Beyond Banners: Restructuring Portal Advertising Deals

by

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"People [in the advertising business] hate you. . . . You're arrogant and condescending."

– Thomas Evans, former chief executive of Geocities, a 1999 Yahoo! Inc. acquisition, at a meeting with Yahoo!'s top brass about the company's aggressive sales tactics.[1]

At the zenith of the "New Economy," an Internet company's deal with a major portal often was all the blessing necessary to go public, raise additional funds or finalize other strategic partnerships. Insiders and analysts alike considered those deals the key to generating the traffic needed for big profits and even bigger valuations. "Two years ago," recalled Patrick Byrne, CEO of Overstock.com,[2] recently in *The New York Times*, "the received wisdom was 'You have to have a portal deal: it is like getting a billboard at the onramp to the Information Superhighway.' . . . People waited in line to sign such deals."[3]

Today, however, many Internet companies are finding it literally impossible to live with those deals and are restructuring—or at least trying to restructure—them to better align the parties' interests. This reversal of fortunes lies mostly in the often uncharted territory in which the parties were working, especially those venture capital-fueled, pure-play Internet companies that struck high-dollar advertising deals with portals like Yahoo! Inc. ("Yahoo"), America Online, Inc. ("AOL"), Microsoft Network, L.L.C. ("MSN") and others—as well as the inexperience of some of the dealmakers among the advertisers. This year is likely to see myriad restructurings of portal deals on terms tailored more than ever to reward concrete results instead of mirroring traditional advertising models. In fact, Overstock.com CEO Byrne practically advises advertisers to <u>insist</u> on restructuring, telling *The New York Times*:

> [I]f there are any Internet CEOs or marketing guys reading this who are locked in to an egregious deal with a portal and want to get out, this is what you do: Stop paying. They will call and threaten you. You say, "Look, we spend $X with you and got about $X/100 value. I will pay for what you delivered so far, but pull us off your site going forward." . . . They will piss and moan and wave the contract in your face, to which you reply, "Go fish, I ain't paying." Then they will send lawyers who will scream and yell and piss and moan and waive the contract in your face, and you say: "Go fish, I ain't paying." And if they are publicly traded their accountants will start telling them that they are going to have to reserve against any more revenue, and its going to look ugly, and they will scream at you some more, and threaten to sue you, and you say, "Go fish. You're publicly traded and you are never going to sue a customer for revenue." And then they will piss and moan some more and take your offer and you will have some of that VC money left with which to build a business.[4]

1. Recent Restructurings

Probably the most notorious restructuring involves the misguided portal deal between AOL

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and Drkoop.com, Inc. ("Drkoop.com"), which has become the poster child for mismanaged portal deals. As *The Industry Standard* reported last July, Drkoop.com entrusted negotiations with AOL to a 27-year old junior-college dropout who the company had hired as a web developer. Under his green guidance, and just a week after Drkoop.com's $88.5 million IPO, the company agreed to pay AOL $89 million over four years to be the portal's premier (but not exclusive) health information provider.[5] The lop-sided portal deal with AOL failed to generate the traffic Drkoop.com expected, leading *Fortune* magazine to conclude that the deal was "disastrous" and label managers at Drkoop.com "not the sharpest scalpels in the bag." Within weeks after closing the deal, and after shelling out about a third of the $89 million to AOL, Drkoop.com reportedly begged AOL to accept new terms under which AOL would receive 3.5 million shares of common stock instead of additional cash payments.[6] AOL's willingness to renegotiate was not mere charity. AOL accepted the restructuring because it understood that Drkoop.com would go bankrupt if AOL insisted on sticking to the original deal.[7]

Other portals also have restructured deals with numerous dot.coms in an effort to maximize available revenues in a declining advertising market—sometimes grudgingly, sometimes enthusiastically. After all, a lot of the money that was available for Internet advertising has dried up, especially as investors have pulled away from dot.com companies over the last eight to 12 months. "There is tremendous pressure from investors now to justify every dollar of your advertising," Robert Levitan, the president of Flooz.com, told *The New York Times* last February.[8] Levitan revealed that Flooz.com had reduced its advertising spending by about 30 percent and is trying to increase the return on its advertising investments by scheduling ads to drive traffic during seasonal periods and channeling ads to less glamorous media such as trade magazines read by the corporate executives most likely to use its service.[9] Indeed, most portals will find that restructuring a deal with an advertiser is better than watching the advertiser abandon the relationship or declare bankruptcy. And the portals like MSN, AOL and Yahoo! are not alone. Amazon.com has had to restructure deals with advertising partners, announcing in 2000 that it lost $2.9 million in revenue for the three months ending June 30 after restructuring agreements with some of its 15 Amazon Commerce Network partners.[10]

Here are just a few examples of other portal deals that were restructured since last March:

- PlanetRx.com/AOL
- Beyond.com/AOL
- Autoweb/CarsDirect.com
- Egghead.com/Yahoo!
- Onvia.com/AOL
- 1-800-Flowers.com/AOL

For Onvia.com—a business-to-business exchange for small and medium-sized enterprises—the restructuring reversed sales and marketing expenses for Onvia.com by $2.3 million during the fourth quarter of 2000.[11] The restructured deal between 1-800-Flowers.com and AOL also saved the advertiser millions. Under the new deal, the online flower-delivery service basically gets for free two additional years of being the portal's exclusive provider of floral and gift products.[12] There is no doubt that many companies doing business on the Web are still clamoring to work with the biggest portals. Even Overstreet.com CEO Byrne concedes, "Of course online media is here to stay."[13] But the leverage has changed and the restructured deals reflect the difference.

2. How the Deals are Changing

In the most general sense, portal deals are moving from a traditional advertising model to a performance-based model that more closely aligns the interests of the media outlet and the advertiser. Thus, these restructurings typically try to tie payments to actual customers secured or merchandise sold instead of just advertising impressions.

2.1 The Traditional Advertising Model

Before these restructurings, Internet portal deals almost uniformly tracked the traditional advertising

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model. Under that model, an advertiser would pay for quality (i.e., the kind of audience delivered by the media outlet and the location of the advertisement on the website) and quantity (i.e., the size of the advertisement and the number of times it would appear). The "quality" for which advertisers paid under the traditional model did *not* concern the creative elements of the advertising—a crucial ingredient usually left entirely in the advertiser's control. Instead, advertisement quality generally concerned only the location of the advertisements and the audience they reached. So, for example, advertisers would pay more for a portal that delivered the audience most likely to buy the advertiser's product, service or content. They also would pay more advertisements that appeared "above the fold" on a portal's website (the space on the screen that greets the user when he or she visits a web page) or for other attractive positions, including the "front door" (sometimes called the site's "home page") or within certain "channels" (subdivisions within a website based on subject matters), some of which are more frequently visited (and therefore more valuable) than others. But quantity mattered as well, so the original portal deals typically provided that the advertiser would pay based on the number of "impressions" that the portal provided (i.e., the number of times that an advertising would appear to users). Other factors also would affect advertising prices, such as the right to be an exclusive provider of certain information, products or services for the portal, or (in large media deals) an "anchor tenant." As an anchor tenant, an advertiser becomes a preferred provider of content (often at great cost) and earns a position greater in size and prominence within the relevant portal's page or area of a page than its competitors. This ensures that the advertiser's promotions will not have to vie for attention with its competitors' promotions on the portal's site.

2.2 The Zenith of Portal Leverage.

Portals based everything on the traditional advertising model and, at the height of their leverage with advertisers, tweaked it further. Consider the following media-fee provision from a typical portal agreement:

> Within 30 days from receipt of an invoice from PORTAL, the ADVERTISER shall monthly pay PORTAL a media fee for all Impressions PORTAL delivers pursuant to this Agreement. During Year One, the ADVERTISER will pay PORTAL $_________ in equal monthly amounts for such Impressions. During Year Two, the ADVERTISER will pay PORTAL $_________ in equal monthly amounts for such Impressions. All payments pursuant to this Section shall be non-refundable.

This provision's brevity reveals the strong leverage that the media outlet enjoyed. There are at least five terms in these four short sentences that are unreasonable. To begin with, all payments are made "non-refundable." Second, the advertiser pays cash for the impressions, not when they are delivered but once a month, regardless of the delivery schedule. Third, the absence of an impression-delivery schedule diminishes the value of such advertising for the advertiser because it leaves the portal free to saturate its site with impressions on some days (when the portal has unsold inventory) and provide no impressions on others (when it can sell its inventory for a higher "CPM").[14] If the advertisements work as intended —i.e., they actually get users to buy the products or services they are promoting—sporadic saturations might require the advertiser to incur employee overtime expenses, purchase extra hardware to cope with traffic surges, and suffer countless logistical problems in satisfying erratic purchase patterns. Fourth, the portal under this provision undertakes no obligation to target potential customers by delivering the impressions to certain channels. As a result, many impressions are wasted on unqualified or less qualified users (i.e., users who have not demonstrated some level of interest in the advertiser's product or service through their choice of content on the site). Finally, this provision includes no commitment to run the impressions above the fold and no proscription against running them on a set of simultaneously rotating banners that might repeatedly show the same advertisement to a single user and count each rotation of the banner against the total number of impressions the portal is required to deliver under the agreement.

2.3 Occasional Alternatives

In some cases, advertising agencies that placed impressions for advertisers were able to fight for more reasonable terms. When they occasionally succeeded, they won provisions for their clients that were essentially the obverse of the media-fee provision above. More reasonable media-fee

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clauses: (1) left payments refundable in the event of a portal's material breach; (2) permitted the advertiser to pay for the impressions as and when they were delivered instead of front-loading the entire payment, (3) required the portal to deliver an equal number of impressions for each month of the agreement (i.e., delivery on a "straight-line" basis); (4) established commitments from the portals to provide the advertisements in certain channels or on particular pages of the portal's site; and (5) set accounting standards such that the portal could only count one impression against the contract regardless of how many advertisements it might put on a pageview.

When most successful, the advertising agencies convinced portals to tie payments to "click-throughs," which often were included in "anchor tenant" deals. Under a click-through scheme, the advertiser generally would pay a lower fixed fee for advertising but would owe additional fees each time the portal delivers a user to the advertiser's website through a link on the portal's site. Thus, an advertiser paid most when its advertising succeeded in moving users from the portal to the advertiser's own site (or at least another site co-branded between the advertiser and the portal) and paid less if the advertising did not work as expected.

Unfortunately, click-through arrangements have problems too. A simple example of a portal advertising deal with an on-line florist illustrates the shortcomings of such an arrangement. Imagine that Ward Cleaver is surfing on MSN using his computer at work and sees an advertisement for 1-800-flowers.com but does not make a purchase, deciding instead to wait until his wife June's birthday. A few weeks later, June's birthday approaches and Ward buys her flowers through 1-800-flowers.com using his computer at home. In this scenario, Ward's choice to use 1-800-flowers.com is the result of the company's advertising on MSN, but it is difficult, if not impossible, for MSN to claim credit for the sale if it has a click-through deal with the online florist since Ward did not use the same computer to make his purchase that he was using when he came across the advertisement for 1-800-flowers.com. Had he done so, a "cookie" placed on his computer from MSN's website would have identified him for click-through accounting purposes. But by using a different computer, tracking Ward's path from MSN to 1-800-flowers.com becomes impossible. This is just one way in which click-through arrangements fail to precisely reward the value that a portal delivers.

2.4 Crying Uncle: Growing Demands for Performance-Based Advertising

Because portal advertisers did not succeed often enough in getting favorable terms, many came to find that strong pro-portal promotion deals based on the traditional advertising model simply cost them too much. As a result, for many businesses that advertise on the Internet, the cost of capturing customers could not justify the investment and in some cases might even mean bankruptcy for the advertiser. "For a long time they sold online media at inflated prices because at first no one knew what it was really worth," notes Patrick Byrne, "and more recently because buyers were locked into contracts they had signed earlier. That is changing fast."[15] For some Internet advertisers, restructuring their promotion agreements might be a matter of life and death and many websites that generate revenue from advertising sales are hearing demands to revamp the deals that advertisers struck with them in 2000. As a result, Internet advertisers are looking for more than just exposure; they are looking for concrete returns on their portal advertising investments. Specifically, they are looking for deals that reward the portal only for those customers it actually delivers to their websites.[16] For example, CNET reported recently that Internet advertisers are arranging "hybrid" performance-based deals that include revenue sharing, access to consumer information, and other ways of sharing the benefits of the portals' resources.[17]

The two compensation models most favorable to advertisers in portal deals are conversion-rate and revenue-sharing arrangements. Under a conversion-rate scheme, an advertiser pays only for "converted" users, those users who actually buy a product or service as a result of an advertisement. Under a revenue-sharing arrangement, the advertiser pays the portal a portion of the revenues generated from its advertisements. Both of these schemes are highly favorable to advertisers because they cost advertisers only for real customers and allow them to generate "mind share" for free. In other words, it costs the advertiser nothing under a

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revenue-sharing or conversion-rate deal to generally promote its product or service and only costs money if the customer makes a purchase.

Considered along a spectrum, therefore, the range of options for compensation terms in a portal advertising generally looks like the figure below.

Despite the converging trends of fewer advertising dollars and a demand for bigger returns on advertising investments, portals are unlikely to willingly restructure a promotion or integrated media agreement unless the advertiser makes a strong business case for it. After all, portal agreements are enforceable contracts, meaning that the portal has relatively good leverage when restructuring talks begin.

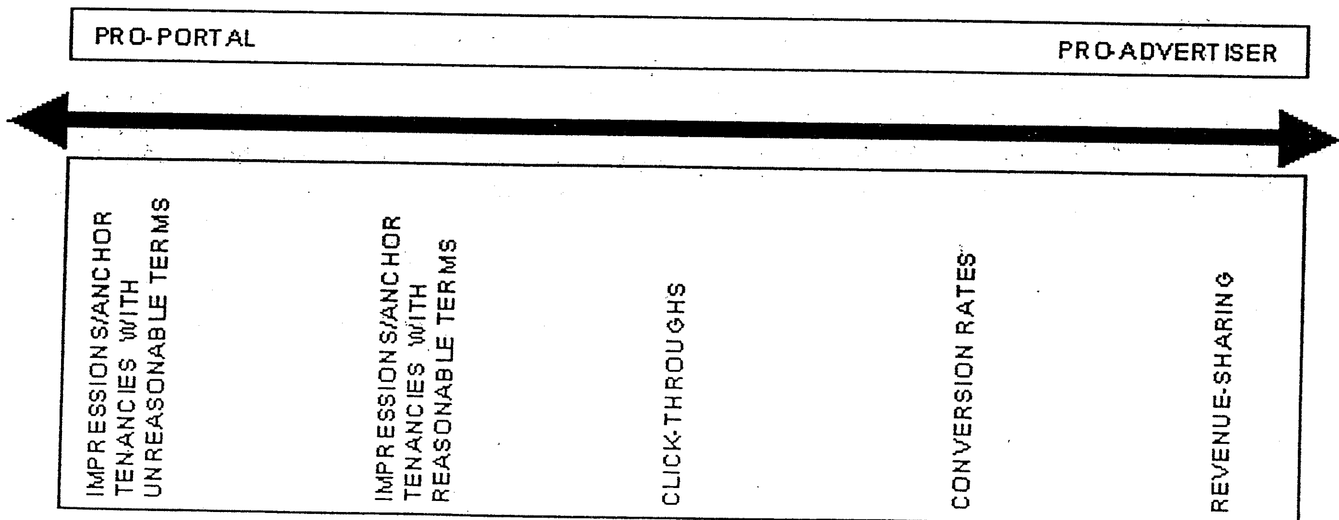
3. Due Diligence for Restructuring Deals

Internet advertisers who want to make the most persuasive case for restructuring a promotion agreement or similar deal will need to do their homework before proposing any changes, including:

- researching the portal's traffic reports (and understanding how they are sometimes inaccurate and/or manipulated);
- checking the portal's and its other advertisers' recent SEC disclosures for the terms of any deals that have been made public; and,
- preparing the strongest business case possible for restructuring, based on the advertiser's own past experience with the portal.

3.1 Traffic Reports

The first thing a buyer who wants to restructure a promotion agreement should do is research traffic reports for the portal and learn how those reports are sometimes misleading or manipulated. The four most prominent third-party rating agencies for web traffic are Media Metrix, Nielsen NetRatings, PC Data and Net Value. Modeling their work on television and radio ratings schemes, these companies pay thousands of Internet users to install monitoring software on their computers which electronically transmits data about their surfing habits to the firms for tabulation. The firms then extrapolate this data to the general population and produce estimates of the traffic that websites experience in terms of pageviews, unique visitors or other metrics.[18] Since the ratings firms generally do not share information about their panels of surfers or their methodologies, their results often differ and a portal may refer only to the most flattering data when negotiating advertising rates. Choosing the most flattering traffic reports is just



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one of the ways that a portal may paint an unduly rosy picture of its reach and audience. A portal also may keep its thumb on the scale by targeting its own advertising at users likely to be monitored by one of the ratings firms rather than more typical surfers, by tweaking the presentation of its pages to get a better count from the metering software used by ratings firms, or by requesting customized traffic reports that are especially susceptible to manipulation.[19] Advertisers should educate themselves about these ratings games before even approaching a portal about restructuring a promotion agreement.

3.2 Recent SEC Disclosures

Sometimes an advertiser can learn what others are paying for similar exposure by looking at a portal's or its advertisers' SEC disclosures. These SEC filings sometimes reveal the terms of deals that other advertisers have struck with various portals. For example, the Form 10-Q filed November 15, 2000 with the SEC by 1-800-Flowers.com for the three months ending October 1, 2000 discussed the substance of the company's portal deal with AOL and revealed how the company "terminat[ed] an interactive marketing agreement with one of the Company's portal partners . . . [and] . . . subsequently entered into a new, enhanced five-year, $22.1 million agreement with the same portal partner, thereby reducing the Company's continuing annualized expense with such partner by $5.6 million." Even better for those researching the terms of the restructuring, the Form 10-Q stated that the company had filed "a report on Form 8-K on September 21, 2000 related to the termination and subsequent replacement of its interactive marketing agreement with America Online, Inc.," including the actual amended contract between AOL and 1-800-Flowers.com. Autoweb.com, Inc.'s August 14, 2000 Form 10-Q for the period ending June 30, 2000 likewise includes as an exhibit its Amended Strategic Co-Marketing Agreement with CarsDirect.com.

3.3 The Past Is Prologue

An advertiser's own experience with a portal probably provides some of the best information with which to propose a restructuring. If traffic reports or monitoring software show that a portal generated just a fraction of the traffic that the portal indicated the advertiser could expect in the ubiquitous PowerPoint presentation, if not in the actual contract itself, an advertiser might reasonably demand a commensurate reduction in media fees. The same result might be justified if the portal's own advertising targeted a different audience than expected and therefore a more target-poor environment for the advertiser.

4. The Best Reasons To Restructure

Just because a portal deal is not economical or fails to meet an advertiser's expectations does not mean a buyer has a *right* to renegotiate. Contracts by their nature are designed, among other things, to allocate the risk of contingencies that are difficult to predict. Consequently, an advertising buyer should approach restructuring a deal from the portal's perspective. The most significant factor in the portal's rational self-interest is the fact that a bankrupt partner is no partner at all. If a portal deal is so onerous that it risks the advertiser declaring bankruptcy, the portal's interest obviously lies in restructuring the deal. Similarly, a struggling partner with one foot in the grave of insolvency brings little credit to the portal, which is supposed to showcase "best of breed" websites to the portal's users. Another factor that portals must consider is the distraction of a dispute. Regardless of how far awry a portal deal goes, most portals and advertisers cannot afford the time, management distraction and expense of a protracted contract dispute. All of these factors, therefore, militate in favor of restructuring deals that are genuinely beyond the ability of an advertiser to perform.

5. Problems With New Models

Unfortunately, even though some portals may be willing to renegotiate promotion agreements with advertisers, the new models for these deals are not entirely satisfactory because all of the alternatives to the traditional advertising model impose a much greater degree of risk on the portal. As noted earlier, two of the most widely proposed formulas for restructured portal deals are basing fees on conversion rates or creating a revenue sharing arrangement. Both have their problems.

5.1 Conversion Rates

Although advertisers will welcome using conversion rates to encourage portals to weed out

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unqualified traffic that might otherwise get pushed to their websites, portals are likely to find that basing their advertising fees on conversion rates leaves much of their fate—perhaps too much—in the advertisers' hands. First of all, the portal generally cannot improve on an advertiser's copy or its business. "Poor creatives" (i.e., ineffectual advertisements) do not sell products or services and neither do bad value propositions (i.e., products or services that do not make sense or cost too much for what they deliver). So the portal that agrees to rely on conversion rates also must rely on the advertiser having good creatives and a compelling product or service. Second, and perhaps worse, even if a portal manages to deliver a customer to an advertiser's website, the entire purchasing process is in the advertiser's hands. And even when a business does everything right, many customers who reach the advertiser's destination leave without buying. According to a study by Boston Consulting Group reported in *The Industry Standard* last November, "Of the millions of people surfing through the more than 10,000 e-tailing sites (of which 1,000 have sales of $500,000 or more), 97 percent leave before buying. And of those who start to fill up a cart, 65 percent abandon it before going through the checkout process . . . ."[20] That is not reassuring at all to a portal relying on conversion rates for its revenue.

5.2 Revenue Share

Revenue sharing will likely leave portals even more unhappy. Indeed, some of the business development professionals at the big portals consider revenue-sharing agreements an invitation to be robbed blind. Because there are no industry benchmarks for what can be expected in these arrangements, a portal has little way of knowing whether the revenue that an advertiser attributes to it is reasonable or just an effort to cheat the portal out of its share of the revenues. Thus, reporting is entirely in the hands of the advertiser and the portal is largely forced to rely on whatever the advertiser claims is the revenue generated by traffic from the portal.

That said, there are audit provisions that portals can insist upon including in promotion agreements to help police the accurate calculation of the revenue-sharing arrangements to whatever extent possible. An effective provision to that effect might require the following:

> Records and Accounts. The Company agrees to keep on a continuing basis during the Term and for four (4) years after the Term, full and accurate records and accounts, including, without limitation all logs and reports, sufficient to permit PORTAL to verify the accuracy of all reports submitted by the Company as hereinabove required. PORTAL shall have the right, at its sole expense, to examine such books and records, whether in electronic format or otherwise, to the extent that such examination is necessary and pertinent to the foregoing verification, during reasonable business hours and at the Company's principle place of business, using its employees or principals, or through outside, authorized representatives. In the event such an examination reveals that any of the reports submitted or payments made by the Company to PORTAL, as hereinabove required, understated the monies owed by five percent (5%) or more, then the Company shall, in addition to the payment of the additional monies owed as determined by such examination, promptly pay to PORTAL the reasonable cost of such examination.

This provision includes a number of features that should foster honest revenue accounting between the advertiser and the portal. First, it requires the advertiser to establish a verifiable record-keeping system. Second, it allows the portal to audit the advertiser's records at random and as often as necessary. Third, this provision supersedes any "record-retention" (read: record destruction) policy the advertiser might have in place by requiring it to maintain the relevant records for at least four years. Fourth, by addressing "records . . . in electronic format," the provision requires the advertiser to include e-mails (some of the most candid information available) among the records subject to audit. And finally, it imposes on the advertiser the costs of the audits whenever they reveal more than nominal underpayments.

Even with such strong contractual protection, however, figuring out what the advertiser owes the portal might be difficult because the portal may never know what it is rightfully owed until it actually performs an audit of its own, which in the context of an on-going business relationship might be politically difficult if not practically impossible.

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6. Typical Elements of a Restructured Website Advertising Deal

Regardless of these difficulties, many portal deals will be restructured to reflect the change in leverage between portals and advertisers. All of these deals are likely to share some common characteristics:

- More performance milestones. Amended deals will include more conversion-rate milestones and revenue shares, and they will include fewer anchor tenancies, impression-based media fees, and click-through payments. These provisions also will permit the advertiser to terminate the agreement if the conversion rates do not meet performance milestones.

- Lower advertising costs. There also is likely to be a net reduction in advertising costs, regardless of the basis for calculating those fees. Indeed, Stephen Riggio, acting chief executive of Barnesandnoble.com and vice chairman of its parent company, told *The New York Times* last month, "I know of some sites whose ad income in 2001 will be one-tenth of what it was in 1999."[21]

- Restructured payments. The smaller payments under these amended deals are likely to be restructured to come at the back end of the transaction, or at least restructured to require payment only when the advertising is actually delivered. Previously, the portals were able to require full payment up front and then deliver the advertising on a negotiated schedule. Most portals probably do not enjoy that kind of leverage any more and therefore will see payments delayed relative to the deals struck in the heyday of Internet advertising.

- Better insolvency protections for the non-defaulting party. The "new" deals will provide portals better protections in the event of insolvency. The original anchor tenancy/impression-based deals had only a generic termination-upon-bankruptcy provision such as this one:

> Either party may terminate this Agreement immediately, and shall have no further obligation under this Agreement, if the other party adopts a plan of complete liquidation or dissolution; becomes insolvent; makes an assignment for the benefit of creditors; makes or sends notice of a bulk transfer; calls a meeting of its creditors with respect to its inability to pay its obligations owed to such creditors on customary terms; defaults under any agreement, document or instrument relating to the party's indebtedness for borrowed money; or ceases to do business as a going concern; or if a petition is filed by or against the party under any bankruptcy or insolvency laws.

Restructured deals likely will explicitly seek to protect the non-bankrupt party better by imposing additional terms such as this one:

> The parties agree that this Agreement is a lease agreement for internet space and that both parties have obligations under this Agreement. The obligations are such that the failure of either party to perform their respective obligations would constitute a material breach of the Agreement. If the Bankruptcy Courts were to review the nature of this Agreement, both parties agree that it would be considered an executory contract and/or unexpired lease under § 365 of the Bankruptcy Code, 11 U.S.C. *et seq.*, unless the Agreement is terminated prior to the filing of a petition for bankruptcy relief.

This second provision offers important protections for the non-bankrupt party because it provides evidence that the parties intended their agreement to be an executory contract (i.e., where there are future obligations on both sides of the agreement) or a lease. Under Section 365 of the Bankruptcy Code, a debtor that is a party to an agreement construed as an executory contract or lease must assume and/or assign the contract and provide adequate assurance of future performance in order to continue to have the benefits of the agreement. Thus, having a clause like this one in a portal agreement makes it much more likely that the creditor may be able to recover pre-petition debts needed for assumption and be provided payment

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ahead of general unsecured creditors to the extent the agreement is assumed and/or assigned.[22]

7. Lessons Learned

So what have Internet denizens learned from their experiences in the last eight to 12 months as advertising budgets shrank and the NASDAQ tumbled? On a microeconomic level, they have learned that the pendulum will swing back away from revenue-sharing arrangements. These deals probably will not provide enough reliable revenue for advertisers, and selling advertising on that basis probably is not cost-effective for a portal. A reasonable middle ground might be found in deals that include performance-based elements such as click-throughs but which can be meaningfully policed. Click-through arrangements are reasonable because they fairly allocate responsibility for success between the advertiser and the portal. Leverage aside, an ideally fair agreement compensates each party for the results it can control and allocates between the parties any risks beyond either of their control. By that measure, conversion-rate and revenue-sharing arrangements are unfair because they impose on portals responsibility for results that are within the advertiser's sole control; namely, closed sales and profitability. Of course, impression-based deals with unreasonable (but industry-standard) terms suffered the same shortcomings on the other end of the spectrum by failing to allocate any responsibility for performance to the portal. Click-through arrangements also are among the fairest for a second reason. They are mutually verifiable. The portal can count the number of users who clicked-through to an advertiser's site, and the advertiser can count exactly how many visitors its website received from a given portal. For these reasons, click-throughs are likely to become the prevailing basis for compensation in website advertising deals when the leverage between advertisers and portals are evenly balanced.

Another lesson in Internet microeconomics is that the goals of an advertising campaign probably should affect the compensation terms of a portal deal. If a business is advertising on the Internet as a "call to action," a campaign to motivate potential customers to actually make a purchase (e.g., "Buy now and get 10% off!"), compensation based on performance probably is most appropriate since the measure of the campaign's success is how many users actually take up the call to arms. On the other hand, if a business wants to advertise simply to build mindshare (e.g., "Coke Adds Life"), impression-based arrangements or anchor tenancies with reasonable terms seem best. In a mindshare campaign, the advertiser's goal is to raise awareness of its product or service in the hope that those who see the advertisements will keep the product or service foremost in their thoughts and become a purchaser when the time is right (e.g., Ward buying flowers on June Cleaver's birthday, not when he saw the banner advertisement on MSN for 1-800-flowers.com). Little thought usually goes into the relationship between how a portal prices its advertising and the goals of the advertiser. Perhaps that will change in the current environment of reduced spending on Internet advertising.

On a macroeconomic level, Internet denizens have learned that a revenue model for a content website, including portals, based on advertising alone does not work. Empirically, few Internet sites have managed to make money with the advertising model. *The New York Times* loses money by relying on advertising to support its online version—even though it attracts the kind of upscale, monied users for which advertisers pay high premiums.[23] Examples like the *Times* lead many to believe that banner advertisements simply cannot generate enough cash to keep a content operation in business.

Why not? Because content providers and portals need more revenue, but advertisers are unwilling to pay more until Internet advertising proves cost effective. Indeed, in some cases, advertising and marketing costs have been the cause of death for some Internet businesses. Take Garden.com, for example. Commenting on the shut-down of this one-time darling of the capital markets, John Thornton, a Garden.com board member and general partner at Austin Ventures, told *Texas Monthly*, "We learned that eventually it's just too damn expensive to get people into your store. That's the whole story."[24] Thornton elaborated that pure-play Internet businesses like Garden.com believed that it would be easy to generate traffic but were wrong and had to spend millions on advertising and marketing to get customers. "That's the story. You can boil it down to that," said Thornton. "This is a

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completely new world. Nobody had a clue what it was going to cost and we and everybody else were wrong about it."[25] In Garden.com's case, *Texas Monthly* reported, the company spent 56.7 percent of its IPO proceeds on advertising and marketing.[26] At those rates, few Internet companies can profitably sell their products or services and therefore have no choice but to reduce their media buys or go out of business.

This is not to say that no one can make money with the advertising model. CNET, arguably the web's most popular site for news and information about technology and tech products, has been profitable for eight of the 10 quarters ending December 2000 and most of its money comes from advertising revenue. CNET also makes money every time a user clicks through to an advertiser's site to investigate a product, regardless of whether the user makes a purchase. As a result of its hybrid revenue streams, the company earned $6.2 million in Q3 of 2000 on an operating basis and had revenues of $56.4 million—nearly 100 percent over the comparable period in 1999.[27] Despite its success, CNET's experience is atypical for adherents of the advertising model and its most recent financial disclosures show that it too is finding it difficult to remain profitable in this increasingly low-margin environment. In a March 2001 announcement to the analyst community, CNET stated that it expects a loss in the first quarter of $5 to $12 million, or four to nine cents a share, before interest, taxes, depreciation and amortization.[28]

Recognizing the shortcomings of this scheme, some major web destinations have tried the subscription model but generally have fared even worse. Only a handful of websites provide content or services that consumers have found sufficiently valuable to actually pay for. ConsumerReports.org, the online version of *Consumer Reports* magazine, is probably the best example. As *The Industry Standard* reported last December, the site earned a $5 million profit in the 12-month period ending last May on about $10 million in revenue. ConsumerReports.org is profitable because the content it provides—reviews and tests of consumer products—is significantly different from the content that most other destinations offer. Even better for the website, the content does not need much updating and remains fresh for long periods of time. This allows the site to run a lean operation with a staff of about 30. Moreover, the content appeals to a wide cross-section of users. And it does not hurt that the site leverages the strong brand and impeccable reputation of its parent.[29] By comparison, the subscription-based online version of *The Wall Street Journal* remains unprofitable, although its editor and publisher Neil F. Budde optimistically predicts that getting into the black "is not too far in the future. We are working on business plans to make it profitable. It's when, not how as a lot of dot.coms are figuring out."[30]

Beyond unique sites like ConsumerReports.org and the online pornography industry, however, the subscription model probably cannot succeed in the market for consumer information, and success with this model most likely is limited to sites providing scientific, corporate and legal information for which professionals long have demonstrated a willingness to pay on a subscription and/or time-online basis (e.g., Lexis-Nexis, Westlaw, Bloomberg, etc.).

8. What the Future Holds

So if advertising is the best game in town but does not work very well, what's left? The answers are unclear, but there are some indications already. In the short term, websites are tinkering at the margins by experimenting with transaction-based revenue models and improving banner ads.

Under a transaction-based model, websites are expected to start charging for the wealth of content they have been giving away, but on a per-use basis at very low prices. Knight Kiplinger, publisher of *The Kiplinger Letter* and KiplingerForecasts.com, predicts that although consumers are accustomed to receiving content for free, "as the freebies become history, and online purchasing of individual articles becomes easy and inexpensive, consumers will have little choice but to accept the new order. . . . Whether it's reading material, music or movies, pay-per-use will become the dominant consumer-purchasing model, co-existing with various flat-rate or time-based subscription plans in the B2B world. In this new order, content will once again be king—or at least a prince. Either way, it will cease to be a pauper, earning nothing and begging for the fleeting attention of fickle users. The kind of content that will get the most attention is accurate, useful information from providers with a reputation

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for quality. In the world of pay-per-read, both professional and consumer users will opt for branded information over no-name generic content. And gimmicky web design will matter a lot less than content quality and utility—the ease of finding just what you need, when you need it."[31]

Until then, the industry is re-vamping its banner ads to revive interest in web-based advertising, improve the efficiency of advertisements, and increase profit margins. Last February, the Internet Advertising Bureau (IAB) followed the lead of CNET and Snowball.com by releasing a new set of industry-wide online advertising guidelines. The IAB, which sets voluntary advertising regulations for the industry, believes the new standards will expand advertisers' options in online media by, among other things, making ads larger and ensuring that the three horizontal "rectangle" sizes are in the same proportions, which should enable advertisers to re-use the same creatives in different advertisement sizes.[32]

These short-term solutions are unlikely to change the fundamentals, however, until broadband technology achieves a critical mass that enables content providers to deliver offerings for which consumers are willing to pay on a higher-margin basis (e.g., streaming media). In the meantime, the industry will likely see five trends. First, there will be more "data mining"—i.e., efforts to gather increasingly granular marketing information about Internet users which portals and other major web destinations can use to better target their advertising (and thereby charge more for it), or that they can sell and turn into another revenue stream.[33] Second, websites will offer ever greater customization. As a result of the industry's extensive collection of personal data about individuals and their online activities, users will see advertisements and offerings aimed directly at their individual "psychographic" and demographic profiles. Third, there will be more consolidation among the portals, which the market has seen already with the demise of the Disney Corporation's Go.com portal.[34] Consolidation necessarily reduces the number of Internet media outlets and thereby increases the advertising rates that the remaining outlets can charge. Fourth, the industry will see "smarter" deals, meaning deals that involve more cross-selling within established media empires (e.g., AOL/Time Warner). And fifth, there will be ever more integrated media sales, especially among the Internet, television and print media, designed to drive users through various media to the advertiser's retail store or website.

Further down the road, as broadband technology becomes ubiquitous, Internet advertising may wreak havoc with television's advertising rate structure. This is why: When the Internet is capable of delivering content comparable to what appears on television today, as well as the interactivity of the Internet, users will find themselves turning more and more often to the computer rather than the television for news, information and entertainment. This turn of events alone should increase the value of Internet advertising. And Internet advertising may grow in value even more because its interactive nature allows advertisers to track the effectiveness of their advertisements better than they ever could with television, which offers only limited ways for advertisers to gauge the real value of a television media buy. In this way, the Internet eventually may completely upend the advertising rate structure of television. (Of course, the interactive nature of the Internet also may entirely undo its value as an advertising medium if its metrics turn out to reveal that commercials have only a limited effect on consumer behavior.)

Whatever the future of Internet advertising brings, the portals and other major web destinations will have to work harder to generate the advertising revenue they may have taken for granted during the "golden age" of the portal deal. In the meantime, the industry has yet to find a consistently profitable revenue model and, until it does, repeatedly restructuring deals might just be a way of life in the Internet economy.

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Notes

[1] Mylene Mangalindan and Suein L. Hwang, *Gang of Six: Coterie of Early Hires Made Yahoo! a Hit But an Insular Place*, The Wall St. Journal, March 9, 2001, at A1.

[2] Overstock.com is the d/b/a for Deals Co., Inc., based in Salt Lake City, Utah.

[3] Saul Hansell, *Now that We're Still Here, Where Do We Go? 7 Answers*, N.Y. Times, February 28, 2001, § D (Technology), at 4 (also available online at http://www.nytimes.com/2001/02/28/technology/28HANS.html).

[4] Hansell, *supra* n.3, at 4.

[5] *Drkoop.com's Darling-to-Dud Saga*, The Industry Standard, May 18, 2000, at 24; Todd Woody, *The Life and Near Death of Drkoop.com*, The Industry Standard, July 24, 2000, at 37.

[6] Nelson D. Schwartz and Margaret Boitano, *Dr. Koop and the Greed Disease*, Fortune, May 29, 2000, at 53.

[7] *See, e.g.*, Woody, *supra* n.5, at 38.

[8] Warren Berger, *After Ads that $houted, Dot-Com Survivors Try Quieter*, Cheaper Spots, N.Y. Times, February 28, 2001, § D (Technology), at D5.

[9] *Id.*

[10] Deborah Kong, *Power Shifts for E-Tailers, Portal Marketing Deals Restructured as Dot-Coms Thin*, USA Today, September 26, 2000, at 1B.

[11] *See* Form 10-Q filed with U.S. Securities and Exchange Commission by Onvia.com, Inc. on November 14, 2000 for the period ending September 30, 2000.

[12] Kong, *supra* n.10, at 1B.

[13] Hansell, *supra* n.3, at 4.

[14] "CPM" is an abbreviation for "cost per thousand" and refers to the price of a given advertisement per 1000 impressions.

[15] Hansell, *supra* n.3, at 4.

[16] *See, e.g.*, Andrea M. Hamilton, *Branding Together*, Red Herring, March 20, 2001, at 81 ("It is also clear that some of the old metrics are no longer alluring. 'People used to like those numbers—X million people are coming to our site. But how does that convert into something meaningful, like sales,' says [Kipp] Cheng[, news editor for IQ News, the technology section of *Adweek Magazine*].").

[17] Jim Hu, *How Quickly the Tables Have Turned in the Online Advertising Business*, CNET News.com, July 26, 2000 (copy of article on file with authors).

[18] *See generally* Maryann Jones Thompson et al., *The Danger of Trading on Ratings*, The Industry Standard, July 14, 2000 at 74.

[19] *Id.*

[20] Gary Andrew Poole, *The Riddle of the Abandoned Shopping Cart*, The Industry Standard, November 10, 2000, at 86.

[21] Hansell, *supra* n.3, at 4.

[22] *See* 11 U.S.C. § 365(b).

[23] Susan Parrott, *NY Times Web Site Hits 5 Yr. Mark*, AP Online, February 22, 2001, *available at* 2001 WL 13675705 (reporting that Arthur Sulzberger, Jr., publisher of *The New York Times*, told an audience at Editor & Publisher's 12th Annual Interactive Newspapers Conference in Dallas that the company "hopes the Internet division will be profitable in two years").

[24] S.C. Gwynne, *Wilted: Garden.com Was Guilty of None of the Typical Dot-Com Excesses. So Why Did the Austin E-Tailer Die on the Vine?*, Tex. Monthly, February 2001, at 49.

[25] *Id.*

[26] *Id.*

[27] Jennifer Greenstein, *Content in Search of Profits*, The Industry Standard, December 11, 2000, at 38.

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[28] *CNET Networks, Inc.: First Quarter Warning Cites Expected Drop in Revenue*, The Wall St. Journal, March 9, 2001, at B5.

[29] Greenstein, *supra* n.26, at 38.

[30] Vinay Kamath, *Eyeballs to Revenue: An Online Model that Works*, FT Asia Intelligence Wire, January 25, 2001, *available at* 2001 WL 3982177.

[31] *What's Ahead for 2001? Predictions from 13 Information Industry Sages*, Information Today, January 1, 2001, *available at* 2001 WL 10514939.

[32] Christopher Saunders, *IAB Approves New Ad Sizes*, InternetNews, February 26, 2001, *available at* http://www.internetnews.com/IAR/article/0,,12_598531,00.html.

[33] *See, e.g.*, Jennifer Lewis, *Customers in the Crosshairs*, Red Herring, March 20, 2001, at 66-68; *see also* Parrott, *supra* n. 22, at 2001 WL 13675705 (quoting New York Times publisher Arthur Sulzberger, Jr. noting that "a major reason" for the online version's advertising success is the company's ability to target advertising to user profiles and content selections).

[34] After two months in mothballs, Disney quietly resurrected a skeletal version of Go.com on March 7, 2001, replacing its once extensive (and expensive) content with links to its sister websites, including espn.com and abc.com, and outsourcing its search engine to one-time rival GoTo.com. *Disney Says Go.com Will Stay*, The N.Y. Times, March 13, 2001 (Technology), § D, at 3. "'We can maintain the page at very little cost by taking feeds from our other sites,' Michelle Bergman, Disney Internet Group spokeswoman, said. 'We can still drive traffic to our sites and leverage our traffic as an asset.'" *Id.* This suggests that Disney thinks it will be easier to maintain some kind of web presence through this period of uncertainty rather than trying to regain a web presence later if portals fulfill their promise.

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