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Inside

Advisory Commission to Make Recommendations on Internet Tax Policies 1

SELLER BEWARE! Your Own Business Methods May Make You a Target for Patent Litigation...................... 3

Internet Merchants are Competing for Your Business in Many Ways, Some of Which You May Not Be Aware .. 5

ADVISORY COMMISSION TO MAKE RECOMMENDATIONS ON INTERNET TAX POLICIES

The United States Advisory Commission on Electronic Commerce (the Commission) was created in 1998 under Public Law 105-277, the Internet Tax Freedom Act. The Commission is composed of three federal officials, eight state and local representatives, and eight representatives from the Electronic Commerce Industry Telecommunications and Consumer Groups. The Commission and staff have for over a year studied various aspects of the use of the Internet and the effects of Internet activity and electronic commerce on international tax policy and the tax policies of the United States and state and local jurisdictions. The Commission is to report its findings to Congress on April 21, 2000. The Commission will conduct its final public meeting on March 20 and 21 in Dallas, Texas. Among other things, the Commission is expected to outline broad policy goals for the taxation of electronic commerce and to recommend legislative action consistent with those goals. More information on the Commission can be found at its Web site, **www.ecommercecommission.org**.

On December 3, 1999, a subcommittee of the Commission presented a final draft of issues and policy options (the Draft Report). The Draft Report resolved very few issues but set out basic principles that should be addressed in the Commission's final report. These principles include:

- Consistent and non-discriminatory tax policies to encourage the international growth of electronic commerce
- No international taxes on electronic commerce
- Harmonization of jurisdictional and administrative rules to coordinate the collection and payment of transactional taxes (such as sales taxes) on cross-border transactions.

The Draft Report also recommended a dramatic simplification of the current telecommunications transaction tax system. This recommendation would include standardization of the procedures and definitions of telecommunications transaction taxes, repeal of the RVW federal excise tax on communications services, and a limit on the number of transaction taxes applicable to telecommunications services.

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In developing recommendations on sales taxes and other transaction taxes on business conducted over the Internet, the Commission has struggled. The Draft Report discusses, without recommending, a possible extension of the three-year Internet Tax Freedom Act moratorium for an additional five years. The purpose of the moratorium extension would be to allow the relatively new and emerging e-commerce industry to continue to develop without market distortions caused by a haphazard tax structure.

Another theme reflected in the Draft Report is that transactions effected over the Internet should not bear any special taxes merely because they occur over the Internet. Internet transactions would be taxed in the same manner and to the same extent as they would be if they were made in a face-to-face sale or mail-order sale.

One obvious problem in applying transaction taxes to sales of goods and services over the Internet is the difficulty taxing authorities have in obtaining jurisdiction over the parties in the transaction under traditional concepts relating to jurisdiction for tax purposes. A sale of a product over the Internet may involve many jurisdictions. The seller may be located in one jurisdiction, the fulfillment house in another, the payment may be completed in a third, and the delivery of the product may be made to a fourth jurisdiction. The due process clause of the U.S. Constitution requires the presence of a taxpayer in a jurisdiction before it can be held subject to a transaction tax. Many states have attempted to establish presence through indirect actions of the taxpayer rather than through actual physical presence in the state.

One of the members of the Commission, Dean Andal, the vice chairman of the California State Board of Equalization, has presented a proposal for a uniform jurisdiction standard to apply to e-commerce. The so-called Andal Proposal was presented to the Commission on September 15, 1999. This proposal would create a uniform national jurisdiction standard for taxing e-commerce based on substantial physical presence.

The Andal Proposal would apply to the imposition of any state or local business activity tax or sales and use tax. Before any such tax could be imposed, the taxing jurisdiction would have to establish that the business had a substantial physical presence in the jurisdiction. The proposal sets out explicit safe harbors that would not constitute substantial presence or subject the business to taxation. The proposed safe harbors would include the following:

- The solicitation of orders or contracts or fulfillment in delivery of property into the state
- The use of intangible property in the state, including copyrights, trademarks, logos and Web pages
- The use of the Internet to create and maintain Web sites accessible by people within the state
- The use of an Internet service provider operating in the state
- The use of unaffiliated third parties for doing warranty and repair services with respect to goods sold into the state.

These activities alone would not subject the business to taxation within the state.

One of the purposes expressed by Andal in his proposal is to establish a uniform national jurisdictional standard that would eliminate uncertainty associated with transactions and would encourage tax collection by minimizing compliance problems. A uniform standard would establish a predictable system of state and local taxation and encourage businesses to comply with state tax laws where applicable.

Several consistent themes have been expressed by the Commission. These include a desire to allow e-commerce to continue to develop free of taxes directed at the medium, elimination of any international taxes on such commerce, and a desire to simplify the administration of state and local taxes. The Andal Proposal, if recommended and ultimately adopted, would be a significant step in the direction of simplification. It would also serve the purpose of permitting businesses engaged in e-commerce to operate without much of the uncertainty present in today's taxing regimes as states continue to assert jurisdiction over e-commerce transactions.

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SELLER BEWARE! YOUR OWN BUSINESS METHODS MAY MAKE YOU A TARGET FOR PATENT LITIGATION

Introduction

Patents are frequently described as legal shields that are useful for protecting high-tech inventions. But this description is deficient for two reasons. First, a patent's greatest value is as a sword, *not* as a shield. Patents are extremely effective economic weapons that can be used to prevent competitors from making, using, or selling specific products or services. Second, the patent system is open to *all* innovations, not just high-tech inventions. According to the U.S. Supreme Court, the patent system is intended to encompass "anything under the sun that is made by man."

Recently, the U.S. Court of Appeals for the Federal Circuit (CAFC) held that there is no rule prohibiting the patentability of "business methods." Consequently, innovative methods or procedures for doing business are now being patented just like any other process or method invention. This ruling, coupled with the growing recognition that U.S. patents are extraordinarily effective tools for legally restricting competitive behavior, has caused the number of business method patents to skyrocket.

The increase in business method patents has given rise to a number of questions: Is the U.S. Patent and Trademark Office (USPTO) adequately equipped to evaluate the patentability of business methods in the public domain? Will the courts enforce business method patents using the same methods? Are such patents more likely to be invalidated due to the abundance of known business procedures and standards used to enforce patents for more traditional technologies?

These questions were considered in the recent case of *Amazon.com v. Barnesandnoble.com*, one of the first post-*State Street* cases in which a court has had an opportunity to evaluate the validity and enforceability of a business method patent.

The Patent

In September 1999, Amazon.com (Amazon) received a patent covering a "one-click" shopping procedure. The procedure enables a buyer to complete a purchase via the Internet by using a single action, such as a click of a computer mouse button. Significantly, Amazon's patent protection is not limited to a specific software or hardware implementation of the procedure. Instead, Amazon's patent provides broad protection for the generic one-click shopping procedure itself.

Barnesandnoble.com (B&N), a direct competitor of Amazon in the sale of books, software, music and other items via the Internet, created its own form of single-action shopping that it called "Express Lane." Express Lane, promoted by B&N as a "major enhancement" to its online business, accounted for a significant portion of B&N's sales.

The Litigation

Shortly after receiving its patent, Amazon sued B&N for patent infringement and sought a preliminary injunction to halt B&N's continued use of the Express Lane feature.

At the preliminary injunction hearing, Amazon acknowledged that essentially all elements of its "one-click" invention were known in the prior art, except for single-action ordering. However, Amazon further asserted (and the trial court agreed) that there was at least one basic, yet significant, difference between the patented one-click invention and each of the prior art references asserted by B&N.

B&N's expert testified that although it would have been an easy matter to modify the prior art to implement the one-click invention, he had never thought of making such modification. The court found this to be an important admission, and one that tended to negate the expert's

testimony about the obviousness of Amazon's patent. Moreover, the court found insufficient evidence in the record of any teaching, suggestion or motivation in the prior art that would have led a person skilled in the field of e-commerce to combine the references in the manner asserted by B&N. In short, despite B&N's effort to demonstrate the invalidity of Amazon's patent by demonstrating the obviousness of the one-click invention, the court concluded that the one-click invention represented an unobvious, and therefore patentable, advance over the state of the art.

Evidence from the patent's file history (coupled with the testimony of a former USPTO commissioner) further convinced the court that the patentability of the one-click invention over the prior art had been thoroughly considered by the USPTO before issuance of the patent. Contrary to B&N's arguments regarding the inadequacy of the patentability evaluation, the trial court found that the examination performed by the USPTO had been exhaustive and competent. Specifically, the patent file history indicated that during the application process the patent examiner had taken a number of additional steps to diligently search for and thoroughly evaluate all relevant prior art that might have rendered the invention unpatentable.

The court also found that objective evidence of commercial success tended to confirm the validity of Amazon's patent. The problem of consumers abandoning the online shopping process was acknowledged by both parties and their experts. The patented invention addressed this problem by reducing the steps required to make a purchase, thereby increasing the likelihood that a customer would complete that purchase. The court found that the validity of the patent was corroborated by the popularity of the one-click feature, its use by millions of customers and other e-commerce retailers, and the accolades it had received from industry analysts and the popular press.

Although the court's discussion of infringement was somewhat less detailed than its discussion of patent validity, the court found strong similarities between the patented one-click invention and the accused Express Lane feature. Indeed, there was sufficient similarity between the two systems for the court to suggest that B&N had simply copied Amazon's invention.

The court concluded that Amazon was entitled to a presumption of irreparable harm, and that such harm would be compounded if infringement were permitted to continue during the 1999 holiday shopping season. The holiday season has historically been a key period for e-commerce customer acquisition, with a significant effect on the long-term prospects of e-commerce business. In 1998, for example, Amazon increased its customer base by nearly 20 percent in the last six weeks of the year, adding more than one million new customer accounts in that time period. The court found invaluable customer loyalty and goodwill would be irreparably lost if B&N was allowed to continue to infringe during the 1999 holiday shopping season.

The court also found that a preliminary injunction was in the public interest. The court stated:

> "The public is served by innovation on the Internet and in electronic commerce, particularly now while it is still developing rapidly. Competition to provide unique, effective and enjoyable consumer experiences will lead to innovation and diversity in online commerce. On the other hand, innovation will be discouraged if competitors are permitted a free ride on each other's patented inventions. Protection of intellectual property rights in innovations will foster greater competition and innovation."

Accordingly, the court granted Amazon's motion for a preliminary injunction. The preliminary injunction took effect on December 4, 1999, and will presumably remain in effect until the time of trial or unless and until the injunction is reversed on appeal to the CAFC.

Conclusion

Perhaps the most important lesson to be learned from the *Amazon.com* case is that this "business method" patent litigation is essentially indistinguishable from litigation involving patents directed to more traditional subject matter. Using the same substantive and procedural rules that are applied in other cases in which a patent owner seeks preliminary injunctive relief, the *Amazon.com* court concluded

that the patentee was likely to succeed on the merits at trial with respect to the issues of validity and infringement.

The trial court's decision to grant injunctive relief has now been appealed to the CAFC. Will the CAFC agree with the thinking of the trial court? Will the trial court's grant of injunctive relief be affirmed or reversed? Answers to these questions will probably not be known soon, since it will likely require at least several months before the CAFC hears the matter and renders its opinion.

However, the strategic value and effectiveness of Amazon's patent have been clearly demonstrated. Amazon's preliminary injunction completely blocked a primary competitor from using a one-click purchasing feature on the Internet during the 1999 holiday shopping season (and probably for many months thereafter). Even if B&N is ultimately able to prove at trial that Amazon's patent is invalid, or not infringed, significant damage has already been done. B&N has been forced to irreversibly change its business plan for the 1999 holiday shopping season (and beyond), a critical time for building brand name recognition and customer loyalty on the Internet.

The *Amazon.com* case serves as a clear warning to *all*—not just high-tech—companies doing business in the United States. Use of low-tech (and even no-tech) business procedures and methods may expose a company to a risk of liability for patent infringement. Therefore, companies mindful of this risk should conduct a search of issued U.S. patents *before* initiating any new business procedure, to determine whether potential infringement problems exist.

Moreover, all companies doing business in the United States should consider the potential advantages of obtaining patent coverage for their own procedures and methods. The key question to ask is: "What innovative product or service of ours do we want to prevent our competitors from making, using or selling?" As companies like Amazon have already discovered, U.S. patents can be extraordinarily effective tools for legally restricting competitive products and services, including many low-tech and even no-tech products and services.

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INTERNET MERCHANTS ARE COMPETING FOR YOUR BUSINESS IN MANY WAYS, SOME OF WHICH YOU MAY NOT BE AWARE

Over the last few years, activity on the Internet has exploded with more and more products and services becoming available for purchase online. We can buy anything from groceries to airline tickets, home furnishings to jewelry, and electronics to automobiles. It appears there are few limits to the commerce that can be conducted over this new medium. As the Internet grows, along with its number of users, merchants are seeing huge business opportunities for themselves and, hence, are becoming more aggressive in their quest for visibility. Some of the tools merchants are using to attract customers have caused concern among consumers and have sparked debate. Here are two examples:

Meta Tags

Meta Tags are codes embedded in the hypertext markup language (HTML) used to create Web sites. When placed in a Web document, these codes are invisible to normal Internet users, yet are utilized by search engines to index and prioritize sites for their search. Web site designers will typically include a list of meta keywords in the code in an attempt to trigger search engines to list their sites in appropriate searches. When a user types one or more keywords into a search engine, the sites that have matching keywords come up as "hits." Search engines utilize different prioritization algorithms to list the hits in order of relevance, but, typically, a large part of the prioritizing involves counting the number

of keywords that match and the number of times they come up in the title, body and meta tags of the document.

Problems have become evident concerning Web sites' usage of meta tags. Since visibility is critical in Internet commerce, and since a major source of visibility by potential customers is gained through Web searches, merchants have become creative in their usage of meta tags. To attract a broader number of Internet users, some merchants are listing an enormous number of meta keywords. These Internet merchants are forming a sort of 'bait and switch' scenario. It has become increasingly common for a company to bury the name of another company or brand within their meta tags so that a user searching specifically for that company or brand will find them as well.

For example, a consumer searching for a specific product, e.g., a Sony compact disc player, might enter keywords such as "compact disc player" and "Sony." A web site for an online stereo shop might have the word "Sony" in its meta tag even though it does not sell that brand. The merchant would be counting on the possibility that the consumer would find something else he/she prefers while at their Web site or would get tired of searching for this brand and would settle on one of the merchant's products.

What seems to be the greatest concern of Internet users regarding this kind of meta tag usage is the degree to which it handicaps a search engine's ability to provide relevant hits. It has become increasingly common these days to get a group of unrelated hits with each Web search. Those useless results you sometimes get might not be the fault of the search engine but could be caused by the Web sites themselves.

Cookies

Cookies are small computer files that are stored on a user's machine to serve as unique identifiers for tracking the user's movements across the Web and to store and retrieve site-specific information. The files contain a log of the links the user has made as well as any information that different Web sites choose to load. These files can be very useful to Internet merchants because of the insight the cookies can provide about their customers as well as the ability to create a personalized experience for each visitor. Since cookies can stay on a user's machine for an indefinite amount of time, they make it possible to see how a person's interests or use of a site changes over time. This can be a valuable marketing tool.

Cookies also make it possible to shop at a Web site using an "electronic shopping basket." A customer at an online CD shop or bookstore can browse and pick up all the items he or she wants before making the actual purchase -- just like in a walk-in store. Each time the customer chooses an item, the item's identifier is loaded into the customer's cookie file. At the time of purchase, the customer gives his credit card number or provides another form of payment, and the Web site reads the customer's cookies to see what he/she is buying. After the purchase, the Web site typically keeps the items listed in the cookie files but labels them as having been purchased. The Web site can then keep track of the customer's interests to provide a more targeted advertising approach. For example, a user returning to an online CD shop might be greeted by an ad for a recently released CD by a band whose CD he or she bought on the last visit. Or, a user might be greeted by an ad for a CD in which it is assumed, by past purchases, the user would have an interest.

In addition to making online shopping more convenient, cookies can hold other useful information. For example, users can, if they choose, allow password-protected Web sites to place their login name and password in their cookie file so that they do not need to manually log in each time they visit. Also, such things as a user's address, phone number and account information can be stored in order to keep the user from having to re-enter such information each time he/she interacts with the site.

The fears regarding cookie usage arise upon consideration of the ability of Web sites to use information attained from users' cookie files for tracking purposes. Because most Web sites use cookies, it is possible for sites to read the cookies and see where the user has been linking. Theoretically, a Web site could follow a user's history through

the Internet without the user's knowledge. This has caused Internet users a great deal of concern with regard to privacy issues.

Conclusion

With all of the changes occurring in the way we shop and do business, it is inevitable that there will be some difficult decisions to be made about how business should be conducted and what is fair play. Online commerce is still in its infancy. There is a great deal of structuring to be done before most consumers and merchants are completely comfortable. Until issues like these are resolved, we will probably continue to witness debate over how online commerce should function.

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