PRESENTATION:

MONETIZATION OF BUSINESS MODEL AND BUSINESS METHOD PATENTS

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This is one of my favorite topics: monetization. I prefer to use the term "monetize" because I feel it is a broader term, referring to any means of extracting value from intellectual property. Although most people may be used to one particular form of monetization, for example, licensing, I'm going to speak about a few more. So hopefully we'll cover some different ground.

I am going to present strategies for monetizing business method patents, primarily from the point of view of the company that wants to use its IP to do something other than merely protect commercial embodiments of the patented invention. Business method patents are a fairly new and increasingly important business asset, and it is important that you appreciate their unique characteristics in order to fully exploit their entire value.

I would like to start by defining "business method" because people use the term differently. I believe that the definition used should be determined by the motivation for selecting the definition. Today the motivation is that we are going to describe how to monetize business method patents. I am going to personally select a fairly narrow definition to use throughout this talk, but will first quickly go through a few of the more common definitions that you may have heard before.

One common definition: *a method that defines a business model for the entire operation of a company or an enterprise or something that supports the operations of a business venture*. That is a completely acceptable definition; it is fairly broad, but reasonable.

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Another definition that you may have seen from some of the pending legislation is actually two definitions, "business method" and "business method invention."[1] It is pretty unwieldy and challenging to use. It is also somewhat over-inclusive. For example, athletics is included. Although some segments of athletics are indeed a pretty impressive business, I do not think that athletics in general is a business.

Some other common definitions, perhaps a little too broad, would be *anything that makes money*, or *an internet patent minus technology*. You actually hear that last one quite a bit – when someone describes how easy it is to work on a business method invention: "you just take away the technology from an internet patent." These definitions are not useful for my purposes, so I won't use them either.

Finally, we come to the definition that I am going to use: *a method involving the interaction between buyers and sellers, or sales interaction.* It is fairly restrictive in the sense that it cuts out some things that you might reasonably expect to be a business method, such as manufacturing operations of a certain enterprise. However, I think that it is pretty useful to use this definition because it is broadly applicable to many types of businesses. If we think about buyers and sellers broadly, then this definition *sales interaction* can cover many types of businesses. For example, you could talk about a brick-and-mortar fast food restaurant, a department store, something online like an online auction, even something you might not ordinarily think of, such as customers interacting with a vending machine or a gambler interacting with a slot machine. If you think about it broadly, these are really customer and seller interactions.

One of the things that I like about this definition, *sales interaction*, is that it forces you to abstract pretty highly as to what you think the invention really is. So, if you think about the invention in broad terms, for example, "what does the seller want to do?" Sellers always want to deliver goods for a price, and they always want to lock in buyers as soon as possible. Buyers, on the other hand, want a very low price and almost always would rather pay later rather than now. Both buyers and sellers exhibit characteristics that are common in many industries.[2]

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[1] Taken from H.R. 1332, the Business Method Patent Improvement Act of 2001:

The term "business method" means:

- (1) a method
  - (a) of
    - (i) processing data; or
    - (ii) performing calculation operations; and
  - (b) which is uniquely designed for or utilized in the practice, administration, or management of an enterprise
- (2) any technique used in athletics, instruction, or personal skill; and
- (3) any computer assisted implementation of a method described in paragraph (1) or a technique described in paragraph (2).

The term "business method invention" means:

- (1) any invention which is a business method (including any software or other apparatus); and
- (2) any invention which is comprised of any claim that is a business method.

[2] Features that are common to many, if not all industries / businesses:

- (1) Sellers deliver goods or services for a price
- (2) Buyers want a low price
- (3) Buyers would rather pay later than now

Business methods can be acquired deliberately or almost incidentally. By deliberately, I mean that you could acquire a business method through purchase or license, or you could create it through a directed research and development effort. At Walker Digital, a research and development think tank, we create business methods.

Another way business methods are created is incidentally, or accidentally, in the sense that perhaps someone in the company just brainstorms and comes up with a new way of doing something.

Why monetize a business method? There may be different reasons, depending on how you acquired it, your motivations and your environment. From Walker Digital's perspective, we realize a return on research and development investments because that is how we acquire our business methods. Companies may want to monetize a business method to enter fields outside their core competency (*e.g.*, the electronics field, the auction field, the business-to-business field). Companies may want to target different customers or different markets. As a result, they might need to monetize business methods with a more experienced partner in the areas that would enable the company to reach customers and markets that it would not have been able to reach alone.

The last point is that you might have a deal set up with your business method really for the sole purpose of facilitating a second deal, thereby using the business method as a "staging area," so to speak. Business methods are very disruptive. Businesses especially do not like to change something that pertains to their customers. A change might require significant investment of time and personnel training, or it might require new hardware or software. Therefore, the deployment of this groundwork – the new hardware, new software, rudimentary customer training, rudimentary training of personnel – might be accomplished in a separate first deal that paves the way for the business method when it gets deployed. It might be as soon as a few months afterwards or it might actually be a few years after the staging area deal is set.

In order to properly monetize a business method patent, you have to focus on three components: (1) the value of the invention; (2) the value of the patent; and (3) the proper monetization strategy. The first two are often discounted because they are perceived as fixed; however, you have just as much flexibility to change the value of the invention and the value of the patent as you do in selecting the monetization strategy.

To maximize the value of an invention, you want to prove to yourself and potential licensees a few aspects of your invention. For example, you want to prove that the invention is horizontal. By that, I mean applicable to many industries. You want to show that the invention is "persistent," that it has a value that will endure and not fade away with time. You also want to show that it is attractive to the target licensee. In doing so, you must target a business method to a concrete problem or opportunity encountered by the licensee. You must effectively communicate this to them, otherwise you are not going to be able to make the deal. Finally, you must continue to develop the invention. You might have the

(4) Buyers prefer immediate gratification in exchange for long-term payment
(5) Sellers would rather have more consumers than less
(6) Sellers value reduction of their costs
(7) Both buyers and sellers value reduction of their risks
(8) Both buyers and sellers would rather do less than more

process in place and it might work well, but you can always make it work better as the business evolves.

You want to show that the invention is applicable to many different businesses. Ideally, you can show that the business method is applicable to any business if you can abstract it highly enough and show there are certain characteristics applicable to any buyers and any sellers. Patentees are used to describing their inventions broadly, so this is an excellent opportunity for them to take those skills and make the invention more valuable.

You want to show that the invention will remain valuable over time, that it does not depend on certain features that are likely to change. With business methods, some things do not change much, while others change frequently. Some features, such as customer behavior, customer preferences and customer expectations, might change very frequently, depending on the particular industry. In fact, they might change in response to the business method that you are deploying. As customers become more savvy, they may prefer to interact differently and you'll have to demonstrate that the invention can keep pace with such change.

The rate of technological change may effect the value of the invention. The technological environment is something that may endure or it may be very transitory, again, depending on the industry. For example, an invention using the telephone may be a good invention, but the value of that invention goes away if suddenly everyone is using the internet in place of the telephone. On the other hand, you do not want to depend on technologies that are underdeveloped. So be cognizant of the industry you are dealing with and appropriately target the right technological features.

Here are a few maxims to help you stay focused on the business value of the business method invention. First, do not concentrate on the technology, concentrate on the value of the technology to the business. Second, do not want depend on unrealistically high levels of labor or technology. For example, your business method may depend on workers in a store giving offers to customers. That may sound simple, but if you do not have someone standing over their shoulder they will almost never do it. So, if you depend on the labor being 100% reliable, then the value of the business method might not be as high as you think.

Third, demonstrate that the invention is attractive to the person you are trying to license or sell it to. This may require a lot of research, especially if you are trying to implement a very broad business method in a variety of industries. You need to know what the industry finds valuable or not valuable. Along these lines, you want to show a few things. The invention must be workable. Low risk of failure is also critical because no one likes to take chances on their business. You do not want to require a huge investment up front because no one wants to take expensive chances. Additionally, you want to give a quantitative analysis that shows the actual financial impact, rather than just a qualitative analysis.

If you do not have both concrete knowledge of how the invention is actually going to make money and an idea of how much money it might make, then you are going to have a hard time selling it. For example, the business method might increase sales on weekends by one-cent. That might not be very persuasive to a potential partner. So you say that profits on weekends improve significantly because of this one-cent sales increase. That is a little better but it is still not what you need. So, you conduct a detailed analysis of the profit; here you will probably need industry expertise. If the typical profit on a weekend sale is only three-cents, well that extra one cent in profit, assuming that it does not incur any other costs, is really an increase in profits of one third, which is more impressive than the first statistic.

Of course, you want to pitch this information from the point of view of the target licensee. Depending on who that is, you might have to work the figures differently. I will demonstrate this by using the previous example. What does the one-cent in extra profit represent to corporate headquarters? Well, if corporate headquarters receives that one-cent extra profit per weekend sale per store, this might mean an extra $520,000 in extra profits for headquarters. This is a much more persuasive and informative figure than merely describing the per-transaction increase or the per-store increase.

The next point is subtle but critical. Everything changes in business. Businesses change very easily. It is necessary to anticipate these changes if you want to keep the value of the invention high. This is especially true in the world of e-commerce. In the early stages of a new business process, you often need to experiment to see what works best. I do not mean experimentation in the sense of enabling the invention, but instead to optimize the value of the invention in order to overcome small but significant pitfalls and traps along the way. Going back to the labor example, you might have a fantastic invention that increases profits significantly, but it only works if you can count on the labor. If you do not have reliability and you do not anticipate such problems, then the value of the invention is going to be reduced significantly.

You should also target complimentary inventions – those that support the invention or are related to the invention and enhance its value. One familiar type of complimentary invention is the "design around." If you have a "design around" patented, then you prevent competitors from diminishing the value of the first patent by taking the design-around route.

Another type of complimentary invention is something that would support the basic business method. Take, for example, a new sales method. The new sales method might require cashiers to give an offer. If unmotivated, cashiers may not give the offer when they should, and therefore the invention will not work. A complimentary invention would be one that assures that they make the offer. It might be voice recognition software that listens to the cashier. If the cashier does not make the offer, then they cannot open the cash drawer and complete the sale. Now, they are motivated to give the offer. We found that cashiers that did not have that kind of prompting – or they did not have someone standing over their shoulder – would give the offer about 3% of the time that they were supposed to. Now with the complimentary invention they do it about 100% of the time.

Maximizing the value of the patent is something that most patent attorneys are familiar with, so I will just touch on one aspect: the prior art search. Conventional wisdom is that the best prior art is not in the patents. I am actually surprised to find out how much prior art relevant to business methods there is in the patent literature. It is just not categorized the way you might think. Patent searchers are not very experienced at finding this information, because it is not their forte. If you know that there is a certain amount of patent literature that is relevant, then obviously you want to search that as well as conduct a patent search. Focus on searchers who have experience with business method patent searching. Be careful of patent search firms that have branched out because they may not have the necessary experience yet. Instead, go to people that have always done literature searching; they can conduct a much better search.

Additionally, open the doors of communication between the searcher and the inventor. Although atypical in many corporations, it works very well. With direct communication, the inventor can really comment on the search strategy. Until business method patent searching becomes a little more widespread, this is really an effective way to make sure that you are getting the best search possible.

Finally, update your searches. Depending on the value of the invention, we usually do one to three update searches, about a year apart, to make sure that we catch all the prior art.

One of the largest barriers to monetizing a business method patent is that potential partners are not accustomed to patents, much less business method patents. They are generally reluctant to change – especially changes that affect their customers in any way. Therefore, you must adapt your processes to take this reluctance into account and attempt to reduce it.

There are three basic monetization strategies: 1) Licensing, which most people are familiar with; 2) Launching a new company, which is a little less common, but is most appropriate in certain circumstances; and 3) acquiring an existing company, which is appropriate in other circumstances.

Most people are familiar with licensing. One may want to license business method patents because there is lower risk involved than the other strategies, or because there is no capital to throw around at other strategies. Licensee reluctance, however, has to be overcome. One way of overcoming it is to base royalties on incremental profits. Incremental profits are those derived solely from the invention. In other words, they are "but for" profits, the profits that you would not have made if the business method invention was not deployed. This is a very powerful tool because you can audit it, show it to the licensee, and base royalties on it. Licensee reluctance can be overcome because they know that they will not pay anything if the business method invention does not yield any extra profits. In exchange for this reduction in risk, the patentee can take a higher royalty rate.

Another way to overcome licensee reluctance is to provide up-front benefits. Going back to the fast-food restaurant example, you might need to upgrade cash registers to run new software. Some of the cash registers may be outdated. Therefore, you could deploy new hardware and structure the royalty to pay for the hardware in addition to paying incremental profits. In such a situation, licensee reluctance may be overcome because they get to keep the hardware and use it for something else if the invention does not work.

Another technique is to create a licensee's race, such that licensees that license from you first have higher benefits and lower royalty rates. Additionally, you want to maintain best licensees by giving the best royalty treatment to those who perform best.

A second strategy involves starting a new company. Why would you start a new company? Right now there is a freeze on IPO funding and other bad news in the market. But sometimes you need to start a new company because there is no one that would properly implement that business method invention. For example, if you were going to create a new method for selling airline tickets, you might find that the airlines are not willing to start doing this themselves. Well then you would probably have to start a new company, which is what Walker-Digital did when we started Priceline. Starting a new company is actually very advantageous, because when you go into a new field the new company is the shield – it takes all the chances. Although this strategy can be risky, if it works out it yields a higher return.

A similar strategy is to acquire an existing company. You might want to start a new company but find that it is not appropriate because it would require specialized skills or resources that are not easy to acquire. For example, if you are going into the vending machine field, you might find that you need a manufacturing base, which you do not have, and a distribution network, which you also do not have. Therefore, starting an entirely new vending machine company would not be a viable option, but maybe you would acquire one. It may not be as painful as you think. Not every company requires a $100 million check to acquire, and you also do not have to invest the money yourself. There are other people that you can bring into the investment structure. Ideally, you can bring in other people who will facilitate the invention. You can bring in other vendors that might require this invention. You might bring in others that derive downstream benefits, like value-added resellers. And you can always partner with a leveraged buyout firm (LBO) to assist in the buyout of an existing company.

Which of these strategies do you pick? How do you pick? First, you need to determine what you want to do with the business method. There are a few factors that you have to consider. Most significantly, you have to determine the effect on customers. You might think that the best strategy would be to license; but licensing to many different licensees may not be effective in a particular market because customers would prefer to get something from one vendor. Maybe you want to start a new company or acquire an existing one, rather than just licensing to a single licensee, which probably would not be as profitable.

Here are a few things to consider when selecting a licensee. Should you partner with the largest in the industry? There are several pros to this approach. They are the largest for a reason, they have the largest market share, and probably the best resources. However, sometimes the largest is the least willing to change. They have the most to lose. Maybe you want to go with the second largest. The second largest has a lot of the same advantages, depending on the industry structure. For example, if you are going to Pepsi instead of Coke, Pepsi is eager to be number one and Pepsi has comparable resources. It is not like that in every industry. Sometimes number two is a far second, so you do not have many of the same advantages. But number two is usually eager to be number one, which is advantageous.

Sometimes you go with a very small player on the theory that they are more flexible. They might be the only one willing to license or to implement the business method invention. Sometimes the smallest player is completely appropriate, especially in a new field, where the largest player is not really that significant.

An upstream partner is someone who provides equipment or other resources to the entity that you really want to deal with. For example, if you wanted to deal with MacDonald's to implement a new sales method, you might go to them and find that they are not in the business of licensing patents. They are not in the business of tailoring their business procedures much at all, so they do not want to get into this field. Although they like the invention, they say it is really not what they do. So a better approach may be to go to the person that manufactures their cash register software. MacDonald's would be much more willing to partner with them because they have a history of doing so. MacDonald's would be much more willing to deploy this software and let the software guide their cashiers in the method, because that is what they have been doing anyway. They usually let software drive their processes. So, if there is an upstream partner, this can actually facilitate licensing quite a bit. Which upstream partner do you select? The smaller ones are a little better, but not always. It depends on the industry. You want to make sure that you have a partner that is appropriate for the target.

In conclusion, business method inventions exhibit characteristics that separate them from other types of inventions. You have to appreciate these differences. If you treat business methods like any other invention, you may not do as well as you would if you recognized their unique characteristics.