Basic Fact Situation

"ItsYourBid.com" ("IYB") is a well-funded Internet start-up. IYB's business model is to create a website on which it will conduct online auctions for new and used heavy industrial machinery (no consumers, only sophisticated businesses). It has identified "AuctionBid.com" ("AB") as the provider of the auction software and bid processing services. AB is an ASP ("application service provider"), which means that it provides software and other services to customers over the Internet. A general discussion of what ASP's are is attached to this memo.

In general, ASPs charge a fixed, per transaction fee to their customer. However, the parties have agreed to a different business model for this transaction. Under this model, AB will not get paid a flat fee per transaction, but will get 3% of the total amount that IYB is entitled to receive from each customer on each transaction. AB is entitled to its 3% whether or not the customer ever pays IYB.

Another twist is how IYB will be paid by its customers. For a seller to post a product for sale on the IYB website, the seller will be required to estimate what it will receive from the auction of that product and pay IYB 10% of that estimate up-front. If the final price from the successful bidder is equal to or less than the estimate, IYB gets nothing more. However, if the final price is higher than the estimate, IYB will get 50% of the difference from the seller. So it behooves sellers not to low-ball their estimates.

Because the above payment strategies are not the normal way that auction sites work, it will be necessary for AB to customize its software specifically for IYB. AB will receive no up-front payments for developing this software, but AB thinks that it will make a lot more money from this custom auction system than from its standard system, so it is willing to invest the money up-front to do the customization. AB will also host the auction site on its computer systems at no additional cost.

Each law firm will receive additional information from its "client" this week in the form of several memos. Next Saturday, your client will meet with you to discuss any specific concerns it has and what it would like, needs and does not want to see in the agreement.

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Page 1 of 2
WHAT IS AN APPLICATION SERVICE PROVIDER?

INTRODUCTION
An application service provider (ASP) is a business that provides computer-based services to customers over a network. The most limited sense of this business is that of providing access to a particular application program (such as medical billing) over the Internet.

The need for ASPs has grown due to the increasing costs of specialized software that have far exceeded the price range of many small to medium-sized businesses. As well, the growing complexities of software have led to huge costs in distributing the software to end users. Through ASPs, the complexities and costs of such software can be reduced. In addition, the issues involved of upgrading the software have been eliminated by placing the onus on ASP to maintain up-to-date services, 24 x 7 technical support, physical & electronic security & built-in support.

The importance of this marketplace is reflected by its size. As of early 2003, estimates of the United States market range from $1.5 to $4 billion. Clients for ASP services include businesses, government organizations, non-profits, and membership organizations.

THE ASP MODEL
The application software resides on vendor's computer system & is accessed by users thru a web browser such as Internet Explorer. Custom client software can also interface to these systems.

Common features associated with ASPs include:
• ASP fully owns and operates the software application(s).
• ASP owns, operates and maintains the servers that support the software.
• ASP makes information available to customers via the Internet.
• ASP generally bills on a "per-use" basis or on a monthly/annual fee.

The advantages to this approach include:
• Software integration issues are eliminated from the client site.
• Software costs for the application are spread over a number of clients.
• Vendors have more experience with the particular software app than in-house staff.
• Key software systems are kept up to date, available & managed for performance by experts.
• Improved reliability, availability, scalability and security of the computer systems.
• A service level agreement guarantees a certain level of service.
• Customer has access to product & technology experts dedicated to specific products.
• Reduction of internal IT costs.

Some inherent disadvantages include:
• The client must generally accept the application as provided since ASPs can only afford a customized solution for its largest clients.
• The client may rely on the provider to provide a critical business function, thus limiting their control of that function and instead relying on the provider.
• Changes in ASP market may result in changes in type or level of service available to clients.
• Integration with the client's non-ASP systems may be problematic.
• Evaluating an Application Service Provider security when moving to an ASP infrastructure can be expensive, as such a firm must assess the level of risk associated with the ASP itself. Failure to properly account for such risk can lead to:
  • Loss of control of corporate data.
  • Loss of control of corporate image.
  • Insufficient ASP security to counter risks.
  • Exposure of corporate data to other ASP customers.
  • Compromise of corporate data.

Some other risks include the inability to account for the financial condition of the ASP in general, i.e. How stable a company is it? Does it have resources to continue business into foreseeable future?
From: Ted Gearhead, Head of MIS
To: Warren S. Reid, CEO
Re: Deal with AuctionBid.com
Date: March 13, 2008

Warren: I have evaluated all of the proposals and think that AuctionBid.com (“AB”) is the right fit for our needs and our unique business model. With our business model (as a “virtual” company) we want to invest as little money as possible up front to get started and AB looks like the ideal solution. We want to avoid buying computer equipment, renting space for a computer center, hiring lots of employees and generally doing what a normal start-up would be doing. AB can both host our website and provide us with the software to process the online auctions. They can run the auctions and maintain the hardware and software for us. It seems like an ideal fit.

The basic structure of the relationship looks pretty straightforward. Our one web designer, Tommy Thumbs, will be designing and programming our website. He will do all of the graphics, set up how the home page and auction pages will look and design the software that will allow sellers to sign up for the service, and post information on the heavy equipment they plan to sell, including descriptions and pictures. Tommy has also designed and is writing the software to allow buyers to sign up, navigate the website and place bids. The only piece that is missing, and it is a critical piece, is the software to actually run the auctions, keep track of bids, etc. That’s where AB comes in.

AB has a software package that permits website like ours to run auctions. For a normal auction site, like eBay, the AB software just “plugs into” the website’s software and works like a charm. However, because we are running our auctions differently, it will be necessary for AB to modify its standard software to work with our business model.

The contract we negotiate will need to provide for AB to make the agreed-upon modifications at its own expense, and to provide us with a modified software package that will plug into the website software that Tommy has designed and is in the process of writing. We have already given AB access to Tommy’s design and AB says the modified software will work without Tommy having to modify what he has already done. While I know that AB is an expert in this sort of software, from past experience, I know that custom software never works as designed and will require some tweaking. So it will be important to provide for a short period of time (probably 30 days) after AB finishes the modification so we can test the software and make sure it works properly. Because we won’t have the computers ourselves to do the testing, AB will need to provide us with access to their computers to do the testing.

My only concern is that AB is extremely busy. Their auction software is very popular and dozens of companies are signing up with AB and having AB run their auctions.

I will be working closely with our outside counsel, so if there are any things you want me to pass on to them, let me know.
Ted. Thanks for your very useful memo. I agree with everything you say. However, I have a couple of concerns that the contract should address.

1. **Getting the site operational.** The auction website IS our business. If it is not operational on schedule, we are out of business. While I am grateful that AB is funding the modifications to their standard software, I am concerned about the schedule. I can imagine that if they get another big client who is paying them for software development or modification, they may put our project on the back burner and we will never get up and running. So, the contract should contain a timetable that will ensure that no matter what, AB will get our website fully operational within six months of signature. That six months should include the one month of testing you mentioned in your memo. Not one day more than six months!!! Are we clear?

2. **Payments to AB.** As you know, the deal is somewhat unusual in that we are not paying AB a fixed price per auction. Instead we are paying them a percentage. I want to make sure the contract is clear that we will pay them 3% of what we are due from the seller for each auction. So that means 3% of the minimum that the seller pays us up front. The minimum will be 10% of what the seller estimates that equipment will sell for. And then, AB is entitled to 3% of what the seller owns us at the end of the auction if the actual sale price exceeds the estimate. Remember, we will be getting 50% of the difference between what the seller estimates the item will sell for and the actual amount it sells for, if it sells for more than the estimate. So AB will also get 3% of the 50% we get.

So, for example, if Seller A estimates that an item will sell for $10,000, we will get 10% of that estimate up front or $1,000. If the item actually sells for $14,000, we will get 50% of the difference between the actual sale price and the estimate (or 50% of $14,000-$10,000, or $2,000). So in this example Seller A will owe us $3,000 ($1,000 + $2,000). Then, AB is entitled to 3% of the $3,000 or $90.

Because it may take a while to get paid by the seller, we will want to have up to 90 days to pay AB from the end of the auction. If we get paid quicker than 90 days, we will pay AB within 10 days of getting the check. If we don’t get paid within 90 day (or at all) we will still owe AB the 3%, which we will pay on the 90th day. Since we are dealing with major corporations (and even some government agencies) I don’t see the risk of not getting paid as a substantial risk.
3. **Tommy Thumb.** We can both agree that Tommy is a genius. Without him we would be screwed. I heard one of AB’s engineers telling Tommy that if he ever decides to leave us, AB would be anxious to hire him. I want to make sure that doesn’t happen. So make sure the contract prohibits AB from hiring or soliciting to hire any of our employees for a minimum of 6 months after the employee leaves the company OR 6 months after our contract with AB ends, whichever is longer.

4. **Service level.** Because the website will be the lifeblood of our company, I can’t take a chance that it will be unavailable for any extended period of time. We need a service level provision in the agreement that provides for 99% uptime during any 24 hour period. If it this level is not met in any three days of a calendar month, AB will pay us $1,000 for any hour or portion of an hour that the website is unavailable. If this is a problem for AB, then AB needs to arrange for a back-up website to which our auction site can be shifted immediately if the primary site goes down or is unavailable on the Internet regardless of the reason. The only exception is monthly maintenance. I am willing to allow the website to be unavailable for up to one hour per month for scheduled maintenance of the computer system. The maintenance must be done on a Sunday night between 2:00 am and 3:00 am Pacific time and cannot exceed one hour.

5. **Term and Termination.** The contract should be 5 years long with an option for us to renew for an additional 5 years on the exact same terms. (The only term that I would be willing to change would be the percentage due to AB from auction sales. I would be willing to go to 4% from 3% during the second five year term.

   Again, because this website is our entire business we cannot allow AB to terminate the agreement regardless of the reason. So the contract should provide that if we breach for any reason, AB’s only remedy is to sue for damages. The only exception is if we fall more than $10,000 behind on the amounts that we owe to AB. In that case, they must give us notice. If we pay all outstanding balances within 30 days of the notice, the contract will continue. If we don’t pay, AB can phase out the website. By that I mean, AB can modify its software so that it does not accept any new auctions, but the software must allow the auctions that are in progress on the 30th day after notice to continue to their conclusion. Once all of the pending auctions have concluded, AB can shut down the website.
To: Michael Krieger, CEO  
From: Connie Coder, VP, Business Development  
Re: Contract with ItsYourBid.com  
Date: March 13, 2008

Michael: After a lengthy period of time, ItsYourBid.com (IYB) has responded favorably to our proposal to provide web hosting and auction software services to them. They are a start-up, but seem to be fairly well-funded. Because this auction site will be their entire business, they are somewhat worried about whether we can provide them with the services they need. But I think I have assuaged their concerns.

As you recall, IYB has a slightly different business model than most of our clients who charge their sellers a flat fee (or percentage) of the selling price, and pay us a fixed, per auction fee. IYB has a more innovative business model, which should work well for their business that focuses on large businesses instead of consumers, and on auctioning off large pieces of machinery that command a fairly high price, rather than focusing on generally low priced consumer goods, like eBay.

However, because their business model is somewhat different, they cannot use our standard, off-the-shelf auction software. They will need some significant modifications to the software to work with their business model.

We have run the numbers, and think that we can make significantly more money by using their proposed business model, where we will receive a fixed percentage of the fees that IYB receives from their sellers, instead of charging IYB a fixed fee per auction. Under the proposed business model, we will receive 3% of what IYB is due from each seller for each auction. So that means 3% of the minimum that the seller pays IYB up front. That minimum is current set at 10% of what the seller estimates the equipment will sell for. In addition, we will be entitled to 3% of what the seller owns to IYB at the end of the auction if the actual sale price exceeds the initial estimate. IYB will be getting 50% of the difference between what the seller estimates the item will sell for and the actual amount it sells for, if it sells for more than the estimate. So we will also get 3% of that 50% as well.

So, for example, if Seller A estimates that an item will sell for $10,000, IYB will get 10% of that estimate up front or $1,000. If the item actually sells for $14,000, IYB will get 50% of the difference between the actual sale price and the estimate (or 50% of $14,000-$10,000, or $2,000). So in this example Seller A will owe IYB $3,000 ($1,000 + $2,000, and we will receive 3% of the $3,000 or $90. That’s much better than the $5 per transaction we usually charge.

And, some of this equipment may sell for tens of thousands of dollars, so our cut will be several thousand dollars.
One of the concerns I had was with the situation where a seller doesn’t pay IYB at all. Unlike sites like eBay, which can simply charge the seller’s credit card or PayPal account the cost of these items is so high that credit cards can’t be used. IYB indicated that the sellers are generally Fortune 1000 companies and are not likely to refuse to pay. There was also a concern we had about when payment would be made. Because they will need to invoice their sellers for payment, we agreed to allow IYB to pay us our fee 90 days after the auction closes, or 10 days from the date they received payment, whichever is earlier. We will get paid whether or not IYB gets paid. That takes care of my concern on that issue.

Because their website auctions will be using this different payment model, it will be necessary to modify our software to provide for this payment model. We agreed in our proposal to do the modifications at our expense. It should not be a great amount of money. We have to interface with the software being developed by IYB for the basic website navigation. I have looked at the design done by their website designer, Tommy Thumb, and it looks relatively straightforward. However, I would be concerned if the software Tommy is developing changes significantly from what we already saw, so the contract should probably limit IYB’s ability to change the software once the contract is signed. If any changes are made subsequently that cause us to redesign or rewrite our software modifications, IYB should be required to pay us for those changes.

We have agreed to get the site operational within six months of signing the agreement. That should not be a problem as long as Tommy is still there or they have someone else to replace Tommy that is just as good. It also depends on their not changing their software design after the contract is signed. If they do so, it may take longer to get the website up.

I am somewhat concerned that if Tommy should leave or IYB decides to expands its programming department, the company might try to steal away some of our programmers. So we should really include a non-solicitation clause in the contract.

I know you will be meeting with our attorneys this Saturday. Let me know of any other issues that they think are important.
MEMORANDUM

To: Connie Coder, VP, Business Development
From: Michael Krieger, CEO
Re: Contract with ItsYourBid.com
Date: March 13, 2008

Connie: Thanks for the memo. I am quite excited about this relationship. As you know, there is a lot of competition in the auction business now. It seems like everyone is starting an auction site. That has had an impact on our revenues. While we seem to be signing up new auction clients on a regular basis, we just aren’t generating the revenues we used to. Traffic on these sites is down. It seems like the bad economy is causing people to spend less money. As a result, we REALLY need to do this deal.

I like IYB’s business model, since we have a chance to make a lot more money on fewer transactions. However, since IYB is a start-up, I am concerned about their financial stability over the long haul. We need to be able to terminate the relationship if IYB gets into serious financial problems. I have talked to their President, who tells me they are flush with cash and not to worry. But I am worrying nonetheless. We will be spending a great deal of money on modifying the software to work with their business model, and we need to make sure we can recoup the money and make a good profit. As such, we need to do the absolute minimum work necessary to get their site up and running.

I have some other potential deals in the works. If one of those comes up that pays us a bunch of cash upfront, we may want to delay the work on the IYB modifications to work on these other projects. See if we can push that six month deadline out to nine months, and include language that gives us a chance to extend the deadline if IYB makes any changes to its website design or programming after we sign the contract that causes us more work than we anticipated.

One of the issues that I talked about with the President is service levels. They want us to guarantee 100% uptime for the website. That is unrealistic. Since they are only selling large machinery versus consumer products, if the website is down for a few minutes or even a few hours per month, it’s no big deal. Let’s offer a guarantee of 97% availability determined on a monthly basis. If it falls below that, we will work diligently to bring it back to the 97% level on 30 days written notice. If we can’t do it, they will pay IYB $100 per day for each day that we fall below the 97% uptime. But that will be their exclusive remedy.

Because we will be incurring costs to host this website, but IYB is only paying us a percentage of actual revenues it receives from sellers, we are totally dependent on their sales efforts to get companies to post machinery on the site. If they can’t attract sellers, they will make no money, and we will make no money. Please include a minimum payments clause. If they don’t pay us at least $5000 per month starting in the 7th month of
the contract, we have the right to terminate the contract on 30 days written notice. I don’t think it will be a problem, but that clause should give them sufficient impetus to go out and market the website.

Of course, we will own all of the rights to the software we develop for them. Once the contract ends, we keep the software. That should make sure they don’t jump ship and move to another auction hosting services. The contract should be a minimum of 5 years, to insure that we can recoup the amounts we are investing in the software, with an option for another 5 years that either party can exercise. If either party exercises the renewal right, I want our percentage to increase from 3% to 6% for the second five year term.

If IYB files for bankruptcy or does not pay us when payments are due, I want the right to terminate the contract on 30 days notice. We will complete all pending auctions, but will not start any new one during that last 30 day period.

I think that is all for now. I may have some additional items after I meet with our lawyers this Saturday.