MORE E-COMMERCE CONSIDERATIONS AND RISKS FOR LENDERS

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INTRODUCTION

The views in this outline and in any oral presentation by this writer do not necessarily reflect the view of this writer's law firm. Legal ethics suggest that, among other duties, an attorney should be prepared to zealously advocate the position of the attorney's client. The writer believes he and other advocates appropriately could advocate different positions on some of the following topics from time to time, depending on the client being represented.

This outline supplements but does not replace any PowerPoint presentation by the writer. It elaborates on some of the topics of the PowerPoint presentation. "I.C." refers to the Iowa Code.

CONSUMER INSTALLMENT CONTRACT RISKS

E-commerce often involves consumer buyers. If a consumer buyer or consumer lessee enters into an installment payment agreement with the e-seller, a special risk arises to lenders who become "holders" of the consumer's obligation to pay. The risk is that they will be encompassed by the Federal Trade Commission's (FTC's) "Holder Rule" and thus "subject to all claims and defenses which the debtor could assert against the" e-seller. 16 C.F.R. §433.2.

Proverbs 13:20: "a companion of fools suffers harm."

If the e-seller, like the fool in *Proverbs,* culpably injures the consumer debtor, the lender-holder, like the proverbial companion, may suffer extensively. The suffering might include not only loss of the consumer's obligation as a collectible item of collateral, but also affirmative claims for damages against the lender-holder. Here are some details:

"Consumers" (here, buyers or lessees from the e-seller), if covered by the FTC's holder rule, look to 16 C.F.R. § 433.2. That regulatory rule states:

> In connection with any sale or lease of goods or services to consumers, in or affecting commerce... it is an unfair or deceptive act or practice within the meaning of Section 5 of that act [i.e., the Federal Trade Commission Act,] for a seller, directly or indirectly, to:
>
> (a) take or receive a consumer credit contract which fails to contain the following provision in at least ten point, bold face, typed:
>
> **NOTICE**
>
> Any holder of this consumer credit is subject to all claims and defenses which the debtor could assert against the seller of goods or services obtained pursuant hereto or with the proceeds hereof. Recovery hereunder by the debtor shall not exceed amounts paid by the debtor hereunder. (emphasis added)

The FTC passed this "Holder Rule" to circumvent §3-302 of the UCC which provides that a holder in due course of any instrument, given for value in good faith, and without notice, is "free from (1) all claims to it on the part of any person; and (2) all defenses of any party to the instrument with whom the holder has not dealt." Apparently the FTC concluded that any financial institution who has financed the seller "paper" (i.e., the contracts, promissory notes, or leases the consumers deliver to the seller) is better able than the consumer to prevent seller misconduct, and to transfer back to the seller any cost of such misconduct that in fact occurs. *See Limits on a Consumer's Ability to Assert Claims and Defenses Under the FTC's Holder in Due Course Rule, Consumer Financial Services Survey: Holder in Due Course,* Business Lawyer, vol. 46, May 1991, p. 1135 *et seq*.

The Holder Rule allows the consumer to assert "all claims and defenses which the debtor could assert against the seller." Therefore, a holder can be held vicariously liable to a consumer for claims provable against a seller. *Perry v. Household Retail Services, Inc.*, 953 F.Supp. 1370 (M.D. Ala. 1996), *rev'd on other grounds in motion for reconsideration,* 119 F.Supp.2d 1268 (M.D. Ala. 2000). The FTC expressly rejected amendments to the Holder Rule that would limit the

consumer to a "defense" or "setoff". *Maberry v. Said*, 911 F Supp. 1393 (D. Kan. 1995). The Holder Rule applies to all claims or defenses connected with the transaction, whether in tort or contract. *Armstrong v. Edelson*, 718 F.Supp. 1372 (N.D. Ill. 1989). However, the Holder Rule does not create new rights or defenses. The FTC gives no special meaning to the words "claims and defenses" which appear in the notice. Rather "the phrase simply incorporates those things which, as a matter of other applicable law, constitute legally sufficient claims and defenses in a sales transaction." *Ambre v. Joe Madden Ford*, 881 F. Supp. 1182 (N.D. Ill. 1995) (quoting 41 Fed. Reg. 20,023-24).

Accordingly, to maintain an affirmative action against a holder, a consumer must prove that a breach on the seller's part warrants rescission or restitution under state law. *Mount v. LaSalle Bank Lake View*, 926 F.Supp. 759 (N.D. Ill. 1996). Each consumer must prove that he/she has a recession or restitution claim under state law. *Id.* at 764; *contra, Lozada v. Dale Baker Oldsmobile*, 91 F. Supp.2d 1087, 1094-97 (W.D. Mich. 2000) (affirmative claims can be brought even if rescission would be unavailable). Additionally, to obtain an affirmative remedy from a holder, the consumer must have started payments and arguably received little or nothing of value from the seller. *Allen v. Jermone Imports, Inc.*, 1998 WL 751633 (E.D. La. Oct. 26, 1998); but some courts don't cite this additional language and may use only a rescission and restitution test. Therefore, the Holder Rule allows the following avenues for a consumer:

> A consumer can (1) defend a creditor suit for payment of an obligation by raising a valid claim against a seller as a set-off, and (2) maintain an affirmative action against a creditor who has received payments for a return of monies paid on account. . . . [H]owever, t]he latter alternative will only be available where a seller's breach is so substantial that a court is persuaded that rescission and restitution are justified. The most typical example of such a case would involve non-delivery, where the delivery was scheduled after the date payments to a creditor commenced. . . . [Therefore, c]onsumers will not be in a position to obtain an affirmative recovery from a creditor, unless they have actually commenced payments and received little or nothing of value from the seller. In a case of non-delivery, total failure of performance, or the like, we believe the consumer is entitled to a refund of monies paid on account.

40 Fed. Reg. 53,524-27 (cited by *Ford Motor Credit Co. v. Morgan*, 536 N.E.2d 587 (Mass. 1989)).

Despite this rather clear language, courts are divided on the issue of whether a consumer may use the Holder Rule as a shield and a sword. A few courts have held the Holder Rule may be used only defensively. In *Labarre v. Credit Acceptance Corp.*, 11 F. Supp.2d 1071 (D. Minn. 1998) *affirmed in part, reversed in part*, 173 F.3d 640 (8th Cir. 1999) the court concluded that the

assignee-creditor could not be held vicariously liable for seller's alleged violations of Motor Vehicle Retail Installment Sales Act because "[t]he Notice creates no new rights or defenses. Rather, it simply prevents the use of certain so-called 'cutoff devices' which would render a consumer liable for payments without regard to any defenses the consumer may have against the seller." *Id.* at 1076. The court would not allow the consumer to turn a shield into a sword because the Holder Rule notice simply means that the "assignment of such contract operates as any ordinary assignment would, in absence of the UCC's 'Holder in Due Course' Rule or 'Waiver of Defenses Clauses.'" *Id.* (quoting *Vietnam Veterans of America, Inc. v. Guerdon Industries, Inc.*, 644 F. Supp. 951, 965 n.10 (D. Del. 1986).

In a very significant development April 28, 1999, the Eighth Circuit decided the appeal in *LaBarre*, 175 F.3d 640 (8th Cir. 1999). The Eighth Circuit partly affirmed and partly reversed. The reversal allowed LaBarre to continue against the creditor-assignee only on RICO claims. The assignee allegedly participated in a scheme to defraud LaBarre by obtaining more expensive insurance than the insurance provided for in the contract between LaBarre and the original seller; then the assignee passed on the extra cost to LaBarre without LaBarre's authorization. Thus, the assignee's direct involvement rather than vicarious liability caused the Eighth Circuit to allow the RICO claim to stand.

The Eighth Circuit affirmed dismissal of various breach of contract, consumer protection statute, and breach of fiduciary duty claims against the assignee. The consumer based these on Holder Rule vicarious liability. The Eighth Circuit stated the Holder Rule's reference to "claims"

> simply incorporates those things which, as a matter of other applicable law, constitute legally sufficient claims and defenses in a sales transaction. . . . Minnesota law subjects any assignee of a consumer credit contract to all of the consumer's claims and defenses against the seller arising from the sale, but also limits the consumer's rights, allowing those rights to be asserted only as a "defense to or set off against a claim by the assignee." Minn. Stat. § 325G.16, subd.3 (1998).

175 F.3d at 644. Because the state law incorporated by the Holder Rule limited a consumer's rights against an assignee to a shield rather than affirmative claims, LaBarre could not affirmatively sue the assignee.

Many courts hold that a consumer may use the Holder Rule as a sword to obtain an affirmative recovery. See generally *Milchen v. Bob Morris Pontiac-GMC Truck*, 680 N.E.2d 698 (Ohio Ct. App. 1996) (reversed trial court dismissal of defendant assignee-creditor because, while a financial institution was exempt from

state consumer fraud act, as an assignee it could held derivatively liable for seller's violations based on the notice in assigned contract); *Maberry v. Said*, 911 F. Supp. 1393 (D. Kan. 1995) (denied summary judgment motion by an assignee-creditor who purchased note for a truck, because claims against seller for violations of state and federal odometer laws as well as state consumer protection law may be used affirmatively to impose liability on assignee-creditor; court noted that the Holder Rule permits damages to include monies paid under the contract and the trade in value of the car the consumer traded in when he purchased the truck).

Most of the courts that allow a consumer to maintain an affirmative action against an assignee-creditor for a return of monies can be divided into two broad categories. First, some courts require that the seller's breach must have been so substantial that the court was persuaded that recession and restitution were justified under state law. *See, e.g. Boggess v. Lewis Raines Motors, Inc.*, 20 F. Supp.2d 979 (S.D.W.Va. 1998) (assignee-creditor's motion to dismiss denied because consumer may assert seller's fraudulent misrepresentation of odometer mileage against a holder because seller's breach was so substantial that a court may be persuaded rescission and restitution are justified).

Second, other courts that allow an affirmative action against an assignee-creditor arguably require that the consumer received little or nothing of value from the seller and do not focus on the rescission inquiry. *See, e.g., In re Hillsborough Holdings Corp.*, 146 B.R. 1015 (M.D. Fla. 1992) (consumers who actually commenced payment and obtained possession of homes, which had value, could not recover for unfair deceptive trade practices because there was no showing that consumers received little or nothing of value).

Two additional notes:

First, there is no private cause of action under the Holder Rule if notice is omitted from the consumer contract. *Bartles v. Alabama Commercial College*, 918 F. Supp. 1565 (S.D. Ga. 1995), *rev'd in part on other grounds aff'd on this issue,* unpub. slip op. at 10 (11th Cir. 1999); *Williams v. National School of Health Tech.*, 836 F. Supp. 273 (E.D. Pa. 1993), *aff'd* 37 F.3d 1491 (3rd Cir. 1994).

Second, many states also have "mini" holder rules, enacted in state statutes. Some of these state rules purport to make the lender-holder subject to claims and defenses of the consumer obligor, even if the contract between the consumer and the original seller omits the language required by the FTC's Holder Rule.

Proverbs 14:29: "a patient man has great understanding."

Lenders to an e-vendor who will use paper contracts for installment payments (whether of rent or purchase price) should be aware of the large risks imposed by the Holder Rule if (a) the contracts contain the holder-is-subject-to-claims-and-defenses language mandated by the FTC or the contract is governed

by a state with a mini holder rule that imposes such status on the holder even if the contract is silent; (b) the vendor is prone to angering its consumer customers because of alleged breaches by the vendor of the contracts or tort laws; and (c) the lender plans to hold the paper. Such a lender may wish to decline to extend credit or, if it extends credit, do so based on collateral other than the installment contracts and decline to obtain a lien on or possession of those contracts.

Even if a lender views its prospective seller-borrower to be upright and not a breacher of duties, the lender should patiently undertake due diligence to check the accuracy of its view. The lender also should consider requiring extra safeguards if the seller-borrower must use the consumer contracts as collateral. For example, the lender may wish to require larger cash reserve accounts and guarantors than it otherwise would, to compensate for the Holder Rule risk. The lender also may wish to include loan covenants requiring immediate notice to the lender of any investigation or demand letter against the seller-borrower by a consumer or government regulator.

As to the special characteristics of cyber commerce, it may be unclear whether a lender having as collateral a batch of unwritten promises to pay by the customers of its e-seller-borrower is a "holder." Can one "hold" an unwritten promise? But a mini holder rule in Iowa discusses "assignees" of a consumer's payment contract, without requiring that the "assignee" be a "holder." So the lender taking such unwritten promises as collateral will be cautious. (This speech does not discuss whether a lienholder who is not an outright assignee is within Iowa's mini holder rule.) See generally I.C. §537.3404.

1. With respect to a consumer credit sale or consumer lease, an assignee of the rights of the seller or lessor is subject to all claims and defenses of the consumer against the seller or lessor arising from the sale or lease of property or services, notwithstanding that the assignee is a holder in due course of a negotiable instrument issued in violation of the provisions prohibiting certain negotiable instruments in section 537.3307; unless the consumer has agreed in writing not to assert against an assignee a claim or defense arising out of such sale, and the consumer's contract has been assigned to an assignee not related to the seller who acquired the consumer's contract in good faith and for value and who gives the consumer notice of the assignment as provided in this subsection and who within thirty days after the mailing of the notice receives no written notice of the facts giving rise to the consumer's claim or defense. Such agreement not to assert a claim or defense is not valid if the assignee receives such written notice from the consumer within such thirty-day period.

I.C. §537.3404(1) (partial quotation).

VALUING INTELLECTUAL PROPERTY

Intellectual property used in e-commerce can significantly raise earnings of an e-commerce vendor, compared with e-commerce competitors who lack the intellectual property (IP). This generally occurs via one or more of the following:

--Price premiums where buyers are willing to pay more because of a perception that the IP enhances the e-commerce vendor's product or service.

--Cost savings when IP allows the product or service to be produced cheaper.

--Expanded market share and thus economies of scale that enhance profits.

One popular way of valuing IP such as a trademarked popular product or a patented e-distribution process is to use a royalty rate of 5% of sales. Russell Parr, CFA, ASA, and expert author on valuing IP, prefers other approaches.

An alternative approach is shown in the formula on the PowerPoint slides accompanying this seminar paper. That approach is sometimes referred to as the "analytical approach." *See generally TWM Mfg. Co. v. Dura Corp.,* 789 F.2d 895, 899 (Fed. Cir. 1986).

If the IP justifies the effort of the analytical approach, it seems preferable to a simplistic sales royalty as a starting point. The analytical approach then could lead parties, such as lenders, to use a roughly equivalent figure measured on sales only, but that figure may diverge widely from 5%.

The analytical approach, however, can have shortcomings. For instance, it does not expressly consider the amount of complementary assets required to exploit the IP. If, as compared with the complementary assets generally used in the industry by competitors who lack the IP, the IP requires much more expensive computer hardware, dedicated phone lines or the like, that will decrease the IP's value.

Sometimes "comparable" sales or licenses provide evidence of IP value. When considering such comparable transactions, however, be alert to whether the license or sales price includes technical assistance. Often it does. One then needs to try to subtract the value of the technical assistance to get a more comparable price. This is especially significant for lenders, who may lack ability to technically assist if they repossess the IP and try to sell or license it to reduce loan losses.

Another valuation approach is called investment rate of return analysis. A basic concept here is to examine total profits of a business and allocate the profits among the different types of assets it uses. Assuming the business is profitable, the analyst can attribute a reasonable rate of return to all non-IP assets used by the business. If profits remain after such attribution, the analyst

has insight into the value of the IP used by the business. Per Russell Parr, analysts can go the next step of indicating a royalty rate for IP capable of being licensed. How? Divide the profits attributed to the IP by the revenues the business generates using the IP. The investment rate of return analyst needs to take care, however, to avoid accidentally understating the value of the company's non-IP intangible assets (e.g., especially skilled and trained workforce, excellent distribution networks) or tangible assets. Such understatement leads to an inflated estimate of the IP's value.

Whatever IP valuation approach is used, lenders should heed Mr. Parr's advice: IP can be the "most risky asset components of the overall business . . . These assets may have little, if any, liquidity" and thus be much less valuable to a lender upon repossession than to the borrower. Still, the world has largely changed from a machine-based economy to a knowledge-based economy. Lenders and borrowers are changing in turn.

Related to IP valuation are markets for one type of IP, domain names. A market player is GreatDomains.com, affiliated with VeriSign, Inc. The accompanying PowerPoint slides provide some details about GreatDomains' services.

As a sidebar, consider GreatDomains.com's Privacy Policy, as viewed online October 14, 2004. Here is an excerpt:

> **With Who Does GreatDomains Share Your Information?**
>
> As a general rule, GreatDomains does not disclose any of your personally identifiable information, unless we have your specific permission, or under special circumstances, such as when we reasonably believe that the law requires that we do so. We do aggregate personally identifiable information and disclose such information in the aggregate as historical, statistical data for marketing, and promotional situations. However, in such situations, it is not possible to personally identify you or your personal information. Certain information, such as your password, credit card information, or bank account number would not be disclosed in such aggregate disclosures.
>
> GreatDomains.com cooperates with all law enforcement inquiries and with *third parties who are enforcing their intellectual property or other proprietary rights*. We, of course, also provide that the information that is necessary to facilitate the actual, ongoing commercial activities conducted on the GreatDomains Web site. For example, we will provide identifying information to the parties that have agreed upon the purchase and sale of a Domain Name, so that they may continue and conclude the transaction. All

> recipients of the transaction agree to the restrictions of on how they can use and disclose such information.
>
> In sum, although we use ***industry standard practices to protect your privacy***, we do not and cannot promise, and ***you cannot expect***, that your personally identifiable communications will always remain private.

(emphasis added). This Privacy Policy excerpt is not recommended by the author. Although there is a modest chance the italicized parts would allow GreatDomains to voluntarily or involuntarily transfer personally identifiable information to a lender if the lender repossessed GreatDomains' business assets, the author believes any such transfer would be problematic under the Privacy Policy's wording. This is a reminder to lenders to diligently review privacy policies of prospective borrowers.

CONCLUSION

E-vendors who seek to borrow significant funds on a secured basis do well to obtain experienced legal counsel. So do prospective lenders to e-vendors, whether the lender is an insider or a financial institution. E-commerce, with its potential efficiencies and increased geographic range of competition, has opportunities to improve the world. These opportunities will be increased if wise lending occurs. It is, after all, proverbial: "A wise one will hear, and will increase learning."

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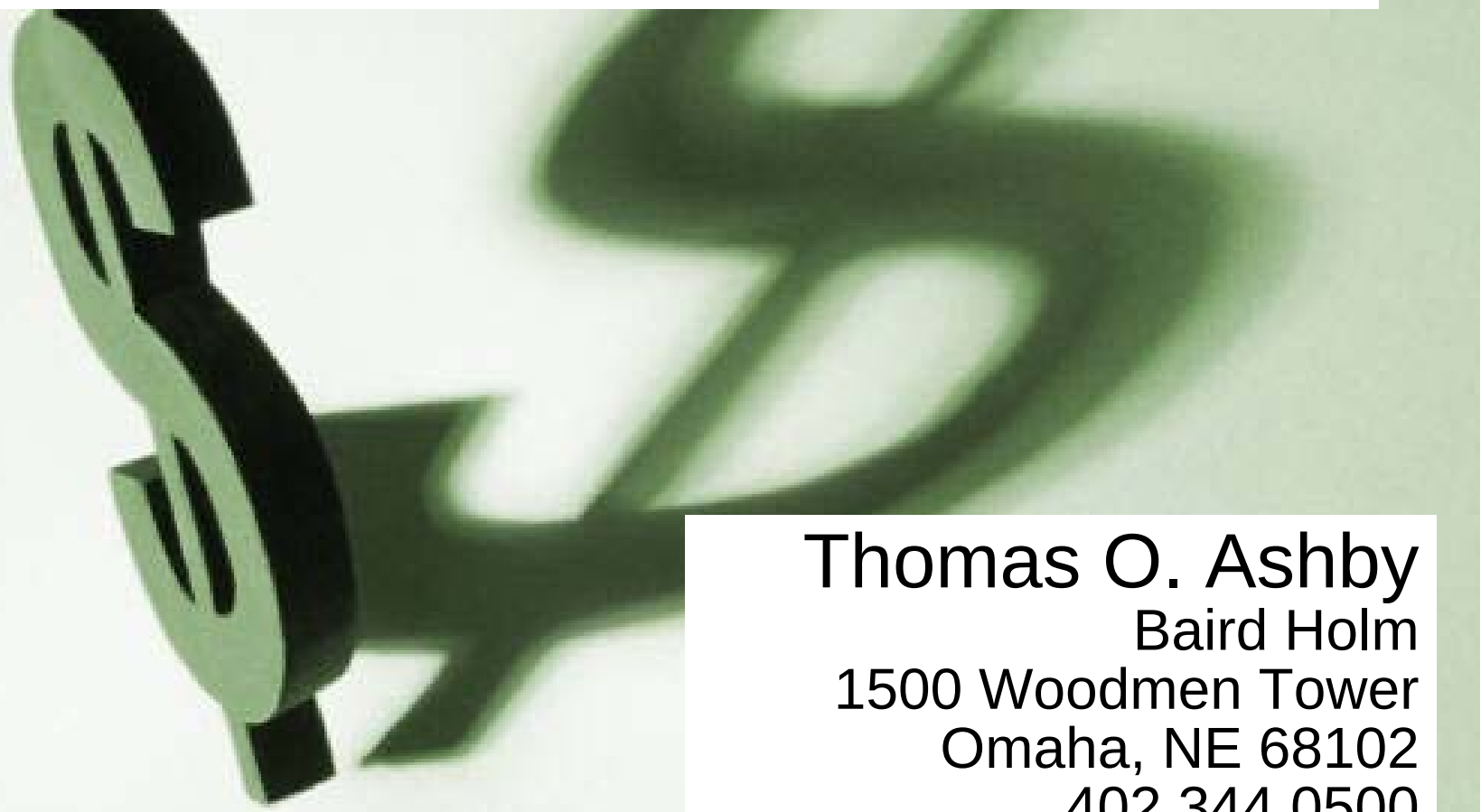
More E-Commerce Considerations and Risks for Lenders



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Cash Flow Requirements

Debt service-related acronyms:

- EBITDA: Earnings before interest, taxes, depreciation and amortization
- EBIT: Earnings before interest and taxes
- EBITDAR: Earnings before interest, taxes, depreciation, amortization and rent

Debt to tangible net worth

Cash Flow Requirements (cont.)

Certain underwriting examples:

A. 1.25 to 1 — EBITDA on worst of the last two years to total annual debt payments.

B. 1.35 or more to 1 — EBITDA to total annual debt payments if no qualify for SBA guaranty and no third party collateral.

C. 1.6 or 2 to 1 — EBITDA to total annual debt payments if no qualify for SBA guaranty, no third party collateral and no third party guaranty.

Cash Flow Requirements (cont.)

D. 1.115 to 1 EBITDA to total annual debt payments if SBA guarantied at 75% or 85% level.

E. 1.110 to 1 EBITDA to total annual debt payments: extreme case if SBA guarantied at 75% or 85% level.

Cash Flow Comments

- Usually easier to get loans as start-up than after 2 or 3 years of losses.
- At the outset, line up more cash than you believe you will need.
  - Some can be unconventional, where not violative of covenants loan documents. E.g., credit cards, personal liquid savings.

Personal Guaranties

Realities:

1. If certificates of deposit, other cash, stocks or bonds, bank almost always will require them pledged.
2. Be aware of guarantor's subrogation rights.
3. Guarantors should consider accruing a guarantee fee. SBA's typically is 2.25% of loan.
4. Lenders should, but may not, require subordination of insider debt.

Key Employees

- Lenders should insist on employment/independent contractor contracts where an employee is key, especially a nonguarantor employee.
- SBA shows some sensitivity to requiring guaranties by key non-owner managers but not to employment contracts.

Valuing Intellectual Property

- Lack of collateral will not preclude SBA guaranty of a loan.
- Borrowers can try to think outside the box when it comes to valuation.
- Russell L. Parr, CFA, MBA, American Society of Appraisers member, and author of three editions of Valuation of Intellectual Property and Intangible Assets (John Wiley & Sons): Intellectual property is typically over 85% of a company's value. Some business executives use as a rule of thumb a reasonable royalty for IP is 25% to 33% of the gross profits, before taxes, from the enterprise operations in which licensed IP is used. But if used in an industry that does not require much overhead support, IP often is particularly valuable because profits are higher.

Parr (cont.)

Thus, at least where commodity products are being produced by the IP user, a more accurate formula may be

Enhanced product profit margin	–	Industry norm profit margin	=	Royalty rate

Parr (cont.)

- If using a market approach to valuing IP, discern whether the licensor promises technical assistance as well as a license. If so, the payment to the licensor must be discounted to show the true market price of the license.
- As of 2000, average domain name sold on the market went for about $10,000 to $15,000.

Parr (cont.)

- Contrast
  - Autos.com sold for $2,200,000
  - Business.com sold for $7,500,000
  - Comedynight.com sold for $539
  - Alpinezone.com sold for $527

GreatDomains.com

customercare@greatdomains.com

Great Domains.com
c/o VeriSign, Inc.
21345 Ridgetop Circle
Dulles, VA 20166
Attn: Customer Service, 4th Floor LSII

GreatDomains.com (cont.)

Prefers:

- .com., .net, .tv, .org
- Single space generic words or 3 characters or less (e.g. 500.com)
- No hyphens

GreatDomains.com (cont.)

- Sales agent and/or
- Escrow agent
  - Escrow-only fees = higher of $500 or 10% of sale price.
  - Once escrow agent gets signed document, buyer has 3 business days to wire funds to GreatDomains.

Privacy Policies Revisited

- Lender with data as collateral
- Buyer of entire business of the data gatherer
- GreatDomains.com as example

"Holder" Rules in Consumer Credit

- Federal Trade Commission.
- Iowa Code §537.3404.

"Holder" Rules (cont.) Lender Considerations

- Prospective borrower's compliance with laws.
- Whether to take security interest or become assignee/holder of consumer contracts.
- Extra means of collection such as guarantors, cash reserves, other collateral.

U.S.A. v. Councilman (1st Cir. Oct. 5, 2004)

- Vacates June 29, 2004, dismissal of a criminal count under federal wiretap law. Defendant allegedly directed a change in "procmail.rc" mail processing code to intercept e-mails from temporary storage and directed employees to read e-mails for commercial advantage.
- Orders briefs on issues of whether prosecution under Stored Communications Act could have been alternative or additional indictment; and whether lenity precludes prosecution.

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