

## Castle Defense

### *Federal Circuit Reinforces Patent Damages Gate in VirnetX* *Part One of a Two-Part Article*

By Rudy Kim and Michelle Yang

The battle over expert testimony on patent damages harkens back to medieval warfare. During that period, as would-be attackers developed new strategies for laying siege to a castle, defensive counter-measures were developed to thwart those siege tactics. As plaintiffs in patent cases have introduced expert testimony based on novel patent damages theories, defendants have asked courts to fulfill their gatekeeping role by preventing certain types of expert testimony from reaching the jury. In its recent *VirnetX, Inc. v. Cisco Sys., Inc.*, decision, the Federal Circuit reinforced the damages “gate” in patent cases by further clarifying the district court’s gatekeeping responsibility for ensuring that unreliable expert testimony on purported patent damages does not reach the jury. Vacating a \$368 million jury award against Apple, the Federal Circuit concluded that the district court should

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have excluded expert testimony on damages because: 1) the purported royalty base was predicated on the “smallest salable unit” of the accused product and failed to apportion between patented and unpatented features; and 2) the purported royalty rate was determined using the assumption that the parties would have agreed to a 50/50 split of incremental profits as a starting point, without showing that this assumption was tied to the facts of the case. *VirnetX, Inc. v. Cisco Sys., Inc.*, No. 2013-1489, --- F.3d --- (Fed. Cir. Sept. 16, 2014) (“slip op.”) (<http://bit.ly/1LffJvd>).

The *VirnetX* decision resolves discrepancies that had arisen among various district courts regarding apportionment and the use of generic assumptions such as the Nash Bargaining Solution in determining a proper royalty rate. The *VirnetX* decision, however, leaves open new potential strategies to be employed (and countered) by parties and their damages experts, which will have to be addressed by district courts in their role as gatekeepers.

#### APPORTIONMENT

##### *The ‘Smallest Salable Unit’*

The term “smallest salable unit” was introduced in *Cornell v. Hewlett-Packard*, 609 F. Supp. 2d 279, 284-85 (N.D.N.Y. 2009) (Rader, J., sitting by designation). Judge Rader, sitting by designation, granted the defendant’s motion for judgment as a matter of law on damages, because the plaintiff used CPU brick revenues as the royalty base rather than processors, which were “the smallest salable infringing unit with

close relation to the claimed invention.” *Id.* at 288. The Federal Circuit subsequently explained in *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 67 (Fed. Cir. 2012), that calculating royalties on a multi-component product “carries a considerable risk that the patentee will be improperly compensated” for the non-infringing components. Thus, “it is generally required that royalties be based not on the entire product, but instead on the ‘smallest salable patent-practicing unit.’” *Id.* (quoting *Cornell*, at 287-88).

District courts soon split on the issue of whether further apportionment was required when an accused product has multiple components, (some of which are infringing and others that are not), when the multi-component product is the smallest salable unit. Some courts concluded “additional apportionment is unwarranted” if the damages expert used revenues from the smallest salable unit as the royalty base. *Internet Machs. LLC v. Alienware Corp.*, No. 6:10-cv-23, 2013 WL 4056282, at 13 (E.D. Tex. June 19, 2013); *see also*, *Summit 6 LLC v. Research In Motion Corp.*, No. 3:11-cv-367, 2013 U.S. Dist. LEXIS 95164, at 34 (N.D. Tex. June 26, 2013). Other courts, however, concluded that “apportionment is required even where ... the accused product is the smallest salable unit.” *See, Dynetix Design Solutions, Inc. v. Synopsys, Inc.*, No. C 11-05973, 2013 WL 4538210, at 3 (N.D. Cal. Aug. 22, 2013); *see also*, *Rembrandt Soc. Media, LP v. Facebook, Inc.*, No. 1:13-cv-158, 2013 WL 6327852, at 5 (E.D. Va. Dec. 3, 2013). In those cases, if the patentee did not apportion, the

patentee could alternatively “show that the patented feature drives demand for the entire product.” *Network Prot. Scis., LLC v. Fortinet, Inc.*, No. C 12-01106, 2013 WL 5402089, at 7 (N.D. Cal. Sept. 26, 2013) (emphasis omitted).

#### ***VirnetX v. Cisco***

In *VirnetX*, the district court instructed the jury that it may not use the entire market value of the accused product to determine the royalty base, unless “the product in question constitutes the smallest saleable unit containing the patented feature.” *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d 816, 840 (E.D. Tex. 2013). The district court allowed VirnetX’s damages expert to identify the iPhone, iPod, and iPad as the smallest salable units and use their entire base price as the royalty base, even though only the “FaceTime” video calling software was accused of infringement. *VirnetX*, slip op. at 4, 30-31. The district court rejected Apple’s arguments to exclude this expert testimony, noting that Apple “failed to advance a credible alternative” for an appropriate royalty base. *VirnetX, Inc. v. Apple Inc.*, at 837 (rejecting Apple’s alternative royalty base of a \$29 software upgrade for Mac computers that added FaceTime functionality).

The Federal Circuit vacated the damages award because the district court’s erroneous jury instruction tainted the jury verdict. *VirnetX*, slip op. at 28-30. In doing so, the Federal Circuit clarified that, “[w]here the smallest salable unit is, in fact, a multi-component product containing several non-infringing features with no relation to the patented feature ... the patentee must do more to estimate what portion of the value of that product is attributable to the patented technology.” *Id.* at 29.

The Federal Circuit also concluded that the district court should have excluded the testimony of VirnetX’s damages expert on the applicable royalty base because he failed to remove unpatented features — such as the touchscreen, camera, processor, speaker and microphone — from the iOS devices’ base price. *Id.* at 31. Rejecting VirnetX’s argument that the iOS software created the largest share of the iOS product’s value, the Federal Circuit reiterated,

“[w]hether ‘viewed as valuable, important, or even essential,’ the patented feature must be separated.” *Id.* (quoting *LaserDynamics*, at 68).

As in *LaserDynamics*, the Federal Circuit rejected the excuse that “practical and economic necessity compelled [the patentee] to base its royalty on the price of an entire [device].” *Id.* at 32 (quoting *LaserDynamics*, at 69). Although Apple’s sales model did not charge separately for the accused FaceTime feature, the Federal Circuit reiterated that “[t]here is no ‘necessity-based exception to the entire market value rule.’” *Id.* (quoting *LaserDynamics*, at 70). Even when faced with the difficulty of assigning value to a feature that may not have been sold, “[t]he law requires patentees to apportion the royalty down to a reasonable estimate of the value of its claimed technology, or else establish that its patented technology drove demand for the entire product.” *Id.*

#### **NASH BARGAINING SOLUTION**

In *VirnetX*, the Federal Circuit also reinforced the requirement that the methodology employed to calculate royalty damages must be tied to the specific facts of the case. In particular, the court addressed VirnetX’s use of the Nash Bargaining Solution. Damages experts had applied this mathematical model, which assumes a 50/50 allocation between the parties of incremental profits attributable to the patented technology, as a starting point for determining a royalty rate. *Id.* at 24-25. While some district courts have accepted the use of the Nash theorem, other courts have rejected it as “indistinguishable from [the] 25% rule rejected in *Uniloc*,” which assumed a 25/75 split of the entire profits for an infringing product. *See, e.g., Gen-Probe Inc. v. Becton Dickinson & Co.*, Nos. 09-cv-2319, 10-cv-0602, 2012 WL 9335913, at 3 & n.3 (S.D. Cal. Nov. 26, 2012); *Sanofi-Aventis Deutschland GmbH v. Glenmark Pharm. Inc., USA*, No. 07-cv-5855, 2011 WL 383861, at 12-13 (D.N.J. Feb. 3, 2011). *See also, Dynetix Design Solutions, Inc. v. Synopsys, Inc.*, No. C 11-05973, 2013 WL 4538210, at 5 (N.D. Cal. Aug. 22, 2013).

In determining a royalty rate, VirnetX’s damages expert relied on the Nash theorem to assume a 50/50 split of incremental profits associated with the accused FaceTime feature as the starting point. He then adjusted the split to allocate 45% of the incremental profits to VirnetX because of its “weaker bargaining position.” *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d 816, 839 (E.D. Tex. 2013) (discussing VirnetX’s weaker bargaining position because of its financial situation). The Federal Circuit concluded that this testimony was improper.

In *VirnetX*, the Federal Circuit concluded that reliance on the Nash Bargaining Solution was akin to the “25 percent rule of thumb” rejected in *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292 (Fed. Cir. 2011), which assumed a 50/50 profit split regardless of the industry, technologies, parties, size of patent portfolio, or value of the patented technology. *VirnetX*, slip op. at 38. While the court did not foreclose use of the Nash theorem if a damages expert can show that the premises of the theorem fit the facts of the case, VirnetX’s damages expert failed to do so. *Id.* Noting that “[b]eginning from a fundamentally flawed premise” results in “a fundamentally flawed conclusion,” the Federal Circuit found that the expert’s “thin attempts” to explain his 10% deviation from the 50/50 baseline based on “conclusory assertions” actually highlighted how this methodology is “subject to abuse.” *Id.* at 39 (quoting *Uniloc*, at 1317. The use of the 50/50 baseline would risk “skewing the jury’s verdict” because juries would “hesitate to stray” from that baseline. *Id.* at 39-40. This testimony should therefore have been excluded. *Id.* at 41.

*In Part Two, next month, we’ll look at strategies that plaintiffs may attempt after VirnetX in attacking the patent damages gate.*

