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A PIECE OF THE NET

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Everyone used to want a "piece of the rock." Now everyone wants a piece of the Net (Internet, also commonly referred to as the Web). The Internet is the most significant influence affecting the way that commerce is conducted today and will be tomorrow, in the United States and globally. Last year, approximately \$6 billion in commerce was transacted through the use of the Internet. The Department of Commerce recently predicted that electronic commerce (e-commerce) will be a \$300 billion industry by the year 2002. However, others predict that \$1 trillion in electronic commerce will be conducted by the year 2000.

Sixty percent of all companies in the United States use the Internet and of those companies, 69 percent use the Internet to sell products and services.¹ While on-line banking has become established on the Internet, insurance companies and insurance-related entities are still beginning to establish their on-line presence and capabilities.² Of the revenue spent advertising on the Internet, 11 percent is spent on advertising financial services, including insurance.³

There are over 65 million users of the Internet in the United States.⁴ Approximately 20 percent of Internet users conduct electronic commerce on the Internet; that is, they shop on the Internet.⁵ Approximately 12 percent of users engage in banking and financial services on the Internet.⁶ It is unclear what percentage of users engage in insurance and insurance-related transactions. However, as technology (hardware and software) further addresses security issues and provide Web sites the capability to provide personal attention and simplify the sale of insurance, more and more purchases of insurance will be made through the use of the Internet.

A recent study shows that at least 120 insurance companies have Web sites. The types of services provided include marketing (50%), basic customer service support (22%), on-line policy quotes (7%) and interactive customer service and on-line sales (1%).⁷ The insurance industry will continue to adopt the interactive potential of the Internet to conduct business as it implements the paradigm of the insurance industry during the 1990's. That is, the general public demands an increase in the services and products which are provided at a lower market price and an increase in customer service.

Significant changes will be made to the type of commercial and financial transactions which are engaged in through the use of the Internet, including issues involving electronic commerce. Regulatory concerns will not only include state insurance departments but will also need to address those concerns of the Federal Reserve Board, Federal Deposit Insurance Corporation, Departments of Treasury and Justice, Federal Bureau of Investigation, Federal Communications Commission, Securities and Exchange Commission, as well as state banking, consumer protection and securities departments. As the banking, insurance and securities industries become increasingly blended as a *financial services* industry, marketing and strategic alliances and joint ventures will be formed to conduct business through the use of the Internet. The use of the Internet presents unique legal risks which need to be addressed and minimized, including the following issues involving marketing and strategic alliances or joint ventures.

Marketing and Strategic Alliances and Joint Ventures

Insurance and financial products which are to be marketed through the Internet involve insurance companies, agents, brokers, financial institutions, securities firms, technology companies and others in marketing and strategic alliances and

brokers, financial institutions, securities firms, technology companies and others in marketing and strategic alliances and joint ventures. Some of the legal issues of concern are:

A. Identification of Participants and Products.

Have the parties adequately identified the potential risks? How can such risks be best protected against? Indemnification provisions should appropriately allocate perceived risks. Consideration should be given as to how much comfort such indemnification provisions provide. While risk can be allocated by contract, attention should also be given to any legal or regulatory restrictions that may limit or prohibit such allocation. Are any of the identified risks capable of being covered by insurance?

(2) What regulatory issues are triggered by the formation of a venture?

(3) What other regulators may be involved and what other legal constraints may apply to a participant or venturer? For example, some venturers may be subject to continuing antitrust decrees; the formation of the venture may call for a Hart-Scott-Rodino filing.

What are the objectives of the venturers and participants? Do they see themselves as entrepreneurs? Are they merely creating an inexpensive, necessary resource to use in their respective businesses at a break-even price *e.g.*, a common "back-office"? Are they acquiring rights to a technology to be used in their respective businesses as well as to market to others. Who "owns" the ultimate customer for the service?

B. Relationships with Vendors and Suppliers.

Information suppliers. The venture may need information on such issues as customer desires and concerns, merchant requirements, customers' level of satisfaction with existing technological solutions. Who owns any data developed or supplied? What restrictions are applicable to the use of such information and its dissemination?

Technology providers. The control of the rights to the technology to be used can be critical to the success of the venture. Where the technology is specialized and where alternatives are not readily available in the marketplace, steps need to be taken to assure that the venture is not unduly dependent on any one vendor. The right to access and use source code, licenses to use patents and the like may be of critical importance to the venture's continuing operation in circumstances where a vendor defaults or decides it no longer wants to remain in the relevant line of business. As well as other customary indemnifications, the venture may also need to receive an indemnification from vendors about the security features of the technology used.

Consultants and Advisors. In the creation of the venture, a venturer, or the potential venturers as a group, may wish to use consultants for a number of purposes, *e.g.*, to develop a marketing plan; to develop software necessary for the venture; or to provide legal or financial advice. How are the costs for such consultant services to be allocated? Who owns the work product developed?

C. The Formation of the Venture.

The general form contemplated for any venture is a limited liability company, a form that has become popular because it combines the limitations on liability found in a corporation with the tax advantages of a partnership.

Governance.

(a) The venture should determine how governing board seats will be apportioned among members.

(b) Commonly, decisions on behalf of the venture will be made by majority vote of the board of managers agreement as requiring a different vote such as super majority vote.

There may also be circumstances where either the formation agreement or the governing law requires the members to approve an action; for example, where the possible liquidation of the venture is being considered.

(2) Capital Obligations of Members of the Venture.

(a) Members may fund their capital contribution with cash or with certain assets obtained from the member, its affiliates or parent which will be contributed to the venture. How such assets are transferred may have tax and regulatory implications which should be analyzed before a commitment is made. An asset may have different valuations depending on whether a book value or a fair market value or some other value is used. The value to be used in establishing the members' capital accounts in the venture should be addressed in the formation agreement.

(b) Commonly, each member would be obligated to contribute to the venture's capital as needed by the venture up to a stated dollar limit as contained in the formation agreement or as determined from time to time by the board of managers of the members.

(c) The parties may wish to obtain a parent guaranty of the obligations of members to make future contributions of capital to the venture, particularly where a member is a special purpose subsidiary created solely to participate in the venture.

(3) Profits and Losses of the Venture.

(a) The formation agreement should establish the percentage of profits each member is entitled to receive.

(b) All losses should be allocated pursuant to the formation agreement.

(c) A member may have a special allocation of profits to offset disproportionate liabilities for losses.

(4) Purposes of the Venture; Non-Competition Provision.

(a) The formation agreement should contain a clearly stated business purpose and may also provide that the venture may undertake other businesses approved by the members.

(b) A common provision in a formation agreement would be a restriction on the ability of members and their affiliates to compete with the venture.

with the venture.

(c) If there is to be any division of functions, the formation agreement should be clear on what duties the members intend the venture to undertake and what functions will be retained by the members.

(5) Various Actions of Members: Membership.

(a) Commonly, the parties will want the members to commit to the venture for some period, *e.g.*, three years, during which a member may not withdraw or withdraw only under very limited conditions.

(b) If a member terminates its membership, the other members may want an option to acquire that member's interest in the venture for some stated or determinable value, pursuant to a right of first refusal or first offer.

(c) Any purchaser of the business interest of a member, with the possible exception of a purchase by another member, should be approved by the board of managers of the venture or the other members.

(6) Transferability of Membership Interests.

(a) The parties should consider what criteria govern who may be a member.

(b) Commonly, the transfer of an interest in the venture would be made only with the consent of the other members except in special circumstances.

(c) The formation agreement might also require that the interest of a member must be offered for sale to the other members upon a change in control of such member at an appraised value or on some other basis.

(7) Termination.

(a) Procedures should be established in the formation agreement for the termination of the venture including (i) the conditions under which termination will occur, (ii) notice requirements, and (iii) the voting requirements called for, *e.g.*, two-thirds of the members.

(b) Commonly, the formation agreement will provide that the assets of the venture will be sold upon termination and any proceeds remaining after the payment of creditors and the costs associated with liquidation shall be distributed to members.

(c) Upon termination of the venture, provision should be made to deal with the venture's assets, including assets developed by the venture, *e.g.*, the venture's proprietary software. Frequently, in such a circumstance, each member will obtain non-exclusive, perpetual licenses to venture-developed technology at a fee for use in their own businesses (which would include the businesses of affiliates).

businesses (which would include the businesses of affiliates).

(d) As an alternative to a sale of the business the parties could provide that, to the extent possible, assets contributed by a member would be returned to that member after discharge of the venture's debts or subject to the rights of the venture's creditors.

(8) Services to Members and Affiliates of Members.

(a) Affiliates of members may/should enter into a contract with the venture to provide or purchase services as the case may be. In some instances the formation agreement may require that members and affiliates purchase services from the venture.

(b) The board of managers should reach agreement on initial pricing of any services which may be sold to a member or its affiliate companies as well as other material terms of such service contracts, in every instance consistent with applicable bank regulatory requirements.

(9) Buy/Sell Between Members of the Venture.

Members may want to provide a mechanism whereby a member may buy out the interest of another member. A commonly used device is a buy/sell provision in the formation agreement which calls for one member to put forward a price at which it will buy another member's interest and the other member may, at its election, either sell its interest in the venture to such member or buy that member's interest at that same price.

(10) Defaults.

(a) The following items are common defaults which, after notice and a reasonable period to cure the same, give rise to a right in favor of the other members to take action against the defaulting party and/or to terminate the formation agreement:

- (i) failure to contribute required capital;
- (ii) the commission of a material illegal act which has a material adverse impact on the venture;
- (iii) engaging in prohibited competition;
- (iv) the bankruptcy or receivership of a member; and
- (v) any material breach of the formation agreement or a related agreement.

(b) Remedies for the nondefaulting member, which may be exercised individually or on behalf of the venture, would commonly include:

- (i) a right on the part of the other members to buy a defaulting member's interest at book value or less;
- (ii) block any distribution of revenues to the defaulting party;
- (iii) sue a defaulting member for damages or to enjoin the activity which constitutes the default;

default;

(iv) equitable remedies; and/or

(v) termination of the venture.

(11) Tax Matters.⁸

(a) The venture should make certain that a limited liability company will be treated as a partnership under local tax laws in each jurisdiction where the venture intends to do business.

(b) Establish capital accounts.

(c) Establish a tax matters member to be responsible for such tax matters as return preparation and filing and the like.

(12) Miscellaneous.

The following items should also be considered for inclusion in the formation agreement:

(a) Choice of governing law.

(b) A dispute resolution mechanism should be included, *e.g.*, mediation or arbitration. Mediation may be preferable since the decision of an arbitrator could bind members to business decisions they do not want to make or cannot make. An escalation procedure might be included before the dispute is referred to a third party.

Endnotes

1 Deloitte and Touche (1998).

2. There are approximately 3.6 million banking customers, 2.7 million securities brokerage customers and 10,000 insurance customers on the Internet. Booz Allen Hamilton (1998).
3. Coopers & Lybrand, "Advertising Revenue Reporting Program" (1998).
4. This number does not account for multiple users who may share a single account to access the Internet.
5. Strategics Group, "E-Commerce Internet Payment Systems" (1998). Music stores, software stores and online auctions are the most popular e-commerce transactions, followed by travel agents, booksellers and car dealers.
6. *Id.*
7. Booz Allen Hamilton (1998).

While not a tax issue for the venture, when a member is transferring property to the venture, potential sales tax issues should be considered.

