Software and Business Method Patents Roll On

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Patents covering software and business methods have been the most controversial aspect of patent law for the last few years. However, the criticism these patents have received has not slowed an explosion of patent litigation as owners of software and business method patents seek to enforce their rights. Software and business method patents raise important questions that every company seeking maximum protection for its IP must face: are these patents enforceable? What types of activities can be protected? What decisions should a business owner make to take advantage of software and business method patents, or to avoid being accused of violating such patents? After a brief primer on patents, we will examine recent U.S. patent litigation with a view toward answering these questions.

What is a patent? In general terms, a U.S. patent is a limited-term right, granted by the U.S. government, to exclude others from making, using or selling the invention defined by the patent claims. Under U.S. patent law, a patent can be obtained on apparatus, methods and "articles of manufacture" that are "new", "useful" and "non-obvious".

What is a business method patent? The term "business method patent" is not defined by statute, but is commonly used to describe patents relating to e-commerce transactions. Business method patents often cover aspects of software and Internet communications. Perhaps the best-known example of a business method patent is Amazon's "one-click" shopping patent.

Until 1998, U.S. courts had not cleared the way for explicit protection of business methods via patents. Then, in *State Street Bank & Trust Co. v. Signature Financial Group Inc.*, the U.S. Federal Circuit held that computer-implemented business methods are eligible for patent protection under U.S. patent laws if they satisfy the same statutory requirements as other types of inventions. Since then, the number of

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business method patents issued by the U.S. Patent and Trademark Office has skyrocketed. The U.S. Patent and Trademark Office reported that applications for software-implemented business method patents grew from 170 in 1995 to 7,800 in 2000. In 2001, the USPTO issued approximately 1000 business method patents, and that number is expected to increase dramatically.

State Street confirmed that business methods can be patented if they meet the statutory requirements of utility, novelty and non-obviousness. The utility test can be satisfied by any useful, lawful function, and is generally a non-issue. The test thus comes down to novelty and non-obviousness – just as it does in any application for a U.S. patent. An invention can be novel if it was not "known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant." In turn, the question of "obviousness" is evaluated as of "the time of invention" and from the perspective of "one of ordinary skill in the art."

Until recently, the most notable example of the enforcement of a business method patent was *Amazon.com, Inc. v. BarnesAndNoble.com, Inc.* in which Amazon sued Barnes & Noble in 1999 for infringement of Amazon's patent covering "one-click" online shopping (a method that enables a complete purchase transaction with one click of a mouse). Although the patent and Amazon's efforts to enforce it were derided by many, a U.S. District Court ruled in favor of Amazon, and enjoined Barnes & Noble from using the feature on its website. The parties settled the litigation this year.

The decision in *Woolston v. eBay, Inc.* provides a more recent example of how business method patents are being aggressively enforced. In May of this year, after a five-week federal trial, a jury awarded Thomas Woolston and his company

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(cont'd from page 1)

MercExchange $35 million for patent infringement by eBay's "Buy It Now" feature, which offers customers the option of buying an auction item at a fixed, preset price. The jury found that eBay willfully infringed Woolston's patent, which was essentially a business method. This decision reconfirms that courts will enforce business method patents, and that companies that ignore them do so at their peril.

Are Software Patents Enforceable? The patentability of software in the U.S. had been blocked by court decisions until the door was opened slightly by the Supreme Court in 1972, in *Gottschalk v. Benson*, and more fully in a string of cases including *Parker v. Flook* (1978), *Diamond v. Chakrabarty* (1980), and *Diamond v. Diehr* (1981). Although the Supreme Court had gone through years of strict scrutiny of patents (Justice Douglas said in 1949 that "the only patent that is valid is one which this Court has not been able to get its hands on"), *Diehr* confirmed that methods are not rendered unpatentable simply because they contain algorithmic aspects or are executed in software. In 1996, the U.S. Patent Office issued guidelines intended to comport with *Diehr* and clarify when a software-based invention is eligible for patent protection. Under current standards, if the claims of a software patent meet the statutory standards of utility, novelty and non-obviousness, then the patent is as enforceable as a patent on a mechanical widget.

One of the most notable recent examples of software patent enforcement is in *Eolas v. Microsoft*, in which a jury awarded more than $520 million in damages to the University of California and Eolas Technologies, Inc., for infringement of the company's patent for technology that allows interactive applications such as "plug-ins" and "applets" to be embedded in Web pages. Plug-ins, applets and similar programs are central to online commerce, since they enable everything from banner ads to interactive customer service. While some have suggested that Microsoft might have no choice but to disable its plug-in architecture based on the finding of patent infringement, it's likely that Microsoft will find other ways to alter its browser software to avoid infringement. At the time of this writing, Microsoft issued a press release indicating changes it has made to avoid infringement.

Are Software and Business Method Patents Ever Invalidated? Although business methods and software patents are enforceable, they may not be bullet proof. In March of this year, a jury in the case of *Stambler v. RSA and VeriSign* found against the patent holder, Leon Stambler. Stambler, an electrical engineer, sued RSA Security Inc., its former subsidiary VeriSign Inc., and others, seeking to enforce his 1990 software patent for the Secure Sockets Layer (SSL) protocol used in virtually every e-commerce transaction. Stambler, who before bringing suit had waged a campaign to obtain royalties for a license under his patents, sought as much as $20 million in damages.

Apart from the significance of this ruling for RSA and all other companies that make, use or sell technology that incorporates SSL, the case illustrates that not every software or business patent issued by the U.S. Patent Office will be enforced by the courts. Instead, courts will continue to scrutinize patents under the standards of novelty and non-obviousness, and analyze the applicability of the patent claims at issue to the accused products or services. If the patent is found wanting in any of those areas, the patent owner will not prevail.

TLB Commentary: *What can software companies and other industry players expect from this area of the law in the future? Unless Congress or the courts create a significant new body of rules, the validity and enforceability of software and business method patents will continue to be governed by the traditional standards of patent litigation, as these recent cases confirm. Litigation based on business method and software patents shows no signs of abating; in fact, the volume of such activity may be increasing.*

The U.S. Patent and Trademark Office issues thousands of software patents each year, and the number of business method patents is growing by leaps and bounds. And unlike copyrights, which require proof of copying to establish infringement, patents cannot be escaped by independent creation. If the invention, whether software or business method, is covered by a patent, someone who innocently and independently creates the same invention, without knowledge of the patent or previous inventors, may be barred from making, using or selling it, and may be liable for significant damages. Thus, the risk that someone owns a patent on technology or a process that is embodied in your product must be taken seriously. Just as companies search for brand names, trademarks and service marks not already taken by others, they are well advised to determine whether technologies are clear for use before committing substantial resources to either R&D or commercialization.

Current Trends in Software Licensing

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While the structure of the traditional software license has remained constant, the business approach of licensors and licensees has changed in significant ways over the past two years. Advances in technology have provided flexibility in the ways that software can be distributed, which has led to changes in the focus of license negotiations. Also, with the tight financing market, companies are turning to strategic licensing arrangements as financing alternatives. The standard off-the-shelf licensing deal for an emerging company is becoming increasingly rare. This article summarizes some of the changes we've observed.

First, customers now are exercising far greater control over the licensing transaction. Along with driving harder bargains, licensees are savvier technology purchasers having gone through the Y2K and Internet frenzies. They've also seen the problems caused by on-line services going out of business overnight and mission critical application providers falling into bankruptcy.

Second, users often want the ability to switch from a traditional license (where the customer takes possession of the application) to an ASP license (or vice versa) during the course of the license. As a result, the agreements for these transactions need to cover the variety of concerns that arise under both the traditional license and ASP relationships. It is important to remember that these two types of relationships are very different. For example, the licensor may have significantly fewer support and maintenance obligations when providing a traditional license than when acting as an ASP. When preparing agreements for these transactions, it is essential to match the major licensor obligations, including the support, warranty and indemnification terms, with the particular form of use of the application.

Third, even with lower priced products, licensees are focusing on maintenance and support levels and response times, and are requesting enhanced warranty coverage. For ASP services, data security has become a significant issue. ASP customers often require the right to perform security audits, and as a result, some of our clients are now including security audits as part of their standard service package.

In contrast to these pro-user positions, we have seen licensees consistently agree to more limited IP indemnification. Traditionally, licensors were expected to provide very broad IP infringement indemnification. Patent infringement was the greatest concern for licensors since this could be unintentional and a claim could arise after a product had been on the market for years. However, licensees now seem more willing to limit the scope of patent infringement indemnification. Limitations that we have found to be acceptable include indemnifications for patents, and in some cases only US patents, issued, or of which the licensor was aware, as of the date of the license.

Customers also seem far more concerned with the financial stability of technology providers. Financial due diligence of early stage licensors has become a common part of the software sales cycle. This is particularly true in mission critical software purchases and where emerging companies are engaged in transactions with large customers.

Finally, with the tight angel and venture capital markets, emerging companies are being forced to look for other sources of capital. Strategic investors have been a viable alternative; however, equity investments from these sources are significantly down. As a result, we have seen more companies turning to strategic source code licenses as a financing alternative. Under these arrangements, the licensor demands a license fee that is significantly higher than an object code license. A source license may lessen a purchaser's concerns about the financial stability of the licensor, and provide licensees significant flexibility in adapting the application to its particular needs. Although these arrangements may only be appropriate for certain companies, in the right situation this can be a good financing alternative for an emerging company.

TLB Commentary: *We are seeing a pick-up in licensing, but buyers are still being very careful. We believe that technology purchasing will continue to increase in the coming quarter, but licensees will continue to exercise significant leverage in their license negotiations.*

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GU Events & Announcements

EVENTS

January 13, 2004 - *Ken Appleby* will be speaking on *Taxation of Foreign Persons Investing in the U.S.* at a seminar on international taxation sponsored by Sterling Educational Services in Boston. Information and registration can be found at http://www.sterlingeducation.com

January 22, 2004 - *Bill Contente* will be presenting *VC Terms - What They Mean and Where They're Going* to the CEO Management Group in Newton, MA. Additional information can be found at http://www.theceoplace.com/boston_spkrs.htm

April 2, 2004 - *Peter Moldave* will be presenting at a seminar on *Sophisticated Licensing Issues* at Suffolk University Law School, Boston, MA. Peter's presentation will focus on licensing patented software. More information will be made available early in 2004.

April 27, 2004 - *Ken Appleby* will be a presenter at a seminar on *Advanced Partnerships, LLCs and LLPs* sponsored by Lorman Education Services held in Peabody, MA. Ken's presentation will focus on sophisticated tax planning for pass-through entities. More information will be made available early in 2004.

ANNOUNCEMENTS

August 25, 2003 - The firm filed a "friend of the court" brief with the U.S Supreme Court, authored by *Andrew Updegrove*, on behalf of ten major standard setting organizations (representing over 8,600 companies, universities and government agencies) in an effort to influence the outcome of *Infineon v. Rambus*, one of the most closely watched cases in the technology industry.

September 22, 2003 - The firm launched its new *Technology Leadership Series* with *The Insider's Guide to Raising Capital*, a program featuring veteran entrepreneurs, venture capitalists and angel investors. Over 120 people attended the program. For information on the next scheduled program see http://www.lgu.com

October 23, 2003 - *Andrew Updegrove,* of the firm, received this year's *Mass High Tech All-Stars Award* in the legal category. The Mass High Tech All-Stars Program "recognizes New Englanders from all sectors of the technology community who help make the region a center of innovation, and spotlights the region's most innovative leaders." Andy was given the award for his ground-breaking work with standards consortia.