

E-COMMERCE NEWSLETTER

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THE INTERNET TAX FREEDOM ACT AND THE CHILD ONLINE PROTECTION ACT

On October 21, 1998, President Clinton signed into law The Internet Tax Freedom Act (the "Act") as part of the 1999 Omnibus Budget Bill. Under the Act, an Internet tax moratorium is in place and will suspend certain Internet taxes from October 1, 1998 until October 21, 2001. Late in the legislative process additional provisions were added to the Act under The Child Online Protection Act (the "COPA") which complicate the rules associated with Internet taxation and separately create a set of penalties for certain online activities. The COPA provisions have attracted the attention of first amendment advocates because of the restrictions placed on Internet content. Some have referred to these provisions as "CDAII" because of similarities to the Communications Decency Act which was ruled unconstitutional by the United States Supreme Court almost two years ago.

The Internet Tax Freedom Act

The Internet Tax Freedom Act's general purpose is to provide a moratorium on most aspects of Internet taxation to permit the federal government to develop a comprehensive

tax policy for Internet commerce. While the scope of the Act is limited, it provides a starting point for public debate and the development of policies on the taxation of Internet commerce. It was generally conceded during the legislative process that the speed in the development of Internet commerce, acceptance of electronic transactions and the popularity of the Internet have far outstripped the ability of state and local governments to adequately address the tax consequences of e-commerce. Also, states and localities have significant constitutional limits on their ability to tax Internet commerce. Without providing any constructive guidelines, the Act encourages the U.S. government to work with foreign governments to develop a worldwide approach to taxation of Internet commerce.

During the three year moratorium, state and local governments will be prohibited from imposing any new Internet tax, "bit tax," or multiple or discriminatory tax on electronic commerce. Several states have imposed a sales or use tax on Internet access charges. The Act prevents any state from imposing such a tax during the moratorium period, but will permit the states currently imposing such tax to continue to impose that tax if they re-enact the tax sometime within the next year. Thus, with very few exceptions, states are prohibited from imposing new taxes on Internet access. The

act does not prevent states from continuing to impose taxes on telecommunications and cable services. The moratorium does not apply to income taxes on gross or net income from Internet or electronic commerce activities and has no application to state or local real estate and ad valorem taxes.

The Internet Tax Freedom Act also contains some general statements of public policy relating to the taxation of the Internet. First, the Act makes clear that the federal government should impose no new federal taxes on Internet activity during the moratorium period. The Act also contains an expression of Congress' intent that the President should seek international agreements to remove barriers to global electronic commerce. The objectives of those agreements will include assuring that United States trading partners do not impose tariffs or other barriers to electronic commerce and that our trading partners eliminate any existing barriers to electronic commerce. Another goal expressed in the Act is to encourage other countries to eliminate barriers on goods and services that are essential to the growth of electronic commerce, including telecommunications equipment and services.

With regard to sales and use taxes, the Act states that during the moratorium states will be prohibited from imposing multiple or discriminatory taxes. Because of constitutional limitations on the ability of a state to tax activities occurring outside the state, the moratorium should prevent the collection of sales taxes for products and services sold over the Internet unless the seller and purchaser of the products and services both have some constitutional nexus in the same state. More than 6,600 state and local jurisdictions impose some form of a sales and use tax. It is obviously administratively difficult, if not impossible, for an Internet commerce business to report and pay sales and use taxes imposed by those jurisdictions. The Act recognizes the complexity of the problem and indicates that fair and administrable rules for sales and use taxes on electronic commerce need to be developed during the moratorium period. In a parallel development, state tax administrators are

discussing the imposition of flat, statewide sales and use tax rates rather than varying tax rates applicable to local jurisdictions. The intent behind these proposed changes is to simplify compliance, particularly for retailers with sales in many jurisdictions.

As a result of the Act, states will generally be prohibited from imposing taxes on Internet access charges or other special charges assessed on electronic commerce. The moratorium on the imposition of sales taxes applies only in those situations in which there is no constitutional nexus with the state seeking to impose the tax. It is important to note that the Act is prospective only and does not change any taxes imposed or collected prior to the date of enactment. The Act establishes an Advisory Commission on Electronic Commerce to study and recommend appropriate rules for international, federal, state and local income and excise taxation of the Internet and electronic commerce. The Commission will consist of representatives from the federal government, state and local governments, and the electronic industry and consumer representatives. The Commission is directed to file a report with Congress including findings and recommendations on the taxation of the Internet. The deliberative process is expected to include public input, and businesses with significant electronic commerce activities should take an active role in the process.

The Child Online Protection Act

Portions of COPA are incorporated in the Act and provide that the use of the World Wide Web for communications of material that is "harmful to minors" is not entitled to protection under the Act's moratorium. The legislation requires that any such material be restricted from access by minors by requiring the use of a credit card, adult access code, digital certificate or other means of technology to restrict access from children under the age of 17. In addition, the legislation provides that the tax moratorium is not available to Internet service providers which do not provide for their customers a screening software to permit

customers to limit access to material on the Internet that is harmful to minors.

More importantly, the COPA adds certain provisions under the telecommunications statutes providing for fines of up to \$50,000 and prison for up to six months for disseminating over the World Wide Web material that is "harmful to minors." These provisions are similar in many ways to the provisions of the Communications Decency Act passed several years ago.

The definition of material which may be harmful to minors includes images, articles, recordings and other information which the average person "applying contemporary community standards" would find is designed to appeal to a person's prurient interest and includes representation of sexual and lewd matters. Finally, included within the definition is material which "taken as a whole, lacks serious literary, artistic, political or scientific value for minors."

The day after the COPA was signed into law, the American Civil Liberties Union, the Electronic Privacy Information Center, the Electronic Frontier Foundation, and others, filed a court challenge in the U.S. District Court for the Eastern District of Pennsylvania requesting an injunction against enforcement of the COPA. The litigation argues that *Reno v. American Civil Liberties Union*, decided by the United States Supreme Court in 1997 and striking down the Communications Decency Act, is authority for the fact that the COPA violates, among other things, the First Amendment of the United States Constitution.

While The Internet Tax Freedom Act is a positive development for electronic commerce businesses and companies doing significant business over the Internet, the provisions added by the COPA complicate matters and will be the subject of significant litigation in the future.

For further information concerning this topic, please contact Brandon Janes in the Austin office of Akin Gump at (512) 499-6294 or via e-mail at bjanes@akingump.com.

LEGAL ISSUES IN FORMING ENFORCEABLE ELECTRONIC CONTRACTS

The Statute of Frauds is a common law rule which provides that certain contracts must be in writing and be signed to be legally binding and enforceable. The historical reason for the rule was to prevent the imposition of contractual obligations on unwary or unconsenting individuals. The Statute of Frauds has been embodied in the Uniform Commercial Code (the "UCC") which governs the sale of goods. The relevant portion of the UCC provides as follows:

"...a contract for the sale of goods for the price of \$500 or more is not enforceable by way of action or defense unless there is some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought..."

With respect to electronic commerce, the fundamental questions under the Statute of Frauds are whether (i) a contract which is documented electronically can constitute a "writing"; and (ii) an electronic "signature" may satisfy the writing requirement. The resolution of these issues is fundamental in determining whether electronic contracts may create enforceable obligations between the parties.

With respect to the writing issue, the UCC defines a writing as including "printing, typewriting or other intentional reduction to tangible form." The courts have considered whether telegrams, telexes and faxes are "writings" within the meaning of the UCC such that enforceable contracts may be created through their respective media. In each case, the courts have determined that the writing requirement had been met. The technology involving telegrams, telexes and telecopies is intrinsically similar to that in electronic commerce because they all involve the transmission of electronic impulses. The distinction is that telegrams, telexes and telecopies always result in the production of a writing, whereas electronic agreements do not automatically result in

writings unless the recipient creates a printout. However, under the court's historically broad interpretation of a "writing" in other contexts, properly drafted electronic documents should satisfy the writing requirement of the Statute of Frauds. Importantly, to the extent needed to prove the writing requirement, the electronic document may always be printed in paper form.

The UCC defines "signed" as including "any symbol executed or adopted by a party with present intention to authenticate a writing." The Official Comments to the UCC state that the key question governing the existence of a "signature" is "whether the symbol was executed or adopted by the party with present intention to authenticate a writing." Such symbols as initials, stamps, thumb prints and letterheads may constitute signatures. The Official Comments instruct the courts to "use common sense and commercial experience in passing upon these matters." Thus, the courts in the telegram and telex cases consistently held that the documents were signed. Assuming the parties evidence the proper intent to "sign" the electronic agreement by carefully drafted provisions, the signature requirement of the Statute of Frauds should be met.

At common law a contract is not formed until an offer is accepted. Because the time and fact of the formation of a contract by acceptance of an offer creates the parties' duties and liabilities, the parties must address the manner in which an offer may be electronically accepted and a binding contractual obligation created. The parties may negotiate the level of certainty which they desire with respect to establishing acceptance of an offer.

This issue frequently arises in the area of electronic commerce. Is the receiving party (the seller) contractually bound upon receipt of the purchase order or should it transmit an acceptance to the sender (the buyer) before a contract is formed? Many agreements provide that an enforceable obligation does not arise until a party has

accepted an offer. We believe this is the better practice because it creates greater certainty.

In the event a dispute arises over the interpretation or performance of an electronic contract, it may be necessary to admit the contract and other relevant documents as evidence in court to prove the intention of the parties. The Federal Rules of Evidence provide in relevant part that the following records may be admissible "...a memorandum, report, record, or data compilation in any form ...if kept in the course of regularly conducted business activity...unless the source of information or method or circumstances of preparation indicate lack of trustworthiness." Thus, the Federal Rules of Evidence treat computer data on the same basis as other business records. The proper practice for establishing the trustworthiness of a computerized business record is that proof must be offered of the following:

- The document is a business record;
- The document has probative value;
- The computer equipment used was reliable; and
- Reliable data processing techniques were used.

The intent of these requirements is to ensure the reliability and trustworthiness of the records on the basis that regularly kept records have a high degree of accuracy. Recent cases have admitted computerized records upon testimony which established (i) the mechanics of data input control designed to ensure accuracy; (ii) the nature of the information constituting the input; and (iii) the business reliance on the printout in the ordinary course of its activities.

These problems are being addressed by the National Conference of Commissioners on Uniform State Laws which is proposing changes to the UCC to add a new Article 2B dealing with licenses of products and is proposing a Uniform Electronic Transactions Act. The Commissioners are also preparing draft rules of evidence to be added to federal and state rules of evidence dealing with the admission of evidence in electronic form. The Commissioners are completing the

final draft of the proposed Article 2B which will be considered by state legislators in the next few years. The combination of passage of Article 2B and adoption of the Uniform Electronic Transactions Act would solve many of the problems outlined here. Until such legislation is adopted, however, businesses must rely on existing law.

All businesses which conduct electronic commerce should take care to ensure that they are able to qualify their documents as business records so they may be admissible in a court of law in the event of litigation. To accomplish this, parties must have sound record retention policies, security procedures and other established procedures which establish the reliability of their records. The use of log books and archival records of transactions, particularly if kept by a third party service provider, is probative evidence of reliability.

For further information concerning this topic, please contact Gary Kissiah in the Austin office of Akin Gump at (512) 499-6294 or via e-mail at gkissiah@akingump.com.

AN INTERNET COMMERCE PRACTICAL GUIDE

As commercial activity has increased over the Internet, so has the use of Web-Wrap agreements. Contracting over the Internet is leading to new contract formalities, as well as new methods of interaction between the contracting parties. Internet related contracts are also being scrutinized by the judiciary because of the realization of the influence that the newly developed electronic commercial arena is having upon traditional fields of law. On the other hand, those actively involved in e-commerce cannot afford to wait and see what solutions the judiciary and legislature will provide in the evolving field of contract law. Thus, as the legal community goes through the process of the formation of Internet and Online Law, the following recommendations are proposed to enhance the binding effect of the Web-Wrap e-contract, and still preserve the business viability of the transaction:

1. Hyperlinks. All Web pages should include reference to the contract and should explicitly state that the transaction is subject to an electronic contract. The online documentation should be integrated with hypertext links, which can seamlessly transfer the consumer to the contract. For example, connection to the link may be at the bottom of each screen, with a statement, on the screen, to the effect that use of the electronic information is subject to the licensing agreement, and that if the consumer has not reviewed the agreement, she should do so by clicking on the link. By providing clear notice and access on each page, a consumer who is hyperlinked into a Web site, rather than through the home page, cannot claim that he was unaware of the agreement and its terms. Finally, the agreement itself should have a hyperlink, which connects the user back to the original document from where he came.

2. Organization. The terms and conditions of the agreement should be organized and presented clearly and concisely, so that the end user can easily navigate the document and focus on what she deems to be of crucial nature before accessing the online information or prior to consummation of the transaction.

3. Language. The agreement should be as concise as possible, written in direct language, which can be read and comprehended by people with no legal background. Assume that the consumer does not have immediate access to a lawyer, or that the courts will not approve a situation requiring a consumer, who is surfing the Net, to discontinue his online activities and consult with an attorney each time before entering into a Web site or clicking the "I accept" button.

4. Objectivity. The agreement should protect the substantive interests of all sides. It should not be one-sided, unconscionable or unreasonable. Given that Web-Wrap agreements do not usually provide an opportunity for conducting bilateral and equally based negotiations, we recommend drafting an objective document. The drafter

should assume that if the contractual arrangement is onerous and slanted in favor of the agreement's drafter, courts will interpret the agreement against the drafting party, or may even go the extra step and rewrite the onerous conditions. If the agreement is drafted in a more objective tone, protecting the interests of all the parties, the likelihood will increase that the courts will give the agreement a binding effect, thus enhancing the overall stability of the electronic environment.

5. Appearance. The agreement is a legal document, even when drafted in non-legal, easy to read language. It is not a marketing or promotional document, as are the other Web-Site documents. There is no need to decorate the E-Contract with fanciful graphics, as may be done in the other documents on the site. The faster transmission speeds of a clean, undecorated document will also reduce the frustrations inherently entailed when reviewing legal documents.

6. Acceptance. The agreement should incorporate a proactive step to manifest acceptance of the offer, such as typing in the words "I agree;" typing in one's name; or pointing and clicking on an "I accept" button. In case of point-and-click manifestations, it is recommended that the default be placed on the rejection (e.g. "I do not accept") button, or that there be no default. Such default (or lack of default) will reduce the likelihood of a claim that the user pressed the "I accept" button unintentionally.

7. Segregation. The Web-Wrap agreement should be a segregated document from the actual subject matter electronic product or information. This will enable the consumer to download, print and review the agreement prior to downloading the product or accessing the subject matter Web site, without incurring additional up-time, which his/her service provider may be charging for. Segregation also assures that, in case of rejecting the agreement, no unnecessary files were placed on the information systems of the consumer, which would have to be deleted. The act of deleting files on the consumer's information systems may cause damage to

other files, or give rise to claims of unauthorized access of the consumer's information systems.

8. Rejection and Return. Rejection or acceptance of Web-Wrap agreements, similar to Shrink-Wrap agreements, may be at different points of time and place that the point of sale. In such cases, the sale is conditioned, among others, upon acceptance of the terms and conditions of the agreement. This is particularly important for the purchase of products, tangible or not, where the agreement is attached to the product, and is not reviewed until after the product is unwrapped or downloaded. The seller should provide the consumer with the opportunity of returning the product in the event of not accepting the agreement. The policy for returning the product should be as easy as the act of its purchase. For intangible products, which are downloaded from the Internet, acceptance and rejection should be manifested in the segregated e-contract prior to the act of downloading of the actual product.

9. Contracting Parties. The agreement should have provisions for stating who the contracting parties are. The drafter of the Web-Wrap agreement should provide for space to be completed by the consumer, which shall become part of the electronic record of the agreement. This will serve not only to clearly identify the contracting parties, but also to reaffirm the consumer's acceptance of the contract, and that clicking on the acceptance button was not a random act of double-clicking.

10. Electronic Record of Affirmation. Before accepting the agreement and consummating the transaction, the parties should reaffirm that they had the opportunity to read the agreement and that they accept the terms and conditions stated therein. Up to that point of time, the parties should be allowed an opportunity to cancel the transaction without any sanctions or penalties. We recommend creating an electronic record of the consumer and the manifestation of acceptance of the offer. The record should be backed up by a hard copy and maintained in the vendor's information systems. Where

possible, acceptance should be stored in the information system of the end user as well, similar to the manner of storing "cookies."

For further information concerning this topic, please contact Jonathan Barsade in the Dallas office of Akin Gump at (214) 969-2710 or via e-mail at JBarsade@akingump.com.

NEW PUBLICATION

Internet and Online Business Law by Jonathan Barsade

The goal of this book is to provide the reader with a better understanding of the interaction between law and commerce as these pertain to the Internet and online commercial activity, enhancing the reader's knowledge and skills so that they can use the Internet more effectively. The book, written in Hebrew and published in November, 1998, is directed toward the Israeli market and focuses upon Israeli and U.S. statutes and case law.

The book not only provides a comprehensive legal analysis, but also takes the perspective of the businessperson. Throughout the book, the reader is provided with practical guidelines and checklists. The book can enlighten the business and technical professional as to the do's and don'ts of doing business over the Internet (including seemingly non-transaction oriented activities, such as the sending and receiving of e-mail, encryption of transmissions and protection of electronic information). Readers will gain a better understanding of the legal realities within which they are operating in order to enhance their financial and business decisions and risk analysis. The book also provides legal professionals with tools to better understand this newly

emerging business and legal arena. It can augment attorneys' professional advice by providing an understanding of different and, oftentimes, competing legal principles, which are now converging into a single borderless electronic arena. With regard to Israel, it is one of the leading consumer markets for the Internet and a recognized world leader in developing and distributing Internet related technologies. Those who deal with the Internet and with Israel will benefit from the insights provided in this comprehensive book.

The author, Jonathan Barsade, LL.B. (Jerusalem) M.B.A. (Berkeley), is admitted to the Bar in Israel, New York and California. Mr. Barsade is an Information Technology attorney in the Intellectual Property Section of the law firm Akin, Gump, Strauss, Hauer & Feld, L.L.P. Mr. Barsade has served as general counsel for, and provided legal advice to, high-tech, Internet and information technology companies. He has lectured extensively on topics related to information technology and has published articles and book-chapters as well. Mr. Barsade has counseled clients in the implementation, maintenance, use and enforcement of intellectual property rights, in domestic and foreign markets, including licensing and technology transfers, and the integration of these rights with clients' general business requirements. Mr. Barsade has represented start-up Internet related software developers, and has counseled general companies as to use of, and access to, the Internet including the integration of intellectual property, business, legal procedural and substantive legal issues in this evolving electronic business environment.

For further information concerning this topic, please contact Jonathan Barsade in the Dallas office of Akin Gump at (214) 969-2710 or via e-mail at JBarsade@akingump.com.

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.

AUSTIN

1900 FROST BANK PLAZA
816 CONGRESS AVENUE
AUSTIN, TX 78701
PHONE: (512) 499-6200
FAX: (512) 703-1111

DALLAS

1700 PACIFIC AVENUE, SUITE 4100
DALLAS, TX 75201
PHONE: (214) 969-2800
FAX: (214) 969-4343

HOUSTON

1900 PENNZOIL PLACE - SOUTH TOWER
711 LOUISIANA STREET
HOUSTON, TX 77002
PHONE: (713) 220-5800
FAX: (713) 236-0822

LOS ANGELES

2029 CENTURY PARK EAST, SUITE 2600
LOS ANGELES, CA 90067
PHONE: (310) 229-1000
FAX: (310) 229-1001

NEW YORK

590 MADISON AVENUE
NEW YORK, NY 10022
PHONE: (212) 872-1000
FAX: (212) 872-1002

PHILADELPHIA

ONE COMMERCE SQUARE
2005 MARKET STREET, SUITE 2110
PHILADELPHIA, PA 19103
PHONE: (215) 405-3500
FAX: (215) 405-3501

SAN ANTONIO

300 CONVENT STREET, SUITE 1500
SAN ANTONIO, TX 78205
PHONE: (210) 281-7000
FAX: (210) 224-2035

WASHINGTON, D.C.

1333 NEW HAMPSHIRE AVENUE, N.W.,
SUITE 400
WASHINGTON, D.C. 20036
PHONE: (202) 887-4000
FAX: (202) 887-4288

INTERNATIONAL OFFICES

BRUSSELS

65 AVENUE LOUISE, P.B. No. 7
1050 BRUSSELS, BELGIUM
PHONE: (011) 32-2-535-2911
FAX: (011) 32-2-535-2900

LONDON

ONE ANGEL COURT
LONDON, EC2R 7HJ
ENGLAND
PHONE: (011) 44-171-796-9600
FAX: (011) 44-171-796-9610

MOSCOW

DUCAT PLACE II
7 GASHEKA STREET, P.B. 20
MOSCOW 123056
PHONE: (011) 7-095-974-2411
FAX: (011) 7-095-974-2412



WWW.AKINGUMP.COM