

Client Alert

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Federal Circuit Addresses Key Damages Issues in Vacating \$386 Million Patent Verdict

This week, the US Court of Appeals for the Federal Circuit issued a precedential decision addressing two important patent damages issues: the entire market value rule and the proper application of the Nash Bargaining Solution in *VirnetX, Inc. v. Cisco Systems, Inc.*, No. 13-1489 (Fed. Cir. Sept. 16, 2014). In vacating a \$386 million damages award against defendant Apple Inc., the Federal Circuit first resolved conflicting treatment of the application of the entire market value rule (EMV) by the district courts in cases where the smallest saleable unit is the entire accused device. Holding that the district court's jury instruction was improper, the Federal Circuit clarified that, unless the EMV rule is satisfied, damages must always be apportioned between patented and unpatented features—even in cases where the smallest salable unit is the accused device itself. Second, the Federal Circuit held that the patentee's damages expert had improperly relied on the Nash Bargaining Solution because he failed to sufficiently tie the controversial theory (positing a 50 percent/50 percent profit split between the patentee and accused infringer) to the specific facts of the case.

The case involved four patents directed to providing secure communication links over networks such as the Internet. The patent owner, VirnetX, accused Apple's popular "FaceTime" feature of infringing two of the patents and Apple's "VPN On Demand" feature of infringing the other two patents. *VirnetX*, at 3-6. Following a five-day jury trial in the Eastern District of Texas before Chief Judge Leonard Davis, the jury found the asserted claims valid and infringed and awarded damages of \$386 million. *Id.* at 6-7. The district court denied Apple's post-trial motions. *Id.*

On appeal, Apple challenged certain claim constructions, the jury's infringement and validity findings, and the jury's damages award. The Federal Circuit affirmed one claim construction and literal infringement of two of the four asserted patents, but modified the construction of another claim term and remanded the infringement case regarding the other asserted patents. *Id.* at 8-19. The court also affirmed the validity of the patents. *Id.* at 21-22. The most interesting aspect of the opinion, however, concerned the disputed damages award.

At trial, VirnetX's expert relied on three theories to support his damages opinion. The first theory was based on a reasonable royalty of 1 percent applied to Apple's revenue from the sale of devices (iPhones, iPods, iPads and Mac computers) incorporating the accused features, FaceTime and VPN On Demand. *Id.* at 24. The expert's second and third theories were based on applications of the Nash Bargaining Solution, whereby VirnetX and Apple would have hypothetically negotiated to split the additional incremental profits realized by Apple for including the FaceTime feature. *Id.* at 24-25.

Writing for a two-judge panel, Chief Judge Sharon Prost of the Federal Circuit first addressed VirnetX's reasonable royalty theory, explaining that it improperly relied on the EMV rule without establishing that the patented feature "drove the demand for accused products." *Id.* at 29 n. 2. The EMV rule permits patentees to apply a royalty rate to sales of an entire multicomponent or multifeature device when the patented feature "constitutes the basis for customer demand." *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1336 (Fed. Cir. 2009). VirnetX failed to establish that the accused FaceTime and VPN On Demand features created the basis for customer demand of the accused products, but it nevertheless

used the base price of the accused products to calculate its royalty base and only excluded charges associated with additional memory purchased. *VirnetX*, at 31.

The damages analysis was also infected by the district court's improper jury instruction regarding when a patentee may invoke the EMV rule. Relying on an improper interpretation of *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51 (Fed. Cir. 2012), the district court instructed the jury that the EMV rule was available when the patented feature creates the customers' demand for the product or when "the product in question constitutes the smallest salable unit containing the patented feature." *VirnetX*, at 28. While *LaserDynamics* did state that in cases "involving multi-component products, patentees may not calculate damages based on sales of the entire product, as opposed to the smallest salable patent-practicing unit, without showing that the demand for the entire product is attributable to the patented feature," the Federal Circuit clarified in *VirnetX* that a patentee cannot invoke the EMV rule simply because an entire product constitutes the smallest saleable unit containing the patented feature. *Id.* at 28-29. Instead, unless the patented feature drives the demand for the entire product and the EMV rule is satisfied, a patentee must always apportion damages and "take care to seek only those damages attributable to the infringing features." *Id.* at 26.

Here, the record was clear that *VirnetX* "made no attempt to separate software from hardware, much less to separate the FaceTime software from other valuable software components." *Id.* The Federal Circuit explained that there was evidence in the record that could have been used to apportion damages, namely a \$29 software upgrade to enable FaceTime on Mac computers and a calculation of incremental revenue of \$15 per mobile device attributable to FaceTime. *Id.* at 30-32. Thus, in addition to the improper jury instruction, the district court should have excluded testimony on *VirnetX*'s reasonable royalty theory because it failed to "apportion the royalty down to a reasonable estimate of the value of its claimed technology." *Id.* at 32-32. Interestingly, the court noted that it expressed no opinion as to whether the \$29 software upgrade is itself sufficiently related to the patented system for a "secure communications link" such that *VirnetX* could rely on the entire \$29 upgrade revenue as a royalty base. *Id.* at 32 n. 3.

Next, the court rejected *VirnetX*'s other two damages estimates that relied on the Nash Bargaining Solution. The Nash Bargaining Solution generally describes a solution reached by two bargaining parties whereby each party receives the same amount of profit. *Id.* at 25. Various district courts have reached inconsistent results regarding the admissibility of damages testimony based on the Nash Bargaining Solution. *Id.* at 37. The court likened the Nash Bargaining Solution to the dubious "25 percent rule of thumb," which posited an outcome in a hypothetical negotiation whereby 25 percent of the value of the infringing technology remains with the patentee and 75 percent of the value goes to the licensee. In *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1315 (Fed. Cir. 2011), the court held that the 25 percent rule was not sufficiently reliable or relevant to be used in ascertaining reasonable royalty damages, presumably in any patent case. *Uniloc*, at 1316-18. The *VirnetX* court did not reject the reliability of the Nash Bargaining Solution out of hand, noting that the Nash Bargaining Solution avoids some of the problems associated with the 25 percent rule because the Nash Bargaining Solution "focuses only on the incremental profits earned by the infringer from the use of the asserted patents." *Id.* at 40. But the court concluded that, here, *VirnetX*'s expert failed to sufficiently tie the applicability of the premises of the Nash Bargaining Solution to the specific facts of the case.

Finally, the court rejected *VirnetX*'s argument that its expert applied the Nash Bargaining Solution to the facts of the case because he made a 10 percent deviation from the 50/50 baseline split. *Id.* at 39-40. While deviation from the 50/50 baseline may be warranted by the facts of a particular case, it is still the patentee's burden to justify why the baseline starting point is appropriate under the facts of the case in the first place. *Id.* The court explained the need to justify the applicability of the Nash Bargaining Solution to future litigants: "[a]nyone seeking to invoke the theorem as applicable to a particular situation must establish that fit, because the 50/50 profit-split result is proven by the theorem only on those premises." *Id.* at 38.

The Federal Circuit remanded the case back to the district court for further proceedings. Meanwhile, *VirnetX* has several pending lawsuits involving the patents at issue, including a second lawsuit against

Apple's newer generation of devices (the iPad Mini and iPhone 5) and Microsoft's Skype service. These cases will no doubt be affected by this decision, as will future cases involving accused products with both patented and unpatented features or damages theories that rely on the Nash Bargaining Solution. Litigants and damages experts alike should be careful not to overreach, and instead to "take care to seek only those damages attributable to the infringing features."

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