# Balancing Issues and Overlapping Jurisdictions in the Global Electronic Marketplace: The UCITA Example

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Abstract

The Internet marketplace is global, technologically dynamic, information-rich, and network based. Policymaking tends to be nation bound, rules oriented, and issue dependent. One example of the tension that result between the economic environment and the policymaking venue is the interdependence between tax policy and international trade negotiations. Another is the changing balance between creator and user and between individual and society in rights to intellectual property and protection of personal information. How policymakers weight these issues against the backdrop of overlapping jurisdictions will materially affect whether individuals, firms, countries, and the world as a whole will benefit from the wealth of information and the possibilities of network externalities offered by the global Internet marketplace. UCITA offers one specific lens through which to trace the tensions created by a more global, digital, and information-based marketplace.

## I. INTRODUCTION

Consumer activity, business strategy, and government policymaking all respond to fundamental economic forces filtered through the commercial, policy, and legal environments. The Internet has already affected commerce by changing the boundaries of the marketplace and the means for transacting in goods, services, and information. Policymakers view this commercial dynamism with

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differing degrees of interest, urgency, and dismay. The legal profession strives to clarify old rules and write new ones, despite the challenge of writing effective law for such a changing landscape. How people in the commercial, policy, and legal realms interact will materially affect whether individuals, firms, countries, and the world as a whole will benefit from the wealth of information and the possibilities of network externalities offered by the global Internet marketplace.

The Uniform Computer Information Transactions Act (UCITA) is an effort to clarify one specific aspect of this landscape; namely the default rules for commercial contracts involving computer information transactions.[1] However, merely selecting computer information transactions and attempting to address their contractual nature alone is impossible due to the current complex character of transactions. The controversy over UCITA is a reflection of this complex character and the broadened set of issues concerning the relationships of national and international business, policy, and law in the new global electronic marketplace.

One statute, which only aims to simplify, clarify, and unify contract law for information transactions has deep implications. The way the Internet is changing the commercial and policy environment renders this statute pervasive. New markets are developing in time, geography, and information which put greater emphasis on the global nature of the marketplace. Process and product innovations bundle goods, services, and information seamlessly, making it more difficult to distinguish between the pieces. Together these changes highlight how the economics of both networks and information create tensions between the global commercial reach of firms and their customers, and local jurisdiction and authority of law, and policymakers.

Thus, UCITA is not just about contract law. When governors vote to implement UCITA, they implicitly take a stand on issues and policies, including: tax regimes, international trade negotiations, the balancing of user/creator and individual/societal interests regarding personal information, and intellectual property rights**.** Besides the balancing act inherent in these issues, the overlapping of jurisdictions

1. Unif. Computer Info. (Transactions Act, 7 U.L.A. 6 (2000)) [hereinafter UCITA], *available at* http://www.law.upenn.edu/b11/ucita/ucita.htm (last visited Feb. 3, 2002).

also causes concerns. A state-level decision regarding how to classify transactions under UCITA has implications for federal and international policymakers. In the end, UCITA cannot be legislated in a vacuum with respect either to types of transactions or to the global marketplace. Policymakers must view this area as a microcosm of the issues facing them in this new world of global Internet commerce.

## II. AN OVERVIEW OF UCITA AND ITS COMPETITION

### *A. What is UCITA? A Narrow Interpretation*[2]

Transactions involving goods, services, and information have different characteristics and, to some extent, require different contract rules. This need was the beginning of an over decade-long effort to expand Article 2 of the Uniform Commercial Code (U.C.C.) concerning the sale of goods. Article 2 of the U.C.C. is a uniform state law, ratified by all fifty states and the various territories of the United States, that originated in the 1930s and 1940s. It has been periodically updated through the joint efforts of the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (A.L.I.). The original focus of this partnership was the editing of Article 2 so it would address some of the differences between goods and services.

Ultimately, the joint drafters recognized the distinct nature of information services, specifically software and licensing, and the importance of clear and uniform contract rules for information transactions, particularly those involving digitally transmitted intellectual property. Their response was the creation of U.C.C. Article 2B in 1996. The joint drafters structured Article 2B similarly to Article 2. They edited and amended as necessary to address those issues distinct to software licensing terms and intellectual property in the light of an environment where the delivery channels for information and intellectual property were becoming remote, interactive, and electronic.

Early in 1999, the partnership between NCCUSL and A.L.I.

2. This section is not designed to be an exhaustive legal treatment, but rather an overview from an economic perspective.

ended. Although A.L.I. gave no explicit reason for the termination, it is speculated that from A.L.I.'s standpoint, the draft of Article 2B did not achieve the appropriate balance between buyer and seller. The NCCUSL moved forward, renaming the product UCITA, and voted to adopt it and recommend it to the states at their annual meeting in Denver, Colorado, in 1999.

Opponents of UCITA argue that its rules significantly alter the balance of rights in favor of existing business producers of information services and intellectual property. They warn that individual users could be exposed to a wide range of possible abuses including nontransparent use clauses, unauthorized remote access to their computers, and obscure forums for dispute adjudication. They also fear innovation could be chilled by excessive protection of the intellectual property produced by incumbents. Contrastingly, proponents of UCITA argue that UCITA is no more and no less than a commercial code, a "default" set of rules for contracting parties to follow unless they agree to different terms. [3]

### *B. Why is UCITA Controversial? An Economic Interpretation*

While UCITA is a legal document, the underpinnings of the economics of information and of networks that have created the controversies are clear. The first issue, a relatively familiar one, is the balance between the rights of the users and the creators of intellectual property. The general idea is that information is costly to create, but

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3. For more details on the history and content of Article 2B and UCITA, see Lorin Brennan & Glenn A. Barber, *A response to, "Why Software Quality Professionals Should Actively Oppose the Uniform Computer Information Transactions Act"*, *SOFTWARE* QUALITY PROF., *available at* http://www.asq.org/pub/sqp/past/vol1_issue4/brunnan.html (lasted visited Mar. 8, 2001); Cem Kaner, *Why Software Quality Professionals Should Actively Oppose the Uniform Computer Information Transactions Act*, SOFTWARE QUALITY PROF., *available at* http://www.asq.org/pub/sqp/past/vol1_issue4/kaner.html (last visited Feb. 2, 2002) (providing numerous links to organizations that oppose UCITA).

*But see* Letter from the Attorneys General of Connecticut, Idaho, Indiana, Iowa, Kansas, Maryland, Nevada, New Mexico, North Dakota, Oklahoma, Pennsylvania, Vermont, Washington and the Administrator of the Georgia Fair Business Practices Act to Gene Lebrun, President, National Conference of Commissioners on Uniform State Laws (July 23, 1999), *available at* http://www.2bguide.com/docs/799ags.html (last visited Feb. 2, 2002); Letter from six members (including three Directors) of the staff of the Federal Trade Commission to Mr. John L. McClaugherty, Chair, Executive Committee, NCCUSL (July 9, 1999), *available at* http://www.ftc.gov/be/v990010.htm (last visited Mar. 3, 2001).

increasingly easy to replicate. Therefore, from a contractual standpoint, the essence of a transaction involving information or intellectual property is not really the sale, but the limited transfer of the right to use the information. Policymakers respond to this by creating patents and other intellectual property protections that support continued innovations.

The pace of technological change, the nature of innovation in Internet technologies, and the importance of networks for the Internet could, however, change the balance between the individual creator's valuation and society's valuation of intellectual property. Protecting intellectual property too tightly, particularly intellectual property of the incumbents and intellectual properly associated with networks, could result in the exclusion of new innovators and reduce the benefits of the Internet to society. Thus, the networked nature of Internet information tightens the overlap between intellectual property protection and competition policy.

In addition, there is the problem of information aggregation. With the Internet, information increasingly resides between the creator and the user. As it is used interactively,[4] the terms of access by both the user and the producer become relevant. Protecting intellectual property leads to the auxiliary issue of the access to, collection of, and appropriate treatment of the private information of the user.

Unique information is increasingly combined with other information over networks. The collection of this information has the economic characteristics of a "public good" or "spillover." In other words, the value of the collected information to one firm is different from the sum of the values of each individual element to the set of individuals. A more familiar example is the collection of cars on the road that create traffic congestion, a "spillover" effect, the cost of which no individual car owner considers when he or she commutes. A related consequence of the information network is that individual users have little economic voice or economic power relative to the aggregator of the information. The nature of spillovers and the resulting lack of relative economic power may open the door for explicit public policy intervention which may serve to properly price

4. For example, "cookies" or application service providers.

or internalize the difference between the social and the private value of the collected information.[5]

UCITA represents a relatively simplistic treatment of transactions in information products and services. It does not do justice to the increased complexity of and overlap between intellectual property and competition policy. Nor does it address the economics of spillovers inherent in information aggregation and networks that are characteristic of the Internet marketplace.

### *C. Alternatives to UCITA?*

The various state governors are not alone in trying to create a consistent and uniform approach to the rules of contracting in the Internet marketplace. Among the others attempting to address both the substance and the jurisdictional questions is the European Commission.[6] The European Parliament approved the Electronic Commerce Directive (Directive) in June 2000 clearing the way for the Directive to become law in all member states over the subsequent eighteen months.[7] Unfortunately, the Directive is only one of a set of directives governing relationships between firms and customers. Taken together, and especially when examined in light of the problems caused by attempting to balance the interests of the aggregator and individual or the firm and customer, the various European Directives provide a mixed and possibly inconsistent

5. For more discussion of the nature of "public goods" in the Internet marketplace, see CATHERINE L. MANN ET AL., *Government Guidance and the Economics of Imperfect Markets for Information*, *in* GLOBAL ELECTRONIC COMMERCE: A POLICY PRIMER 37-41 (2000).

6. A more narrow example is that of the International Chamber of Commerce "E-terms service." *See* International Chamber of Commerce, The ICC Electronic Commerce Project (ECP) (Mar. 8, 2001), *available at* http://www.iccwbo.org/home/electronic_commerce/electronic_commerce_project.asp (last visited Feb. 2, 2002). This site defines "E-terms service" as "all the tools that are necessary to compose contracts on-line and conduct electronic transactions with a minimum of legal risk . . . ." *Id.* While the ICC product appears less broad in its scope than UCITA, the ICC is trying to codify its "best business practice" policy which was supposed to be the objective underlying the revisions to Article 2. Certainly, some of the transactions likely to be covered by E-terms will involve cross-border transfer of information services and intellectual property by electronic means.

7. *See* Directive 2000/31/EC of the European Parliament and of the Council on Certain Legal Aspects of Information Services, in Particular Electronic Commerce in the Internal Market, 2000 O.J. (L178), *available at* http://europa.eu.int/eur-lex/3en/archive/2000/1_8200000717en.html (last visited Feb. 2, 2002).

policy.

The Directive covers many of the same online information service transactions which contain intellectual property and have been embraced by UCITA, including: Internet service providers, databases, e-mail services, online solicitation, and professional services. The Directive differs from UCITA in that it does not cover intellectual property. While the Directive applies to service providers within the European Union (EU), several provisions discuss the challenges of cross-border commerce and the potential conflict of national laws in the context of transactions between EU countries and third countries.[8]

Furthermore, with respect to jurisdictional balance, the Directive clarifies that mutual recognition of national laws shall apply and that information society services are "subject to the *law of the Member State in which the service provider is established*."[9] However, there are other directives covering consumer interests, including those with regard to unfair terms, misleading advertising, distance contract protections, consumer credit or investment services, protection of personal data, and product safety.[10] UCITA covers at least some of these concerns either explicitly or implicitly. These other directives taken together imply that the Directive "cannot have the result of depriving the consumer of the protection afforded to him by the mandatory rules related to contractual obligations of *the law of the Member State in which he has his habitual residence*."[11] Therefore, the terms of adjudication, the approach to disclosure and warranty, and the protection of personal information remain unclear in this world where borders are less meaningful.

Other multilateral organizations are also addressing the issues embraced in UCITA although in a piecemeal fashion. United Nations Commission on International Trade Law (UNCITRAL) offers a model law on electronic commerce which focuses particularly on the legality of the electronic contract itself, and less on the terms of the

8. *Id.*
9. *Id.* at ¶ 22 (emphasis added).
10. *Id.* at ¶¶ 11-17.
11. *Id.* at ¶ 55 (emphasis added). Other European laws including the Brussels convention and the recently proposed Rome II Green paper affirm this right of consumers to adjudication in courts in their own territories.

contractual relationship.[12] The World Intellectual Property Organization (WIPO) is working on multilateral treaties for intellectual property protection. Several multilateral agreements have been passed and await ratification by members.[13] The Organization for Economic Cooperation and Development (OECD) has numerous missives on issues of consumer protection, security, contracts, and a privacy-policy generator.[14] While there is not a lack of legal effort, there is a fundamental lack of understanding among these regulatory bodies that the unbounded global environment that they wish to govern demands a comprehensive approach, not the fragmented effort observed to date.[15]

## III. THE INTERNET AND THE GLOBAL MARKETPLACE: KEY ECONOMIC IMPLICATIONS

The technology of information and networks, and increasingly information itself, are key drivers of the Internet and electronic commerce. Historically, information technologies, such as computers, hardware, and software, were used to process numbers, create databases, and enhance corporate operations. Firms have collected and processed information about prices, preferences, inventories, and inputs to improve internal operations and sales, but most of this information has been kept internal to these firms. The revolution of the Internet enhances and extends information technologies to provide a global reach, interoperability, and accessibility to these technologies, the underlying information, and the firms and customers. This network is what creates the new marketplace and makes it both unique and substantial.[16]

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12. *See* United Nations Commission on International Trade Law, UNCITRAL, *available at* http://www.unictral.org (last visited Feb. 3, 2002).

13. *See* World Intellectual Property Organization [hereinafter WIPO], *homepage*, *at* http://www.wipo.int (last visited Mar. 8, 2001). The two treaties passed in December 1996 updated the Berne Convention. The WIPO copyright treaty and the WIPO Performances and Phonograms Treaty. For further discussion of these treaties, see MANN, *supra* note 5, at 118.

14. *See* homepage of OECD, *available at* http://www.oecd.org (last visited Feb. 3, 2002). For an overview, see MANN, *supra* note 5, at 154-56.

15. For a more comprehensive discussion of what is being done on Internet issues in global forums, including for example ICANN, see MANN, *supra* note 5, at 104-14, 143-72 (discussing legal frameworks and the government in the international arena).

16. *See* CARL SHAPIRO & HAL R. VARIAN, INFORMATION RULES: A STRATEGIC GUIDE

### *A. New Markets in Time, Geography, and Information*

The structure and capabilities of the Internet reduce frictions in the marketplace in the three dimensions of time, geography, and information. The Internet marketplace fosters global production of products and services tailored exactly to the buyer's needs and available exactly when the buyer wants. For example, now tenders put on the Internet by large firms in the United States, such as General Electric, receive responses from small firms in Africa. Prior to the advent of the Internet, these firms would have had no chance to compete. Global customer service in the native language of the caller and response to specific questions associated with their order can be made available twenty-four hours a day, seven days a week. Internet access means that artisans in remote villages in Vietnam can sell in the global market. The *Financial Times* packages its material in several different ways, updates it continuously for different time zones, offers links from it to stories in other sources, and transmits it through several distribution channels in order to satisfy the information needs of specific recipients. Business-to-business exchanges and auctions widen the range of participants, improve price revelation, and allow more timely purchases and deliveries of parts and services.

These efficiencies that minimize time and geography constraints, combined with the information and network characteristics of the Internet marketplace, allow for more ways for business to create value. Firms can focus on the part of the process they do best and outsource other parts to subsidiaries or strategic allies anywhere in the world. Moreover, more stages of the production process can be digitized when "assembly" and the delivery of value is via the network itself. International teams are collaborating on more projects through the resources of the Internet. This explosion of new information, new markets, and new teams means that contracts, jurisdictions, and the rights and responsibilities for product and performance have become more complex and inherently international in nature.

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TO THE NETWORK ECONOMY (1999).

### *B. Bundling of Goods, Services, and Information*

The Internet marketplace will increasingly offer product "bundles" which are priced uniquely by time, location, and what was formerly termed the "final" good or service. Airlines already use this strategy for pricing seats. FedEx and other package delivery services, which have separate prices for the delivery of packages in the early-, mid-, and late-day time, also use this strategy.

The Internet leads to the prevalence of such bundling which also creates more market niches for firms to occupy. For example, some Bloomberg clients pay for real-time stock prices, others get that information for free with a delay of twenty minutes, but pay for a time series of the historical data.[17] Bloomberg bundles its information in different ways because the customer's needs are different. This process creates more value to both the firm and the customer. In another example, some people buy computers from Dell.com and some from Gateway Country Stores. They do not choose one store over the other because the computers are different, but because of personal preferences for shopping, touching, leasing, customer assistance, and because of other factors, such as entertainment value. The computer is just one part of the product bundle that is being purchased. The Internet enhances the ability to bundle and use time, geography, and information more effectively, even for intermediate good producers such as industrial suppliers.

With the bundling of tangibles and intangibles and strategic alliances around the globe, it is increasingly difficult to determine exactly where, in a geographical sense, or when, in terms of the stage of production and bundling, value is created. Product bundles can be offered through firms who can be located anywhere, who can change locations quickly, and whose ultimate residence may be hard to establish. Even tangible merchandise, purchased at a specific point in time and at a particular location might only be identifiable by the delivery destination of record rather than the ultimate user. In the case of a bundle characterized by a digitized and downloaded transaction, neither the origin point nor the ultimate user may be

17. Bloomberg is one of the largest non-bank financial services companies in the world.

determinable. Napster music is a good example of this. These issues have important implications in the areas of trade, taxation, and law, where jurisdictions are often defined by political or geographic boundaries, rather than along commercial or economic lines.

### *C. Balance and Overlap: Two Examples*

The economic activity via the Internet is complex and it bundles globally sourced goods, services, and information. In contrast, the jurisdictions of government remain, at their broadest, national. Within the context of national policymaking, governments often address issues in isolation from one another. Policy choices made by one nation on one agency of government might impinge upon the policy choices made by another.

The policy response to one issue raised by transactions on the Internet will need to reflect other issues also raised by these complex transactions. One example is the issue of how to classify transactions in electronic commerce bundles. This decision may impinge on the manner in which a government raises tax revenues and engages in international trade negotiations. Another example is the decision regarding how to protect personal information. A decision in this area may affect not only the protection of intellectual property within that country at that point in time, but also the incentives to create innovative new technologies and to generate global growth.

## IV. CLASSIFYING ELECTRONIC COMMERCE TRANSACTIONS: IMPLICATIONS FOR TRADE NEGOTIATIONS AND TAX POLICIES

The issue of how to classify electronic commerce transactions is anything but innocuous. Are these bundles goods or services, or both or neither? Do sales generate business income or do leases generate royalties? UCITA was written to help define the difference between goods and services and sales and leasing. Transactions of information and copyrightable material be classified as services, some of which yield royalties. If the transactions are classified as such, as required by UCITA, there would be profound effects on tax policy, as well as on the approach governments take toward international trade negotiations.

### *A. International Trade Negotiations*

International trade negotiations are deeply affected by decisions to classify flows and transactions as goods or services. This distinction is fundamental to the current structure of the World Trade Organization (WTO), the premier multilateral body for international trade negotiations. The WTO has two functional agreements on trade: the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS).[18] These agreements vary greatly with respect to the signatories' basic commitments.

GATT, the precursor to the WTO, originated in the late 1940s, and requires signatories to commit to free trade in goods. Countries can and have made derogations from that basic commitment, such as quotas on apparel or tariffs on machinery. These derogations have been the foundation for numerous multilateral rounds of negotiations.[19] Unless a country explicitly negotiates a tariff, quota, or other constraint through the WTO, the transaction in the good is presumed to receive free-trade treatment. Moreover, a basic commitment of GATT is that a country cannot treat another specific country worse in trade agreements. All trade in goods is presumed to receive most-favored-nation status and national treatment. This status ensures that products traded between any two countries will receive the same trade treatment and that import sales receive the same treatment as domestic sales.

On the other hand, GATS, which only came into force in 1993, does not require countries to make any basic commitment to free trade in services. Instead, each country creates a schedule of allowed practices under four general headings or modes: cross-border transactions, transactions associated with consumption abroad, transactions associated with a commercial presence, and the

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18. This is an extremely cursory overview of the WTO and its two main components, GATT and GATS. For more detail and analysis, see JOHN H. JACKSON, THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS (1997). For a good "side-by-side" comparison of the rights and obligations under GATT vs. GATS, see Richard N. Snape and Malcolm Bosworth, *Advancing Services Negotiations*, *in* THE WORLD TRADING SYSTEM: CHALLENGES AHEAD (Jeffrey J. Schott ed., 1996).

19. Note that agriculture was never part of the GATT, so that countries never have committed to free trade in this arena either.

movement of natural persons. These schedules outline what trade will be allowed, anything else will not be allowed. A hypothetical example for a country, citizens could travel abroad to receive medical services, but medical professionals would not be allowed to practice across the border. Foreign banks would not be permitted to offer services across the border but could offer services if a commercial presence was licensed.

Electronic transactions were not considered in the GATS scheduling process. It remains unclear how they should be treated. There are potential conflicts between the modes and some opportunities to gain from trade could be lost if they are not allowed. In the context of the previous examples, radiology pictures can be transmitted to licensed medical professionals across the border via the Internet to be read. As these transmissions were not explicitly scheduled, it is not clear whether this transaction would be allowed. The benefits to the local population of quality medical care, as is enabled by the Internet, could be lost. In the aforementioned financial transaction, cross-border sales enabled by the Internet may not be scheduled or allowed under the first mode. A country could force a bank to open a local office, under mode 3, in order to deliver Internet sales. This requirement would raise the cost and reduce the gains from trade. These specific examples illustrate that the complex nature of bundled transactions will create huge problems in classifying these transactions as goods or services, and within services, by which delivery mode.

The issue is not simply academic. Already, differences in the classification of electronic commerce transactions, including information services, have emerged as a point of conflict in trade negotiations between the United States, the EU, and other countries. The EU asserted that "[a]ll GATS provisions, whether relating to general obligations . . . or specific commitments . . . are applicable to electronic deliveries," and, therefore, these products should fall under the purview of GATS.[20] While most countries, including the United States, agree that services delivered over the Internet are covered by

20. *See* Preparations for the 1999 Ministerial Conference, Work Programme on Electronic Commerce Communication from the European Communities and their member states, WTO Do. WT/GC/W/306, T12 (Aug. 9, 1999).

GATS, they believe other Internet products should be treated like a good or are a hybrid between a good and a service. Electronic books and downloaded software are popular examples of those other products. The United States has argued that more time is needed to monitor the development of electronic commerce before any final classification takes place because of this controversy. [21]

UCITA represents yet another voice in this discussion, demonstrating how the jurisdictions of policymaking units increasingly overlap. UCITA represents the viewpoint of the State Governors and appears to correlate more closely with the EU position than that of the U.S. trade negotiators. The implications for United States international trade negotiations if UCITA becomes the prevalent law and classifies many of these transactions as services is unclear.

### *B. Tax Policy*

It should be no surprise that questions of how the Internet and electronic commerce will affect taxes has received early and intense policy attention. Policymakers are concerned about the potential erosion of their tax revenue.[22] In addition, firms and businesses want

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21. WTO members could avoid the thicket of classification issues and simply follow the course of most liberal treatment of the transaction, whether in GATT or GATS. In some cases, this approach could mean that electronic delivery of goods and services would be treated more favorably than other modes of delivery as currently scheduled in the GATS. For example, digitized software could be sold over the Internet without incurring the tariff of "shrink-wrapped" software. This liberalizing bias would be beneficial for trade and growth. *See* Catherine L. Mann & Sarah Cleeland Knight, *Electronic Commerce in the World Trade Organization*, *in* THE WTO AFTER SEATTLE 19 (Jeffrey J. Schott ed., 2000). Other students of this topic, however, note that such an approach would imply a reneging on GATS commitments agreed to in the Uruguay Round. *See* William Drake & Kalypso Nicoliades, *The Information Revolution and Services Trade Liberalization After 2000*, *in* GATS 2000: NEW DIRECTIONS IN SERVICES TRADE LIBERALIZATION 241 (Pierre Sauve & Robert Stern eds., 2000); Claude Barfield & Mark Goombridge, *E-Commerce and the GATS 2000*, AM. ENTERPRISE INST. (1999).

22. Efforts to measure the potential loss of tax revenue are difficult because of dynamic response. For a discussion for this treatment in the United States, see Austan Goolsbee & John Zittrain, *Evaluating the Costs and Benefits of Taxing Internet Commerce*, NAT'L TAX J. 413, 413-28 (1999) (calculating a loss over the next few years of less than two percent of sales tax revenues). For a discussion of the full range of countries around the world, see Susan Teltscher, *Revenue Implications of Electronic Commerce: Issues of Interest to Developing Countries*, UNCTAD, Apr. 2000 (reporting a loss of tax revenues of less than one percent overall,

to know how much they need to pay and to whom. Thus far, most analyses of the relationship between electronic commerce and taxes have focused on how to implement existing regimes given the changing environment.[23] Electronic commerce and the Internet, however, are challenging current tax regimes that depend on knowing the "what, who, where, and how" of transactions.

Various domestic and international groups have been discussing how to apply tax law to electronic commerce transactions.[24] The areas of greatest challenge are sales and value-added taxes, particularly when the tax treatment of goods and services differs. An additional challenge concerns how electronic commerce activities might be treated under the rules of permanent establishment and with respect to the "character" of income earned.[25] UCITA spans both of these tax issues because it could classify many transactions as services and treat revenue from some transactions as lease or royalty income. Yet, these challenges are not limited to the treatment of domestic transactions, but can extend to transactions that cross international borders where tax treatment may be different. Inconsistencies have already surfaced in the tax treatment of transactions between the United States and the EU, as well as between the individual member states of the EU.

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although the figure is higher for some countries).

23. *See generally* INT'L TAX REV., Sept. 1999 (reviewing how the following countries and regions are addressing interpreting existing tax law for electronic commerce: Australia and New Zealand, Canada, Germany, India, Ireland, Israel, Japan, Latin America, the Netherlands, Singapore, South Africa, United Kingdom).

24. *See generally Draft Contents of the 2002 update to the Model Tax Convention*, OECD (Oct. 2, 2000), *available at* http://www.oecd.org/pdf/m00018000/M00018559.pdf. (providing an overview of the OECD Model Tax Convention). Since 1997, the OECD, in conjunction with non-member governments and private sector groups representing business and tax accountants, has been analyzing how electronic commerce might impact international and domestic taxes. As a result of that effort, the "Tax Framework Conditions" were adopted, reaffirming five key principles that guide governments in the application of taxes within the overall regime: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility.

25. *See* The OECD Model Tax Convention, *available at* http://www1.oecd.org//daf/fa/treaties/treaty.htm (last visited Feb. 3, 2002) (providing overview of model agreement). Many countries have used this blueprint as a framework for bilateral tax treaties. It apportions tax responsibility and revenue to avoid the double taxation of income earned through foreign investment. *See generally* http://www.oecd.org//daf/fa/material/mat_07. htm#material_Model (visited Mar. 19, 2001) (providing the most recent information on the articles of the model convention).

When the Congress passed the Internet Tax Freedom Act in 1998, keeping domestic Internet transactions free from any "new" taxes for three years without revoking existing sales or use taxes, it mandated a review of the implications of electronic commerce for domestic sales taxes. A majority of members of the designated reviewing body, the Gilmore Commission (Commission) opined that digital products downloaded over the Internet, including software, books, or music, should not be taxed and that, in the interests of tax neutrality, their tangible equivalents would also be tax exempt.[26] Since services provided to the final consumer are often not taxed in the United States, this strategy would classify digital products as services and "harmonize down" the tax treatment of their tangible equivalent.

The Commission's opinion has implications for taxing authority and tax jurisdiction. Indeed, one objective of the Commission's proposal was to encourage states and localities to harmonize their own rates and reduce the myriad of state and local taxes totaling over 30,000. Both are administratively cumbersome and encourage tax strategizing behavior.[27] The Commission did not address the implications at the international level because it did not have the mandate to consider cross-border issues.

The EU applies a value-added-tax (VAT) to both goods and services. Nonetheless, the issues of how to classify transactions and the challenge of cross-border jurisdiction remain. In contrast to the United States, EU classifies all electronic transmissions, including "soft goods,"[28] as services. As services, they should be taxed at the appropriate VAT rate rather than being harmonized down to a low rate.[29] Recognizing the cross-border nature of Internet activity, the

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26. The Commission could not formally recommend a plan of action to Congress because the Commission could not reach the required super majority view.

27. The National Governors Association is examining how to simplify their sales and use taxes in an effort to apply computer technologies to tax administration. *See* Raymond C. Scheppach, Statement on Streamlined Sales Tax project Vote (Dec. 22, 2000), *at* http://www.nga.org/nga/newsRoom/1,1169,C_PRESS_RELEASE^D_1067,00.html.

28. Soft goods include software, books, music.

29. For an overview of the treatment of electronic commerce transactions, see http://europa.eu.int/scadplus/leg/en/lvb/l31041.htm (last visited Feb. 20, 2002). While the EU ruling would seem to simplify and increase certainty in the tax environment, there are too many different rules for taxing services that govern applicable location and rates. This attempt at the simplicity is an illusion.

EU has proposed that businesses both within and outside the EU apply, collect, and remit VAT taxes on those products purchased or downloaded from the Internet by non VAT-registered entities, typically individuals.[30] The EU believes that non-EU firms should establish their tax identity within an EU locality in order to determine the appropriate tax rate when selling products from business to business even if the firm had no other economic reason to establish this presence.[31] This extraterritorial application of tax authority is another example of the jurisdictional challenges posed by electronic commerce.

As if the issues for indirect taxation did not pose enough difficulties, electronic commerce, specifically treatment proposed by UCITA presents even more challenges to direct taxation. The key issues in this area are international apportionment of and the "character" of income earned on these transactions. UCITA does not address the first issue and only partially addresses the second in a domestic context.

The first of these issues is international apportionment of business income. There are two different ways to account for business income earned in a cross-border setting, that which is source based and that which is residence based. [32] Source and residence based taxation schemes working together create double-taxation of some income. Bilateral and multilateral tax treaties attempt to allocate income earned to the source and to the residence according to "permanent establishment" and give tax credits to minimize double-taxation.

It is difficult to define permanent establishment for electronic commerce transactions.[33] Physical presence is much less important in

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30. *See* Edmund L. Andrews, *Europe Plans to Collect Tax on Some Internet Transactions*, N.Y. TIMES, Mar. 2, 2000, at C4.

31. Document of the EU commission regarding electronic commerce and indirect taxation, *available at* http://www.europa.eu.int/scadplus/leg/en/lvb/l31041.htm (last visited May 26, 2002).

32. As a general statement, income earned by U.S. firms and individuals is taxed at U.S. rates regardless of where the income was earned. This taxation is an example of a "residence" based taxation system. Other countries, particularly developing countries, tax income earned by non-resident firms operating in the country. This approach is an example of a "source" based taxation system. *See* Ned Maguire, *Taxation of E-commerce: An Overview*, INT'L TAX REV., Sept. 1999, at 3-12.

33. The definition of a permanent establishment rests on two foundations: (1) fixed place of business or physical presence; and (2) dependent agents who conclude contracts on behalf of

value creation for information-rich and network-based productions. Moreover, the mobility of information-based firms further undermines physical presence and questions the characterization of dependent agents. Finally, the complexity of Internet marketplaces, for example, the virtual auctions and the business to business exchanges, challenges the notion that the organization has one "head" which could help define either permanent establishment or dependent agent. Consequently, the challenge in allocation of income to different governmental jurisdictions will be increasing as will the threat of double taxation and the inherent incentives for non-compliance.

The second issue is the character of income. By classifying some contracts for information services as leases of intellectual property, UCITA allows some of the business income to be classified as royalty income. Different countries, however, classify the character of income earned inconsistently. In fact, the income earned from sales and income earned from licenses or royalties might be taxed at different rates within the same jurisdiction.[34]

In conclusion, the higher information content of bundles created in the global Internet marketplace highlights the disparities in tax administration and jurisdiction. This disparity creates incentives for tax avoidance. UCITA's effort to clarify contracts makes domestic and cross-border tax issues less clear.

## V. BALANCING E-COMMERCE RIGHTS: PERSONAL INFORMATION, INTELLECTUAL PROPERTY, AND INNOVATION[35]

With the benefits of electronic commerce come the challenges of how to protect intellectual property, manage personal information, and promote innovation. The opportunities for global electronic commerce that information technologies create increases the value of

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the corporation as a normal course of business.

34. In March 2000, the OECD Technical Advisory Group (TAG), which included OECD member governments, non-member governments, as well as business advisory groups, tabled for discussion on a document examining this aspect. *See* Technical Advisory Group on Treaty Characterization of Issues Arising from Electronic Commerce, *available at* http://www.oecd.org//daf/fa/treaties/tcecommpay.htm (last visited Mar. 19, 2001).

35. *See* MANN, *supra* note 5, at 103-42.

intellectual property and information. This increase in value is true whether it be end user information, such as databases, or the software that enables the transactions, such as business method software. These same technologies make it more difficult to protect the same intellectual property. Additionally, there is a dynamic balance among innovators and society: intellectual property protection that favors the incumbent can limit next-stage innovation to the detriment of society.

A question is whether there is a role for policy intervention to balance several rights: the rights of those who create intellectual property versus those who use it, the rights of individuals to protect their personal information against those who want to use it to create new products and services, and the rights of incumbents versus future innovators. Policymakers from different bodies may not weight the various parties equally and may choose different approaches to intervention. While balancing these rights is difficult, further difficulty is created because different governments and their citizens view their role in the balancing act differently. The UCITA controversy represents a microcosm of these issues from the perspective of the United States.

### *A. Personal Information*

Data collection on the Internet is a large business. Electronic commerce "cookies" track, collect, and compile personal information, allowing the creation and combination of data banks of personal preferences. Consumers and businesses are increasingly concerned about the collection, accuracy, and use of this information. A tension exists between the collectors of information (firms as information aggregators) and the providers of information (individual business or consumers). This tension represents the "spillover" problem presented earlier.

Industry aggregators value the collection of information highly because they can sell the aggregate to businesses who want to produce better tailored products. These firms want to collect information from everyone and tend to ignore the entreaties of individual users who want less collection of personal or unique data. Concerned individual consumers and businesses face an undesirable choice. They can either use the Internet and be fearful that the

personal information collected online will be used inappropriately or refrain from using the Internet and lose the information and exchange benefits of this new medium. There is a vast spectrum of businesses, consumers, and information. This diversity means that the proper balance between users and providers of information is multidimensional.

Policymakers can take two approaches in attempting to achieve the proper balance of rights and ensure that the spillover inherent in the collection of information is internalized by the information aggregators. They can either mandate a comprehensive approach for how information aggregators treat data or, they can focus on creating incentives for innovative effort so that aggregators can broaden the range of choices regarding whether and how data are collected, compiled, and cross-referenced.

The different approaches of the EU and the United States exemplify these alternatives. The EU approach mandates omnibus data protection legislation governing the collection, use, and dissemination of personal information. Meanwhile, the United States has encouraged a more market driven approach to innovation and self-regulation.[36] It is uncertain which approach better balances the rights of aggregators of personal information with individual rights.

The economic, second-best theory indicates that the market and mandate solutions cannot be ranked with regard to their potential for achieving the highest levels of economic success for a *country* as a whole. While neither case meets all *individual* demands, there is a difference between the market and the mandate approach to policy intervention. Under the market approach, firms face incentives to attempt to satisfy individuals' privacy demands, particularly if those demands are effectively communicated to the aggregators and are supported by government enforcement. The incentives come partly from the very network benefits that are being lost if the privacy policy is insufficient and users defect. In contrast, under the mandate

36. In addition, there is specific legislation to protect certain data, such as financial information, and information about children, and to restrict certain practices such as unauthorized use of IDs and passwords. Similar legislation on medical data is pending. Omnibus privacy legislation is being considered in U.S. Congress in 2001 under several different guises, but even if passed, the legislation probably would not be as explicit as that outlined in the EU Privacy Directive.

approach, the private sector has fewer incentives to innovate to resolve market imperfections because there are common rules for all to follow. As well, the enforcement issues remain. In such a technologically dynamic environment, retaining the incentive for private sector response is crucial.

Beyond the conflict of these alternatives within the domestic marketplace, is the issue of overlapping of government jurisdictions. The cross-border implications of alternative approaches to data privacy make it important to find an interoperable policy approach. Consider, for example, the effort that culminated in the so-called "safe-harbor" agreement signed on March 14, 2000 between the United States and the EU.

United States and EU trade negotiators recognized the differences in their approaches to balancing the rights of individuals and information aggregators. If the EU were to embargo U.S. firms from cross-border data flows, the economic effect on U.S. firms would be substantial. But European consumers would also be hurt because fewer products could be tailored to their needs. Under the agreement, U.S. firms receiving personal data from the EU must subscribe to self-regulatory organizations such as BBB*Online*, register online at the U.S. Department of Commerce, and face legal action from the Federal Trade Commission if they do not adhere to the rules.[37]

This compromise is criticized by a number of groups and organizations. Some consumer groups argue that it lessens protections Europeans are guaranteed by their law. Other consumer and industry groups reject it for importing EU privacy laws into the United States. The National Business Coalition for E-Commerce and Privacy raises questions of national sovereignty and characterizes the agreement as a form of a non-tariff barrier. Countries not party to the safe-harbor agreement speculate what will happen to their firms if they do not meet the standards of the EU Privacy Directive. They are concerned if they can enter the U.S. safe-harbor and if they even want to enter. UCITA addresses none of these issues, despite the fact that it deals directly with information and information services.

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37. For more details, see U.S. Dept. of Commerce, Safe Harbor Overview, *at* http://www.export.gov/safeharbor/sh_overview.html (last visited Feb. 3, 2002).

### *B. Intellectual Property*

As a general statement, the architects of intellectual property law are faced with weighing the need to protect intellectual property that is expensive to produce but easy to replicate, against the desire to promote competition and further innovation that builds on existing knowledge.[38]

Accordingly, any analysis of intellectual property issues must proceed along several fronts at once. First, to balance the rights of innovators and users at a single point in time, intellectual property law needs to protect the materials created and transmitted over the Internet, as well as the delivery mechanics that allow transmission. Second, to balance the rights of incumbents against the objectives of promoting innovation, intellectual property law must address the *scope* and *time duration* of protection. Finally, because the Internet and innovation know no borders, intellectual property lawmakers must foster international cooperation. Given these demands on intellectual property law, it is no surprise that UCITA's efforts to codify into contract law the balance between creators and users of intellectual property has created controversy.

The Internet and electronic commerce change the nature of the balance between users and creators of information. Information is an increasingly important component of the product bundle. Information, by itself, can be used without being depleted. Aggregate information, such as, databases, has value beyond the individual datapoints. At the same time, digital delivery of perfect copies is possible, and indeed, desirable. For example, software in the context of an application service provider or a database of medical knowledge underpinning an expert system must be accurate. This view of intellectual property law and electronic commerce suggests that the enormous potential of electronic commerce cannot be realized without assurances that a seller's intellectual property will not be misappropriated, and that buyers will receive authentic

38. *See* MANN, *supra* note 5, at 117-20 (serving as original source); *see also* KEITH MASKUS, INTELLECTUAL PROPERTY RIGHTS IN THE GLOBAL ECONOMY (2000) (providing comprehensive analysis of the economics of intellectual property, and empirical analysis and policy discussion).

products.

On the other hand, open standards and protocols, along with ease of entry have been key to the exceedingly rapid development of the Internet and electronic commerce thus far. Network effects mean that information and intellectual property have increasing value when more people have access to, use, and augment the Internet. Intellection property protection that limits the ability of firms to create interoperable software will constrain the value of the whole network and act to bar new firms and participants. For example, if Linux software writers were forced to copyright their product, the growth of an operating system that might soon challenge Windows would be limited. Or, consider how suits against Napster music format and exchange could limit the ability of new artists to break into the marketplace of incumbent music groups. This kind of intellectual property protection could not only slow the growth of electronic commerce generally, but could also exacerbate the divide between early adopters and later entrants.

In intellectual property, the issue for transmitted materials is probably one of the more clear-cut because new technologies make it relatively easy to circumvent controls and to widely distribute illegal copies. Accordingly, this issue was the first addressed by national and international bodies. In December 1996, under the auspices of the WIPO, several nations negotiated the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty creating the underpinnings for strong intellectual property protection on the Internet.[39] Unfortunately, key elements for implementing these agreements were not addressed. Those elements include third-party liability, application of the "fair use" doctrine, and limitation of devices to defeat copyright protection. In these three areas, the pace of technological change is forcing signatories to determine how to adjudicate protections within the realm of intellectual property itself, and moreover, how to balance intellectual property protection with other policymaking mandates, such as consumer protection.

Fundamental questions concerning patent rights for software need

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39. *See* Electronic Commerce and Intellectual Property Issues (Mar. 7, 2001), *at* http://ecommerce.wipo.int/primer/index.html (addressing main issues of electronic commerce).

to be addressed.[40] Recent court decisions, congressional legislation, and new policies by both the U.S. Patent Office and European patent convention have collectively expanded subject matter eligibility.[41] As a result, business-method software has become the fastest growing category for new patents being granted. There is the potential for a proliferation of patents covering basic electronic commerce software, not unlike Amazon.com's One-Click feature and Priceline.com's reverse auction method. These patents could undercut innovation in Internet business methods to the detriment of the development of the Internet and later-stage adopters.

Business-method patents also expose the jurisdictional tensions between national approaches and commitments under international agreements regarding the duration of protection. Specifically, international patent protection extends twenty years and allows reverse engineering of software; neither element makes sense for business-method software. First, reverse engineering allows new entrants to build on and augment existing platforms, which in turn can yield the tailored approaches that benefit classes of users. It also furthers network benefits by ensuring the interoperability on which those benefits depend. Such reverse engineering, however, scuttles the very protection granted to the developer of the business-method software. Second, while nearly everyone agrees that a twenty year grant is too long for patents covering business-method software, that standard was negotiated in the international forum. Individual countries have little incentive to change their domestic laws and certainly no ability to change the statutory life of patents agreed to in international jurisdictions.[42]

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40. For a legal perspective on these issues, see Bradley K. Groff, *Patent Protection for Business Methods: E-Commerce and Beyond*, GA. B.J. (Feb. 2000), *available at* http://www.gabar.org/pdf/ghj/feb00.pdf.

41. The relevant court decision was *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368 (Fed. Cir. 1998). The relevant legislation is the American Inventors Protection Act of 1999, Pub. L. 106-113, § 1000(a)(9) (1999). The European patent convention is expected to effectively legitimize patenting of business-method software. For more discussion, see *Patent Wars*, ECONOMIST, Apr. 18, 2000, at 75-78; Katherine Horvath, *Patents Protect Your Business Methods*, *available at* www.frojac.com/pubs/Patents_Protect_Business_Methods.html (last visited Mar. 7, 2001); Lisa I. Fried, *Can Feds Keep Up With E-Patents?* N.Y. L.J., Mar. 24, 2000.

42. *See* Brenda Sandburg, *PTO Ups the Ante*, RECORDER (Mar. 29, 2000), *at* http://www.lawnewsnetwork.com/practice/iplaw/A20062-2000Mar29.html.

In the midst of these multinational and multidimensional forces and issues, UCITA sets out to codify in contract law a new balance of rights. UCITA affects creators, users, incumbents, future innovators, privacies, consumer protection, federal law, and international agreements. On its face, one state contract law cannot take sufficient account of these many factors.

## VI. CONCLUSION: BALANCING RIGHTS AND OVERLAPPING JURISDICTIONS

Trade and tax, personal information and intellectual property, innovation, and competition are all areas where potential conflicts lurk between the individual and the aggregate, the global economic marketplace and the domestic policy jurisdiction, current producers, and future societal gains. UCITA is silent on how to resolve most of these conflicts.

Policymakers already have influence, they should also pose objectives. In this fast-paced technologically dynamic environment, they must avoid predetermining approaches or codifying exclusionary rules. It is important to create incentives for the private sector to help manage both the differences between individual and society as well as the problems of cross-border jurisdictional overlap. Because the private sector reaps rewards from both network benefits niche markets, it will seek interoperable approaches to solve the problems of spillovers and jurisdictional overlap. Interoperable policies allow national policies to reflect differences in national attitudes, yet also allow the network benefits of the global marketplace to shine through. Imposing rules and mandates risks locking in sub-optimal solutions. Instead, policymakers should pose objectives and backstop them with enforcement. This approach will help to create the right incentives for firms to respond to this challenge and thus work toward a solution instead of working to evade the national constraints.

In addition to cross-border jurisdictional overlap, policies within a country must be more carefully integrated with an eye toward consistency in the face of the forces of electronic commerce. One example is, the decision of how to classify international trade transactions which impacts the policy choices on tax regimes. The

issue of whether to mandate a particular approach to personal data can affect intellectual property protection and future innovation. One issue, even within solely the national context, will have implications for the policy set available to policymakers for other issues.

In sum, electronic commerce is bringing to the forefront issues of how to balance individual and aggregate uses of information with domestic and cross-border responsibilities. Unfortunately, UCITA is a narrowly conceived law that skirts these important economic, political, and social issues.