CRA Insights: Intellectual Property

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CRA Insights: Intellectual Property is a periodic newsletter that provides summaries of notable developments in IP litigation.

Recent developments in IP damages

VirnetX, Inc., et al. v. Cisco Systems, Inc., et al., 2013-1489 (CAFC)

On September 16, 2014, the Court of Appeals for the Federal Circuit (CAFC) issued a ruling in *VirnetX Inc., et al v. Cisco Systems, et al.*,[1] vacating the jury's damages award against Apple Inc. (Apple) and remanding the case for further proceedings.[2]

The case involves four patents related to technology for providing security over networks such as the Internet. VirnetX, Inc. (VirnetX) and Science Applications International Corporation (SAIC) filed suit against Apple in the Federal District Court for the Eastern District of Texas, alleging Apple's servers that run FaceTime on Apple devices and Mac computers infringe two of the patents-in-suit, and that Apple's iPhone, iPad, and iPod Touch infringe the other two patents based on their inclusion of a feature called VPN On Demand. At trial, the jury found that Apple infringed all four of the patents-in-suit and none of the infringed claims were invalid. It awarded reasonable royalty damages totaling $368.2 million. On appeal, the CAFC found the District Court had erred in its jury instructions regarding damages and in failing to exclude the testimony of VirnetX's damages expert.

At trial, the expert presented three approaches to computing damages. The first involved applying a 1% royalty rate to a royalty base consisting of (1) Apple's revenue from sales of the accused iPhones, iPods, and iPads which ranged from $199 to $649 per device;[3] and (2) $29 per Mac computer, based on the price of an upgrade that included FaceTime. This approach resulted in claimed damages of up to $708 million. The expert's other two approaches involved quantifying the amount of profit Apple purportedly earned from the FaceTime feature and applying a profit split based on the Nash Bargaining Solution, which resulted in damages of up to $606 million.

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[1] Case No. 2013-1489.

[2] VirnetX's case against Cisco was tried separately.

[3] The expert calculated this amount using the base price at which each product was sold, excluding only charges for additional memory sold separately.

In arriving at his opinion about the reasonable royalty base for his first approach, the expert relied on the fact that FaceTime is not sold separately for iPhones, iPods, and iPads, and thus those devices themselves represent the smallest saleable units. The court instructed the jury that in determining the royalty base "you should not use the value of the entire apparatus or product unless either: (1) the patented feature creates the basis for the customers' demand for the product, or the patented feature substantially creates the value of the other component parts of the product; or (2) the product in question constitutes the smallest saleable unit containing the patented feature."

The CAFC found that this jury instruction "misstates our law," and the jury's verdict was tainted by the erroneous instruction. It explained, "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. Indeed, we recently reaffirmed that '[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.'" (citing *LaserDynamics, Inc. v. Quanta Computer, Inc.,* 694 F.3d 51, 70 (Fed. Cir. 2012)) It added "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.'" (citing *Uniloc USA, Inc. v. Microsoft Corp.,* 632 F.3d 1292, 1320 (Fed. Cir. 2011)) The Court recognized "the difficulty that patentees may face in assigning value to a feature that may not have ever been individually sold." However, it noted "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." (citing *Unisplay,S.A. v. Am. Elec. Sign Co.,* 69 F.3d 512, 517 (Fed. Cir.1995))

For similar reasons, the CAFC concluded the District Court erred by allowing the expert's testimony about the royalty base. VirnetX argued the expert's approach was appropriate because "software creates the largest share of the product's value" for the products at issue. However, the Court found that "[w]hether 'viewed as valuable, important, or even essential,' the patented feature must be separated." (citing *LaserDynamics*, 694 F.3d at 68) According to the Court, the expert "made no attempt to separate software from hardware, much less to separate the FaceTime software from other valuable software components."

The CAFC stated the expert should have identified a patent-practicing feature with a sufficiently close relation to the claimed functionality. It pointed out that the record contained evidence of smaller per unit figures for FaceTime, namely the $29 cost of the Mac software upgrade and a $15 per device amount that the expert presented as "Apple's incremental revenues due to FaceTime." Accordingly, "VirnetX cannot simply hide behind Apple's sales model to avoid the task of apportionment."

To arrive at his 1% royalty rate, the expert relied on six license agreements which Apple argued were not sufficiently comparable to the license that would have resulted from the hypothetical negotiation. However, the CAFC found "the district court here did not abuse its discretion in permitting [the expert] to rely on the six challenged licenses. To begin with, four of those licenses did indeed relate to the actual patents-in-suit, while the others were drawn to related technology. Moreover, all of the other differences that Apple complains of were presented to the jury, allowing the jury to fully evaluate the relevance of the licenses. No more is required in these circumstances." In reaching this conclusion, the Court explained "[w]e have held that in attempting to establish a reasonable royalty, the 'licenses relied on by the patentee in proving damages [must be] sufficiently comparable to the hypothetical license at issue in suit.'…However, we have never required identity of circumstances; on the contrary, we have long acknowledged that 'any reasonable royalty analysis necessarily involves an element of approximation and uncertainty.' Thus, we have cautioned that 'district courts performing reasonable royalty calculations [must] exercise vigilance when considering past licenses to technologies other than the patent in suit,' and 'must account for differences in the technologies and economic circumstances of the contracting parties.'" (citing *Lucent Techs., Inc. v. Gateway, Inc.*, 580 F.3d 1301, 1325 (Fed. Cir. 2009); *LaserDynamics*, 694 F.3d at 79; *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010); *Finjan, Inc. v. Secure Computing Corp.*, 626 F.3d 1197, 1211 (Fed. Cir. 2010))

With regard to the expert's profit apportionment approaches, the CAFC agreed with Apple's challenge to the expert's use of the Nash Bargaining Solution. After citing a number of district court decisions involving the Nash Bargaining Solution, it stated "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 Court compared the Nash Bargaining Solution to the 25% rule, which it had previously rejected in *Uniloc*, and concluded that "although the Nash Bargaining Solution does offer one improvement over the 25% rule," it "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." Thus "the expert's use of the Nash Bargaining Solution, though somewhat different [from the 25% rule] is related, and just as fatal to the soundness of the testimony."

The CAFC acknowledged the expert "attempt[ed] to account for the unique facts of the case" by using a split of 45/55 rather than 50/50. However, the Court concluded the expert's "thin attempts to explain his 10% deviation from the 50/50 baseline in this case demonstrates how this methodology is subject to abuse. His only testimony on the matter was that although he 'considered other splits,' he ultimately determined that a 10% deviation—resulting in a 45/55 split— was appropriate 'to reflect the fact that Apple would have additional bargaining power over VirnetX back in . . . 2009.' Such conclusory assertions cannot form the basis of a jury's verdict." (citing *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 146 (1997))

The CAFC added that "[m]ore importantly, even 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." (citing *Uniloc*, 632 F.3d at 1320)

Apple had also challenged the expert's calculation of the amount of profit for use in his profit apportionment approach, claiming his methodology did not adequately isolate the incremental profits attributable to the patented technology. However the Court declined to reach a conclusion on that issue because it had determined that the testimony should have been excluded for invoking the Nash Bargaining Solution.

Chief Judge Prost authored the opinion on behalf of the panel.

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