WHEN DOT-COMS DIE:
THE E-COMMERCE CHALLENGE TO CANADA'S BANKRUPTCY LAW

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The Internet is responsible for a broad range of new forms of economic activity that challenges all businesses, from small local firms to multinational giants. Despite the recent instability of many Internet companies, analysts remain optimistic about the future growth and critical importance of e-commerce and the Internet economy.[1] In 1999, Statistics Canada estimated that 806,000 Canadian households used the Internet to place 3.3 million orders for goods and services.[2] By 2004, global Internet commerce is expected swell to CDN $3.9 trillion.[3] As these numbers increase, it becomes apparent that e-commerce is becoming an integral component of the national and world economy.

A new lexicon has developed for the different e-commerce business models. "Brick and mortar" companies are those that have only a presence in the physical world and are without a commercial Internet presence (virtually every major company now has a web site but a brick and mortar company typically uses its site for passive promotional purposes and not to engage in online commercial activity). "Bricks and clicks" companies are brick and mortar companies that combine a physical presence with one online. Examples include Indigo,[4] Wal-Mart,[5] and Future Shop.[6] "Pure-play companies" or "dot-coms" operate exclusively online. Examples include Amazon.com,[7] Egghead.com,[8] and Travelocity.ca.[9]

The dot-com category serves a variety of different markets. Business to consumer companies (B2C) deal with individual consumers in a retail or service setting. Business to business companies (B2B) provide goods or services to other businesses. Although B2B has less public prominence than B2C, most analysts agree that the B2B sector garners a much higher

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[1] R. E. Litan, Think Again: The Internet Economy, *Foreign Policy* (March – April 2001), online : Foreign Policy <http://www.foreignpolicy.com/issue_marapr_2001/thinkagain.html> (date accessed: 12 June 2001).
[2] Canada, Industry Canada, *Internet Shopping in Canada* (Ottawa: Statistics Canada, 2001), online: Statistics Canada <http://www.statcan.ca/english/research/56F0004MIE/56F0004MIE01003.pdf> (date accessed: 10 March 2001) [hereinafter *Internet Shopping in Canada*] at 3.
[3] See "Canadian Internet Commerce Statistics Summary Sheet", online: E-Commerce Task Force <http://e-com.ic.gc.ca/using/en/e-comstats.pdf> (date accessed: 10 March 2001).
[4] *See Indigo.ca* <http://www.indigo.ca>.
[5] *See Wal-Mart* <http://www.walmart.com>.
[6] *See FutureShop.ca* <http://www.futureshop.ca>.
[7] *See Amazon.com* <http://www.amazon.com>.
[8] *See Egghead.com* <http://www.egghead.com>.
[9] *See Travelocity.ca* <http://www.travelocity.ca>.

volume of business than B2C.[10] Consumer to consumer companies (C2C) facilitate transactions between individual consumers. Ebay,[11] an online auction site that serves the C2C market, generates revenue from transactional fees, ancillary services, and advertising. Also relevant are government to business (G2B) and government to consumer/citizen (G2C).

The e-commerce marketplace has witnessed dramatic shifts in recent years. During the late 1990s, venture capital flowed freely into Internet-based ventures, leading to thousands of novel and not-so-novel companies chasing dreams of cashing out with a quick IPO.[12] The Internet market staged a stunning reversal in late 2000 and early 2001, however, as a re-evaluation of Internet company valuations led to the collapse of thousands of companies with insufficient capital reserves.[13] As a result, headlines touting the latest dot-com IPO success were replaced with news of yet another dot-com failure.[14]

With the sudden failure of many dot-coms, the unthinkable has become reality – dot-com bankruptcies have become as common as dot-com success stories.[15] The new interest in dot-com bankruptcies create several interesting legal issues since dot-coms feature business characteristics that differentiate them from more traditional companies. The competitive and commercially crowded nature of the Internet means that dot-coms must get to market fast and quickly establish public awareness.[16] While a traditional manufacturing or retail operation may plan for gradual expansion, adding capacity as sales and revenue dictate, dot-coms are frequently premised on explosive growth with the rapid establishment of dominant market position critical to long-term survival. As the dot-com business model matures and venture capitalists become

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[10] Canadian E-Business Opportunities Roundtable, *Fast Forward: Accelerating Canada's Leadership in the Internet Economy* (Canadian E-Business Opportunities Roundtable, 2000) at p. 12 [hereinafter *Fast Forward*].
[11] *See eBay* <http://www.ebay.com>.
[12] K. Regan, Venture Capital Flowing, But Slowly, *E-commerce Times* (30 January 2001), online: E-commerce Times < http://www.ecommercetimes.com/perl/story/7097.html> (date accessed : 13 June 2001).
[13] A.E. Cha, Collapse of Dot-coms Stifles Tech Innovators, *Washington Post* (30 April 2001), online: Washington Post < http://www.washingtonpost.com/wp-dyn/articles/A20704-2001Apr29.html> (date accessed : 12 June 2001).
[14] J. Swartz and D. Kong, Dot-coms Sell at Fire Sale Prices, *USA Today* (5 September 2000), online: USA Today < http://www.usatoday.com/life/cyber/invest/ina072.htm> (date accessed : 13 June 2001) [hereinafter *Fire Sale*].
[15] E. Luening, Dot-coms Still Shutting At Quick Pace, *CNET News* (1 May 2001), online: CNET News < http://news.cnet.com/news/0-1005-200-5781211.html> (date accessed : 2 May 2001).
[16] C. Bicknell, "Startups, Make Noise or Die" *Wired News* (11 November 1999), online: Wired News <http://www.wired.com/news/print/0,1294,32352,00.html> (date accessed: 25 June 2000).

more selective, a trend towards a more traditional business approach is emerging, with more emphasis on profit and organic, internally financed growth.[17]

Dot-coms also typically face high start-up costs. The speed with which dot-coms go to market requires significant funds for development and marketing.[18] Financing often comes from external sources, since dot-coms lack sufficient (or any) revenues to fund growth from internal resources. Funding usually takes the form of equity, since there are few assets to pledge as security.

The significant capital invested in dot-com companies does not typically result in significant tangible assets.[19] Premises and equipment are leased, software licenced, and production and delivery of goods outsourced. Substantial funds may be spent on creating market awareness or in assembling a highly skilled employee base.[20] Since employees are, however, highly mobile they are not generally considered a tangible asset. In the event of bankruptcy, the assets of a dot-com are normally only "a hodgepodge of goodwill, intangible rights and intellectual property."[21]

The difficulty of effectively valuing these intangible assets may quickly emerge as a key issue when dealing with dot-com bankruptcies. Whereas tangible assets, such as property, buildings, inventory, and capital equipment have a free and competitive market to determine their value, these markets do not generally exist for intangible assets. Consequently, their valuation becomes a highly subjective exercise.

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[17] J. Useem, "Dot-Coms: What Have We Learned?" *Fortune* (17 October 2000), online: Fortune <http://www.fortune.com/2000/10/30/dot.htm> (date accessed: 20 October 2000) [hereinafter *Dot-com Lessons*].
[18] An extreme example of this is Epidemic Marketing, which spent $1.2 million of its start up capital on a single 30 second commercial during Superbowl 2000, R. Petrin & B. Woodall, "The Dot-Com Bankruptcy Epidemic" *The Bullseye* (14 June 2000), online: The Bullseye <http://www.thebullseye.com/articles/tech/epidemic06142000.html> (date accessed: 04 August 2000).
[19] "When a Dot Com Goes Bust" *Reuters* (7 June 2000), online: Wired News <http://www.wired.com/news/print/0,1294,36820,00.html> (date accessed: 8 June 2000) [hereinafter *When a Dot Com Goes Bust*].
[20] *Dot-com Lessons*, *supra*, note 17.
[21] *When a Dot Com Goes Bust, supra*, note 15.

This article examines the challenges posed by e-commerce to Canada's bankruptcy legislation, particularly the *Bankruptcy and Insolvency Act*.[22] Bankruptcy legislation that is responsive to the dynamics of e-commerce will benefit Canadians in two important ways. First, creditors of failed companies can be confident of fair treatment. Second, certainty in how the assets of Internet companies will be treated upon bankruptcy should assist venture capitalists and other financiers to reduce investor risk.

Two primary themes emerge from the examination of Internet economy bankruptcies -- uncertainty in applying the law and the speed of e-commerce. Dot-coms face uncertainty in a number of key areas including the legal status of core assets such as domain names and web sites, technology licences, jurisdiction, and the legal treatment of sensitive information. This uncertainty hampers the ability of dot-coms to obtain financing while it negatively impacts creditors and debtors in the event of bankruptcy.

E-commerce business cycles and dot-coms operate at "Internet speed." This rapid pace challenges the ability of current bankruptcy mechanisms and procedures to function in a meaningful way so that troubled companies can be reorganized and creditors can maximize their recovery.

This article is divided into three parts. Part one, which features three case studies of prominent Internet bankruptcies, provides a guide to the critical legal issues that have emerged within the context of dot-com failures. Part two identifies five key legal issues arising from Internet bankruptcies including the legal status of domain names, technology licences, Internet jurisdiction, privacy, and protection of stored data. Part three outlines conclusions and recommendations for further study and analysis.

Part I: Bankruptcy Case Studies

[22] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c.B-3 [hereinafter the *Act*].

In recent months, the harsh realities of the Internet economy have hit a wide range of dot-coms.[23] Predictions that increasing competition, falling stock prices and weak financial performance will combine to kill off most online retailers by the end of 2001 have become reality.[24] In fact, tracking the latest of round of dot-com layoffs has become a sport, with several web sites tallying the latest troubling news.[25]

Although the dot-com marketplace is the midst of a period of consolidation, during which many dot-com ventures will fail, this does not signal the end of e-commerce.[26] The automotive industry took 90 years to shrink from 240 car makers worldwide to 40, through a consolidation process involving business failures, reorganizations and mergers. Online businesses are experiencing a similar natural business cycle, albeit at an accelerated pace.[27]

i) Boo.com

To better understand the subtleties of e-commerce bankruptcies, it is helpful to examine some high profile failures. The Boo.com saga, which in many respects foreshadowed the current climate, best illustrates the accelerated business cycle of dot-coms. It took only six months for a company once touted as the darling of the venture capitalists to achieve even greater notoriety as one of the greatest e-commerce failures.

Boo.com, arguably one of the most anticipated e-commerce start-ups in the history of the Internet, was billed as an international fashion boutique featuring a variety of sports apparel,

[23] *Fire Sale*, *supra*, note 14.
[24] K. Regan, "Forrester: Most Dot-Coms Will Sink by 2001" *E-Commerce Times* (12 April 2000), online: E-Commerce Times <http://www.ecommercetimes.com/news/articles2000/000412-7.shtml> (date accessed: 25 May 2000).
[25] Industry Standard Layoff Tracker, Industry Standard < http://www.thestandard.com/trackers/layoff/> (date accessed : 13 June 2001).
[26] J. Glasner, "Dead Startups: Shrinking Violets" *Wired News* (11 May 2000), online: Wired News <http://www.wired.com/news/print/0,1294,36069,00.html> (date accessed: 25 May 2000) [hereinafter *Shrinking Violets*].
[27] "Net consolidation is a natural, accelerated business cycle" *CNET News.com* (23 June 2000) online:CNET News.com <http://news.cnet.com/news/0-1007-201-2084725-0.html> (date accessed 8 August 2000).

outdoor gear and footwear from internationally recognized names.[28] The London Times reported that Boo.com was rated as one of the U.K.'s top 25 e-commerce companies before it had sold a single piece of inventory.[29] A public relations blitz, reported to cost US$25 million, helped fuel the hype, generating US$125 million in capital before its site was operational.[30]

Marketing hype touted the site as "the first of any kind to conduct transactions in multiple currencies and languages" utilizing its cutting-edge technology.[31] Boo.com's online shopping experience was enhanced by three-dimensional product displays as well as traditional mannequins, providing the shopper with a sense of how the clothing might look when worn.

After months of technical delays, Boo.com finally launched in early November 1999. Its commercial operations did not provide sufficient revenue to sustain the company. Since it spent much of its initial capital prior to launch, Boo.com burned through its remaining cash reserves quickly. As the company began to collapse, Boo.com's management managed to close a new round of financing in early May 2000.[32] It proved to be too little, too late, however, as soon after Boo.com became Europe's first big dot-com failure.[33]

KPMG was asked to assume the role of liquidator. As with the vast majority of dot-com businesses, few assets remained. It was originally thought that the company's international fulfillment capability, which purportedly allowed the company to ship to 18 countries including Canada and the United States in less than a week,[34] would be a very attractive selling point. Upon closer examination, it was discovered that this capability was actually outsourced to

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[28] B.Warner and P. Sprenger, "Surprise! Boo.com Finally Launches" *The Standard* (3 November 1999), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1153,7389,00.html> (date accessed: 24 May 2000).
[29] *Shrinking Violets*, *supra*, note 26.
[30] P. Sprenger, "Boo Founder: Don't Cry for Me" *The Standard* (11 February 2000), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1153,9702,00.html> (date accessed: 24 May 2000).
[31] *Shrinking Violets*, *supra*, note 26.
[32] P. Sprenger, "More Creaks and Groans at Boo.com" *The Standard* (4 May 2000), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1153,14775,00.html> (date accessed: 24 May 2000).
[33] H. Cowdy, "Boo.com Collapses" *Reuters* (18 May 2000), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1151,15231,00.html > (date accessed: 24 May 2000).
[34] B. Warner, "Selling Bits of Boo.com" *The Standard* (19 May 2000), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1151,15281,00.html> (date accessed: 24 May 2000).

Deutsche Post and United Parcel Service and was not a corporate asset.[35] Without it, Boo.com had no assets to offer other than its brand, limited intellectual property and its web site.[36]

KPMG Corporate Recovery sold the company in pieces -- Boo.com's back-end systems sold to Bright Station, a London-based e-commerce technology company, for approximately US$380,000, a mere fraction of the original development cost.[37] U.S. portal Fashionmall.com purchased the web site, domain names and associated Boo.com trademarks for an undisclosed amount.[38]

Boo.com is the archetypal dot-com failure. It was a company born in a flurry of hype, raising a large influx of start-up capital based on a promising concept. The majority of Boo.com's funding was spent early in the company's life to establish brand recognition. Almost all of the functions of its business were outsourced. Boo.com did not make, stock or deliver the clothes that it sold. At the time of its failure, there were few assets to satisfy creditors, who were primarily private equity holders. Brand recognition, one of the company's key operating assets generated at an enormous cost, had fleeting value at bankruptcy. In bankruptcy, Boo.com presented few alternatives. Without a viable business or adequate revenues, there was nothing to reorganize and no buyers could be found for the company as an entire entity.[39]

ii) Craftshop.com

While liquidation appears to be the obvious route when dealing with companies that have few tangible assets in bankruptcy, some companies may follow the lead of Craftshop.com.

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[35] "Boo.com Sale Suffers Blow" *Reuters* (21 May 2000), online: Yahoo! Canada News <http://ca.dailynews.yahoo.com/ca/headlines/bs/story.html?s=v/ca/20000521/bs/tech_boo_col_1.html> (date accessed: 24 May 2000).

[36] Ibid.

[37] B. Cummings and B. Warner, "Boo.com Is Picked Apart" *The Standard* (31 May 2000), online: The Standard.com <http://www.thestandard.com/article/article_print/1,1153,15575,00.html> (date accessed: 31 May 2000).

[38] Ibid.

[39] An interesting epilogue to Boo.com is that the experience of failure itself turned out to be a valuable asset for the owners, as they received a significant fee from a publisher to write about the failure, which is seen as a turning point in Internet business trends. J. Casey, "A Study in Failure" *Guardian* (10 October 2000), online: Guardian <http://www.guardianunlimited.co.uk/Archive/Article/0,4273,4074314,00.htm> (date accessed: 13 October 2000).

Craftshop.com, an online retailer of sewing, art, and hobby supplies, filed for Chapter 11 bankruptcy protection in Delaware in May 2000.[40] In the United States, Chapter 11 protection is the most common sanctuary sought by debt-laden brick and mortar companies. Generally, a company that files for such protection, plans to remain operational by asking the courts to hold its creditors at bay while the company reorganizes its affairs and debt obligations.

Unlike Boo.com, Craftshop.com had an operating commercial web site that was popular with customers and was generating revenue, though expenses still exceeded earnings.[41] In a bouyant market, investors were willing to pour cash into money losing ventures, confident of future growth and earnings. As the market stagnated in early 2000, investors began to reassess their portfolios and cut funding to many money losing ventures like Craftshop.com.[42]

With Craftshop.com's assets limited to cash, a domain name, 60,000 scanned images, inventory and its client database,[43] observers questioned whether there was actually anything to reorganize. Since few dot-coms have turned a profit,[44] a company with "no hard assets and no positive cash flow will have a difficult, if not impossible time convincing the U.S. trustee's office to allow it to file for Chapter 11."[45] Moreover, with other opportunities to explore, most dot-com entrepreneurs do not want to be saddled with the hassle of restructuring and will likely walk away from the debt-plagued enterprise to start fresh with a new idea. Courts may also be wary of granting Chapter 11 protection since the competitive e-commerce market dictates that many dot-coms will fail. This makes Chapter 7 filings, which provide organizational structure for liquidating assets, a more effective course of action.[46]

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[40] "CMGI Affiliate Craftshop.com Files for Bankruptcy" *Reuters* (22 May 2000) online: The Standard.com <http://www.thestandard.com/article/article_print/1,1153,15339,00.html> (date accessed: 24 May 2000).

[41] J. Jaffe, "Craftshop.com is first of many" *The Daily Deal* (11 May 2000), online: The Daily Deal.com <http://www.thedailydeal.com/features/inthenews/A22321-2000May10.html> (date accessed: 22 June 2000) [hereinafter *Craftshop.com is first of many*].

[42] L. Lorek, "Grim Reapers Prey on Dot-Com Failures" Inter@ctive *Week* (10 July 2000) online: ZDNet <http://www.zdnet.com/intweek/stories/news/0,4164,2601544,00.html> (date accessed: 7 August 2000).

[43] *Craftshop.com is first of many*, *supra*, note 41.

[44] *When a Dot Com Goes Bust*, *supra*, note 19.

[45] F. Alvardo, "Faltering New Firms Will Find Bankruptcy Lawyers Reluctant" *Miami Daily Business Review* (13 March 2000), online: Law News Network.com <http://www.lawnewsnetwork.com/stories/A18374-2000Mar10.html> (date accessed: 25 May 2000).

[46] A. Orr, "Dot-coms Find Second Chances Hard to Come By", *San Jose Mercury News* (23 August 2000), online San Jose Mercury News <http://www.mercurycenter.com/svtech/news/breaking/merc/docs/064281.htm> (date accessed: 23 August 2000).

Months after filing for Chapter 11, Craftshop.com remained in limbo, as it was unclear whether it would be reorganized or liquidated. The web site was still active, featuring craft related articles and links, however any attempt to purchase products at the web site was met with a message that the online shop was "under construction."[47] More recently, the content has been removed with the craftshop.com domain pointing to a holding page.[48]

iii) Toysmart.com

Toysmart began as a small suburban Boston brick and mortar toy retailer. With the arrival of new management and venture capital funding, the company ventured online in 1997. Toysmart achieved some success in its first two years, but required additional funding to continue to develop and to compete in the highly competitive toy market.[49] In 1999, Disney invested approximately US$45 million in cash and promotional services for a controlling interest in the company.[50] Sales for the 1999 Christmas season did not meet expectations, however, despite the site's rating as the Internet's third most popular toy site in December 1999.[51]

In the spring of 2000, Disney re-assessed its Internet strategy, deciding to concentrate on entertainment and leisure rather than online retailing. In May 2000, Toysmart ceased operations and pressure from creditors forced it to file for Chapter 11 bankruptcy protection.[52] As a popular Internet company with a good record of fulfilling customer orders, Toysmart seemed like a possible candidate for reorganization. When neither new funding nor a purchaser for the company as a going concern could be found, Toysmart's assets were put up for auction.

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[47] H. Metz & E. Forman, "Dot-coms are here to stay" *The Eagle Tribune* (3 July 2000) online: eagletribune.com <http://www.eagletribune.com/news/stories/20000703/FP_001.htm> (date accessed 18 August 2000).
[48] <http://www.craftshop.com>, (date accessed : 13 June 2001).
[49] L. Lorek, *"When Toysmart Fell Apart"* Inter@ctive *Week* (7 August 2000) online: ZDNet < http://www.zdnet.com/intweek/stories/news/0,4164,2611907,00.html> (date accessed: 7 August 2000) [hereinafter *"When Toysmart Fell Apart"*].
[50] J. Couzin, "Broken Toys" *The Standard* (23 May 2000) online: TheStandard.com <http://www.thestandard.com/article/article_print/1,1153,15363,00.html> (date accesed: 24 May 2000).
[51] K. Regan & N. Macaluso, "Disney Pulls Plug on Toysmart.com" *E-Commerce Times* (23 May 2000) online: EcommerceTimes.com <http://www.ecommerce times.com/news/articles2000/000523-4.shtml> (date accessed: 25 June 2000).
[52] G. Sandoval & J. Pelline "*Toysmart shutting down"* Cnet News.com (22 May 2000) online: Cnet News.com <http://news.cnet.com/news/0-1007-200-1920890.html> (date accessed: 24 May 2000).

In bankruptcy, Toysmart resembled a traditional brick and mortar operation. Over 200 employees were laid off without severance and unpaid invoices from suppliers totaled over US$21 million. The company's assets included web site development and software created specifically for the Toysmart web site (virtually worthless in bankruptcy), US$5 million in physical assets and inventory, limited intellectual property, and a customer database consisting of 250,000 names.[53]

The sale of the more traditional tangible assets of Toysmart presented no new challenges. Minimal recovery from the sale of IP was predictable. Although many failed dot-coms, including Craftshop.com, had previously sold customers databases, the sale of Toysmart's database attracted considerable attention for several reasons. First, the public had begun to voice growing concern over consumer privacy. Second, Toysmart's data was particularly sensitive since much of it had been gathered from children. Third, Toysmart had posted a privacy policy on its web site indicating that it would "never" share customer information with third parties. In fact, Toysmart had been a licencee of TRUSTe, an organization that certifies privacy policies and allows sites to display TRUSTe seal, since September 1999.[54]

Both the U.S. Federal Trade Commission (FTC) and TRUSTe opposed the attempted sale of Toysmart's customer database. In July 2000, the FTC sued the company for breach of the *Federal Trade Commission Act*[55] and, later, for breach of the *Childrens' Online Privacy Protection Act* (COPPA).[56] Later that month, the FTC announced that it had reached an agreement with Toysmart, setting conditions for the sale the customer database.[57] The settlement restricted the sale of the database to a "Qualified Buyer" who would agree to abide by Toysmart's privacy policy. If the purchaser intended to alter the use or ownership of the database, it would be required to give prior notice and to obtain customer consent. Toysmart

[53] *When Toysmart Fell* Apart, *supra*, note 49.
[54] FTC Complaint <http://www.ftc.gov/os/2000/07/toysmartcmp.htm> (date accessed: 11 June 2000).
[55] 15 U.S.C. § 42, et. seq.
[56] 15 U.S.C. § 6501, et seq.
[57] Federal Trade Commission, Press Release "FTC Announces Settlement with Bankrupt Web Site, Toysmart.com, Regarding Alleged Privacy Policy Violations" (21 July 2000) online: ftc.gov <http://www.ftc.gov/os/2000/07/toysmartcmp.htm> (date accessed: 11 June 2000).

also agreed to review the customer database and remove any information that was gathered in contravention of COPPA. If the database was not sold within twelve months, Toysmart agreed to destroy it.[58]

Thirty-nine states opposed the FTC settlement, filing objections to the settlement in Bankruptcy Court. The states claimed that the settlement did not live up to Toysmart's original privacy pledge.[59] Toysmart temporarily withdrew the customer database from the asset sale due to the objections.[60] A federal bankruptcy court judge refused to rule on the validity of the FTC settlement, stating that the question was merely hypothetical since there was no prospective buyer in place.[61]

The attempted sale of the Toysmart customer database also sparked legislative action. During the same week that the FTC filed suit against Toysmart, legislation was introduced in both the House and the Senate designed to restrict or ban the sale or transfer of personal information collected under a pledge of privacy.[62]

Consumer privacy on the Internet is a hot legal issue.[63] The Toysmart matter, which was finally resolved in January 2001 when Disney purchased the controversial customer database and proceeded to destroy it, brought the Internet privacy debate into the realm of bankruptcy.[64]

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[58]Federal Trade Commission v. Toysmart.com, LLC (2000) (Draft Stipulation and Order Establishing Conditions on Sale of Customer Database) online: FTC <http://www.ftc.gov/os/2000/07/toysmarttbankruptcy.1.htm> (date accessed: 9 August 2000).

[59]M. Austria Farmer, *"Toysmart suspends auction of customer list"* CNet News.com (27 July 2000) online: CNet News.com <http://news.cnet.com/news//0-1007-200-2359462.html > (date accessed: 9 August 2000).

[60] Ibid.

[61] "Judge: No one wants to play with Toysmart's list" *Associated Press* (17 August 2000), online: Cnet News <http://news.cnet.com/news//0-1007-200-2549755.html?tag=st.cn.sr.ne.1> (date accessed: 21 August 2000).

[62]*Privacy Policy Enforcement Act of 2000 (Introduced in the Senate)* S 2857 IS and *To make illegal the sale, share, or transfer of information aquired on the Internet with a pledge that it would not be released (Introduced in the House)* HR 4814 IH.

[63] Several other insolvent U.S. dot-coms which have attempted to sell off customer information have ended up in litigation. Living.com, for example, was sued by the Texas Attorney General over a plan to sell its customer list. The matter was ultimately settled with Living.com agreeing to destroy all customer information except names and email addresses and only selling that information once customers had an opportunity to opt out. See G. Sandoval "Texas officials, Living.com reach settlement on privacy", Cnet News.com (25 September 2000) online: <http://news.cnet.com/news/0-1007-200-2864965.html> (dated accessed: 13 October 2000), S. Bonisteel "Texas Protects Privacy Of Bankrupt Living.com's Customers" *Newsbytes* (28 September 2000) online: Newsbytes <http://www.newsbytes.com/pubNews/00/155868.htm> (date accessed: 13 October 2000).

[64] G. Sandoval, Judge Oks Destruction of Toysmart List, *CNET News* (31 January 2001) online: CNET News <

Customer databases and profiles are often a dot-com's most valuable assets. The sale of customer databases puts the creditors interest in realizing the maximum possible return on assets into direct conflict with consumer privacy rights. Despite closure in the Toysmart matter, many questions remain unanswered. What if Toysmart had not established a privacy policy? What if the database was acquired through the purchase of the entire company by a third party? In the Canadian context, what legislation, if any, would govern the sale of customer databases on bankruptcy? Given the emergence of several cases similar to the Toysmart affair, the issue continues to hover over dot-com bankruptcies.[65]

The e-commerce bankruptcy case studies illustrate many of the challenges that bankruptcy legislation faces in light of the growing importance of e-commerce. Boo.com exemplifies the fast pace of e-commerce business cycles, the limited asset base left at bankruptcy and the speed with which dot-com assets lose their value. Craftshop.com demonstrates the difficulties that even relatively successful dot-com businesses face when trying to reorganize through a proposal in bankruptcy. Toysmart highlights some of the pitfalls and competing interests that may arise when liquidators of dot-com failures attempt to sell assets and maximize creditor recovery.

Part III: Key Legal Issues in Internet Bankruptcies

i) Domain Names and Web Sites

a) Domain Name Legal Status

The Domain Name System (DNS) is a hierarchical, domain-based naming scheme that is superimposed over the entire Internet.[66] Its primary purpose is the mapping of IP addresses to alphanumeric domain names. For example, when a user types in a domain name such as

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http://news.cnet.com/news/0-1007-200-4673304.html>, (date accessed : 12 June 2001).

[65] G. Sandoval, Etour Accused of Selling Customer Info, *CNET News* (25 May 2001) online: CNET News < http://news.cnet.com/news/0-1005-200-6047468.html> (date accessed : 13 June 2001) [hereinafter *eTour*].

[66] For more on thehistorical development of the Internet and the establishment of the DNS system, see, Katie Hafner & Matthew Lyon, Where Wizards Stay Up Late: The Origins Of The Internet (1996).

www.lawbytes.com, that domain name is translated into the Internet protocol number equivalent 208.231.177.24. Since it is very difficult to remember lengthy IP addresses, the domain name approach makes it easier to access content on the web.

Both the governance and law relating to domain names is continually evolving. During the Internet's early stages, domain names were administered on a volunteer basis and available on a first come, first serve basis with few restrictions. As the administration of domain names became more onerous with the growth on the Internet, the administration of country-code domains, such as dot-ca (Canada) or dot-uk (United Kingdom), was delegated by Jon Postel, one of the Internet's founders, to various private, corporate, academic or governmental entities in different countries on an ad hoc basis. Many country-code domain name administrators have since developed different rules pertaining to the registration and ownership of country-code domains.

Domain names are often the most obvious asset of an Internet company.[67] The rights of a domain name registrant are defined to a significant extent by its contract with the domain name registrar. Although domain names are regularly bought, sold, and transferred, their precise legal status has not yet been fully defined. The majority of domain name case law is U.S. in origin and deals with the use of a domain name infringing on a trademark. Decisions that examine the legal status of domain names tend to define what a domain name is not, rather than clarifying what it is.

For example, in *Kremen* v. *Cohen*[68] the plaintiff sued for the return of a domain name (sex.com) that he claimed was fraudulently transferred to the defendant. Network Solutions Inc. (NSI), the body responsible for the assignment and transfer of .com domain names at the time, was named as a defendant. NSI brought a motion for summary judgment, requesting that the claims against it be dismissed. The court granted the motion, dismissing the claims based on

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[67] Although domain names may be purchased for as little as $15.00, a market for the resale of domain names has emerged with highly sought after names selling for millions of dollars. See, C. Barnes, 'Catchy domain names lose their luster' *Cnet News.com* (16 October 2000) online: Cnet News.com < http://news.cnet.com/news/0-1005-200-3185398.html > (date accessed: 9 November 2000) [hereinafter *Catchy Domains*].

[68] *Kremen.* v. *Cohen,* 99 F. Supp. 2d 1168 (N.D. Cal. 2000).

breach of contract and breach of fiduciary duty on the grounds that there had been no consideration (the name was registered at a time when NSI did not charge a registration fee) and no fiduciary relationship. The court dismissed the claims based on conversion after finding that a domain name was not tangible property or part of the limited class of intangible property subject to the tort of conversion in California.[69]

In *Dorer* v. *Arel*,[70] the plaintiff sought to have a domain name included in a sheriff's sale, leaving the court to examine whether a domain name may be treated as a property right. The court denied the request, concluding that the registrar's dispute resolution process was the appropriate venue to address domain name transfer issues. In *obiter*, the court argued that the domain name is not a personal property right subject to judicial lien, but rather represents a bundle of intangible contract or intellectual property rights.[71]

Network Solutions, Inc. v. *Umbro International, Inc.*[72] is another case in which the court was asked to determine if a domain name could be seized and sold in satisfaction of a judgment. The garnishment motion was first heard by the Virginia Circuit Court, which concluded that the name could not be garnisheed since the debtor had no possessory interest in the name.[73] On appeal to Supreme Court of Virginia, the court ruled that a domain name is not a liability capable of garnishment under Virginia law, as it was an intangible asset, with the rights to the assets defined by the contract between the holder and the registrar.[74] The appellate court in *Umbro* discussed the potential legal status of a domain name. It noted that in bankruptcy matters, some courts have characterized phone service and the phone number as part of a single contractual right that does not form property in bankruptcy.[75] Other courts have characterized phone numbers as constituting intellectual property separate from the contract to provide telephone

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[69] As of June 2001, the Sex.com dispute remains unresolved. In April 2001, a California judge ruled that the domain was wrongfully transferred, awarding $65 million in damages. Sex.com Defendant Must Pay $65 Million, *Bloomberg News, CNET News* (3 April 2001), online: CNET News < http://news.cnet.com/news/0-1005-200-5469196.html> (date accessed : 13 June 2001).
[70] *Dorer* v. *Arel*, 60 F. Supp. 2d 558 (E.D. Va. 1999).
[71] Ibid. at 560-1.
[72] *Network Solutions Inc.* v. *Umbro International, Inc, et al*, 529 S.E. 2d 80 (Va. 2000) [Umbro Appeal].
[73] *Network Solutions Inc.* v. *Umbro International, Inc.*, 50 U.S.P.Q. 2d 1786 (Va.Cir.Ct. 1999).
[74] Umbro Appeal, *supra*, note 72.
[75] *Slenderella Sys. of Berkeley, Inc. v. Pacific Tel. & Telegraph Co.,* 286 F.2d 488, 490 (2nd Cir.1961).

service and therefore property in bankruptcy.[76] To the extent that domain names can be analogized to phone numbers, their status in bankruptcy will suffer the same uncertainty.

There is little Canadian case law on the status of domain names. One exception is a dispute over the molson.com and molsonbeer.com domain names that provides some insight into the difficulty Canadian courts face in effectively characterizing the property qualities of domain names. *Molson Breweries* v. *Kuettner*,[77] a 1999 Federal Court case, involved an objection by Molson Breweries to the registration of the molson.com domain name by another party. Molson cited their trademark registration in the names and sought to have the domain name registrations placed "on hold" pursuant to the domain name dispute policy that was in effect at the time. Network Solutions, the domain name registrar, required that a court accept deposit of the names in order to place the domains on hold pending resolution of the outstanding legal proceedings.

The court refused to accept the deposit of a domain name (in the form of a registration certification), however, despite consent from both parties. The refusal was based in part on the inability of either party to effectively describe the property characteristics of a domain name and what responsibilities a court undertakes by accepting possession of the domain name.

In practice, there are few conflicts in dealing with domain names at bankruptcy. All parties concerned are usually interested in maximizing the value of the assets. Registrars have well defined procedures for the transfer of domain names and generally co-operate with uncontested transfer requests.[78] Accordingly, policy makers should closely monitor domain name jurisprudence to ascertain the legal treatment of domain names but need not adopt specific new policy measures on this issue at the present time.

b) Domain Name Transfers

[76] *Georgia Power Co. v. Security Inv. Properties, Inc.,* 559 F.2d 1321 (5th Cir.1977).
[77] *Molson Breweries* v. *Kuettner* (9 December 1999) F.C.J. No. 1941 (F.C.T.D.).
[78] W.E. Agin, *Bankruptcy and Secured Lending in Cyberspace*, (New York: Bowne & Co., 2000) at 3-10 [hereinafter *Cyberspace*] and W.E. Agin *"What is a domain name anyway? Impact of Network Solutions and Umbro Rulings"* e-Commerce (June 2000) 17 No. 2 ECOMMERCE 1, online: Lexis Nexis .

The transfer of domain names also raises issues relevant to the disposal of domain names as assets in a bankruptcy. Both trademark law and registration rules can limit who may hold certain domain names. A domain name that does not infringe a trademark when used by the bankrupt may become an infringing use if transferred to a third party. For example, if a dry cleaner that hypothetically owns and uses "ford.ca" declared bankruptcy and the domain name was sold to a car leasing company, the new use might infringe on the trademark of the Ford Motor Company.[79]

Differing rules on domain name transfers raises another complication. Generic Top Level Domain names (gTLDs) are administered by the Internet Corporation for Assigned Names and Numbers (ICANN), a California non-profit corporation.[80] Registration of most gTLDs have few restrictions, operating on a first come, first serve basis, and the transfer of gTLDs rarely raise significant concerns.

The administration of country code Top Level Domain names (ccTLDs), however, is handled by a registry authority within each country. In Canada, the .ca ccTLD is administered by the Canadian Internet Registration Authority (CIRA).[81] CIRA is an independent body in which the Canadian government plays a limited role with observer status on the CIRA board.[82] Until November 2000, the criteria for obtaining a .ca domain limited registrations to Canadians and only permitted one registration per person or corporation in each official language. Dot-ca domain names were required to refer to the registrant's legal name, incorporated name or Canadian trade-mark. To obtain a federal .ca domain [rather than a provincial (on.ca) or municipal (toronto.on.ca) domain] the registrant had to provide documentary proof of federal incorporation, trade-mark registration, or physical presence in more than one province or territory. As of November 2000, the criteria for registration and ownership of .ca domain has

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[79] For more on the clash between domain names and trademark law in a Canadian context, *see Sprint Communications Company LP vs. Merlin International Communications Inc*., 2000 Fed. Ct. Trial LEXIS 1333 (FCTD 2000).
[80] A. Michael Froomkin, Wrong Turn in Cyberspace : Using ICANN to Route Around the APA and the Constitution, 50 Duke L.J. 17 (2000).
[81] For more information on CIRA and the history of .ca domain administration, *see* www.cira.ca.
[82] On March 11, 1999, the federal government recognized CIRA by means of a letter from the Assistant Deputy Minister of Spectrum, Information Technologies and Telecommunications, Mr. Michael Binder, in a letter to Mr. Rob Hall, then the Chairman of the Board of CIRA.

been relaxed, though certain restrictions, known as Canadian Presence Requirements, remain in effect. These limitations mean that on liquidation, a .ca domain name cannot be freely transferred to the highest bidder, since registrars will only accept transfers to individuals and entities that meet the Canadian ccTLD requirements.[83]

Limitations on domain name transfers and questions surrounding the property nature of domain names may make it more difficult for companies to use domain names as collateral for financing, thereby limiting the ability of new or struggling companies to raise funds.[84] If uncertainty over the legal status of a domain name in bankruptcy causes a delay in disposing of the name, the value of the domain name may plummet, limiting creditor recovery.

c) Web Sites

If the domain name is the address of a dot-com, the web site is its home and public face. As an asset, a web site may have value in its technology and public awareness. In the Boo.com case, the technology that enabled the company to deal with different languages and currencies and to display wares in a flexible three dimensional format gave the web site technology inherent value independent of its particular use by Boo.com.

Public awareness, or "branding" of a web site is a second source of value. Attractive site features, marketing campaigns or pure luck may create a web site with valuable recognition. The value of the web site stems from its recognition and popularity with the public or a particular segment of the public.[85]

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[83] For more on the Canadian Presence Requirements, *see* CIRA, *supra*, note 81. For more on concerns regarding transfers of Canadian domain names outside of Canada, *see*, *Itravel2000.com Inc. v. Fagan*, 2001 Ont. Sup. C.J. LEXIS 564 (Ont. Sup. Ct. 2001).

[84] Scour.com provides an example of how legal uncertainty can adversely impact a dot-com. This relatively successful file sharing service was forced to seek Chapter 11 protection in the U.S. due to the uncertainty surrounding copyright on the Internet. Scour.com faced potential legal liability of U.S $250 billion for alleged copyright infringement. See, B. Berkowitz, D. Levin 'Corporate Gluttony Not Among Scour's Deadly Sins, but Creditors Still Total 200' *Inside* (17 October 2000), online: Inside.com <http://www.inside.com…Cached/0,2770,11757_13_32_1,00.htm> (date accessed: 25 October 2000).

[85] *Cyberspace supra* note 78 at p.14-6.

Web sites are actually a bundle of familiar intellectual property rights, such as copyright (on text, sound and graphics) and patents on specialized processes (such as Amazon's patent on one click ordering)[86] and, as such, are a more certain asset than domain names. The more traditional nature of web sites means that certain institutions will actually finance web site development in return for a security interest, usually a Purchase Money Security Interest (PMSI) in the site using the underlying technology and intellectual property as security.[87]

At bankruptcy, the key issue is the speed with which web sites are managed to avoid a depreciation of the asset. The trustee must decide to sell or operate the site and act on the decision immediately.[88] Since user loyalty has a short life span, a site that is inaccessible for even a few days may lose most of its public awareness, leaving the trustee with a worthless web site.[89]

A complicating feature of web sites is that they are intangible, consisting of data stored on computer hardware. If the hardware is leased or used as security, it is possible that the information necessary to operate the web site will be inadvertently removed or destroyed on repossession. This concern diminishes if the web site is hosted by a third party.

An assignment in bankruptcy typically results in a cessation of operations and sale of the assets to provide recovery to creditors, where assets are sold while the operations continue as a going concern. A web site is unusual in that ceasing to operate the site almost guarantees that the asset will have no value. Thus, the trustee is forced into a position similar to that of a proposal in bankruptcy, where the bankrupt business continues operation.

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[86] S. Juunarkar, Amazon Sues BarnesandNoble.com Over Patent, *CNET News* (22 October 1999), online: CNET News < http://news.cnet.com/news/0-1003-200-922281.html> (date accessed : 13 June 2001).
[87]W.E. Agin, "The Intangible Side Of Equipment Leasing: Third-Party Claims Against Stored Data" (2000) 19 No. 3 LDREQLN 1.
[88] The Internet may also provide some of the solutions to the speed with which dot-com assets depreciate. Several sites now specialize in the online liquidation of failed dot-com companies, G. Sandoval, "Overstock gears up with sporting goods site" Cnet News.com (12 October 2000) online: Cnet News.com < http://news.cnet.com/news/0-1007-200-3176226.html> (date accessed: 13 October 2000).
[89]*Cyberspace supra* note 78 at p. 14-6.

If the trustee decides to sell the web site, the requirement for speed creates additional challenges. The trustee will have very little time to determine what elements, if any, of the web site the bankrupt business actually owns. The web site may be entirely outsourced, licenced from a copyright holder, or already encumbered as security. Assuming the bankrupt company actually owns the web site, the trustee may be torn between the requirement to sell quickly and the obligation to dispose of the asset in a commercially reasonable manner.[90] Either option is problematic since the current absence of a competitive market in web sites limits the ability to obtain a credible valuation.

Current legislation does provide the trustee with the power to act quickly, however. Section 18 of the Act grants the trustee in bankruptcy the right to sell any property that is likely to depreciate rapidly in value prior to the first meeting of creditors without the approval of either the creditors or the inspectors.[91] Similarly, section 63(7)(b) of the Ontario PPSA provides that a secured creditor may sell property of the debtor without notice if the secured party believes on reasonable grounds that the collateral will decline speedily in value.[92] The combined effect of these provisions may enable trustees to respond to the challenge presented by rapid changes in the Internet marketplace. They do not, however, provide an effective answer for the complications created by uncertain ownership rights and valuations.

<u>ii) Technology licencing</u>

The most common business model for the distribution of software technology is for the owner of the technology to copyright the software and then licence its use to others. Copyright is a statutory creation that gives the copyright holder the right to prevent others from using or copying the software.[93] A licence is a promise by the copyright holder/licensor not to enforce its copyright against the licensee. Upon bankruptcy of the licensor, the trustee will attempt maximize the value of the bankrupt estate by selling off assets, including the copyright software.

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[90] *Cyberspace supra* note 78 at p. 14-3.
[91] *Bankruptcy and Insolvency Act*, supra, s. 18.
[92] *Ontario Personal Property Security Act*, s. 63(7)(b). I am grateful to David Baird for bringing this provision to my attention.
[93] E.R.Gold, "Partial Copyright Assignments: Safeguarding Software Licensees against the Bankruptcy of Licensors" (2000), 33 C.B.L.J. 193 at 203 [hereinafter: *"Partial Copyright Assignment*"].

Although the trustee takes the copyright subject to the licence, a third party purchaser takes title to the copyright free of most of restrictions created by the licence, even if the third party has notice of the pre-existing licence.[94]

Because the licence is classified as a contractual right (rather than a property right), the licensee's remedies are limited to claims for damages or specific performance against the bankrupt estate.[95] Neither option is very helpful. An award for damages simply puts the licensee in line with other unsecured debtors. An order for specific performance will only be valid against the trustee and does not bind the third party purchaser.

The growing popularity of enterprise software and of dot-coms whose operations depend entirely on licenced software heightens the impact of the uncertainty of technology licences on bankruptcy. It is now common for large corporations, whether brick and mortar or dot-coms, to deploy software that carry out key functions across the entire organization. Licenced software may handle all customer orders, payroll, warehousing or other key corporate functions. If the licensor goes bankrupt and the purchaser of the software copyright does not to honour the existing licence (perhaps because the purchaser and the licensee are competitors in some sphere) the licensee's operations could face paralysis.[96] For dot-coms the risk is even greater because they are normally entirely dependent on licenced software. A significant slow down or cessation of a dot-com's operations for any period of time could cause the dot-com to suffer a debilitating loss of customer traffic.

Historically the uncertain nature of technology licences has been most acute in the United States and the United Kingdom, where trustees in bankruptcy have the statutory right to disclaim most executory contracts.[97] Most licences are considered executory and could therefore be disclaimed, with the licensee being limited to a claim for damages against the bankrupt's estate.[98]

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[94]Ibid. at 203.
[95]Ibid. at 206-7.
[96]Ibid. at 197-9.
[97] Executory contracts are contracts where both sides have obligations left to perform under the contract.
[98]W.A. Adams and G.G.S. Takach "Insecure Transactions: Deficiencies in the Treatment of Technology Licences in Commercial Transactions Involving Secured Debt or Bankruptcy" (2000), 33 C.B.L.J. 321 at 351 [hereinafter: *"Insecure Transactions"*].

To limit uncertainty relating to technology licences, the United States amended its Bankruptcy Code to provide that notwithstanding a trustee disclaiming a licence as an executory contract, the licencee retains all rights under the licence contract, including the right to exclusivity (if any), provided that the licensee continues to fulfill its obligations under the contract (such as royalty payments).[99] This legislative reform remedied much of the uncertainty and risk created by the bankruptcy of a technology licensor.

Although Canadian trustees do not have a right to disclaim executory contracts, the practical reality of bankruptcy creates the same effect in Canada. The trustee may sell the copyright to a third party, who is not bound by the licence. A Canadian court will not make an order of specific performance against a trustee if it is no longer possible for the trustee to fulfill the licence terms. The only relief is against the bankrupt and his estate and this relief is largely illusory.

Various non-legislative solutions have been proposed to address the uncertainty created by licensor bankruptcy. These solutions range from excluding the licence from the bankrupt's estate, source code escrows, or characterizing the transaction as an assignment so that it is proprietary in nature and not contractual.[100] Each solution suffers from its own drawbacks. Uncertainty remains because the solutions depend on courts interpreting and agreeing with the characterization placed on the transactions. The solutions require transaction by transaction drafting, which is not a realistic alternative in many software transactions. Canadian licensees will also face considerable resistance from U.S. licensors when they request specialized contracts that give the licensee a partial assignment of the copyright, rather than a bare licence.[101] Practically, few Canadian licensees will wield sufficient leverage to obtain adequate protection.

The uncertainty created by the treatment of technology licences in Canada affects both licensees and licensors. Licencees run the risk of losing technology vital to the operation of their business, or renegotiating new licences with a new copyright holder who knows that the business is committed to the technology and would face significant costs to transfer to a new technology.

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[99]Ibid. at 353.
[100]Ibid. at 353 to 368 and *Partial Copyright Assignments supra* note 93 at 211-27.

Licensors face a loss of customer confidence as soon as there is any hint of financial trouble with the licensor. Customers, worried that they may lose the value of their technology licence on the licensor's bankruptcy, will either purchase elsewhere or demand more favourable terms. This constricts the licensor's revenue stream, exacerbating the financial difficulties.

Resolving the uncertainty that surrounds technology licences upon the licensor's bankruptcy requires legislative reform. Non-legislative solutions depend on the vagaries of contractual drafting and court interpretations therefore rendering them unsatisfactory. In approaching a legislative solution, it is necessary to balance the conflicting interests of the bankrupt, secured debtors, unsecured debtors and licensees. Legislative reform that secures the rights of licencees who obtain licences in the normal course of business is preferable, since it creates commercial certainty and brings the Canadian approach into line with that of the United States.

iii) Jurisdiction

The *Act* grants Canadian courts jurisdiction over persons (which includes corporations) who reside or carry on business in Canada.[102] The *Act* defines corporations to include any federally or provincially incorporated company or any incorporated company that is authorized to carry on business in Canada or that has an office or property in Canada.[103] The locality of a debtor is determined by the principal place where the debtor carried on business in the preceding year, or where the debtor resided in the preceding year, or where the greater portion of the debtor's property is located (if the first two branches of the test are not applicable).[104] The most problematic element of jurisdiction in bankruptcy matters will be determining when a corporation is carrying on business in Canada and subject to the *Act*.

Jurisdictional uncertainty is an issue that impacts virtually all Internet-related policy matters. The Internet provides individuals and companies with a global reach at a relatively low

[101] *Partial Copyright Assignment supra* note 93 at 224, and *Insecure Transactions supra* note 98 at 370.
[102] *Bankruptcy and Insolvency Act, supra* note 1, at s. 2(1) "debtor".
[103] *Ibid.* at s. 2(1) "corporation".
[104] *Ibid.* at s. 2(1) "locality of a debtor".

cost by eliminating the need for physical presence to conclude commercial transactions. Individuals and businesses that operate online can typically be accessed from anywhere in the world. If jurisdiction were based on the location of the person accessing the online business, online companies would potentially be subject to the laws of every nation. Such an arrangement would stifle e-commerce as the burden of complying with the laws of every jurisdiction would be immense. Dot-coms would prefer that jurisdiction be determined by the physical location of their head office or some other physical element. Clients and customers who deal with dot-coms, however, need to know the applicable jurisdiction of the online business with which they are dealing. Even with this information, they may be denied any effective legal redress if they must travel to the jurisdiction of the business.

The leading case in determining whether online activity is sufficient to establish jurisdiction is *Zippo Mfg. Co.* v. *Zippo Dot Com, Inc.*[105] Although *Zippo* is a U.S. case, its analysis of jurisdictional issues has been adopted by courts in other countries. The court in *Zippo* determined that not all online activity was the same, so the court developed a "passive versus active" test that recognizes that a spectrum of activities occurs online and that each must be individually examined. The legal response ought to differ with the nature of each activity.

At one end of the spectrum are "passive" web sites that are largely informational in nature. These sites feature minimal interactivity and function much like an electronic brochure. In the interest of fairness, and to help facilitate e-commerce, courts have agreed to take a hands-off approach to such sites. This decision recognizes that site owners cannot reasonably foresee facing legal action in a far-off jurisdiction based simply on the availability of information.

At the other end of the spectrum are those sites that conduct e-commerce. These sites, which feature significant interactivity by functioning as the online equivalent of a real space store, are characterized as "active" sites. Courts have repeatedly asserted their authority over such sites, arguing that site owners are aware of the risk of facing legal actions in multiple jurisdictions since they are doing business globally through the Internet.

Falling between these two are sites that provide more than simple information but less than full-blown e-commerce. These sites present courts with a tough balancing act. It is important to note that the passive versus active test does not remain static. A site characterized as active two years ago could today be considered passive, since the level of interactivity found on the world's leading e-commerce sites have increased dramatically.

For Canadian companies, the passive versus active test must be considered when venturing online. *Braintech Inc.* v. *Kostiuk,*[106] a 1999 British Columbia Court of Appeal case, was the first Canadian appellate level decision to address the Internet jurisdiction issue. Of concern in that case was a series of allegedly defamatory messages posted on a stock chat site by a B.C. resident. Braintech, a B.C.-based company with a small branch in Texas, sued the message poster in a Texas court, where large damage awards are common. The strategy paid off, as the company was awarded roughly US$400,000 in damages. When the company returned to B.C. to enforce the judgment, the courts examined the appropriateness of the Texas court's assertion of jurisdiction over the dispute.

The B.C. Court of Appeal adopted the passive versus active test and ruled that the Texas court had improperly asserted its jurisdiction. It argued that the postings were passive in nature and thus constituted insufficient grounds to grant the Texas court authority over the case.

Despite the widespread acceptance of the *Zippo* doctrine (and indeed the export of the test to other countries including Canada), cracks in the test began to appear late in 1999. In fact, closer examination of the case law indicates that by 2001, many courts were no longer strictly applying the *Zippo* standard but rather were using other criteria to determine when assertion of jurisdiction was appropriate, leading to further jurisdictional uncertainty.[107]

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[105] *Zippo Mfg. Co.* v. *Zippo Dot Com, Inc.* 952 F. Supp. 1119 (W.D.Pa. 1997).
[106] *Braintech Inc*. v. *Kostiuk* (1999), 171 D.L.R. (4th) 46 (B.C.C.A.).
[107] In addition to the cases discussed infra, see also *Search Force v. DataForce Intern*., 112 F.Supp.2d 771 (S.D. Ind., 2000); *Neato v. Great Gizmos*, 2000 WL 305949 (D. Conn., 2000); *Bochan v. La Fontaine*, 68 F.Supp.2d 701 (E.D. Va., 1999*); Rothschild Berry Farm v. Serendipity Group LLC*, 84 F.Supp.2d 904 (S.D. Ohio, 1999); *Uncle Sam's Safari Outfitters, Inc. v. Uncle Sam's Navy Outfitters – Manhattan, Inc.*, 96 F.Supp.2d 919 (E.D. Mo., 2000), *Compuserve v. Patterson*, 89 F.3d 1257 (6th Cir. 1996); *Neogen Corp. v. Neo Gen Screening, Inc.*, 109 F.Supp.2d 724 (W.D. Mich., 2000); *Panavision Intern., L.P. v. Toeppen*, 141 F.3d 1316 (9th Cir. (Cal), 1998).

Numerous judgments reflect that courts in the U.S. moved toward a broader, effects-based approach when deciding whether or not to assert jurisdiction in the Internet context. Under this new approach, rather than examining the specific characteristics of a Web site and its potential impact, courts focused their analysis on the actual effects that the Web site had in the jurisdiction. Indeed, courts are now relying increasingly on the effects doctrine established by the U.S. Supreme Court in *Calder v. Jones*.[108]

This doctrine holds that personal jurisdiction over a defendant is proper when a) the defendant's intentional tortious actions b) expressly aimed at the forum state c) causes harm to the plaintiff in the forum state, of which the defendant knows is likely to be suffered. In *Calder*, a California entertainer sued a Florida publisher for libel in a California district court. In ruling that personal jurisdiction was properly asserted, the court focused on the effects of the defendant's actions. Reasoning that the plaintiff lived and worked in California, spent most of her career in California, suffered injury to her professional reputation in California, and suffered emotional distress in California, the court concluded that defendant had intentionally targeted a California resident and thus it was proper to sue the publisher in that state.

The application of the Calder test can be clearly seen in an Internet context in *Blakey v. Continental Airlines, Inc.*,[109] an online defamation case involving an airline employee, living in Seattle and based out of Houston. The employee filed suit in New Jersey against her co-employees, alleging that they published defamatory statements on employer's electronic bulletin board, and against her employer, a New Jersey-based corporation, alleging that it was liable for the hostile work environment arising from the statements. The lower court granted the co-employees' motion to dismiss for lack of personal jurisdiction and entered summary judgment for the employer on the hostile work environment claim.

In reversing the ruling, the New Jersey Supreme Court found that defendants who published defamatory electronic messages with the knowledge that the messages would be

[108] 465 U.S. 783 (1984)
[109] 164 N.J. 38 (N.J. 2000)

published in New Jersey could properly be held subject to the state's jurisdiction. The court applied the effects doctrine and held that while the actions causing the effects in New Jersey were performed outside the state, this did not prevent the court from asserting jurisdiction over a cause of action arising out of those effects.

The broader effects-based analysis can also be seen moving beyond the defamatory tort action at issue in *Calder* and *Blakey* to a range of disputes including intellectual property and commercial activities. On the intellectual property front, *Nissan Motor Co. Ltd. v. Nissan Computer Corporation,*[110] typifies the approach. The plaintiff, an automobile manufacturer, filed a complaint in California district court against a Massachusetts-based computer seller, alleging that the defendant's "nissan.com" and "nissan.net" Internet domain names infringed on its "Nissan" trademark. Prompting the complaint was an allegation that the defendant altered the content of its "nissan.com" Web site to include a logo that was similar to the plaintiff's logo, as well as include links to automobile merchandisers and auto-related portions of search engines. In October 1999 the parties met to discuss the possibility of transferring the nissan.com domain name. These negotiations were ultimately unsuccessful. The defendant brought a motion to dismiss for lack of personal jurisdiction and improper venue and the plaintiff brought a motion for a preliminary injunction in March 2000.

In considering the defendant's motion, the court relied on the effects doctrine to assert jurisdiction, ruling that the defendant had intentionally changed the content of its web site to exploit the plaintiffs' goodwill and to profit from consumer confusion. Moreover, since the plaintiff was based in California, the majority of the harm was suffered in the forum state. The court rejected the defendant's argument that it was not subject to personal jurisdiction because it merely operated a passive web site. Although the defendant did not sell anything over the Internet, it derived advertising revenue through the intentional exploitation of consumer confusion. This fact, according to the court, satisfied the *Cybersell* requirement of "something more" in that it established that the defendant's conduct was deliberately and substantially directed toward the forum state.

Courts have also refused to assert jurisdiction in a number cases based on what is best described as insufficient commercial effects. For example, in *People Solutions, Inc. v. People Solutions, Inc.*[111] the defendant, a California-based corporation, moved to dismiss a trademark infringement suit brought against it by a Texas-based corporation of the same name. The plaintiff argued that the suit was properly brought in Texas since the defendant owned a web site that could be accessed and viewed by Texas residents. The site featured several interactive pages that allowed customers to take and score performance tests, download product demos, and order products online.

The court characterized the site as interactive but refused to assert jurisdiction over the matter. Relying on evidence that no Texans had actually purchased from the web site, the court held that "[p]ersonal jurisdiction should not be premised on the mere possibility, with nothing more, that Defendant may be able to do business with Texans over its web site."[112] Instead, the plaintiff had to show that the defendant had "purposefully availed itself of the benefits of the forum state and its laws." [113]

A copyright dispute over craft patterns yielded a similar result in *Winfield Collection, Ltd. v. McCauley*.[114] The plaintiff, a Michigan-based manufacturer of craft patterns, filed a complaint in Michigan district court accusing the defendant, a resident of Texas, of infringing copyrighted craft patterns that it had supplied to the defendant. The defendant moved to dismiss the suit for lack of personal jurisdiction. The plaintiff argued that the court could exercise personal jurisdiction because a) the defendant had sold crafts made with the plaintiff's patterns to Michigan residents on two occasions, and b) the defendant maintained an interactive web site that could send and receive messages.

The court refused to assert jurisdiction, dismissing both arguments. With respect to the plaintiff's first argument, the court focused on the fact that the sales were in fact concluded on

[110] 89 F.Supp.2d 1154 (C.D. Cal., 2000)
[111] 2000 WL 1030619 (N.D. Tex., 2000).
[112] 2000 WL 1030619 at 5.
[113] Ibid.
[114] 105 F.Supp.2d 746 (E.D. Mich., 2000).

eBay, an online auction site. Since the items were sold to the highest bidder, the defendant had no advance knowledge about where the products would be sold. As such, she did not purposefully avail herself of the privilege of doing business in Michigan.

In response to the plaintiff's second argument, the court held that it was not prepared to broadly hold "that the mere act of maintaining a web site that includes interactive features *ipso facto* establishes personal jurisdiction over the sponsor of that web site anywhere in the United States."[115] In its judgment the court noted that the plaintiff had provided it with the unpublished opinion in a case called *Amway v. Proctor & Gamble*. In that case, the court held that "something more" than mere activity should be required to assert personal jurisdiction and found that "something more" to be the effects doctrine. The court held that the plaintiff could not rely on that doctrine since it failed to identify a continuing relationship with Michigan or with any resident of Michigan.

In the context of bankruptcy, the Canadian courts have considered whether doing business by telephone is sufficient to establish bankruptcy jurisdiction outside the province in which the debtor resides. *In re John M. Tobin,*[116] the Quebec Superior Court ruled that the use of a telephone by a debtor resident in Ontario to place orders with a broker in Quebec did not constitute doing business in Quebec for the purpose of establishing bankruptcy jurisdiction in Quebec. The court found that the telephone activities were isolated transactions not in the line of the debtor's day to day business. The ruling does not exclude the possibility of frequent telephone contacts into another jurisdiction, by a telephone based business, creating a basis for finding that a debtor carried on business in that jurisdiction. The Internet makes it possible for a corporation to carry on business and have real effects in another jurisdiction without physically entering that jurisdiction. The reasoning in *Tobin* suggests that decisions on jurisdiction must look at the specific activities of the party and not just the media used to carry out the activities.

[115] Ibid. at 751.
[116] *In re John M. Tobin*, 12 C.B.R. 55 (Que. S.C. in bankruptcy).

Historically, there has been a close association between where a company carries on business and the location of the company's physical assets. While mail order and telephone order have existed for some time, the dominant business model included at least some company assets related to production or distribution located in the jurisdiction where a company carried on business. Doing business online erodes the close tie between the residence of a debtor and location of assets on the one hand, and where business in carried out on the other. This draws into question whether jurisdiction under the *Act* should be dictated by physical presence in the jurisdiction. As previously discussed, the tendency of dot-com businesses to outsource virtually all stages of production, marketing and distribution means that dot-com companies may have only a limited physical presence.

Some organizations have brought the concept of jurisdiction dictated by physical presence into the Internet age by tying jurisdiction to the location of the server. Based on the wording of the *Copyright Act*, the Canadian Copyright Board came to the conclusion that royalties were only payable on copyrighted music that originated from a server located in Canada.[117] The Organization for Economic Co-operation and Development (OECD) has tackled the issue of jurisdiction in the application of tax treaty wording to electronic commerce.[118] Companies that operate internationally are generally taxed in the jurisdictions where they have a "permanent establishment." In the context of electronic commerce, the question of what constitutes a permanent establishment arises. The OECD's proposed characterization centres on the fixed physical location of the server that is primary to the company's operation.

Deciding when jurisdiction in bankruptcy should be found requires a re-assessment of the policy behind the jurisdictional tests and a balancing of the various interests involved in bankruptcy. If an online company is actively doing business in Canada but the principals and assets of the company are located elsewhere, does it make any practical sense for a Canadian court to assert jurisdiction? If the company is located outside Canada but targets consumers or

[117]The decision, known popularly as the "Tariff 22" decision, is available at <http://www.cb-cda.gc.ca/decisions/m27101999-b.pdf> (date accessed 17 August 2000).

businesses in Canada is the assertion of jurisdiction appropriate? These are relevant considerations whether examining the "locality of a debtor" to find the correct province in Canada in which to bring proceedings or considering when foreign companies and individuals should be subject to Canadian bankruptcy law and courts.

It may be tempting to rely on the evolving civil jurisdictional case law to determine jurisdiction in bankruptcy matters. However, the policy considerations in bankruptcy may be different from those in general civil litigation. The evolving nature of Internet jurisdiction case law also entails a lengthy period of uncertainty in relation to jurisdictional questions. If explicitly defining when online activities will attract jurisdiction in bankruptcy matters, such definitions must take into account the rapid pace of technological change.

iv) Privacy

Most companies collect and record information on their customers. Dot-coms may collect information explicitly or surruptitiously through tracking devices, such as "cookies" which are small files deposited on the user's hard drive that facilitate detailed tracking of where a user goes on a site and what they do.[119] These small files can be left on the user's hard drive, allowing the company to track the user between visits to their site. Because the Internet is a network, it is possible for users to be tracked from site to site and over time, this information creates a detailed profile. Even if information is collected with the user's knowledge and consent, any subsequent sharing of that information with third parties becomes a critical privacy concern.

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[118]"Revised Draft of the Clarification on the Application of the Existing Permanent Establishment Definition to Electronic Commerce (3 March 2000)" OECD online:<http://www.oecd.org/daf/fa/treaties/art5rev_3March.pdf> (date accessed: 17 August 2000)
[119] See, <http://www.cookiecentral.com>.

Many governments, including Canada and the European Union, have passed legislation governing how personal information may be collected and used.[120] The *Act* must be reviewed to determine whether it adequately protects the privacy of third parties at bankruptcy.

For many dot-coms, their customer database (which often contains detailed financial and behavioural profiles) is a key asset. Restrictions on the ability of companies to use customer information as collateral will severely limit their ability to obtain financing. At bankruptcy, limitations on the use or transfer of customer information reduces the compensation to creditors. Yet it must be recognized that third parties who provide their personal information during the course of business have a legitimate expectation of privacy. This expectation is enhanced when the company collecting the information has a privacy policy that pledges to maintain user privacy.

The Toysmart bankruptcy demonstrates the public concern over privacy of personal information collected online and the conflict that may arise between maximizing creditor recovery and protecting consumer privacy. To satisfy creditors, the receivers attempted to sell Toysmart's customer database. Much of the information contained in the database related to children and was collected under a privacy policy that promised the information would "never" be shared with a third party. Since the resolution of that case, others have arisen including a dispute over the customer list of now-bankrupt eToys[121] and the sale of the eTour customer list.[122] Both lists were reported to be far larger than the Toysmart customer database, with millions of names each.

The liquidation of customer databases as part of a piecemeal sale of assets on bankruptcy is not the only way that customer databases can be transferred to third parties. A bankrupt or

[120] *Personal Information Protection and Electronic Documents Act,* 2000, S.C. 2000 c. 5 [hereinafter *PIPEDA*], and Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data *Official Journal L 281 , 23/11/1995 p. 0031 - 0050*.
[121] Cornyn Asks Delaware Judge To Block Sale Of Customer List (16 April 2001), online: Texas Attorney General < http://www.oag.state.tx.us/newspubs/releases/2001/20010416etoys.htm> (date accessed : 13 June 2001).
[122] *ETour*, *supra*, note 65.

insolvent business may be bought out in its entirety. In this situation, the company that collected the information still owns it, but the company is now owned by a third party. The third party may combine the customer information with other databases or use the information in ways not contemplated by the customer or disclosed by the first owner. While the information does not technically change ownership or control in the course of a buy out, many of the same privacy concerns arise.

Historically, a number of privacy cases have dealt with the seizure of debtor's personal and business records by a receiver or trustee and the debtor's right to privacy.[123] The increasing breadth and detail of personal information collected online has made the privacy of third party information an important issue in bankruptcy. Third party information concerns arise in two situations. First, when the debtor has collected sensitive information from customers or clients and this information is sold as an asset in bankruptcy. Second, when the debtor is in the business of processing information and third party information is stored on hardware that is seized by a secured debtor or liquidator.[124]

While the *Act* gives very little direction on the privacy rights of third party information on bankruptcy, the enactment of the *Personal Information Protection and Electronic Documents Act* (*PIPEDA*) earlier this year does provide new statutory privacy protections. *PIPEDA* applies to a broad range of organizations that collect personally identifying information in the course of commercial activities.[125] *PIPEDA* governs the collection, use and disclosure of personal information and requires organizations to disclose to individuals what information they intend to

[123] *Groupe G. Tremblay Syndics Inc.* v. *Canada (Superintendent of Bankruptcy)*, [1997] 2 F.C. 719 (F.C.T.D).
[124] Court administration of bankruptcy proceedings raises another privacy concern. Bankruptcy court filings require the disclosure of confidential information relating to the debtor and creditors. As court filings become available online, confidential information found in filings can be more easily accessed by the general public. This has become a serious concern in the U.S. where Federal and State authorities are examining ways to increase personal privacy in the bankruptcy process, B. Krebs, "Regulators Examine Threat to Privacy in Bankruptcy Filings" *Newsbytes* (29 September 2000) online: Newsbytes.com <http://www.newsbytes.com/pubNews/00/155944.htm> (date accessed: 13 October 2000).
[125] Privacy Commissioner of Canada: A Guide For Canadians (online: Privacy Commissioner of Canada < http://www.privcom.gc.ca/information/02_05_d_08_e.asp> (date accessed : 13 June 2001).

collect, how such information will be used, and to obtain consent before collecting and using the information. [126]

Since *PIPEDA* is new legislation, there is no practical experience available to determine how it will affect dealings with third party information on bankruptcy. It is quite likely that many organizations will draft fairly broad purpose statements that encompass the sale of information. It is not clear whether the purchase of an entire company, including its customer information, would constitute disclosure under *PIPEDA*. While *PIPEDA* is a crucial piece of legislation to consider when examining the issue of third party information on bankruptcy, the actual effect of the legislation will vary from case to case, depending on the particular circumstances of use, disclosure, and consent.

There has been significant legislative activity in the U.S. dealing with online privacy in general and the protection of personal information on bankruptcy in particular. In the wake of the Toysmart controversy, bills were introduced in both the House and Senate. The House bill, which goes beyond bankruptcy in scope states that:

> "It shall be considered an unfair practice in or affecting commerce which violates section 5 of the Federal Trade Commission Act (15 U.S.C. 45) for a person to sell on the Internet information such person acquired with a pledge that the information would be kept private and not released or for a person to share or transfer to another such information on the Internet."[127]

The Senate bill focuses specifically on bankruptcy, specifying that personally identifying information gathered under a privacy policy by the bankrupt shall not be an asset in bankruptcy.[128] Most recently, the Senate passed s. 420, a bankruptcy omnibus bill that included the following provision pertaining to dot-com bankruptcies:

> " if the debtor has disclosed a policy to an individual prohibiting the transfer of personally identifiable information about the individual to unaffiliated third persons, and the policy remains in effect at the time of the bankruptcy filing, the trustee may not sell or lease such personally

[126] Ibid.
[127] *To Make Illegal The Sale, Share, Or Transfer Of Information Aquired On The Internet With A Pledge That It Would Not Be Released (Introduced in the House)* HR 4814 IH.
[128] *Privacy Policy Enforcement Act of 2000 (Introduced in the Senate)* S 2857 IS s.2.

identifiable information to any person, unless--

(A) the sale is consistent with such prohibition; or

(B) the court, after notice and hearing and due consideration of the facts, circumstances and conditions of the sale or lease, approves the sale or lease.'.

The legislation, aimed specifically at failing dot-coms, also mandates the creation of an ombudsman office to oversee and approve the sale of private data.[129]

Although the U.S. does not have universal personal information protection legislation, there are several laws that protect specific types of information (such as health, financial and social insurance number information) and protect information relating to specific classes of persons (such as children).[130] These laws are relevant when dealing in bankruptcy with the types of information or parties that they govern.

Re Josephine V. Wilson Family Trust v. *Swartz*,[131] a 1993 Ontario bankruptcy case, provides helpful guidance on how third party information might be treated by a Canadian court in the event of bankruptcy. The plaintiff was a secured creditor of the defendant, who worked as a dentist. The plaintiff sought to seize the property of the dentist, including the records and charts of his patients. The court found that although the physical records were the property of the dentist, the information contained in the records was impressed with a trust that made it exempt from seizure under the security agreement. The court examined the relationship in which the information was given and found that the practitioner-patient relationship was one of trust, fiduciary in nature. The relationship gave rise to an assumption that any information would be kept confidential. The court also considered the type of information given. Health information has traditionally been viewed as sensitive and personal in nature. The relationship in which the information was disclosed and the type of information given led the court to conclude that patients had a "legitimate expectation of privacy." The court concluded that based on this legitimate expectation, "[f]or public policy reasons, it seems to me, patients should not be placed

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[129] H. F. Phillips, Senate Oks Measure To Keep Dot-Coms From Selling Personal Customer Data, *San Jose Mercury News* (15 March 2001) online < http://www.siliconvalley.com/docs/news/depth/priv031601.htm> (date accessed : 13 June 2001).

[130] For coverage of U.S. privacy legislation, *see*, the Electronic Privacy Information Center, <http://www.epic.org>.

in the position of having to rely upon the proper conduct of a receiver or upon a protective court order in a receivership to ensure that their privacy is maintained."[132]

The court in *Re Josephine* acknowledged that its decision to protect the public interest in preserving the confidentiality of patient records may have adverse effects on the ability of health related business to secure financing using goodwill as collateral.[133] However, it maintained that any transfer of patient information would require the prior consent of the patient.

The court's approach in *Re Josephine* adopts the analysis employed in debtor privacy circumstances to third party information privacy. In a number of decisions, Canadian courts have concluded that Section 8 of the *Charter* provides a right to personal privacy, not a right to property.[134] In the context of the seizure of debtor's records, the courts have considered the sensitivity of the information and the purpose of the records to determine whether the disclosure of the information constituted an infringement of the debtor's personal right to privacy. The analysis always involves a balance of interests. Corporate business records may be highly sensitive, but courts generally find a low expectation of privacy, particularly when disclosure is part of the bankruptcy process and the debtor privacy interest is weighed against the creditors' interest in recovery.

The analysis in *Re Josephine* must be applied on a case by case basis when determining whether third party information may be dealt with as an asset in bankruptcy. In this sense, the case law provides as little concrete guidance as *PIPEDA*. There is no clear instructions of what relationships and what types of information will create a fiduciary obligation that will limit the transfer of the information. Privacy policies are a relatively new creation and there is scant case law on the legal effects of a web site privacy policy.

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[131]*Re Josephine V. Wilson Family Trust* v. *Swartz* (1993), 16 O.R. (3d) 268 (Gen.Div.).
[132]Ibid. at 274.
[133]Ibid. at 277.
[134] For cases dealing with debtor privacy under the *Charter* and debtor privacy in general, see: *Slattery(Trustee of)* v. *Slattery*, [1993] 3 S.C.R. 430, *Groupe G. Tremblay Syndics Inc.* v. *Canada (Superintendent of Bankruptcy)*, [1997] 2 F.C. 719 (F.C.T.D), *R.* v. *Ezzeddine*, [1996] A. J. No. 338 (Alta. Q.B.), *British Columbia (Deputy Sheriff)* v. *Canada*, [1997] B.C.J. No. 1386 (B.C.S.C.), and, *Re Jenset* (1986), 56 O.R. (2d) 570 (Ont. S.C.).

The tendency of dot-coms to outsource most functions gives rise to a second privacy concern. A prime example of how outsourcing creates privacy concerns is evident in a scandal last year involving Toyrus.com.[135] Toysrus.com collects information from customers, including children. The information is collected under a privacy policy that states that the information will not be shared with third parties. A privacy investigator discovered that contrary to the company's disclosure, customer information was being transferred to a company called Coremetrics, which conducts market analysis for a number of dot-coms. The temptation for Coremetrics to copy or cross reference customer information is considerable. The outsourcing of information analysis to Coremetrics creates serious privacy concerns and led to several class action lawsuits in the U.S.[136]

In the context of bankruptcy, when a company that processes information for others fails, many issues are raised. What right do individuals and companies whose information has been transferred to the failed enterprise have to advance notice that potentially sensitive information may be at risk? Who is responsible for determining if the information is entitled to privacy protection, either under *PIPEDA* or common law? What standing do parties other than the company that outsourced the information analysis have to require its return? Who is liable for any misuse or destruction of information?

Admittedly, neither customer databases nor privacy concerns are new. What is new is the greatly expanded scope of data collection and an e-commerce environment where customer information is regarded as a core asset. These new dynamics, combined with increasing public awareness of online privacy issues, have created new privacy concerns on bankruptcy. There is no satisfactory answer to be found in the current law. The *Act* is silent on the issue of privacy. The *PIPEDA* and the case law provide some guidance but depend heavily on the facts of a particular situation and are cumbersome to apply. Indeed, the lack of any obligation on receivers

[135] C. Oakes "Toys R Us Ends Data Practice?" *Wired News* 16 August 2000 online: Wired News <http://www.wired.com/news/business/0,1367,38244,00.html> (date accessed: 18 August 2000).
[136] S. Olsen, Toysrus.Com Drops Tracking Service Amid Pressure, *CNET News* (14 August 2000), online: CNET News < http://news.cnet.com/news/0-1007-200-2520471.html> (date accessed : 12 June 2001).

and trustees to give third parties notice of dealings in potentially sensitive information means that many individuals cannot protect their legitimate expectation of privacy in a timely manner. It is also unclear what standing individuals other than the debtor have in order to complain about abuse of private information.[137]

The current uncertainty surrounding sensitive information is not acceptable. However, amendments addressing privacy will alter the balance of interests on bankruptcy. Blanket protection of sensitive information will drastically reduce the ability of dot-coms to raise financing and limit the ability of creditors to maximize their recovery from the bankrupt's estate. Allowing free dealing in sensitive information would undermine the legitimate expectation of privacy, an expectation that is recognized in the Charter, *PIPEDA* and common law. Any process established under the *Act* to deal with privacy issues will have to include a mechanism for assessing the nature of the information in question as well as a mechanism for notifying the parties affected by the information in question. The vast majority of persons affected by the transfer of information retained by a bankrupt company would not be creditors and would not normally receive notice nor have standing.

v) Stored Data

Even if the data held by a bankrupt is not entitled to privacy protection, it still creates certain challenges to the *Act*. Data is stored on computer equipment, which many dot-coms lease rather than own. If the debtor defaults on the lease in the process of going bankrupt, the lessor may take possession of the computer equipment. Depending on the lease terms and the perfection of any security interest, the lessor may have a lien on the data stored on the equipment. If the lessor does not have a lien, then the data becomes an asset in bankruptcy to be administered by the trustee. If the data is controlled by a trustee, he or she must act quickly to maximize the value of the data and possess sufficient expertise to handle the data in a reasonable manner.

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[137]In *Re Josephine*, it was the debtor who opposed the transfer of patient records. If the debtor was indifferent,

If a trustee decides to maintain the operation of the dot-com and use the stored data, he or she must be able to take over operations within hours. For example, if the bankrupt company provides procurement management services online for large corporate interests, the company will lose customers quickly if it cannot provide the service. Failing to provide service or providing negligent service may attract liability.

Where a trustee decides sell the stored data, he or she may be caught in a conflict between acting quickly and acting in a commercially reasonable manner, though, as discussed above, the Act contemplates moving quickly where the circumstances warrant it. Much stored data will lose its value very quickly. However, there is not yet an efficient competitive market for novel forms of intellectual property. Unlike perishable foods, it is often not possible to contact a wholesaler to determine the market price on a given day. The trustee may, in its haste to deal with the data expediently, not act in what is traditionally considered a commercially reasonable manner. In one U.S. case, a bank that repossessed and sold a software program was barred from further recovery of the outstanding debt. The court found that the bank had not acted in a commercially reasonable manner by failing to advertise the sale of the software in trade journals and newspapers.[138]

The challenges posed by stored data do not require amendments to the *Act*. The authority granted to trustees under section 18 of the Act should be sufficient to allow for the prompt resumption of business or disposal of data assets. The larger issue is one of developing trustee expertise to ensure that there is an awareness of the value, concerns, and liabilities related to dealing with stored data.

Part III: Conclusions and Recommendations

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it is worth considering what standing the patients would have in bankruptcy court to complain.

[138] *Mercantile Bank* v. *B&H Associated Inc.,* 330 Ark. 315, 954 S.W. 2d 226 (Ark.1997).

Canada has not yet felt the full brunt of e-commerce bankruptcies. As indicated in the recent Statistics Canada survey, Canadian business has been slow to embrace e-commerce despite the high level of penetration of Internet technology.[139] Canadian companies involved in technology business tend to be involved in manufacturing the infrastructure of the Internet, rather than involved in doing business on the Internet. Canadian dot-coms tend to be financed with private capital, rather than through public shares or secured financing.[140] The private equity holders, often venture capitalists, are a fairly restricted group so the failure does not have the far reaching impact it might otherwise have.

Only a small percentage of failed technology ventures end up in bankruptcy court.[141] For venture capitalists or investors, bankruptcy proceedings are a very public demonstration of acknowledging defeat and a bad investment.[142] Rather than undergo the public scrutiny that accompanies a bankruptcy proceeding or attract unwanted media attention, dot-coms will likely search for a buyer or liquidate their assets. Contrary to the protestations of Welsh poet Dylan Thomas, most dot-coms will "go gently into that good night" without the awareness of the majority of the Internet community. The limited asset base and the fact that the major creditors are usually also the major investors leave little incentive for bankruptcy proceedings.

However, as the dot-com business sector grows and matures, future bankruptcies will affect more than just venture capital investors. Dot-com undertakings that actually do business with the public for several months or years before failing leave behind a wide range of creditors, not all of whom are sophisticated investors who can calculate the risks beforehand.[143]

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[139] *Internet Shopping in Canada*, *supra*, note 2.
[140] J. Freedman, Venture Capital Shortage Crippling Calgary Dot-Coms, *Internet News* (28 December 2000) online: Internet News < http://www.internetnews.com/intl-news/article/0,,6_546861,00.html> (date accessed : 13 June 2001).
[141] *Shrinking Violets*, *supra*, note 26.
[142] Ibid.
[143] "Failing dot-coms leave unpaid creditors—and celebrity endorsers—out in cold" *USA Today* (19 October 2000) online: USA Today <http://www0.mercurycenter/news/breaking/merc/docs/019253.htm> (date accessed: 20 October 2000), G. Sandoval, "Failed dot-coms worry consumers waiting for goods" *Cnet News.com* (18 October 2000) online: <http://news.cnet.com/news/0-1007-200-3229489.htm> (date accessed: 20 October 2000).

The preceding review identified the key legal issues in Internet bankruptcy -- domain names and web sites, technology licensing, jurisdiction, privacy, and stored data. Arising from that discussion, two dominant themes emerged: legal uncertainty and speed.

Market efficiency requires participants to have access to accurate information, enabling parties to efficiently allocate risk. In the bankruptcy context, inefficiency is created by unequal access to information, poor quality information, or high transaction costs. Without accurate information, parties cannot effectively allocate risk prior to bankruptcy. Once bankruptcy occurs, it is difficult for parties to determine whether liquidation or restructuring is the best option.

Much of the inefficiency in dot-com bankruptcy process is not due to bankruptcy legislation but rather is attributable to the evolving and immature nature of the dot-com business environment. The dot-com business environment is, however, quickly evolving towards a more rational basis. The hype of a catchy domain name alone, without any business plan, was once enough to raise millions from investors. The domain name market has now settled down to a more commercially rational and efficient basis, resulting in much lower valuations.[144]

Within the legislative context, there is room to increase certainty and reduce procedural delays, which will increase the market efficiency of dot-com bankruptcies. The unclear legal status of domain names and the restrictions on their transfer creates uncertainty that limits the ability of dot-coms to pledge domain names as collateral and interferes with creditor recovery. web sites are also particularly vulnerable to the speed of the Internet. On bankruptcy, the trustee must act quickly to preserve the value of the web site, by either running the operation or disposing of the site. Procedural delays, an inefficient market for re-sale of intangibles and lack of trustee expertise may result in declining returns to creditors.

[144] *Catchy Domains*, *supra*, note 67.

Software licensees face considerable uncertainty in the event of licensor bankruptcy since the future owner of the copyrighted software may not honour existing contracts. The non-legislative solutions to the effect of bankruptcy on technology licences are expensive and unreliable. With the rise of enterprise software and dot-coms that depend entirely on licenced software, the effect of the unpredictability of technology licences on bankruptcy grows. Should Canada follow the U.S. lead by enacting a legislative amendment, the uncertainty will be diminished but the balance between creditors and debtors will be altered as well.

The physical presence of the debtor or assets traditionally determines bankruptcy jurisdiction. Since a server can be placed anywhere, the Internet disconnects physical presence from carrying on a business. New tests that focus on the effects of the activity rather than physical location of assets are needed for determining jurisdiction in an online context.

The Internet enhances the ability to collect personal information creating new privacy concerns. In the bankruptcy context, dot-com customer databases are storehouses of personal information and potentially valuable assets. The *Act* must balance the potentially competing interests of creditors with the privacy expectations of Internet users.

The complexities of dealing with stored data underlines the expertise that is required to avoid trustee liability and the challenges of dealing with dot-com assets. Stored data also underlines the need for speed in Internet bankruptcies. The party responsible for dealing with the stored data must act quickly to determine who owns what information and sell "perishable" data quickly.

Any changes to the *Act* will affect the balance of interests represented in the *Act*. Any amendments made to accommodate dot-com bankruptcies will alter the balance of interests between the debtor, secured creditors and unsecured creditors.[145] Recognition must also be

[145] In relation to increasing the speed of the bankruptcy process, some have suggested restricting the use of stays or alternatively transferring the debtor's property immediately to the creditors. Such changes in the bankruptcy

given to new interests in bankruptcy proceedings created by the emerging Internet business models. The right of third parties to protect their legitimate expectation of privacy is an interest that must be recognized and accommodated. A critical question is whether the procedures currently set out in the *Act* can be made to operate quickly enough to fulfill the objectives of the *Act*. For the Internet economy to flourish in Canada, effective solutions to the challenge of e-commerce to bankruptcy legislation must be identified and implemented. As in case of a dot-com failure, there isn't a moment to lose.

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process, however, would radically rebalance the rights of the parties and the emphasis put on each of the policy objectives. See, R. Morck and B. Yeung, "Canadian Public Policy in a Knowledge Based Economy" at pp. 31-32.