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Federal Circuit Patent Bulletin: *VirnetX, Inc. v. Cisco Sys., Inc.*

September 16, 2014

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On September 16, 2014 in *VirnetX, Inc. v. Cisco Sys., Inc.*, the U.S. Court of Appeals for the Federal Circuit (Prost,* Chen) inter alia affirmed-in-part, reversed-in-part, vacated-in-part, and remanded the district court's judgment entering the jury verdict that Apple infringed U.S. Patents No. 6,502,135, No. 7,418,504, No. 7,490,151, and No. 7,921,211, which related to Internet security technology, and the award of $368,160,000 in damages. The Federal Circuit stated:

Upon a finding of infringement, "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." The most common method for determining a reasonable royalty is the hypothetical negotiation approach, which "attempts to ascertain the royalty upon which the parties would have agreed had they successfully negotiated an agreement just before infringement began." A reasonable royalty may be a lump-sum payment not calculated on a per-unit basis, but it may also be, and often is, a running payment that varies with the number of infringing units. In that event, it generally has two prongs: a royalty base and a royalty rate.

Authors

Lawrence M. Sung
Partner
202.719.4181
lsung@wiley.law

No matter what the form of the royalty, a patentee must take care to seek only those damages attributable to the infringing features. [A] patentee must in every case give evidence tending to separate or apportion the defendant's profits and the patentee's damages between the patented feature and the unpatented features, and such evidence must be reliable and tangible, and not conjectural or speculative; or he must show, by equally reliable and satisfactory evidence, that the profits and damages are to be calculated on the whole machine, for the reason that the entire value of the whole machine, as a marketable article, is properly and legally attributable to the patented feature.

Thus, when claims are drawn to an individual component of a multi-component product, it is the exception, not the rule, that damages may be based upon the value of the multi-component product. "A patentee may assess damages based on the entire market value of the accused product only where the patented feature creates the basis for customer demand or substantially creates the value of the component parts." In the absence of such a showing, principles of apportionment apply.

These strict requirements limiting the entire market value exception ensure that a reasonable royalty "does not overreach and encompass components not covered by the patent." Thus, "[i]t is not enough to merely show that the [patented feature] is viewed as valuable, important, or even essential to the use of the[overall product]." Instead, this court has consistently held that "a reasonable royalty analysis requires a court to . . . carefully tie proof of damages to the claimed invention's footprint in the market place." Additionally, we have also cautioned against reliance on the entire market value of the accused products because it "cannot help but skew the damages horizon for the jury, regardless of the contribution of the patented component to this revenue." . . .

To be sure, we have previously permitted patentees to base royalties on the "smallest salable patent-practicing unit." However, the instruction mistakenly suggests that when the smallest salable unit is used as the royalty base, there is necessarily no further constraint on the selection of the base. That is wrong. For one thing, the fundamental concern about skewing the damages horizon—of using a base that misleadingly suggests an inappropriate range—does not disappear simply because the smallest salable unit is used.

Moreover, the smallest salable unit approach was intended to produce a royalty base much more closely tied to the claimed invention than the entire market value of the accused products. [T]he requirement that a patentee identify damages associated with the smallest salable patent-practicing unit is simply a step toward meeting the requirement of apportionment. Where the smallest salable unit is, in fact, a multi-component product containing several non-infringing features with no relation to the patented feature (as VirnetX claims it was here), the patentee must do more to estimate what portion of the value of that product is attributable to the patented technology. To hold otherwise would permit the entire market value exception to swallow the rule of apportionment.

In reaching this conclusion, we are cognizant of the difficulty that patentees may face in assigning value to a feature that may not have ever been individually sold. However, we note that we have never required absolute precision in this task; on the contrary, it is well-understood that this process may involve some degree of approximation and uncertainty. We conclude that the district court's jury instruction regarding the entire market value rule was legally erroneous. Moreover, that error cannot be considered harmless, as VirnetX's expert relied on the entire value of the iOS devices as the "smallest salable units," without attempting to apportion the value attributable to the VPN On Demand and FaceTime features. Thus, it is clear that the jury's verdict was tainted by the erroneous jury instruction. . . .

In recent years, numerous district courts have confronted experts' invocations of the Nash Bargaining Solution as a model for reasonable royalty damages, with varying results. For the reasons that follow, we agree with the courts that have rejected invocations of the Nash theorem without sufficiently establishing that the premises of the theorem actually apply to the facts of the case at hand. The use here was just such an inappropriate "rule of thumb." Previously, damages experts often relied on the "25 percent rule of thumb" in determining a reasonable royalty rate in a hypothetical negotiation. That rule hypothesized that 25% of the value of the infringing product would remain with the patentee, while the remaining 75% would go to the licensee. [W]e held the "25 percent rule of thumb" to be inadmissible "because it fails to tie a reasonable royalty base to the facts of the case at issue." In so doing, we noted that the rule did not differentiate between different industries, technologies, or parties. Rather, it assumed the same 25/75 royalty split regardless of the size of the patent portfolio in question or the value of the patented technology. The problem as that the 25% rule made too crude a generalization about a vastly more complicated world.

The problem with [the use by VirnetX's damages expert, Mr. Roy Weinstein] of the Nash Bargaining Solution, though somewhat different, is related, and just as fatal to the soundness of the testimony. The Nash theorem arrives at a result that follows from a certain set of premises. It itself asserts nothing about what situations in the real world fit those premises. Anyone 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. Weinstein did not do so. This was an essential failing in invoking the Solution. Moreover, we do not believe that the reliability of this methodology is saved by Weinstein's attempts to account for the unique facts of the case in deviating from the 50/50 starting point. . . . Beginning from a fundamentally flawed premise and adjusting it based on legitimate considerations specific to the facts of the case nevertheless results in a fundamentally flawed conclusion.

[E]ven if an expert could identify all of the factors that would cause negotiating parties to deviate from the 50/50 baseline in a particular case, the use of this methodology would nevertheless run the significant risk of inappropriately skewing the jury's verdict. This same concern underlies our rule that a patentee may not balance out an unreasonably high royalty base simply by asserting a low enough royalty rate. Although the result of that equation would be mathematically sound if properly applied by the jury, there is concern that the high royalty base would cause the jury to deviate upward from the proper outcome. [T]he use of a 50/50 starting point—itself unjustified by evidence about the particular facts—provides a baseline from which juries might hesitate to stray, even if the evidence supported a radically different split.

Even the 25% rule had its share of support in the literature, which had observed that, at least as an anecdotal matter, a 25% royalty rate was a common starting point—and not far off from a common end point—of licensing negotiations across numerous industries. Nevertheless, we rejected it, insisting on testimony tied to the particular facts. The same insistence is vital here. We note that the Nash Bargaining Solution does offer at least one noticeable improvement over the 25% rule: where the 25% rule was applied to the entire profits associated with the allegedly infringing product, the Nash theory focuses only on the incremental profits earned by the infringer from the use of the asserted patents. But while we commend parties for using a theory that more appropriately (and narrowly) defines the universe of profits to be split, the suggestion that those profits be split on a 50/50 basis—even when adjusted to account for certain individual circumstances—is insufficiently tied to the facts of the case, and cannot be supported.