

APPORTIONMENT GETS A WHOLE LOT OF ATTENTION IN LANDMARK *VIRNETX, INC. V. APPLE INC.* (PART I)

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The Federal Circuit delivered its clearest, most in-depth damages opinion in more than two years in *VirnetX, Inc. v. Apple Inc.* The court now (1) requires apportionment of the smallest saleable patent-practicing unit if it contains significant unpatented features, (2) gives a glimmer of hope to those seeking comparable licenses, and (3) effectively buries the Nash Bargaining Solution as a method for determining royalty rates.¹

This first issue of *IpQ* in 2015 reviews the procedural history of the case and the Federal Circuit’s analysis of apportionment of the smallest salable patent-practicing unit. The next issue of *IpQ* will tackle the portions that address comparable licenses and the Nash Bargaining Solution.

District Court Judgment

VirnetX sued Apple, alleging Apple’s FaceTime servers and VPN On Demand feature infringed its four method patents relating to technology for providing security over the Internet.² Over Apple’s *Daubert* challenge, VirnetX’s damages expert testified to three reasonable royalty theories:³

- **EMVR Royalty** – A 1-percent royalty applied to the lowest sales price of each Apple device containing the accused features based on (1) VirnetX’s established policy of seeking 1 to 2 percent of the entire market value of sales of accused products, and (2) six allegedly comparable licenses.⁴ The methodology led to damages calculations of \$708 million for FaceTime and VPN On Demand.
- **Nash Bargaining Solution Analysis No. 1** – Invoked the Nash Bargaining Solution (“NBS”) to suggest a 50/50 split of incremental profits purportedly associated with the patented technology, and proposed a 45%/55% split (patentee/infringer) of those profits which led to damages of \$588 million for FaceTime.⁵
- **Nash Bargaining Solution Analysis No.2** – Extrapolating from a customer survey, the patented feature “drove sales” for 18 percent of all sales of the accused products.⁶ Applying the NBS 45%/55% split once again, damages calculations totaled \$606 million for FaceTime.⁷

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¹ *VirnetX, Inc. v. Apple Inc.*, 767 F.3d 1308 (Fed. Cir. 2014).

² *Id.* at 1315, 1314.

³ *Id.* at 1325.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 1326.

With regard to the entire market value rule, the district court instructed the jury that:

When determining a 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.⁸

Importantly, this instruction equated the basis for consumer demand with the smallest salable patent-practicing unit for the purpose of applying the entire market value rule.

The jury decided that all of the patents were valid and infringed, awarding VirnetX more than \$368 million in damages.⁹

Apple moved for judgment as a matter of law (JMOL) or, in the alternative, for a new trial or remittitur on several grounds relating to damages.¹⁰ The district court denied Apple's motion, reasoning:

- VirnetX did not implicitly invoke the entire market value rule in its damages theory.¹¹ VirnetX provided some evidence that the infringing features of smallest infringing unit necessarily utilized some aspects of the accused devices, thus establishing a "close relationship to the claimed invention."¹² Moreover, Apple failed to provide an alternative to the smallest salable unit proposed by VirnetX.¹³
- VirnetX presented substantial evidence to support the 1-percent reasonable royalty rate offered by its expert.¹⁴
- VirnetX's damages expert adequately supported his alternate damages model based on the Nash Bargaining Solution.¹⁵

Federal Circuit Opinion

On appeal, Apple challenged each of VirnetX's three damages theories as well as the jury instruction regarding the entire market value rule. After analyzing the issues, the Federal Circuit reversed the damages award and remanded the case.¹⁶

Apportionment – Smallest Salable Patent Practicing Unit

The Federal Circuit ruled that the district court's instruction to the jury on the EMVR was erroneous.¹⁷ Identifying the smallest saleable patent-practicing unit is *not* the end of the EMVR analysis. "[A] patentee's obligation to apportion damages

⁸ *Id.* at 1327.

⁹ *Id.* at 1316.

¹⁰ *Id.*

¹¹ *VirnetX Inc. v. Apple Inc.*, 925 F.Supp.2d 816, 837 (ED Tex. 2013).

¹² *Id.* citation from *Cornell Univ. v. Hewlett-Packard Co.*, 609 F.Supp.2d 279, 288 (N.D.N.Y. 2009); see *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 67 (Fed. Cir. 2012).

¹³ *Id.*

¹⁴ *Id.* at 838.

¹⁵ *Id.* at 839.

¹⁶ *VirnetX, Inc. v. Apple Inc.*, 767 F.3d 1308, 1326 (Fed. Cir. 2014).

¹⁷ *Id.* at 1328.

only to the patented features does not end with the identification of the smallest saleable unit if that unit still contains significant unpatented features.”¹⁸

It is well established that a patentee must seek only damages *attributable to the infringing feature(s)*, apportioning the value of the patented and non-patented features of an accused product accordingly.¹⁹ 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 on the value of the entire multi-component product.*²⁰ In applying the narrow exception of the EMVR, damages may be assessed on the entire market value of a product *only where the patented feature creates the basis for customer demand.*²¹ It is not enough that the patented feature is viewed as valuable, important or even essential to the use of the overall patent.²² The patented feature must be *what motivates consumers to purchase the accused product* in the first place.²³ To establish the value of the patented feature, a reasonable royalty analysis must carefully tie proof of damages to the claimed invention’s footprint in the market place.²⁴ Precise application of the EMVR is important because indiscriminate use of the entire market value of the accused product will only “skew the damages horizon for the jury.”²⁵

Evaluated against this legal backdrop, the district court’s EMVR jury instruction misstated the law.²⁶ The instruction mistakenly suggested that, when the smallest saleable unit is used as the royalty base, there is no further constraint on the selection of the royalty base.²⁷ This is not the law:

- The risk of skewing the damages horizon does not disappear simply because the smallest saleable unit is used.²⁸
- The smallest saleable unit approach was intended to produce a royalty base much more closely tied to the patented invention than the entire market value of the accused products.²⁹

Thus, “the requirement that a patentee identify damages associated with the smallest saleable patent-practicing unit is simply a step toward meeting the requirement of apportionment.”³⁰ Where there is a multi-component product containing patented and non-patented features, the patentee must do more than identify the smallest saleable unit to estimate the portion of the value of the product attributable to the patented feature.³¹ Were that not so, the EMVR exception would quickly swallow the general rule of apportionment.³²

¹⁸ *Id.* at 1329.

¹⁹ *Id.* at 1326 citing *Garretson v. Clark*, 111 U.S. 120, 121 (1884).

²⁰ *Id.* at 1326 citing *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 67-68 (Fed. Cir. 2012).

²¹ *Id.* at 1326 citing *Versata Software, Inc. v. SAP Am., Inc.*, 717 F.3d 1255, 1268 (Fed. Cir. 2013).

²² *Id.* at 1326 citing *LaserDynamics, Inc.*, 694 F.3d at 70.

²³ *LaserDynamics, Inc.*, 694 F.3d at 68.

²⁴ *VirnetX, Inc.*, 767 F.3d at 1327 citing *ResQNet.com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010).

²⁵ *Id.* at 1327 citing *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1320 (Fed. Cir. 2011).

²⁶ *Id.* at 1327.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.*

³² *Id.*



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Apportionment – Royalty Base

VirnetX improperly relied on the EMVR without demonstrating the patented feature drove demand for the accused products. VirnetX’s damages expert “did not even attempt to subtract any other unpatented elements from the base, which therefore included various features indisputably not claimed by VirnetX.”³³

Conclusions

It is crucial to consider the following, in light of the *VirnetX* opinion on apportionment:

- The ruling in *VirnetX* is legally sound. The EMVR exception to the apportionment rule requires proof that the patented feature drives consumer demand for the accused product – that the presence of the patented functionality is what motivates consumers to buy the multicomponent product in the first instance.³⁴
- When the patented feature drives consumer demand for an identifiable component (the smallest salable patent practicing unit), the EMVR is met for that component.
- If the patented feature does not drive consumer demand for the proffered “smallest salable patent-practicing unit,” further apportionment will be necessary to avoid improperly awarding damages for product features unrelated to the patent.
- The *VirnetX* opinion severely limits the utility of the smallest salable patent-practicing unit analysis. The analysis is nothing more than a test for determining whether patented value has been sufficiently apportioned. It is not an end point for the apportionment analysis unless the patented feature drives demand (as defined in *LaserDynamics*) for the component identified as the smallest salable patent-practicing unit.
- The *VirnetX* opinion suggests there may be some play in the apportionment rule if the smallest salable patent-practicing unit contains less than “significant unpatented features.”³⁵ Only the brave or desperate will test this language because there is no case law guidance on what “significant unpatented features” might be in a particular case.
- Ultimately, the *VirnetX* opinion confirms the difficulties patentees face in apportioning patent value. When the patented feature is incorporated in a multi-component product, the patentee simply must apportion patent value.

³³ *Id.* at 1328.

³⁴ *LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 68 (Fed. Cir. 2012).

³⁵ *VirnetX, Inc.*, 767 F.3d at 1329.