LOOKING A GIFT HORSE IN THE MOUTH: AN ANALYSIS OF FREE INTERNET STOCK OFFERINGS

Joel Michael Schwarz[*]

Cite as: Joel Michael Schwarz, *Looking a Gift Horse in the Mouth: An Analysis of Free Internet Stock Offerings*, 6 MICH. TELECOMM. TECH. L. REV. 89 (2000)
available at <http://www.mttlr.org/volsix/Schwarz.html>

* Special Counsel for Internet Matters, Investor Protection & Securities Bureau, State of New York, Attorney General's Office. As a prosecutor for the Attorney General's Office, he has had extensive experience investigating and prosecuting Internet securities fraud, including illegal securities touting and a sweep of pyramid scheme sales over the Internet. Mr. Schwarz was also one of the primary authors of the New York State Attorney General's report on the online brokerage industry, entitled "Wall Street to Web Street," issued November 22, 1999, and serves on NASAA's Internet Enforcement Project Group. Finally, Mr. Schwarz successfully prosecuted and secured the first decision in the country holding that Internet gambling violates state and federal law, in State of New York v. World Interactive Gaming Corp., No. 98-404428, 1999 WL 591995 (N.Y. Sup. Ct. July 22, 1999).

Any opinions and/or observations expressed herein as furnished by the author are his alone, and are not to be construed in any fashion, either directly or indirectly, as the formal or informal opinions of the New York State Attorney General's Office or the New York State Attorney General, who will not be bound thereby.

The author would gratefully like to acknowledge the contributions of his Research Assistants Eleanor A. Heard and Joshua Bauchner. The author would also like to acknowledge the help of William H. Mohr and Susan L. Ross.

Both MTTLR and the author have copies of relevant web pages on file, as noted below. Many of these websites still exist, but the information about the share distribution programs has been removed. In such cases, the URL is not listed, but the name of the website is.

INTRODUCTION

How much should an investor pay for one share of stock in Yahoo? Or a share of stock in America Online? As publicly traded companies, one need only consult the stock charts in any local newspaper to determine the value the market has placed on these shares. Despite what many Internet sector analysts have professed to be astronomically high valuations, these publicly traded companies possess easily verifiable valuations determined by the free market forces that constitute the building blocks of our economy, and safeguarded by the oversight of federal regulators such as the Securities & Exchange Commission ("SEC"). But what about shares of stock in a small non-public start-up Internet company called "FreeStockOverTheInternet.com," the ownership of which is evidenced solely by cyber-shares? How much should someone pay for a share in that company? And how does one value a share of FreeStockOverTheInternet.com?

Since the premiere of Travelzoo.com's ("Travelzoo") offer to distribute ten shares of company stock to each individual registering on its website and providing personal information,[1] numerous start-up Internet companies have implemented similar programs (hereinafter referred to

1. Travelzoo.com Corp. (visited Aug. 29, 2000) <http://www.travelzoo.com/pin.asp>.

as "share distribution programs") as a means of publicizing their companies and luring web-traffic. At first blush, this arrangement would appear to be a "win-win deal between mass viewers and the Internet ventures."[2] As "FreeIPO.com," an Internet company seeking to establish itself as a clearing house for free stock offers and technology support explained it, "[t]he concept is to give away a portion of your company to the millions of net surfers in exchange for the publicity . . ."[3]

But is this stock really free? Are these companies actually offering shares of stock, or merely the prospect of receiving shares of stock at some indeterminate date in the future? When must these offers comply with the registration requirements of the Securities Act of 1933 ("the Act" or "the 1933 Act")? And what other statutes should companies operating these programs take into consideration?

This Article begins, in Part I, with an analysis of various Internet-based share distribution programs, including share distributions through referrals, share distributions through contests or sweepstakes, and programs for the distribution of contingent interests in shares of stock. Part II of this Article examines the value of the personal information provided by individuals when registering for shares of stock in light of the increasing use of this information for marketing, advertising and resale to third party information brokers. Part III begins with a review of pre-Internet case law pertaining to the use of corporate spin-offs as a means of distributing free shares of stock. It then analyzes the response by the SEC to a number of companies that sought permission to distribute (and in some cases did in fact distribute) shares of stock in exchange for the provision of personal information. Finally, Part IV analyzes other laws that companies should consider before offering these Internet-based share distribution programs, and concludes that, based upon the value attributed to personal information, certain share distribution programs could violate state pyramid and gambling laws.

I. REVIEW OF VARIOUS FREE INTERNET STOCK OFFERS

Capitalizing on the "Internet IPO frenzy"[4] to own stock in anything that ends in a "dot com," many companies have emulated Travelzoo's share distribution program. In fact, since the advent of Travelzoo's program, numerous variations on this program have proliferated on the

2. FreeIPO.com (visited Aug. 30, 2000) <http://www.freeipo.com>.

3. FreeIPO.com, *Why Free IPO?* (visited Aug. 30, 2000) <http://www.freeipo.com/why.html>.

4. *See* FreeIPO.com, *Frequently Asked Questions* (visited Aug. 30, 2000) <www.freeipo.com/how.html>.

Internet. In addition to the traditional share distribution programs, some Internet start-ups have offered sweepstakes where lucky winners can win shares of stock, while others have offered to distribute "reservations" for prospective shares of stock if and when the company goes public. One start-up company has even begun offering shares of stock through what it terms a unique program for which it claims to have filed a patent.

A. *Plain Vanilla Share Distribution Programs*

WebWorksMarketing.com, Inc. ("WebWorks") began its program on January 24, 1999, offering website registrants shares of stock as a means of marketing its long-distance telephone service. Pursuant to WebWorks' program, individuals could earn: (1) three shares of stock by registering on the WebWorks website and providing personal information; (2) an additional share of stock, up to a maximum of ten additional shares, for each new member referred to the WebWorks website; (3) twenty-five shares of stock in return for subscribing to the long-distance telephone service offered by Telco Communications Group, Inc. ("Telco"); and (4) an additional twenty-five shares of stock in return for remaining a customer of Telco for six months.[5] Approximately four months after implementing its program, WebWorks claimed to have issued 1,000,000 shares of stock to registered visitors worth, according to what the company referred to as a "complex equation," $38.40 a share once the company goes public.[6]

On March 21, 1999, Internet auction firm WowAuction.com, Inc. ("WowAuction") began offering its own share distribution program through which individuals could receive three shares of stock in exchange for registering on its website.[7] WowAuction also offered an additional share of stock, up to seven additional shares of stock, in return for each referral that listed the newly registered member as a reference when registering.[8] Finally, WowAuction offered registered members the chance to be one of five winners of 10,000 shares of WowAuction stock in a drawing to be held at some future date. According to WowAuction's website, the share distribution program was supposed to last until September 15, 1999, or until WowAuction distributed a total of 500,000 shares of stock.[9] Although WowAuction did not provide a valuation for its stock, which according to its website was supposed to go public during the third quarter of 1999, it did offer potential valuations by way of

5. *See* WebWorksMarketing.com, Inc., on file with MTTLR.
6. *Id.*
7. *See* WowAuction.com, Inc., on file with MTTLR.
8. *Id.*
9. *Id.*

comparisons to the purchase prices of various real-world auction houses, including the purchase of City Auction by Ticketmaster for approximately $54 million.[10]

YouNetwork Corp. ("YouNetwork") holds the distinction of being one of the first start-up Internet companies to file a registration statement for its share distribution program with the SEC.[11] According to its registration statement, YouNetwork intends to operate a "Consumer Network" shopping website, through which consumers will be able to link to various retailers and make purchases.[12] In order to promote traffic to its website and encourage individuals to make purchases, YouNetwork proposes to give away 1,000,000 shares of Class A stock to visitors who register with its website, and 1,000,000 shares of Class B stock to individuals who earn rebates accumulated by making purchases through its Consumer Network.[13]

B. *Share Distribution Programs with a Twist*

As a variation on the traditional share distribution program, ExitNorth.com, Inc. ("ExitNorth") offered to distribute 10,000 shares of stock, through a contest, to each of ten "lucky winners."[14] In order to enroll in this contest, ExitNorth required website visitors to provide personal information during the registration process. ExitNorth also offered registered members the opportunity to increase their chances of winning by referring other individuals to register for the contest.[15] According to its website, ExitNorth was apparently engaged in the business of selling long-distance telephone service for Uni-Tel Global Communications.[16]

C. *Contingent Share Distribution Programs*

Instead of distributing actual shares of stock, some Internet companies offer visitors the opportunity to register for contingent shares of stock that are to be distributed upon the occurrence of some future event. For example, PopularLink.com ("Popular Link"), a shopping portal for car enthusiasts, game players, and sword, gun and knife collectors, offers individuals the opportunity to register on its website to receive either

10. *Id.*

11. *See* YouNetwork Corp., SEC Registration Statement SB-2 (filed Feb. 5, 1999) <http://www.sec.gov/Archives/edgar/data/1078306/0000950136-99-000152.txt>.

12. *Id.*

13. *Id.*

14. *See* ExitNorth.com, Inc. (visited Aug. 30, 2000) <http://www.exitnorth.com>; contest pages on file with MTTLR.

15. *Id.*

16. *Id*.

reservation numbers for 5 shares of stock, or a $25 cash bonus.[17] Popular Link also offers reservation numbers for additional shares of stock to registered members who refer others to the website.[18] According to an explanation provided by Popular Link on its website, reservation numbers "will be paid or converted to actual issued stock numbers after Popular Link successfully file[s] with the SEC for [an] IPO (initial public offering)."[19]

Similarly, Himmel Technology, LLC operates a website called Tradehall.com ("Tradehall"), which is designed to function as a "global trading network" through which people can place items up for auction and others can bid on those items.[20] Akin to Popular Link's program, instead of offering actual shares of stock to individuals who register on its website, Tradehall "*contemplat[es]* rewarding its registered members with equity shares in the company free of charge *if and when it becomes a public entity*."[21] Additionally, Tradehall professes to be "considering" distributing an extra one-half share of stock to each registered member who refers someone to the Tradehall website.[22]

In yet another variation on the original theme, Lifestyle Travel Concepts ("Lifestyle") asks visitors to register for "25 stock options" that it will issue "upon the commencement of our IPO," as well as for a free weekly online travel magazine.[23] Although the actual exercise price of the stock options are "as of yet undetermined . . . the range should be between $0.40 and $1.00 per option" depending "on the overall value of the initial offering and the number of shares authorized."[24] Visitors can also earn "an additional 25 stock options whenever any qualified person registers for our Free Stock Offer" and lists the newly registered member as a referral.[25]

Among one of the more interesting stock distribution programs is an Internet portal website called MyGo.com ("MyGo"). MyGo offers individuals the opportunity to register for shares of stock in the company, and to win up to 1000 additional shares of stock by qualifying as one of the top 300 members to refer people to the MyGo website.[26] What makes

17. *See* PopularLink.com (visited Aug. 30, 2000) <http://www1.freeipo.com/popularlink/step1.html> (now offering only $25 bonus after successful IPO); older offer on file with MTTLR.
18. *Id.*
19. *Id.*
20. *See* Tradehall.com, on file with MTTLR.
21. *Id.* (emphasis added).
22. *Id.*
23. LifestyleTravel.net, on file with MTTLR.
24. *Id.*
25. *Id.*
26. *See* MyGo.com, on file with MTTLR.

this offer so interesting is that at the time MyGo began offering these shares of stock in its company, it was not even an incorporated entity, although it did profess on its website to have plans to "complete this process shortly after all free shares have been given away."[27] In fact, by a notice posted on its website dated July 10, 1999, MyGo claimed to have distributed free shares of stock in the company to 20,000 individuals, although it still remained unincorporated as of September 13, 1999.[28]

D. *Another "Unique" Twist On the Traditional Share Distribution Program*

In what it characterizes as an entirely "unique" method for distributing shares of stock, a personal portal website operated by MyOwnEmpire, Inc. ("MyOwnEmpire") offers to distribute a single share of stock to each visitor that registers on its website *and* who then makes MyOwnEmpire's website her start page and visits the site at least ten days out of every 30 days for a 90 day period.[29] A user can also earn up to an additional four shares of stock by referring other people to the MyOwnEmpire website.[30] In an apparent attempt to avoid having its share distribution program classified as a sale under the 1933 Act, MyOwnEmpire tries to remove the emphasis of the program on the registration process by conditioning the stock distribution on a member's utilization of its website.[31] According to its website, MyOwnEmpire claims to be operating the program "pursuant to an exemption provided by rule 504 of regulation D as promulgated by the SEC under federal law, and also pursuant to California Corporation Code Section 25113(b)(I)."[32]

II. WHAT VALUE DO THESE SHARE DISTRIBUTION PROGRAMS PROVIDE TO INTERNET COMPANIES?

A. *Is There Value in the Personal Information Provided by Website Visitors?*

A poll conducted in early 1999 of Chief Technology Officers from some of the top technology firms around the country revealed that over

27. *Id.*
28. *Id.*
29. *See* MyOwnEmpire, Inc., on file with MTTLR.
30. *Id.*
31. *Id.* MyOwnEmpire believes its method of share distributions to be so unusual that it has apparently filed for a patent on its consumer-owner business model.
32. *Id.*

60% of those surveyed believed that the personal information collected from Internet consumers was "critical to their business success."[33] In essence, this poll confirmed that the personal information collected from individuals has become a valuable commodity to both the businesses that host these websites, as well as to third party marketers that purchase this information.

Utilizing basic supply and demand principles, the value of this information is best illustrated by the amount of money that companies are willing to pay to acquire it. For example, after filing for bankruptcy, Toysmart.com, Inc. ("Toysmart") received a number of bids for one of its most valuable assets, its database of customers' personal information, including a bid of $50,000 from the Walt Disney Company, the majority owner of Toysmart.[34] "The average return for a dollar spent on direct-mail advertising is ten dollars, more than twice the return when compared with television commercials."[35] Electronic marketing could potentially be even more lucrative. "According to one estimate, direct-marketing-generated electronic commerce could rise to $30 billion by 2002."[36]

In addition to utilizing this information for marketing purposes, many companies also sell this personal information to other companies, securing additional revenues from the very same information. "Indeed, with profit margins of up to sixty percent, some companies reportedly earn more from selling customer lists than from selling their own goods or services."[37] In recognition of this fact, a number of companies in 1999 began offering free computers to consumers in exchange for their personal information, including demographic information and information about their shopping habits.[38] Some companies have allegedly even pursued merger agreements with other companies because of the lists of information they possess.[39]

With the advent of technology-driven business models that now have the ability to link disparate pieces of information into detailed

33. *CIO Magazine Poll Shows CTOs Grapple with Double Standard on Internet Privacy Regulations*, PR NEWSWIRE, Mar. 31, 1999.

34. *Judge Shelves Plan for Sale of Online Customer Database*, N.Y. TIMES, Aug. 18, 2000, at C2.

35. Jeff Sovern, *Opting In, Opting Out, Or No Options At All: The Fight For Control of Personal Information*, 74 WASH. L. REV. 1033, 1051 (1999).

36. *Id.* at 1047.

37. *Id.* at 1045.

38. *See* Kim Komando, *Personal Information a Hot Item These Days*, FRESNO BEE, Oct. 4, 1999, at C2.

39. *See* Sovern, *supra* note 35, at 1046.

"dossiers," the value of this information has continued to rise.[40] One commentator, John Hagel III, co-author of *Net Worth*, has surmised, "[t]he most valuable economic asset of these Internet businesses is the profiles—the ability to capture information about the customer and use it for economic purposes. The profile is really the core business assumption."[41] Even some governments have recognized the value of personal information, having turned to selling this information as a means of boosting revenues. For example, "Illinois raises $10 million annually from the sale of public records," while "New York takes in more than $49 million by selling information on motorists . . . ."[42] In fact, the U.S. Postal Service even sells its listing of 108 million permanent change-of-address cards to direct marketers.[43]

Although the potential uses of personal information have continued to increase, "it is becoming easier and less expensive to obtain access to it."[44] Nonetheless, the mere fact that the per unit cost of acquiring the information has dropped does not in any way detract from its value to the companies. The multiple marketing and advertising opportunities created by the information clearly demonstrate value to the company in possession of the information.[45]

As a result of this value, many businesses have gone to great lengths to acquire and utilize the information to their competitive advantage, sometimes at the peril of violating federal or state law. For example, in February 1999, the Federal Trade Commission ("FTC") sanctioned GeoCities for selling valuable personal information collected from its members, despite its posted privacy policy that promised to keep this information confidential.[46] Similarly, in November 1999, Real Networks found itself the subject of irate consumer sentiment and class-action lawsuits when consumers discovered that the company had been assigning identification numbers to its software that it could then utilize to track the listening habits of its Real Jukebox users and compile detailed information profiles of those users.[47]

---

40. *See* Erica S. Koster, *Zero Privacy: Personal Data on the Internet*, 16 No. 5 COMPUTER LAW. 7, 10 (1999).

41. Kenneth Neil Cukier, *Is There a Privacy Time Bomb*, RED HERRING, Sept. 1999, at 38.

42. Koster, *supra* note 40, at 8–9.

43. *Id* at 9.

44. *See* Sovern, *supra* note 35, at 1037.

45. *See infra*, text accompanying notes 84–94.

46. *See GeoCities*, Docket No. C-3849 (Feb. 12, 1999) (Final Decision and Order available at http://www.ftc.gov/os/1999/9902/9823015d&o.htm).

47. *See* Paul Gilster, *Real Networks' Real Big Mistake*, NEWS & OBSERVER (Raleigh, NC) Nov. 22, 1999, at D4 (noting that as a result of the company's activities, at least two class-action lawsuits had already been filed: one in Pennsylvania and one in California).

In the hopes of curtailing improper collection and use of consumers' personal information without legislative intervention, many industry groups have called for industry self-regulation.[48] Likewise, certain governmental agencies have also expressed a preference for self-regulation over legislation. Throughout 1999, the FTC repeatedly urged the Internet community to police its use of personal information, having conducted numerous audits of various websites to determine the level of compliance with what it deemed acceptable privacy practices.[49] In July 1999, the FTC released a Report to Congress on the progress of industry self-regulation.[50] As the FTC recognized, two of the more notable industry responses were: (1) the proliferation of privacy organizations such as Truste (www.truste.com) and the BBBonline (www.BBBonline.com), both of which review websites and provide seals of approval to sites that comply with their privacy standards; and (2) the adoption of policing and complaint resolution requirements.[51] Yet even these website privacy certification organizations have not escaped criticism. For example, despite Real Networks' having been caught red-handed inappropriately collecting and utilizing consumers' personal information, Truste relied upon a technicality in order to refuse to revoke the seal of approval it had previously bestowed upon Real Networks, thereby raising accusations of bias and self-interest.[52]

Less than a year after the FTC concluded that legislative intervention was unwarranted, however, the FTC reversed its position. In its Report to Congress on May 22, 2000, the FTC, recognizing that the lure of unlocking the value intrinsic in this personal information was too great for some companies to resist, recommended that Congress enact legislation "to empower the FTC to pass rules *requiring* websites to give notice of their information practices, to allow individuals to control how their data is used, to allow individuals to access and correct their data

48. *See, e.g.*, *On the Web You Have No Secrets*, PC WORLD, July 1, 1999, at 22 (The Online Privacy Alliance, a group composed of more than 80 businesses, was launched in July 1998 to promote self-regulation as a solution to privacy concerns); Cukier, *supra* note 41, at 39 ("As a result of pressure from consumers and privacy advocates, the World Wide Web Consortium, a standards forum, has issued a draft specification called Platform for Privacy Preferences, or P3P.").

49. *See Self-Regulation and Privacy Online, Before the Subcomm. on Telecomm., Trade, and Consumer Protection of the House Comm. on Commerce*, 106th Cong. (1999) (Statement of Robert Pitofsky, Chairman, FTC).

50. *Id.*

51. *Id.* at 9–12.

52. *See* Gilster, *supra* note 47. Specifically, Truste avoided revoking Real Networks' seal by alleging that Real Networks had not violated Truste's policies because the "data wasn't being collected on a Web site." *Id.*

and to require security measures."[53] Even with the FTC's reversal, however, there remains a lack of consensus on how best to deal with the increasing value placed upon personal information by corporate America. For example, even after the FTC's Report, Secretary of Commerce William Daley reiterated the Clinton Administration's position that new legislation with regard to privacy was unnecessary.[54] It is still unclear whether the self-regulatory or legislative models will ultimately become the restraining force behind the use of personal information.[55]

Concurrent with E-commerce's attempt at self-regulation, a number of bills aimed at protecting personal information and regulating its collection, maintenance and use have already been introduced in Congress. In 1999, the 106th Congress saw the introduction of numerous bills designed to protect valuable personal information, including the Consumer Internet Privacy Protection Act of 1999 (H.R. 313), which "would regulate the use by ISPs of their subscriber's personal data"; the Children's Privacy Protection and Parental Empowerment Act of 1999 (H.R. 369), which would "prohibit the sale of personal information about children under the age of sixteen without their consent"; and the Financial Information Privacy Act of 1999 (H.R. 30), which "would regulate the sharing and sale of personally identifiable sensitive financial information by financial institutions."[56] Even the Executive Office, while maintaining its call for self-regulation, has expressed concern over the temptation to collect, maintain and use this valuable personal information, leading to the Clinton administration's "appoint[ment of] Ohio State University law professor Peter Swire as its Chief Counselor for Privacy" and the hosting of a major conference on Internet policy guidelines at the White House in June 1999.[57]

In fact, the value of this personal information has become so integral to the continued success of numerous businesses, that businesses have actually begun to view this personal information not merely as intangible electronic bytes of data, but rather as a valuable asset—a piece of

53. *FTC Seeks Authority To Regulate Online Privacy*, TECH LAW JOURNAL, May 23, 2000 <http://www.techlawjournal.com/privacy/20000523.htm> (emphasis added) (two of the five FTC Commissioners dissented).

54. *Id.*

55. Some believe that self-regulation is inevitable because the ever-increasing value of this personal information will create an incentive for many companies to "husband the data like a trade secret rather than disseminate it to the highest bidder." *See* Cukier, *supra* note 41.

56. *See* Koster, *supra* note 40, at 11. All three bills were still in committee as of August 2000.

57. *Id.*; s*ee also Internet Commerce Said to be in Danger*, TIMES-PICAYUNE, June 20, 1999, at A13.

property for which they have begun to seek legal protection.[58] The case of *U.S. West, Inc. v. F.C.C.*, decided by the Tenth U.S. Circuit Court of Appeals, is instructive in this regard.[59]

The dispute in *U.S. West* centered around regulations that the Federal Communications Commission ("F.C.C.") promulgated in order to implement the Telecommunication Act of 1996.[60] Specifically, these F.C.C. regulations required "telecommunications companies, in most instances, to obtain affirmative approval from a customer before the company [used] that customer's CPNI [customer proprietary network information] for marketing purposes."[61] Customer proprietary network information is statutorily defined as "(A) information that relates to the quantity, technical configuration, type, destination, and amount of a telecommunications service subscribed to by any customer . . . and (B) information contained in the bills pertaining to a telephone exchange service or telephone tool service received by a customer . . ."[62] In essence, CPNI consists not so much of the data explicitly supplied by customers, but rather of "highly personal data . . . gathered only as a by-product of subscribing to their services—without the subscribers' explicit permission."[63]

In arguing against the restrictions placed upon the use of CPNI, a coalition of telecommunication providers led by U.S. West asserted that these restrictions violated their First Amendment right to commercial free speech.[64] U.S. West also asserted that the CPNI information represented "valuable property" that belonged to the carriers.[65] As such, U.S. West argued that the F.C.C.'s prohibition on the use of this information "greatly diminish[ed] its value" and actually rose to the level of a "taking" in violation of the Fifth Amendment.[66]

---

58. *See* Komando, *supra* note 38 ("Individual consumer information is a hot commodity these days . . . ."); Cukier, *supra* note 41 ("The value of personal information is uncontested. Many Net companies are discovering that the most potentially lucrative asset in their business model isn't the products they sell but the data they collect about their visitors . . . Personal information is becoming so lucrative that it is creating a seller's market . . . ."); *see also* John Davidson, *Your PC is Having a Clandestine Affair*, AUSTL. FIN. REV., Nov. 4, 1999, at 39 ("In this information-based shopping revolution, information privacy becomes your most precious, precarious asset, your bargaining chip.").

59. U.S. West, Inc. v. FCC, 182 F.3d 1224 (10th Cir. 1999), *cert. denied sub nom.*, Competition Policy Inst. v. U.S. West, Inc., 120 S. Ct. 2215 (2000).

60. *Id.* at 1228–29.

61. *Id.* at 1228.

62. 47 U.S.C. § 222(F)(1) (Supp. II 1996).

63. Denise Caruso, *Consumers' Desire For Information Privacy Ignored*, N.Y. TIMES, Aug. 30, 1999, at C5.

64. *See U.S. West*, 182 F.3d at 1230.

65. *Id.*

66. *Id.*

As the *New York Times* reported:

> . . . [i]n a 2-1 ruling published on August 18 [1999], which has obvious implications for the data-hungry Internet economy, the 10th U.S. Circuit Court of Appeals said that rules protecting consumers from having information like the numbers they call and the services they subscribe to used without their permission interfered with the phone companies' First Amendment rights to free speech.[67]

Because the court found the F.C.C. regulations to be violative of the First Amendment, it never addressed the Fifth Amendment challenge. Nonetheless, U.S. West's Fifth Amendment challenge illustrates the fact that corporate America has begun to acknowledge the value of this personal consumer information as an asset, and has elevated the status of this information to that of legally cognizable property for which it has asked the courts to provide constitutional protection.

More recently, Toysmart's attempted sale of its personal information database in order to pay off its creditors demonstrated the value of this information.

> Toysmart, which has sold toys and educational merchandise via its Web site since January 1999, announced on May 22, 2000, that it had ceased operations and retained the services of a management consultant to find one or more buyers who would be interested in acquiring the company's assets. Those assets included its database containing personal information about customers.[68]

Subsequent to Toysmart's announcement, its creditors filed a petition for involuntary Chapter 11 bankruptcy.[69] "Facing bankruptcy . . . the online toy retailer said it was going to sell its *most valuable asset*—customers' names, addresses and order histories."[70] As an illustration of the value of this personal information, in July 2000, Toysmart rejected two offers to purchase this personal information, "including one of

67. *See* Caruso, *supra* note 63.

68. *Privacy: Federal Trade Comm'n v. Toysmart.com—FTC Files First Enforcement Action Under New Child Privacy Law*, COMPUTER AND ONLINE INDUSTRY LITIG. REP., Aug. 1, 2000, at 9–10.

69. *Id.*

70. Keith Perine, *Who Are the Privacy Police?*, THE STANDARD, Aug. 7, 2000 <http://www.thestandard.com/article/display/0,1151,17324,00.html> (emphasis added).

$50,000 from a unit of the Walt Disney Company, the majority owner of Toysmart.com."[71]

Toysmart's attempt to capitalize on the value of this personal information has had reverberations across the United States and Europe. In July 2000, as a direct result of Toysmart's attempted sale of customer information, Senators Patrick Leahy and Robert Torricelli introduced what has been dubbed "The Privacy Policy Enforcement in Bankruptcy Act of 2000," which would bar the sale of personally identifiable information by bankrupt businesses.[72] As Samuel Gerdano, Executive Director at the American Bankruptcy Institute aptly pointed out, "dot-coms . . . don't have patents, or a factory. They have a name and *a list*. That's about all they've got going for them."[73] Even England, alarmed by the potential abuses of this valuable information, has been drafting legislation to deal with the sale of personal information databases by bankrupt companies.[74]

Despite the Toysmart case, the sale of personal information continues to flourish. Capitalizing on the growing popularity of Internet auction sites, a company called Market Logistics Group made numerous attempts in early August 2000 to sell "a mailing list with the names, addresses and phone numbers of more than 200,000 active U.S. investors, before being shut down by eBay and Yahoo."[75] While federal and state regulators continue to struggle with methods for protecting consumers' personal information from inappropriate use and disclosure, the continuing attempts by companies to sell this personal information only strengthens the premise that this personal information possesses significant intrinsic value.

---

71. *Judge Shelves Plan for Sale of Online Customer Database*, *supra* note 34 ("Other bankrupt dot-com companies have [also] sold their customer data, though Craftshop.com, an arts and crafts retailer, also withdrew its list from sale last month [July 2000].").

72. Brian Krebs, *Lawmakers Intro Privacy Bill in Wake of Toysmart Scandal*, NEWSBYTES, July 12, 2000 <http://www.newsbytes.com/pubNews/00/152015.html> (noting that Representatives William Delahunt and Spencer Bachus also introduced a bill in the House which "would give the Federal Trade Commission (FTC) the express right to investigate and bring actions against websites that violate their own privacy policies.").

73. Doug Brown, *White House Studies Bankruptcy Privacy*, INTERACTIVE WEEK, Aug. 7, 2000 <http://www.zdnet.com/intweek/stories/news/0,4164,2612068,00.html> (emphasis added).

74. *Regulator to Draft Database Sale Guidelines*, FINANCIAL TIMES, July 18, 2000, at 8.

75. Stefanie Olson, *eBay, Yahoo Nix Auctions of Personal Data*, CNET, Aug. 7, 2000 <http://news.cnet.com/news/0-1007-200-2457350.html>.

B. *What Other Value Is Created For Companies Through These Share Distribution Programs?*

In addition to the intrinsic value of the personal information itself, share distribution programs also provide other types of value to the offering companies. As one start-up Internet company disclosed in its registration statement with the SEC, "the principal competitive factors" that a start-up Internet company may contend with are: "number of members; . . . quality of merchandise and retailers; . . . brand recognition; member loyalty; . . . [and] broad demographic focus . . . ."[76] Businesses can use share distribution programs to satisfy each of these goals.

The goals of increasing website membership and promoting member loyalty are facilitated through share distribution programs because "equity ownership in [a] company will help establish [the company] as a preferred destination among web users" and will help "to rapidly attract a sizeable membership base."[77] As BonusBoulevard, Inc. ("Bonus Blvd."), a New York based start-up Internet company explained, "[t]he purpose of the [share distribution] offering is not to raise capital directly but to create interest in, traffic to, and purchasing through, our online shopping mall."[78] Additionally, YouNetwork explains that these share distribution programs can also further the goal of enhancing brand recognition in start-up Internet companies.[79]

The competitive goals of increasing the quality and variety of the retailers associated with a website are also dependent, at least in part, on expanding the membership base because the more prestigious Internet retailers will generally want to be associated with the more popular, higher-traffic websites.[80] As MyOwnEmpire explains on its website, "Internet companies are after one thing, your eyeballs, and we must admit we are no different (except we cut you in 'big time' on the deal)."[81] The maintenance of relationships with a large number of retailers,

---

76. BonusBoulevard, Inc., SEC Registration Statement SB-2/A (filed Sept. 3, 1999) <http://www.sec.gov/Archives/edgar/data/1089471/0000950117-99-001884-index.html> at 13.

77. YouNetwork Corp., SEC Registration Statement SB-2/A (filed July 13, 1999) <http://www.sec.gov/Archives/edgar/data/1078306/0000950136-99-000955-index.html> at 18.

78. BonusBoulevard, *supra* note 76, at 21.

79. *See* YouNetwork, *supra* note 11, at 32.

80. *Id.* at 13.

81. *See* MyOwnEmpire, *supra* note 29, "About My Own Empire—Share Value" webpage, at 3; s*ee also* Cukier, *supra* note 41 ("According to a 1998 study of online retailing by the Boston Consulting Group and Shop.org, an association of online merchants, 65 percent of revenues derived from e-commerce sites is re-invested in marketing and advertising—a bid to grab eyeballs.").

known in the industry as "affiliate relationships," also provides a direct monetary benefit to many of these start-up Internet companies[82] because they can earn commissions on purchases made by customers for whom they are responsible for referring, or linking, to the websites of these retailers.[83]

As discussed above, one of the greatest potential uses of the personal information collected through these share distribution programs is for marketing and advertising. Although some start-up Internet companies require nothing more than the provision of a visitor's name, street address, and electronic mail ("E-mail") address, even this basic information can provide a number of valuable benefits to these companies.[84]

First, this registration information provides a list of active E-mail addresses to which a company can E-mail information and marketing offers for a small fraction of what it would ordinarily cost to market these people by mail.[85] "The information typically collected allows businesses the chance to increase the effectiveness of their direct marketing campaigns, which may translate into higher sales."[86]

Second, some of the more specialized websites gain an additional benefit from registering members, in that special interest members are prime advertising targets for companies engaged in the sale of specialty products. For example, as Popular Link asserts on its website, "PopularLink.com is a site for mature and 'cool' people. If you are in any way offended by our products, do not apply for free shares."[87] Accordingly, it is reasonable to conclude that at least a percentage of the visitors who register on Popular Link's website are interested in swords, guns, knives and other similar collectibles, thus making those registered members prime candidates for direct marketing by companies selling those types of products. Similarly, it is reasonable to conclude that

82. As described in Bonus Blvd.'s SB-2/A filing:

> [a]ffiliate relationships . . . involve a form of marketing based on revenue sharing between a retailer and other web site owners known as affiliates. When an affiliate relationship is established, the affiliate's web site is linked electronically to the web site of a retailer. When prospective customers visit the affiliate's web site, they may chose to be linked to, and then may make a purchase at, the retailer's web site. The retailer then pays a commission, which ordinarily equals a percentage of the amount of the purchases made.

See supra note 76, at 24–25.

83. *Id.* at 30; *see also* YouNetwork, *supra* note 77, at 19.

84. *See* Lifestyle, *supra* note 23; Popular Link, *supra* note 17.

85. *See* YouNetwork, *supra* note 77, at 24; *see also* Sovern, *supra* note 35, at 1045.

86. YouNetwork, *supra* note 77, at 24.

87. Popular Link, *supra* note 17.

individuals who take the time to visit and register for free shares on Lifestyle's website are interested in travel and tourism opportunities.

The value of the personal information is even greater when the company is able to collect detailed information about the registered visitors in addition to the basic registration information such as name and E-mail address.[88] For example, in order to register for shares of stock in ExitNorth, visitors must provide not only their name, street address and E-mail address, but also information about their calling patterns and the long-distance fees that they incur.[89] The ability to target and directly market the sale of long-distance telephone services is becoming an increasingly valuable commodity in the highly competitive world of long-distance phone carriers.[90]

Similarly, MyOwnEmpire's collection of information about a user's sex and birth date, along with the optional information that it collects about a user's income, occupation, and level of education, helps to create a valuable and much sought after database that it can use for its own marketing programs, for attracting additional retailers and advertisers, or for reselling to third party marketers.[91] Indeed, MyOwnEmpire freely discloses the value of this information:

> MyOwnEmpire makes money from: (1) advertisements; (2) reselling great products and services just like other portals do; (3) sending you to sites that pay us a commission for listing them just like other portals do. The difference is we TELL you when we are making money off of you instead of pretending we are presenting information just to be helpful . . . The more we know about you, the more relevant ads we can show you. The more relevant ads we can show you, the more advertisers are willing to pay bigger bucks for that ad because they know there is a chance you'll actually be interested.[92]

In addition to the immediate advertising and marketing value of attracting members, there is an additional benefit to these share distribution programs that accrues over time. Specifically, as a member

88. *See, e.g.*, Sovern, *supra* note 35, at 1034–35.

89. *See* ExitNorth, *supra* note 14.

90. *See, e.g.*, *New Millennium Certain to Bring Continued Change in the Communications Arena; Expect to See Increased Competition and a Sustained Focus on Customer Issues in All Industry Segments*, BUSINESS EDITORS, Dec. 21, 1999, at 14.

91. *See* MyOwnEmpire, *supra* note 29. YouNetwork likewise collects detailed information about the people registering for free shares, including name, address, E-mail address, home and work phone numbers, company name and age group. *See* YouNetwork, *supra* note 11.

92. MyOwnEmpire, *supra* note 29.

continues to visit the website and make purchases, the company is able to collect additional information about the member's use patterns and purchases, often referred to as "byproduct information." This byproduct information helps to create an even more detailed user profile, which in turn enhances the value of the information and the ability to market to that user.[93]

The use of this byproduct information appears to be precisely what YouNetwork envisioned when it discussed its marketing plan in its SEC filing:

> [w]e expect to gather a significant base of information about our members through registration information, responses to closed end beta tests and purchasing information obtained from third parties. As members join us, and as we obtain purchasing history data, the level of information regarding our members will continue to grow. We intend to use this growing database to target offers, increase our range of product offerings, and to encourage future transactions and involvement with our website.[94]

III. SEC DETERMINATIONS REGARDING SHARE DISTRIBUTION PROGRAMS

A. *Prior Precedent—Share Distributions Through Corporate Spin-offs*

The key registration provision of the 1933 Act appears in Section 5(c):

> [i]t shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .[95]

Pursuant to Section 2(a)(3) of the Act, "[t]he term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value."[96]

---

93. *See* Komando, *supra* note 38, at C2 ("Since the greatest value in your personal data lies in how it can be used to get you to buy more stuff, the details of your shopping habits are the most valuable."); Sovern, *supra* note 35, at 1038–40; *see also U.S. West*, 182 F.3d at 1224.

94. YouNetwork, *supra* note 77, at 25.

95. Securities Act of 1933, § 5(c) (1997).

96. Securities Act of 1933, § 2(a)(3) (1997).

Although questions regarding the application of the Act's registration requirements to Internet-based share distribution programs is of relatively recent vintage, questions regarding their applicability to corporate spin-off programs date back over a quarter of a century, well before the Internet represented the consumer paradigm that it does today. The SEC first challenged the application of these registration requirements to corporate stock distributions in the Southern District of New York in 1971 in *SEC v. Harwyn Indus. Corp.*[97] As District Judge Mansfield synopsized:

> [i]n this action the Securities and Exchange Commission ("the Commission") seeks to plug up what some have treated as a loophole in the federal securities laws permitting a company, by 'spinning-off' its subsidiary's shares to the parent's stockholders without registration, to convert the subsidiary into a public corporation whose unregistered shares would be actively traded on the market.[98]

The scheme utilized by Harwyn Industries Corp. ("Harwyn") occurred in three stages. First, Harwyn, with its over-the counter stock and approximately 600 public shareholders, would incorporate various subsidiaries.[99] Harwyn would then enter negotiations with various private companies resulting in agreements wherein the Harwyn subsidiaries would acquire the assets of the private companies "in exchange for issuance of controlling interests in the subsidiaries to those contributing such assets . . ."[100] The second stage of the scheme involved "the 'spin-off' distribution by the parent, Harwyn, to its stockholders of the unregistered shares of its subsidiar[ies] . . . ."[101] The third stage of this scheme involved "the development of an over-the-counter trading market in the unregistered shares thus spun-off," the shares being quoted on the over-the counter listings, or "pink sheets," published by the National Quotations Bureau.[102] In at least two of these spin-offs, an authorized representative of Harwyn sent some type of notice to the National Quotations Board prior to the listing of these shares on the pink sheets.[103]

In reviewing the propriety of Harwyn's issuance of these spin-off shares, the court first compared Harwyn's spin-off to a conventional stock dividend: "[w]here a conventional stock dividend of its *own shares*

97. 326 F. Supp. 943 (S.D.N.Y. 1971).
98. *Id.* at 945.
99. *Id.* at 946–51.
100. *Id.* at 945.
101. *Id.*
102. *Id.* at 946.
103. *Id.* at 946, 950.

is distributed by a public company that has complied with the registration requirements of the 1933 Act, subsequent purchasers of the shares have the benefit of detailed financial information about the company making possible informed investment decisions on their part."[104] In contrast, Harwyn's distribution did not involve a conventional stock dividend, but rather, the effect of the spin-off was "to convert a Harwyn subsidiary into a publicly held company, with the shares thus distributed to outside stockholders" without the benefit of "detailed financial information about the company."[105] As the court noted, the spin-offs violated the "spirit and purpose" of the registration requirements of Section 5 of the 1933 Act, which were enacted to protect investors by promoting the full disclosure necessary to make informed investment decisions.[106]

The court then went on to analyze whether the spin-offs constituted sales under Section 5 of the 1933 Act. The court initially noted that the defendants received two distinct benefits as a result of the spin-offs. First, they avoided registration costs.[107] Second, the court noted that "although they [the Harwyn officers] could not, as insiders, publicly sell their own shares without registration, their ability to market or hypothecate their shares and to finance the subsidiary's operations could be greatly facilitated by the existence of an active trading market at definite prices."[108] As such, the court ruled that a sale of shares took place because the defendants received value as a result of the spin-offs.

In their defense, the defendants asserted that they had acted in reliance upon what had become generally perceived as a "long-standing loophole" in the 1933 Act,[109] namely that the distribution of spin-off shares by a parent corporation was deemed to be a stock dividend, not a sale, because the value received by the parent corporation as a result of the spin-off did not come directly from the share recipients.[110] In response, the court stated that there was no reason to believe "that the 'value' requiring registration must flow from the immediate parties who received the stock, in this case Harwyn's shareholders."[111] Instead, the court deemed the spin-off transactions to be "intimately" tied to the agreements between Harwyn's subsidiaries and the private companies,

104. *Id.* at 952 (emphasis added).

105. *Id.* at 952–53.

106. *Id.* at 953. In conducting its analysis, the court also noted that in the case of each spin-off, the defendants had available all of the pertinent information had they actually wanted to file a registration statement.

107. *Id.* at 952.

108. *Id.* at 952–53.

109. *Id.* at 953.

110. *Id.* at 953–54.

111. *Id.* at 954.

agreements that contemplated the infusion of new value into the subsidiaries and the eventual public trading of their shares.[112] Viewing the share distributions as part of the overall transactions, and the fact that "value" did in fact accrue to Harwyn as a result of these transactions, the court ruled that the defendants should have registered the shares under Section 5 of the 1933 Act.[113]

The SEC again challenged the distribution of unregistered stock through corporate spin-offs in the Fourth Circuit in *SEC v. Datronics Engineers, Inc*.[114] Similar to the scheme utilized in *Harwyn*:

> Datronics would enter into an agreement with the principals of a private company. The agreement provided for the organization by Datronics of a new corporation, or the utilization of one of Datronics's [sic] subsidiaries, and the merger of the private company into the new or subsidiary corporation. It stipulated that the principals of the private company would receive the majority interest in the merger-corporation. The remainder of the stock of the corporation would be delivered to, or retained by, Datronics for a nominal sum per share . . . Datronics was bound by each of the nine agreements to distribute among its shareholders the rest of the stock.[115]

Akin to the defendants in *Harwyn*, the *Datronics* defendants argued that the distribution of shares constituted "a dividend parceled out to stockholders from its portfolio of investments," and not a sale, since the distribution to shareholders was free and Datronics received no value from the shareholders in return.[116] After reviewing the Southern District of New York's ruling in *Harwyn*, the Fourth Circuit found that value had in fact accrued to the defendants because they had created a market for the stock through the distribution of the shares around the country, thereby making it easier for them to sell their stock on the open market almost immediately after they completed the spin-offs.[117] Additionally, "the stock retained by Datronics was thereby given an added increment

112. *Id.*

113. *Id.* at 954–55. Although the court found that the defendants had violated Section 5 of the 1933 Act, the court, in its discretion, refused to order equitable relief in the form of an injunction because: (a) Harwyn had acted on the advice of counsel; (b) the Commission had passed up previous opportunities to dispel the inferences which had given rise to the perceived loophole; and (c) the defendants assured the court that they would not engage in further distributions of the type in dispute. *Id.* at 955–58.

114. 490 F.2d 250 (4th Cir. 1973).

115. *Id.* at 253.

116. *Id.*

117. *Id.* at 253–54.

of value."[118] The court also noted that the company reinforced the public character of the stock by sending letters to shareholders announcing future spin-offs, fanning even greater interest in the shares.[119]

In finding that the defendants violated Section 5 of the 1933 Act, the Fourth Circuit implicitly adopted the *Harwyn* court's analysis of the entire transaction as a means of finding value in a corporate share distribution program. Indeed, in this case as in *Harwyn*, the value came from the creation of the public market for the shares of stock, not from the individual share recipients. Akin to the *Harwyn* court, the Fourth Circuit also noted that the unregistered spin-offs violated the intent of the 1933 Act's registration requirements, which was to provide protection to the investing public through adequate disclosure.[120]

More than a decade after the *Harwyn* and *Datronics* decisions, the SEC again dealt with the issue of corporate spin-offs in *In the Matter of Capital General Corp.*[121] In the *Capital General* case, the SEC issued findings and a cease and desist order regarding the activities of Capital General Corp.'s ("Capital General") President, David R. Yeaman, and Capital General's Vice-President, Krista Castleton, who together had incorporated approximately 92 subsidiary corporations over a period of 5 years.[122] Through advertisements placed in nationally circulated publications, Capital General advertised that it "had publicly-held issuers available for merger."[123] As a result of the solicitations, Capital General was able to transfer control of 36 of its subsidiaries to the promoters of private companies in exchange for monetary payments, and the retention by Yeaman and Castleton of a "substantial percentage of stock in each of the issuers."[124] Like the facts in the *Harwyn* case, once Capital General completed the mergers between the privately held companies and its subsidiaries, Capital General would list the newly issued stock on the pink sheets, or on the National Association of Securities Dealers' OTC

118. *Id.*

119. *Id.*

120. *Id.*; *see also Harwyn*, 326 F. Supp. 943, 953 (S.D.N.Y. 1971).

121. Release No. 34-32669, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,223, at 84,417 (July 23, 1993).

122. *Id.* at 84,418. Subsequent to incorporating each of these subsidiaries, Capital General would file a registration statement on Form 10, pursuant to § 12(g) of the Securities Exchange Act of 1934. Capital General, Yeaman, and a number of Capital General's subsidiaries were also the subject of a cease and desist action by the New Jersey Bureau of Securities, based upon their violation of New Jersey securities laws, having issued shares of unregistered, nonexempt common stock in the Capital General subsidiaries to approximately 24 New Jersey residents. *In the Matter of Capital General Corp.*, Order Denying Exemptions and to Cease and Desist, N.J. Dept. of Law and Public Safety, Div. of Consum. Aff., Bureau of Securities, OAL Docket No. BOS 01534-94, July 14, 1994.

123. *Capital General*, *supra* note 121, at 84,420.

124. *Id.*

Bulletin Board.[125] Altogether, Capital General "distributed 100 shares of each of at least 69 of the Capital General subsidiaries (collectively 'the Capital General issuers') to between approximately 275 to 900 persons throughout the United States, ostensibly as gifts," without filing registration statements pursuant to the 1933 Act.[126]

As the defendants asserted in the *Harwyn* case, the *Capital General* respondents argued that their corporate spin-offs did not implicate the 1933 Act's registration requirements because the persons receiving the shares of stock received them for free, and were "not called upon to make an investment judgment."[127] Relying upon the *Harwyn* and *Datronics* analysis of the "entire transaction," the SEC responded that "while the spin-off itself might not be a Securities Act distribution, 'the entire process including the redistribution in the trading market which can be anticipated and which may indeed be the principal purpose of the spin-off, can have that consequence.' "[128]

Analyzing each of the transactions in its entirety, the SEC found that: (a) Capital General and Yeaman had in fact received value by creating a public market for the securities; (b) Yeaman retained a significant portion of the shares; and (c) "that, as a public company, the issuer could [then] be sold for greater consideration."[129] The SEC also noted that there appeared to be no "independent business purpose" for the share distributions, and that the creation of subsidiaries and the subsequent distribution of their shares upon merger with privately held companies appeared to have been the primary business of Capital General and Yeaman for over 5 years.[130] Citing to the Securities Exchange Act of 1934, Release No. 4982, the SEC again noted that devices such as those used by Capital General are problematic because they contravene the "purposes and provisions" of the 1933 Act, by distributing shares without information about the issuer, thus opening the door for fraud and deceit.[131]

125. *Id.*

126. *Id.* In addition to registration violations, the SEC noted that Capital General had also made various misrepresentations and had engaged in fraudulent conduct. A detailed discussion of these fraud issues, however, is beyond the scope of this article.

127. *Id.*

128. *Id.* (quoting Exchange Act Release No. 4982 [1968–1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,725 (July 2, 1969)).

129. *Id.* at 84,424.

130. *Id*.

131. *Id.*

B. *Share Distribution Programs Transition Onto the Internet*

Moving ahead approximately 6 years post-*Capital General*, the law firm of Vanderkam & Sanders wrote to the SEC on January 15, 1999 on behalf of an Internet company they represented. The firm sought interpretive advice as to whether a program that distributes shares of stock in return for requiring the share recipients to register on a website would constitute an "offer" as defined in Section 2(a)(3) of the 1933 Act, such that it would be subject to the registration requirements of Section 5.[132] As Mr. Sanders reasoned in his letter, "[i]nasmuch as the definition of 'offer' in Section 2(3)[sic] specifically relates to transactions in securities for 'value,' it appears that if no 'value' is given for the securities there is no offer."[133] Mr. Sanders further opined that he did not believe that "the mere completion of a registration form [on a website] would satisfy the value requirement of Section 2(3) [sic]."[134]

Subsequent to the Vanderkam & Sanders letter, and prior to the SEC's response, two additional inquiry letters were sent to the SEC, from the American Brewing Company ("American Brewing")[135] and from Simplystocks.com ("Simplystocks").[136] Pursuant to a letter from American Brewing, the company sought to distribute "one free share of non-voting common stock for each case of American Brewing beer purchased at retail."[137] After collecting the requisite number of coupons, and forwarding the pertinent identification information to the company, a person would be able to redeem the coupons for a share of stock in the American Brewing Company.[138] According to American Brewing's President, no registration of the share distribution program would be necessary because there would be absolutely no cost to the redeemer.[139]

---

132. *See* Letter from Michael Sanders, Partner, Vanderkam & Sanders, to U.S. Securities and Exchange Commission (Jan. 15, 1999) (1999 WL 38281 (S.E.C.)) (hereinafter "Vanderkam & Sanders Letter").

133. *Id.*

134. *Id.*

135. *See* Letter from George Poncy, President, American Brewing Company, to U.S. Securities and Exchange Commission (Jan. 25, 1999) (1999 WL 38280 (S.E.C.)) (hereinafter "American Brewing Company Letter").

136. *See* Letter from Jay Lancy, President, Simplystocks.com, to U.S. Securities and Exchange Commission (Jan. 19, 1999) (1999 WL 51836 (S.E.C.)) (hereinafter "Simplystocks Letter").

137. *See* American Brewing Company Letter, *supra* note 135.

138. *Id.*

139. *Id.* According to the American Brewing Company Letter, the most likely way it would pass the cost on to recipients of these free shares of stock would be to raise prices, and its restraint in not raising prices could easily be verified since any price increase would by law have to be posted.

Pursuant to the proposal letter from Simplystocks, individuals would register to receive shares of stock in return for visiting the Simplystocks website and providing their name, address, social security number, phone number, E-mail address and log-in information.[140] After completing the requisite registration information, individuals would be entered into a stock pool, to which 8% of Simplystocks' shares would be distributed. An additional 2% of the shares would also be distributed to 1 individual selected from the pool, in a separate drawing.[141] Citing to previous share distribution programs, including Travelzoo's program, Simplystocks' President invited the SEC to join the company in "uncharted waters" and to set a precedent for the issuance of stock over the Internet.[142]

In response to these 3 No-Action Letter requests, and without citing to any legal precedent, the SEC stated "that the issuance of securities in consideration of a person's registration on or visit to an issuer's website would be an event of sale within the meaning of Section 2(a)(3) of the Securities Act of 1933," which would in turn violate Section 5 of the Act unless the issuance was the subject of a registration statement or a valid exemption.[143] Unfortunately, however, the SEC failed to provide guidance in its response as to how it attributed value to the act of registering with an issuer's website.

Despite the SEC's denial of these 3 No-Action Letter requests, Andrew Jones and James Rutten wrote to the SEC on April 21, 1999 seeking permission to operate a share distribution program of their own.[144] In this letter, Jones and Rutten proposed two methods for distributing shares of stock. First, a person could "use a 'mail-in' method by sending a self-addressed stamped envelope to Beta Corp. [a fictitious company created for illustration purposes], along with his or her name, address and [E]-mail address . . . Beta Corp. will then write back, issuing the shares to the person and giving the person basic information about Beta Corp . . . ."[145] The second option would require a person to visit the company's website and register, after which the person would be given

140. *See* Simplystocks Letter, *supra* note 136.

141. *Id.*

142. *Id.*

143. *See* Letter from Michael Hyatte, Special Counsel, U.S. Securities and Exchange Commission, to American Brewing Company (Jan. 27, 1999) (1999 WL 38280 (S.E.C.)); *see also* Letter from Michael Hyatte, Special Counsel, U.S. Securities and Exchange Commission, to Simplystocks.com (Feb. 4, 1999) (1999 WL 51836 (S.E.C.)).

144. *See* Letters from Andrew Jones and James Rutten to U.S. Securities and Exchange Commission (Apr. 21, 1999) (1999 WL 377873 (S.E.C.)) (hereinafter "Jones & Rutten Letters").

145. *Id.*

the shares of stock, as well as information about Beta Corp., the terms of the stock offer, and other generic information.[146] In support of their proposal, Jones & Rutten assured the SEC that the personal information provided would be used "solely for corporate purposes" and would "never be used for advertising."[147]

In a follow-up to a telephone conversation with the SEC on May 20, 1999, Jones & Rutten attempted to distinguish their share distribution program from that of Simplystocks by claiming that "none of our prospective shareholders would be required to do anything to receive shares" and that "none of our shareholders would even be required to visit an Internet website."[148] Nonetheless, the SEC denied Jones & Rutten's request, again stating that the proposed share for stock-leave distribution would constitute a sale, which would either need to be registered or fall within a valid exemption.[149]

C. *A Call to Action: The SEC's Response to Internet-Based Share Distribution Programs*

In spite of the SEC's well-publicized position that the distribution of stock in return for requiring individuals to register with a website is a sale subject to the 1933 Act's registration requirements,[150] a number of Internet companies, including WowAuction and WebWorks, proceeded with their share distribution programs without registering. On July 21, 1999, the SEC issued 4 Cease and Desist Orders ("Orders") in connection with these share distribution programs.[151]

In each of the Orders, the SEC began by reviewing the statements made by the companies on their websites in furtherance of their programs. Pursuant to the programs in *In re WebWorksMarketing.com, Inc*.

---

146. *Id*.

147. *Id.*

148. Letter from Andrew Jones and James Rutten to U.S. Securities and Exchange Commission (May 24, 1999) (1999 WL 377873 (S.E.C.)).

149. *See* Letter from Michael Hyatte, Special Counsel, U.S. Securities and Exchange Commission, to Andrew Jones and James Rutten (June 8, 1999) (1999 WL 377873 (S.E.C.)) (denying issuance of no-action letter).

150. *See, e.g.*, Mark Veverka, *Despite Yellow Flags, New Internet Portal Plans to Give Away Stock: MyOwnEmpire.com Thinks Its Offer Won't Irk SEC Regulators*, S.F. CHRON., Apr. 7, 1999, at D1.

151. *See In re* Loofbourrow, Exchange Act and Securities Act Admin. Proc. Release No. 33,7700, File No. 3-9934, 1999 WL 514038 (July 21, 1999); *In re* Sotirakis, Exchange Act and Securities Act Admin. Proc. Release No. 33,7701, File No. 3-9935, 1999 WL 514040 (July 21, 1999); *In re* WebWorksMarketing.com, Inc., Exchange Act and Securities Act Admin. Proc. Release No. 33, 7703, File No. 3-9937, 1999 WL 514083 (July 21, 1999); *In re* Wowauction.com, Inc., Exchange Act and Securities Act Admin. Proc. Release No. 33,7702, File No. 3-9936, 1999 WL 514042 (July 21, 1999).

("*WebWorks*"), *In re Loofbourrow* ("*Loofbourrow*") and *In re Wowauction.com, Inc.* ("*WowAuction*"), individuals were offered the opportunity to receive shares of stock in return for providing personal information through a registration process.[152] Individuals were also offered the opportunity to earn additional shares of stock in return for referring others to the websites.[153] Pursuant to the WowAuction program, five registered users were also offered the opportunity to win 10,000 shares of stock through a drawing that was scheduled to be held on September 15, 1999.[154] Pursuant to the WebWorks program, individuals could also earn additional shares of stock by subscribing to the long-distance service of Telco, which the company was promoting.[155]

In a minor variation on the first three programs, the program used in *In re Sotirakis* ("*Sotirakis*") offered to distribute shares of stock to individuals in exchange for both registering with a website, called Kinesis, and then linking their own websites to the Kinesis website.[156] Individuals who did not have a website to link to the Kinesis website were given a smaller number of shares for merely registering with Kinesis.[157] Individuals were also able to earn additional shares of stock by referring others who in turn linked their websites to the Kinesis website.[158] Interestingly, akin to the MyGo website discussed in Part I. C., the companies in both *Sotirakis* and *Loofbourrow* were distributing shares of stock despite the fact that neither of them had actually been incorporated in any state.[159]

After noting that Section 2(a)(3) of the 1933 Act "defines 'sale' or 'sell' to 'include every contract of sale or disposition of a security or interest in a security for value,'" the SEC answered the question first posed by Vanderkam and Sanders: how a distribution of securities in return for requiring a share recipient to register on a website would constitute a "sale" of securities, implicating the 1933 Act's registration requirements.[160] Citing to the *Capital General* and *Harwyn* cases, the SEC noted that, although these Internet companies did not receive value directly from the people to whom they distributed the shares of stock,

152. *See Loofbourrow*, 1999 WL 514038, at *2; *WebWorks*, 1999 WL 514083, at *1; *WowAuction*, 1999 WL 514042, at *1.

153. *See Loofbourrow*, 1999 WL 514038, at *2; *WebWorks*, 1999 WL 514083, at *1; *WowAuction*, 1999 WL 514042, at *1.

154. *WowAuction*, 1999 WL 514042.

155. *See WebWorks*, 1999 WL 514083.

156. *See Sotirakis*, 1999 WL 514040.

157. *Id.*

158. *Id.*

159. *See Loofbourrow*, 1999 WL 514038; *see also Sotirakis*, 1999 WL 514040.

160. *See WebWorks*, 1999 WL 514083, at *2.

the value received by these companies could nonetheless be found by looking to the entire transaction.[161] "[A] gift of stock is a 'sale' within the meaning of the Securities Act when the purpose of the 'gift' is to advance the donor's economic objectives rather than to make a gift for simple reasons of generosity."[162] The SEC then observed that in each of these cases the companies received value in the form of the creation of a market for their shares, and in some cases, generation of interest in their future planned IPOs.[163]

The SEC then went on to note that the issuance of stock through these share distribution programs over the Internet also helped to provide value unique to the Internet medium, including advertising the websites, increasing brand recognition,[164] enhancing the sales of products on their websites,[165] and attracting people interested in investing capital in these fledgling Internet companies.[166]

Having satisfied the value element of Section 2(a)(3), the SEC next cited the *American Library Ass'n v. Pataki* holding that the Internet is "an instrument of interstate commerce," in support of the Section 5 requirement that the sale or offer for sale be made utilizing a communication in interstate commerce.[167]

Finally, the SEC quickly dismissed the possibility that these share distribution programs might qualify for an exemption under Rules 505 or 506 of Regulation D.[168] The SEC likewise dismissed the possibility of applying the Rule 504 exemption to these programs.[169]

---

161. *Id.*; *see also Capital General*, Release No. 34-32669, [1993 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶ 85,223, at 84,417 (July 23, 1993); SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

162. *WebWorks*, 1999 WL 514083, at *3.

163. *Id.*

164. *See Loofbourrow*, 1999 WL 514038, at *2; *Sotirakis*, 1999 WL 514040, at *3; *WebWorks*, 1999 WL 514083, at *3.

165. *See WowAuction*, 1999 WL 514042, at *2.

166. *See Loofbourrow*, 1999 WL 514038, at *3.

167. *See WebWorks*, 1999 WL 514083, at *3 (citing American Library Ass'n v. Pataki, 969 F. Supp. 160, 173 (S.D.N.Y. 1997)). Having established that each of the free share distribution programs constituted a "sale" under securities law, the respondents in both the *WebWorks* and *Loofbourrow* cases were also cited for having violated Section 17(a) of the 1933 Act and Section 10(b) of the Securities and Exchange Act of 1934 based upon the fraudulent conduct in which they engaged in furtherance of said "sale." *WebWorks*, 1999 WL 514083, at *4; *Loofbourrow*, 1999 WL 514038, at *4.

168. *See WebWorks*, 1999 WL 514083; *see also* Regulation D, 17 C.F.R. §§ 230.501–508 (1999).

169. *See WebWorks*, 1999 WL 514083. The SEC also noted that effective April 7, 1999, Rule 504 was amended to limit the circumstances under which general solicitations for offerings not exceeding an aggregate annual amount of $1 million may be made, specifically: (1) if the offering is "registered under state law requiring public filing and delivery of a disclosure

D. *An Analysis of the SEC's Cease and Desist Orders*

Analyzing the reasoning provided in the SEC's Orders, one can easily discern how *Harwyn* and *Capital General* could be used to support a finding that these Internet-based share distribution programs constituted sales subject to the Act's registration provisions. Akin to the programs in *Harwyn*, *Capital General*, and *Datronics* (hereinafter referred to as "*Harwyn* and its progeny"), the SEC found that the companies had designed these share distribution programs to create a market for the sponsoring company's stock and to raise interest in future public offerings by these companies.[170] For example, WebWorks advised people to "[h]old on to the shares until we take our company public. At this time you will be free to sell your shares on the open market . . ."[171] The goal of creating interest in future public offerings, however, is by no means limited to the four companies targeted by the SEC. For example, in recognition of investor exuberance for IPOs, the FreeIPO.com website encourages Internet companies "to offer free shares or cash bonus[es] to *build momentum for successful initial public offering[s]* . . . In the *current Internet IPO frenzy* environment where Internet stocks are traded [for] hundreds and even thousands [of] dollars per unique viewer, FreeIPO creates a win-win deal between mass viewers and the Internet ventures."[172] Indeed, the very name "FreeIPO" speaks volumes as to the company's intent.

One can also discern the analogy between the *Harwyn* court's analysis of the "entire transaction" as a means of finding value, and the SEC's analysis of the "entire transaction" in order to find value in these Internet-based share distribution programs. In *Harwyn* and its progeny the courts considered whether the distribution of shares of stock in a spin-off corporation, without the receipt of any value from the share recipients themselves, would constitute a sale of securities such that the distribution would be subject to the 1933 Act's registration requirements.[173] In each of those cases, the courts necessarily looked to the "entire transaction" in order to find value because nothing of value was provided by the share recipients themselves.[174]

---

document to investors before sale, or (2) [if it is] exempted under state law permitting general solicitation and advertising so long as sales are only made to accredited investors." *Id.* *2–3.

170. *See* SEC v. Datronics Engineers, Inc., 490 F.2d 250 (4th Cir. 1973); SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971); *Capital General*, Release No. 34-32669, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,223, at 84,417 (July 23, 1993).

171. *WebWorks*, 1999 WL 514083, at *3.

172. FreeIPO.com, *supra* note 2 (emphasis added).

173. *See Datronics*, 490 F.2d at 250; *Harwyn*, 326 F. Supp. at 943; *Capital General*, Release No. 34-32669, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,223, at 84,417.

174. *Id*.

In each of its Orders, the SEC conducted a similar analysis of the "entire transaction" in order to find value; specifically, the SEC found each of the programs created value for the issuing company by creating a demand for its stock and interest in future public offerings by the company. Similar to the court's reasoning in *Harwyn* and its progeny, and looking solely to these two attributes of value, neither the creation of a public market nor the creation of a demand for company stock would flow directly from the share recipients themselves. As such, the SEC would necessarily have to look to the "entire transaction" in order to find value.

Such an analysis seems strained, however, because these two attributes of value were not the only value created by these share distribution programs. Unlike the share recipients in *Harwyn* and its progeny, the SEC found the share recipients in these Internet-based share distribution programs to have provided two additional attributes of value *directly to the companies*. First, these share distribution programs encouraged people to visit the company websites, thereby increasing the coveted web traffic and number of unique hits. As the SEC's Director of Enforcement Richard Walker noted, such a program is a "useful mechanism for attracting traffic to a Web site and that has real value . . . [i]t enhances the product and raises credibility . . ."[175] Second, these programs required individuals to provide personal information to the companies during the registration process, information that the companies could use to conduct direct marketing, to attract additional advertising to their websites, and to sell to third party information brokers.[176]

In light of these very significant differences, it seems unnecessary for the SEC to take a broader view of the "entire transaction" in order to find value because the share recipients in these cases clearly provided something of value directly to the companies in return for the shares. Thus, it is difficult to understand why the SEC would limit its findings to *Harwyn* and its progeny, when the facts underlying these four Orders presented much more cogent reasons for finding the value that would qualify the programs as sales subject to the Act's registration requirements.

In essence, although the SEC acknowledged the value of the personal information, it did not appear to integrate this value into its decision making process, except as almost an afterthought, choosing instead to focus on the more settled "creation of a public market" as the primary value metric. As a result, there are still a number of unresolved

175. Edward Wyatt, *S.E.C. Settles Four Cases Offering 'Free Stock,'* N.Y. TIMES, July 23, 1999, at D2.

176. *See supra* Part II.

questions regarding the use of these Internet-based share distribution programs in the future. For example, would the provision of only a name during the registration process, with nothing else, constitute value under § 2(a)(3)? Would the company offering shares of stock have to register if it agreed not to sell or disclose the information, and not to use the information for marketing or targeted advertising of its own, or by others? Would it alter the analysis of value if the company did not accept advertising on its website?

Even before the SEC issued these Orders, there was already confusion as to how a company should view the personal information provided by individuals while registering for these share distribution programs. For example, even after the SEC thrice refused to issue No-Action Letters, the May 24, 1999 letter from Jones & Rutten evidenced their failure to appreciate what the SEC believed was the value imparted during the registration process: "[w]e believe that our proposed offering is fundamentally different from other proposed offerings on which the Division has commented because none of our prospective shareholders would be required to do anything to receive shares . . . Indeed, none of our shareholders would even be required to visit an Internet website."[177] It seems clear from this letter that the authors did not grasp the value inherent in the registration information itself, which, whether furnished online or through the mail, still qualifies as value provided by the share recipients.

Although the SEC did not place its primary focus on the unique value of personal information provided through Internet-based share distribution programs, the SEC clearly recognized the special value of this information in the cyber-world. As important as registration may be in a real-world offering, it takes on even greater significance in the context of an Internet offering because of the unique questions that can arise through ownership of securities held, not in certificate form, but rather as cyber-shares, and as a result of the facilitation of the offering through an impersonal, and at times anonymous, medium like the Internet. Additionally, because of the increasing value attributed to this information in the cyber-world, companies should apprise share registrants of how their personal information is used, and what they are receiving in return for parting with this highly valuable information.

Disclosure through registration would also go a long way toward answering some of the questions raised by Representative Edward J. Markey to SEC Chairman Arthur Levitt in a letter regarding these free stock offers over the Internet:

177. Jones & Rutten Letters, *supra* note 144.

> [d]o the shareholders have common or preferred stock? Are the shareholders owners of the company, and what is their relationship to any other shareholders (i.e. insider shareholders)? Will the shareholders receive annual reports? Do the shareholders have voting rights? Can the shareholders replace management or demand seats on the company's board? Can they file shareholder resolutions at an annual shareholder meeting?[178]

The SEC has already demonstrated a sensitivity to the need for better disclosures in conjunction with securities offerings over the Internet. Although not designed specifically in response to these share distribution programs, the SEC enacted changes to the Rule 504 exemption from the 1933 Act's registration requirements in 1999 in order to ensure that proper disclosure is given to potential investors, many of whom are more commonly being solicited via the Internet. The 504 exemption of Regulation D "provides an exemption from Securities Act registration for securities offerings of non-reporting companies that do not exceed an aggregate annual amount of $1 million."[179] Although Regulation D generally exempts these offerings from federal securities registration requirements, issuers must nonetheless register in each state in which they make an offering, unless a state exemption is available.[180]

In 1992, when the SEC first enacted Regulation D, it placed substantial reliance on the individual states' securities laws "because the size and local nature of these small offerings did not appear to warrant imposing extensive federal regulation."[181] Where once these small 504 exempted offerings were generally confined to a small local area within a given state, these offerings are now being made available on a nationwide basis with relative ease, due at least in part to the technological innovations provided by the Internet.[182] Nationwide 504 exempted offerings are also being utilized more frequently in fraudulent offerings by micro-cap companies.[183]

Due to concern that companies were using the 504 exemption to issue securities on a nationwide basis in states without registration or prospectus delivery requirements,[184] facilitated in part through the boundless reach of the Internet, the SEC amended Rule 504. Under the

178. *Markey Asks SEC to Answer Questions Regarding 'Free Stock Offerings on Internet,'* 31 Sec. Reg. & L. Rep (BNA) 423 (Apr. 2, 1999).

179. Revision of Rule 504 of Regulation D, Securities Act Release No. 7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114 at 81,769 (Feb. 25, 1999).

180. *Id*. at 81,770.

181. *Id.* at 81,771.

182. *Id*.

183. *Id.*

184. *Id*.

amended Rule 504, issuers must register the transaction "under a state law requiring public filing *and delivery of a disclosure document before sale*."[185] For a sale to occur in a state without this sort of provision, the issuer must register the transaction in another state with such a provision, and *must deliver* a disclosure document filed in that state *to all purchasers before sale in both states may occur*.[186] In light of the value of the personal information provided during the website registration process, the SEC's concern about adequate disclosure would appear to be equally applicable to Internet-based share distribution programs. In 504 exempted offerings, as well as Internet-based share distribution programs, compliance with the 1933 Act's registration requirements is consistent with one of the Act's primary concerns, namely to protect investors by ensuring that they have adequate information to make logical and fully informed investment decisions.

E. *Internet-Based Share Distribution Programs Revisited*

1. Share Distributions in Exchange for Registration or Referrals

Utilizing the reasoning set forth in the SEC's July 21, 1999 Orders as guidance, we can now revisit the share distribution programs discussed in Part I.

First, it would appear that any program that promises to distribute shares of stock in return for the provision of personal information constitutes a sale under Section 2(a)(3) of the 1933 Act, and must comply with the Act's registration requirements.[187] As such, YouNetwork properly registered its share distribution program wherein it offered to distribute 1,000,000 shares of Class A stock to individuals who registered on its website.

YouNetwork's rebate program, whereby YouNetwork converts rebate points, earned through product purchases, into Class B common stock, would also appear to be a sale that would require registration under the 1933 Act. By way of analogy, in the *WebWorks* case the company offered to distribute shares of stock to individuals in return for both subscribing to the Telco long-distance phone service, as well as for

185. *Id.* at 81,774 (emphasis added). The other option for securing a 504 exemption under amended Rule 504 would require issuance of securities under a state law that permits general solicitations so long as sales are *only* made to "accredited investors," as defined in Regulation D. *Id.*

186. *Id.*

187. It is important to note that YouNetwork did in fact register to issue its free shares. *See* YouNetwork, *supra* note 11.

remaining a subscriber for a pre-specified period of months.[188] Citing Section 2(a)(3) of the 1933 Act, the SEC noted that "'[a]ny security given or delivered with, or as a bonus on account of, any purchase of . . . any other things, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value.'"[189] Similarly, YouNetwork's distribution of rebates in return for purchasing products, rebates which YouNetwork will convert to Class B common stock, could likewise be deemed a distribution of securities as a bonus for making a purchase. As the SEC held in its *WebWorks* Order, such a program would constitute a sale that would fall within the ambit of the 1933 Act's registration requirements.

2. Contingent Share Distribution Programs

With regard to the Internet sites that offer various contingent interests in shares of stock, the SEC's value analysis is likewise instructive.

Altogether, there were four websites discussed above that offered registrants some type of contingent interest in the soliciting companies. Popular Link solicits personal information, but cautions registrants that "[a]ll shares and cash bonus numbers are *reservation numbers*, and will be paid or converted to actual issued stock numbers after Popular Link successfully files with [the] SEC for [an] IPO (initial public offering)."[190]

Similarly, Lifestyle discloses on its website that "we are allowing you to register for our weekly Travel e-zine on this site and receive 50 free shares of stock *upon the commencement of an IPO*. You will be notified by E-mail on how to receive the actual shares of stock."[191] Lifestyle's free share offer is somewhat confusing, however, because while the foregoing statement appears to offer individuals 50 *free* shares of stock in return for registering with the website, a footnote on the Lifestyle website appears instead to refer to this plan as providing up to 50 options on shares.[192] Moreover, according to this footnote, these options would not be free, but would instead be exercisable at some future date, in return for money: "[t]he exercise price for the stock options is as of yet undetermined, however, the range should be between $0.40 and $1.00 per option."[193] Regardless of which plan Lifestyle actually offers,

188. *See WebWorks*, 1999 WL 514083, at *3.

189. *Id*.

190. Popular Link, *supra* note 17 (emphasis added).

191. Lifestyle, *supra* note 23 (emphasis added).

192. *Id.* at n.3. Also confusing is the notation in the footnote that Lifestyle is distributing these shares not merely for registering with the website, but for recruiting others to join the program. It is therefore unclear how a registrant actually receives these shares of stock, and what the registrant is receiving.

193. *Id.*

for purposes of this discussion of contingent share distribution programs we will presume that the program involves either the provision of shares of stock, contingent on the company holding an IPO, or the provision of stock options that will vest if and when the company goes public.

In a slight variation on the first two programs, Himmel Technology's Tradehall website discloses that "it is *contemplating* rewarding its registered members with equity shares in the company free of charge *if and when* it becomes a public entity."[194] Finally, MyGo offers what it terms 4 free shares of stock to individuals who sign up on its website, and an additional 1000 free shares of stock to each of the top 300 members who refer new members to its website.[195] Further down on the web page, however, MyGo discloses that it is not actually an incorporated entity, so that, although individuals are allegedly given free shares of stock upon registering with the website, people apparently need to wait until MyGo completes the incorporation process in order to gain their "ownership interest" in the stock.[196] Thus, MyGo appears to offer contingent shares of stock in its company, contingent upon it becoming incorporated.

Although the exact description of the interests distributed through each of these programs varies, each involves the distribution of something less than an actual share of stock. The question then becomes whether these share distribution programs are subject to the 1933 Act's registration requirements, because each company appears to sell, at best, only a contingent interest in their securities in return for the provision of personal information.

In *Rubin v. U.S.*,[197] the United States Supreme Court analyzed the application of Section 2(a)(3) of the 1933 Act to a securities transaction that involved the "disposition" of a security, although not the actual sale of the security. Specifically, *Rubin* involved the appeal of a corporate vice-president indicted on three counts of violating, and conspiracy to violate, various federal anti-fraud statutes, including Section 17(a) of the 1933 Act, which prohibits the use of fraud in the offer or sale of securities.[198] One of the primary questions raised on appeal was whether the pledge of stock as collateral for a loan constituted an "offer or sale" of that stock, such that the Act's anti-fraud provisions applied, when the stock itself was represented as good, marketable and unrestricted, but

194. Tradehall, *supra* note 20 (emphasis added).
195. *See* MyGo, *supra* note 26.
196. *Id.*
197. 449 U.S. 424 (1981).
198. *Id*. at 425–27.

was in fact restricted, nonmarketable and practically worthless.[199] In order to answer this question, the Court necessarily analyzed Section 2(a)(3) of the Act and concluded that "a pledge of shares of stock unmistakably involves a 'disposition of [an] interest in a security, for value.' Although pledges transfer less than absolute title, the interest thus transferred nonetheless is an 'interest in a security.'"[200] Further clarifying its position, the Court went on to note that "[i]t is not essential under the terms of the Act that full title pass to a transferee for the transaction to be an 'offer' or a 'sale.'" [201] The Court also observed that "[t]reating pledges as included among 'offers' and 'sales' comports with the purpose of the Act," which is to promote the disclosure of information and to prevent fraud.[202] Expanding upon this theory, the Court also observed that:

> [t]he economic considerations and realities present when a lender parts with value and accepts securities as collateral security for a loan are similar in [an] important respect to the risk an investor undertakes when purchasing shares. Both are *relying* on the value of the securities themselves, . . . regardless of whether the transferor passes full title or only a conditional and defeasible interest . . . .[203]

Although no temporal propinquity exists between *Rubin* and these Internet-based share distribution programs, this test for reliance easily extends to contingent share distribution programs, because they each involve the provision of valuable personal information by the website registrant in reliance upon the potential worth of the shares of stock being distributed.[204] Indeed, the companies themselves go to great lengths on their websites to tout the potential value of their stock and to play off of the "Internet IPO Frenzy."[205] Even if a company promises a website registrant only a conditional receipt of shares, such as a reservation number for the receipt of shares if and when the company goes public,

199. *Id*. at 428.
200. *Id*. at 429.
201. *Id*. at 430.
202. *Id.* at 431.
203. *Id.* (emphasis added).
204. *See supra* Part II for a detailed discussion of the "value" of this personal information.
205. *See*, *e.g.*, WebWorks, *supra* note 5 ("Assuming you received the full 63 shares, the total net asset value of your shares (on paper), will be approximately $2,419.20 in theory"); WowAuction, *supra* note 7 ("In related [I]nternet auction news, City Auction was acquired by Ticketmaster in late February for . . . approx. $54 million. . . Moreover, eNet recently bought Auctiongate for $5.8 million . . . And at the market close on March 8, 1999, eBay's total stock worth was over $20 billion!!").

that person can be said to have parted with value in expectation of, and reliance upon, the value touted by the company.

At the very least, these contingent share distribution programs engender the "disposition of a security." Like *Rubin*, the disposition is complete at the time the buyer (in this case the registering member) provides the personal information, and the seller (in this case the Internet company) provides the buyer with reservation numbers, or some other means of evidencing the potential shares of stock.[206] The risk that the contingent interest may never result in the actual provision of the shares, if for example the company does not hold an IPO, does not alter the fact that a disposition has occurred, thus invoking the registration and disclosure provisions of the 1933 Act.[207]

In *Abrams v. Oppenheimer Gov't Sec., Inc*., the Seventh Circuit likewise examined the types of contingent securities transactions that might fall within the 1933 Act's definition of an offer or sale of securities. [208] Specifically, the Seventh Circuit considered whether entry into a Government National Mortgage Association ("GNMA") forward contract constitutes the purchase and sale of the underlying GNMA security, such that the transaction would be subject to the anti-fraud provisions of the 1933 Act, even though the GNMA forward contract itself is not a security as defined by the Act.[209] Plaintiff Abrams entered the forward contract in dispute on February 6, 1981, with the settlement date set for May 20, 1981. Despite the fact that plaintiff made an initial "good faith" deposit on the contract of $19,200, defendant Oppenheimer made a request for an additional deposit from plaintiff in April 1981, allegedly to cover a decrease in the market value of the underlying GNMA securities.[210] Plaintiff refused to pay this money, alleging that the contract's settlement date was set for May 20, 1981, and further alleging that the defendant had made material misrepresentations during the sale of the contract.[211] As a result of plaintiff's refusal to pay the deposit, defendant sold plaintiff's contract at the prevailing market price, and returned only

206. *See, e.g., Rubin*, 449 U.S. at 429–30.

207. *See* Yoder v. Orthomolecular Nutrition Inst., Inc., 751 F.2d 555, 559, n.4. (2nd Cir. 1985) ("We perceive no reason why a contingency attached to a contractual right to acquire stock should remove that right from securities law coverage simply because it increases the risk that plaintiff will not obtain the shares.").

208. 737 F.2d 582 (7th Cir. 1984).

209. *Id.* at 583.

210. *Id*. at 584.

211. *Id*.

$1,700 of the initial good faith deposit to plaintiff.[212] Plaintiff thereafter commenced an action to recover the remaining $17,500 of his deposit.[213]

In order to consider the allegations of fraud, the court first assessed whether the sale of a forward contact constitutes the sale of a security as defined by the 1933 Act. To answer this question, the court first looked to the Act's definition of the term sale, which includes "every contract of *sale or disposition of a security* or interest in a security, for value."[214] The court then went on to note that "[i]t is well established that a *contract to purchase and sell* securities *constitutes a purchase or sale* of the securities for the purpose of the securities laws."[215] In analyzing the GNMA forward contract, the court held that neither the delay in the actual delivery of the securities, *nor the fact that the contract pertained to "when issued" securities that had not yet been issued*, would "deny the existence of the contract for the purchase and sale of the securities."[216] In support of this holding, the court explained that the terms of the GNMA forward contract had a "sufficient nexus" to the underlying securities to be characterized as a contract to "purchase," "acquire," "sell" or "otherwise dispose of" securities.[217] Specifically, the contract obligated the plaintiff to take delivery of the GNMA security on the settlement date, and entitled the purchaser to payment of principal and interest on the 15th of each month following settlement.[218] The contract was thus "a firm commitment to take delivery, as opposed to a GNMA standby commitment which gives the seller the right to deliver to the buyer only if the seller so desires."[219] It therefore appears that one of the keys to assessing whether a contract to sell securities in the future constitutes a sale under the 1933 Act is whether there is a "firm commitment," where both the buyer and seller are locked in to the transaction, even though the securities themselves are not exchanged at that time, and indeed, may not yet have even been issued.

In light of the foregoing, it would appear that many of the contingent share distribution programs discussed above constitute sales under the 1933 Act, although they distribute only contingent interests, as long as they involve a contractually firm commitment to dispose of the securities at some future date. For example, Popular Link's provision of reservation numbers for shares of stock, numbers that it will allegedly convert

212. *Id*. at 585.
213. *Id*.
214. Securities Act of 1933, § 2(a)(3) (1997) (emphasis added).
215. *Abrams*, 737 F.2d at 587 (emphasis added).
216. *Id.*
217. *Id.* at 587–88.
218. *Id.*
219. *Id.*

to issued stock after a successful IPO, could be characterized as a contract to "purchase," "acquire," "sell" or "otherwise dispose of" securities. As the *Abrams* court reasoned, a contract to purchase and sell securities in the future can constitute a purchase or sale of the underlying security, and neither a delay in the actual delivery of the security nor the fact that the contract pertains to "when issued" securities, will remove the transaction from within the parameters of a sale.[220] Additionally, the fact that the interest transferred may be only a conditional and defeasible interest, and that there is a risk the contingency might never come to fruition, will not alter this analysis.[221]

Turning to the assessment of whether these contingent share distribution programs constitute contracts, such that they would evidence a firm commitment by both parties to the transaction, we must revisit basic contract law. Generally, in order for a contract to be legally binding there must be consideration, meeting of the minds, and mutuality of obligation.[222] Based upon the value of the personal information provided by a website registrant, the furnishing of this information could be deemed the visitor's consideration for the contract.[223] Similarly, by providing a website registrant with a contingent interest in shares of stock, an Internet company likewise provides consideration, thereby establishing the requisite mutuality of obligation. "Where the requirement of consideration is at issue . . . contract law has traditionally settled for the most insignificant of performances as a sufficient 'detriment'—a hawk, a horse, a robe, a peppercorn."[224] Finally, because a company only requests the personal information after providing a registrant with an explicit description of the share distribution program and a description of the contingent share interest which she would receive, there can be said to be a meeting of the minds. Thus, a contract for a contingent interest in securities, such as the distribution of reservation numbers for shares of stock, constitutes a contract for the disposition or sale of those securities, which must be registered pursuant to the Act. Popular Link's apparent attempt to circumvent the requisite registration process by offering registrants "reservation numbers" as opposed to shares of stock would therefore appear to be unavailing.

Similarly, Lifestyle's share distribution program would also appear to fall within the ambit of the 1933 Act's registration requirements.

220. *Id.* at 587.

221. *See Rubin*, 449 U.S. at 431; s*ee also Yoder*, 751 F.2d at 559, n.4.

222. RESTATEMENT (SECOND) OF CONTRACTS § 3.

223. *See supra* Part II, for a detailed discussion of the "value" of this personal information.

224. E. ALLAN FARNSWORTH, CONTRACTS 1.6 (2d ed. 1990).

Lifestyle in no way qualifies its offer to issue shares of stock to website registrants "upon the commencement of an IPO," and even promises that it will notify these registrants by E-mail on how to receive the actual shares of stock once the company goes public.[225] Therefore, once the registrant provides the personal information requested by the website, the contract is fully executed, and a firm commitment is established.

If, instead of distributing contingent shares of stock, however, Lifestyle were distributing stock options, as alluded to in footnote 3 on Lifestyle's website, the analysis would likely be different. Unlike the promotion in Popular Link, where the disposition of the security is complete once the member provides the personal information and the company issues the reservation numbers, the provision of an option would mean that the disposition of securities would not actually take place until some future date, if at all, at which time the member would be given the right to exercise the option and convert it into stock at the exercise price. In fact, the 1933 Act specifically exempts stock options from its definition of a sale:

> [t]he issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security.[226]

It would therefore appear that the provision of an option for securities would fall outside of the Act's definition of a sale, and a website utilizing such a distribution program may not need to register the program with the SEC.

Application of the registration requirements to Tradehall's share distribution program on the other hand, raises a completely different issue. Unlike the Popular Link and Lifestyle programs, Tradehall does not promise to give away free shares at any time, even if the company does go public. Instead, Tradehall's offer makes it clear that it is only "contemplating" giving away free shares. As the *Abrams* court noted, the key to assessing whether a contract to purchase securities which are to be issued in the future constitutes a sale of those securities under the 1933 Act is whether there is a "firm commitment" where both the buyer

225. *See* Lifestyle, *supra* note 23.

226. Securities Act of 1933, § 2(a)(3) (1997).

and seller are locked in to the transaction.[227] Because the Tradehall website clearly qualifies its offer with the use of the word "contemplating," making the provision of shares optional, it could be argued that this obviates the possibility of establishing a firm offer to sell securities. Because Tradehall does not guarantee the receipt of shares at some future date, Tradehall's offer arguably falls outside the scope of a disposition or sale of securities, and as such would not have to be registered under the 1933 Act.

Finally, applying the *Rubin* and *Abrams* analysis to MyGo's share distribution program, in conjunction with the SEC's holding in *Sotirakis*, it becomes clear that even MyGo's contingent share distribution program would be subject to the 1933 Act's registration requirements.[228] As the SEC held in *Sotirakis*, the fact that an unincorporated entity issues shares of stock does not affect the analysis of whether the distribution constitutes a sale under the 1933 Act.[229] Quoting *Yoder v. Orthomolecular Nutrition Inst., Inc.*, the SEC ruled that a "[s]ale of Kinesis stock occurred even though Kinesis stock certificates did not exist and were not delivered," because a sale of stock may occur under the securities law even if the contract is never fully performed.[230] The fact that MyGo is an unincorporated entity would not appear to affect whether MyGo's program is adjudicated to be a sale of stock. The only question to be answered, therefore, would be whether the contingent interest distributed by MyGo qualifies as a firm commitment, such that a disposition of that stock occurs at the time an individual signs up on the MyGo website.

Again utilizing the reliance test from *Rubin*, it is clear that individuals provide their registration information to MyGo in reliance upon, and with the expectation of, receiving shares of stock. The fact that MyGo's website boasts that "MyGo is giving away free shares of its stock" and a user can "*[b]ecome a co-owner today* and own a piece of [her] favorite portal" clearly raises an expectation upon which the registrant could rely.[231] In contrast to the Tradehall offer, the fact that MyGo in no way qualifies its provision of a potential "ownership interest" in its stock upon its incorporation leads to the conclusion that MyGo is making a firm commitment to distribute the stock once it incorporates. Thus, the contract is fully executed, and MyGo's obligation to distribute the stock fully vests, the moment a new member provides personal information to

227. *See Abrams*, 737 F.2d at 582.

228. *See Rubin*, 449 U.S. at 424; *Abrams*, *supra* note 227, at 582; *Sotirakis*, 1999 WL 514040, at *2.

229. *See Sotirakis*, 1999 WL 514040, at *2.

230. *Id.*

231. MyGo, *supra* note 26 (emphasis added).

the company during the share registration process. This analysis seems to apply equally to MyGo's situation, even though MyGo has not yet incorporated or issued shares.[232]

3. Share Distribution Through Contests

The distribution of stock through a contest or drawing, such as ExitNorth's program, can most closely be analogized to the facts in *Matter of Sotirakis*.[233] Despite the fact that the company in which Mr. Sotirakis was offering shares of stock was never incorporated, the SEC nonetheless found that securing personal registration information in return for the promise of receiving the company's stock qualified as an offer for sale under the 1933 Act. Quoting the Second Circuit's decision in *Yoder v. Orthomolecular Nutrition Inst., Inc.*,[234] the SEC noted that "[a] contract for the issuance or transfer of a security may qualify as a sale under the securities laws even if the contract is never fully performed."[235] In the *Sotirakis* case, the company could not actually fulfill the contract because it was not a legal corporate entity capable of issuing stock.

Likewise, whenever a company distributes stock through a contest, such as ExitNorth's offer to provide stock to ten lucky winners,[236] there is always a risk that the company might not fully perform the contract as to any individual entrant, because only a pre-specified number of entrants will eventually win the stock, while all of the other contest entrants will, by the terms of the contest, not receive any shares of stock. But, as the *Yoder* court noted in a footnote, there is "no reason why a contingency attached to a contractual right to acquire stock should remove that right from securities law coverage simply because it increases the risk that plaintiff will not obtain the shares."[237] The Seventh Circuit's holding in *Abrams* further bolsters this proposition, having held that a contract to sell or dispose of a security or interest in a security, for value, is subject to the securities laws, even if the contract is not yet performed, and even if the contract pertains to "when issued" securities.[238] Shares of

232. *See Abrams*, 737 F.2d at 589; *Sotirakis*, 1999 WL 514040.
233. *See Sotirakis*, 1999 WL 514040.
234. 751 F.2d at 559.
235. *Sotirakis*, 1999 WL 514040, at *2.
236. *See* ExitNorth, *supra* note 14, at 6.
237. *Yoder*, 751 F.2d at 559, n.4.
238. *See Abrams*, 737 F.2d at 587. Although *Abrams* dealt with a contract that would be executed in the future, a contract that locked in both the buyer and the seller, the court's holding is still applicable to share distribution contests. Even though only a certain number of contest entrants will receive the shares, each and every person enters the contest pursuant to the terms laid out on the website, and thus each and every entrant enters into a contract with

stock distributed through contests would therefore appear to qualify as sales under the securities law and would need to be registered pursuant to the 1933 Act's registration requirements. The registration requirement holds true even though a company may not distribute the shares at the time an individual registers for the program, and even though only a few of the program registrants actually will receive the stock.[239]

4. A New Method for Distributing Stock

Taking a completely different approach to its distribution of shares of stock, MyOwnEmpire offers to distribute a single share of stock to each visitor that registers on its website *and* then makes MyOwnEmpire's website her start page and visits the site at least 10 days out of every 30 days for a 90-day period.[240] In essence, MyOwnEmpire appears to be avoiding the emphasis of the program on the registration process by instead conditioning the share distribution on a member's utilization of its website.[241] It is clear that a firm commitment to distribute MyOwnEmpire's stock does not arise at the time that a newly registered member provides the personal information, because a person would not qualify for the stock for at least 90 days after registration. Additionally, because a registering individual could fail to visit the MyOwnEmpire website the requisite number of times, and thus never qualify for the stock, that individual cannot rely upon the expectation of receiving stock at the time of registration.

Does that mean that MyOwnEmpire's share distribution program does not qualify as a sale or disposition of securities such that it would be exempted from the 1933 Act's registration requirements? Probably not. Just because the sale or disposition of the securities does not take place at the time the personal information is provided, does not obviate the possibility that a sale or disposition of the securities occurs at a later point in time. Recall that there is also value in having individuals visit a website numerous times, because these visits not only offer a company additional opportunities to sell its products or services, but they also raise the company's web hit statistics, which can in turn increase the company's advertising revenue.[242] In essence, every time an individual visits the website, she provides value to the site. Once the individual

---

the website providing personal information upon the understanding that they will be entered into a drawing, the winners of which will receive the shares of stock.

239. For a discussion of other laws that may apply to contests for free share distributions, see Part IV.

240. *See* MyOwnEmpire, *supra* note 29.

241. *Id.* MyOwnEmpire believes its method of share distributions to be so unique that it has apparently filed for a patent on its consumer-owner business model.

242. *See* Wyatt, *supra* note 175.

visits the site the requisite number of times, her right to shares vests, and it is at that time that a disposition and sale of the shares takes place. Thus, although MyOwnEmpire's program prevents the provision of personal information from giving rise to a sale as defined by Section 2(a)(3) of the 1933 Act, the member's subsequent visits to the website can nonetheless provide the value necessary for the program to be a sale under the Act. The structure of MyOwnEmpire's program merely delays, but does not obviate, the sale of securities that would give rise to the registration requirements under the 1933 Act.[243]

IV. State Laws Potentially Implicated by Internet-Based Share Distribution Programs

A. *State Pyramid and Chain Distribution Statutes*

As discussed in Part I, many Internet-based share distribution programs offer registered members the opportunity to accrue additional shares of stock in return for referring others to the websites who themselves become members (hereinafter "referral programs").[244] Although these referral programs may seem innocuous on the surface, in light of the value of the personal information supplied by visitors during the registration process, these referral programs could be viewed as illegal chain distribution or pyramid schemes (collectively "pyramid schemes") under various state laws.[245]

Virtually every state in the United States outlaws pyramid schemes, which are schemes involving the payment of something of value in exchange for the opportunity to receive compensation for recruiting new members into the scheme.[246] In pyramid schemes, the primary focus is on recruiting others into the scheme in return for "headhunting fees."[247] In contrast, legal multi-level marketing programs focus on the actual sale of goods to consumers through independent sales people who sell directly

243. On its website, MyOwnEmpire claims to be exempt from the federal registration requirements based upon its alleged qualification for a Rule 504, Regulation D exemption under federal law, and a state exemption under California Corporation Code Section 25113(b)(I). *See* MyOwnEmpire, *supra* note 29. As the goal of this article is to assess the application of the federal registration requirements to various share distribution programs, this article will not address whether, having qualified as sale of stock under the 1933 Act, the company may nonetheless skirt the registration requirements by claiming an exemption.

244. *See*, *e.g.*, Travelzoo, *supra* note 1; Popular Link, *supra* note 17.

245. *See supra* Part II, for a more detailed discussion of the "value" of this personal information.

246. *See In re* Amway Corp., 93 F.T.C. 618, 667 (1979).

247. *Id.*

to consumers on a commission basis.[248] These sales channels are known as "multi-level" because they have a number of levels of supervision, generally comprised of "independent distributors acting as wholesalers as well as retailers."[249]

The primary distinction between the two programs is that in a pyramid scheme the focus is primarily on recruiting new individuals until the well of new recruits dries up, at which time many of the scheme's participants lose their investments. In contrast, while referrals help to enhance the distribution channels in multi-level marketing programs, the focus is nonetheless on the sale of actual consumable products, not on the headhunting. Additionally, although pyramid schemes always involve the payment of something of value in order to enroll in the scheme, multi-level marketing programs generally do not charge for the right to enroll in the program.

Because both pyramid schemes and multi-level marketing programs involve the use of referrals, we need to scrutinize these web-based referral programs in order to determine into which category they fall. Generally, one may differentiate between pyramids and multi-level marketing programs by focusing on two primary questions: 1) whether the purpose of the program is to sell products or merely recruit additional individuals into a chain; and 2) whether the recruits are required to provide something of value in order to enroll in the program.[250] Although a number of the Internet companies operating referral programs actually sell merchandise on their websites, the referral programs themselves generally do not involve the sale of any goods, but instead require only that registered members refer people to their websites. For example, Bonus Blvd. discloses that:

> [w]e will also distribute 1,000,000 Class A shares to members based upon their referrals of new members to our web site. Each time a new member lists an existing member as the referring party in the new member's registration at our web site, we will distribute one share to the referring member.[251]

Because the only requirement for receiving shares of stock through Bonus Blvd.'s referral program is to have a newly referred member list a referring member as the referring party, there can be no question that the main focus of the program is on headhunting. Thus, the primary question

248. *Id.* at 670.

249. *Id.* at 670–72.

250. *See, e.g.*, N.Y. GEN. BUS. LAW § 359-fff (McKinney 1996); NEV. REV. STAT. § 598.100(3) (1999).

251. BonusBoulevard, *supra* note 76, at 42.

then becomes whether registrants who enroll in this program are providing anything of "value." Just as the application of the 1933 Act's registration requirements hinged on the SEC's definition of "value," the application of many state pyramid statutes likewise turns on the consideration, or value provided by the referrer and her references.

For example, Nevada's Revised Statutes defines a pyramid promotional scheme as:

> [a] program or plan for the disposal or distribution of property and merchandise or property or merchandise by which a participant gives or pays a valuable consideration for the opportunity or chance to receive any compensation or thing of value in return for procuring or obtaining one or more additional persons to participate in the program, or for the opportunity to receive compensation of any kind when a person introduced to the program or plan by the participant procures or obtains a new participant in such a program.[252]

In order to qualify as a pyramid program in Nevada, the program must satisfy four elements: 1) the program must involve the distribution of property or merchandise; 2) a participant must pay a "valuable consideration" to enroll in the program; 3) a participant must recruit one or more persons who also enroll in the program; and 4) the participant must receive "compensation or [a] thing of value" in return for her recruiting efforts.

Inasmuch as these Internet companies design their referral programs to distribute shares of company stock, these programs could be classified as programs for the distribution of property, thereby satisfying the first prong of this test. The examination next turns to whether a person is required to pay a "valuable consideration" in order to secure the opportunity to recruit others.

Recall that these Internet companies generally condition the receipt of shares of stock upon an individual's visit to, and registration with a website—at which time she is asked to provide personal information.[253] Having registered with the website, the company then permits her to, and indeed encourages her to, refer other people to the website, in return for receiving additional shares of stock in the company.[254] As the SEC observed in its Orders, a person visiting these websites and registering for shares of stock in these Internet companies does indeed provide

252. NEV. REV. STAT. § 598.100(3) (1999).
253. *See supra* Part I.
254. *Id.*

"something of value" in order to enroll in the program.[255] The question then becomes whether, in light of Nevada's failure to define "valuable consideration," the value that the SEC attributed to this personal information constitutes "valuable consideration" under Nevada law.

As the SEC reasoned in its Orders, these Internet-based share distribution programs, which would include referral programs, provide value to Internet companies by increasing brand recognition, advertising the websites, enhancing the sales of products on the websites and attracting people interested in investing capital in these fledgling Internet companies.[256] One could therefore argue that the benefits provided by share recipients constitutes valuable consideration that would satisfy Nevada's pyramid statute.

Even if the benefits noted by the SEC are considered too tenuous to satisfy Nevada's "valuable consideration' requisite, the personal information provided by registrants might nonetheless constitute valuable consideration.[257] Specifically, this personal information could be deemed valuable consideration based upon its potential use by companies either to market products to their own members, or to sell to third party information brokers.[258] For example, Bonus Blvd. discloses in its SEC filing that "[w]e may in the future use for our own purposes or sell to third parties compiled information including in many instances personal information obtained from our members upon their authorization."[259] Similarly, YouNetwork discloses in its SEC filing that:

> [w]e expect to gather a significant base of information about our Members through registration information, responses to closed end beta tests and purchasing information obtained from third parties . . . [w]e intend to use this growing database to target offers, increase our range of product offerings and encourage future transactions and involvement with the YouNetwork site.[260]

Further bolstering the attribution of legal value to this personal information is U.S. West's assertion that the information collected about its subscribers, which it refers to as CPNI, constitutes "valuable

255. *See Loofbourrow*, 1999 WL 514038; *Sotirakis*, 1999 WL 514040; *WebWorks*, 1999 WL 514083; *WowAuction*, 1999 WL 514042.

256. *See Loofbourrow*, 1999 WL 514038; *Sotirakis*, 1999 WL 514040; *WebWorks*, 1999 WL 514083; *WowAuction*, 1999 WL 514042.

257. *Cf. supra* text accompanying notes 68–74 (discussing Toysmart's proposed sale of personal information).

258. *See supra* text accompanying notes 162–166.

259. BonusBoulevard, *supra* note 76, at 31.

260. *See* YouNetwork, *supra* note 11, at 25.

property" worthy of Fifth Amendment protection.[261] Similarly, Toysmart's attempt to sell its database of customers' personal information as a means of paying off creditors, as well as the amounts of the bids placed for that information by potential buyers, further illustrates the value of this information.[262] One could therefore objectively conclude, based upon the value attributed to this personal information by the very companies against whom these laws might be enforced, that this personal information constitutes "valuable consideration" under Nevada's pyramid statute.[263]

The third element of Nevada's pyramid statute requires that the newly recruited individual also enroll as a participant in the program.[264] Because a newly recruited individual can only receive shares of stock after registering with the website herself, she too can be said to have become a participant in the program.

Finally, Nevada's pyramid statute requires that the person who pays a valuable consideration and recruits others, receive "compensation or [a] thing of value" in return for the recruitment activities. In the context of these Internet referral programs, the thing of value would be additional shares of company stock, which a company awards only after the new recruit lists the referring member as the person who referred her to the website. Because the definition of "compensation or [a] thing of value" does not specify a minimum value, as long as the shares of stock are redeemable for some amount of par value, regardless of how de minimus that might be, it follows that the shares of stock would be a "thing of value." For example, Bonus Blvd. declares its Class A stock to have a par value of $.0001 per share.[265] Thus, since all stock presumably has some par value, distribution of this stock through a referral program would satisfy the final element of Nevada's pyramid statute.

The potential for infracting a state's pyramid prohibitions through the operation of an Internet referral program is by no means limited solely to Nevada. For example, these Internet referral programs could also be viewed as violative of Illinois' prohibition of pyramid schemes. Pursuant to the Illinois Criminal Code, a pyramid sales scheme:

> means any plan or operation whereby a person, in exchange for money or other thing of value, acquires the opportunity to receive a benefit or thing of value, which is primarily based upon

261. *See U.S. West*, 182 F.3d at 1230.

262. *Cf. supra* text accompanying notes 68–74 (discussing Toysmart's proposed sale of personal information).

263. *See supra* Part II.

264. NEV. REV. STAT. § 598.100(3) (1999).

265. *See* BonusBoulevard, *supra* note 76, at 4.

> the inducement of additional persons, by himself or others, regardless of number, to participate in the same plan or operation and is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed or to be sold or distributed to person's for purposes of resale to consumers.[266]

Under Illinois law, "[a]ny person who knowingly sells, offers to sell, or attempts to sell the right to participate in a pyramid sales scheme commits a Class A Misdemeanor."[267]

In order to qualify as a pyramid scheme under Illinois' statute, the program must: 1) require that a participant pay "money or other thing of value"; 2) in return for the opportunity to receive "a benefit or thing of value"; 3) "which is primarily based upon the inducement of additional persons" to participate in the same plan or operation; and 4) which "is not primarily contingent on the volume or quantity of goods, services, or other property sold or distributed or to be sold or distributed to person's for purposes of resale to consumers."

Akin to Nevada's requirement that a person pay a "valuable consideration," a "thing of value" under Illinois' law could likewise be found in the provision of personal information during the registration process.[268] In fact, as the Illinois Appellate Division ruled in *People of the State of Ill. v. Knop*, "the phrase 'thing of value' includes more than a monetary fee. The language is not limited to the payment of money or a tangible equivalent."[269] Citing to an analogous statute construed by the Missouri Court of Appeals, the Illinois Court noted that consideration should be interpreted broadly, and can even "include[] the responsibility that a marketer assumes toward the organization and its marketing policies."[270]

A company may satisfy the second prong of Illinois' statute, which requires that an individual be given the opportunity to receive a "benefit or thing of value," by providing shares of stock in return for recruiting others. The fact that the company expressly provides these additional shares of stock as compensation for soliciting the referral satisfies the third prong of Illinois' pyramid statute, which calls for a person to receive the thing of value in return for inducing the recruitment. Finally,

---

266. 720 ILL. COMP. STAT. ANN. 5/17-7(a) (West 1993).

267. 720 ILL. COMP. STAT. ANN. 5/17-7(a) (West 1993).

268. *See supra* Part II, for a more detailed discussion of the "value" of this personal information.

269. 619 N.E.2d 203, 212 (Ill. App. Ct. 1993) (quoting State ex. rel. Webster v. Membership Marketing, Inc., 766 S.W.2d 654, 658 (Mo. Ct. App. 1989)).

270. *Id.*

because the referral programs operated by these websites generally do not involve the sale of any goods or products, the exception encompassed within the fourth prong of Illinois' pyramid statute clearly would not apply.

In essence, what this analysis demonstrates is that by focusing their referral programs on recruitment, in light of the increasing value attributed to personal information provided online, many Internet-based share distribution programs could unintentionally infringe upon state pyramid prohibitions.

B. *State Gambling Laws*

As an alternative means of promoting traffic to their websites and securing valuable personal information, some Internet companies have integrated contests into their share distribution programs (hereinafter referred to as "share distribution contests"). For example, ExitNorth offered one hundred thousand shares of its "pre-IPO stock," which was to be "split between 10 lucky winners."[271] Other Internet companies host contests and drawings for shares of stock as a supplement to their primary share distribution programs.[272]

Proceeding again from the presumption that traveling to a company's website and providing personal information constitutes the provision of legally significant value, one could classify these contests as lotteries or sweepstakes, which are strictly regulated by state gambling statutes. In apparent recognition of this fact, Bonus Blvd. cautions potential investors that "the sweepstakes industry is subject to extensive regulation on the local, state and federal levels. This regulation applies whether sweepstakes are promoted over the Internet, through the mail or otherwise . . . Regulations governing the conduct of sweepstakes vary from state to state and from country to country."[273] Analyzing these share distribution contests in light of various state gambling statutes once again reveals that these programs might violate various state statutory prohibitions.

For example, New York State's Constitution prohibits "the sale of lottery tickets, pool-selling, bookmaking, or any other kind of gambling [within the State], except lotteries operated by the State and the sale of lottery tickets in connection therewith as may be authorized and prescribed by the legislature . . . ."[274] In order to enforce this prohibition, the

271. *See* ExitNorth, *supra* note 14, at 6.
272. *See*, *e.g.*, BonusBoulevard, *supra* note 76, at 26.
273. *Id.* at 15.
274. N.Y. CONST. art. 1, § 9 (amended 1985).

New York State legislature enacted Article 225 of the Penal Law, prohibiting "unlawful gambling activity," defined as any gambling activity that is not *explicitly authorized* by the State of New York.[275] Accordingly, should an Internet company's share distribution contest qualify as a lottery under New York State law, the contest could presumably be viewed as "unauthorized gambling activity" in New York.

As defined in New York Penal Law Section 225.00(10):

> [l]ottery means an unlawful gambling scheme in which (a) the players pay or agree to pay something of value for chances, represented and differentiated by numbers or by combinations of numbers or by some other media, one or more of which chances are to be designated the winning ones; and (b) the winning chances are to be determined by a drawing or by some other method based upon the element of chance; and (c) the holders of the winning chances are to receive something of value.[276]

The first prong of New York's definition of a lottery requires that a player, in this case a visitor who registers with an Internet company's website, "pay or agree to pay something of value for chances."[277] Pursuant to Penal Law § 225.00(6), something of value:

> means any money or property, any token, object or article exchangeable for money or property, or any form of credit or promise directly or indirectly contemplating transfer of money or property or any interest therein, or involving extension of a service, entertainment or a privilege of playing at a game or scheme without charge.[278]

As U.S. West argued to the Tenth Circuit Court of Appeals, personal information about subscribers is indeed property worthy of Fifth Amendment protection.[279] Thus, the provision of this personal information could theoretically qualify as the provision of property under New York Penal Law § 225.00(6).

Additionally, because companies may sell this personal information to third party information brokers, or may use this information in direct targeted marketing to their own members, the information could also be deemed a "token, object or article exchangeable for money or property." Indeed, as the Toysmart debacle recently demonstrated, many companies

275. *See* People v. Kim, 585 N.Y.S.2d 310, 313 (N.Y. Crim. Ct. 1992).
276. N.Y. PENAL LAW § 225.00(10) (McKinney 2000).
277. N.Y. PENAL LAW § 225.00(10) (McKinney 2000).
278. N.Y. PENAL LAW § 225.00(6) (McKinney 2000).
279. *See U.S. West*, 182 F.3d at 1224.

have come to view this information as an important, and in some cases vital, asset that they can sell for substantial amounts of money.[280] For example, Bonus Blvd. freely discloses in its SEC filing that it may, upon authorization from its members, use the personal information provided by those members for its own purposes, or may sell the information to third parties.[281] A visitor registering with a website could therefore conceivably be viewed as having paid something of value for a chance in the share distribution contest.

Concomitant with establishing that the player paid something of value, the first prong of New York's statute also requires that the chances be "represented and differentiated by numbers or by combinations of numbers or by some other media, one or more of which chances are to be designated the winning ones."[282] Although the companies operating these share distribution contests do not disclose their methodology for tracking each registrant, we can logically presume that the companies necessarily assign each registrant some type of unique identifier distinguishing one registrant from another. Moreover, because these Internet companies allow prospective contestants to enter by registering on their websites, which are generally hosted on computer web servers, it is logical to presume that the companies identify the registrants' chances electronically, and store them in electronic form, in some type of database. Finally, because these Internet companies operate in cyberspace, existing primarily on a system comprised of a multi-tiered architecture, it would be illogical for them manually to draw the sweepstakes or contest when these computer systems are so well equipped for this very task.[283] As such, it is also logical to presume that the computer system will, at some point, designate one or more of the unique identifiers to be the winning chance(s). Bearing the foregoing assumptions in mind, and noting that New York's Penal Law allows for the unique identifier of the chances to be represented by any "media," it would appear that a contest that is hosted on, and determined by, a company's computer system could satisfy this first prong.

The second prong of a lottery under New York law requires that "the winning chances . . . be determined by a drawing or by some other

280. *Cf. supra* text accompanying notes 68–74 (discussing Toysmart's proposed sale of personal information).

281. *See* BonusBoulevard, *supra* note 76, at 31.

282. N.Y. PENAL LAW § 225.00(10) (McKinney 2000).

283. *See, e.g.*, Office of the New York Attorney General Eliot Spitzer, Investor Protection and Securities Bureau, Internet Bureau, "From Wall Street to Web Street—A Report on the Problems and Promise of the Online Brokerage Industry" (Nov. 22, 1999) (discussing a three-tiered architecture).

method based upon the element of chance."[284] As an example of the element of chance inherent in these Internet share distribution contests, Bonus Blvd. discloses in its SEC registration filing that "100,000 Class A shares will be awarded to one member who is selected *at random* as the 'grand prize' winner of our sweepstakes contest . . ."[285]

The third prong of New York's definition of a lottery requires that "the holders of the winning chances . . . receive something of value."[286] Arguably the shares of stock received by the contest winners, although not yet publicly traded, possesses some value. Indeed, many of these companies go to great pains to tout the value of their stock and to encourage people to register for shares.[287] Even though the shares of stock in these Internet companies lack a public market, the shares of stock would still satisfy this final prong because the statute defines something of value to include "any money or property, any token, object or article exchangeable for money or property . . ."[288] Therefore, furnishing shares of stock to the winning contestants would likely be deemed adequate to satisfy this final prong of New York's lottery statute.

As demonstrated by this analysis, it is feasible for these share distribution contests to satisfy all of the elements of a lottery under New York law. Presuming a company allowed New Yorkers to enter the lottery from New York via registration, these share distribution contests could be considered criminal enterprises in New York State.[289] As the New York State Supreme Court ruled in *People v. World Interactive Gaming Corp*., regardless of a computer server's location, "[t]he act of entering the bet and transmitting the information from New York via the Internet [is] adequate to constitute gambling activity within [] New York State."[290] Similarly, even if a company locates the computer servers used to host the Internet share distribution contest outside of New York State, by merely allowing New York residents to enter the contest through the furnishing of something of value, in this case personal information, the

284. N.Y. PENAL LAW § 225.00(10) (McKinney 2000).

285. Bonus Boulevard, *supra* note 76, at 42 (emphasis added).

286. N.Y. PENAL LAW § 225.00(10) (McKinney 2000).

287. *See, e.g.*, WebWorks, *supra* note 5 ("Assuming you received the full 63 shares, the total net asset value of your shares (on paper), will be approximately $2,419.20 in theory."); WowAuction, *supra* note 7 ("In related [I]nternet auction news, City Auction was acquired by Ticketmaster in late February . . . for . . . approx. $54 million . . . cNet recently bought Auctiongate for $5.8 million . . . . And at the market close on March 8, 1999, eBay's total stock worth was over $20 billion!!.").

288. N.Y. PENAL LAW § 225.00(6) (McKinney 2000).

289. *See* People v. World Interactive Gaming Corp., No. 404428/98, 1999 WL 591995, at *1 (N.Y. Sup. Ct. July 22, 1999).

290. *Id.* at 4.

contest could be deemed to occur in New York and thus violate New York State law.

An examination of other state statutes yields potentially similar results. California's Constitution bars the legislature from authorizing lotteries, except for the California State Lottery, expressly authorized in a subsequent clause.[291] As the California Gambling Control Act sets forth in its legislative findings and declarations, "[s]tate law prohibits commercially operated lotteries . . . ."[292] Section 319 of California's Penal Law defines a lottery as:

> any scheme for the disposal or distribution of property by chance, among persons who have paid or promised to pay any valuable consideration for the chance of obtaining such property or a portion of it, or for any share or any interest in such property, upon any agreement, understanding, or expectation that it is to be distributed or disposed of by lot or chance, whether called a lottery, raffle, or gift-enterprise, or by whatever name the same may be known.[293]

Pursuant to California Penal Code § 320, any person who "contrives, sets up, proposes, or draws any lottery, is guilty of a misdemeanor."[294] As the California Supreme Court observed in *California Gasoline Retailers v. Regal Petroleum Corp.*, a lottery under California law is comprised of three elements: 1) the disposition of property; 2) upon a contingency determined by chance; and 3) to a person who has paid a *valuable consideration* in return for the chance of winning the prize.[295]

With regard to the first element, there can be little doubt that the distribution of shares of stock to contest winners constitutes a scheme for the disposition of property. Furthermore, companies such as Bonus Blvd. freely disclose that they distribute this property based upon chance, the chance generally being a drawing of all of the registered people on a given website.[296] Thus, these share distribution contests could also satisfy the second element of the *California Gasoline Retailers'* test.

---

291. *See* CAL. CONST. art IV, § 19 (amended March 8, 2000).

292. CAL. BUS. & PROF. CODE § 19801(a) (Deering 2000). In order to clarify the purpose of the Gambling Control Act as it relates to lotteries, § 19806 states that "[n]othing in this chapter [the Gambling Control Act] shall be construed in any way to permit or authorize any conduct made unlawful by Chapter 9 (commencing with Section 319) of . . . Title 9 of Part 1 of the Penal Code, or any local ordinance." CAL. BUS. & PROF. CODE § 19806 (Deering 2000).

293. CAL. PENAL CODE § 319 (Deering 1999).

294. CAL. PENAL CODE § 320 (Deering 1999).

295. *See* California Gasoline Retailers v. Regal Petroleum Corp., 330 P.2d 778, 782 (1958).

296. *See* BonusBoulevard, *supra* note 76, at 42–43.

The final element requires that a person pay a "valuable consideration" in return for entering the scheme and securing a chance to win a prize. Once again, drawing upon the SEC's finding of value in the personal information provided by individuals during the registration process, as well as the value that both the Internet community and federal and state legislators have assigned to this information, one could assert that the information constitutes "valuable consideration" under California law.[297] As such, it could be argued that these Internet share distribution contests constitute lotteries under California law, and are thus illegal in California as well.

CONCLUSION: STRAIGHT FROM THE HORSE'S MOUTH

Although it may be premature to judge the long-term effects of the SEC's Orders requiring registration of Internet-based share distribution programs, it appears that the message has reached the Internet community. For example, a November 16, 1999 Wall Street Journal article noted that "[t]wo upstart online companies that aren't yet public—DoctorSurf.com, Inc. of Largo, Fla., and YouNetwork Corp. of New York—have quietly received the green light to give away SEC-registered shares to surfers signing up on their websites."[298]

Merely complying with federal securities registration requirements, however, does not in any way ensure compliance with other statutes that may be implicated by these share distribution programs. For instance, although states have not yet enforced their pyramid scheme or gambling prohibitions against companies operating share distribution programs, public outcry over the collection, use and sale of personal information continues to grow. It is feasible that public sentiment could eventually pressure regulators and prosecutors to undertake initiatives to crack down on the collection and use of this personal information. If so, states may look to any means available for deterring the inappropriate collection and use of this information, such as the enforcement of pyramid scheme and lottery prohibitions. As states continue to pass new privacy legislation, these share distribution programs could also be imperiled by more restrictive privacy laws.

Aside from the legal considerations, some Internet-based share distribution programs also risk running afoul of ethical boundaries. For

297. *See supra* Part II, for a more detailed discussion of the "value" of this personal information.

298. Gregory Zuckerman, *SEC Clears Web Firms' Stock Giveaway*, WALL ST. J., Nov. 16, 1999, at C1.

example, the program being proposed by DoctorSurf.com, Inc. ("DoctorSurf") has raised eyebrows in the medical community. Pursuant to DoctorSurf's share distribution program, "[t]he first 250,000 doctors who join DoctorSurf.com can get 100 shares of DoctorSurf.com simply by providing detailed information about themselves."[299] The distribution of DoctorSurf shares to doctors, which in itself would not appear to implicate any ethical concerns, becomes more problematic, however, when the company accepts advertising from medical and drug companies.[300] In assessing the ethics of such a program, Dr. Herbert Rakatansky, Chairman of the American Medical Association's ethics council noted, "there's no prohibition against doctors buying stock in the open market in, say, a pharmaceutical company because the number of shares outstanding are so great that a doctor can't influence the stock price by his prescribing patterns."[301] The same might not hold true, however, when doctors own shares in a small lightly traded start-up Internet company which accepts advertising from medical and drug companies. Bearing in mind that many informational websites are valued based upon their advertising revenue, if the prescribing patterns of doctors were in any way able to influence the advertising dollars spent by medical and drug companies on the DoctorSurf site, such patterns could realistically affect the value of DoctorSurf's stock.

Another potential ethical consideration might arise because medical and drug advertisers on a site owned primarily by doctors could arguably gain some competitive advantage through the arrangement. For example, consumers might view an advertiser's affiliation with a website sponsored and owned primarily by doctors as an implicit endorsement of the products advertised. As Dr. Rakatansky observed, "any possible ethical issues . . . turn on who would control the site's content and whether advertising and content would be clearly distinguishable."[302] Clear and conspicuous disclaimers might be useful to some extent, but would they truly resolve all of the potential ethical issues raised by such a website?

These concerns are by no means restricted to Internet-based companies owned by doctors. For example, a New York Times article in November 1999 uncovered potential conflicts of interest that have arisen when cardiologists have promoted devices that they invented in

299. *Id.* at C22.

300. *Id.* (noting that DoctorSurf has publicly stated that it is considering accepting advertising by medical and drug companies on its website).

301. *Id.* at C1, C22.

302. *Id.* at C22.

return for stock in the companies that own the rights to those devices.[303] As the New York Times article noted, "[a]t bottom, some cardiologists fear that the influence of potential riches has distorted medicine's search for truth."[304] To deal with these conflicts, cardiologists have adopted a loose policy of voluntary disclosure.[305] Unfortunately, these disclosure policies apparently have suffered from numerous flaws and have not worked as well as many would have liked.[306]

Similarly, one could foresee conflicts of interest arising in the context of doctor-owned Internet websites aligned with drug and medical companies. For example, what conflicts might arise if a doctor who owns shares in DoctorSurf decides to publish an article on the website reviewing her use of a product sold by a medical or drug company that advertises on the site?

Although these ethical considerations might seem somewhat abstract, they serve to illustrate that in addition to addressing the applicability of securities laws, as well as state pyramid scheme and gambling prohibitions, companies must also review their share distribution programs to ensure that they comply with various ethical tenets. Without theorizing how this new chapter in securities regulation might conclude, this article has illustrated the considerations that these companies may wish to ponder before implementing their share distribution programs.

It has been said that when one purchases a horse, it is advisable to look into the horse's mouth and examine the horse's teeth, as this is the best way to ascertain the horse's true age, and thus, to learn whether the seller has been truthful about the animal he is selling. Contrary to the proverb that one should not look a gift horse in the mouth, before accepting an offer of free shares of stock, and giving away valuable personal information, one should investigate the veracity of the claims made, as well as the potential pitfalls of the offer. Only by looking the gift horse squarely in the mouth can one hope

303. Eichenwald and Kolata, *Hidden Interest—A Special Report; When Physicians Double as Entrepreneurs*, N.Y. TIMES, Nov. 30, 1999, at A1, C16.

304. *Id.* at A1 (noting that in the early 1990s, Dr. Maurice Buchbinder served as a principal investigator in studies for the Rotablader, a tiny drill used to remove plaque from arteries, while holding a stake in the company that sold the device, a stake worth millions of dollars. A few years later in 1993, however, the Food and Drug Administration found significant deficiencies in Dr. Buchbinder's research, "including failures to conduct proper follow-up or to appropriately report problems experienced by patients. The University subsequently banned him from performing other experiments on patients.").

305. *Id.*

306. *Id.*

to verify that the seller is actually offering a ground floor opportunity in a potentially lucrative *and* legal program, and not an old nag suffering from statutory and ethical maladies.