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Business Method Infringement Damages

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WHAT IF AMAZON.COM had lost its motion for a preliminary injunction to prevent Barnesandnoble.com from using Amazon's patented single-action, or "one-click," ordering system for on-line transactions? Suppose Amazon had instead prevailed only after trial. What damages would it be able to recover?

The question would be a good one for a law school examination. It raises lots of issues; it is timely; and there is no clear or easy answer. Both of the potential forms of recovery — lost profits and reasonable royalties — raise difficult, though not insoluble, problems of proof for holders of business method patents.

In its motion for preliminary relief, Amazon claimed that the "one-click" option was unique, and played a pivotal role in distinguishing Amazon's on-line site from those of other retailers. Amazon argued that only a preliminary injunction would prevent erosion of the good will and customer loyalty generated by its "one-click" ordering feature, and that the harm resulting from the diversion of new customers to Barnes & Noble's Web site would be irreparable. Amazon dismissed Barnes & Noble's arguments on irreparable harm as applicable only where lost profits were easily calculable or where the value of a patent had been established by a license, thus implying, without explicitly arguing, that its damages would be incalculable.

Barnes & Noble argued that, no matter how the harm was classified as a loss of good will, loss of customers or loss of market share — it all came down to lost sales, which are compensable by money damages. Barnes & Noble wisely did not suggest how such damages should be calculated, and the court granted a preliminary injunction.

But what if the court denies a preliminary injunction in a business method case, and the defendant continues to use the accused technology throughout the litigation, or if the original infringement has gone undetected for a substantial period of time? What can the holder of a software-driven business method patent do to establish damages adequate to compensate for the infringement? Such patents are being applied for and issued in ever-increasing numbers, and some of their holders have kicked off licensing programs, writing warning letters and offering to open negotiations with accused infringers.[1] But no court has yet addressed the damages problems raised by infringement of such patents, or of similarly situated patents for financial products. And prior decisions provide only imperfect analogues.

Claims for Lost Profits

The patentee is entitled to obtain lost profits only if it can show a reasonable probability that it would have made the additional profits if there had been no infringement, i.e., that the infringement caused the lost profits. In its *Panduit*[2] decision, the Federal Circuit provided a four-factor test for evaluating lost profits claims. The patent holder must demonstrate: demand for the patented feature; lack of an acceptable non-infringing alter native; adequate manufacturing and selling capacity to make the additional claimed sales; and the profit that would have been earned on the additional sales.

In a business method or financial products case, each of these issues will be subject to sharp dispute. Indeed, proving customer demand for the patented feature can be particularly difficult in a business method case, since the patented method itself is not being sold. Rather, the method is a tool being used to sell another product. The problem is even more acute when the method is used at some distance from the customer inter face — where, as in the *State Street Bank* case,[3] for example, a patented method is used to compute and report costs shared by mutual funds.

The Federal Circuit has made it clear that recoverable profits are not limited to those earned on the sale of the patented product or technology itself, or even on products that result from the patented technology. Products made by a patented process or incorporating a patented process can be the subject of a lost profits claim,[4] as can products which compete with the infringing product, even when they do not incorporate the patented feature.[5] But, to satisfy the first part of the *Panduit* test, the patent holder must show that the patented feature is linked to customer demand for the product on which profits are claimed. A failure of proof on this point will be fatal to a lost profits claim, as it was in *Slimfold* [6](where the patented feature created manufacturing conveniences and cost savings, but had no effect on customer preference).

Thus, Amazon, for example, would need to show that its “one-click” ordering feature drove customer demand for its books and other products. In its opposition to Amazon’s preliminary injunction motion, Barnes & Noble argued that there was no proven link between the “one- click” ordering option and sales. Other Web site features, as well as such mundane factors as product selection, price or timely shipping are just as likely to influence customer choice and customer loyalty.

To overcome such arguments, the patent holder will need to support its claims by hard evidence: customer surveys; market data showing sales patterns before and after the infringement; studies of the market before and after the introduction of the patented feature; projections analyzing the expected results of adopting the patented feature; and expert reconstructions of the market can be essential to the patentee’s success on this point. Preferably, much of the proof will come from contemporaneous business documents, rather than studies made for litigation.

The second *Panduit* factor, lack of an acceptable non-infringing alternative, will also generate disputes in business method cases, especially those involving e-commerce, in light of the argument that Web sites and procedures can be easily and quickly redesigned to avoid a patent ed feature. Rut a potential design-around solution is no defense to a lost profits claim.[7] The fact that anon-infringing alter native was not on the market during the damage period, in fact, creates a rebuttable inference that the proposed alternative was not "available."[8] The defendant must still prove that the non- infringing substitute was a genuine choice, not a mere possibility. As the Federal Circuit put it in *Grain Processing*,[9] "Acceptable substitutes that the infringer proves were available during the accounting period can preclude or limit lost profits; substitutes only theoretically possible will not."

Thus, on this point, both the patent holder and the alleged infringer must be ready with real-world facts and reliable expert opinions: Are the proposed alternatives old features that were abandoned, new features that have only recently been adopted, or proposed solutions which are still not in commercial use? Are the proposed alternatives ready for market or still on the drawing board? Have they been tested? If some form of regulatory approval is necessary, have they been approved? If they are still on the shelf, why were they never used? If they were adopted after the damage period started, how long did it take and how much did it cost to switch to the new technology? Did the switch change customer demand? Well-documented factual answers to these questions are also essential to a successful claim for lost profits.

The third *Panduit* factor, adequate capacity to carry out increased sales levels, may seem insignificant in the virtual world, where "e-tailers" seem to be free of the burdens that "bricks and mortar" companies face in expanding sales volume. Although the patentee's burden of proof on the issue of capacity, as on the other *Panduit* factors, requires not certainty but only a "reasonable probability,"[10] unfounded speculation will not satisfy the burden; hype cannot replace factual evidence. The patentee must present "an expansion scenario which shows what steps, including some time-consuming capital investment, it conceivably could have taken to meet the demand."[11] Such a scenario would need to include not only what steps were physically possible, but such elements as available financing, technical feasibility and the capacity of essential suppliers.

Amazon itself has reportedly spent more than $300 million building a network of warehouses and distribution centers so that It would be able to meet peak sales demands and make timely shipments.'[12] Proof of such actual expansion, how long it took and how much it cost would be directly relevant to the issue of whether a patent holder could have expanded its capacity to service the increased demand that would have exist ed absent Infringement.

Finally, the patent owner must show the profits that it would have made from the diverted sales. Despite glib generalizations about the legendary unprofitability of dot-corns, It is entirely possible for a business method patent owner to satisfy this fourth element of the *Panduit* test. The cases do not require the patent holder to earn profits on an overall basis. They require the claimant to show that it would have earned an incremental profit on the additional sales it would have made in the absence of infringement.[13] Fixed costs are excluded in determining these incremental profits. Even where a company appears to be burning cash faster than new investors can supply it, it should be possible to produce a reliable and admissible calculation of the incremental profit that could have been achieved on each additional sale.

Thus, with complete and accurate accounting records, well-documented market and customer intelligence, and creative but reliable experts, the holder of a business method patent should be able to present a credible case for the recovery of lost profits.

Recovering Royalties

The recovery of a reasonable royalty should, theoretically, be even simpler, since the patent statute provides that, "Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the Invention by the infringer, together with interest and costs as fixed by the court."[14]

But the nature of business method and financial product patents raises difficult questions as to the form of the appropriate royalty; and the base to which the royalty should be applied. Indeed, the situation might be simpler if the patent law still provided, as it did prior to 1946, for different forms of compensation, depending upon whether the patented technology was sold or used. In a case where the patented technology had been used to make or sell another product, the law formerly allowed the patent holder to seek an accounting and disgorgement of the profits made by the defendant. While the accounting remedy is still available for misappropriation of trade secrets, and would seem well-suited to misappropriation (by infringement) of a business method, the patent law does not permit recovery of the defendant's profits.[15]

In the absence of an accounting for the infringer's profits, the parties and the court must fashion a royalty which takes into consideration the nature of the business method at issue and how it works. Does it increase sales by making It easier or more attractive for customers to place orders? Or does it make it easier for the patent holder to control inventory, prepare accounting statements or limit costs? Since the use of a business method which makes sales easier or lowers costs generally does not enhance the value of the product to the consumer or increase the price that the consumer is willing to pay, the use of a traditional royalty structured as a percentage of sales would seem inappropriate. Indeed, in cases where the patented technology creates manufacturing conveniences or saves costs, but has no effect on customer demand or price, the courts have not only disallowed lost profits claims; they have heavily discounted the royalty rate.[16]

In the Amazon case, would an appropriate royalty be based on the number of sales that used the infringing method, or on sales volume in dollars? Each of these methods would seem to be unfair to one party or the other. Since Amazon sells a variety of products that differ substantially in price, if the royalty base is sales volume, one infringing order could generate vastly different royalties from another infringing order. If the royalty is based on the number of sales, Amazon would receive, and Barnes & Noble would have to pay, the same amount for a small order as for a large one.

If a royalty had to be set for the infringement of the *State Street Bank* patent on an accounting system used for a "hub and spoke" group of mutual funds, should the royalty be based on the number of shareholders, the amount of assets under management, the number of trans actions accounted for or something else? Again, each of these possibilities would seem to be unfair to one party or the other.

The touchstone for any reasonable royalty analysis must be the factors list ed by the court In *Georgia Pacific*."[17] These factors are numerous and broad enough to allow the court to tailor a reasonable royalty which provides fairness as well as adequate compensation. Ultimately, the parties will need to provide expert testimony to Inform the court of the industry customs and standards that are actually followed in negotiating and set ting contractual royalties for business method licenses, and the proof on the reasonable royalty issue should begin with this factor.

If the experts can testify reliably that a license for a comparable business method would normally provide for royalties in the form of per-use fees or lump sum payments, or that the royalty would be based on the number of Web site visits, number of customers or some other measure, there is no reason why a court should refuse to calculate a reasonable royalty for infringement In the same form or on the same basis.

Indeed, the Federal Circuit has already approved damage awards based on per use fees or lump sum payments in appropriate cases. The court's decision in *Maxwell v. J. Baker*[18] provides an appropriate analogy. In that case, the patent holder designed a system which would keep pairs of shoes from being separated prior to their retail sale. The invention consisted of tabs sewn into the inside of each shoe, through which a thread or string could be passed to connect each shoe to its mate. The system was of great value to the retailer, but of virtually no value to the ultimate customer. The court approved a royalty fixed In the amount of five cents for each pair of shoes using the claimed system, plus a lump sum payment set by the jury as the amount necessary to provide adequate compensation, over and above the per use fee.

In *Stickle v. Heublein*,"[19] the court found that neither a percentage royalty nor per-use fee would be an appropriate form of royalty for infringement of a machine used to prepare taco shells. In that case, the Federal Circuit directed the trial court to award a lump sum payment as a royalty, but also suggested that the trial court could award "an amount of dam ages greater than a reasonable royalty" so that the total award would provide adequate compensation.

Conclusion

Being the first company to use a new business method can provide a clear competitive edge in the rapidly changing e-commerce market. That the value of this edge is incalculable may frequently persuade the courts to grant preliminary relief. But an injunction pending trial is an extraordinary form of relief. Business method patent holders need to start building an evidentiary record — in advance of litigation, and, if possible, even before adopting a new method — to support a substantial damage claim. Otherwise they cannot hope to obtain adequate compensation for the loss of their competitive advantage or to discourage competitors from believing that infringement will carry a low enough price tag to make it worth the risk.

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[1] "Royalties Sought On Forgotten Patent," *The New York Times*, June 26, 2000.
[2] *Panduit Corp. v. Stahlin Bros. Fibre Works, Inc.*, 575 F.2d 1152 (6th Cir. 1978).
[3] *State Street Bank & Trust v. Signature Financial Group, Inc*., 149 F.3d 1368 (Fed. Cir. 1998).
[4] E.g., *Minco, Inc. v. Combustion Engineering, Inc.*, 95 F.3d (Fed. Cir. 1996); *King Instruments Corp. v. Perego*, 65 F.3d 941 (Fed. Cir. 1995).
[5] *Rite-Hire Corporation v. Kelley Company, Inc.*, 56 F.3d 1538 (Fed. Cir. 1995).
[6] *Slimfold Manufacturing Company, Inc. v. Kinkead Industries, Inc*., 932 F.2d 1453 (Fed. Cir. 1991).
[7] *Minco, Inc.*, 95 F.3d at 1119.
[8] *Grain Processing Corp. v. American Maize-Products Co*., 185 F.3d 1341 (Fed. Cir. 1999).

[9] 185 F.3d at 1353.
[10] E.g., *Standard Havens Products, Inc. v. Gencor Industries, Inc*., 935 F.2d 1360 (Fed. Cir. 1991) cert. denied, 506 U.S. 817 (1992).

[11] *Polaroid Corp. v. Eastman Kodak Co.*, 16 U.S.RQ. 2d 1481, 1510(0. Mass 1990).

[12] 'Can Amazon Make It?' *Business Week*, July 10, 2000
[13] *Paper Converting Machine Co. v. Mogna-Graphics Corp*., 745 F.2d it (Fed. Cir. 1984).

[14] 35 U.S.C. §284.

[15] *Aro Mfg. Co. v. Convertible Top Replacement Co*., 377 U.S. 476, 505-07 (1964).

[16] *Slimfold Manufacturing Company,* 932 F.2d at 1459.

[17] *Georgia-Pacific Corp. v. United States Plywood Corp*., 318 F. Supp. 1116 (S.D.N.Y. 1970), modified and aff'd sub nom., *Georgia-Pacific Corp. v. United States Plywood-Champion Papers, Inc*., 446 F.2d 295 (2d Cir. 1971), cert. denied, 404 U.S. 870 (1971).

[18] *Maxwell v. J. Baker, Inc.,* 86 F.3d 1098 (Fed. Cir. 1996)
[19] *Stickle v. Heublein, Inc.*, 716 F.2d 1550 (Fed. Cir. 1983).