FENWICK & WEST LLP

Intellectual Property Bulletin

Fenwick & West LLP — Fall 1998

FENWICK & WEST LLP

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Software Patents and Internet Business Methods in the Wake of *State Street Bank*

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Earlier this year, the United States Court of Appeals for the Federal Circuit took a step that some believed would have a major impact on the patentability of computer software and the conduct of business on the Internet. In *State Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368 (Fed. Cir. 1998), the Federal Circuit clarified the tests for determining whether the subject matter of a computer-based business application is subject to patent protection. In the wake of the court's decision, one media headline screamed, "Floodgates Open for Patent Cases." Another report predicted "Big Headaches for Internet Shopkeepers."

In reality, however, *State Street Bank* marks the culmination of an incremental, sensible and somewhat predictable evolution in the law concerning what "inventions" are "patentable" under Section 101 of the Patent Act. Nevertheless, although the legal change wrought by the case is relatively modest, the case and its aftermath raise important issues to be considered by companies seeking to obtain patent protection for their software, as well as by those who do business on the Internet.

State Street Bank v. Signature Financial Group

In *State Street Bank*, the Federal Circuit addressed two patentability issues that relate to software and the conduct of business on the Internet. Signature's patented invention was a data processing system that permitted the administrator of a particular type of "hub and spoke" mutual fund partnership to monitor and record the flow of financial information and to make the calculations needed to maintain the arrangement. In particular, the patent's claims were directed to a computer system that computed various asset values and other financial data about the funds. The district court held the patent invalid under Section 101 both as an unpatentable mathematical algorithm and as an unpatentable business method.

The Federal Circuit reversed on both grounds. First, the court effectively eliminated the "mathematical algorithm" exception to patentability and replaced it with a test that considers whether any invention—including one that incorporates mathematical algorithms—is "reduced to some type of practical application, *i.e.*, 'a useful, concrete and tangible result.'" A practical application is evidenced by the transformation of data. According to the court, permissible transformations are not limited to changes in physical matter—even a pure transformation of numbers is acceptable as long as it produces a useful result:

Today, we hold that the transformation of data, representing discrete dollar amounts, by a machine through a series of mathematical calculations into a final share price, constitutes a practical application of a mathematical algorithm, formula, or calculation, because it produces a "useful, concrete and tangible result"—a final share price momentarily fixed for recording and reporting purposes . . .

The requirement that the useful result be "concrete and tangible" apparently was satisfied by the fact that the share price was "momentarily fixed for recording and reporting purposes," that is, stored in a computer memory.

After dispatching the mathematical algorithm exception, the court turned its attention to the so-called "business method exception," which, according to one school of thought, precluded patenting methods of doing business. The court took the opportunity to "lay this ill-conceived exception to rest," correctly noting that neither the Federal Circuit nor its predecessor court had ever invoked the exception to invalidate a patent. Instead, cases in which the court had invalidated patents for business methods had really turned on other issues, such as obviousness, the lack of novelty or the attempt to patent an abstract idea. The court clarified that in the future, the issue of whether a patent's claims are directed to patentable subject matter under Section 101 "should not turn on whether the claimed subject matter does 'business' instead of something else."

State Street Bank's Impact

Around the time the *State Street Bank* opinion was published last summer, a number of seemingly broad patents covering Internet business methods and software applications issued, followed closely by press releases describing the patents and media reports touting a major shift in the way such patents are handled by the U.S. Patent and Trademark Office. One much-hyped patent, U.S. Patent No. 5,794,207, is directed to the Internet company Priceline.com's method for running a "reverse auction" over the Internet, in which a potential buyer makes a conditional offer, secured by a credit card, to purchase items such as plane tickets at a price specified by the buyer. The offer is passed along to a number of potential sellers; if one accepts the offer, payment is transferred to the seller via the buyer's credit card and the sale is complete. Other patents were directed to other, similarly simple, methods of operating on the Internet. In light of these patents, a brave new world seemed to beckon.

But the novelty of this world is greatly exaggerated. As the *State Street Bank* court pointed out, the business method exception was already largely illusory. Moreover, the PTO has been granting patents for software for years, notwithstanding any exception for mathematical algorithms. Under the PTO's *Examination Guidelines for Computer-Related Inventions*, issued in 1996, software was generally considered patentable subject matter if it fell into one of the Guide-lines' so-called "safe harbors." Under this approach, a software invention was likely to be patentable if it a) received real-world data and processed it, or b) produced a real-world output. Manipulation of information inside a computer alone was more difficult, but still not impossible, to patent.

State Street Bank opens the latter category to potential patentability by invigorating a somewhat forgotten notion in patent law. An old series of cases held that the essence of patentability was the transformation of matter from one form to another. For example, a lathe is patentable because it takes an item, such as a piece of wood, and makes something different from it, such as a table leg.

State Street Bank brings the transformation test into the 1990s. Now the transformation can be of "data"—*i.e.*, information or just numbers. The transformation of real-world data is no longer required, nor is a real-world effect. All that is necessary is a practical application that produces a useful result. While this new threshold is quite low, and certainly makes it much easier to demonstrate patentable subject matter, there was no dearth of software patents before *State Street Bank*. Nevertheless, the perception that the "flood gates are open" exists, and the notion that Internet and software patents are now easier to obtain may lead to a sharp increase in applications for such patents.

***State Street Bank* and the PTO**

Given the low threshold for patentable subject matter, the *State Street Bank* decision makes it clear that the real issue of determining software patentability is whether the invention meets the other standards for patentability—specifically novelty and nonobviousness.

In this regard the PTO continues to improve in examining software patent applications, though some observers believe the PTO has some difficulty implementing the standards of novelty and nonobviousness to this field. For example, patent examiners—typically young engineers—may lack the expertise or broad familiarity with business software necessary to evaluate patents that cover Internet business models. In addition, the resources available in the PTO for locating nonpatent software prior art are not totally comprehensive. Publications concerning software are not completely organized into a comprehensive, easily accessible database, nor are the myriad previously created software products and processes, which can be very difficult to locate. Under these circumstances, the PTO may sometimes issue software patents for ideas that are not really new and nonobvious—such as retrofitting an existing business model for use on the Internet.

This does not mean that potential Internet patentees should avoid seeking protection for their inventions. Indeed, because *State Street Bank* has increased the perception that this type of patent is now easier to obtain, it is more important than ever for an inventor to apply for appropriate patent protection.

The important thing now is to make sure these patents have staying power. Because a patent that can easily be invalidated by potential infringers is obviously of limited value, inventors should work carefully with their patent attorneys to obtain patents that can withstand a serious validity challenge. The following precautions are especially important in the software field:

Critically evaluate the inventiveness of your idea. Consider what portion of your software invention or Internet business method is really a new, nonobvious development in the art. The patent with the broadest coverage is not useful if it is not sustainable. Sometimes, the greatest competitive value comes from a precisely crafted patent that provides reliable coverage for the key solution provided by the invention. Do not assume that taking an existing business method and putting it on the Internet is patentable. Often, in spite of the hype or positive customer reaction, it is not.

- *Provide the examiner with as much relevant prior art as is reasonably available.* Because patent examiners often lack access to and knowledge of software-related publications, products and processes, it is important to submit to the PTO as much relevant prior art as reasonably can be located. This effort may include a search of nonpatent prior art, which is far less likely to be available to the examiner than previously issued patents. While the circumstances will not always justify an exhaustive prior art search, the option should be considered.

- *Craft the scope of claims and disclosure at multiple levels of abstraction.* The patent should define the essential functional aspect of the invention independently of the details for its implementation. The goal is to capture the essence of the invention in a way that does not limit it to the description of the implementation detail. However, claims should be written that cover the functional and structural design and architecture, along with any implementation features that have strategic value.

Although these considerations are relevant to the prosecution of any patent, they are especially important here. While *State Street Bank* may not be the earthquake in the law of patentability that some believe it is, the perception still exists. As the resulting stampede to the Patent Office proceeds, it is important to obtain patents that will remain viable in the face of any challenge.

Quick Updates

Supreme Court Decides When an Invention Is "On-Sale"

In *Pfaff v. Wells Electronics, Inc.*, 48 U.S.P.Q. 2d 1641, 1998 U.S. Lexis 7268 (October 6, 1998), the Supreme Court held that an invention is "on sale" under 35 U.S.C. §102(b), when (1) the invention is the subject of a commercial offer for sale, and (2) the invention is ready for patenting. Under §102(b), a patent claiming such an invention is invalid if the invention was "on sale" before the critical date—which is one year before the patent application was filed. Here, both conditions were satisfied because the inventor accepted a purchase order prior to the critical date, and drawings sent to the manufacturer before the critical date fully disclosed the invention. The Court reasoned that the meaning of the word "invention" in the Patent Act "unquestionably refers to the inventor's conception rather than to a physical embodiment of that idea."

800 SPIRITS Mark Does Not Preclude Use of Toll-Free 800 Telephone Number

In 800 *Spirits Inc. v. Liquor by Wire Inc.*, 14 F. Supp. 2d 675 (D.N.J. 1998) the U.S. District Court for the District of New Jersey held that a liquor delivery company that uses the mark "800 SPIRITS" may not preclude a competitor from using the telephone number "1-800-SPIRITED." Although 800 Spirits did not use the telephone number 1-800-SPIRITS, it had registered and used the mark "800 SPIRITS" but the registration lapsed. In 1995, 800 Spirits again applied for registration of "800 SPIRITS" and was opposed by Liquor by Wire, Inc., based on its use of the 1-800-SPIRITED phone number. 800 Spirits sued Liquor by Wire for violation of the Lanham Act, trademark dilution, and state law violations. Liquor by Wire counterclaimed for unfair competition and a declaratory judgment. The court granted summary judgment for the defendant, holding that "A service mark that uses '800' with a generic term cannot as a matter of law preclude use of substantially similar telephone numbers."

Golf Course Service Marks Infringed, but Holes Not Inherently Distinctive

In *Pebble Beach Co. v. Tour 18 I Ltd.*, 155 F. 3d 526 (5th Cir. 1998) the U.S. Court of Appeals for the Fifth Circuit held that use of golf course service marks to promote simulations of famous golf course holes violated the Lanham Act and a Texas antidilution statute. Pebble Beach Co., Resorts of Pinehurst, Inc., and Sea Pines Co. Inc. sued Tour 18 I Ltd. for service mark and trade dress infringement, services mark and trade dress dilution, unfair competition and false advertising. The district court found that the use of the marks was infringing and that a lighthouse feature of the Sea Pines course was protectable but declined to provide trade dress protection for any other hole. Both parties appealed. The Fifth Circuit agreed that golf course design is nonfunctional but rejected arguments from Pebble Beach and Pinehurst that their holes were inherently distinctive. The court amended the district court's injunction to permit nominative uses of the marks but left intact the order to remove the lighthouse.

Inequitable Conduct Not Found for Failure to Submit a Reference That Was Cited in a Parent Patent Application

In *ATD Corp. v. Lydall, Inc.*, 48 U.S.P.Q. 2d 1321 (Fed. Cir. 1998) the Federal Circuit held that an applicant prosecuting a divisional patent application did not engage in inequitable conduct before the U.S. Patent and Trademark Office by failing to submit either a U.S. patent already cited in the parent application or a Patent Cooperation Treaty (PCT) search report citing the same U.S. patent to the corresponding PCT application. The court reasoned that according to Section 609 of the M.P.E.P., a patent examiner will consider information cited or submitted in a parent application when examining a continuing application. Additionally, the court stated that although international search reports may contain information material to patentability if they contain closer prior art than that which was before the U.S. examiner, it is the reference itself, not the information generated in prosecuting foreign counterparts, that is material to prosecution. Therefore, the details of foreign prosecution are not an additional category of material information.

Federal Circuit May Use Interference Proceedings to Construe Claims

In *Phillips Petroleum Co. v. Huntsman Polymers Corp.*, 157 F.3d 866 (Fed. Cir. 1998), the Federal Circuit held that a term appearing only in the preamble of a claim is a limitation when the patentee's attempts to delete the term from the claim during interference proceedings were rejected by the examiner. The court reasoned that a term appearing in the preamble is limiting when it is required to confer meaning on the claim. Here, the patentee attempted to delete the word "block" from the claims during the course of two separate interference proceedings, arguing that the term was an unnecessary feature of the invention. On both occasions the examiner disagreed, indicating that the term was essential to the claim. The patentee eventually acquiesced to the examiner's logic. Accordingly, the court held that the term "block copolymer" as recited in the preamble was a claim limitation.

Preliminary Injunction against "Rio" Device Denied

On October 9th, the Recording Industry Association of America (RIAA) filed suit against Diamond Multimedia in the U.S. District Court for the Central District of California, seeking an injunction against the release of a new digital audio playback device. The RIAA asserted that the sale of the "Rio," which is designed to play audio files downloaded from a computer, would violate the terms of the Audio Home Recording Act of 1992 (17 U.S.C. §§ 1001 et seq. "AHRA"). The AHRA requires makers of certain devices capable of producing digital copies of musical works to register the devices with the Copyright office, incorporate serial copy limitations into the devices and pay royalties from sales of the devices to groups affected by the illegal copying of musical works.

After initially entering a temporary restraining order in favor of the RIAA, Judge Audrey Collins denied the RIAA motion for a preliminary injunction on October 26, describing the RIAA's probability of success on the merits as "mixed." The ruling was based at least in part on Judge Collins's conclusion that, had Diamond included in the Rio a system for limiting serial copying, as the plaintiffs claim the AHRA requires, the resulting device would have been "functionally equivalent" to the Rio without such a system.

Digital Millennium Copyright Act Signed into Law

The Digital Millennium Copyright Act (17 U.S.C. §§ 1201-1204 "DMCA") was signed into law on October 28. In addition to implementing World Intellectual Property Organization copyright treaties negotiated in 1996, the DMCA provides both civil and criminal penalties for any circumvention of technological measures that either control unauthorized access to copyrighted works or protect a right of a copyright owner. The manufacture, importation or sale of devices designed primarily to aid in circumvention of such technological measures is also prohibited by the DMCA, which defines the prohibited forms of circumvention as including the descrambling of scrambled works (such as television broadcasts), the decrypting of encrypted works and the avoidance, removal, deactivation or impairment of technological protection measures. The DMCA also prohibits the unauthorized removal or alteration of copyright notices and notices of terms and conditions for use that accompany a copyrighted work. The DMCA provides that it shall not "affect rights, remedies, limitations, or defenses to copyright infringement, including fair use."

Claim of Misappropriation of Trade Secrets Requires Adequate Identification of the Trade Secrets

In *Imax Corp. v. Cinema Technologies, Inc.*, 152 F.3d 1161 (9th Cir. 1998), plaintiff Imax brought a misappropriation of trade secret and unfair competition action against Cinema Technologies and Neil Johnson (together "CTI"). CTI designed and built a projector system to compete with Imax's projector system by studying the Imax projector system patents and its customer sites. Imax's patents covered the existence and manner of operation of components within its projector system. The precise dimensions and tolerance of the components, however, were claimed as trade secrets by Imax and its customers were forbidden from disclosing them. CTI asserted that Imax failed to sufficiently describe the "dimensions and tolerances" that Imax claimed as trade secrets in its projector system. Imax countered that the patent documents and the testimony of its expert provided a sufficient description of the trade secrets and that it did not have to provide the precise "dimensions and tolerances" of the trade secrets. Because Imax did not provide the precise "dimensions and tolerances," the district court found that Imax did not meet its burden of identifying the misappropriated trade secrets, and thus granted CTI summary judgment on the trade secrets claim. The district court also granted summary judgment for CTI on the unfair competition claim.

On appeal the Ninth Circuit court affirmed summary judgment for the trade secret claim. In affirming, the court stated that Imax failed to satisfy its burden because it did not sufficiently describe the subject matter of the trade secret to separate it from general knowledge in the trade or of special knowledge of those skilled in the trade. Moreover, the court noted that because the movie projector was highly sophisticated and complex, it would have been “unlikely that the district court or any trier of fact would have expertise in discerning exactly which of the projector system’s many ‘dimensions and tolerances’ were trade secrets.” The court also reversed and remanded the unfair competition claim, stating that genuine issues of material fact did exist as to whether CTI had constructive knowledge of a confidential relationship between Imax and its customers when CTI decided to study the Imax projector system at Imax customer sites.

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