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Professor Joel R. Reidenberg
Fordham University School of Law
140 West 62nd Street
New York, NY 10023
Tel: 212-636-6843
Fax: 212-636-6899
Email: reidenberg@sprynet.com

The Toysmart Bankruptcy

As I begin, I would like to express on behalf of Stephen Kline his regret at being unable to participate today. His office was several hundred meters from the World Trade Center and his presence is needed in New York right now. I am honored to stand-in for such an able prosecutor and I will do my best to present his case.

Mr. Kline was to speak to you about the Toysmart bankruptcy proceeding. The case raises the critical issue of the enforcement of privacy commitments when a company files for bankruptcy.¹

I propose to describe the company briefly, address the conflict between the bankruptcy code and Toysmart's privacy promises, describe the intervention by the state Attorneys General and the Federal Trade Commission, report on the final resolution of the case and draw several conclusions from the proceeding.

1. A Profile of Toysmart.com

Toysmart was an online retail merchant that specialized in the sale over the Internet of educational and developmental toys for children. The Disney Company was the major investor in Toysmart through a subsidiary, Buena Vista Internet Group.

Toysmart collected personal information from customers at the company's web site. The personal information included name, address, billing data, shopping preferences, and family profile information such as children's birthdays and toy interests.

Toysmart's privacy policy stated, "you can rest assured that your information will never be shared with a third party."²

¹ For an excellent scholarly treatment of bankruptcy and privacy, see Walter W. Miller, Jr. & Maureen A. O'Rourke, Bankruptcy Law v. Privacy Rights: Which holds the trump card? 38 Houston L. Rev. -- (forthcoming)

² <http://www.ftc.gov/os/2000/07/toyexh1.pdf>

In 1999, Toysmart had a very successful holiday season. By June 2000, Toysmart filed for bankruptcy.

2. The Conflict between Bankruptcy Code and Toysmart's Privacy Commitment

US bankruptcy law strives to realize the largest financial benefit for the creditors of a debtor company. The bankruptcy code gives great latitude to the liquidation of a company's assets and even allows for the annulment of certain types of contractual obligations in order to bolster the value of the debtor's estate.

As was customary in bankruptcy, the trustee attempted to sell Toysmart's customer database as an asset in order to raise funds for the company's creditors. The customer database contained the personal information of more than 250,000 people who frequented the web site.

Unlike the typical bankrupt company, however, Toysmart had posted a privacy policy on its web site and the sale of the customer data to a third party as part of the liquidation would have been a violation of that policy.

In addition, the Toysmart customer data also contained information about children. Under the recently enacted Children's Online Privacy Protection Act of 1998 ("COPPA"),³ a company must obtain parental consent before disseminating the personal information of children. Toysmart had not obtained such consent.

Hence, the case presented the novel issue of a conflict between the bankruptcy code's rules on the liquidation of assets and the company's privacy promise and statutory obligations toward children's information.

3. State and Federal Interventions in the Bankruptcy Proceeding

The attempted sale of the Toysmart customer data became a public scandal in the United States and the Federal Trade Commission intervened in the bankruptcy proceeding.⁴ The FTC asserted that the disclosure of customer information to a third party would be an 'unfair and deceptive' practice under Section 5 of the Federal Trade Commission Act and then subsequently objected that such a sale would also violate COPPA.

At the same time, forty-four state Attorneys General intervened as a coalition led by the New York State Attorney General's Office.⁵ The states intervened under separate state consumer protection statutes that, like the federal statute, protected against unfair and

³ 15 U.S.C. §§ 6501-6505.

⁴ See *FTC v. Toysmart.com, LLC, and Toysmart.com, Inc.* (District of Massachusetts) (Civil Action No. 00-11341-RGS).(First Amended Complaint) <http://www.ftc.gov/os/2000/07/toysmartcomplaint.htm>

⁵ See Office of the New York Attorney General, Press Release: Toysmart bankruptcy settlement ensures consumer privacy protection (January 21, 2001) http://www.oag.state.ny.us/press/2001/jan/jan11a_01.html

deceptive practices and under the federal COPPA. Each state Attorney General had jurisdiction as a result of the privacy promise extended to consumers within each of the respective states. COPPA specifically empowers the state Attorneys General to bring enforcement actions.

The state coalition was an outgrowth of the work of the Privacy Task Force of the National Association of Attorneys General. Indeed, the states are actively trying to coordinate their work on privacy issues.

In July 2000, the Federal Trade Commission was willing to accept a settlement that would have allowed the sale of the customer list to a “qualified buyer.”⁶ Essentially, the term was defined as a company in the same type of business (i.e. educational toys for children) that would agree to Toysmart’s commitments for the treatment of the personal information. However, the state Attorneys’ General refused the proposed settlement because it did not obligate Toysmart to obtain the opt-in permission of customers.

Initially, the bankruptcy judge refused to accept the FTC’s settlement proposal since there was no real buyer to consider and Toysmart then withdrew the customer data as an asset for sale.⁷

4. Resolution through Public Pressure

The public outcry over the proposed sale of the customer database continued and turned out to be a critical element in the resolution. Disney was concerned about the scandal and through a subsidiary agreed to buy the data for US \$ 50,000.00 and to destroy the personal information within 30 days of the company’s dissolution. The creditors of Toysmart accept Disney’s offer even though another reportedly higher offer for US \$100,000 was available. The creditors believed that the risk of continued privacy litigation was not worth the difference.

5. After-Effects of the Case

The Toysmart case and its resolution appear to have stimulated two important trends. The first is that a number of major web companies such as Amazon and eBay revised their privacy policies to allow for the sale of the customer database as part of the sale of the business. These new policies preclude any future action for ‘unfair or deceptive’ practices and diminish the level of privacy protection afforded to consumers in the case of corporate bankruptcies.

⁶ See FTC v. Toysmart.com, LLC, and Toysmart.com, Inc. (District of Massachusetts) (Civil Action No. 00-11341-RGS).(Proposed Stipulated Consent and Final Order)(July 21, 2000)
<http://www.ftc.gov/os/2000/07/toysmartconsent.htm>

⁷ Gary Anthes, Toysmart, FTC overruled on sale of customer data, ComputerWorld (Aug. 17, 2000)
http://www.computerworld.com/cwi/story/0,1199,NAV47_STO48699,00.html

The second trend is the legislative effort to revise the bankruptcy code. A number of proposals now seek to protect privacy commitments in the event of bankruptcy and to give consumers greater control over personal information in the bankruptcy courts against the creditors of debtor-companies.

6. Conclusions

Several conclusions can be drawn from the Toysmart case. First, despite the lack of general privacy legislation in the United States, the case illustrates that in exceptional circumstances other consumer protection statutes may be available to assure the fair treatment of personal information. Second, the case also shows that public pressure and publicity were essential components of the ultimate protection of Toysmart's database, though for many future cases, the pressure and publicity will be hard to mobilize. Perhaps most significantly, the case demonstrates the important role of the state Attorneys General. Without the aggressive pursuit of the case by the coalition of states, including the rejection of the FTC's compromising settlement, the outcome is likely to have been quite different. However, this critical role for the state prosecutors requires a complex, coordination that may not be easy to maintain in future cases. And lastly, the exceptional circumstances of Toysmart suggest that future bankruptcy cases will not have as satisfactory an outcome. Toysmart had a privacy statement that promised an absolute ban on third party transfers. In the future, many companies are unlikely to have any such privacy policy that would offer consumers or state prosecutors the opportunity to challenge the disposition of personal information in a bankruptcy.

While Toysmart was the first round in the conflict between bankruptcy and privacy, this type of case is likely to arise in many different countries and the dynamics of the US proceeding can be of some comparative value for data protection commissions around the world.

Thank you very much.