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A Guide To Understanding Fed. Circ.'s VirnetX Opinion

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Patent holders and plaintiffs lawyers, please do not panic.

The Federal Circuit's opinion in VirnetX v. Cisco Systems Inc. (and Apple Inc.) does not spell the end of damages in patent cases. It does not change the existing paradigm about how to support a damages model with evidence. It does not even foreclose the use of the Nash bargaining solution (as explained fully below).

At least, not logically. Practically, district courts may react to the opinion and impose higher burdens on patent holders than VirnetX requires. Indeed, the Federal Circuit has erased a $368 million award. But an examination of the opinion itself reveals that by simply following the Federal Rules of Evidence, a patent holder can comply with VirnetX and every other damages ruling from the Federal Circuit.

Let's take it one section at a time.

The Facts

Only a few facts are necessary to understand the opinion. VirnetX asserted patents for providing security over networks such as the Internet. (Slip Op. at 3-6.) Two patents claimed a system for establishing secure communication links; VirnetX asserted these against Apple's "FaceTime" video call feature in iPhones, iPods and iPads. Another two patents claimed a method of establishing a secure Web connection using a virtual private network (VPN); VirnetX asserted these against Apple's "VPN On Demand" feature in iPhones, iPods, and iPads.

VirnetX's expert testified to three independent damages models. (Slip Op. at 24-25.)

First, he applied a 1 percent royalty to a base computed from the sale prices of all accused devices (such as iPhones) to account for infringement by both FaceTime and VPN On Demand ($708 million model).

Second, he estimated Apple's profits associated with FaceTime by determining revenue associated with the front-facing camera on the accused devices, then applied the Nash bargaining solution to reason that the parties should split that profit 50/50, and then adjusted slightly based on bargaining power to conclude that Apple should keep 55 percent of the profit and VirnetX should receive 45 percent ($588 million model).

Third, he estimated Apple's profits associated with FaceTime by using a consumer survey, again applied the Nash bargaining solution (50/50 split), and again applied the same bargaining power rationale to award Apple 55 percent of the profits and VirnetX 45 percent ($606 million model).

The jury awarded $368,160,000 in damages.

The Federal Circuit disagreed.

Application of the "Entire Market Value Rule"

The Federal Circuit dedicated eight pages to discussing the "entire market value rule" in the context of a jury instruction on royalty base and of VirnetX's first damages model which consisted of applying a 1 percent royalty rate to sales of all accused devices. It seems that this outcome could have been accomplished in a single page.

The key passages can be found on pages 28-29. In short, the patentee must apportion out of its damages model all value attributable to non patented features. This is not new. But it is captured nicely in statements like:

However, the [jury] 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. This is wrong.

And:

In other words, the requirement that a patentee identify damages associated with the smallest salable patent-practicing unit is simply a step toward meeting the requirement of apportionment.

The jury instruction did not explain that a damages award must apportion out the value of all nonpatented features. Applying a 1 percent royalty to all sales of accused devices did not attempt to do so either. Both the instruction and the theory went down.

The court's additional seven pages of discussion on this topic serve to highlight an important point not yet explored in most cases: the "entire market value rule" appears to be an application of the balancing test in Federal Rule of Evidence 403. The "rule" ensures that "a reasonable royalty does not overreach." (Slip Op. at 27.) It protects against "using a base that misleadingly suggests an inappropriate range" of damages. (Slip Op. at 28 29.) That is, it prohibits the introduction of evidence if it would be unfairly prejudicial to the accused infringer — an application of Rule 403.

The implications of this have not been explored. Is the "entire market value rule" really a substantive patent law rule? Should regional circuit procedural standards be applied? Why must it be applied only one way (against the patent holder)?

All questions for another article. On to the next VirnetX topic.

Reliance on Licenses

The Federal Circuit upheld VirnetX's reliance on its own licenses to argue that it would accept a 1-2 percent royalty on product price in a hypothetical negotiation. Small victory, because the court already had tossed the base on VirnetX's first damages model. The analysis, however, reveals a couple useful points for future cases.

The admissibility of an expert's reliance on licenses is a fact-specific inquiry. In VirnetX, the Federal Circuit emphasized that an exact fit between prior licenses and the facts of the case is not required if the jury is able to account for the differences. (Slip Op. at 34 35.) If a patent holder wants to rely on a license, it should make sure its expert accounts for the differences between the license and the facts of the case. The Federal Circuit found that the differences between the licenses and the facts had been presented adequately to the jury. (Note the contrast between the treatment of the licenses/facts and the Nash bargaining solution/facts, discussed below.)

All licenses can be broken down into economic terms. How much value did the licensee receive? How much money did the licensor receive? In what form was the consideration paid? In short, account for the economic differences between your evidence of prior transactions and the facts of the case, and the evidence has a better chance of being admitted.

Allocating Incremental Profits Among Patentee and Infringer

In his second and third damages models, VirnetX's expert attempted to quantify incremental profits from the patented features. The expert quantified the incremental profits first by determining revenue associated with the front-facing camera on the accused devices and second by using a consumer survey.

Would these methods have held up? It is impossible to know, because the Federal Circuit skipped over them and instead threw out the damages award based on the expert's allocation of the incremental profits between the patentee and the infringer. VirnetX thus is not helpful on the critical question of how to quantify incremental profits. Instead it provides a fulsome explanation of what not to do next if you make it over the incremental profits hurdle. Fortunately, from within a fulsome explanation of what not to do we can glean insight on what a patentee should do.

VirnetX deals specifically with the Nash bargaining solution, which effectively splits incremental profits 50/50 between patentee and infringer. After the demise of the "25 percent rule" in Uniloc, it is not surprising to see that simply assuming the patentee would get 50 percent instead is not per se admissible.

But the key point in VirnetX on allocating incremental profits is not that the Nash bargaining solution is inadmissible; instead, the key point is that neither the Nash bargaining solution nor any other allocation method is per se inadmissible — you just have to fit the methodology to the facts of the case.

The Federal Circuit explicitly suggested that the Nash solution could be used if the proper foundation is laid:

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.

That is, show the economic similarities — and differences — between the profit allocation theory and the facts. This is no different than licenses. Licenses, profit allocation models and hypothetical negotiations all are transactions that can be broken down into economic components and compared.

Many patentees have struggled with this step because they have attempted easy, blanket solutions where there is no one solution for every case. Every case has different facts. The patentee must do the work to align the transactional evidence with the facts. And forget shortcuts.

Conclusion

In sum, the lengthy discussion in VirnetX revolves around two rules. First, apportion from the royalty base all value associated with nonpatented features (put another way, isolate the value of the patented features). Second, account for the economic differences between the facts of the case and prior transactions or allocation methodologies. Many quotes from this opinion will be taken out of context and applied incorrectly. But all statements in VirnetX are consistent with these two rules. Follow them, and perhaps damages case law will no longer require translation.

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