# *INTERNET*

# *TRADE EXCHANGES*

**by**

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When General Motors and Ford announced in November, 1999 that each company was forming an Internet trade exchange, the e-commerce landscape was radically altered. In February, 2000, the auto industry re-shocked the e-commerce world when GM, Ford and DaimlerChrysler announced the formation of the largest industry-sponsored exchange, Covisint. In the several months that have transpired since February, hundreds more exchanges have been announced[2], and almost as rapidly, the business models upon which these exchanges were based have morphed into much more sophisticated strategic business initiatives. While initial justification for exchanges centered on reducing purchasing costs, the greatest impact will likely be in providing supply chain management and product collaboration services. Making these new types of services available and integrating them into decision making processes will have a profound impact on how the business community acquires, processes and protects the number one business asset of the new millennium – information.

Exchanges are not "just another joint venture," but rather the formation of a complete new form of doing business with diverse and complex business relationships. A new breed of e-commerce savvy business executives are involved in driving exchanges into the markets, and understanding how exchanges will behave in the marketplace will be the key to their success. The business models which support the exchange business form are rapidly changing, and the practitioner must be aware of this change and anticipate and plan for the challenges inherent in this change. This Article identifies some of the key legal areas involved in forming an Internet trade exchange.

## I. The Business of Trade Exchanges

Exchanges are portals or "hubs" through which buyers and sellers can conduct electronic transactions. At the core of the exchange is the exchange software engine, complex technology

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1 Mr. Gallitano was a partner at Piper Marbury Rudnick & Wolfe when this article was written, but is now a partner at Gallitano & O'Connor.

2 B2B e-commerce sales are exceeding consumer spending on the Internet by a 10 to 1 margin (see Rugs Banham, "*Special Report: E-Commerce 'The World is Enough,' Internet Trading Hubs Open Up Global Markets to Even the Smallest Companies*'", at http://www.efonet.com/html/Arheles/CFO/2000/000Jatnew.html). Unlike the B2B market, which requires millions of users to reach critical mass, the B2B market needs only a few industry market leaders to reach critical mass. B2B comprised only .2% of all business sales in 1999 but is expected to grow to 9.4% of sales in only three years. Forrester Research projects that B2B sales will increase from $43 billion in 1998 to $2.7 trillion by 2004 (see Adam Feurstein, "*Report: Online B-to-B Trade to Reach $6T By 2005*," at http://www.upside.com/texis/) and Jupiter Communications anticipates that number will jump to $6 trillion by 2005, representing 42% of total B2B non-service spending in the United States.

that provides the infrastructure to facilitate the various services provided by the exchange. There are several basic services provided by trade exchanges which can be categorized as follows: Auctions; catalogue buying; and bid and quote services. Usually, auction services (both forward auctions and reverse auctions[3]) provide a venue for suppliers and buyers to list, for sale or purchase, on the exchange goods and services for bidding by other buyers and suppliers. Catalog services usually permit buyers to purchase goods and services from catalogs posted on the exchange by suppliers. Finally, bid and quote services usually allow buyers and suppliers to post requests for quotations and requests for proposals with respect to goods and services on the exchange to initiate responses from other potential suppliers and buyers.

More advanced service offerings are projected to provide strategic competitive advantage services to exchange participants. The exchanges that will be able to implement these services rapidly, and more importantly, evolve and adapt these services to serve its participants better will create more value for its customers and hence create value in the exchange as a separate business entity. These advanced services include supply chain management, including logistics, transportation, *etc*., and product collaboration.

## II. Joint Venture Formation Considerations

The very first exchanges were formed by dot.com companies that saw a business opportunity in creating a neutral electronic platform for buyers and sellers in a particular industry such as steel (E-Steel) and chemicals (Chemdex). However, with the advent of industry-sponsored exchanges, sparked by the auto industry and followed closely by the aerospace, paper and forest products, retail and energy industries, the bricks and mortar companies have positioned themselves to be the leaders in this segment of the B2B industry.

### A. Antitrust Considerations

Industry-sponsored exchanges have created their own challenges, most notably in the antitrust arena because the joint ventures are combining the interests of competitors. In launching its inquiry into Covisint, the FTC wanted to take a close look at the formation of these "exchange" entities. Issues that exchanges will need to address from the antitrust perspective will likely include:

- ✓ Board composition of the joint venture and whether the joint venture is independent from the industry sponsors
- ✓ Exclusivity clauses and commitments by the joint venture partners to channel their business through the exchange
- ✓ Confidentiality and security of data

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3 In a forward auction, suppliers post materials for bids by buyers, while in a reverse auction, buyers post a demand item.

- ✓ Restrictions on outsource purchasing and aggregation
- ✓ Customer relations
- ✓ Open technology architecture

With the FTC's recent approval of the auto exchange Covisint, the FTC appears to be laying the groundwork for similar treatment of other large, industry-sponsored trade exchanges.

### B. **Corporate Form/Securities Considerations**

The type of corporate form the exchange can take can vary depending on whether the entity will or may go public in the future. Although outside the scope of this paper, there are tax advantages to considering a limited liability company form with an additional corporation formed to act as a management company. Other corporate and tax considerations include whether the exchange should be U.S.-based or offshore.

### C. **Channel Conflict and Exclusivity Clauses**

Perhaps the most complex issue that faces exchanges is the scope and breadth of exclusivity commitments – whether in the form of committing types of business transactions, volumes of business and/or restricting investments in competing exchanges or other e-commerce initiatives. Unfortunately, many of these key business terms are agreed to and/or structured by advisors who are not well versed in antitrust law or without a full understanding of all of the joint venturers' other e-commerce strategies. Oftentimes the scope of the business committed and/or exclusivity arrangements are contradictory to a joint venturer's other e-commerce strategies, *i.e.*, "channel conflict", and a joint venture participant should not execute any document which contains terms that may preclude implementing their separate e-commerce strategies in the future.

The problem of channel conflict can be masked in a variety of ways, from requiring joint venture participants to "contribute" competing equity business interests to the exchange for the benefit of all exchange joint ventures, to permitting the joint venture Board to change the mission of the joint venture and expand the scope of non-competition and bind all participants, even to the detriment of a minority joint venture participant.

Channel conflict becomes ever more problematic considering the rapid pace in which e-commerce business opportunities are being created. Witnessing the rapid evolution of exchange business theory since just even last year, it is virtually impossible to predict with any real degree of accuracy what the e-commerce B2B landscape will look like in 2 to 3 years.

The other inherent danger in not fully addressing the channel conflict/exclusivity problem is that joint venture participants still need to be competitive vis-à-vis their industry counterparts. If the exchange operates to neutralize a joint venture partner's ability to differentiate itself in the marketplace, then the partner's ability to compete and hence its overall value can be negatively impacted. What is styled the new business form of the 21st Century may in fact create a neutralizing, agnostic effect as a joint venture participant attempts to implement new e-commerce strategies.

If joint venture participants to an exchange are considering any form of exclusivity, the following is recommended:

- ✓ Determine the source of the exclusivity requirement –
  - Have the principals of the joint venture partners considered all the ramifications to their businesses in agreeing to exclusivity?
- ✓ Determine whether existing or proposed e-commerce strategies conflict or may conflict with the proposed scope and/or term of exclusivity
- ✓ Adjust accordingly

## III. Technology Provider and Customer Relationships Within a Trade Exchange

There are a myriad of technology provider and customer relationships that form the critical building blocks of a properly structured exchange. Set forth below are some of the key relationships that must be considered and negotiated. Because of the sophisticated nature of these arrangements, practitioners should have a solid practice or foundation in each of these types of technology transactions or acquire the expertise.

| Item | Legal Documentation | Key Focus Areas |
|---|---|---|
| Trade Exchange Software | License, including implementation and development | Scope of license, development, scalability, ownership |
| Technology Platform | Hosting service arrangement if technology will be physically maintained and/or operated by a third party | Backup systems, fault tolerant architecture, disaster recovery, performance standards |

| Item | Legal Documentation | Key Focus Areas |
|---|---|---|
| Portal Operations | Operations agreement to operate and maintain the trade exchange | Service level standards |
| Support and Maintenance | Supporting, enhancing and maintaining the trade exchange software | Software defects, maturity, future enhancements and service level standards |
| Trading Partners | Trading Partner Agreement | Trade exchange liability, individual access rules, transaction rules, privacy and export control |
| | Interconnecting to the Trade Exchange | Software license, web hosting arrangements |

## IV. Select Legal Issues to Consider in Forming and Implementing a Trade Exchange

In traditional business transactions, parties operate within a well-defined and intricate set of business rules – contract, financial, insurance, *etc*. If a problem arises, these established business rules provide a backdrop context in which to resolve the matter and address risk of loss and liability. In the e-commerce world, however, the framework for resolving contractual disputes and liability has not been fully developed. Therefore, whether a company is sponsoring a trade exchange or is participating in a trade exchange, it is important to clearly define up front and as much as possible the legal relationships between the trade exchange and its buyer and seller participants (the balance of this Article will refer to such participants as "***Trading Partners***"). The basic mechanism to achieve such definition is through a contract between the exchange and the Trading Partner. While there can be different names given to this contract relationship, this Article will refer to this arrangement as a "***Trading Partner Agreement***" or "***TPA***".

### A. Trade Exchange Liability – The Utility Model

Liability relating to exchange operations is a problematic and thorny issue. Liability could stem from problems with specific transactions, *i.e.*, transactions are not properly time-stamped; inaccurate pricing, *etc*., or could derive from Trading Partners themselves as in copyright infringement matters.

Some exchanges are contracting with their Trading Partners under a "utility" or tariff model. Patterned after liability positions taken in the communications industry, the utility model would not hold the exchange liable for problems or issues relating to connectivity, transmission errors and the like. Some could argue that the utility model should not apply to the exchange environment because exchanges will be processing information (as opposed to merely transmitting information); however, given the pricing for transactions and expected margins, an exchange that opts to assume any degree of transactional value liability probably will not survive the initial round of suits brought against it. If the exchange is viewed as a utility, the TPA should disclaim any warranty or guarantee as to the exchange operations or availability, including liability exposure for disruptions in services. Similar to the communications industry, liability should be limited to the cost of the actual service provided and should not extend to any losses related to business opportunities.

## B. <u>Other TPA Considerations</u>

In addition to the foregoing, the following subject matters should be considered in developing a TPA:

> ***Enforceability***. The B2B exchange environment requires strict adherence to the rules developing on acceptance of on-line terms and conditions. Careful consideration must be given to which state law should apply (UETA *vs*. non-UETA states), the recently enacted E-Sign legislation, and court decisions on the enforceability of "click through" agreements. Attention also needs to be given to the technology supporting these functions and processes involved in updating on-line terms.
>
> ***Participant Requirements***. Exchanges may have specific criteria relating to which companies and/or individuals on behalf of the company ("***Authorized Users***") can participate in the exchange. The registration process and the TPA should outline and disclose any criteria in determining who can participate in the exchange.
>
> ***Transaction Rules***. Because transactions are the center of exchange operations, the TPA should include a detailed set of transaction rules. The transaction rules should address both the Trading Partner's and its Authorized User's participation on the exchange. The transaction rules should accurately and carefully reflect the business services provided by the exchange and should also be consistent with how the exchange technology actually works. Thus, it is advisable to conduct a detailed review of the specific business services and the functionality of the exchange technology (software) before drafting the transaction rules. Given the rapid evolution that will take place in exchange service offerings, a process should be in place to periodically review service enhancements and update the transaction rules from time-to-time.
>
> ***Fee Structures***. Catalog loading and maintenance, auction fees and other transaction related fees of the exchange should be clearly identified in the TPA. The TPA should contain flexibility to add new service categories and fees, as well as adjustments to existing fees. Since transaction fees most likely will be a significant component of an exchange's revenue model, the TPA and/or transaction rules should prohibit Trading Partners from circumventing the exchange's interest in its transaction fees (such as selling the goods off-line after finding a buyer on the trade exchange to avoid paying the exchange's transaction fees).

***Disputes Between Trading Partners***. Disputes between Trading Partners will inevitably arise either through a dispute in the basic terms reached by the Trading Partners (payment, damaged goods, *etc*.). A number of exchanges have taken the position that these types of disputes should be settled directly by the disputing Trading Partners and not the exchange.

***Confidentiality of Trading Partner Information***. Supplier Trading Partners will provide the exchange with content to post ("***Trading Partner Content***"), and transactions will generate detailed Trading Partner-specific transaction information ("***Trading Partner Transaction Information***"). The TPA should address the confidentiality of Trading Partner Content and Trading Partner Transaction Information, and should outline precisely what information the exchange will make generally available on the exchange, will use for other purposes (such as creating aggregate data) or will otherwise distribute to third parties. These provisions should be incorporated into the privacy policy as well as the confidentiality provisions of the TPA.

***Content Posted on the Exchange***. Exchanges cannot possibly supervise all Trading Partner Content or other content (such as hyperlinks) posted on the exchange. Thus, exchanges are vulnerable to potential infringement or defamation claims. To guard against liability related to the Trading Partner Content, the TPA should require Trading Partners to indemnify the exchange against claims relating to the applicable Trading Partner Content.

***Enhanced Content***. In order to place supplier product on the exchange, Trading Partner Content must be adapted to fit the format requirements of the exchange ("***Enhanced Content***"). In such instances, the exchange may provide such services at its own expense and/or may want ownership or license rights in such Enhanced Content. The TPA should address the exchange's interest and ownership in the Enhanced Content.

***Security***. The TPA should address the security and confidentiality aspects of its relationship with the Trading Partners. For instance, if the Trading Partner is responsible for issuing and administering passwords and/or user ids to its Authorized Users, the TPA should address the Trading Partners' obligations with regard to maintaining records of the passwords and/or user ids, terminating passwords and/or user ids and/or the improper use of the passwords and/or user ids.

## C. Terms of Access

Rules governing use and access by the individual Authorized Users of a Trading Partner of the exchange should be considered. Topics can include:

- ✓ Warnings as to unauthorized content
- ✓ Copyright infringement and obligations for reporting infringement claims

- ✓ Restrictions on creating links to other websites
- ✓ Tampering or interfering with the operations of the exchange
- ✓ Obscene, defamatory, harassing or otherwise unlawful activities

## V. Evolution of Trade Exchanges

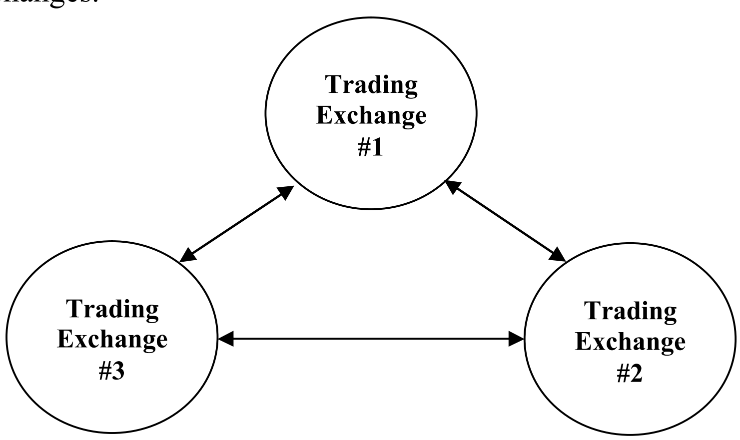
Exchanges are evolving into more sophisticated marketplace forums, and at Internet speed. Some of the larger exchanges are being implemented in stages, and at each stage there are new or additional legal aspects to be considered with respect to the operation of the exchanges.

### A. Tier 1 and Tier 2 Exchange Activities

At the present, most large, industry-sponsored exchanges are working diligently to implement their technology systems and facilitate content loading of their core or top tier suppliers. Once completed, these exchanges will be able to facilitate buy/sell transactions between their industry sponsor owners and their top tier suppliers ("***Tier 1 Transactions***"). In the next stage of the exchange development, the suppliers on the exchange now begin buying and selling amongst themselves ("***Tier 2 Transactions***").

### B. Exchange to Exchange Linkages

In the next evolution, exchanges will link to other exchanges, creating in essence a worldwide web of exchanges.




One technology company[4] has recognized the need to create a framework for these relationships. Given the nascent stage of development of basic exchange infrastructure, it may be some time

[4] Commerce One, Inc., a leading provider of exchange technology, spearheaded the formation of Global Trade Web Association, a separate organization set up to provide exchange-to-exchange interoperability.

before any meaningful exchange-to-exchange relationships can be structured. However, the need to rapidly deploy global strategies at a reduced cost, and the nuances of regional and localization (language, custom, *etc*.) may accelerate the development of these relationships.

In structuring exchange-to-exchange relationships, a whole host of issues need to be considered such as addressing supplier relations, sole/exclusive portal branding *vs*. co-branding, avoiding channel conflict, physical limitations and network planning on supplier content, pricing files and interoperability of data, exclusive arrangements (*i.e.*, can a "hosting" exchange have a similar arrangement with the "hostee" exchanges competitors). A number of operational details will also need to be addressed such as call center functions, billing and invoicing, supplier content maintenance and the like.