which is protected as a mark" and

B. "registers, traffics in, or uses a domain name that"

[1] is "identical or confusingly similar" to a distinctive trademark,

or

[2] "is identical or confusingly similar to or dilutive" of "a famous mark." 15 U.S.C. § 1125(d)(1)(A).

68. **BAD FAITH INTENT:** In determining whether "a bad faith intent" is present, a court may consider any relevant evidence, including the following:

A. "the trademark or other intellectual property rights of the person, if any, in the domain name;

B. the extent to which the domain name consists of the legal name of the person or a name that is otherwise commonly used to identify that person;

C. the person's prior use, if any, of the domain name in connection with the bona fide offering of any goods or services;

D. the person's bona fide noncommercial or fair use of the mark in a site accessible under the domain name;

E. the person's intent to divert consumers from the mark owner's online location to a site accessible under the domain name that could harm the goodwill represented by the mark, either for commercial gain or with the intent to tarnish or disparage the mark, by creating a likelihood of confusion as to the source, sponsorship, affiliation, or endorsement of the site;

F. the person's offer to transfer, sell, or otherwise assign the domain name to the mark owner or any third party for financial gain without having used, or having an intent to use, the domain name in the bona fide offering of any goods or services, or the person's prior conduct indicating a pattern of such conduct;

G. the person's provision of material and misleading false contact information when applying for the registration of the domain name, the person's intentional failure to maintain accurate contact information, or the person's prior conduct indicating a pattern of such conduct;

H. the person's registration or acquisition of multiple domain names which the person knows are identical or confusingly similar to marks of others that are distinctive at the time of registration of such domain names, or dilutive of famous marks of others that are famous at the time of registration of such domain names, without regard to the goods or services of the parties; and

I. the extent to which the mark incorporated in the person's domain name registration is or is not distinctive and famous . . . "15 U.S.C. § 1125(d)(1)(B).

69. THE DEFENSE: "Bad faith intent . . . shall not be found in any case in which the court determines that the person believed and had reasonable grounds to believe that the use of the domain name was a fair use or otherwise lawful."

70. IN REM JURISDICTION: The trademark owner may use the ACPA to file an in rem civil action against the domain name. The in rem proceeding is available if:

A. If the trademark owner "is not able to obtain in personam jurisdiction over a person who would have been a defendant in a civil action," or

B. "through due diligence was not able to find a person who would have been a defendant in a civil action." 15 U.S.C. § 1125(d)(2)(A).

71. The in rem proceeding can be useful when dealing with foreign cybersquatters.

72. IN REM VENUE: The in rem proceeding can be brought in one of two places:

A. "in the judicial district in which the . . . domain name authority that registered or assigned the domain name is located" (15 U.S.C. § 1125(d)(2)(A)), or

B. "in the judicial district in which . . . documents sufficient to establish control and authority regarding the disposition of the registration and use of the domain name are deposited with the court." 15 U.S.C. § 1125(d)(2)(C).

73. Domain name authorities are required to provide a court with documents sufficient to establish the court's control and authority regarding the disposition of the registration and use of the domain name" upon receipt of "a filed, stamped copy of a complaint filed by the owner of a mark in a United States district court." 15 U.S.C. § 1125(d)(2)(D).

74. IN REM REMEDIES: Because the in rem proceeding is against the domain name itself, and not the registrant, there are no monetary damages available. The only remedies available are:

A. "a court order for the forfeiture or cancellation of the domain name
or

B. the transfer of the domain name to the owner of the mark." 15 U.S.C. § 1125(d)(2)(D).

75. REMEDIES: There is no limitation on remedies for an "in personam" action. In addition to obtaining a court order requiring the transfer or cancellation of the domain name, the owner of a federally registered trademark may also be entitled to recover "(1) defendant's profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action." 15 U.S.C. § 1117(a). The court may award treble damages and, "in exceptional cases," the prevailing party's attorney's fees. Id.

76. In Heathmount A.E. Corp. v. Technodome.com, U.S.D.C., E.D. Va., (7/24/00), the American Plaintiff owed the trademarks "Technodome" and "Destination: Technodome." The Canadian Defendant owned the domain names "technodome.com" and "destinationtechnodome.com." The American Plaintiff was not able to obtain personal jurisdiction over the Canadian Defendant. The federal district court permitted the American Plaintiff to bring a suit against the domain names themselves pursuant to the ACPA.

77. The ACPA does not mean that a trademark owner can necessarily stop a third party's use of a domain name which is identical to the owner's trademark. This is because that third party may have a legitimate right to use that domain name.

A. As noted earlier, in the brick-and-mortar world it is common for merchants to use the same trademark for different goods or services. A company may register a trademark as its domain name, even if that prevents others who have legitimate rights in that mark from using the mark as their Internet address.

B. Wyatt Technologies, the developers of the "the first multi-angle light scattering (MALS) instruments for absolute macromolecular and particle characterization," had a legitimate right to register "wyatt.com" as its domain name. Consequently,

Wyatt, Tarrant & Combs cannot use the ACPA to wrest the domain name from Wyatt Technologies (though it has inquired as to whether Hulk Hogan might intercede).

78. **PREVENTIVE MEASURES:** There are at least two steps which a business might take to protect its trademark from cybersquatters.

A. First, the business might register its trademark under multiple top-level domain names. For example, the Yahoo web site can be found under yahoo.com, yahoo.web, or yahoo.net.

B. Second, the business owner might obtain domain registrations for names which sound similar to his domain name and which consumers might mistakenly enter into their computers.

WHY BOTHER?

79. A trademark owner must control the use of his trademark. That is because the trademark's value lies in its ability to identify the owner's goods or services. If others use that mark for different goods or services, the trademark loses its meaning and the trademark owner has lost his rights in that mark. The Internet is a two-edged sword. It makes trademark abuse easier than ever before, but it also makes the discovery of trademark infringement easier.

80. Courts may well hold that because Internet searching is relatively easy, trademark owners have the duty to periodically police the Internet. If an infringer of a mark should have been discovered through routine diligence, yet was allowed to go unchallenged, the trademark owner could lose its trademark.

###

APPENDIX A

Rules for Uniform Domain Name Dispute Resolution Policy (the "Rules")

(As Approved by ICANN on October 24, 1999)

Administrative proceedings for the resolution of disputes under the Uniform Dispute Resolution Policy adopted by ICANN shall be governed by these Rules and also the Supplemental Rules of the Provider administering the proceedings, as posted on its web site.

1. Definitions

In these Rules:

Complainant means the party initiating a complaint concerning a domain-name registration.

ICANN refers to the Internet Corporation for Assigned Names and Numbers.

Mutual Jurisdiction means a court jurisdiction at the location of either (a) the principal office of the Registrar (provided the domain-name holder has submitted in its Registration Agreement to that jurisdiction for court adjudication of disputes concerning or arising from the use of the domain name) or (b) the domain-name holder's address as shown for the registration of the domain name in Registrar's Whois database at the time the complaint is submitted to the Provider.

Panel means an administrative panel appointed by a Provider to decide a complaint concerning a domain-name registration.

Panelist means an individual appointed by a Provider to be a member of a Panel.

Party means a Complainant or a Respondent.

Policy means the Uniform Domain Name Dispute Resolution Policy that is incorporated by reference and made a part of the Registration Agreement.

Provider means a dispute-resolution service provider approved by ICANN. A list of such Providers appears at www.icann.org/udrp/approved-providers.htm.

Registrar means the entity with which the Respondent has registered a domain name that is the subject of a complaint.

Registration Agreement means the agreement between a Registrar and a domain-name holder.

Respondent means the holder of a domain-name registration against which a complaint is initiated.

Reverse Domain Name Hijacking means using the Policy in bad faith to attempt to deprive a registered domain-name holder of a domain name.

Supplemental Rules means the rules adopted by the Provider administering a proceeding to supplement these Rules. Supplemental Rules shall not be inconsistent with the Policy or these Rules and shall cover such topics as fees, word and page limits and guidelines, the means for communicating with the Provider and the Panel, and the form of cover sheets.

2. Communications

(a) When forwarding a complaint to the Respondent, it shall be the Provider's responsibility to employ reasonably available means calculated to achieve actual notice to Respondent. Achieving actual notice, or employing the following measures to do so, shall discharge this responsibility:

(i) sending the complaint to all postal-mail and facsimile addresses (A) shown in the domain name's registration data in Registrar's Whois database for the registered domain-name holder, the technical contact, and the administrative contact and (B) supplied by Registrar to the Provider for the registration's billing contact; and

(ii) sending the complaint in electronic form (including annexes to the extent available in that form) by e-mail to:

(A) the e-mail addresses for those technical, administrative, and billing contacts;

(B) postmaster@<the contested domain name>; and

(C) if the domain name (or "www." followed by the domain name) resolves to an active web page (other than a generic page the Provider concludes is maintained by a registrar or ISP for parking domain-names registered by multiple domain-name holders), any e-mail address shown or e-mail links on that web page; and

(iii) sending the complaint to any address the Respondent has notified the Provider it prefers and, to the extent practicable, to all other addresses provided to the Provider by Complainant under Paragraph 3(b)(v).

(b) Except as provided in Paragraph 2(a), any written communication to Complainant or Respondent provided for under these Rules shall be made by the

preferred means stated by the Complainant or Respondent, respectively (see Paragraphs 3(b)(iii) and 5(b)(iii)), or in the absence of such specification

(i) by telecopy or facsimile transmission, with a confirmation of transmission; or

(ii) by postal or courier service, postage pre-paid and return receipt requested; or

(iii) electronically via the Internet, provided a record of its transmission is available.

(c) Any communication to the Provider or the Panel shall be made by the means and in the manner (including number of copies) stated in the Provider's Supplemental Rules.

(d) Communications shall be made in the language prescribed in Paragraph 11. E-mail communications should, if practicable, be sent in plaintext.

(e) Either Party may update its contact details by notifying the Provider and the Registrar.

(f) Except as otherwise provided in these Rules, or decided by a Panel, all communications provided for under these Rules shall be deemed to have been made:

(i) if delivered by telecopy or facsimile transmission, on the date shown on the confirmation of transmission; or

(ii) if by postal or courier service, on the date marked on the receipt; or

(iii) if via the Internet, on the date that the communication was transmitted, provided that the date of transmission is verifiable.

(g) Except as otherwise provided in these Rules, all time periods calculated under these Rules to begin when a communication is made shall begin to run on the earliest date that the communication is deemed to have been made in accordance with Paragraph 2(f).

(h) Any communication by

(i) a Panel to any Party shall be copied to the Provider and to the other Party;

(ii) the Provider to any Party shall be copied to the other Party; and

(iii) a Party shall be copied to the other Party, the Panel and the Provider, as the case may be.

(i) It shall be the responsibility of the sender to retain records of the fact and circumstances of sending, which shall be available for inspection by affected parties and for reporting purposes.

(j) In the event a Party sending a communication receives notification of non-delivery of the communication, the Party shall promptly notify the Panel (or, if no Panel is yet appointed, the Provider) of the circumstances of the notification. Further proceedings concerning the communication and any response shall be as directed by the Panel (or the Provider).

3. The Complaint

(a) Any person or entity may initiate an administrative proceeding by submitting a complaint in accordance with the Policy and these Rules to any Provider approved by ICANN. (Due to capacity constraints or for other reasons, a Provider's ability to accept complaints may be suspended at times. In that event, the Provider shall refuse the submission. The person or entity may submit the complaint to another Provider.)

(b) The complaint shall be submitted in hard copy and (except to the extent not available for annexes) in electronic form and shall:

(i) Request that the complaint be submitted for decision in accordance with the Policy and these Rules;

(ii) Provide the name, postal and e-mail addresses, and the telephone and telefax numbers of the Complainant and of any representative authorized to act for the Complainant in the administrative proceeding;

(iii) Specify a preferred method for communications directed to the Complainant in the administrative proceeding (including person to be contacted, medium, and address information) for each of (A) electronic-only material and (B) material including hard copy;

(iv) Designate whether Complainant elects to have the dispute decided by a single-member or a three-member Panel and, in the event Complainant elects a three-member Panel, provide the names and contact details of three candidates to serve as one of the Panelists (these candidates may be drawn from any ICANN-approved Provider's list of panelists);

(v) Provide the name of the Respondent (domain-name holder) and all information (including any postal and e-mail addresses and telephone and

telefax numbers) known to Complainant regarding how to contact Respondent or any representative of Respondent, including contact information based on pre-complaint dealings, in sufficient detail to allow the Provider to send the complaint as described in Paragraph 2(a);

(vi) Specify the domain name(s) that is/are the subject of the complaint;

(vii) Identify the Registrar(s) with whom the domain name(s) is/are registered at the time the complaint is filed;

(viii) Specify the trademark(s) or service mark(s) on which the complaint is based and, for each mark, describe the goods or services, if any, with which the mark is used (Complainant may also separately describe other goods and services with which it intends, at the time the complaint is submitted, to use the mark in the future.);

(ix) Describe, in accordance with the Policy, the grounds on which the complaint is made including, in particular,

(1) the manner in which the domain name(s) is/are identical or confusingly similar to a trademark or service mark in which the Complainant has rights; and

(2) why the Respondent (domain-name holder) should be considered as having no rights or legitimate interests in respect of the domain name(s) that is/are the subject of the complaint; and

(3) why the domain name(s) should be considered as having been registered and being used in bad faith

(The description should, for elements (2) and (3), discuss any aspects of Paragraphs 4(b) and 4(c) of the Policy that are applicable. The description shall comply with any word or page limit set forth in the Provider's Supplemental Rules.);

(x) Specify, in accordance with the Policy, the remedies sought;

(xi) Identify any other legal proceedings that have been commenced or terminated in connection with or relating to any of the domain name(s) that are the subject of the complaint;

(xii) State that a copy of the complaint, together with the cover sheet as prescribed by the Provider's Supplemental Rules, has been sent or transmitted to the Respondent (domain-name holder), in accordance with Paragraph 2(b);

(xiii) State that Complainant will submit, with respect to any challenges to a decision in the administrative proceeding canceling or transferring the domain name, to the jurisdiction of the courts in at least one specified Mutual Jurisdiction;

(xiv) Conclude with the following statement followed by the signature of the Complainant or its authorized representative:

"Complainant agrees that its claims and remedies concerning the registration of the domain name, the dispute, or the dispute's resolution shall be solely against the domain-name holder and waives all such claims and remedies against (a) the dispute-resolution provider and panelists, except in the case of deliberate wrongdoing, (b) the registrar, (c) the registry administrator, and (d) the Internet Corporation for Assigned Names and Numbers, as well as their directors, officers, employees, and agents."

"Complainant certifies that the information contained in this Complaint is to the best of Complainant's knowledge complete and accurate, that this Complaint is not being presented for any improper purpose, such as to harass, and that the assertions in this Complaint are warranted under these Rules and under applicable law, as it now exists or as it may be extended by a good-faith and reasonable argument."; and

(xv) Annex any documentary or other evidence, including a copy of the Policy applicable to the domain name(s) in dispute and any trademark or service mark registration upon which the complaint relies, together with a schedule indexing such evidence.

(c) The complaint may relate to more than one domain name, provided that the domain names are registered by the same domain-name holder.

4. Notification of Complaint

(a) The Provider shall review the complaint for administrative compliance with the Policy and these Rules and, if in compliance, shall forward the complaint (together with the explanatory cover sheet prescribed by the Provider's Supplemental Rules) to the Respondent, in the manner prescribed by Paragraph 2(a), within three (3) calendar days following receipt of the fees to be paid by the Complainant in accordance with Paragraph 19.

(b) If the Provider finds the complaint to be administratively deficient, it shall promptly notify the Complainant and the Respondent of the nature of the deficiencies identified. The Complainant shall have five (5) calendar days within

which to correct any such deficiencies, after which the administrative proceeding will be deemed withdrawn without prejudice to submission of a different complaint by Complainant.

(c) The date of commencement of the administrative proceeding shall be the date on which the Provider completes its responsibilities under Paragraph 2(a) in connection with forwarding the Complaint to the Respondent.

(d) The Provider shall immediately notify the Complainant, the Respondent, the concerned Registrar(s), and ICANN of the date of commencement of the administrative proceeding.

5. The Response

(a) Within twenty (20) days of the date of commencement of the administrative proceeding the Respondent shall submit a response to the Provider.

(b) The response shall be submitted in hard copy and (except to the extent not available for annexes) in electronic form and shall:

(i) Respond specifically to the statements and allegations contained in the complaint and include any and all bases for the Respondent (domain-name holder) to retain registration and use of the disputed domain name (This portion of the response shall comply with any word or page limit set forth in the Provider's Supplemental Rules.);

(ii) Provide the name, postal and e-mail addresses, and the telephone and telefax numbers of the Respondent (domain-name holder) and of any representative authorized to act for the Respondent in the administrative proceeding;

(iii) Specify a preferred method for communications directed to the Respondent in the administrative proceeding (including person to be contacted, medium, and address information) for each of (A) electronic-only material and (B) material including hard copy;

(iv) If Complainant has elected a single-member panel in the Complaint (see Paragraph 3(b)(iv)), state whether Respondent elects instead to have the dispute decided by a three-member panel;

(v) If either Complainant or Respondent elects a three-member Panel, provide the names and contact details of three candidates to serve as one of the Panelists (these candidates may be drawn from any ICANN-approved Provider's list of panelists);

(vi) Identify any other legal proceedings that have been commenced or terminated in connection with or relating to any of the domain name(s) that are the subject of the complaint;

(vii) State that a copy of the response has been sent or transmitted to the Complainant, in accordance with Paragraph 2(b); and

(viii) Conclude with the following statement followed by the signature of the Respondent or its authorized representative:

"Respondent certifies that the information contained in this Response is to the best of Respondent's knowledge complete and accurate, that this Response is not being presented for any improper purpose, such as to harass, and that the assertions in this Response are warranted under these Rules and under applicable law, as it now exists or as it may be extended by a good-faith and reasonable argument."; and

(ix) Annex any documentary or other evidence upon which the Respondent relies, together with a schedule indexing such documents.

(c) If Complainant has elected to have the dispute decided by a single-member Panel and Respondent elects a three-member Panel, Respondent shall be required to pay one-half of the applicable fee for a three-member Panel as set forth in the Provider's Supplemental Rules. This payment shall be made together with the submission of the response to the Provider. In the event that the required payment is not made, the dispute shall be decided by a single-member Panel.

(d) At the request of the Respondent, the Provider may, in exceptional cases, extend the period of time for the filing of the response. The period may also be extended by written stipulation between the Parties, provided the stipulation is approved by the Provider.

(e) If a Respondent does not submit a response, in the absence of exceptional circumstances, the Panel shall decide the dispute based upon the complaint.

6. Appointment of the Panel and Timing of Decision

(a) Each Provider shall maintain and publish a publicly available list of panelists and their qualifications.

(b) If neither the Complainant nor the Respondent has elected a three-member Panel (Paragraphs 3(b)(iv) and 5(b)(iv)), the Provider shall appoint, within five (5) calendar days following receipt of the response by the Provider, or the lapse of the time period for the submission thereof, a single Panelist from its list of

panelists. The fees for a single-member Panel shall be paid entirely by the Complainant.

(c) If either the Complainant or the Respondent elects to have the dispute decided by a three-member Panel, the Provider shall appoint three Panelists in accordance with the procedures identified in Paragraph 6(e). The fees for a three-member Panel shall be paid in their entirety by the Complainant, except where the election for a three-member Panel was made by the Respondent, in which case the applicable fees shall be shared equally between the Parties.

(d) Unless it has already elected a three-member Panel, the Complainant shall submit to the Provider, within five (5) calendar days of communication of a response in which the Respondent elects a three-member Panel, the names and contact details of three candidates to serve as one of the Panelists. These candidates may be drawn from any ICANN-approved Provider's list of panelists.

(e) In the event that either the Complainant or the Respondent elects a three-member Panel, the Provider shall endeavor to appoint one Panelist from the list of candidates provided by each of the Complainant and the Respondent. In the event the Provider is unable within five (5) calendar days to secure the appointment of a Panelist on its customary terms from either Party's list of candidates, the Provider shall make that appointment from its list of panelists. The third Panelist shall be appointed by the Provider from a list of five candidates submitted by the Provider to the Parties, the Provider's selection from among the five being made in a manner that reasonably balances the preferences of both Parties, as they may specify to the Provider within five (5) calendar days of the Provider's submission of the five-candidate list to the Parties.

(f) Once the entire Panel is appointed, the Provider shall notify the Parties of the Panelists appointed and the date by which, absent exceptional circumstances, the Panel shall forward its decision on the complaint to the Provider.

7. Impartiality and Independence

A Panelist shall be impartial and independent and shall have, before accepting appointment, disclosed to the Provider any circumstances giving rise to justifiable doubt as to the Panelist's impartiality or independence. If, at any stage during the administrative proceeding, new circumstances arise that could give rise to justifiable doubt as to the impartiality or independence of the Panelist, that Panelist shall promptly disclose such circumstances to the Provider. In such event, the Provider shall have the discretion to appoint a substitute Panelist.

8. Communication Between Parties and the Panel

No Party or anyone acting on its behalf may have any unilateral communication with the Panel. All communications between a Party and the Panel or the Provider shall be made to a case administrator appointed by the Provider in the manner prescribed in the Provider's Supplemental Rules.

9. Transmission of the File to the Panel

The Provider shall forward the file to the Panel as soon as the Panelist is appointed in the case of a Panel consisting of a single member, or as soon as the last Panelist is appointed in the case of a three-member Panel.

10. General Powers of the Panel

(a) The Panel shall conduct the administrative proceeding in such manner as it considers appropriate in accordance with the Policy and these Rules.

(b) In all cases, the Panel shall ensure that the Parties are treated with equality and that each Party is given a fair opportunity to present its case.

(c) The Panel shall ensure that the administrative proceeding takes place with due expedition. It may, at the request of a Party or on its own motion, extend, in exceptional cases, a period of time fixed by these Rules or by the Panel.

(d) The Panel shall determine the admissibility, relevance, materiality and weight of the evidence.

(e) A Panel shall decide a request by a Party to consolidate multiple domain name disputes in accordance with the Policy and these Rules.

11. Language of Proceedings

(a) Unless otherwise agreed by the Parties, or specified otherwise in the Registration Agreement, the language of the administrative proceeding shall be the language of the Registration Agreement, subject to the authority of the Panel to determine otherwise, having regard to the circumstances of the administrative proceeding.

(b) The Panel may order that any documents submitted in languages other than the language of the administrative proceeding be accompanied by a translation in whole or in part into the language of the administrative proceeding.

12. Further Statements

In addition to the complaint and the response, the Panel may request, in its sole discretion, further statements or documents from either of the Parties.

13. In-Person Hearings

There shall be no in-person hearings (including hearings by teleconference, video-conference, and web conference), unless the Panel determines, in its sole discretion and as an exceptional matter, that such a hearing is necessary for deciding the complaint.

14. Default

(a) In the event that a Party, in the absence of exceptional circumstances, does not comply with any of the time periods established by these Rules or the Panel, the Panel shall proceed to a decision on the complaint.

(b) If a Party, in the absence of exceptional circumstances, does not comply with any provision of, or requirement under, these Rules or any request from the Panel, the Panel shall draw such inferences therefrom as it considers appropriate.

15. Panel Decisions

(a) A Panel shall decide a complaint on the basis of the statements and documents submitted and in accordance with the Policy, these Rules and any rules and principles of law that it deems applicable.

(b) In the absence of exceptional circumstances, the Panel shall forward its decision on the complaint to the Provider within fourteen (14) days of its appointment pursuant to Paragraph 6.

(c) In the case of a three-member Panel, the Panel's decision shall be made by a majority.

(d) The Panel's decision shall be in writing, provide the reasons on which it is based, indicate the date on which it was rendered and identify the name(s) of the Panelist(s).

(e) Panel decisions and dissenting opinions shall normally comply with the guidelines as to length set forth in the Provider's Supplemental Rules. Any dissenting opinion shall accompany the majority decision. If the Panel concludes that the dispute is not within the scope of Paragraph 4(a) of the Policy, it shall so state. If after considering the submissions the Panel finds that the complaint was brought in bad faith, for example in an attempt at Reverse Domain Name Hijacking or was brought primarily to harass the domain-name holder, the Panel shall declare in its decision that the complaint was brought in bad faith and constitutes an abuse of the administrative proceeding.

16. Communication of Decision to Parties

(a) Within three (3) calendar days after receiving the decision from the Panel, the Provider shall communicate the full text of the decision to each Party, the concerned Registrar(s), and ICANN. The concerned Registrar(s) shall immediately communicate to each Party, the Provider, and ICANN the date for the implementation of the decision in accordance with the Policy.

(b) Except if the Panel determines otherwise (see Paragraph 4(i) of the Policy), the Provider shall publish the full decision and the date of its implementation on a publicly accessible web site. In any event, the portion of any decision determining a complaint to have been brought in bad faith (see Paragraph 15(e) of these Rules) shall be published.

17. Settlement or Other Grounds for Termination

(a) If, before the Panel's decision, the Parties agree on a settlement, the Panel shall terminate the administrative proceeding.

(b) If, before the Panel's decision is made, it becomes unnecessary or impossible to continue the administrative proceeding for any reason, the Panel shall terminate the administrative proceeding, unless a Party raises justifiable grounds for objection within a period of time to be determined by the Panel.

18. Effect of Court Proceedings

(a) In the event of any legal proceedings initiated prior to or during an administrative proceeding in respect of a domain-name dispute that is the subject of the complaint, the Panel shall have the discretion to decide whether to suspend or terminate the administrative proceeding, or to proceed to a decision.

(b) In the event that a Party initiates any legal proceedings during the pendency of an administrative proceeding in respect of a domain-name dispute that is the subject of the complaint, it shall promptly notify the Panel and the Provider. See Paragraph 8 above.

19. Fees

(a) The Complainant shall pay to the Provider an initial fixed fee, in accordance with the Provider's Supplemental Rules, within the time and in the amount required. A Respondent electing under Paragraph 5(b)(iv) to have the dispute decided by a three-member Panel, rather than the single-member Panel elected by the Complainant, shall pay the Provider one-half the fixed fee for a three-member Panel. See Paragraph 5(c). In all other cases, the Complainant shall bear all of the Provider's fees, except as prescribed under Paragraph 19(d). Upon

appointment of the Panel, the Provider shall refund the appropriate portion, if any, of the initial fee to the Complainant, as specified in the Provider's Supplemental Rules.

(b) No action shall be taken by the Provider on a complaint until it has received from Complainant the initial fee in accordance with Paragraph 19(a).

(c) If the Provider has not received the fee within ten (10) calendar days of receiving the complaint, the complaint shall be deemed withdrawn and the administrative proceeding terminated.

(d) In exceptional circumstances, for example in the event an in-person hearing is held, the Provider shall request the Parties for the payment of additional fees, which shall be established in agreement with the Parties and the Panel.

20. Exclusion of Liability

Except in the case of deliberate wrongdoing, neither the Provider nor a Panelist shall be liable to a Party for any act or omission in connection with any administrative proceeding under these Rules.

21. Amendments

The version of these Rules in effect at the time of the submission of the complaint to the Provider shall apply to the administrative proceeding commenced thereby. These Rules may not be amended without the express written approval of ICANN.

APPENDIX B

15 U.S.C. §§1125. False designations of origin; false description or representation

(a) (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which--

(A) is likely to cause confusion, or to cause mistake, or to deceive as to the affiliation, connection, or association of such person with another person, or as to the origin, sponsorship, or approval of his or her goods, services, or commercial activities by another person, or

(B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

(2) As used in this subsection, the term "any person" includes any State, instrumentality of a State or employee of a State or instrumentality of a State acting in his or her official capacity. Any State, and any such instrumentality, officer, or employee, shall be subject to the provisions of this Act in the same manner and to the same extent as any nongovernmental entity.

(3) In a civil action for trade dress infringement under this Act for trade dress not registered on the principal register, the person who asserts trade dress protection has the burden of proving that the matter sought to be protected is not functional.

(b) Any goods marked or labeled in contravention of the provisions of this section shall not be imported into the United States or admitted to entry at any customhouse of the United States. The owner, importer, or consignee of goods refused entry at any customhouse under this section may have any recourse by protest or appeal that is given under the customs revenue laws or may have the remedy given by this Act in cases involving goods refused entry or seized.

(c) (1) The owner of a famous mark shall be entitled, subject to the principles of equity and upon such terms as the court deems reasonable, to an injunction against another person's commercial use in commerce of a mark or trade name, if such use begins after the mark has become famous and causes dilution of the distinctive quality of the mark, and to obtain such other relief as is provided in this subsection. In determining whether a mark is distinctive and famous, a court may consider factors such as, but not limited to--

(A) the degree of inherent or acquired distinctiveness of the mark;

(B) the duration and extent of use of the mark in connection with the goods or services with which the mark is used;

(C) the duration and extent of advertising and publicity of the mark;

(D) the geographical extent of the trading area in which the mark is used;

(E) the channels of trade for the goods or services with which the mark is used;

(F) the degree of recognition of the mark in the trading areas and channels of trade used by the mark's owner and the person against whom the injunction is sought;

(G) the nature and extent of use of the same or similar marks by third parties; and

(H) whether the mark was registered under the Act of March 3, 1881, or the Act of February 20, 1905, or on the principal register.

(2) In an action brought under this subsection, the owner of the famous mark shall be entitled only to injunctive relief as set forth in section 34 unless the person against whom the injunction is sought willfully intended to trade on the owner's reputation or to cause dilution of the famous mark. If such willful intent is proven, the owner of the famous mark shall also be entitled to the remedies set forth in sections 35(a) and 36, subject to the discretion of the court and the principles of equity.

(3) The ownership by a person of a valid registration under the Act of March 3, 1881, or the Act of February 20, 1905, or on the principal register shall be a complete bar to an action against that person, with respect to the mark, that is brought by another person under the common law or a statute of a State and that seeks to prevent dilution of the distinctiveness of a mark, label or form or advertisement.

(4) The following shall not be actionable under this section:

(A) Fair use of a famous mark by another person in comparative commercial advertising or promotion to identify the competing goods or services of the owner of the famous mark.

(B) Noncommercial use of a mark.

(C) All forms of news reporting and news commentary.

(d)(1)(A) A person shall be liable in a civil action by the owner of a mark, including a personal name which is protected as a mark under this section, if, without regard to the goods or services of the parties, that person--

(i) has a bad faith intent to profit from that mark, including a personal name which is protected as a mark under this section; and

(ii) registers, traffics in, or uses a domain name that--

(I) in the case of a mark that is distinctive at the time of registration of the domain name, is identical or confusingly similar to that mark;

(II) in the case of a famous mark that is famous at the time of registration of the domain name, is identical or confusingly similar to or dilutive of that mark; or

(III) is a trademark, word, or name protected by reason of section 706 of title 18, United States Code, or section 220506 of title 36, United States Code.

(B)(i) In determining whether a person has a bad faith intent described under subparagraph (A), a court may consider factors such as, but not limited to--

(I) the trademark or other intellectual property rights of the person, if any, in the domain name;

(II) the extent to which the domain name consists of the legal name of the person or a name that is otherwise commonly used to identify that person;

(III) the person's prior use, if any, of the domain name in connection with the bona fide offering of any goods or services;

(IV) the person's bona fide noncommercial or fair use of the mark in a site accessible under the domain name;

(V) the person's intent to divert consumers from the mark owner's online location to a site accessible under the domain name that could harm the goodwill represented by the mark, either for commercial gain or with the intent to tarnish or disparage the mark, by creating a likelihood of confusion as to the source, sponsorship, affiliation, or endorsement of the site;

(VI) the person's offer to transfer, sell, or otherwise assign the domain name to the mark owner or any third party for financial gain without having used, or having an intent to use, the domain name in the bona fide offering of any goods or services, or the person's prior conduct indicating a pattern of such conduct;

(VII) the person's provision of material and misleading false contact information when applying for the registration of the domain name, the

person's intentional failure to maintain accurate contact information, or the person's prior conduct indicating a pattern of such conduct;

(VIII) the person's registration or acquisition of multiple domain names which the person knows are identical or confusingly similar to marks of others that are distinctive at the time of registration of such domain names, or dilutive of famous marks of others that are famous at the time of registration of such domain names, without regard to the goods or services of the parties; and

(IX) the extent to which the mark incorporated in the person's domain name registration is or is not distinctive and famous within the meaning of subsection (c)(1) of section 43.

(ii) Bad faith intent described under subparagraph (A) shall not be found in any case in which the court determines that the person believed and had reasonable grounds to believe that the use of the domain name was a fair use or otherwise lawful.

(C) In any civil action involving the registration, trafficking, or use of a domain name under this paragraph, a court may order the forfeiture or cancellation of the domain name or the transfer of the domain name to the owner of the mark.

(D) A person shall be liable for using a domain name under subparagraph (A) only if that person is the domain name registrant or that registrant's authorized licensee.

(E) As used in this paragraph, the term "traffics in" refers to transactions that include, but are not limited to, sales, purchases, loans, pledges, licenses, exchanges of currency, and any other transfer for consideration or receipt in exchange for consideration.

(2)(A) The owner of a mark may file an in rem civil action against a domain name in the judicial district in which the domain name registrar, domain name registry, or other domain name authority that registered or assigned the domain name is located if--

(i) the domain name violates any right of the owner of a mark registered in the Patent and Trademark Office, or protected under subsection (a) or (c); and

(ii) the court finds that the owner--

(l) is not able to obtain in personam jurisdiction over a person who would have been a defendant in a civil action under paragraph (1); or

(II) through due diligence was not able to find a person who would have been a defendant in a civil action under paragraph (1) by--

(aa) sending a notice of the alleged violation and intent to proceed under this paragraph to the registrant of the domain name at the postal and e-mail address provided by the registrant to the registrar; and

(bb) publishing notice of the action as the court may direct promptly after filing the action.

(B) The actions under subparagraph (A)(ii) shall constitute service of process.

(C) In an in rem action under this paragraph, a domain name shall be deemed to have its situs in the judicial district in which--

(i) the domain name registrar, registry, or other domain name authority that registered or assigned the domain name is located; or

(ii) documents sufficient to establish control and authority regarding the disposition of the registration and use of the domain name are deposited with the court.

(D)(i) The remedies in an in rem action under this paragraph shall be limited to a court order for the forfeiture or cancellation of the domain name or the transfer of the domain name to the owner of the mark. Upon receipt of written notification of a filed, stamped copy of a complaint filed by the owner of a mark in a United States district court under this paragraph, the domain name registrar, domain name registry, or other domain name authority shall--

(I) expeditiously deposit with the court documents sufficient to establish the court's control and authority regarding the disposition of the registration and use of the domain name to the court; and

(II) not transfer, suspend, or otherwise modify the domain name during the pendency of the action, except upon order of the court.

(ii) The domain name registrar or registry or other domain name authority shall not be liable for injunctive or monetary relief under this paragraph except in the case of bad faith or reckless disregard, which includes a willful failure to comply with any such court order.

(3) The civil action established under paragraph (1) and the in rem action established under paragraph (2), and any remedy available under either such action, shall be in addition to any other civil action or remedy otherwise applicable.

(4) The in rem jurisdiction established under paragraph (2) shall be in addition to any other jurisdiction that otherwise exists, whether in rem or in personam.

(Amended Nov. 16, 1988, 102 Stat. 3946; Oct. 27, 1992, 106 Stat. 3567; Jan. 16, 1996, 109 Stat. 985; Aug. 5, 1999, 113 Stat. 218; Nov. 29, 1999, 113 Stat. 1501A-545.)

**TRENDS AND LEGAL CONSEQUENCES
IN E-COMMERCE**

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Wilmington, Delaware*

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SECTION F

*TRENDS AND LEGAL
CONSEQUENCES IN E-COMMERCE*

F-1

University Of Kentucky
Computer Law Institute

DONALD A. COHN

March 2001

TRENDS

- Focus on Three Megatrends**
 - The Public Infrastructure**
 - New Employment Rules**
 - Globalization of E Business**

TRENDS

RISK IS GOOD!!!!

DUMB ----- SMART

HIGH ----- LOW

- Risks Can Be High and Dumb
- Risks Can Be Low and Smart

Public Infrastructure

- Building Blocks
 - Technology
 - Business
 - Legal
 - Security
- Are All of the Building Blocks Ready for Prime Time?
- **KEY ISSUE IS “BUSINESS CONTINUITY”**
 - Gartner Group Expects 60% of the Approx. 500 ASP’s In Existence to Fail This Year (Info Week)
 - Bankruptcy or Acquisition

Business Issues

- **Technology Seems To Be Ready For Some App's**
- **Most Buyers Wants Small Company Pricing and Big Company Business Continuity Reliability and Security**
- **Vendors Are Relatively Small and Possibly Transient**
- **How Fast Should We Go in Migration?**
- **How Do We Manage Individual Outsourcing?**
- **What Is the Right Business Model**
- **Experimentation**

Business Issues

- **The Internet is Free - “+’s & “-’s”**
 - **Companies not have to invest in infrastructure**
 - **railroads**
 - **phones**
 - **telegraph**
 - **Radio and TV stations**
 - **Can vendors make enough money**
 - **Right now the pricing point seems to be “Free”**
 - **No competitive advantage from:**
 - **Investment in solely owned infrastructure**
 - **Intellectual Property**

FREE AGENCY PHENOMENUM

- Free Data Storage On Internet Servers**
- Free E-mail**
- Free Applications**
- Global Reach**
- Mass Independence-technology Enabled Employees**
 - Private Outsourcing**
 - Individual Has Complete Control Of Company Data And Applications**

FREE AGENCY PHENOMENUM

- In A Wired Society There Are No Secrets**
- Implications For Business**
 - Policies To Address These Issues**
 - Companies Must Provide Easy, Fast, Up To Date Solutions For Employees To Minimize Free Agency**
- Examples**



th@nk free

-
- HOME
-
- FIND OUT MORE
-
- PARTNERS
-
- ABOUT US
-
- IN THE NEWS



OUR MISSION IS

FROM CUBICLE CONFINEMENT.

Current Members:

USER ID:

PASSWORD:

LOGIN

[FORGOT YOUR PASSWORD?](#)

[AOL USERS](#)

[THINKFREE OFFICE STANDARD EDITION NOW AVAILABLE](#)



[THINKFREE OFFICE OFFLINE INSTALLER](#)

[THINKFREE RELEASE NOTES](#)
ThinkFree Office 1.5
Release 6



ThinkFree Office

YOUR WORKPLACE IN CYBERSPACE™

 ThinkFree Office™ is anywhere,
anytime computing. Now you can sit
down at any computer with a web
browser and run our 

YOUR WORKPLACE IN CYBERSPACE

LOGIN

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ThinkFree Office 1.5

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Released - September 1, 2000

 ThinkFree Office™ is anywhere,

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- Free worldwide PC-to-PC voice calling over the Internet
- Integrated PC-based voice mail
- Video calling and video mail
- File and picture transfer



INSTALL IT NOW!

HOME

F-11

http://driveway.com/



Your Smart Drive on the Web

Member Name

LOG ON

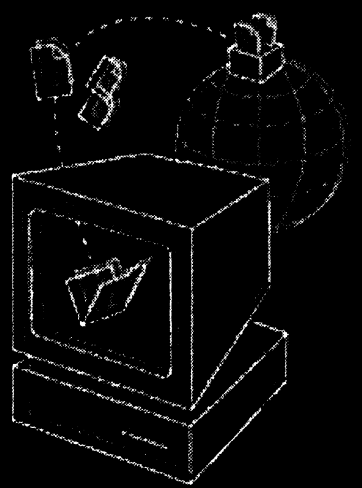
Password

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25 MB of free storage!

SIGN UP

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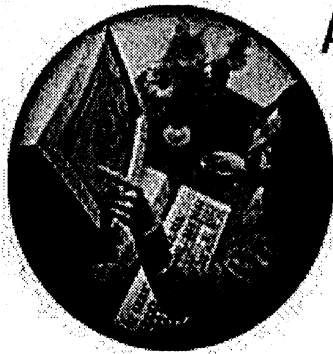
HOME

BECOME A MEMBER

ATTEND

ABOUT My.PLACEWARE

HELP



A New Communications Medium
for **LIVE**, Interactive **MEETINGS**
over the **INTERNET**.

View the QuickTour

Already a Member?

With
MY.PLACEWARE
You Can:

- ✓ Schedule web meetings
- ✓ Present and demonstrate
- ✓ Interact in real-time



Register Now
click here

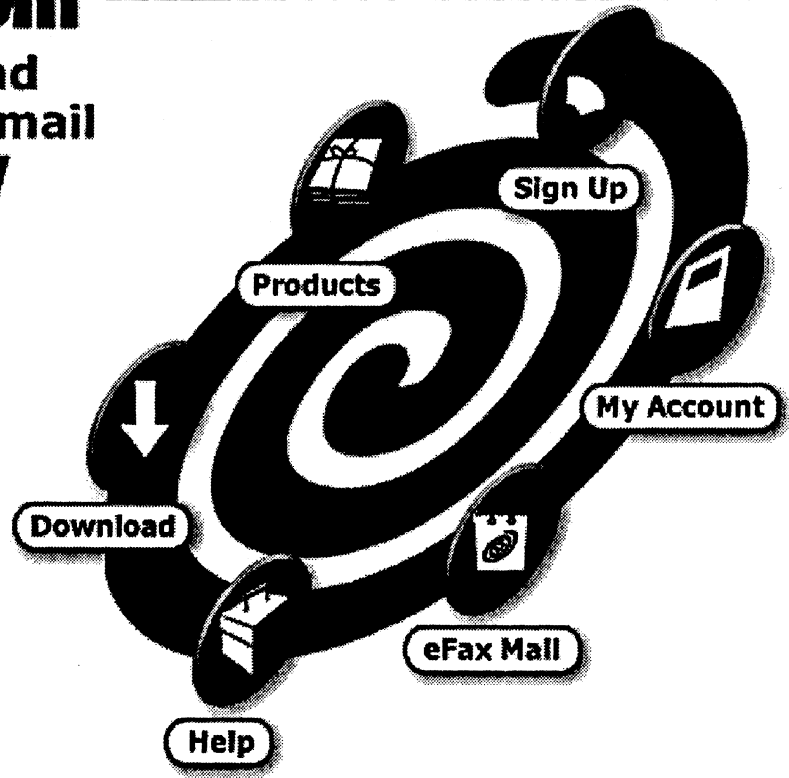


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Get facts fast: **go**



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What's New!

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eFax Corporate

eFax wireless
HARDCOPY

eFax toolkit

Your First 500 Pages FREE!

Click Here For Details
Broadcast faxes!

eFax Send
for the Web

F-14



Welcome to Dialpad

Make FREE unlimited long distance phone calls to anyone in the U.S. There's nothing to download or install. Make calls while you're online.



user login

User Name

Password
 GO

[Forgot Password?](#)

- [what's dialpad?](#)
- [about us](#)
- [jobs](#)
- [contact](#)



Over 10 Million people are using Dialpad to make free, long-distance calls.

Join Now
[click here](#)

System Requirements:
Microsoft Windows 95/98/NT, MS Internet Explorer 4.0 or better/ Netscape Navigator 4.5 or better, Internet connection, sound card, & headset.

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[click here](#)

Visit our store to get the best buys on headsets and other great products!

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dialpadAgent
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- Let friends know you're online!
- Automatic login.

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F-15



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REGISTERED USERS

user name:

password:

Remember me

Auto login

VISIT AN I-DRIVE

desktop (http://i-drive.com)

Save

NEWS FOR USERS

Your FREE Personal Space on the Web



"i-drive is my favorite."
—Newsweek May 4, 2000

- Access your files from anywhere
- Save big media files in seconds
- Create music playlists and photo albums
- Clip and save Web pages
- [Learn more](#)

i-drive introduces **drag and drop!**

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Stream MP3s right off your i-Drive. [More...](#)

Make Photo Albums!

Create your own. Check out ours. [More...](#)

Get Games and Software!

Cool games and software at ZDNet. [More...](#)

Save the Web!

With Fido, collect and save web pages. [More...](#)

Share Your Files!

Share your music and photos with friends. [More...](#)

Add i-drive to your desktop

Drag and drop desktop files right into your i-Drive. [More...](#)

F-16

Public Infrastructure Migration

- **Public Infrastructure Becoming Industrial Strength**
 - **Becoming Superior to Private Internal Networks**
 - **Downtime**
 - **Capability**
 - **Cutting Edge Applications**
 - **Improving Faster Than Private Networks**
 - **Cost Reduction Will Drive Trend From User Perspective**
 - **Economies of Scale**
 - **Capability to Access and Use Anywhere on Any System**

The Migration

- **Revenue Stream Will Drive Trend From Vendor Perspective**
 - **Equipment Purchases and Leases Are Not Cost Effective**
 - **Moore's Law**
 - **Machines Outpacing Our Ability to Use Them**
 - **Software Has Not Kept up**
 - **Transition From Product Revenues to Service Revenues**
 - **Rapid Change in This Direction**
 - **Open Source Software Will Become Trend**
 - **Free “Technology” Will Set Pricing Point**

Impact

- **Companies Will Have to Deal With Multiple Vendors on the Web**
 - **Offering Slices of the Infrastructure**
 - **No Single Source Solution to Date**
 - **Interoperability? Not Soon / Maybe Never**
 - **Lose of Control of Company Critical Infrastructure**

Impact

- **Requires Businesses to Develop and Have a Much More Flexible Perspective**
 - **Ability to Move From One Vendor to Another Quickly**
 - **Multiple Vendors to Provide Cushion**
 - **Ride Evolution of Technology to Meet New Business Needs**
 - **Business Continuity - a Key Issue**

Legal Issues

- **Business Continuity**
 - **Bankruptcy**
 - **Voiding of Contracts**
 - **Sale of Software & Data**
 - **Vendor Default**
 - **DuPont Default**
 - **Termination Assistance**
 - **Disaster Recovery**
 - **Software Escrows - False Security**

Legal Issues

- **Contracting**
 - **Risk Allocation**
 - **Indemnity**
 - **Limitation of Liability**
 - **Warranties**
 - **Generally Vendors Want No Risk**
 - **Indemnify Vendors for Vendors Negligence!!!**
 - **Confidentiality, License, Service & Other Agreements May Not Be Sufficient**
 - **Vendor Cooperation / Integration Provisions**

Legal Issues

- **Contracting**
 - **Like I.T. Outsourcing**
 - **Constant Negotiation**
 - **Long Term Vs. Short Term Agreement**
 - **Pricing Issues After Commit to Outsourcer**
 - **Cost of Managing Relationship**
 - **Performance Goals**
 - **Outages, Down Time, Support Etc.**

Legal Issues

- **Intellectual Property**
 - **Ownership of Data**
 - **E.G. E Mails, Stored Data, Faxes**
 - **Assignment of Rights/Restrictions on Use**
 - **Business Method Patent - the Big Wild Card!**
 - **Can A Company Base a Long Term Business on Informational Intellectual Property?**
 - **Intel. Prop. Registrations, Contract Limitations May Not Be Enough**
 - **Difficult to Advise Clients**
 - **Costs to Defend Rights**
 - **Likelihood of Success**
 - **Law Is Unsettled in Many Areas**

Legal Issues

- **Security**
 - **Company Secrets on Non Company Systems**
 - **Restrictions on Use and Access by Vendor and 3rd Parties - Confidentiality**
 - **Violations of Company Privacy Policy**
 - **Vendor Employee Leaves Company**
 - **Hackers**
 - **Businesses Will Have to Reorient and Not Rely Solely on Internal System Security**

Legal Issues

- **Privacy**
 - **Data Transfer Agreements**
 - **EU Directive On Data Protection**
 - **Vendor Audits**
 - **Collection of Information- Notices and Consents**
- **Judgement Proof Vendors**
 - **You Get What You Pay for !!!**
 - **Start Up's Historically Not Worried About Legal Implications**
- **Educating Clients**
 - **Counsel Clients to Understand Legal Implications**

Trends

- **New Employment Rules !!!!!**
 - **The Just in Time Employee - the “New Phenom”**
 - **Labor Auctions on the Web**
 - **Skilled New Economy Workers Day Trading Their Careers**
 - **Based on Scarce Talent Re Demographics**
 - **Career Is a Series of Projects Rather Than a Static Job**
 - **Less Tolerance for Hangers on**
 - **Compensation = Net Present Value of an E-Employee’s Contribution**

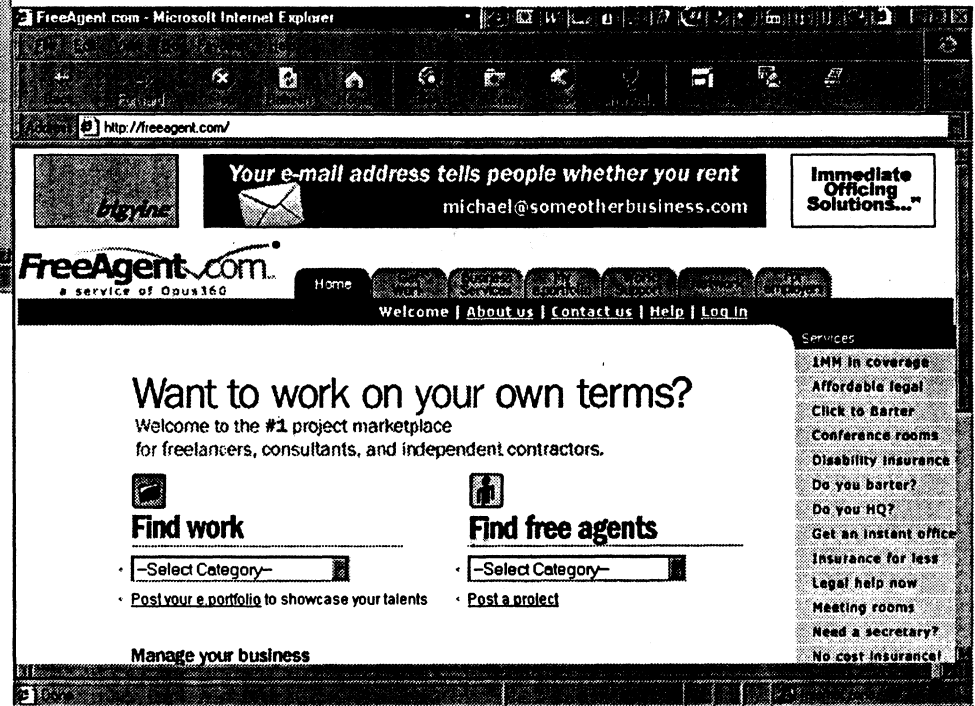
New Employment Rules

– Key Employees

- **Key Employees Kept Within Company**
- **Everything Else Outsourced**
- **Still Most Will Think of Themselves As Free Agents**
- **Impact**
 - **Lonely & Insecure Workers?**
 - **Law of Jungle?**

Website Examples

Monster.com



Freeagent.com

New Employment Rules

- **Legal Implications**
 - **Co-employment & Benefits**
 - **Use of Systems for Both Private and Work Activities**
 - **Who Owns IP Rights to “Employee “ Created Content**
 - **Liability for Workers Actions**
 - **Legal Responsibility for Use of Services, Content, Etc.**
 - **The Beginning of the End of Workers Comp?**
 - **Labor Organizing**

New Employment Rules

- **Legal Implications**
 - **More Litigation With Less Employee Loyalty**
 - **Trade Secrets**
 - **Employee Monitoring Issues**
 - **Privacy Issues**
 - **Internet Use Policy- Any Use?**

Trends

- **Globalization**
 - “E Commerce” to “G Commerce”
 - **E Commerce Work Raises More Fundamental Changes in Legal Practice!!**
 - **Not Just About Internet**
 - **Conflicting Laws**
 - **Need for Global Business and Legal Perspective**
 - **How Provide Global Advice?**
 - E.G. Commercial Law Affiliates
 - **[Http://www.claonline.Org](http://www.claonline.Org)**
 - **New European Alliance**

Globalization

- **Legal Implications**
 - **Conflicting Laws**
 - **Will We Ever Have a Global UCC?**
 - **Taxes**
 - **Privacy**
 - **Antitrust**
 - **Differing Philosophies**

Globalization

- **Legal Implications**
 - **Lawyers Not Trained to Think or Work Globally**
 - **All Commercial Lawyers Will Have to Become More Globally Oriented**
 - **Learn to Work As Part of Global Legal Team**
 - **More Legal Resources Will Be Needed**
 - **Attorney Retooling**
 - **Client Education**
 - **Networks of Lawyers**
 - **Business Opportunity for Legal Profession**

Globalization

- **Opacity Index “ the O Factor”**
 - **PWC Launches First Global Index That Measures the Impact of Business, Economic, Legal and Ethical Opacity on Cost of Capital Around the World**
 - **Legal Protection for Business Tops the Factors List**

Globalization

- **Check List for “Globalized” Commercial Lawyers**
 - **Basics of Civil Law System**
 - **International Contract Law**
 - **Customs and Trade Law**
 - **Competition and Trade Practice Law**
 - **Intellectual Property Law**
 - **International Dispute Resolution**
 - **International Taxation**

Globalization

- **Preliminary Steps To Take**
 - **Increase Interaction Between International Specialists and Domestic Colleagues**
 - **In House and Out Side Counsel**
 - **Presentations on International Legal Subjects**
 - **Have in House Attorneys Participate in Outside Organizations Involved With International Aspects**
 - **ACCA**
 - **ABA**



Question



**TERMS AND CONDITIONS,
INTERNET USER AGREEMENTS AND
CLICK-WRAP AGREEMENTS**

*Cynthia L. Stewart
Frost Brown Todd LLC
Louisville, Kentucky*

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SECTION G

TERMS AND CONDITIONS, INTERNET USER AGREEMENTS AND CLICK-WRAP AGREEMENTS

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SECTION G

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SECTION G

Terms and Conditions, Internet User Agreements and Click-Wrap Agreements

With the movement of old economy brick and mortar businesses on-line and the creation of new business concepts as a result of the capabilities of the Internet, businesses are looking for a means to establish guidelines with respect to the use of their web sites and the conduct of business through such sites. Accordingly, the vast majority of companies have placed on their web sites some form of notice or agreement that purports to govern the relationship between the web site owner and the user. These notices or agreements (later referred to as "User Agreements"), which businesses hope will prove binding upon a web site user, go by several different titles including "Terms & Conditions", "Internet User Agreement", "Terms of Use", "Terms of Service", "Legal Disclaimers", "Conditions of Use" and so on. They also range in content from a mere restatement of applicable law to an agreement to arbitrate disputes between the parties. As Internet commerce has increased, the sophistication of these User Agreements has correspondingly increased and the provisions of these agreements appears limited only by the imagination of a good contract lawyer.

This Article will discuss the enforceability of User Agreements and will then survey the various types of User Agreements currently in use and the category of web sites for which the various User Agreements are appropriate. Finally, this article will provide sample provisions for various types of sites and discuss the applicability of the Digital Millennium Copyright Act to web site providers.

1. Enforceability

To properly begin a discussion on the enforceability of User Agreements, we must first begin with a discussion of ProCD, Inc. v. Zeidenberg, 86 F.3rd 1447 (7th Cir. 1996). The ProCD case was the first significant case relating to the enforceability of shrink-wrap agreements and other similar agreements. In the ProCD case, the Circuit Court held that user terms contained on the inside of a user's manual and on the CD-Rom product itself that restricted the use of the product to non-commercial use were enforceable. The ProCD product consisted of telephone directories that the defendant posted on a web site and licensed to subscribers. The court confirmed that the UCC applied to the transaction and that the terms contained inside the packaged product were enforceable as Zeidenberg did not reject the product after inspecting the product and the terms. The court concluded that "shrinkwrap licenses are enforceable unless their terms are objectionable on grounds applicable to contracts in general (for example, if they violate a rule of positive law, or if they are unconscionable.)" Id. at 1449.

The next important case is Hill v. Gateway 2000, Inc., 105 F. 3rd 1147 (7th Cir. 1997), cert denied, 118 S. Ct. 47 (1998). This case is significant for two reasons. First, the case involved a consumer as opposed to a commercial transaction, and second, the

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Court specifically upheld the enforceability of an arbitration clause. In this case, Mr. Hill ordered a Gateway computer by phone and paid with a credit card. Contained in the box in which the computer was shipped were contract terms that provided, among other terms, certain representations and warranties of Gateway, a mandatory arbitration clause and the right to return the computer for a full refund within 30 days of receipt. Mr. Hill did not return the computer within that time frame, and the Seventh Circuit mandated arbitration for the parties. The enforcement of the arbitration clause by the Seventh Circuit blocked the certification of a class action by Gateway computer purchasers and thereby effectively blocked any additional actions against Gateway on a consumer level. The court noted that "a contract need not be read to be effective; people who accept take on the risk that unread terms may in retrospect prove unwelcome." *Id.* at 1148..

In Hotmail Corporation v. Van Money Pie Inc., et al., 47 U.S.P.Q. 2d (BNA) 1020 (N.D. Ca., April 16, 1998), the contract in question was, for the first time, a click-through agreement. Hotmail offers free e-mail, but to obtain the service, a user is required to click through a terms of service agreement that, among other restrictions, prohibited spam. The defendant in this case used the Hotmail email service to send spam that advertised pornographic materials. The court issued a preliminary injunction in favor of Hotmail, indicating that Hotmail would likely prevail on the merits with respect to its breach of contract claim.

Next comes Ticketmaster Corp., et al. v. Tickets.com, Inc., 54 U.S.P.Q. 2d (BNA) (C.D. Cal. 2000) in which the District Court held that simply posting Terms and Conditions at the bottom of a web site that provided that use of the web site constituted assent to the Terms and Conditions did not create a contract. Tickets.com was deep-linking to pages in Ticketmaster's site for the purpose of permitting customers of Tickets.com to access event tickets that Ticket.com could not provide. Ticketmaster's Terms and Conditions forbade deep linking and the commercial use of Ticketmaster's site and information. Although the District Court dismissed Ticketmaster's claim of breach of contract, several other of Ticketmaster's claims survived, including unfair competition and reverse passing off. In addition, the court granted Ticketmaster the opportunity to amend its complaint to show that Ticket.com had knowledge of the terms set forth in the Terms and Conditions and had manifested its agreement to those terms.

Finally, a recent and interesting case on the subject is Register.com, Inc. v. Verio, Inc., 126 F. Supp. 2d 238 (S.D.N.Y. December 11, 2000). In this case, Verio used a search robot to regularly search the WHOIS database of Register.com to ascertain information regarding domain name registrants. Verio used this information to market its web site development and other services to the registrants. The Register.com agreement provided as follows: "By submitting a WHOIS query, you agree that you will use this Data only for lawful purposes and that, under no circumstances will you use this Data to: (1) allow, enable, or otherwise support the transmission of mass unsolicited, commercial advertising or solicitations via e-mail (spam); or (2) enable high volume, automated, electronic processes that apply to Network Solutions (or its systems). . . . By submitting this query, you agree to abide by this policy." This language appears on the same web site page that delivers the requested information. The court granted a

preliminary injunction in favor of Register.com upholding other claims in addition to breach of contract and indicating that clicking "I agree" in this circumstance was not necessary. Verio had manifested its consent by proceeding to submit a WHOIS query in light of the clearly provided terms of use restrictions.

2. Types of User Agreements

Generally speaking, there appear to be three ways that on-line businesses make use of User Agreements. First, although this approach is becoming less common, some e-businesses merely post a notice outlining (and sometimes enhancing) current copyright and trademark law and reminding users of the application of those laws to that entity's web site. This version of a User Agreement is typically referenced only at the bottom of a home page and is accessible only by clicking on the User Agreement link. While this type of User Agreement may be used for many different types of web sites, it is most appropriately used for the "brochure ware" category of web sites that provide information or self promotion only and do not provide goods or services through the site. An enhanced version of this approach often includes a disclaimer of all warranties that might otherwise apply to the web site. A sample of such a User Agreement is set forth below.

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The second approach that e-businesses take with respect to User Agreements is to attempt to impose on users terms and provisions that can be quite extensive. These User Agreements are typically attached as a link to the home page and provide that use of the site constitutes agreement to the terms. Alternatively, or sometimes in addition, prior to a user being able to complete a transaction on a web site a notice is provided indicating that by completing the transaction, the user is subject to the web site User Agreement. These User Agreements often provide for a particular judicial forum, a choice of law, mandatory arbitration, a limitation of liabilities and a disclaimer of warranties that may include products provided by the company itself, as opposed to third party suppliers. Please refer to Exhibit A to this Article for a copy of the Amazon.com Conditions of Use and the Target.com Terms and Conditions.

The third type of User Agreement is a full blown agreement with terms that are typical in business transactions. This type of agreement is generally implemented as a click through agreement in the context of a business to business transactional site. As discussed below, the use of User Agreements in this context provides a significant opportunity for e-businesses to shift some negotiating power from the purchaser to the provider.

3. Use of User Agreements for Business to Business e-Commerce

Assuming the overuse of User Agreements in the business to consumer context does not bring on unduly harsh legislation or court rulings, the User Agreement in the e-commerce context provides tremendous opportunity for the e-commerce business to benefit from well-drafted provisions. In this context, both parties are sophisticated, so there is no unfairness or unconscionability. However, in exchange for the convenience of conducting business through a web site, the user must yield to the set terms and conditions of the e-business. The offer and acceptance of terms in this case is impersonal, and the e-business typically does not interact with clients who might not like the terms of the User Agreement. Further, there is no opportunity for the "battle of the forms" to take place. The service or product is ordered instantly and is subject to the provider's User Agreement, with no opportunity or forum for objection or providing alternative terms. Finally, as we all know, even sophisticated parties seldom read User Agreements.

To better ensure that the e-business terms and conditions are enforceable, however, the User Agreement should be click through. This approach has been legislatively endorsed by the E-Sign Act. If a User Agreement is not clicked through but is merely a tiny link at the bottom of a home page, a user of the site has ammunition to argue that the user did not receive reasonable notice of the terms of the User Agreement. Because many B to B transactions are significant and not the type that can be easily unwound, this is a risk to be avoided. On the other hand, in-house and outside counsel may face significant resistance from e-businesses with respect to click through agreements. Many e-businesses believe click through agreements to be counter to the smooth flow of e-commerce. E-businesses do not want to slow down or complicate a B to B transaction with a click-through agreement. At this point, the issue is one of risk tolerance. If the risk of not having an agreement in place is high, then the e-business should use a click through agreement or resort to the traditional method of manual signatures. If the risk is not so high, then the e-business may want to use the Amazon.com method described above or merely post the terms and conditions as a link.

Record Keeping. A second complication is the record keeping component of click through agreements. Under the E-Sign Act and general principals of contract law, the e-business must keep sufficient records with respect to clicked through agreements to establish that the user did in fact click through the agreement. The e-business must also be able to produce the version of the agreement that was agreed to. The record keeping component of this process is as important as any other aspect, because with no evidence of an agreement to produce, there is no agreement. Version control and record keeping is especially important because click through agreements tend to change fairly regularly.

4. Sample Provisions for B to B User Agreements.

In light of the above observations, set forth below are sample provisions that all B to B e-commerce companies should consider. Even though the terms and conditions are in a business context, the author still recommends using plain English as much as possible in drafting User Agreements. In addition, the provisions set forth below can be strengthened or watered down, depending on what the particular market will bear. Even in a B to B context, the market is competitive and some providers attempt to get an edge by not offering offensive or overreaching click through agreements.

Sample Provisions

The Rules. First, an e-commerce company has the opportunity to establish the basic rules for the operation of the B to B site. This is a significant opportunity that could often not be accomplished in other contexts, such as when conducting business by phone. This is an opportunity for the business to describe in user friendly terms how the business works, thus explaining why it is appropriate for certain limits to be placed on liability, for the user to assume certain risks and for certain warranties to be disclaimed.

To use the XYZ site and our Services, you must complete a registration form on behalf of yourself or the company (the "User") that will use our Services. By submitting the registration form, you are telling us that you are authorized to sign for and bind the User. You agree to provide to us current, complete and accurate information and to update your information to keep it current. If the User is a company or other entity, the representative of the company or other entity who will be the primary contact as between the company or entity and XYZ (the "Primary Contact") must identify to XYZ those individuals ("Authorized Representatives") who, in addition to the Primary Contact, are authorized to act for the company or other entity with respect to transactions and communications with XYZ or through the XYZ site. A User that is a company or other entity may communicate to or through and otherwise use the XYZ site only through a Primary Contact or an Authorized Representative.

The XYZ site allows you the opportunity to correct or update your information, and change or add Authorized Representatives, on-line as a feature of the site. XYZ may reject an applicant if it determines (in its sole discretion) that the User is not an appropriate User or is not making, nor has not in the past made, proper use of the Services or the site. XYZ need not provide a reason for its rejection.

Additional Rules. In addition, the provider of a B to B site may want to lay out certain rules of behavior for its users. A violation of these rules may also be a criminal or civil violation, but by putting the restrictions in a click through agreement, the violation is also a breach of contract.

Offensive, Libelous or Unlawful Messages; Copyright and Other Restrictions on Use of Service.

(a) **No Offensive Content.** You agree that you will not use, or allow others to use your account, to post, transmit, promote, or facilitate the distribution of any threatening, abusive, libelous, defamatory, obscene, pornographic, profane or otherwise objectionable information of any kind.

(b) **No Illegal Material Or Encouragement Of Illegal Behavior.** You agree that you will not use, or allow others to use, your account to post, transmit, promote, or facilitate the distribution of any unlawful or illegal material, including but not limited to material that would constitute or encourage a criminal offense, give rise to civil liability or otherwise violate any applicable local, state, national or international law. You agree that you will not use this site to commit a crime, or to plan, encourage or help others to commit a crime.

(c) **No Violation Of Copyright, Trademark Or Trade Secret Rights.** You agree that you will not use the site to publish, post, distribute or disseminate another's proprietary information, including but not limited to trademarks, trade secrets or copyrighted information, without the express authorization of the rights holder.

(d) **No "Spamming," Advertisements Or Chain Letters.** You agree that you will not use, or allow others to use your account, to post, transmit, promote, or facilitate the distribution of any unsolicited advertising (including but not limited to mass or bulk e-mail), promotional materials or other forms of solicitation to other individuals or entities. You will not post or transmit requests for money to persons not personally known to you, petitions for signature, chain letters or letters relating to pyramid schemes. Except as specifically permitted by this Site, you will not post or transmit any advertising, promotional materials or any other form of solicitation. We reserve the right, in our sole discretion, to determine whether such post or transmission constitutes an advertisement, promotional material or any other form of solicitation.

(e) **No "Hacking."** You agree that you will not use, or allow others to use your account, to unlawfully access other computers or services, or to cause a disruption of service to other on-line users.

(f) **No System Disruption.** You may not use, or allow others to use, your account to cause disruption of the normal use of the system by others including without limitation disrupting our backbone network, nodes, or services.

(g) **No Impersonation Of Others.** You agree that you will not impersonate another user or otherwise falsify one's user name in e-mail or in any post or transmission to any newsgroup or mailing list or other similar groups or lists.

(h) **No "Viruses."** You agree that you will not use, nor allow others to use, your account to intentionally transmit computer "viruses," or other harmful software programs and that you will use your best efforts to prevent the unintentional transmission of such viruses or other harmful software programs.

XYZ's Right to Remove. XYZ reserves the right not to post any data or materials to, or to remove any data or materials from, its site, without notice to a User and without liability to XYZ. You agree to release XYZ from any claims or allegations that may result from such removal. Further, you agree to release XYZ from any liability or cost arising out of any action or inaction of any other user of the site that is in violation of law or of this or other agreements with XYZ. If you are a

California resident, you waive California Civil Code § 1592, which says: "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor. At the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

Other Standard Provisions. Set forth below are several other standard provisions that an e-business should consider for its User Agreement.

Indemnity. User hereby agrees to, at its own expense, indemnify, defend and hold XYZ harmless from and against any loss, cost, or damages, liability and/or expense arising out of or relating to (a) a third-party claim, action or allegation of infringement based on information, data, files or other content submitted by User, (b) any fraud, manipulation, or breach of this Agreement by User, or (c) any third-party claim, action or allegation brought against XYZ arising out of or relating to a dispute between one or more Users.

NO WARRANTY. YOU AGREE THAT YOU USE THIS WEB SITE AT YOUR OWN RISK. WE HAVE TAKEN COMMERCIALY REASONABLE STEPS TO PROVIDE A SECURE AND EFFECTIVE WEB SITE, HOWEVER, WE ARE SOMETIMES AT THE MERCY OF THIRD PARTIES, ACTS OF GOD AND/OR TECHNOLOGY. THEREFORE, WE DO NOT GUARANTEE CONTINUOUS, UNINTERRUPTED OR SECURE ACCESS TO OUR SITE. FURTHER, WE AND OUR SUPPLIERS PROVIDE THE XYZ.COM WEB SITE AND OUR SERVICES AND PRODUCTS "AS IS" AND WITHOUT ANY WARRANTY OR CONDITION, EXPRESS OR IMPLIED, UNLESS OTHERWISE NOTED. OUR SUPPLIERS MAY MAKE SOME EXPRESS WARRANTIES WITH RESPECT TO THEIR PRODUCTS OR SERVICES, AND TO THE EXTENT THOSE EXIST, SUCH SUPPLIERS WILL SEPARATELY PROVIDE THOSE WARRANTIES TO YOU IN WRITING OR NOTE THEM ON THIS SITE. WE AND OUR SUPPLIERS SPECIFICALLY DISCLAIM THE IMPLIED WARRANTIES OF TITLE, MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE AND NON-INFRINGEMENT WITH RESPECT TO THIS SITE AND ANY GOODS OR SERVICES OFFERED OR SOLD THROUGH THIS SITE. Some states do not allow the disclaimer of implied warranties, so the foregoing disclaimer may not apply to you. Check your local laws for any restrictions or limitations regarding the exclusion of implied warranties.

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YOU AGREE THAT OUR LIABILITY TO YOU IN ANY CASE (WHETHER IN CONTRACT OR TORT) WILL NOT EXCEED AMOUNTS PAID TO US (IF ANY) FOR THE GOODS OR SERVICES OUT OF WHICH THE LIABILITY AROSE. TO THE EXTENT WE MAY HAVE BREACHED ANY TERM OF THIS AGREEMENT, YOU AGREE THAT YOUR ONLY OTHER REMEDY IS TO DISCONTINUE USE OF THIS WEB SITE.

If you are a California resident, you waive California Civil Code § 1592, which says: "A general release does not extend to claims which the creditor does not know or suspect to exist in his favor. At the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

Governing Law. You agree that this Agreement is governed by the laws of the Commonwealth of Kentucky, excluding any application of conflicts of laws rules or principles. You agree that the sole jurisdiction and venue for any litigation arising from your use of, or purchase of products or services through, our site shall be an appropriate federal or state court located in Louisville, Kentucky.

Arbitration. You agree that at any claim or controversy relating to this Agreement or this web site will be settled by binding arbitration in accordance with the Commercial Arbitration Rules of the American Arbitration Association. You agree that any claim or controversy you may have will be arbitrated on an individual basis and will not be consolidated in any arbitration with any claim or controversy of any other party. You agree that the arbitration will be conducted in Louisville, Kentucky and that judgment on the arbitration award may be enforced by any court having proper jurisdiction. You agree that the costs of conducting the arbitration will be divided equally between you and XYZ.com. You or XYZ.com may seek interim or preliminary relief from a court for the

purpose or protecting your or our rights pending the completion of the arbitration; provided, however, that you agree that any legal proceeding arising out of or in connection with this Agreement or our site will be brought by you or us in the appropriate state or federal court in Louisville, Kentucky.

5. Digital Millennium Copyright Act Notice

In October of 1998, Congress enacted the Digital Millennium Copyright Act (the "DMCA"), which addressed many copyright issues pushed to the forefront by the prevalence of the Internet. In particular, the DMCA provides to "service providers" certain safe harbors from monetary damages in the case of vicarious copyright infringement if the service provider meets certain criteria. To begin the analysis, the author notes that the DMCA provides two definitions of "service provider". One definition is clearly meant to include traditional internet service providers. 17 U.S.C. § 512 (k)(1)(A). However, the other definition in the DMCA for "service provider" is quite broad including any "provider of online services or network access, or the operator of facilities therefor". 17 U.S.C. § 512 (k) (1)(B). This definition is broad enough to include businesses that provide networked systems, in addition to practically all companies that maintain a publicly accessible web site.

Generally, under the DMCA, a service provider (defined in the broader sense) can qualify for the DMCA safe harbor (meaning the service provider will not be liable for monetary damages as a result of a copyright infringement) if the service provider: (1) did not have actual knowledge that the material was infringing; (2) was not aware of facts or circumstances from which infringing activity would be apparent; (3) upon obtaining such knowledge or awareness, acted expeditiously to remove, or disable access to, the material; (4) did not receive a financial benefit directly attributable to the infringing activity; and (5) upon notification of the claimed infringement responded promptly to remove, or disable access to, the material claimed to be infringing. 17 U.S.C. § 512 (c) (1). To receive the benefit of the safe harbor, however, the service provider must provide on its web site a means for those who believe their copyright to have been infringed to provide notice to the service provider through a designated agent. 17 U.S.C. § 512 (c)(2) (See Exhibit 2 for sample notices.) In addition, the service provider must file with U.S. Copyright Office the name of the designated agent and other information requested by the Copyright Office. *Id.* (See Exhibit 3 for the most recent version of the information form that can be used to convey the required information to the Copyright Office.)

In a case of first impression on the notice issue, the Fourth Circuit recently held that a notice from a complaining party with respect to alleged copyright infringement that substantially complies with the notice requirements is all that is needed to alert the service provider that it needs to take action. ALS Scan Inc. v. Remarq Communities Inc., 4th Cir., No. 00-1351, 1/6/02). In the ALS Scan case, ALS Scan notified Remarq, an internet service provider, that two newsgroups to which Remarq provided access contained hundreds of postings by users that infringed ALS Scan's copyrights. Remarq responded by stating that it would remove the infringing materials if ALS Scan would

identify them "with sufficient specificity". ALS Scan stated that the newsgroups contained more than 10,000 infringing images and requested that the newsgroups be discontinued. The District Court held that ALS Scan's notice was sufficient to provide notice to Remarq under the DMCA and Remarq was therefore required to act in compliance with the DMCA to preserve its immunity to monetary damages for copyright infringement under the DMCA. Id.

While the DCMA was in large part a codification of existing common law, the safe harbor discussed above provides an additional method to reduce risk. While available with little downside from a legal perspective, the author has found some clients reluctant to take advantage of the safe harbor due to the significant increase in the length of the User Agreement as a result of the notice and as to the perception that the risk is relatively low in most cases. To avoid lengthening the User Agreement, an e-business should consider referencing the notice in the User Agreement and then providing a separate link for the notice.

In conclusion, the User Agreement can be an opportunity and effective tool for e-businesses to minimize the risk of conducting business on-line, and at this stage, the provisions that might be inserted into such an agreement are limited only by the imagination of counsel.

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Your order is not complete until you click here:

Purchase Summary

Billing Address:

Cynthia L. Stewart
2204 N. Rose Island Road
Prospect Kentucky 40059
United States

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To be paid by Credit Card

MasterCard: ****-****-****12247

EXP: 02/2004

[EDIT](#)

Purchase Details

Order #1: Cynthia L. Stewart

Cynthia L. Stewart
2204 N. Rose Island Road
Propsect Kentucky 40059
United States

[EDIT](#)

Subtotal of Items: \$16.77

Shipping & Handling: \$4.48

Total Before Tax: \$21.25

Tax: \$0.00

Shipping method: Standard Shipping
Shipping Preference: Ship this when complete

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Total for this Address: \$21.25

Order Items



A Painted House

John Grisham

\$16.77

Availability: Usually ships in 24 hours

Qty: 1 Wrap: None

Message: No Message

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Revised January 31, 2000

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EXHIBIT B

NOTICE AND PROCEDURE FOR MAKING CLAIMS OF COPYRIGHT INFRINGEMENT

We may give notice to our users by means of a general notice on any WDIG Site, electronic mail to a user's e-mail address on our records, or by written communication sent by first class mail to a user's address on our records.

Pursuant to Title 17, United States Code, Section 512(c)(2), notifications of claimed copyright infringement should be sent to Service Provider's Designated Agent. See Notice and Procedure for Making Claims of Copyright Infringement.

Notification must be submitted to the following Designated Agent:

- Service Provider(s): Infoseek Corporation and WDIG
- Name of Agent Designated to Receive Notification of Claimed Infringement: Laurence J. Shapiro
- Full Address of Designated Agent to Which Notification Should be Sent: 500 South Buena Vista Street, Burbank, CA 91521-7710
- Telephone Number of Designated Agent: (818)623-3200
- Facsimile Number of Designated Agent: (818)623-3637
- Email Address of Designated Agent:
designated.agent@dig.com
- Email Address of Designated Agent for ESPN.com:
<http://espn.go.com/sitetools/s/terms.html>

To be effective, the notification must be a written communication that includes the following:

1. A physical or electronic signature of person authorized to act on behalf of the owner of an exclusive right that is allegedly infringed;
2. Identification of the copyrighted work claimed to have been infringed, or multiple copyrighted works at a single online site are covered by a single notification, a representative list of such works at that site;
3. Identification of the material that is claimed to be infringing or to be the subject of infringing activity and that is to be removed or access to which is to be disabled, and information reasonably sufficient to permit the service provider to locate the material;
4. Information reasonably sufficient to permit the service provider to contact the complaining party, such as an address, telephone number, and if available, an electronic mail address at which the complaining party may be contacted;
5. A statement that the complaining party has a good faith belief that use of the material in the manner complained of is not authorized by the copyright owner, its agent, or the law;
6. A statement that the information in the notification is accurate, and under penalty of perjury, that the complaining party is authorized to act on behalf of the owner of an exclusive right that is allegedly infringed.

Digital Millennium Copyright Act Notice

NOTICE TO COPYRIGHT OWNERS

XYZ Corp. respects the intellectual property of others, and we ask our users to do the same.

If you believe that your work has been copied in a way that constitutes copyright infringement, you must provide XYZ's Copyright Agent the following information, which must be in writing:

- i) A physical or electronic signature of a person authorized to act on behalf of the owner of an exclusive right that is allegedly infringed.
- ii) Identification of the copyrighted work claimed to have been infringed, or, if multiple copyrighted works at a single online site are covered by a single notification, a representative list of such works at that site.
- iii) Identification of the material that is claimed to be infringing or to be the subject of infringing activity and that is to be removed or access to which is to be disabled, and information reasonably sufficient to permit XYZ Corp. to locate the material.
- iv) Information reasonably sufficient to permit XYZ Corp. to contact the complaining party, such as an address, telephone number, and, if available, an e-mail address at which the complaining party may be contacted.
- v) A statement that the complaining party has a good faith belief that use of the material in the manner complained of is not authorized by the copyright owner, its agent, or the law.
- vi) A statement that the information in the notification is accurate, and under penalty of perjury, that the complaining party is authorized to act on behalf of the owner of an exclusive right that is allegedly infringed.

XYZ Corp.'s Designated Agent for Notice of claims of copyright infringement is _____, who can be reached as follows:

By U.S. mail: _____

By e-mail: _____

By Phone: _____

By Fax: _____

Copyright Agent

Yahoo! respects the intellectual property of others, and we ask our users to do the same. Yahoo! may, in appropriate circumstances and at its discretion, terminate the accounts of users who infringe the intellectual property rights of others.

If you believe that your work has been copied in a way that constitutes copyright infringement, please provide Yahoo!'s Copyright Agent the following information:

1. an electronic or physical signature of the person authorized to act on behalf of the owner of the copyright interest;
2. a description of the copyrighted work that you claim has been infringed;
3. a description of where the material that you claim is infringing is located on the site;
4. your address, telephone number, and email address;
5. a statement by you that you have a good faith belief that the disputed use is not authorized by the copyright owner, its agent, or the law;
6. a statement by you, made under penalty of perjury, that the above information in your Notice is accurate and that you are the copyright owner or authorized to act on the copyright owner's behalf.

Yahoo!'s Copyright Agent for Notice of claims of copyright infringement can be reached as follows:

By mail:

Anthony P. Coll
c/o Yahoo! Inc.
3400 Central Expressway
Santa Clara, CA 95051

By phone:

(408) 530-5080

By fax:

(408) 992-7398

By email:

copyright@yahoo-inc.com

EXHIBIT C

**Interim Designation of Agent to Receive Notification
of Claimed Infringement**

Full Legal Name of Service Provider: _____

Alternative Name(s) of Service Provider (including all names under which the service provider is doing business): _____

Address of Service Provider: _____

**Name of Agent Designated to Receive
Notification of Claimed Infringement:** _____

Full Address of Designated Agent to which Notification Should be Sent (a P.O. Box or similar designation is not acceptable except where it is the only address that can be used in the geographic location):

Telephone Number of Designated Agent: _____

Facsimile Number of Designated Agent: _____

Email Address of Designated Agent: _____

Signature of Officer or Representative of the Designating Service Provider:
_____ **Date:** _____

Typed or Printed Name and Title: _____

**Note: This Interim Designation Must be Accompanied by a \$20 Filing Fee
Made Payable to the Register of Copyrights.**

**Amended Interim Designation of Agent to Receive Notification
of Claimed Infringement**

Full Legal Name of Service Provider: _____

**Alternative Name(s) of Service Provider (including all names under which the service
provider is doing business):** _____

Address of Service Provider: _____

**Name of Agent Designated to Receive
Notification of Claimed Infringement:** _____

**Full Address of Designated Agent to which Notification Should be Sent (a P.O. Box
or similar designation is not acceptable except where it is the only address that can be used in the geographic
location):**

Telephone Number of Designated Agent: _____

Facsimile Number of Designated Agent: _____

Email Address of Designated Agent: _____

**Identify the Interim Designation to be Amended, by Service Provider Name and Filing
Date, so that it may be Readily Located in the Directory Maintained by the Copyright
Office:** _____

Signature of Officer or Representative of the Designating Service Provider:
_____ **Date:** _____

Typed or Printed Name and Title: _____

**Note: This Amended Interim Designation Must be Accompanied by a \$20 Filing Fee
Made Payable to the Register of Copyrights.**

[Home](#) · [Forms](#) · [Records](#) · [Registration](#) · [Law](#) · [Comments](#) · [Library of Congress](#)

Directory of Service Provider Agents for Notification of Claims of Infringement

The following service providers have filed designations of agents for notification of claims of infringement pursuant to Section 512(c) of the Copyright Act. The Copyright Office's current directory of agents consists of this list, with links to copies, in PDF format, of the designations filed on behalf of service providers. You must have the Adobe Acrobat Reader installed on your computer to view and print the forms. The Adobe Acrobat Reader is available for free from [Adobe Systems Incorporated](#).

Go To: [A](#) [B](#) [C](#) [D](#) [E](#) [F](#) [G](#) [H](#) [I](#) [J](#) [K](#) [L](#) [M](#) [N](#) [O](#) [P](#) [Q](#) [R](#) [S](#) [T](#) [U](#) [V](#) [W](#) [X](#) [Y](#) [Z](#)
[Numerals/Symbols](#)

Service Provider Agents List

-A- [A S Billing](#)
[A S Networks](#)
[A S Networks, LLC](#)
[A&E Television Networks](#)
[A+Net Internet Services](#)
[A-Online Information Services, Inc.](#)
[A-PINIONS.COM](#)
[A-PINIONS.ORG](#)
[A-Plus Technologies, Inc.](#)
[A-Plus.net](#)
[AA.NET](#)
[AAA Techmarket, Inc.](#)
[Aadzz](#)
[AAFP](#)
[AAL Capital Management Corporation](#)
[AAL CMC](#)
[AAL FBS](#)
[AAL Member Credit Union \(Appleton, WI\)](#)
[AAL MCU](#)
[AAL Trust Company](#)
[AAL Trust Company, FSB](#)
[aal.org](#)
[aande.com](#)
[AAP](#)
[abandon.com](#)

[abbreviations.com](#)
[ABC](#)
[ABC40/29](#)
[ABC-KHBS-KHOG](#)
[ABC Multimedia, Inc.](#)
[abc.go.com](#)
[abcbackgrounds.com](#)
[abcbanners.com](#)
[abccfb.com](#)
[abcchildrenfirst.com](#)
[abcclassroom.com](#)
[abcfonts.com](#)
[abcfreebies.com](#)
[abcfreecenter.com](#)
[abcfreesite.com](#)
[abcfreeware.com](#)
[abcqiant.com](#)
[abcqiant.net](#)
[abcqiantbackgrounds.com](#)
[abcqiantgraphics.com](#)
[abcqina.com](#)
[abcquestbooks.com](#)
[abcicons.com](#)
[ABCMediaNet.com](#)
[ABCMNF.com](#)
[ABCNews Internet Ventures](#)
[abcnews.go.com](#)
[abcnews.go.com/local/wabc](#)
[abcnews.go.com/local/wls](#)
[abcnews.go.com/locl/wpvi](#)
[abcnewsradio.com](#)
[abcpolls.com](#)
[abc7.com](#)
[abc7chicago.com](#)
[abccreensavers.com](#)
[abcshareware.com](#)
[ABCsports.com](#)
[abc12.com](#)
[abcthemes.com](#)

[abcwallpaper.com](#)
[Abilene Network](#)
[Abilene on Line](#)
[Ability Software and Productions](#)
[Abilizer](#)
[Abilizer Solutions, Inc.](#)
[Abilizer.com](#)
[Abilizer.net](#)
[Abilnet](#)
[Abingdon.net](#)
[About Stress, Inc.](#)
[About.com](#)
[About.com, Inc.](#)
[AboutStress.com](#)
[AboveNet Communications, Inc.](#)
[ABOVEPEER, LLC](#)
[Abra, Inc.](#)
[Abracat](#)
[Abracat Relationships](#)
[absolutedesigns.com](#)
[absolutepower.com](#)
[ABTS Industries, Inc.](#)
[ABTSNET](#)
[abuse.net](#)
[Academic Computing and Instructional Technical Services, University of Texas-Austin](#)
[Academic.com](#)
[ACC](#)
[ACC \(MI\)](#)
[acc.rivals.com](#)
[Access Montana](#)
[Access Washington](#)
[Accessing.net](#)
[Accessing.net, Inc.](#)
[AccessLine Communications Corporation](#)
[AccessOne, Inc.](#)
[ACE COMMUNICATIONS GROUP](#)
[ACE Contact Manager](#)
[ACE TELEPHONE ASSOCIATION](#)
[acclaim.epson.com](#)

acmecity.com
AcNet
ACNielsen
ACNielsen Corporation
AcroNet
AcroNet Internet
AcroNet Professional Internet Services, Inc.
Action Web Media
active-ink.net
active-ink.org
ActiveBass
activebass.com
ActiveGuitar
activeguitar.com
activeinc.net
activeinc.org
ActiveInk Incorporated
activeink.com
activeink.net
activeink.org
actofgod.com
Ad One, LLC
Adams NetWorks, Inc.
Adams State College (Alamosa, CO)
Adams Telephone Co-Operative
addamsfamilyreunion.com
addictedtolove.com
Adelphia Communications Corporation
Adgrafix Corp.
adictionaryof.com
adidasbigtime.rivals.com
Admine
Admine.com, Inc.
adn.com
adnsearch.com
Adobe Dynamic Media
Adobe Premiere World
Adobe Systems, Inc.
AdobeDynamicMedia.com

AdobePremiereWorld.com
AdobePremiereWorld.net
AdobePremiereWorld.org
Adrian College (MI)
Adscentral.com
Adult Community Training Center, Community Service
Adult Learning Service
adultthumb.com
Advance Internet
Advance Internet, Inc.
Advance Leader
Advance Magazine Publishers, Inc.
Advance News Service, Inc.
Advance Publications Internet
Advanced Building Networks
Advanced Computer Concepts, Inc.
ADVANCED INTERNET TECHNOLOGIES, INC.
Advanced Network & Services, Inc.
advanced.org
Advanced Tel, Inc.
Advanced Web Creations
Advantive Associates, Inc.
Advise Internet Services
Advoco
Advoco.com
Advoco.com, Inc.
AERON-CHAIR.COM
AETN Interactive
aetv.com
Affinia
Affinia, Inc.
Affinity
Affinity Hosting
Affinity Internet, Inc.
Aqape
Aqape Information Systems
Aqape IS
Agency for Instructional Technology
agentLIFE

agentLIFE, Inc.

agentLIFE.com

Agilent

Agilent.com

Agilent Technologies

Agilent Technologies, Inc.

Agito, Inc.

agitoinc.com

AgJournal

Agriculture Program, Texas A&M University

agriculture.com

agricultureonline.com

Ahwatukee Foothill News (Irvine, CA)

ahwatukee.com

AI

AIANET

aicpcu.org

Aid Association for Lutherans, FBS

aiis.net

AIM

Aimnet Corporation

AIMS (Greeley, CO)

Aims College (Greeley, CO)

Aims College Corporate Education Center (Greeley, CO)

Aims Community College (Greeley, CO)

Aims Community College Continuing Education Authority (Greeley, CO)

Aims Community College Foundation (Greeley, CO)

Aims Junior College District (Greeley, CO)

AINet

AIP

airforce.rivals.com

AirMedia.com

AirSwitch Corporation

AIRTOUCH CELLULAR

AIRTOUCH COMMUNICATIONS, INC.

airwarrior.com

Airwave

Airwave Wireless, Inc.

Airwave.com, Inc.

AIS

AIS, Inc.

AIT (Advanced Internet Technologies)

AIT (Agency for Instructional Technology)

Akeva

Alabama Live

Alabama Live, LLC

Alabama Public Library Service (Montgomery)

alabama.rivals.com

alabamapreps.rivals.com

alamedacarpets.com

ALASKA.NET

alaskasports.rivals.com

Albany Division of Time Warner Entertainment-Advance/Newhouse Partnership

Albany Herald

Albany Herald Publishing Company, Inc.

Albert Einstein College of Medicine (New York)

Albion College (MI)

albums.photo.epson.com

Albuquerque ROS

Albuquerque Tribune

Alchemedia2

Aldera

aldera.com

Alfadon Productions

Alfred State College (NY)

Alfred University (NY)

Algonac Investment Internet Service

Algonac Investments, LLC

Alibaba.com Corporation

Alibaba.com Korea Corporation

ALIBRIS

All Information Systems

AllAdvantage

AllAdvantage.com

AllAdvantage.com, Inc.

allcanadagriron.rivals.com

allcanadahoops.rivals.com

Alldomains.com Inc.

Allegheny College (Meadvile, PA)
Allen Technology, Inc.
Allentown College of St. Francis De Sales (Center Valley, PA)
Allied Riser Communications, Inc.
Alloy Online, Inc.
alloy.com
alloymail.com
allstargame.com
ALLTEL COMMUNICATIONS, INC.
Allure
Allwebsites.com
Allwhois.com
AlMinuto.com
almostheroes.com
aloha.rivals.com
Alpena Community College (MI)
Alphal Communications
AlphaShift
alphashift.com
AlphaSoft, Inc.
ALS
Alta Vista Technololgy, Inc.
AltaVista
AltaVista.com
AltaVista Companyfile
Altculture.com, Inc.
ALTERNATE ACCESS, INC.
alternateroutestudios.com
Altopia Corporation
Altrasoft, Inc.
Amaranth Networks, Inc.
amaranth.net
amaranthnetworks.com
amateursirens.com
Amazon Internet
amazon.com
Amazon.com Auctions
Amazon.com, Inc.
America Online

America Online, Inc.

America.to

americaeast.rivals.com

American & Efird

American Academy of Otolaryngology--Head and Neck Surgery Foundation, Inc.

American Academy of Pediatrics

American Academy of Family Physicians

American Association of Pharmaceutical Scientists

American Broadcasting Companies

American City Business Journals

American City Business Journals, Inc.

American College of Rheumatology (Atlanta)

American Computer

American Express Bank, Ltd.

American Express Company

American Express Financial Advisors

American Express Travel Related Services Company

American InfoMetrics, Inc.

American Institute for Chartered Property Casualty Underwriters

American Institute for Chartered Property Casualty Underwriters. Institute
Research Council

American Institute of Physics, Inc.

AMERICAN PHOTO

American Society for Quality

American Society for Quality, Inc.

American Society of Composers, Authors and Publishers

American Society of Interior Designers, Inc.

American Tourister, Inc.

American University (Washington, DC)

americanparknetwork.com

americanpassage.com

americanpresident.com

Americaservicenet.com

Americaservices.net

Ameriquotes.com, LLC

Ameritech Interactive Media, Inc.

Ameritech Interactive Media Services, Inc.

Amiga Forever

amigaforever.com

Amplex

Amplex Electric, Inc.
Amplex Internet
AMR Research
AMR Research, Inc.
Amtrak
AMUG
AMUG Internet Services
analyzethis.com
AnaServe, a Concentric Network Company
AnaServe, Inc.
Anchorage Daily News
AncientSites
Andale, Inc.
Andersen (Arthur) LLP
Andersen Consulting, LLP
Anderson, Gavin
Anderson (Gavin) & Company
Anderson (Gavin) & Company, Inc.
Anderson Independent-Mail
Anderson Online
andover.edu
andover.net
Andover.Net, Inc.
andovernews.com
ang-publicnotices.com
ang2000.com
angelfire.com
angels.rivals.com
Angstrom, Inc.
Animall, Inc.
Animation World Network
animationexpress.com
animationworldnetwork.com
animationworldnetwork.net
animationworldnetwork.org
AniVision, Inc.
annak.rivals.com
Annapolis.com
Annex BBS

Annex Telecommunications, Inc.
annex.com., Inc.
ANR SoftCOM, Inc.
ANRCorp.Net
ANS Communications, Inc.
Ansteorra, Inc.
AnyDay.com, Inc.
anygivensunday.net
Anyuser.com
Anyuser.com, Inc.
Anyuser.net
AnyWare Computers, Inc.
aok4y2k.com
AOL
AOL Calendar
AOL Foundation
AOL Hometown
AOL Instant Messenger
aol.com
AOLTV
AOLTV, Inc.
aoltv.com
APB Multimedia, Inc.
APB News
APB Online
aperfectmurder.com
Aperian, Inc.
APINIONS.NET
APINIONS.ORG
Aplus-Domain.com
Appalachian State University (Boone, NC)
Appeal Democrat
appealdemocrat.com
AppGenesys, Inc.
Apple Computer, Inc.
AppleCore Development
AppliedTheory Corporation
apost.com
AppsOnline

Aprisa, Inc.

aprisa.com

aquariumhobbyist.com

Aracnet

Aracnet Internet Services

Arapahoe Community College (Littleton, CO)

ARBIS

ARBIS, Inc.

ARBIS Internet Solutions, Inc.

ARC

Architectural Digest

archivists.org

arch.wustl.edu (Washington University, St. Louis, MO)

archerynetwork.rivals.com

ArcSoft, Inc.

argus-anq.com

Arizona Central

Arizona Macintosh User's Group

Arizona Republic

arizona.rivals.com

arizonacentral.com

arizonapreps.rivals.com

arizonarepublic.com

arizonastate.rivals.com

arizonatribune.com

Arkansas Archeological Survey

Arkansas Hearst-Argyle Television, Inc.

Arkansas Tech (Russellville)

Arkansas Tech University (Russellville)

arkansas.rivals.com

arkansaspreps.rivals.com

arkansasstate.rivals.com

Arlee Montana Internet

Arlington Hills Branch Library (Saint Paul)

Armstrong Atlantic State University

army.rivals.com

ARNet, Inc.

aroundalone.com

aroundalone.org

[arpa.com](#)

[Art Matrix](#)

[Art Matrix - Lightlink](#)

[Arthur Andersen, LLP](#)

[artinsider.com](#)

[Artinsider.com, Inc.](#)

[Artist Channels](#)

[Artist TV](#)

[ARTISTdirect, Inc.](#)

[ArtManager Online Services, LLC](#)

[artnet.com](#)

[Artnet Worldwide Corporation](#)

[artsci.wustl.edu \(Washington University, St. Louis, MO\)](#)

[artsci.wustl.edu/Art \(Washington University, St. Louis, MO\)](#)

[ArtsEdNet](#)

[AS400 Network](#)

[as400network.com](#)

[as400networkstore.com](#)

[asaarchery.rivals.com](#)

[ASCAP](#)

[Ascentrix Technologies, Inc.](#)

[Ashford.com, Inc.](#)

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[ASQ](#)

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[Associated Information Services, Inc.](#)

[Association for Electronic Health Care Transactions, Inc.](#)

[Assured Life Association](#)

[asteroid.com](#)

[astronomic.com](#)

[astros.rivals.com](#)

At Home

At Home Corporation

At Home Network

At Road, Inc.

At Work

AT&T CERFnet

AT&T Corporation

AT&T Global Network Services

AT&T Global Network Services, LLC

AT&T Global Services

AT&T Road Runner

AT&T Solutions Group

AT&T WorldNet Services

Athletic Attic

Athletic Lady

athletics.rivals.com

atlantic-records.com

atlantic10.rivals.com

atlanticeasthoops.rivals.com

Atlee Station

atmckinsey.com

ATMNet

Atom

Atom Corporation

Atom Films

atom.com

atomfilms.com

Atrieva

atrieva.com

ATU

atvnews.rivals.com

Au Fait Communications

AuBid.com

Auburn Hills Public Library (MI)

Auburn Seawolf

Auburn University (AL)

auburn.rivals.com

AuctionGate

auctiononline123.com

[auctionsonline123.com](#)

[Audiogalaxy](#)

[Audiogalaxy, Inc.](#)

[Audiomakers.com](#)

[AUDIOMAKERS.COM, INC.](#)

[audiopix.com](#)

[AudioVeda.com](#)

[August Associates](#)

[August Consulting Associates](#)

[Augusta State University \(GA\)](#)

[Augustana College \(Sioux Falls, SD\)](#)

[augustaonline.com](#)

[Austin Community College](#)

[Austin Division of Time Warner Entertainment-Advance/Newhouse Partnership](#)

[Authorize.net](#)

[authorizenet.com](#)

[Auto-ez](#)

[auto-fill.com](#)

[Automatic Media, Inc.](#)

[AV.com](#)

[avalanche.rivals.com](#)

[AvantGo, Inc.](#)

[aviationX, Inc.](#)

[Avid Production Network](#)

[Avid Technology, Inc.](#)

[Avid Universe](#)

[AvidProNet](#)

[AvidUniverse.com](#)

[AvidUniverse.net](#)

[AvidUniverse.org](#)

[AvonIL.net](#)

[Avotar](#)

[AvTel Communications](#)

[AvTel Communications, Inc.](#)

[AWC](#)

[AWESOMECAKES.COM, INC.](#)

[AWN](#)

[AWN, Inc.](#)

[AWN.com](#)

[aworldofbooks.com](#)
[AWWWsome Net Services, Inc.](#)
[Aye Net](#)
[Ayrix Technologies, Inc.](#)
[A&Z Consulting](#)
[Az Star Net](#)
[AZ TRAVEL MARKETING, INC.](#)
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ETHICAL ISSUES RAISED IN THE PRACTICE OF LAW

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SECTION H

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Ethical Issues Raised in the Practice of Law

Kurt X. Metzmeier and James A. Becker

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I. General Background to the Ethics of Internet Use in the Practice of Law

A. Ethical Issues Raised by the Use of Computer Networks

1. Confidentiality concerns
2. Advertising issues
3. Solicitation questions
4. Unauthorized practice

B. Human Issues Raised by The Use of Computer Networks

1. Experts agree that a firm's most serious risk are its employees
2. Inadvertent Error
3. Human Engineering
4. Misconduct

C. Ethics and the Nonlawyer Assistants

1. KRPC 5.3 requires that lawyers supervising nonlawyers "employed or retained by or associated with" a law practice have "in effect measures giving reasonable assurance" that these employees uphold the KRPC. This applies to computing staff! Supervising attorneys have an ethical obligation to assure that computing and networking staff are trained on the obligations of the KRPC, especially those relating to client communications

2. Preventative measures for all nonlawyer employees including information systems staff:

- a. New employee orientation on KRPC
- b. Employee manuals (signed)
- c. Computer use policies (for all employees) (signed)

3. Ethics and IT Staff

Computer personnel need special attention. They have far more access to client information than any other employees. The computing culture is very different from the law firm culture and fosters the belief that "information wants to be free." IT personnel need to be educated as to the importance of confidentiality, especially in regards to client records.

4. Special measures for IT personnel

- a. Take care to hire well
- b. Be as careful as if the IT job involved handling large sums of money
- c. Check references

5. Rules also apply to contract employees and consultants. Preventative measures include choosing reputable consultants with strong references and contractual language incorporating confidentiality assurances

6. Social Engineering

A common hackers tool that takes advantage of the naiveté. The hacker calls a low level employee and uses plausible details that the acquire from public sources (web site, phone books) to convince them to divulge passwords

7. Misconduct

Computer security experts agree that the most serious risk for disclosure of confidential communications is through employee misconduct. The most famous disclosure of client information in Kentucky, the Brown & Williamson case, occurred this way (though without computers).

II. Ethical Issues Relating to Email

A. Encryption

1. Not Required (KBA E-403) "unless unusual circumstances require enhanced security measures"
2. Should be considered for highly sensitive communications
3. PGP -- Difficult to configure
4. Encryption of attached documents using Microsoft Word & Corel Word Perfect effective for many concerns

B. Inadvertent Disclosure

1. Mis-addressed e-mail far more serious likelihood than interception
2. Prevention best policy:
 - *Avoid vague "nicknames"
 - *Use warning/disclaimer
 - *Sample Warning Disclaimer

This e-mail message, together with any attachments, is intended only for the personal and confidential use of the recipient(s) named above. This message may be an attorney-client communication and as such is privileged and confidential. If you are not the intended recipient, you are hereby notified that you have received this document in error and that any review, dissemination, distribution, or copying of this message is strictly prohibited. If you have received this message in error, please notify us immediately ... and delete the message from your computer.

C. Email and Solicitation, Advertising

- 1 "Unless the lawyer uses the Internet or other electronic mail service to direct messages to a specific recipient [in which case the rules governing solicitation would apply] only the general rules governing communications regarding a lawyer's services and

advertising [KRPCs 7.10, 7.20, and the so-called advertising rules set forth at KRPCs 7.01-7.08] should apply..." (KBA E-403)

2. Solicitation Issues

- a. Mass mailings (Spam)
- b. Lawyer participation in listservs
- c. Lawyer participation in "chat rooms"

3. Spam

- a. Unsolicited commercial e-mail
- b. Disliked by both e-mail users and Internet Service Providers (ISP's)
- c. CompuServe has successfully sued commercial e-mailers under theory that they abused computer facilities owned by the ISP
- d. Shapero v. KBA, 486 US 466
- e. RPC 7.30 bars all solicitation when
 - (2)(a) client makes desire known that he or she does not want it
 - (2)(b) it involves coercion, duress or harassment
 - (3) Written solicitation must follow 7.10 advertising rules

4 Listservs

- a. What is a listserv?
 - *Listserv is a server that distributes e-mails to all list members
 - *Members post public messages to entire list
 - *Only limited anonymity
 - *Very valuable tool for keeping up on breaking developments
- b. The participation of lawyers on listservs raise a number of issues:
 - * Solicitation
 - *Inadvertent creation of an attorney-client relationship
 - *Unauthorized practice of law (in jurisdictions where they are not licensed)
- c. Listservs: Solicitation

KRPC 7.02(1)(f) states that: "Any communication by a lawyer to third parties that is published or broadcast by a third party who is not in any way controlled by the lawyer, and for which publication or broadcast the lawyer pays no consideration, shall be exempt from all the provisions of these Rules except Rule 7.10 [barring "false, deceptive or misleading" information]."

The participation by lawyers on listservs maintained by third parties is consistent with KRPC 7.02(1)(f) and KBA opinions regarding appearances by lawyers on radio and TV programs (KBA E-50, E-270).

- d. Listservs: Establishment of an Attorney-Client Relations
 - *Will turn on what the "client" reasonably perceives
 - *Lawyers should be wary of seeming to respond to specific questions
- e. Listservs: Avoiding the Establishment of an Attorney-Client Relations
 - *Include disclaimer in signature line
 - *Lawyers should avoid going "off-list" to discuss specific problems
 - * Seek out "lawyer's only lists"
 - *Avoid lists where non-lawyers tend to trade in bad legal advice

5. Chat rooms et al

- *Anonymous real-time discussion forums
- *Regularly exercised option to take public discussions private
- *Hosted by users ISP (traditionally AOL strength) or by free websites like Yahoo!
- *While none of the published state opinions on the use of e-mail specifically bar attorney's from participating (as lawyers) in chat rooms, the atmosphere of anonymity and privacy intensifies the dangers suggested for listserv participation.

III. Ethics and the World-Wide Web

A. Web Pages as Advertising

1. KBA E-403 indicates that web pages are to be considered advertising in most situations

- 2. In general, web pages should follow KRPC 7.01 - 7.25, in particular:
 - a. Must submit copies for approval (KRPC 7.05(1) and (2))
 - b. Need to label pages as advertising (KRPC 7.25)
 - c. Must carry the name of one lawyer licensed in Kentucky (KRPC 7.20 (3))
 - d. Cannot be false or misleading (KRPC 7.10)

B. Other Issues Raised by Web Pages

- 1. Domain names
- 2. Hidden indexing & metatags
- 3. Client confidentiality and client testimonials
- 4. Solicitation issues
 - a. Web boards
 - b. Emailed web pages
- 5. Privacy
 - a. Rights of Adults
 - c. Rights of Children.

IV. Suggested Reading

1. Peter Krakaur's www.legalethics.com
2. Jerry Lawson, *The Complete Internet Handbook for Lawyers* (ABA, 1999)
3. Paul D. Shaw, *Managing Legal and Security Risks in Computing* (1998)
4. Stuart McClure, Joel Scambray, George Kurtz, *Hacking Exposed: Network Security Secrets and Solutions* (2000)

V. Appendices:

Appendix I: KBA E-403

Appendix II: Sample Forms

Form II-1. Confidentiality Warning Disclaimer for E-mail Signature

Form II-2. Sample Warning to Computing Staff

Form II-3. Sample Computer Use Policy

Appendix III. Simple Password Protection of Microsoft Word and Corel Word Perfect Documents

Appendix I: KBA E-403

Question 1:

May a lawyer use electronic mail services including the Internet to communicate with clients without encryption?

Answer:

Yes, unless unusual circumstances require enhanced security measures.

Question 2:

Is the creation and use by a lawyer of an Internet "web site" containing information about the lawyer and the lawyer's services that may be accessed by Internet users, including prospective clients, a communication falling within KRPCs 7.09 [Prohibited Solicitation] or 7.30 [Direct Contact With Prospective Client]?

Answer:

Qualified No. Unless the lawyer uses the Internet or other electronic mail service to direct messages to a specific recipient [in which case the rules governing solicitation would apply] only the general rules governing communications regarding a lawyer's services and advertising [KRPCs 7.10, 7.20, and the so-called advertising rules set forth at KRPCs 7.01-7.08] should apply to a lawyer's "web-site" on the Internet.

References: Illinois Op. 96- 10 (1997); Kurt Metzmeier & Shaun Esposito, How to Avoid Losing Your License on the Information Superhighway: Ethical Issues Raised by the Use of the Internet in The Practice of Law (*Kentucky Bench & Bar*, Spring 1998).

OPINION

Despite widespread use of the Internet, the Committee has received few inquiries regarding its use. Still, the Committee is of the view that this opinion should be issued to provide some guidance and some comfort. The subject is addressed in a recent article cited in the references, which is available from the UK Law Library, and which has been submitted for publication in the *Bench & Bar*.

The Committee finds persuasive the comprehensive and thoughtful opinion of the Illinois State Bar Association, ISBA Advisory Opinion No. 96-10, excerpts of which we attach as an Appendix.

APPENDIX

ILLINOIS STATE BAR ASSOCIATION

ISBA Advisory Opinion on Professional Conduct

Opinion No. 96-10

May 16, 1997

Topic: Electronic communications; confidentiality of client information; advertising and solicitation.

Digest: Lawyers may use electronic mail services, including the Internet, without encryption to communicate with clients unless unusual circumstances require enhanced security measures. The creation and use by a lawyer of an Internet "web site" containing information about the lawyer and the lawyer's services that may be accessed by Internet users, including prospective clients, is not "communication directed to a specific recipient" within the meaning of the rules, and therefore only the general rules governing communications concerning a lawyer's services and advertising should apply to a lawyer "web site" on the Internet. If a lawyer uses the Internet or other electronic mail service to direct messages to specific recipients, then the rules regarding solicitation would apply.

Ref.: Illinois Rules of Professional Conduct, Rules 1.6, 7.1, 7.2, 7.3 and 7.4

ISBA Opinion Nos. 90-07 and 94-11

Electronic Communications Privacy Act, 18 USC §2510, et seq.

QUESTIONS

The Committee has received various inquiries regarding ethical issues raised by use of electronic means of communication, including electronic mail and the "Internet," by lawyers. These inquiries usually involve two general areas of concern. The first is whether electronic mail may be used to communicate with clients regarding client matters in view of a lawyer's duty under the ethics rules to maintain the confidentiality of client information. The second is whether the creation and use of a "web site" and other forms of contact with prospective clients may be conducted by lawyers on the Internet, and if so, whether the rules regarding "in person" solicitation should apply to such contact.

Because of the technical nature of the discussion, the Committee will use the following commonly accepted definitions in this opinion. The Internet is a super network of computers that links together individual computers and computer networks located at academic, commercial, government and military sites worldwide, generally by ordinary local telephone lines and long-distance

transmission facilities. Communications between computers or individual networks on the Internet are achieved throughout the use of standard, nonproprietary protocols.

Electronic mail, commonly known as e-mail, is an electronic message that is sent from one computer to another, usually through a host computer on a network. E-mail messages can be sent through a private or local area network (within a single firm or organization), through an electronic mail service (such as America Online, CompuServ or MCI Mail), over the Internet, or through any combination of these methods.

A bulletin board service (sometimes called a "BBS") is an electronic bulletin board on a network where electronic messages may be posted and browsed by users or delivered to e-mail boxes. A "newsgroup" is a type of bulletin board service in which users can exchange information on a particular subject. A "chat" group is a simultaneous or "real time" bulletin board or newsgroup among users who send their questions or comments over the Internet.

The World Wide Web is that part of the Internet consisting of computer files written in a particular format (the "HTML" format) that includes "hyperlinks" (text or symbols that the user may click on to switch immediately to the item identified) as well as graphics and sound, to enable the creation of complex messages. A "home page" is a computer file containing text and graphics in the HTML format usually containing information about its owner, which can be obtained over the Internet and viewed by transmitting it from the owner's computer to the user's terminal. A "web site" is a set of computer files containing text and graphics in the HTML format and organized around a central home page.

The Electronic Communications Privacy Act, 18 USC §2510, et seq. (the "ECPA"), is the federal codification of the intrusion arm of the common law tort of invasion of privacy applied to electronic communication and provides criminal and civil penalties for its violation. The ECPA is actually the 1986 revision of the federal wiretap statute originally enacted in 1968, but the term ECPA is now commonly used to refer to the entire statute, as amended.

OPINION

The first issue, whether a lawyer may use electronic mail services including the Internet to communicate with clients, arises out of a lawyer's duty to protect confidential client information. Rule 1.6(a) of the Illinois Rules of Professional Conduct provides that "...a lawyer shall not, during or after termination of the professional relationship with the client, use or reveal a confidence or secret of the client known to the lawyer unless the client consents after disclosure." AS the Terminology provisions of the Rules state, the information a lawyer must protect includes information covered by the lawyer-client privilege (a "confidence") as well as information that the client wishes to be held inviolate or the revelation of which would be embarrassing or detrimental to the client (a "secret").

The duty to maintain the confidentiality of client information implies the duty to use methods of communication with clients that provide reasonable assurance that messages will be and remain confidential. For that reason, the Committee concluded in Opinion No. 90-07 (November 1990) that a lawyer should not use cordless or other mobile telephones that were easily susceptible to interception when discussing confidential client matters. The Committee also opined that a lawyer conversing with a client over a cordless or mobile telephone should advise the client of the risk of the loss of confidentiality.

With the increased use of electronic mail, particularly electronic mail transmitted over the Internet, have come suggestions that electronic messages are not sufficiently secure to be used by lawyers communicating with clients. At least two state ethics opinions have concluded that because it is possible for Internet or other electronic mail service providers to intercept electronic mail service providers to intercept electronic mail messages, lawyers should not use electronic mail for "sensitive" client communications unless the messages were encrypted or the client expressly consented to "non-secure" communication. South Carolina Bar Advisory Opinion 94-27 (January 1995); Iowa Supreme Court Board of Professional Ethics and Conduct Opinion 96-1 (August 29, 1996). After reviewing much of the available literature on this issue, the Committee disagrees with these opinions.

Among the numerous recent articles regarding a lawyer's use of electronic mail, the Committee found three to be particularly useful and informative. These are: Joan C. Rogers, "Malpractice Concerns Cloud E-Mail, On-Line Advice," ABA/BNA Lawyers' Manual on Professional Conduct (March 6, 1996); Peter R. Jarvis & Bradley F. Tellam, "High-Tech Ethics and Malpractice Issues," 1996 Symposium Issue of the Professional Lawyer, p. 51 (1996); David Hricik, "Confidentiality and Privilege in High-Tech Communications," 8 Professional Lawyer, p. 1 (February 1997). From these and other authorities, there is a clear consensus on two critical points. First, although interception of electronic messages is possible, it is certainly no less difficult than intercepting an ordinary telephone call. Second, intercepting an electronic mail message is illegal under the ECPA.

Courts and ethics committees have uniformly held that persons using ordinary telephones for confidential communications have a reasonable expectation of privacy. The three common types of electronic mail messages appear no less secure. For example, electronic messages that are carried on a local area or private network may only be accessed from within the organization owning the network. Such messages would therefore clearly appear subject to a reasonable expectation of privacy.

Other electronic messages are carried by commercial electronic mail services or networks such as America Online, CompuServ or MCI Mail. Typically, these services transmit e-mail messages from one subscriber's computer to another computer "mailbox" over a proprietary telephone network. Typically, the computer mailboxes involved are password-protected. Because it is possible for dishonest or careless personnel of the mail service provider to intercept or misdirect a message, this form of electronic mail is arguably less secure than messages sent over a private network. AS a practical matter, however, any ordinary telephone call may also be intercepted or misdirected by dishonest or careless employees of the telephone service provider. Again, this possibility has not compromised the reasonable expectation of privacy of ordinary telephone users. The result should be the same for electronic mail service subscribers.

The third type of electronic mail, that carried on the Internet, typically travels in another fashion. Rather than moving directly from the sender's host computer to the recipient's host computer, Internet messages are usually broken into separate "packets" of data that are transmitted individually and then re-assembled into a complete message at the recipient's host computer. Along the way, the packets travel through, and may be stored temporarily in, one or more other computers (called "routers") operated by third parties (usually called an "internet service provider" or "ISP") that help distribute electronic mail over the Internet.

Unlike a cordless cellular telephone message, for example, an Internet e-mail is not broadcast over the open air waves, but through ordinary telephone lines and the intermediate computers. When an Internet message is transmitted over an ordinary telephone line, it is subject to the same protections and difficulties of interception as an ordinary telephone call. To intercept an Internet communication while it is in transit over telephone lines requires an illegal wiretap.

Consequently, the real distinction between an Internet electronic message and an ordinary telephone call is that Internet messages may be temporarily stored in, and so can be accessed through, a router maintained by an ISP. It is possible that an employee of an ISP (as part of the maintenance of the router) could lawfully monitor the router and thereby read part or all of a confidential message. As in the case of telephone and proprietary electronic mail providers, it is also possible for dishonest employees of an ISP to intercept messages unlawfully. The Committee does not believe that the opportunity for illegal interception by personnel of an ISP makes it unreasonable to expect privacy of the message.

As noted above, it is also clear that unauthorized interception of an Internet message is a violation of the ECPA, which was amended in 1986 to extend the criminal wiretapping laws to cover Internet transmissions. As part of the 1986 amendments, Congress also treated the issue of privilege in 18 USCA §2517(4), as follows:

No otherwise privileged wire, oral, or electronic communication intercepted in accordance with, or in violation of, the provisions of this chapter shall lose its privileged character.

This provision demonstrates that Congress intended that Internet messages should be considered privileged communications just as ordinary telephone calls.

In summary, the Committee concludes that because (1) the expectation of privacy for electronic mail is no less reasonable than the expectation of privacy for ordinary telephone calls, and (2) the unauthorized interception of an electronic message subject to the ECPA is illegal, a lawyer does not violate Rule 1.6 by communicating with a client using electronic mail services, including the Internet, without encryption. Nor is it necessary, as some commentators have suggested, to seek specific client consent to the use of unencrypted e-mail. The Committee recognizes that there may be unusual circumstances involving an extraordinarily sensitive matter that might require enhanced security measures like encryption. These situations would, however, be of the nature that ordinary telephones and other normal means of communication would also be deemed inadequate.

With respect to the second general issue, the extent to which a lawyer may use Internet web site to communicate with clients and prospective clients, the Committee believes that the existing Rules of Professional Conduct governing advertising, solicitation and communication concerning a lawyer's services provide adequate and appropriate guidance to a lawyer using the Internet. For example, the Committee views an Internet home page as the electronic equivalent of a telephone directory "yellow pages" entry and other material included in the web site to be the functional equivalent of the firm brochures and similar materials that lawyers commonly prepare for clients and prospective clients. An Internet user who has gained access to a lawyer's home page, like a yellow pages user, has chosen to view the lawyer's message from all the messages available in that medium. Under these circumstances, such materials are not a "communication directed to a specific recipient" that would implicate Rule 7.3 and its provisions governing direct contact with prospective clients. Thus, with respect to a web site, Rule 7.1, prohibiting false or misleading statements concerning a lawyer's services, and Rule 7.2, regulating advertising in the public media, are sufficient to guide lawyers and to protect the public.

On the other hand, lawyer participation in an electronic bulletin board, chat group, or similar service, may implicate Rule 7.3, which governs solicitation, the direct contact with prospective clients. The Committee does not believe that merely posting general comments on a bulletin board or chat group should be considered solicitation. However, if a lawyer seeks to initiate an unrequested contact with a specific person or group as a result of participation in a bulletin board or chat group, then the lawyer would be subject to the requirements of Rule 7.3. For example, if the lawyer sends unrequested electronic messages (including

messages in response to inquiries posted in chat groups) to a targeted person or group, the messages should be plainly identified as advertising material.

Finally, lawyers participating in chat groups or other on-line services that could involve offering personalized legal advice to anyone who happens to be connected to the service should be mindful that the recipients of such advice are the lawyer's clients, with the benefits and burdens of that relationship. In Opinion No. 94-11 (November 1994), the Committee addressed an analogous situation arising out of a "call-in" legal advice service as follows:

The committee believes that callers to the legal advice service are clients of the law firm who are entitled to the protection of clients afforded by the Rules of Professional Conduct. However, it does not appear that either the law firm or the cellular telephone service makes any effort to determine the identity of the callers and check for potential conflicts of interest prior to the time that the callers' questions are asked and the legal advice is given. (Presumably the callers' identities are revealed after the advice is rendered through the billing process. If the cellular telephone company handles the billing for the law firm, this procedure may also violate client confidences. See ISBA Opinion No. 93-04) Under these circumstances, it would be possible for the law firm to give legal advice to callers whose interest are directly adverse to other firm clients, including other callers, in violation of Rule 1.7(a), or whose interests are materially adverse to the firm's former clients, including other callers, concerning the same or a substantially related matter, in violation of Rule 1.9

Lawyers participating in similar activity over the Internet would be subject to the same concerns expressed in Opinion No. 94-11.

For these reasons, the Committee believes that Illinois lawyers may appropriately make use of the Internet in serving and communicating with clients and prospective clients subject to the existing rules governing confidentiality, advertising and solicitation.

Appendix II: Sample Forms

Form II-1. Confidentiality Warning Disclaimer for E-mail Signature

This e-mail message, together with any attachments, is intended only for the personal and confidential use of the recipient(s) named above. This message may be an attorney-client communication and as such is privileged and confidential. If you are not the intended recipient, you are hereby notified that you have received this document in error and that any review, dissemination, distribution, or copying of this message is strictly prohibited. If you have received this message in error, please notify us immediately by telephone (555-555-5555) or by return e-mail and delete the message, along with any attachments, from your computer. Thank you.

Form II-2. Sample Warning to Computing Staff

The Rules of Professional Responsibility that bind all practicing lawyers in Kentucky make attorneys responsible for ensuring that these rules of ethical conduct are followed by the "non-lawyers" they employ. Therefore, *Gates, Jobs & Ellison* warns all employees upon their hiring that the willful violation of any ethical rule is grounds for immediate termination and that the firm will not rule out criminal or civil remedies for serious violations.

The most relevant of these rules is the rule barring the disclosure of any "client information," even information that would not be considered confidential to the layperson. The Kentucky Bar Association's Committee on Ethics has advised that even the unauthorized disclosure of the names of current and former clients violates this ethical trust.* Therefore, it is the firm policy of *Gates, Jobs & Ellison* to immediately terminate any employee who intentionally discloses any client information to persons not authorized to receive such information. It is the responsibility of the network administrators, desktop support specialists and all other computing personnel to not only personally adhere to this policy, but to ensure that all reasonable security measures are in place to ensure that client information is not disclosed.

*A widely used treatise of legal ethics notes that the "general obligation" under Rule 1.6 "gives rise to a number of duties." Charles W. Wolfram, *Modern Legal Ethics* §6.7.5 (1986). Among these duties is a duty "to see that the client's interest in full confidentiality of information is adequately protected. ... The lawyer's files should be confidentially maintained, and nonlawyer employees should be instructed, and periodically reminded, to keep all office matters strictly confidential." Generally, all client communications, even those that are not "confidences," fall under this general obligation. *See*, KBA E-253 (1981) (committee advised that even the very existence of an attorney-client relationship should be held confidential).

Form II-3. Sample Computer Use Policy

Preface

To protect the integrity of the computer system against unauthorized or improper use and to protect authorized users from the effects of unauthorized or improper usage of the system, the law firm of *Gates, Jobs & Ellison* reserves the rights to limit or restrict any account holder's usage, and to inspect or remove any data, file, or system resources which may undermine the authorized use of that system, without notice to the user. The Firm also reserves the right to periodically check the system and any other rights necessary to protect the Firm's computer facilities.

Users of the Firm's facilities are required to comply with the Computer Use Policy, and by using the system, the user agrees to comply with and be subject to the Policy and these Conditions of Use. Serious violations of the Policy by nonlawyer employees are subject to immediate termination. Attorney-employees are also subject to dismissal or severance of the partnership relationship.

The Firm reserves the right to amend this statement at any time with or without notice.

Computer Use Policy

1. You must use only those computer accounts, files or directories that have been authorized for your use. The unauthorized use of another's account, files or directories, as well as the providing of false or misleading information for the purpose of obtaining access to computing facilities, is strictly prohibited and may be regarded as grounds for immediate termination of employment.
2. You may not authorize anyone to use your account for any reason. You are responsible for all usage on your account(s). You must take all reasonable precautions, including password maintenance and file protection measures, to prevent use of your accounts by unauthorized persons.
3. You must use your accounts only for the purposes for which they were authorized. Firm accounts must not be used for private consulting or any other commercial use without prior approval from the Managing Attorney. You must not use your accounts for unlawful purposes, such as the installation of fraudulently or illegally obtained software.
4. You must not access or copy files that belong to another account without prior authorization from the account holder. All requests for access to files or directories should go through the Managing Attorney who will request the Network Administrator to make such changes. Files may not be taken to other sites without permission from the managing attorney. **Improper use or disclosure of client files is grounds for immediate discharge.**

5. You must not use the system irresponsibly, or needlessly affect the work of others. This includes transmitting or making accessible offensive, annoying or harassing material; intentionally damaging the system; intentionally damaging information not belonging to you; or intentionally misusing system resources or allowing misuse of system resources by others.

6. You are responsible for reporting to the Network Administrator any violation of these guidelines by another individual, **especially any violation that may compromise client information**. You are also encouraged to report any information relating to a flaw in, or bypass of, computer facilities security.

Failure to comply with the above guidelines, or the unauthorized or illegitimate use of *Gates, Jobs & Ellison's* computing facilities or resources, shall constitute a violation of policy and will subject the violator to disciplinary action, including the possibility of immediate termination.

Employee Computing Account Agreement

Name _____

Position _____

Supervising
Attorney _____

I have read the **Computer Use Policy**. I agree to follow the rules contained in this Policy. I understand that if I violate the rules, I may face disciplinary action, including immediate termination.

Signature _____ - _____ Date _____

Form II-4. Disclaimer for E-mail Signature for Use on Law-Related Listservs

This email expresses only the generalized personal opinion of the writer and is not meant to be construed as legal advice. Nothing in this message is to be construed as creating a lawyer-client relationship. The views expressed are mine alone and are not be ascribed to the firm of *Hue, Due and Lue*.

III. Simple Password Protection of Microsoft Word and Corel Word Perfect Documents

To assign a password to a Word Perfect 5.0, 5.1, 6.0, 6.1, 7.0, 8.0 file,

- 1 Click **File, Save As.**
- 2 Specify the file you want to password-protect.
- 3 Make sure the file format is Corel WordPerfect 5 or later.
- 4 Click **Password protect**, then click **Save.**
- 5 Type the password you want to use, then click **OK.**
- 6 Retype the password, then click **OK.**

To Require a password to open a Word file,

- 1 Open the document.
- 2 On the **File** menu, click **Save As.**
- 3 Click **Options.**
- 4 In the **Password to open** box, type a password, and then click **OK.**
- 5 In the Reenter password to open box, type the password again, and then click **OK.**
- 6 Click **Save.**

SCIENTIFIC EVIDENCE IN PATENT CASES

Special Guest Lecturer - 2001

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San Francisco, California*

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SCIENTIFIC EVIDENCE IN PATENT CASES

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I. Introduction

One of the most significant challenges in any patent case is explaining the technology to the decision-maker, whether that is a judge or a jury. This presentation will cover two distinct aspects of that challenge: the special rules of evidence applicable to scientific evidence and, particularly, to expert testimony; and the manner in which scientific evidence is frequently presented, particularly techniques for effectively presenting that evidence.

The basic problem is that the decision-maker is, in general, not familiar with the technology at issue. Inventions claimed in patents and the devices accused of infringing those claims are frequently the result of work by engineers or scientists applying years of specialized training. As an attorney in a patent case, you have only hours or, at most, a few days, to communicate to the decision-maker the salient aspects of the body of knowledge applied by those engineers and scientists.

While challenging, educating the judge or jury can be done. The rules of evidence allow testimony by experts in the field, who serve as the teachers. There are techniques for presenting such testimony so that it is watchable and understandable, including the use of visual aids and demonstrations.

To successfully present scientific evidence, the attorney must first learn the technology, because there is no substitute for knowing what you are talking about. The attorney must then exercise judgment concerning what aspects of the technology need to be presented.

Some judges or jury members may have an aversion to learning technology at the beginning of the case. This aversion can be overcome by applying several specific techniques: (1) showing respect for the intelligence of the audience; (2) using analogies to devices or concepts that are within the more common experience of people; and (3) explaining the "how and why" of the technology.

II. Rules of Evidence Applicable to Scientific Evidence

A. What Is "Scientific Evidence"?

Strictly speaking, one cannot really distinguish "scientific" evidence from any other kind of evidence. In its broadest sense, the word "science" refers to a continuing process by which we

gather information about our universe and try to explain what we have gathered. All evidence can be characterized as “scientific” in some sense.

Conventionally, however, certain fields of endeavor are viewed as “technological” or “scientific,” including all subjects having names that include the words “engineering,” “computer,” “medicine,” “biology,” “physics” or “chemistry.” The subject matter of patents is similarly viewed as “technological,” even though many patents relate to subjects as ordinary as picture frames and chairs.

B. “Expert Witnesses” May Give “Opinion” Testimony

Although the presentation of “scientific” evidence conjures up (appropriately, in general) the image of a court-qualified “expert witness,” it should always be kept in mind that the need for an “expert” witness under the Federal Rules of Evidence is governed by the opinion nature of the testimony to be given, not whether the subject matter is “scientific.” The Federal Rules of Evidence give special treatment to “opinion” testimony.

Federal Rule of Evidence 701 sets forth the general rule that the opinion testimony of most witnesses “is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness’ testimony or the determination of a fact in issue.”¹

Federal Rule of Evidence 702 sets forth the exception to Rule 701, authorizing “a witness qualified as an expert” to testify “in the form of an opinion or otherwise.”² Rule 702 authorizes the use of expert opinion testimony “[i]f scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue.” To qualify as an expert witness, Rule 702 requires that the witness have pertinent “knowledge, skill, experience, training, or education.”

C. Expert Testimony Must Be Reliable and Relevant

Case law respecting the standards for admissibility of expert testimony is extensive, and a complete review is beyond the scope of this presentation. There is now a difference between federal court standards and some state court standards.

The split between federal and state standards arose in the wake of the U.S. Supreme Court’s decision in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S.Ct. 2786

¹ Federal Rule of Evidence 701 provides in full: “If the witness is not testifying as an expert, the witness’ testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness’ testimony or the determination of a fact in issue.”

² Federal Rule of Evidence 702 provides in full: “If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.”

(1993). There, the U.S. Supreme Court held that Federal Rule of Evidence 702 had superceded what had to that point been the leading expert testimony case, *Frye v. United States*, 293 F. 1013 (1923).

Under the venerable *Frye*'s test, expert opinion based on a scientific technique is inadmissible unless the technique is "generally accepted" as reliable in the relevant scientific community. Virtually every state subsequently adopted the *Frye*'s test.

The *Daubert* decision changed the standard for admissibility of expert evidence to one that is superficially more flexible, but in practice is often more restrictive. "General acceptance" is no longer a necessary precondition to the admissibility of scientific evidence, but the trial judge is charged with the "gatekeeping" function of ensuring that an expert's testimony both rests on a reliable foundation and is relevant. Evidence of "general acceptance" (or lack thereof) can be a factor in determining the reliability (or lack thereof) of the proposed testimony, but it is no longer determinative by itself.

Other factors identified by the *Daubert* decision include:

- Whether a theory or technique can be (or has been) tested;
- Whether it has been subjected to peer review and publication; and
- Whether, in respect to a particular technique, there is a high known or potential rate of error and whether there are standards controlling the technique's operation.

This was a non-exclusive list, which the District Court could apply as appropriate.

The underlying facts in *Daubert* happened to involve the admissibility of various scientific tests and analyses on whether Benedictin caused birth defects. There followed some debate over the scope of the *Daubert* test, particularly whether it applied to any expert testimony, or only to "scientific" studies.

That controversy was resolved (in federal court) by the U.S. Supreme Court in *Kumho Tire Company v. Charmichael*, 526 U.S. 137, 119 S.Ct. 1167 (1999). In *Kumho Tire*, the Supreme Court made clear that *Daubert*'s "gatekeeping" obligation applies to all expert testimony. Again, it was emphasized that the District Court could flexibly apply the *Daubert* factors, or other appropriate factors, as relevant.

Some, but not all, states have chosen to apply the *Daubert/Kumho Tire* standard to expert testimony in state court.

D. Bases for Expert Opinions

Under Federal Rule of Evidence 703³, the expert may draw upon three sources for the factual basis of opinions: (1) the expert's own perceptions; (2) facts or data "made known" to the expert before or at the hearing; and (3) facts or data otherwise inadmissible but "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject."

Rule 703's reference to the expert's own perceptions simply means that the expert may, like a percipient witness, rely upon the expert's own personal knowledge. A simple example is an experiment performed by the expert personally.

Facts or data "made known" to the expert refers to permitting the expert to assume hypothetical facts. Hypotheticals are used in two distinct ways. One way, typically on direct examination, is to match the facts of the hypothetical to the facts to be proven, so that the expert's opinion on the hypothetical may be applied to the facts proven. Another way, frequently used on cross-examination, is to explore the outer limits of the reasoning the expert is applying, generally in an attempt to force the expert to take an unreasonable position on hypothetical facts, thereby discrediting the expert's reasoning.

While the expert can certainly rely upon facts proven with admissible evidence, the expert is also allowed to rely on inadmissible evidence "[i]f of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject." This liberalization of the bases upon which an expert opinion may be formed is a useful way to streamline the presentation but is also subject to attempted abuse.

A simple example of the proper use of evidence "of a type reasonably relied upon" is a medical doctor providing an opinion based on a patient's X-ray film. Strictly applied, the rules of evidence would require significant foundational testimony regarding how the X-ray was taken, what equipment was used, who the technician was, and a chain of custody on the film. However, because doctors make life and death decisions based on such films if generated in the normal course at their office or hospital, Rule 703 permits the expert to rely on the X-ray with the more limited foundation specified in the rule, namely that the evidence is "of the type reasonably relied upon" by the expert in the field.

While liberalized, there remains the requirement that the evidence be shown to be "of the type reasonably relied upon" by experts in the field. In order to meet this foundational requirement, the expert's opinion in general must be the type of opinion given by experts in the field using that type of evidence. Accordingly, while it may be permissible for a physician to give a diagnostic opinion based on an X-ray film with a limited foundation, it might be improper for an "X-ray machine" expert to give an opinion concerning the operation of the X-ray camera based on a film that is not fully authenticated.

³ Federal Rule of Evidence 703 provides in full: "The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence."

It is also important to note that such evidence may be the basis for an opinion, but is not proof of the underlying facts. The physician may rely upon the X-ray to opine that the person depicted in the X-ray film has a certain condition, but the X-ray film must still be tied to an injured plaintiff using admissible evidence.

E. Opinions on Ultimate Issues Are Permissible

Federal Rule of Evidence 704(a) expressly permits the expert to testify in the form of an opinion to an ultimate issue to be decided by the trier of fact.⁴ Thus, for example, in a patent case, experts may directly opine on whether an accused device infringes a patent claim or whether a prior art reference anticipates a patent claim.

F. Testifying to the Opinion First

Federal Rule of Evidence 705 allows the expert to give the opinion testimony and reasons without first testifying to the underlying facts or data, unless the court otherwise orders.⁵ As a practical matter, this allows a streamlined direct examination that starts with the ultimate opinion, without getting bogged down in the details of the underlying data. The rule is premised on the right of opposing counsel to obtain, through expert discovery, the underlying data for use, as appropriate, on cross-examination.

G. The Role of Discovery

The procedure for expert discovery is central to the presentation of technical information at trial. In effect, the Federal Rules of Civil Procedure require a full disclosure of the work the expert has done to form the opinion, all bases for the opinion, and the opinion itself. Federal Rule of Civil Procedure 26(a)(2). Failure to provide such full disclosure can be grounds for excluding all or part of the expert's testimony.

III. Presentation of Scientific Evidence

The real task at hand is to educate the judge or jury sufficiently about a field of knowledge to enable the judge or jury to evaluate the facts that give rise to the case. In "non-scientific" cases, the facts of the case are of common enough experience that no special

⁴ Federal Rule of Evidence 704(a) provides: "(a) Except as provided in subdivision (b) [relating to opinions on the state of mind of criminal defendants], testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact."

⁵ Federal Rule of Evidence 705 provides: "The expert may testify in terms of opinion or inference and give reasons therefore without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination."

education is required. What distinguishes the “scientific” case is the need for special education on the background against which to evaluate the facts of the case.

A. Non-Opinion Testimony on Scientific Principles

Although typically an expert witness is used, scientific or technical evidence can be presented by either “expert” witnesses under Rule 702 or “percipient” witnesses under Rule 701. Because the evidentiary distinction between “expert” and “percipient” testimony involves the permitted scope of opinion testimony, non-opinion testimony on the background of technology can be provided by a knowledgeable “percipient” witness who has not necessarily been qualified as an “expert” for giving opinion testimony. This is an important tactical consideration because the rules and procedures applicable to discovery of “experts” and “percipient” witnesses are quite different. In general, a testifying “expert” must write a formal report and all work the expert did to reach the expert opinions rendered is discoverable, making the testifying expert an “open book.” Non-expert witnesses are not subject to these special discovery rules.

Even if an expert witness is used, although an expert is allowed to give opinion testimony, the expert’s testimony will generally include a great deal of non-opinion testimony. Indeed, properly presented, the non-opinion testimony can be more persuasive than the ultimate opinion itself. The comments to Federal Rule of Evidence 702 recognize this:

Most of the literature assumes that experts testify only in the form of opinions. The assumption is logically unfounded. The rule accordingly recognizes that **an expert on the stand may give a dissertation or exposition of scientific or other principles relevant to the case, leaving the trier of fact to apply them to the facts.** Since much of the criticism of expert testimony has centered upon the hypothetical question, it seems wise to recognize that **opinions are not indispensable and to encourage the use of expert testimony in non-opinion form when counsel believes the trier can itself draw the requisite inference.**

Advisory Committee Notes, Rule 702 (emphasis added.)

As a practical matter, qualified “expert” witnesses are often used to give even the non-opinion technical background because their “expert” credentials provide credibility and the particular witness can be selected specifically for his or her presentation skills. The scientific or technical evidence is often presented in the form of a direct examination of the witness through which the witness provides a non-opinion tutorial on the basics of the relevant technical field. Properly orchestrated, this presentation can be made very watchable and the technology can be explained lucidly in appropriate detail.

B. Demonstrative Evidence

1. Samples

One of the clearest and most direct ways to present technical evidence is with a sample of the technology. If there is a key device that can be brought into court, do so. If there are peripheral pieces of equipment, bring them, too. If it is software, load it onto a computer and bring that to court.

Once the sample is in the courtroom, the expert can run it through its paces in a demonstration. Seeing the device in question in action is a powerful learning experience.

From an evidentiary standpoint, the sample and its demonstration can be made admissible as evidence by laying an appropriate foundation for the sample.

2. Graphics and Models

Not all technology is embodied in a device that is susceptible to being demonstrated in the courtroom. Models and graphics can be used to illustrate such technology, but models and graphics raise evidentiary issues that must be carefully thought through.

From an evidentiary standpoint, the problem with any model or graphic is that it is a surrogate for the real thing and is, therefore, different from the real thing. As such, in order for a model or graphic to be admissible as evidence, an appropriate foundation must establish that the model or graphic accurately depicts certain features of the real device or technology.

An appropriate foundation will be impossible if care is not taken in the preparation of the model or graphic to make it as accurate a depiction of the real thing as possible. For example, the model or graphic should be to scale, based on accurate measurement of the dimensions of the thing depicted. You should have available for trial a witness with personal knowledge of the dimensions of the thing (for example, by direct measurement) and a witness who can testify to the preparation of the model or graphic by scaling those actual dimensions.

Where the measurement of the actual dimensions are by something other than a ruler, a whole layer of additional foundation can be required. The method of measurement may require explanation as well as testimony that the measurement method was properly conducted.

3. Special Problems with Animations

Animations have become very popular forms of graphics, but extraordinary care is required in their preparation if they are to be admissible into evidence or even shown at all. The stakes can be high, because such animations are expensive to prepare, take time to prepare, and, once prepared, can be difficult to alter quickly.

The person preparing the animation is typically not a lawyer, but an artist, who will suggest taking certain artistic licenses to create images that will convey a particular point to the judge or jury. But even simple deviations from reality, such as the use of artificial colors for contrast or emphasis, can be a ground for objection that the animation is misleading. That is not to say such a technique is not appropriate or permissible with a particular graphic, but the lawyer must be aware of the risks and prepare for possible objections, perhaps by having alternative versions of the animation prepared.

4. Aids to Testimony That Are Not Admitted into Evidence

The differences between a model or graphic and the thing depicted frequently raise a serious barrier to actually admitting the model or graphic into evidence. An alternative use of models and graphics is as a “demonstrative exhibit,” which is a testimonial aid that is not itself admitted into evidence. Because they are not admitted into evidence, the court will typically allow more latitude for artistic license to enhance viewability, but even that latitude will not extend to permitting use of a model or graphic that is misleading. Accordingly, counsel should always strive to make such models or graphics as accurate as possible, even if they are not being offered as admissible evidence.

C. Practical Techniques for Teaching the Judge and Jurors

1. The Technophobic Audience

Almost by definition, an expert witness is needed because the judge or jury does not know the technology. Because the typical judge or juror is old enough to have had an opportunity to learn technology, it is a fair inference that at least some judges and jurors have deliberately chosen not to learn technology. Overcoming any aversion a judge or juror has to learning technology is a distinct challenge to the presentation of scientific evidence.

It is the author’s personal view that many of those with an aversion to learning technology learned that aversion because typical teaching methods used in schools to teach science are not as effective as they could be. For example, although people learn easily through story-telling, scientific principles are generally not presented in story form. For reasons that may or may not be valid in a particular course, many science teachers deliberately present the material, and test the students’ comprehension, in a fashion designed more to filter those with an aptitude for the material than to make the material accessible to all.

As a litigator, you cannot make up for past deficiencies in the science curriculum to which the judge or juror has been exposed. What you can do is avoid repeating those mistakes.

2. Expect the Judge and Jurors to Learn

Experienced litigators all agree on one thing about the vast majority of judges and jurors: they want to get it right. Accordingly, no matter how averse they are to learning technology, at the beginning of the trial, they are motivated to learn whatever they have to learn in order to reach a just result. But that early motivation can be lost if not immediately capitalized upon.

First and foremost, respect the ability of the judge or juror to learn what needs to be learned. Some lawyers take the view that judges and jurors are incapable of learning the material and must instead be emotionally manipulated to the desired conclusion. That approach is guaranteed to leave the judge or juror uneducated about the technology—by you. That approach is not necessarily going to stop your opponent from educating the judge and jury, and in a close case, the judge or jurors may find their sympathies leaning toward the advocate who trusted them with the knowledge required for them to make an informed decision.

A particular judge or juror may not know technology, but he or she will have been around enough to know whether a lawyer's approach to explaining the technology is intended to lead to understanding as a foundation for an informed decision or is instead a simple hard sell intended to coerce a result. The animosity people typically express for the "hard sellers" we encounter, such as car salesmen—and even lawyers—suggests that the better way is to make the effort to teach.

There is no shortage of evidence that people rise, or fall, to expectations. If you as a lawyer assume the judge and jurors can learn what you are going to teach, they will sense your confidence in them and respond by making the effort to learn. If, on the other hand, you communicate pessimism about their ability to grasp the material, they will sense that as well, and quickly give up.

3. Engage the Judge's and Jurors' Curiosity by Teaching "How and Why"

In talking to the judge or jury, for example in opening statement, it is a mistake to characterize the technical material as difficult or hard. Avoid apologizing for it.

Instead of apologizing, take a positive approach, stating simply that part of the evidence will include an explanation of how and why something works. This "how and why" approach will engage a quality that almost everyone has, whether they think of themselves as averse to technology or not: their curiosity. Almost everyone has wondered why the sky is blue. Tell the judge and jury that you are about to answer that question for them.

Of course, the issue is probably not the color of the sky. Instead the issue is how messages are transmitted to a computer, or how silicon wafers are prepared for becoming the brains of a computer, or how DNA is sequenced to unravel the genome.

The issue will always be susceptible to such a characterization. No one is going to pay you to try a case involving purely theoretical matters. The technology at issue is being used to achieve a practical result that the judge and jury will be able to grasp. You can spark curiosity about how that result is achieved, and that curiosity will reinforce the desire of the judge and jurors to get it right, providing the motivation to learn what you need to teach.

The key to making any technical material accessible is to explain “why.” Scientific principles are our best explanation for how the universe works. As an explanation, it has a reasonable logic. Engineering is the application of scientific principles to solve practical problems. There is a practical reason for all engineering solutions.

Explaining the “why” will help the judge and jurors understand the technological issue. In general, there is little need to get into complicated math or equations or to use a lot of scientific jargon. Instead, explain “why” in story form, where a protagonist (e.g., your client) has an obstacle to overcome, and the technology is the solution.

4. Use Analogies

Another way to make technology accessible is by drawing analogies to things that are more familiar to the judge and jurors. However, choose the analogy carefully. It must fit well enough not to be turned around by your opponent or misapplied by the judge and jurors.

5. Get It Right

As noted above, the judge and jurors want to get it right. The lawyer must get it right, also. Simplification should not imply inaccuracy. In general, technical material can be presented accessibly, yet right.

This is particularly important if, as a good advocate should, the lawyer sincerely believes in the client’s position. Inaccuracy for the sake of simplification can back-fire in a number of ways. First, inaccuracies might be brought out by one’s opponent, impeaching one’s credibility. Second, inaccuracies might create an opportunity for the opponent to make an improper argument that would not be viable if the technical presentation had been sound.

This means working closely with the technical witnesses, including the designated “experts” and any other engineer or scientist who might testify, to make sure they are not, for example, unilaterally inaccurately oversimplifying, on the assumption that lawyers are too dumb to understand the technology. Stress to all the technical witnesses that they should resist the temptation to “dumb down” where that leads to inaccuracy. Instead, work to find a way to accessibly explain it accurately.

IV. Conclusion

Presenting scientific evidence is challenging from an evidentiary and persuasive standpoint. The presentation must be presented in a form that is consistent with the rules of evidence, particularly the rules applicable to expert opinion testimony and demonstrative exhibits. It must also be made accessible to a judge and jurors who, in general, lack the technical background and may even be averse to learning technology.

The rules of evidence place constraints on the form of the presentation, but not on the substance (assuming the substance is sufficiently well grounded to be found reliable). Key elements of the presentation are the selection of an expert who can make a good presentation and preparation of demonstrative evidence to illustrate the technology.

Though initially uninformed, typical judges and jurors are motivated to learn by their desire to decide the case correctly. That motivation to learn can be reinforced by taking a positive attitude toward the teaching process and engaging the curiosity of the judge and jurors by explaining the "how and why" of the technology at issue.

**PRESENTING
SCIENTIFIC
EVIDENCE**

Timothy P. Walker

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THE CHALLENGES OF PRESENTING SCIENTIFIC EVIDENCE

- ◆ Conform Form of Presentation to Applicable Rules of Evidence
- ◆ Teach New Technological Concepts to Potentially Technophobic Audience

WHAT IS “SCIENTIFIC” EVIDENCE?

- ◆ All Evidence is “Scientific” (or Not).
- ◆ Some Subject Matter is Outside the Experience and Training of Many Judges and Jurors.
- ◆ Judges and Jurors Must Be Taught Sufficient Background to Evaluate the Operative Facts of the Case.

THE EXPERT WITNESS

- ◆ Teaches Principles with Non-opinion Tutorial.
- ◆ Authorized to Advocate with Opinion Testimony. FRE 702.

EXPERT TESTIMONY MUST BE RELIABLE

◆ *Daubert*

- Appoints Judge as “Gatekeeper”
- Requires Expert Opinion be Reliable and Relevant

◆ *Kumho Tire*

- Confirms *Daubert* Principles Apply to all Expert Testimony

KEYS TO SUCCESSFUL PRESENTATION OF SCIENTIFIC EVIDENCE

- ◆ Know What You Are Talking About.
- ◆ Respect the Ability of the Judge and Jurors.
- ◆ Expect the Judge and Jurors to Learn.
- ◆ Select the Right Witness.
- ◆ Use Demonstrative Aids.
- ◆ Explain the How and Why of the Technology.

KNOW WHAT YOU ARE TALKING ABOUT

- ◆ There Is No Substitute for Knowing What You Are Talking About.
- ◆ You Cannot Effectively Teach What You Do Not Understand, Even Through Direct Examination of an Expert Witness.
- ◆ You Cannot Effectively Cross-Examine an Expert on a Subject You Do Not Understand.

RESPECT THE ABILITY OF THE JUDGE AND JURORS

- ◆ Assume:
 - You Are Not Smarter Than They Are.
 - Your Expert Is Not Smarter Than They Are.
- ◆ Therefore:
 - If You Learned It, So Can They.
 - If They Don't Get It, It Is Because You Failed to Explain It.

EXPECT THE JUDGE AND JURORS TO LEARN

- ◆ Tell Them That Knowledge of the Material Is Needed to Properly Decide the Case.
- ◆ Tell Them You Are Confident They Will Learn What Needs to Be Learned.
- ◆ Do NOT Give Them Excuses:
 - Do NOT Say (or Imply) the Material Is Hard.
 - Do NOT Say (or Imply) Learning the Material Is Optional.

SELECT THE RIGHT WITNESS

- ◆ You Have a Choice
 - Technical “Percipient” Witness
 - Expert Witness of Your Choosing
- ◆ Choose a Witness with Strong Communication Skills
 - Appropriate Appearance
 - Good Stage Presence
 - Well-Spoken

USE DEMONSTRATIVE AIDS

- ◆ Picture Worth 1,000 Words
- ◆ Seeing Is Believing

DEMONSTRATIVE AIDS TYPES

- ◆ Samples
- ◆ Demonstrations
- ◆ Models
- ◆ Graphics
- ◆ Animations

EVIDENTIARY POINTS FOR DEMONSTRATIVE AIDS

- ◆ Each Difference Between Demonstrative Aid and Real Thing Is Potential for Objection.
- ◆ Make Demonstrative Aid as Accurate as Possible.
- ◆ Demonstrative Aid Need Not Be Admitted into Evidence.

SAMPLES

- ◆ There Is Nothing Like the Real Thing
- ◆ Powerful Teaching Tool
- ◆ Relatively Easy to Admit into Evidence
if Foundation for Authenticity Made

MODELS

- ◆ Next Best Thing to Sample
- ◆ To Ensure Admissibility, Must Be to Scale
- ◆ To Ensure Admissibility, Must Be Accurate in All Respects Except Scale

GRAPHICS

- ◆ Keep It Simple

DEMONSTRATIONS

- ◆ Practice, practice, practice
- ◆ Practice, practice, practice
- ◆ Practice, practice, practice

ANIMATIONS

- ◆ Are Never the Real Thing
- ◆ Anticipate Objections in Preparation
 - Expensive to Produce
 - Take Time to Produce and Change

EXPLAIN HOW AND WHY

- ◆ Engage the Curiosity of the Judge and Jurors.
- ◆ Explain the Practical Benefit of the Technology.
- ◆ Explain the Problem the Technology Solves.
- ◆ Explain How the Technology Solves the Problem.

SCIENTIFIC EVIDENCE IN PATENT CASES

Special Guest Lecturer - 2001

*Timothy P. Walker
Preston Gates & Ellis LLP
San Francisco, California*

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I. Introduction

One of the most significant challenges in any patent case is explaining the technology to the decision-maker, whether that is a judge or a jury. This presentation will cover two distinct aspects of that challenge: the special rules of evidence applicable to scientific evidence and, particularly, to expert testimony; and the manner in which scientific evidence is frequently presented, particularly techniques for effectively presenting that evidence.

The basic problem is that the decision-maker is, in general, not familiar with the technology at issue. Inventions claimed in patents and the devices accused of infringing those claims are frequently the result of work by engineers or scientists applying years of specialized training. As an attorney in a patent case, you have only hours or, at most, a few days, to communicate to the decision-maker the salient aspects of the body of knowledge applied by those engineers and scientists.

While challenging, educating the judge or jury can be done. The rules of evidence allow testimony by experts in the field, who serve as the teachers. There are techniques for presenting such testimony so that it is watchable and understandable, including the use of visual aids and demonstrations.

To successfully present scientific evidence, the attorney must first learn the technology, because there is no substitute for knowing what you are talking about. The attorney must then exercise judgment concerning what aspects of the technology need to be presented.

Some judges or jury members may have an aversion to learning technology at the beginning of the case. This aversion can be overcome by applying several specific techniques: (1) showing respect for the intelligence of the audience; (2) using analogies to devices or concepts that are within the more common experience of people; and (3) explaining the "how and why" of the technology.

II. Rules of Evidence Applicable to Scientific Evidence

A. What Is "Scientific Evidence"?

Strictly speaking, one cannot really distinguish "scientific" evidence from any other kind of evidence. In its broadest sense, the word "science" refers to a continuing process by which we

gather information about our universe and try to explain what we have gathered. All evidence can be characterized as “scientific” in some sense.

Conventionally, however, certain fields of endeavor are viewed as “technological” or “scientific,” including all subjects having names that include the words “engineering,” “computer,” “medicine,” “biology,” “physics” or “chemistry.” The subject matter of patents is similarly viewed as “technological,” even though many patents relate to subjects as ordinary as picture frames and chairs.

B. “Expert Witnesses” May Give “Opinion” Testimony

Although the presentation of “scientific” evidence conjures up (appropriately, in general) the image of a court-qualified “expert witness,” it should always be kept in mind that the need for an “expert” witness under the Federal Rules of Evidence is governed by the opinion nature of the testimony to be given, not whether the subject matter is “scientific.” The Federal Rules of Evidence give special treatment to “opinion” testimony.

Federal Rule of Evidence 701 sets forth the general rule that the opinion testimony of most witnesses “is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness’ testimony or the determination of a fact in issue.”¹

Federal Rule of Evidence 702 sets forth the exception to Rule 701, authorizing “a witness qualified as an expert” to testify “in the form of an opinion or otherwise.”² Rule 702 authorizes the use of expert opinion testimony “[i]f scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue.” To qualify as an expert witness, Rule 702 requires that the witness have pertinent “knowledge, skill, experience, training, or education.”

C. Expert Testimony Must Be Reliable and Relevant

Case law respecting the standards for admissibility of expert testimony is extensive, and a complete review is beyond the scope of this presentation. There is now a difference between federal court standards and some state court standards.

The split between federal and state standards arose in the wake of the U.S. Supreme Court’s decision in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S.Ct. 2786

¹ Federal Rule of Evidence 701 provides in full: “If the witness is not testifying as an expert, the witness’ testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding of the witness’ testimony or the determination of a fact in issue.”

² Federal Rule of Evidence 702 provides in full: “If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.”

(1993). There, the U.S. Supreme Court held that Federal Rule of Evidence 702 had superceded what had to that point been the leading expert testimony case, *Frye v. United States*, 293 F. 1013 (1923).

Under the venerable *Frye*'s test, expert opinion based on a scientific technique is inadmissible unless the technique is "generally accepted" as reliable in the relevant scientific community. Virtually every state subsequently adopted the *Frye*'s test.

The *Daubert* decision changed the standard for admissibility of expert evidence to one that is superficially more flexible, but in practice is often more restrictive. "General acceptance" is no longer a necessary precondition to the admissibility of scientific evidence, but the trial judge is charged with the "gatekeeping" function of ensuring that an expert's testimony both rests on a reliable foundation and is relevant. Evidence of "general acceptance" (or lack thereof) can be a factor in determining the reliability (or lack thereof) of the proposed testimony, but it is no longer determinative by itself.

Other factors identified by the *Daubert* decision include:

- Whether a theory or technique can be (or has been) tested;
- Whether it has been subjected to peer review and publication; and
- Whether, in respect to a particular technique, there is a high known or potential rate of error and whether there are standards controlling the technique's operation.

This was a non-exclusive list, which the District Court could apply as appropriate.

The underlying facts in *Daubert* happened to involve the admissibility of various scientific tests and analyses on whether Benedictin caused birth defects. There followed some debate over the scope of the *Daubert* test, particularly whether it applied to any expert testimony, or only to "scientific" studies.

That controversy was resolved (in federal court) by the U.S. Supreme Court in *Kumho Tire Company v. Charmichael*, 526 U.S. 137, 119 S.Ct. 1167 (1999). In *Kumho Tire*, the Supreme Court made clear that *Daubert*'s "gatekeeping" obligation applies to all expert testimony. Again, it was emphasized that the District Court could flexibly apply the *Daubert* factors, or other appropriate factors, as relevant.

Some, but not all, states have chosen to apply the *Daubert/Kumho Tire* standard to expert testimony in state court.

D. Bases for Expert Opinions

Under Federal Rule of Evidence 703³, the expert may draw upon three sources for the factual basis of opinions: (1) the expert's own perceptions; (2) facts or data "made known" to the expert before or at the hearing; and (3) facts or data otherwise inadmissible but "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject."

Rule 703's reference to the expert's own perceptions simply means that the expert may, like a percipient witness, rely upon the expert's own personal knowledge. A simple example is an experiment performed by the expert personally.

Facts or data "made known" to the expert refers to permitting the expert to assume hypothetical facts. Hypotheticals are used in two distinct ways. One way, typically on direct examination, is to match the facts of the hypothetical to the facts to be proven, so that the expert's opinion on the hypothetical may be applied to the facts proven. Another way, frequently used on cross-examination, is to explore the outer limits of the reasoning the expert is applying, generally in an attempt to force the expert to take an unreasonable position on hypothetical facts, thereby discrediting the expert's reasoning.

While the expert can certainly rely upon facts proven with admissible evidence, the expert is also allowed to rely on inadmissible evidence "[i]f of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject." This liberalization of the bases upon which an expert opinion may be formed is a useful way to streamline the presentation but is also subject to attempted abuse.

A simple example of the proper use of evidence "of a type reasonably relied upon" is a medical doctor providing an opinion based on a patient's X-ray film. Strictly applied, the rules of evidence would require significant foundational testimony regarding how the X-ray was taken, what equipment was used, who the technician was, and a chain of custody on the film. However, because doctors make life and death decisions based on such films if generated in the normal course at their office or hospital, Rule 703 permits the expert to rely on the X-ray with the more limited foundation specified in the rule, namely that the evidence is "of the type reasonably relied upon" by the expert in the field.

While liberalized, there remains the requirement that the evidence be shown to be "of the type reasonably relied upon" by experts in the field. In order to meet this foundational requirement, the expert's opinion in general must be the type of opinion given by experts in the field using that type of evidence. Accordingly, while it may be permissible for a physician to give a diagnostic opinion based on an X-ray film with a limited foundation, it might be improper for an "X-ray machine" expert to give an opinion concerning the operation of the X-ray camera based on a film that is not fully authenticated.

³ Federal Rule of Evidence 703 provides in full: "The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence."

It is also important to note that such evidence may be the basis for an opinion, but is not proof of the underlying facts. The physician may rely upon the X-ray to opine that the person depicted in the X-ray film has a certain condition, but the X-ray film must still be tied to an injured plaintiff using admissible evidence.

E. Opinions on Ultimate Issues Are Permissible

Federal Rule of Evidence 704(a) expressly permits the expert to testify in the form of an opinion to an ultimate issue to be decided by the trier of fact.⁴ Thus, for example, in a patent case, experts may directly opine on whether an accused device infringes a patent claim or whether a prior art reference anticipates a patent claim.

F. Testifying to the Opinion First

Federal Rule of Evidence 705 allows the expert to give the opinion testimony and reasons without first testifying to the underlying facts or data, unless the court otherwise orders.⁵ As a practical matter, this allows a streamlined direct examination that starts with the ultimate opinion, without getting bogged down in the details of the underlying data. The rule is premised on the right of opposing counsel to obtain, through expert discovery, the underlying data for use, as appropriate, on cross-examination.

G. The Role of Discovery

The procedure for expert discovery is central to the presentation of technical information at trial. In effect, the Federal Rules of Civil Procedure require a full disclosure of the work the expert has done to form the opinion, all bases for the opinion, and the opinion itself. Federal Rule of Civil Procedure 26(a)(2). Failure to provide such full disclosure can be grounds for excluding all or part of the expert's testimony.

III. Presentation of Scientific Evidence

The real task at hand is to educate the judge or jury sufficiently about a field of knowledge to enable the judge or jury to evaluate the facts that give rise to the case. In "non-scientific" cases, the facts of the case are of common enough experience that no special

⁴ Federal Rule of Evidence 704(a) provides: "(a) Except as provided in subdivision (b) [relating to opinions on the state of mind of criminal defendants], testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact."

⁵ Federal Rule of Evidence 705 provides: "The expert may testify in terms of opinion or inference and give reasons therefore without first testifying to the underlying facts or data, unless the court requires otherwise. The expert may in any event be required to disclose the underlying facts or data on cross-examination."

education is required. What distinguishes the “scientific” case is the need for special education on the background against which to evaluate the facts of the case.

A. Non-Opinion Testimony on Scientific Principles

Although typically an expert witness is used, scientific or technical evidence can be presented by either “expert” witnesses under Rule 702 or “percipient” witnesses under Rule 701. Because the evidentiary distinction between “expert” and “percipient” testimony involves the permitted scope of opinion testimony, non-opinion testimony on the background of technology can be provided by a knowledgeable “percipient” witness who has not necessarily been qualified as an “expert” for giving opinion testimony. This is an important tactical consideration because the rules and procedures applicable to discovery of “experts” and “percipient” witnesses are quite different. In general, a testifying “expert” must write a formal report and all work the expert did to reach the expert opinions rendered is discoverable, making the testifying expert an “open book.” Non-expert witnesses are not subject to these special discovery rules.

Even if an expert witness is used, although an expert is allowed to give opinion testimony, the expert’s testimony will generally include a great deal of non-opinion testimony. Indeed, properly presented, the non-opinion testimony can be more persuasive than the ultimate opinion itself. The comments to Federal Rule of Evidence 702 recognize this:

Most of the literature assumes that experts testify only in the form of opinions. The assumption is logically unfounded. The rule accordingly recognizes that **an expert on the stand may give a dissertation or exposition of scientific or other principles relevant to the case, leaving the trier of fact to apply them to the facts.** Since much of the criticism of expert testimony has centered upon the hypothetical question, it seems wise to recognize that **opinions are not indispensable and to encourage the use of expert testimony in non-opinion form when counsel believes the trier can itself draw the requisite inference.**

Advisory Committee Notes, Rule 702 (emphasis added.)

As a practical matter, qualified “expert” witnesses are often used to give even the non-opinion technical background because their “expert” credentials provide credibility and the particular witness can be selected specifically for his or her presentation skills. The scientific or technical evidence is often presented in the form of a direct examination of the witness through which the witness provides a non-opinion tutorial on the basics of the relevant technical field. Properly orchestrated, this presentation can be made very watchable and the technology can be explained lucidly in appropriate detail.

B. Demonstrative Evidence

1. Samples

One of the clearest and most direct ways to present technical evidence is with a sample of the technology. If there is a key device that can be brought into court, do so. If there are peripheral pieces of equipment, bring them, too. If it is software, load it onto a computer and bring that to court.

Once the sample is in the courtroom, the expert can run it through its paces in a demonstration. Seeing the device in question in action is a powerful learning experience.

From an evidentiary standpoint, the sample and its demonstration can be made admissible as evidence by laying an appropriate foundation for the sample.

2. Graphics and Models

Not all technology is embodied in a device that is susceptible to being demonstrated in the courtroom. Models and graphics can be used to illustrate such technology, but models and graphics raise evidentiary issues that must be carefully thought through.

From an evidentiary standpoint, the problem with any model or graphic is that it is a surrogate for the real thing and is, therefore, different from the real thing. As such, in order for a model or graphic to be admissible as evidence, an appropriate foundation must establish that the model or graphic accurately depicts certain features of the real device or technology.

An appropriate foundation will be impossible if care is not taken in the preparation of the model or graphic to make it as accurate a depiction of the real thing as possible. For example, the model or graphic should be to scale, based on accurate measurement of the dimensions of the thing depicted. You should have available for trial a witness with personal knowledge of the dimensions of the thing (for example, by direct measurement) and a witness who can testify to the preparation of the model or graphic by scaling those actual dimensions.

Where the measurement of the actual dimensions are by something other than a ruler, a whole layer of additional foundation can be required. The method of measurement may require explanation as well as testimony that the measurement method was properly conducted.

3. Special Problems with Animations

Animations have become very popular forms of graphics, but extraordinary care is required in their preparation if they are to be admissible into evidence or even shown at all. The stakes can be high, because such animations are expensive to prepare, take time to prepare, and, once prepared, can be difficult to alter quickly.

The person preparing the animation is typically not a lawyer, but an artist, who will suggest taking certain artistic licenses to create images that will convey a particular point to the judge or jury. But even simple deviations from reality, such as the use of artificial colors for contrast or emphasis, can be a ground for objection that the animation is misleading. That is not to say such a technique is not appropriate or permissible with a particular graphic, but the lawyer must be aware of the risks and prepare for possible objections, perhaps by having alternative versions of the animation prepared.

4. Aids to Testimony That Are Not Admitted into Evidence

The differences between a model or graphic and the thing depicted frequently raise a serious barrier to actually admitting the model or graphic into evidence. An alternative use of models and graphics is as a “demonstrative exhibit,” which is a testimonial aid that is not itself admitted into evidence. Because they are not admitted into evidence, the court will typically allow more latitude for artistic license to enhance viewability, but even that latitude will not extend to permitting use of a model or graphic that is misleading. Accordingly, counsel should always strive to make such models or graphics as accurate as possible, even if they are not being offered as admissible evidence.

C. Practical Techniques for Teaching the Judge and Jurors

1. The Technophobic Audience

Almost by definition, an expert witness is needed because the judge or jury does not know the technology. Because the typical judge or juror is old enough to have had an opportunity to learn technology, it is a fair inference that at least some judges and jurors have deliberately chosen not to learn technology. Overcoming any aversion a judge or juror has to learning technology is a distinct challenge to the presentation of scientific evidence.

It is the author’s personal view that many of those with an aversion to learning technology learned that aversion because typical teaching methods used in schools to teach science are not as effective as they could be. For example, although people learn easily through story-telling, scientific principles are generally not presented in story form. For reasons that may or may not be valid in a particular course, many science teachers deliberately present the material, and test the students’ comprehension, in a fashion designed more to filter those with an aptitude for the material than to make the material accessible to all.

As a litigator, you cannot make up for past deficiencies in the science curriculum to which the judge or juror has been exposed. What you can do is avoid repeating those mistakes.

2. Expect the Judge and Jurors to Learn

Experienced litigators all agree on one thing about the vast majority of judges and jurors: they want to get it right. Accordingly, no matter how averse they are to learning technology, at the beginning of the trial, they are motivated to learn whatever they have to learn in order to reach a just result. But that early motivation can be lost if not immediately capitalized upon.

First and foremost, respect the ability of the judge or juror to learn what needs to be learned. Some lawyers take the view that judges and jurors are incapable of learning the material and must instead be emotionally manipulated to the desired conclusion. That approach is guaranteed to leave the judge or juror uneducated about the technology—by you. That approach is not necessarily going to stop your opponent from educating the judge and jury, and in a close case, the judge or jurors may find their sympathies leaning toward the advocate who trusted them with the knowledge required for them to make an informed decision.

A particular judge or juror may not know technology, but he or she will have been around enough to know whether a lawyer's approach to explaining the technology is intended to lead to understanding as a foundation for an informed decision or is instead a simple hard sell intended to coerce a result. The animosity people typically express for the "hard sellers" we encounter, such as car salesmen—and even lawyers—suggests that the better way is to make the effort to teach.

There is no shortage of evidence that people rise, or fall, to expectations. If you as a lawyer assume the judge and jurors can learn what you are going to teach, they will sense your confidence in them and respond by making the effort to learn. If, on the other hand, you communicate pessimism about their ability to grasp the material, they will sense that as well, and quickly give up.

3. Engage the Judge's and Jurors' Curiosity by Teaching "How and Why"

In talking to the judge or jury, for example in opening statement, it is a mistake to characterize the technical material as difficult or hard. Avoid apologizing for it.

Instead of apologizing, take a positive approach, stating simply that part of the evidence will include an explanation of how and why something works. This "how and why" approach will engage a quality that almost everyone has, whether they think of themselves as averse to technology or not: their curiosity. Almost everyone has wondered why the sky is blue. Tell the judge and jury that you are about to answer that question for them.

Of course, the issue is probably not the color of the sky. Instead the issue is how messages are transmitted to a computer, or how silicon wafers are prepared for becoming the brains of a computer, or how DNA is sequenced to unravel the genome.

The issue will always be susceptible to such a characterization. No one is going to pay you to try a case involving purely theoretical matters. The technology at issue is being used to achieve a practical result that the judge and jury will be able to grasp. You can spark curiosity about how that result is achieved, and that curiosity will reinforce the desire of the judge and jurors to get it right, providing the motivation to learn what you need to teach.

The key to making any technical material accessible is to explain “why.” Scientific principles are our best explanation for how the universe works. As an explanation, it has a reasonable logic. Engineering is the application of scientific principles to solve practical problems. There is a practical reason for all engineering solutions.

Explaining the “why” will help the judge and jurors understand the technological issue. In general, there is little need to get into complicated math or equations or to use a lot of scientific jargon. Instead, explain “why” in story form, where a protagonist (e.g., your client) has an obstacle to overcome, and the technology is the solution.

4. Use Analogies

Another way to make technology accessible is by drawing analogies to things that are more familiar to the judge and jurors. However, choose the analogy carefully. It must fit well enough not to be turned around by your opponent or misapplied by the judge and jurors.

5. Get It Right

As noted above, the judge and jurors want to get it right. The lawyer must get it right, also. Simplification should not imply inaccuracy. In general, technical material can be presented accessibly, yet right.

This is particularly important if, as a good advocate should, the lawyer sincerely believes in the client’s position. Inaccuracy for the sake of simplification can back-fire in a number of ways. First, inaccuracies might be brought out by one’s opponent, impeaching one’s credibility. Second, inaccuracies might create an opportunity for the opponent to make an improper argument that would not be viable if the technical presentation had been sound.

This means working closely with the technical witnesses, including the designated “experts” and any other engineer or scientist who might testify, to make sure they are not, for example, unilaterally inaccurately oversimplifying, on the assumption that lawyers are too dumb to understand the technology. Stress to all the technical witnesses that they should resist the temptation to “dumb down” where that leads to inaccuracy. Instead, work to find a way to accessibly explain it accurately.

IV. Conclusion

Presenting scientific evidence is challenging from an evidentiary and persuasive standpoint. The presentation must be presented in a form that is consistent with the rules of evidence, particularly the rules applicable to expert opinion testimony and demonstrative exhibits. It must also be made accessible to a judge and jurors who, in general, lack the technical background and may even be averse to learning technology.

The rules of evidence place constraints on the form of the presentation, but not on the substance (assuming the substance is sufficiently well grounded to be found reliable). Key elements of the presentation are the selection of an expert who can make a good presentation and preparation of demonstrative evidence to illustrate the technology.

Though initially uninformed, typical judges and jurors are motivated to learn by their desire to decide the case correctly. That motivation to learn can be reinforced by taking a positive attitude toward the teaching process and engaging the curiosity of the judge and jurors by explaining the "how and why" of the technology at issue.

**PRESENTING
SCIENTIFIC
EVIDENCE**

Timothy P. Walker

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THE CHALLENGES OF PRESENTING SCIENTIFIC EVIDENCE

- ◆ Conform Form of Presentation to Applicable Rules of Evidence
- ◆ Teach New Technological Concepts to Potentially Technophobic Audience

WHAT IS “SCIENTIFIC” EVIDENCE?

- ◆ All Evidence is “Scientific” (or Not).
- ◆ Some Subject Matter is Outside the Experience and Training of Many Judges and Jurors.
- ◆ Judges and Jurors Must Be Taught Sufficient Background to Evaluate the Operative Facts of the Case.

THE EXPERT WITNESS

- ◆ Teaches Principles with Non-opinion Tutorial.
- ◆ Authorized to Advocate with Opinion Testimony. FRE 702.

EXPERT TESTIMONY MUST BE RELIABLE

◆ *Daubert*

- Appoints Judge as “Gatekeeper”
- Requires Expert Opinion be Reliable and Relevant

◆ *Kumho Tire*

- Confirms *Daubert* Principles Apply to all Expert Testimony

KEYS TO SUCCESSFUL PRESENTATION OF SCIENTIFIC EVIDENCE

- ◆ Know What You Are Talking About.
- ◆ Respect the Ability of the Judge and Jurors.
- ◆ Expect the Judge and Jurors to Learn.
- ◆ Select the Right Witness.
- ◆ Use Demonstrative Aids.
- ◆ Explain the How and Why of the Technology.

KNOW WHAT YOU ARE TALKING ABOUT

- ◆ There Is No Substitute for Knowing What You Are Talking About.
- ◆ You Cannot Effectively Teach What You Do Not Understand, Even Through Direct Examination of an Expert Witness.
- ◆ You Cannot Effectively Cross-Examine an Expert on a Subject You Do Not Understand.

RESPECT THE ABILITY OF THE JUDGE AND JURORS

- ◆ Assume:
 - You Are Not Smarter Than They Are.
 - Your Expert Is Not Smarter Than They Are.
- ◆ Therefore:
 - If You Learned It, So Can They.
 - If They Don't Get It, It Is Because You Failed to Explain It.

EXPECT THE JUDGE AND JURORS TO LEARN

- ◆ Tell Them That Knowledge of the Material Is Needed to Properly Decide the Case.
- ◆ Tell Them You Are Confident They Will Learn What Needs to Be Learned.
- ◆ Do NOT Give Them Excuses:
 - Do NOT Say (or Imply) the Material Is Hard.
 - Do NOT Say (or Imply) Learning the Material Is Optional.

SELECT THE RIGHT WITNESS

- ◆ You Have a Choice
 - Technical “Percipient” Witness
 - Expert Witness of Your Choosing
- ◆ Choose a Witness with Strong Communication Skills
 - Appropriate Appearance
 - Good Stage Presence
 - Well-Spoken

USE DEMONSTRATIVE AIDS

- ◆ Picture Worth 1,000 Words
- ◆ Seeing Is Believing

DEMONSTRATIVE AIDS TYPES

- ◆ Samples
- ◆ Demonstrations
- ◆ Models
- ◆ Graphics
- ◆ Animations

EVIDENTIARY POINTS FOR DEMONSTRATIVE AIDS

- ◆ Each Difference Between Demonstrative Aid and Real Thing Is Potential for Objection.
- ◆ Make Demonstrative Aid as Accurate as Possible.
- ◆ Demonstrative Aid Need Not Be Admitted into Evidence.

SAMPLES

- ◆ There Is Nothing Like the Real Thing
- ◆ Powerful Teaching Tool
- ◆ Relatively Easy to Admit into Evidence
if Foundation for Authenticity Made

MODELS

- ◆ Next Best Thing to Sample
- ◆ To Ensure Admissibility, Must Be to Scale
- ◆ To Ensure Admissibility, Must Be Accurate in All Respects Except Scale

GRAPHICS

◆ Keep It Simple

DEMONSTRATIONS

- ◆ Practice, practice, practice
- ◆ Practice, practice, practice
- ◆ Practice, practice, practice

ANIMATIONS

- ◆ Are Never the Real Thing
- ◆ Anticipate Objections in Preparation
 - Expensive to Produce
 - Take Time to Produce and Change

EXPLAIN HOW AND WHY

- ◆ Engage the Curiosity of the Judge and Jurors.
- ◆ Explain the Practical Benefit of the Technology.
- ◆ Explain the Problem the Technology Solves.
- ◆ Explain How the Technology Solves the Problem.

INTERNET ESPIONAGE ISSUES

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SECTION J

INTERNET ESPIONAGE ISSUES

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INTERNET ESPIONAGE ISSUES

NETWORK AND COMPUTER SECURITY

Network and computer security is not just a software problem or just a hardware problem. It is a people problem. The risks are real and can lead to significant problems.

Lawyers should care about security issues because their clients may be liable or may sustain losses that are recoverable from third parties or the responsible parties. Either way, common risk management principles apply to help avoid problems.

Worse, if the client's network or computer is not secure, it could compromise the value of electronic records and signatures so that the integrity of electronic records is at stake. Further, network and computer security, and attacks on either, could become discovery issues. Lawyers can help by alerting clients to business risks such as network downtime; viruses and Trojan horse and denial of service attacks; loss of data; and exposure of data either trade secrets or confidential customer data.

Consider some potential sources of attack. A PriceWaterhouseCoopers survey suggested that the greatest threat was from insiders such as current and former employees, on-site contractors, consultants and "OEM"s, vendors, suppliers and even strategic partners.

Other potential threats come from "outsiders" such as hackers or "crackers," competitors, shareholders/speculators, the media and Governments, e.g. Echlon and Carnivore.

Companies fail to plug well known technological holes which account for a great number of the successful break-ins. The SANS Institute (Cert.org) is a center of Internet Security Expertise located at the Software Engineering Institute operated by Carnige Mellon University. Among other things, it tracks security holes in operating systems, e-mail browsers and other common software. More specifically, CERT/CC studies internet security vulnerabilities, provides instant response services to sites that have been the victims of attack, publishes a variety of security alerts, does research in wide area network computing and develops information and training to help companies improve security at their sites. Treat yourself to a visit to the SANS Institute website at cert.org.

In addition to the technological holes that account for a great number of successful break ins, SANS says people do their share as well. Their short paper "Mistakes People Make That Lead to Security Breaches" lists The Five Worst Security Mistakes End Users Make, The Seven Worst Security Mistakes Senior Executives Make and The Ten Worst Security Mistakes Information Technology People Make and then adds a bonus,

number eleven: "allowing untrained, uncertified people to take responsibility for securing important systems."

For a truly chilling experience, browse the CERT/CC site at www.cert.org, access the document "State of the Practice of Intrusion Detection Technologies," read Section 1 "Intrusion Detection – What Is It and Why Is It Needed." Section 1.1 "The Seriousness of Cyber Attacks" documents about a dozen significant attacks between September 1998 and October 1999 including ones where hackers apparently working from Russia had systematically broken into U.S. Defense Department computers for more than a year, raided unclassified computer networks at U.S. Energy Department nuclear weapons and research labs at NASA and many university research facilities. Several frightening examples are described.

Also, consider denial of service ("DoS") attacks. A DoS attack "floods" a network with bogus information or information requests that prevents legitimate network traffic thereby disrupting connections between two machines, preventing access to service or preventing a particular individual from accessing a service or disrupting service to a specific system or person. However, service overloading and message flooding are but two of several ways that DoS attack may occur.

Writing in the Richmond Journal of Law and Technology, Jeff

Nemerofsky states:

There are several ways a denial of service attack may occur—service overloading and message flooding are but two—and these attacks may be directed against either a user, a host computer, or a network. These attacks have a vernacular all their own and can be categorized as “fork bombs,” “malloc bombs,” “SYN flood” and “mail bombs,” with specific names such as “Ping of Death,” “Teardrop,” “Boing,” “New Tear” and “IceNewk.” For instance, one attack paints a huge black window on the user’s screen in such a way that the user can no longer access the remainder of their screen.

6 J.L. & Tech. 23 (Spring 2000)

For your own and your client’s sakes, get your guard up.

THE COMPUTER FRAUD AND ABUSE ACT

In response to these and other threats, Congress enacted the first Computer Fraud and Abuse Act in 1984 and has amended it from time to time thereafter, in 1986, 1994 and 1996. In its present form, the Act provides:

(a) Whoever—(5)(A) through means of a computer used in interstate commerce or communications, knowingly causes the transmission of program, information, code, or command to computer or computer system if- (i) the person causing the transmission intends that such transmission will-

(I) damage, or cause damage to, a computer, computer system, network information, data, or program; or (II) withhold or deny, or cause the withholding or denial, of the use of a computer, computer services, system or network, information, data, or program; and (ii) the transmission of the harmful component of the program, information, code, or command- (I) occurred without the authorization of the persons or entities who own or are responsible for the computer system receiving the program, information, code, or command; and (II)(a) causes loss or damage to one or more other persons of value aggregating \$1,000 or more during any 1-year period; . . . shall be punished

In 1998, Robert Morris, a 23 year old first year graduate at Cornell University's Computer Science program created a computer program later known as the internet "worm" or "virus." Morris intended to release the worm into university, government or military computers around the country to demonstrate the inadequacies of the then current security measures. However, after releasing his worm, Morris discovered it was actually infecting many other machines eventually causing computers at over 6000 educational institutions and military sites around the country to cease functioning. *U.S. v. Morris*, 928 F.2d 504 (2nd Cir. 1991)

Morris was prosecuted and found guilty of violating the Computer Fraud and Abuse Act, Section 1030 (a)(5)(A) which prohibited intentional, unauthorized access to federal computers and sentenced to three years

probation, four hundred hours of community service, fined \$10,500 and the cost of his supervision. *Id.* at 506

Morris claimed that the statutory language “intentionally accesses a Federal interest computer without authorization, and by means of one or more instances of such conduct, alter, damages, or destroys information in any such Federal interest computer, . . .” required the Government to prove that he intentionally accessed the Federal computer and intentionally altered information or prevented its use. The 2nd Circuit agreed with the District Court that the intent required applied only to the act of accessing the system, not the alteration of information or prevention of authorized use, and let Morris’ convictions stand. *Id.* at 510-11.

In 1994, Congress amended the 1986 Computer Fraud and Abuse Act to broaden the Federal laws that related to computer “worms” and “viruses.” Coverage of the Act was expanded to include computers used in interstate commerce. The requirement of an unauthorized access was removed so that company insiders and authorized users could be held liable and certain types of reckless conduct and intentional acts were deemed criminal.

Then in 1996, Congress further expanded the 1994 act to include computers in the private sector, called protected computers, as well as those in the government domain. It let the conviction stand. Today, the 1999

statute covers protected computers, or computers no longer strictly under government domain.

Not unexpectedly, America Online, Inc. has been involved in a number of cases involving the Computer Fraud and Abuse Act and other statutes. For example, in *America Online, Inc. v. LSGM, Inc., et al.*, 46 F.Supp. 2nd 444 (E.D.Va. 1998), AOL sued website operators and their principals alleging that they sent unauthorized and unsolicited bulk e-mail advertisements to AOL customers. The district court held that the operators' use of providers' internet domain name violated Lanham Act prohibitions on false designations of origin, operators' use of domain name constituted dilution and operators violated Computer Fraud and Abuse Act and the Virginia Computer Crimes Act. Moreover, the operators' conduct amounted to trespass to chattels under Virginia law. Specifically, AOL estimated that defendants in concert with their "site partners" transmitted more than 92 million unsolicited and bulk e-mail messages advertising their pornographic websites to AOL members for approximately June 17, 1997 to January 21, 1998. Indeed, defendants admitted that they sent approximately 300,000 e-mail messages a day at various intervals from their Michigan offices. Further, defendants admitted to maintaining AOL memberships to harvest or collect e-mail addresses of other AOL members, to using the AOL Collector

and e-mail Pro/Stealth Mailer extractor programs to collect e-mail address of AOL members and to using software to evade AOL's filtering mechanisms. Defendants also forged the domain information "aol.com." in the thumbline of e-mail messages sent to AOL members and committed a number of other violations of AOL's Terms of Service.

According to the court, the defendants violated 18 U.S.C. §1030(a)(2)(C) of the Computer Fraud and Abuse Act which prohibits individuals from "intentionally accessing a computer without authorization or exceeding authorized access, and thereby obtaining information from any protected computer if the conduct involved interstate or foreign communication." Also, defendants exceeded authorized access in violating the Computer Fraud and Abuse Act. Similarly, defendants impaired computer facilities by their conduct in violation of the Computer Fraud and Abuse Act damaging AOL's computer network, reputation and good will. Also see *Cyber Promotions, Inc. v. America Online, Inc.*, 948 F.Supp. 436 (E.D. Pa. 1996); *America Online, Inc. v. National Healthcare Discount, Inc.*, 121 F.Supp. 2nd 1255 (N.D. Iowa 2000); *America Online, Inc. v. Greatdeals.net, et al.*, 949 F.Supp. 2nd 851 (E.D. Va. 1999); and *America Online, Inc. v. IMS, et al.*, 24 F.Supp. 2nd 548 (E.D. Va. 1998).

I have attached a Cybercrime Case List which identifies approximately 25 civil or criminal which involve the Computer Fraud and Abuse Act.

THE ECONOMIC ESPIONAGE ACT

Although the Economic Espionage Act contains several sections, the first two define the elements of an EEA violation. Specifically, Section 1831 applies to violations by a foreign agent, while Section 1832 applies to both foreign and domestic violations. In either instance, the six fundamental elements to an EEA violation are:

- Stealing or, without authorization, misappropriating or obtaining information;
- When the defendant knows or substantially is certain that the information is a proprietary trade secret or of actual or potential independent economic value;
- When the defendant acts with a purpose of economic quick benefiting someone other than the owner of the information;
- When the defendant acts with knowledge that the offense would injure the owner of the trade secret;
- Where the information is related to or included in a product that is produced or placed in interstate or foreign commerce; and

- Where the owner has taken reasonable steps to keep the information secret under the EEA, it is critical to establish that the information stolen or misappropriated was in fact a "trade secret" as defined in Section 1839(3).

Other provisions of the EEA are significant. Section 1835 of the Act expressly provides for "order to preserve confidentiality." Under Section 1835, district court has authority to enter orders that are "necessary and appropriate to preserve the confidentiality of trade secrets" in any prosecution or other proceeding under the act. However, such orders must be consistent with the Federal Rules of Civil and Criminal Procedure, the Federal Rules of Evidence and "all other applicable laws." Already, this qualification has generated tensions between the rights of defendants to discovery and the prosecution's obligation to protect the proprietary nature of the information at issue.

Next, Section 1836 permits the Department of Justice to obtain a civil injunction against the violation of the Act and confers original jurisdiction on U.S. district courts. This civil remedy provides an additional means of protecting a company's trade secrets that have been misappropriated.

The Justice Department has adopted a "clear violations" policy. In one prosecution, the Justice Department charged two brothers who did

maintenance for PPG Industries. The brothers stole and then attempted to sell customer lists, blueprints, secret formulas, product specifications and videotapes of new machinery to PPG's competitor, Owens-Corning. Owens-Corning alerted PPG. Undercover agents caught the brothers. Each was convicted.

The first international prosecution was brought against Taiwanese nationals who attempted to steal information from Bristol-Myers Squibb Company related to the development of their anti-cancer drug "Taxol." *U.S. v. Hsu*. One was convicted and sentenced to time served. The other remained in Taiwan which has no extradition treaty with the United States. In several subsequent prosecutions, employees or contractors have misappropriated information and offered it to competitors. Imprisonment and substantial fines have often resulted.

In these cases, obviously, the existence of a trade secret is very important. U.S. companies who would seek the protection of such prosecutions should adopt a viable policy for trade secret protection including at least the following:

- Designate a corporate security officer
- Establish ownership of developments early and often

- Have employees sign certification pages quarterly or semi-annually
- Encrypt proprietary information
- Adopt access restrictions
- Carefully restrict access of vendors and consultants
- Treat business plans with special care
- Perform entrance and exit interviews with the company security officer
- Perform periodic "trade secret" audits
- Do not use cell phones for business use
- When flying, carry documents and laptops in the overhead bin
- Use polarized or LCD laptop screens

CONCLUSION

As this short discussion shows, network and computer security is a vital step to protecting oneself from hackers, crackers, snoopers, downloaders, tamperers, spoofers, jammers or flooders and virus mongers. As always, an ounce of prevention is worth a pound of cure.

However, the Computer Fraud and Abuse Act as presently drawn provides both civil and criminal protection and remedies against people who

violate it in any of the several ways the Act forbids and, where theft of trade secrets are at issue, the Economic Espionage Act can provide a remedy.

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CYBERCRIME CASE LIST

America Online, Inc. v. GreatDeals.Net, 49 F.Supp.2d 851, 1999-1 Trade Cases P 72,534 (E.D.Va., May 04, 1999)(NO. CIV. A. 99-62-A)

America Online, Inc. v. IMS, 24 F.Supp.2d 548, 48 U.S.P.Q.2d 1857 (E.D.Va., Oct 29, 1998)(NO. CIV. A. 98-0011-A)

America Online, Inc. v. LCGM, Inc., 46 F.Supp.2d 444, (E.D.Va., Nov 10, 1998)(NO. CIV. A. 98-102-A)

America Online, Inc. v. National Health Care Discount, Inc., 121 F.Supp.2d 1255 (N.D.Iowa, Sep 29, 2000)(NO. C98-4111-PAZ)

Cyber Promotions, Inc. v. American Online, Inc., 948 F.Supp. 436, 65 USLW 2488, 24 Media L. Rep. 2505, 25 Media L. Rep. 1193 (E.D.Pa., Nov 04, 1996)(NO. CIV. A. 96-5213)

eBay, Inc. v. Bidder's Edge, Inc., 100 F.Supp.2d 1058, 54 U.S.P.Q.2d 1798 (N.D.Cal., May 24, 2000)(NO. C-99-21200RMW)

Edge v. Professional Claims Bureau, Inc., 64 F.Supp.2d 115 (E.D.N.Y., Sep 10, 1999)(NO. CV 98-5464)

Hotmail Corp. v. VanS Money Pie Inc., 1998 WL 388389, 47 U.S.P.Q.2d 1020 (N.D.Cal., Apr 16, 1998)(NO. C-98 JW PVT ENE, C 98-20064 JW)

LeBlanc v. Allstate Ins. Co., 2000 WL 825683 (E.D.La., Jun 22, 2000)(NO. CIV. A. 99-2724)

(*New Mexico*) State v. Rowell, 119 N.M. 710, 895 P.2d 232 (N.M.App., Mar 16, 1995)(NO. 15,365)

North Texas Preventive Imaging L.L.C. v. Esenberg, 1996 WL 1359212 (C.D.Cal., Aug 19, 1996)(NO. SA CV 96-71AHS(EEX))

Register.com, Inc. v. Verio, Inc., 126 F.Supp.2d 238 (S.D.N.Y., Dec 08, 2000)(NO. 00 CIV. 5747 (BSJ))

Seidl v. Greentree Mortg. Co., 30 F.Supp.2d 1292 (D.Colo., Oct 18, 1998)(NO. CIV. A. 97-WY-2087-A)

Shaw v. Toshiba America Information Systems, Inc., 91 F.Supp.2d 926 (E.D.Tex., Aug 26, 1999)(NO. 1:99-CV-012 (TH))

Shaw v. Toshiba America Information Systems, Inc., 91 F.Supp.2d 942 (E.D.Tex., Jan 28, 2000)(NO. 1:99-CV-0120 (TH))

Shurgard Storage Centers, Inc. v. Safeguard Self Storage, Inc., 119 F.Supp.2d 1121 (W.D.Wash., Oct 30, 2000)(NO. C00-1071Z)

U.S. v. Brady, 820 F.Supp. 1346 (D.Utah, Apr 07, 1993)(NO. 92-CR-265J)

U.S. v. Czubinski, 106 F.3d 1069, 65 USLW 2571, 79 A.F.T.R.2d 97-1664, 97-2 USTC P 50,622 (1st Cir.(Mass.), Feb 21, 1997)(NO. 96-1317)

U.S. v. Middleton, 231 F.3d 1207, 00 Cal. Daily Op. Serv. 9194, 2000 Daily Journal D.A.R. 12, 198 (9th Cir.(Cal.), Nov 16, 2000)(NO. 99-10518)

U.S. v. Morris, 928 F.2d 504, 59 USLW 2603 (2nd Cir.(N.Y.), Mar 07, 1991)(NO. 774, 90-1336)

U.S. v. Riggs, 739 F.Supp. 414 (N.D.Ill., Jun 05, 1990)(NO. 90 CR 0070)

YourNetDating, Inc. v. Mitchell, 88 F.Supp.2d 870 (N.D.Ill., Mar 01, 2000)(NO. 00 C 1187)

THE COMPUTER FRAUD AND ABUSE ACT

US Code : Title 18. Section 1030 US Code

Sec. 1030. Fraud and related activity in connection with computers

(a) Whoever -

(1) having knowingly accessed a computer without authorization or exceeding authorized access, and by means of such conduct having obtained information that has been determined by the United States Government pursuant to an Executive order or statute to require protection against unauthorized disclosure for reasons of national defense or foreign relations, or any restricted data, as defined in paragraph y. of section 11 of the Atomic Energy Act of 1954, with reason to believe that such information so obtained could be used to the injury of the United States, or to the advantage of any foreign nation willfully communicates, delivers, transmits, or causes to be communicated, delivered, or transmitted, or attempts to communicate, deliver, transmit or cause to be communicated, delivered, or transmitted the same to any person not entitled to receive it, or willfully retains the same and fails to deliver it to the officer or employee of the United States entitled to receive it;

(2) intentionally accesses a computer without authorization or exceeds authorized access, and thereby obtains -

(A) information contained in a financial record of a financial institution, or of a card issuer as defined in section 1602(n) of title 15, or contained in a file of a consumer reporting agency on a consumer, as such terms are defined in the Fair Credit Reporting Act (15 U.S.C. 1681 et seq.);

(B) information from any department or agency of the United States; or

(C) information from any protected computer if the conduct involved an interstate or foreign communication;

(3) intentionally, without authorization to access any nonpublic computer of a department or agency of the United States, accesses such a computer of that department or agency that is exclusively for the use of the Government of the United States or, in the case of a computer not exclusively for such use, is used by or for the Government of the United States and such conduct affects that use by or for the Government of the United States;

(4) knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value, unless the object of the fraud and the thing obtained consists only of the use of the computer and the value of such use is not more than \$5,000 in any 1-year period;

(5)

(A) knowingly causes the transmission of a program, information, code, or command, and as a result of such conduct, intentionally causes damage without authorization, to a protected computer;

(B) intentionally accesses a protected computer without authorization, and as a result of such conduct, recklessly causes

damage, or

(C) intentionally accesses a protected computer without authorization, and as a result of such conduct, causes damage;

(6) knowingly and with intent to defraud traffics (as defined in section 1029) in any password or similar information through which a computer may be accessed without authorization, if -

(A) such trafficking affects interstate or foreign commerce;

or

(B) such computer is used by or for the Government of the United States; [1]

(7) with intent to extort from any person, firm, association, educational institution, financial institution, government entity, or other legal entity, any money or other thing of value, transmits in interstate or foreign commerce any communication containing any threat to cause damage to a protected computer; shall be punished as provided in subsection (c) of this section.

(b) Whoever attempts to commit an offense under subsection (a) of this section shall be punished as provided in subsection (c) of this section.

(c) The punishment for an offense under subsection (a) or (b) of this section is -

(1)

(A) a fine under this title or imprisonment for not more than ten years, or both, in the case of an offense under subsection (a)(1) of this section which does not occur after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and

(B) a fine under this title or imprisonment for not more than twenty years, or both, in the case of an offense under subsection (a)(1) of this section which occurs after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph;

(2)

(A) a fine under this title or imprisonment for not more than one year, or both, in the case of an offense under subsection (a)(2), (a)(3), (a)(5)(C), or (a)(6) of this section which does not occur after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and [2]

(B) a fine under this title or imprisonment for not more than 5 years, or both, in the case of an offense under subsection (a)(2), if -

(i) the offense was committed for purposes of commercial advantage or private financial gain;

(ii) the offense was committed in furtherance of any criminal or tortious act in violation of the Constitution or laws of the United States or of any State; or

(iii) the value of the information obtained exceeds \$5,000;

[3]

(C) a fine under this title or imprisonment for not more than ten years, or both, in the case of an offense under subsection (a)(2), (a)(3) or (a)(6) of this section which occurs after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and (3)(A) a fine under this title or imprisonment for not more than five years, or both, in the case of an offense under subsection (a)(4), (a)(5)(A), (a)(5)(B), or (a)(7) of this

section which does not occur after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and

(B) a fine under this title or imprisonment for not more than ten years, or both, in the case of an offense under subsection (a)(4), (a)(5)(A), (a)(5)(B), (a)(5)(C), or (a)(7) of this section which occurs after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and [4]

(d) The United States Secret Service shall, in addition to any other agency having such authority, have the authority to investigate offenses under subsections (a)(2)(A), (a)(2)(B),

(j) The United States Secret Service shall, in addition to any of the United States Secret Service shall be exercised in accordance with an agreement which shall be entered into by the Secretary of the Treasury and the Attorney General.

(e) As used in this section -

(1) the term "computer" means an electronic, magnetic, optical, electrochemical, or other high speed data processing device performing logical, arithmetic, or storage functions, and includes any data storage facility or communications facility directly related to or operating in conjunction with such device, but such term does not include an automated typewriter or typesetter, a portable hand held calculator, or other similar device;

(2) the term "protected computer" means a computer -
(A) exclusively for the use of a financial institution or the United States Government, or, in the case of a computer not exclusively for such use, used by or for a financial institution or the United States Government and the conduct constituting the offense affects that use by or for the financial institution or the Government; or
(B) which is used in interstate or foreign commerce or communication;

(3) the term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, and any other commonwealth, possession or territory of the United States;

(4) the term "financial institution" means -

(A) an institution, with deposits insured by the Federal Deposit Insurance Corporation;

(B) the Federal Reserve or a member of the Federal Reserve including any Federal Reserve Bank;

(C) a credit union with accounts insured by the National Credit Union Administration;

(D) a member of the Federal home loan bank system and any home loan bank;

(E) any institution of the Farm Credit System under the Farm Credit Act of 1971;

(F) a broker-dealer registered with the Securities and Exchange Commission pursuant to section 15 of the Securities Exchange Act of 1934;

(G) the Securities Investor Protection Corporation;

(H) a branch or agency of a foreign bank (as such terms are defined in paragraphs (1) and (3) of section 1(b) of the International Banking Act of 1978); and

(I) an organization operating under section 25 or section

25(a) [5] of the Federal Reserve Act. [6]

(5) the term "financial record" means information derived from any record held by a financial institution pertaining to a customer's relationship with the financial institution;

(6) the term "exceeds authorized access" means to access a computer with authorization and to use such access to obtain or alter information in the computer that the accessor is not entitled so to obtain or alter;

(7) the term "department of the United States" means the legislative or judicial branch of the Government or one of the executive departments enumerated in section 101 of title 5: and [7]

(8) the term "damage" means any impairment to the integrity or availability of data, a program, a system, or information, that -

(A) causes loss aggregating at least \$5,000 in value during any 1-year period to one or more individuals;

(B) modifies or impairs, or potentially modifies or impairs, the medical examination, diagnosis, treatment, or care of one or more individuals;

(C) causes physical injury to any person; or

(D) threatens public health or safety; and

(9) the term "government entity" includes the Government of the United States, any State or political subdivision of the United States, any foreign country, and any state, province, municipality, or other political subdivision of a foreign country.

(f) This section does not prohibit any lawfully authorized investigative, protective, or intelligence activity of a law enforcement agency of the United States, a State, or a political subdivision of a State, or of an intelligence agency of the United States.

(g) Any person who suffers damage or loss by reason of a violation of this section may maintain a civil action against the violator to obtain compensatory damages and injunctive relief or other equitable relief. Damages for violations involving damage as defined in subsection (e)(8)(A) are limited to economic damages. No action may be brought under this subsection unless such action is begun within 2 years of the date of the act complained of or the date of the discovery of the damage.

(h) The Attorney General and the Secretary of the Treasury shall report to the Congress annually, during the first 3 years following the date of the enactment of this subsection, concerning investigations and prosecutions under subsection (a)(5).

Footnotes

[1] So in original. Probably should be followed by "or".

[2] So in original. The word "and" probably should not appear.

[3] So in original. Probably should be followed by "and".

[4] So in original. The "; and" probably should be a period.

[5] See References in Text note below.

[6] So in original. The period probably should be a semicolon.

[7] So in original. The word "and" probably should not appear.

THE ECONOMIC ESPIONAGE ACT

US Code : Title 18, Section 1831 US Code

Sec. 1831. Economic espionage

(a) In General. - Whoever, intending or knowing that the offense will benefit any foreign government, foreign instrumentality, or foreign agent, knowingly -

- (1) steals, or without authorization appropriates, takes, carries away, or conceals, or by fraud, artifice, or deception obtains a trade secret;
- (2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys a trade secret;
- (3) receives, buys, or possesses a trade secret, knowing the same to have been stolen or appropriated, obtained, or converted without authorization;
- (4) attempts to commit any offense described in any of paragraphs (1) through (3); or
- (5) conspires with one or more other persons to commit any offense described in any of paragraphs (1) through (3), and one or more of such persons do any act to effect the object of the conspiracy, shall, except as provided in subsection (b), be fined not more than \$500,000 or imprisoned not more than 15 years, or both.

(b) Organizations. - Any organization that commits any offense described in subsection (a) shall be fined not more than \$10,000,000.

US Code : Title 18, Section 1832 US Code

Sec. 1832. Theft of trade secrets

(a) Whoever, with intent to convert a trade secret, that is related to or included in a product that is produced for or placed in interstate or foreign commerce, to the economic benefit of anyone other than the owner thereof, and intending or knowing that the offense will, injure any owner of that trade secret, knowingly -

- (1) steals, or without authorization appropriates, takes, carries away, or conceals, or by fraud, artifice, or deception obtains such information;
- (2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys such information;
- (3) receives, buys, or possesses such information, knowing the same to have been stolen or appropriated, obtained, or converted without authorization;
- (4) attempts to commit any offense described in paragraphs (1) through (3); or
- (5) conspires with one or more other persons to commit any offense described in paragraphs (1) through (3), and one or more of such persons do any act to effect the object of the conspiracy, shall, except as provided in subsection (b), be fined under this title or imprisoned not more than 10 years, or both.

(b) Any organization that commits any offense described in subsection (a) shall be fined not more than \$5,000,000.

US Code : Title 18, Section 1833 US Code

Sec. 1833. Exceptions to prohibitions

This chapter does not prohibit -

- (1) any otherwise lawful activity conducted by a governmental entity of the United States, a State, or a political subdivision of a State; or**
- (2) the reporting of a suspected violation of law to any governmental entity of the United States, a State, or a political subdivision of a State, if such entity has lawful authority with respect to that violation.**

US Code : Title 18, Section 1834 US Code

Sec. 1834. Criminal forfeiture

(a) The court, in imposing sentence on a person for a violation of this chapter, shall order, in addition to any other sentence imposed, that the person forfeit to the United States -

- (1) any property constituting, or derived from, any proceeds the person obtained, directly or indirectly, as the result of such violation; and**
- (2) any of the person's property used, or intended to be used, in any manner or part, to commit or facilitate the commission of such violation, if the court in its discretion so determines, taking into consideration the nature, scope, and proportionality of the use of the property in the offense.**

(b) Property subject to forfeiture under this section, any seizure and disposition thereof, and any administrative or judicial proceeding in relation thereto, shall be governed by section 413 of the Comprehensive Drug Abuse Prevention and Control Act of 1970 (21 U.S.C. 853), except for subsections (d) and (j) of such section, which shall not apply to forfeitures under this section.

US Code : Title 18, Section 1835 US Code

Sec. 1835. Orders to preserve confidentiality

In any prosecution or other proceeding under this chapter, the court shall enter such orders and take such other action as may be necessary and appropriate to preserve the confidentiality of trade secrets, consistent with the requirements of the Federal Rules of Criminal and Civil Procedure, the Federal Rules of Evidence, and all other applicable laws. An interlocutory appeal by the United States shall lie from a decision or order of a district court authorizing or directing the disclosure of any trade secret.

US Code : Title 18, Section 1836 US Code

Sec. 1836. Civil proceedings to enjoin violations

- (a) The Attorney General may, in a civil action, obtain appropriate injunctive relief against any violation of this section.**
- (b) The district courts of the United States shall have exclusive original jurisdiction of civil actions under this subsection.**

US Code : Title 18, Section 1837 US Code

Sec. 1837. Applicability to conduct outside the United States

This chapter also applies to conduct occurring outside the United States if -

- (1) the offender is a natural person who is a citizen or permanent resident alien of the United States, or an organization organized under the laws of the United States or a State or political subdivision thereof; or
- (2) an act in furtherance of the offense was committed in the United States.

US Code : Title 18, Section 1838 US Code

Sec. 1838. Construction with other laws

This chapter shall not be construed to preempt or displace any other remedies, whether civil or criminal, provided by United States Federal, State, commonwealth, possession, or territory law for the misappropriation of a trade secret, or to affect the otherwise lawful disclosure of information by any Government employee under section 552 of title 5 (commonly known as the Freedom of Information Act).

US Code : Title 18, Section 1839 US Code

Sec. 1839. Definitions

As used in this chapter -

- (1) the term "foreign instrumentality" means any agency, bureau, ministry, component, institution, association, or any legal, commercial, or business organization, corporation, firm, or entity that is substantially owned, controlled, sponsored, commanded, managed, or dominated by a foreign government;
- (2) the term "foreign agent" means any officer, employee, proxy, servant, delegate, or representative of a foreign government;
- (3) the term "trade secret" means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if -
 - (A) the owner thereof has taken reasonable measures to keep such information secret; and
 - (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, the public; and
- (4) the term "owner", with respect to a trade secret, means the person or entity in whom or in which rightful legal or equitable title to, or license in, the trade secret is reposed.

**HOW THE INTERNET REALLY WORKS
(For Businesses)**

*Fred Louis
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Cincinnati, Ohio*

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SECTION K



How the Internet Really Works (for Businesses)

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ORACLE

The Internet Changes Computing

- **More than the World Wide Web Global Network**
- **Complete New Model for Corporate Computing**
 - **Universal Standards**
 - **Easy to Develop**
 - **Inexpensive to Run**

Internet Computing

- **Corporate networks become Internets**
- **Database applications move to servers**
- **Database data consolidates onto large servers**
- **Users access database applications via browser**

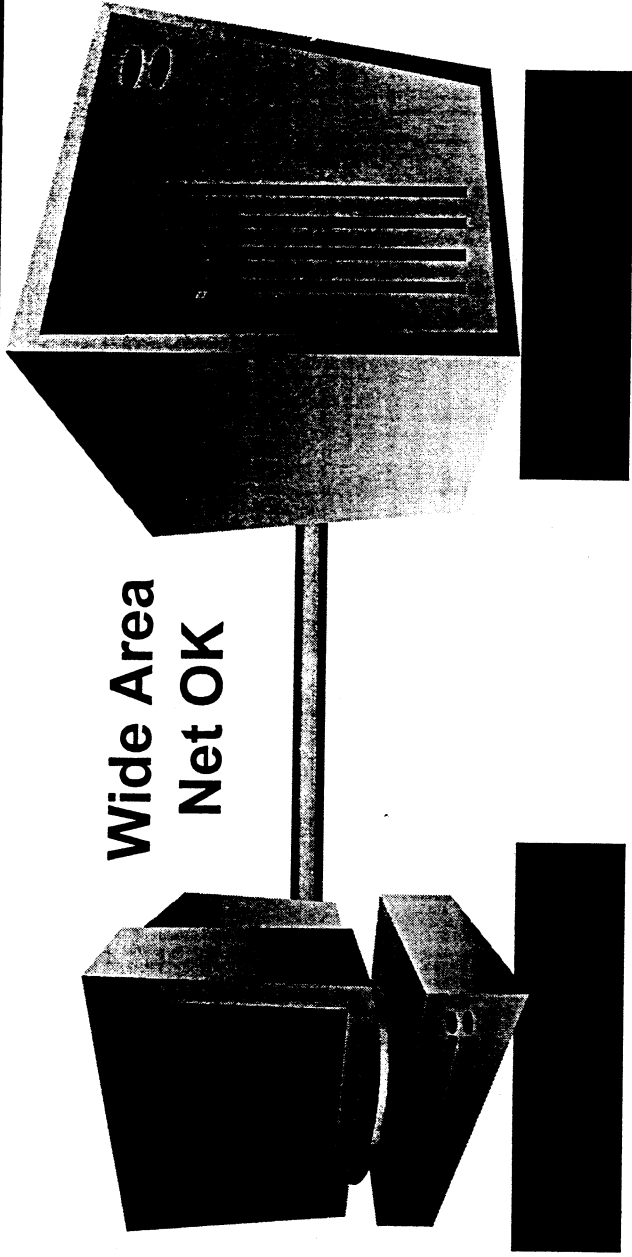
Internet Computing Benefits

- **Centralize Complexity**
 - Lower labor, network and hardware costs
- **Consolidate Information**
 - Improve Information quality
- **Internet Browser Access**
 - Easier, cheaper application and data access
- **Easy to Program**

• **Better Applications**

ORACLE

Mainframe Computing



Character UI

Expensive Hardware

Difficult to program – application backlog

ORACLE

Client Server Computing



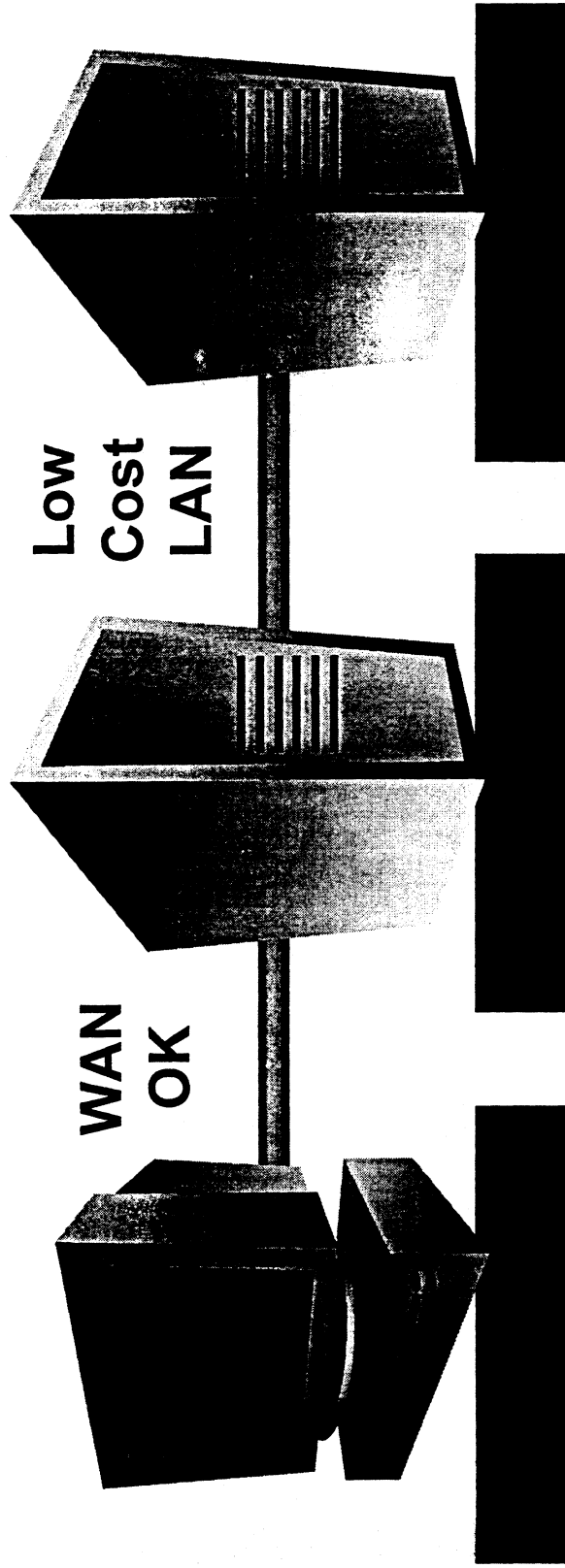
Multimedia UI

Low Cost Hardware

Distributed Complexity & Fragmented Data

ORACLE

Internet Computing



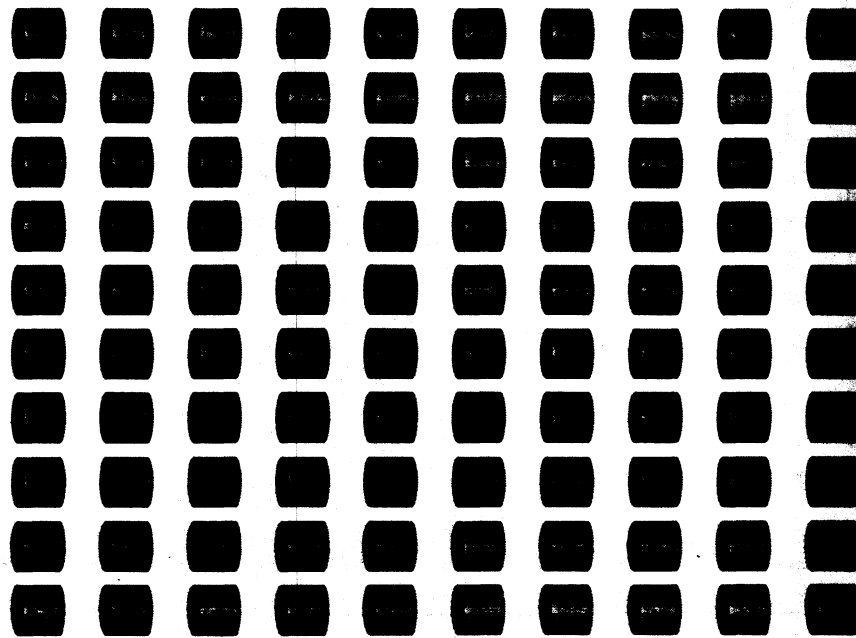
Multimedia UI

Low Cost Server Hardware

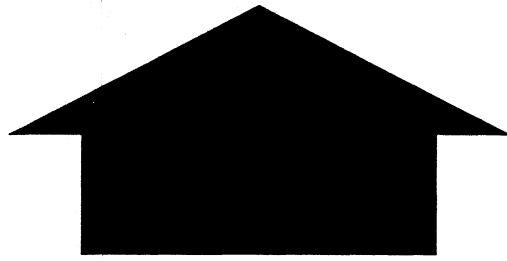
*Centralized Complexity, Consolidated Data,
Easy to Program*

ORACLE

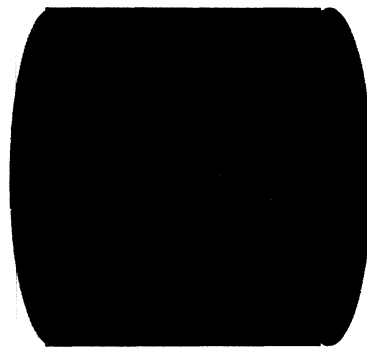
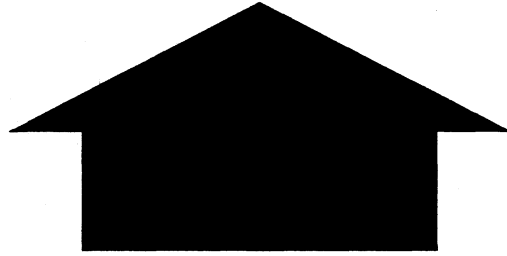
Database Consolidation - Better Information



100 Databases



5 Databases

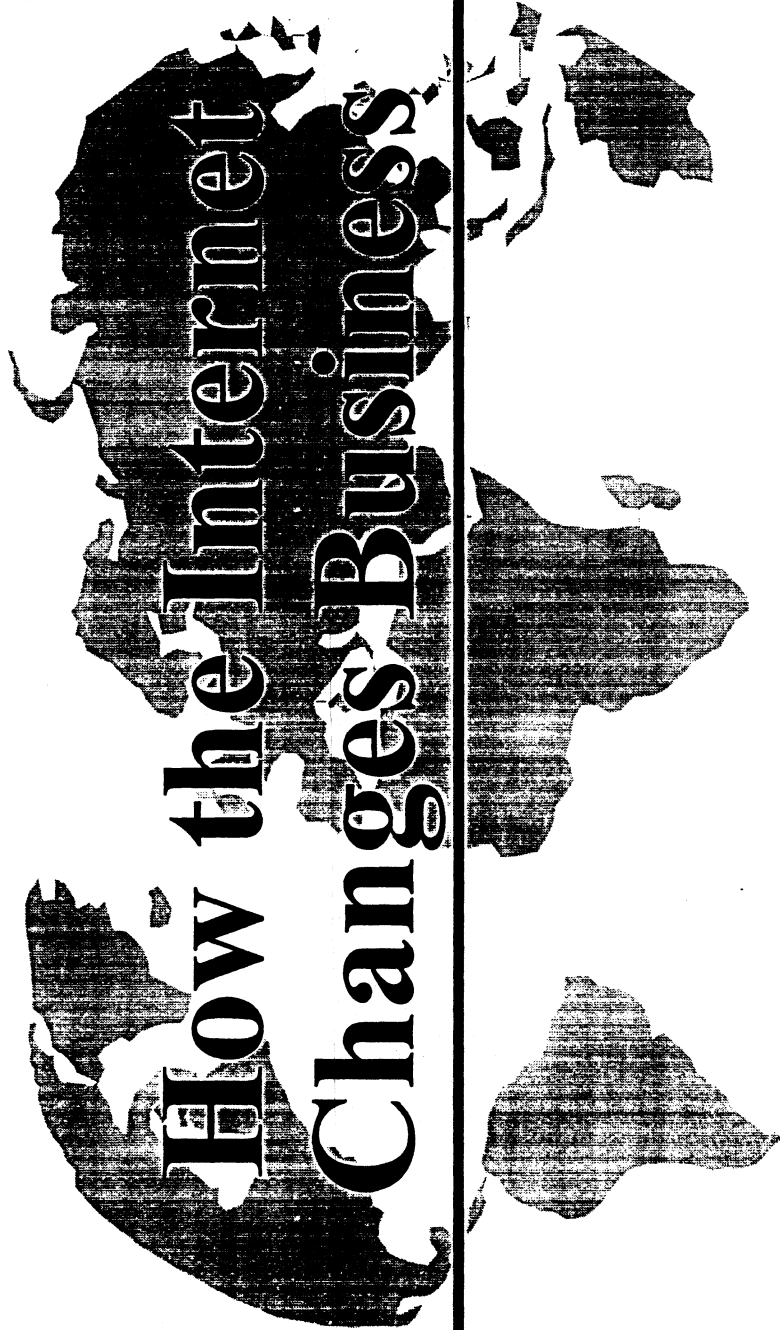


1 Database

ORACLE

Internet Computing

- **Centralize complexity - lower costs**
- **Consolidate information - better information**
- **Internet browser access - better access**
- **Easy to program - better applications**



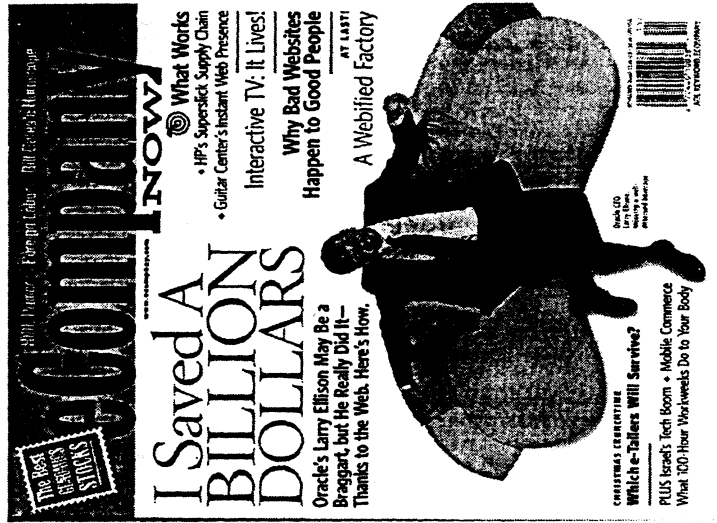
How the Internet Changes Business

Product Catalogue

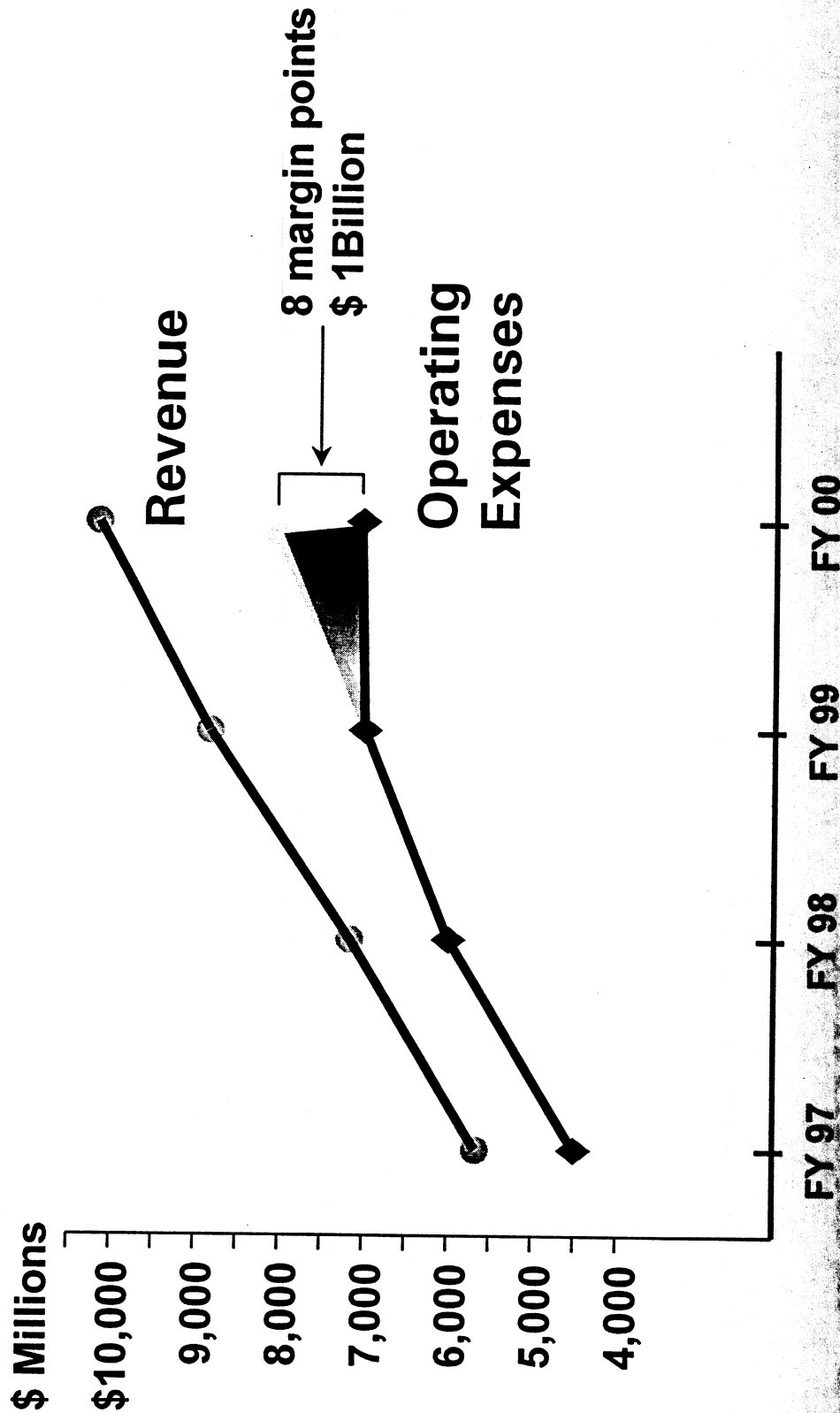
ORACLE

The Headlines

- Oracle Saved \$1 Billion
- Oracle Grew Margin
- \$1 Billion = 8 Margin Points
- Oracle Gets More Done With Same Resources

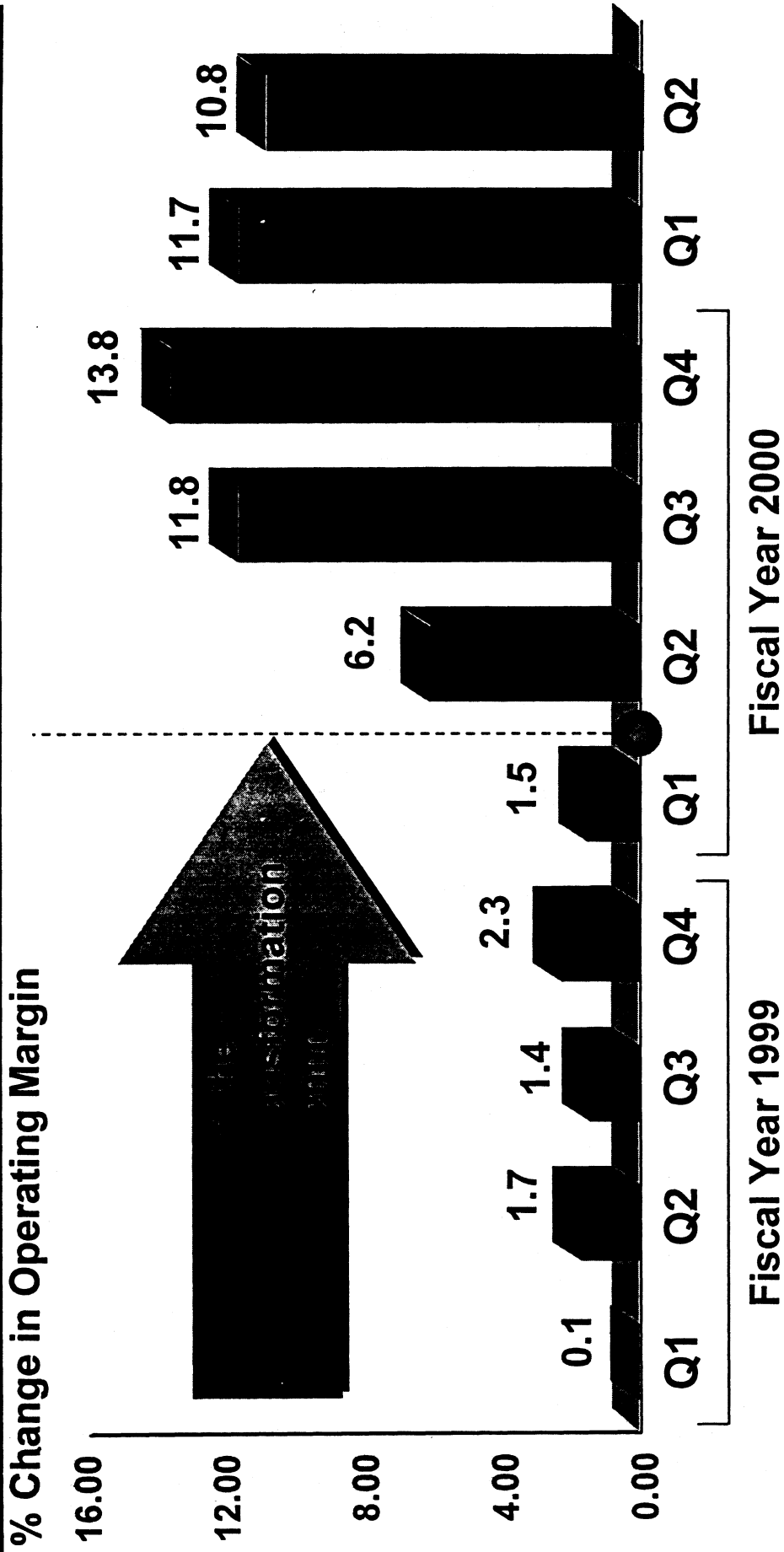


What Did Oracle Do?



ORACLE

When Did Oracle See Benefits?



ORACLE

The Challenge

Customer-side

Internal

Supply-Side

40%
Customer
Loss

Oracle

This slide features a large '40%' at the top left, the word 'Customer' in the middle, and 'Loss' at the bottom right. The Oracle logo is in the bottom right corner.

40%
Costs
Reduced

Oracle

This slide features a large '40%' at the top left, the word 'Costs' in the middle, and 'Reduced' at the bottom right. The Oracle logo is in the bottom right corner.

40%
Reduction in
Supply Costs
with
Oracle

Oracle

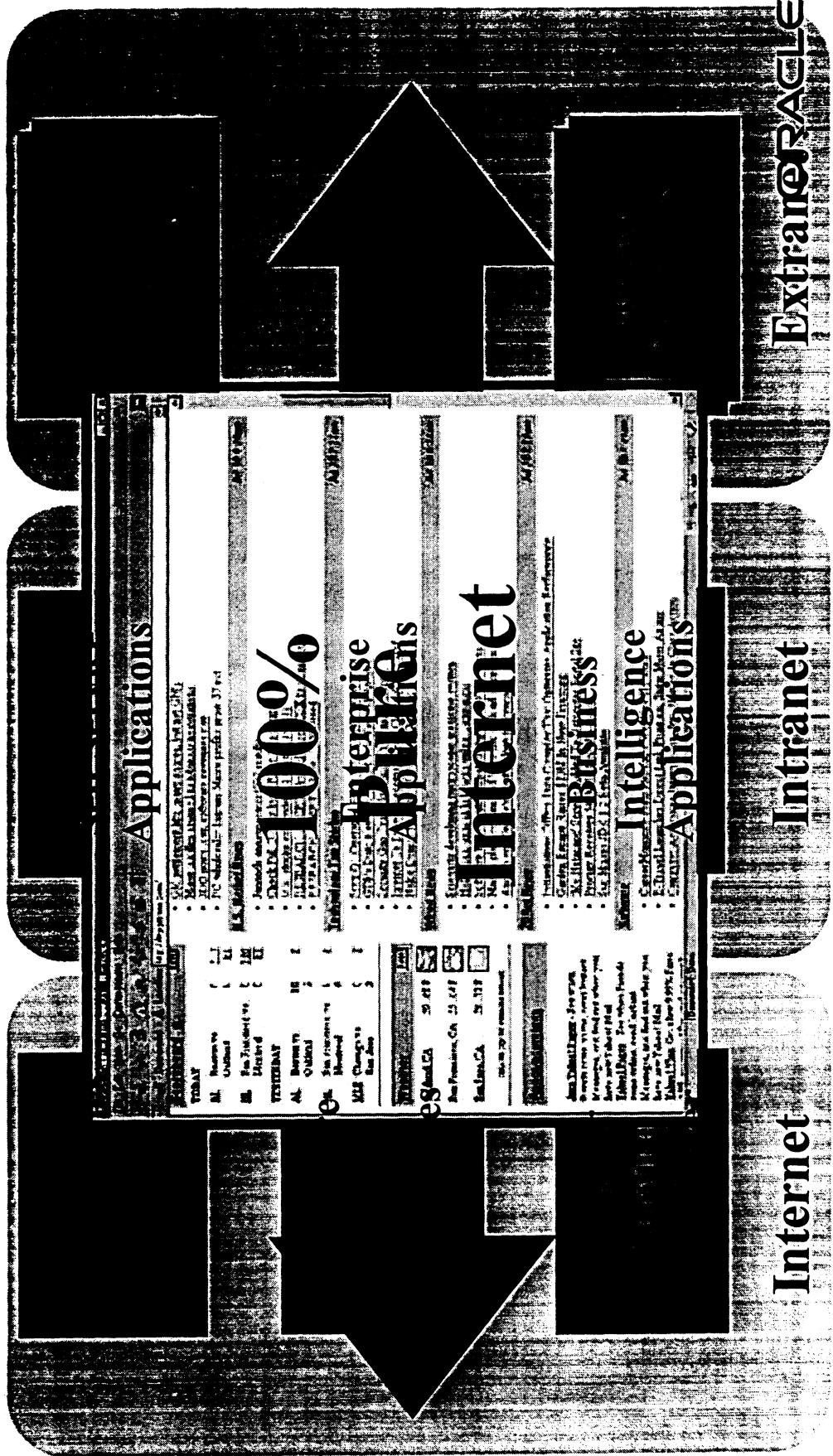
This slide features a large '40%' at the top left, the text 'Reduction in Supply Costs' in the middle, and 'with Oracle' at the bottom right. The Oracle logo is in the bottom right corner.

Adopt internet technology everywhere

Customer-side

Internal

Supply-Side

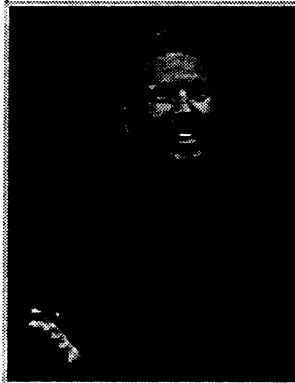


Ученый институт истории СССР
Секция истории СССР

HOW WE SAVED A BILLION DOLLARS

BY LARRY ELLISON

At the start of fiscal year 2000, we announced that Oracle would become an e-business, and in doing so, save one billion dollars. In other words, we would use our own application software—the Oracle E-Business Suite—to put every aspect of our business on the Internet. The success of our move into the 'new economy' would be measured the 'old economy' way. The question was—once Oracle became an e-business, would our margins improve enough for us to save a billion dollars? The answer turned out to be no. We're going to save a lot more.



LAWRENCE J. ELLISON
ORACLE CHAIRMAN & CEO

A billion dollars in annual savings translates to a 10-point improvement in our operating margin. We've already exceeded that goal. In the fourth quarter, our operating margin was up nearly 14 points to over 41%. For the full year, net income without investment gains increased 61% to over \$2 billion. Net income including investment gains was over \$6 billion. Cash went from \$3 billion to \$8 billion. Sales topped \$10 billion. The stock was up 500%. Oracle's market capitalization approached a quarter of a trillion dollars. It was a good year.

Not everything went up. Revenue went up from \$8.8 billion to \$10.1 billion, but headcount went down from 44,000 to 41,000. Application sales went up 61% in Q4, but quarterly expenses went down. We're selling more. We're spending less. And we're only half-way through our e-business transformation. How much faster can sales grow? How much more can we save? We'll find out this year, when we complete the process of becoming an e-business.

*It's not
just about
how well
your software
works together...*

But what is an e-business anyway? It's all about the Internet and globalization.

An e-business uses a global network—the Internet—and a global database to integrate all aspects of doing business. Every business function—marketing, sales, supply chain, manufacturing, customer service, accounting, human resources, everything—uses the same global network and the same global database. An e-business runs on one unified computer system. Everybody is connected. And all the information is in one place.

Oracle was the first software company to move its application products to the Internet. In fact, we started moving all our software to the Internet back in 1995. So we've been using our own Internet application software to run our business for the past couple of years. Our Internet systems were a big improvement over the old client/server systems they replaced. Having all our customers, suppliers and employees online made Oracle a more responsive and efficient organization. But the huge productivity gains we were looking for somehow eluded us. All our applications were on the Internet. Everyone was connected. What was the problem?

Our information was scattered across hundreds of separate databases. That was the problem! Each one of our organizations—marketing, sales, service, etc.—had its own computer system. Each computer system had its own database. We had hundreds of databases around the world. Our data was so fragmented, it was difficult for people to find the information they needed to do their jobs.

Separate databases also made it difficult to share information between organizations. And if groups can't share information, they don't cooperate. So, marketing didn't cooperate with sales.

Germany didn't cooperate with France. It was lack of shared information that was limiting cooperation between groups at Oracle—not cultural differences or flawed human nature. And lack of cooperation led to duplication of effort and inefficiency. To eliminate this inefficiency, we had to make information easier to find and easier to share. But how?

The solution was quite simple. If we put all our information in one place—a global database on the Internet—then everyone would know where to look to find the information they needed. While conceptually simple, this single, unified database approach required fundamental changes to our application software. It turned out to be a massive engineering effort involving thousands of computer programmers. But when we finished the Oracle E-Business Suite, it was the first and only set of applications to work with a single global database.

We also developed several new applications, so that the E-Business Suite would be complete. Today, the suite includes every application you need to run your business—marketing, sales, supply chain, manufacturing, customer service, accounting, human resources—everything. It works in every country and in every language. The E-Business Suite is the first and only complete set of applications ever to have been built.

Before Oracle released a complete suite of applications, customers had no alternative to acquiring application software from multiple vendors. Customers had to carefully analyze and choose the 'best' application software for each part of their company. For example, a customer might choose Epiphany for marketing, Siebel for sales, Broadvision for the Web store, Clarify for service, Ariba for procurement, i2 for supply chain, SAP for manufacturing and accounting, and PeopleSoft for human resources.

Unfortunately, these products were not designed or built to work together.

And it's not the responsibility of the software vendors to make their different products work together. Instead, you, the customer, are responsible for making all the different products work together. It's a process called systems integration. Systems integration consists of connecting the different vendors' systems—a kind of gluing them together—in the hope of making them work like a unified system. IBM heavily promotes this multi-vendor systems integration approach. And IBM employs 130,000 consultants to help you make it work.

Systems integration is an enormously complex, expensive and time-consuming process. And there are serious limits to the level of integration you can achieve with a multi-vendor system. The biggest problem is that every vendor's applications are engineered to work with their own separate database. Systems integration cannot make different vendors' applications work with a single database. So, if you choose five software vendors, you get five separate and distinct databases. And that's if you operate in just one country. If you operate globally, the data fragmentation problem multiplies.

Of course, it would be much easier if all your applications were designed and built to work together. Then no systems integration would be necessary. Then information would be easy to find and share, because it would be in one global database. That's what you get when you choose the unified set of applications that make up the Oracle E-Business Suite.

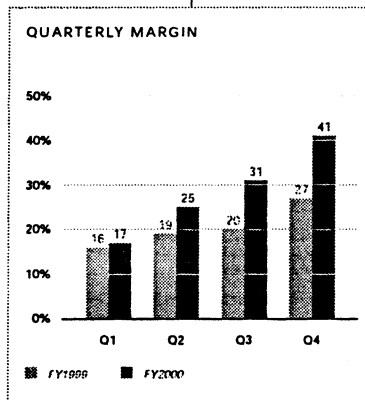
Choosing between a unified suite of applications or a multiple-vendor approach is not simply a matter of software strategy. It's not just about how well your software works together. It's about how well your organizations work together. Sharing information is key to eliminating duplication of effort. Sharing information is key to achieving specialization and economies of scale. Sharing information is key to standardizing business processes and implementing best practices. Sharing information between employees, distribution partners, and customers has already helped Oracle save over a billion dollars.

Now, everyone is excited about the prospect of saving more. But when we first began to move our business processes to the Internet and our information into a global database, we encountered a lot of

resistance. Most Oracle managers wanted to proceed 'cautiously.' But I felt that if we didn't move fast, we were going to miss the biggest opportunity in the history of business. It took a while for me to understand that changing technology was the easy part of becoming an e-business. Convincing people to change the way they worked—that was

the hard part.

Before you can change, you have to admit you have a problem, you have to understand your problem, and you have to communicate the problem clearly so everyone understands why the change is needed. In our case, the problem was quite clear: our information was so fragmented, people didn't have access to the information they needed to do their jobs. Since we're the world leader in information



...It's about how well your organizations work together.

BY LARRY ELLISON

Sharing information is key to eliminating duplication of effort.

management technology, this was especially embarrassing. But it was intriguing, too. If we were having trouble with our internal computer systems—and we're supposed to be experts—how well were other companies doing?

I talk with CEOs almost every day. Virtually none of them have access to all the information they need, even though all of them are spending a fortune on information technology (IT). If we could solve our internal business systems problems, we would be in an ideal position to help our customers better understand and solve their problems. Solving our problems would not only help us save money, it would demonstrate that we really were experts—not just in technology—but in using technology to efficiently run a business.

Back to the problem. All of Oracle's information was in databases—of course—but there were too many of them. We had hundreds of large server computers managing hundreds of separate databases. For example, Oracle had six separate customer databases—marketing, Web store, telesales, field sales, accounting and services. And that was just in the United States.

Around the world we had over a hundred customer databases. France had six customer databases. So did Japan and Brazil. Virtually every country we did business in had multiple customer databases. Scattering our customer information across more than a hundred separate customer databases was our worst data fragmentation problem, but not our only one. We had 140 product and pricing databases, 70 separate human resources databases and 97

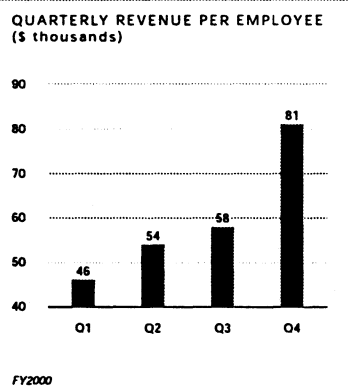
e-mail databases. The list went on and on.

Every country had its own data center filled with computer hardware. Each data center had its own IT staff maintaining separate systems for marketing, sales, service, etc. We were paying top dollar to maintain hundreds of separate computer systems and hundreds of separate databases around the world. The more we spent, the worse it got. Every time we added a new computer system and database, our information got more fragmented. The more databases we had, the harder it was to get information about our business.

We had another problem. Since every organization within Oracle had its own computer system, every organization could invent its own business processes, and then tailor its computer systems to automate those processes. Marketing in France invented its own marketing processes and tailored its marketing computer system to suit.

Germany did the same. So did the U.K. And so on. Every country invented its own business processes for marketing, sales, service—everything—and operated the way it deemed best. Everything was non-standard. The duplication of effort was appalling.

To solve our problems, the only thing we really had to do was move our business processes to the Internet, and our information to a global database. But we wanted to do more than simply solve old problems—however big they were. We wanted to use the Internet to pursue new opportunities. To do that, we would have to do more than globalize our computer systems. We would have to globalize our business. That meant



changing the way we were organized and managed. The Internet global network and global database were simply the technologies that made globalization possible.

Oracle has always been organized hierarchically by geography. The business is divided into four geographic regions—North America, Europe, Asia Pacific and Latin America. Each region was managed by a senior executive with a regional headquarters staff. Each country had a general manager plus teams of people doing marketing, sales, service, accounting, legal, etc. Every regional headquarters and every country had its own computer systems to support its activities.

These distributed computer systems, along with divided management responsibility, conspired to create our duplication of effort problems. Marketing was a typical example. We had a marketing group at corporate headquarters. We had another marketing group at European headquarters. We had a marketing team in every country. In the end, our country managers would invent the marketing strategy they felt was best for each of their countries. So, every country had different marketing policies, processes and programs.

Take a simple matter like pricing. For a long time I headed a group at Oracle headquarters that set global prices for our products. Or so I thought. In actuality, my pricing 'decisions' were first reviewed by the corporate headquarters marketing group, second by our European headquarters marketing group, and then by every country's marketing team. The price could get changed several times—sometimes up, sometimes down—before it got to the customer. Some countries would decide not to sell the product at all.

Oracle was in effect a feudal operation run by a group of autonomous general managers. We could set global prices and other global policies at corporate

headquarters, but it was difficult to monitor or enforce them. For years, our general managers set their own prices, invented their own policies and procedures, and ran their own computer systems. As long as they delivered adequate profit, we left them alone to run their businesses.

This loose federation of independent organizations had worked reasonably well for a long time. But in an era of increasing globalization, it was breaking down. Our customers wanted us to offer the same prices, products and services around the world. And we wanted to eliminate duplication of effort. We wanted to set a price once—not 150 times. We wanted to develop a marketing program once—not 150 times. We wanted to develop a business process once—not 150 times. We needed to globalize the business.

The very first organizational change we made was globalizing IT. We decided to move all the IT people from the countries and regional headquarters to a new Global IT organization. Our general managers fiercely resisted this change. They were not enthusiastic about relying on corporate headquarters for their essential automation systems. They were used to being self-sufficient. How could we convince them to support our globalization program?

We changed their compensation plans. Our general managers have always been paid a bonus based on how much they increased sales and profits. If they continued to run their own IT departments, they had to pay for it out of their budgets, thus lowering their profit margin and their annual bonuses. Or, they could use our new Global IT systems for 'free.' We would not charge them for global services. Resistance diminished, but it didn't go away. Our general managers just didn't trust a corporate headquarters organization to deliver all the computer systems they needed to run their businesses.

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Global IT first had to prove itself.

The proof came with the highly visible success of Global IT's very first project—global e-mail. When Global IT started the project, Oracle had 97 client/server e-mail systems running on 97 large server computers located all over the world. Every country had its own e-mail system and its own team of people to manage it. The new Global IT organization replaced all 97 of the old e-mail systems with a single Internet e-mail system running entirely on two computers in our global data center in California. (For safety, we have copies of all our data plus stand-by computers in our backup data center in Colorado.)

The global e-mail project was a stunning success. We used the Internet and our own database technology to link everyone in the company to a single, unified e-mail system. The new e-mail system is one-tenth the cost of all the systems it replaced. It's faster than the old in-country e-mail systems. It's more reliable and more secure. It supports all local languages. It's much easier to use. And it's 'free' to the country managers.

Oracle saves over \$30 million a year as a result of the Internet e-mail project. And in the process, the new Global IT organization had proven itself. We no longer had to push for people to be transferred from the countries to Global IT. The country managers loved the idea of computer systems that just worked, especially when they didn't have to pay for them.

As we completed the globalization of IT, we gained huge economies of scale not only in labor, but also in purchasing computer equipment and network services. The best example of this was our newly upgraded global network. It cost less than our old network, yet the new network is much faster and more reliable. And that's just what we needed for the next phase of our e-business transformation.

Global e-mail had been relatively quick and easy. The improvements in e-mail were immediately visible to everyone in the company. We proved that this Internet thing actually works and saves money. But the cheap thrills were over. The next computer systems to go global on the Internet were marketing and sales.

We decided to globalize the marketing organization as well as the marketing computer systems. We left the marketing people in the countries, but they now reported to a Global Marketing executive—not the country or regional managers. In the end, only sales and associated consulting services still reported to our country managers. And even these activities are automated and monitored by our new global computer systems. Oracle has abandoned the model of distributed general management. Management specialization was part of our globalization process.

The deal with the country managers was always the same. The marketing changes were no exception. If the country managers kept their marketing people and marketing computer systems, they paid for them. Marketing services—people and systems—provided by global organizations were 'free.' Trust in corporate headquarters and confidence in Internet technology had grown dramatically as a result of the recent success of Global IT. In a very short time, most marketing people around the world were voluntarily moved to the Global Marketing organization.

The benefits were immediate. Marketing costs went down because duplication of effort was eliminated. Every country stopped designing its own marketing programs, because we used the Internet to implement the same marketing programs all over the world. Every country stopped doing its own pricing, because customers could see the

official price list at our global Web store at oracle.com. The prices we set at headquarters were instantly visible all over the world. No more delays. No more duplication of effort. No more bureaucracy. No more ignoring policy.

But Global Marketing's most important set of accomplishments centered around using the Internet to increase the reach of our marketing programs. For example, generating leads via e-mail is a thousand times cheaper than using conventional direct mail, and we get a better response rate—even in Colombia, South America. It works all over the world. Today, we spend less to generate leads. We generate more and better qualified leads. And e-mail is environmentally more friendly than direct mail—even if you use brown paper.

Global Marketing moved our product seminars to the Internet. Internet seminars cost about two dollars per attendee, while a hotel seminar costs a hundred times more. Internet seminars are better attended because they consume less time for everyone involved—prospects, references and product experts alike. Now our best product experts and our best customer references meet regularly with large numbers of prospects from all over the world, and it only takes an hour out of their day. Most people don't miss traveling to hotel seminars. And nobody misses the food.

We moved all of our product demonstrations to the Internet. So now we demonstrate our software products at our Internet seminars and on our Web store. Anyone can see how our latest products work by simply clicking a button. If they like what they see, they can get more information or buy with another click. Internet product demonstrations and our Web store delivered big productivity gains to our sales force. But that was just the beginning.

Our new Internet sales system has made our entire sales process more

uniform and automated. When prospective customers come to our Web site, we collect information about them and then immediately route them to the latest information about the products and services that interest them. In a day or two, the system automatically follows up with additional information via e-mail and, optionally, regular mail. And the system keeps the salesperson informed through every step of the process.

Ideally, we make the sale at our Web store without assistance from a salesperson. Everyone agrees it's ideal because Oracle's costs are minimized and the salesperson's time is conserved. And there's no conflict, because we pay the salesperson the same commission regardless of how we sell—Web store, on the telephone, or face-to-face.

Our Internet sales system automates and enforces a step-by-step process for selling our products. It's a global system so the sales process is the same all over the world. The system tracks every lead from capture, through every stage of the sales process, up to the close. This gives us a highly accurate view of sales activity, so we can forecast the quarter with much greater accuracy than ever before.

And our sales force is about to become even more productive, because of a level of cooperation with distribution partners that was impossible before the Internet. The newest version of our online sales system allows us to share leads with distribution partners. We just began sharing leads with a leading computer manufacturer and large consulting firm. Our respective sales teams will work cooperatively throughout the entire sales process. Our Internet sales system is a sales force multiplier. Our one sales force just became many.

And our many service organizations are becoming one—on the global Internet. Our 6,000 person customer support organization had been divided into several geographic groups. Each

*Sharing
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HOW WE SAVED A BILLION DOLLARS

BY LARRY ELLISON

group had its own computer systems and its own support database. Sound familiar? Last year customer support submitted a plan for more hiring and lower margins. The plan was not approved. Instead we used the Internet to improve customer service and satisfaction without hiring any additional people.

First, we moved all of our service information onto our Web site. That gave all our customers immediate self-service access to most of the information they needed. Now we are moving all of our customer support people to a single global system on the Internet. Once we complete that process later this year, we will be able to organize our thousands of support service people by product expertise rather than geography. That means our most qualified people will work on customer problems, regardless of where in the world the problem occurs. We will track problems around the clock and around the globe. Our support people will be more productive and our customers more satisfied.

A year ago, education was our worst performing organization. They submitted a budget with margins targeted at a dismal 13%. I thought education was capable of margins of 50%—but they would have to move aggressively to the Internet. They would have to market and sell classes on the Internet, register students on the Internet and teach classes on the Internet. Education is doing all of this and more. By the end of the year their margins hit 33%. When we complete our e-business transformation, I bet they'll be at 50%.

I could go on and on. There are numerous additional examples of improvement at Oracle. But virtually every improvement was a result of the same strategy. We standardized our business processes and moved them to the Internet. We consolidated all our separate databases into a single global

database. We unified all our separate computer systems using the E-Business Suite.

Shared information enabled people to communicate more clearly and work together better—as a team. Since our new unified computer systems were interdependent, groups using those systems become dependent upon one another. With interdependency came cooperation, specialization and economies of scale. When we globalized our business, our operational inefficiencies began to melt away. It was amazing.

The introduction of Internet technology led us to globalization which, in turn, gave rise to even deeper changes at Oracle—changes in the culture and values of the company and its management. Oracle had been a company made up of many independent business groups, managed by self-reliant generalists who valued their autonomy. Oracle has become a company of interdependent business groups, managed by specialists who value their knowledge and excel at teamwork.

As a result, it's more fun to work at Oracle these days. There's less management conflict, because decisions are based on up-to-date, shared information. Facts, not force of personality, rule the day. The more we know, the more rational our decisions.

Oracle's getting smarter.
Oh, the possibilities...

