



ONE THUMB UP, ONE THUMB DOWN

Comparable Licenses, Nash Bargaining Solution Get Clear VirnetX Treatment

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Determining damages, always complicated and convoluted, may be a bit clearer following the Federal Circuit’s opinion in *VirnetX, Inc. v. Apple Inc.* The court chose to (1) give a glimmer of hope to litigants relying on comparable licenses, while (2) effectively burying the Nash Bargaining Solution as a formula to determine royalty rates.¹

District Court Judgment

After Apple’s *Daubert* challenge was turned aside, VirnetX’s damages expert testified to three reasonable-royalty theories, one based on six allegedly comparable licenses and two that relied on the Nash Bargaining Solution (“NBS”).²

The jury decided all of the patents in question were valid and infringed, awarding VirnetX more than \$368 million in damages.³ The district court then denied Apple’s motion for judgment as a matter of law (JMOL) relating to the comparable licenses and the NBS.⁴

First, the court said VirnetX presented substantial evidence to support the 1% reasonable-royalty rate offered by its expert. The district court rejected Apple’s “timing” argument that two of the comparable licenses relied upon by the patent owner’s damages expert predated the patents-in-suit,⁵ while three post-dated the hypothetical negotiation by three years, thus creating no comparable licenses at the time of the negotiation.⁶

Second, the district court decided VirnetX’s damages expert supported his alternate damages model using the Nash Bargaining Solution.⁷ In doing so, the district court rejected Apple’s argument that VirnetX’s expert’s analysis was unreliable because he failed to use generally accepted methods for applying the NBS.⁸ Apple also unsuccessfully argued that the expert’s profit split was arbitrary and akin to the now-improper “25% rule of thumb.”⁹

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1 *VirnetX, Inc. v. Apple Inc.*, 767 F.3d 1308 (Fed. Cir. 2014).
2 *Id.* at 1325. (See *IpQ VII:1*)
3 *Id.* at 1316.
4 *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d 816, 823, 837, 839 (E.D. Tex. 2013).
5 *VirnetX, Inc. v. Apple Inc.*, 767 F.3d at 1330.
6 *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d at 837-38; *VirnetX, Inc. v. Apple Inc.*, 767 F.3d at 1330.
7 *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d at 839; *VirnetX, Inc. v. Apple Inc.*, 767 F.3d at 838-399.
8 *VirnetX, Inc. v. Apple Inc.*, 925 F. Supp. 2d at 839.
9 *Id.*; See *Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1312-13, 1315 (Fed. Cir. 2011).

Federal Circuit Opinion

On appeal, Apple challenged each of VirnetX's damages theories. After analyzing the issues, the Federal Circuit affirmed the district court's comparable license analysis, but reversed the damages award based on the NBS and remanded the case.¹⁰

Comparable Licenses – Royalty Rate

The Federal Circuit said the district court did not abuse its discretion by allowing VirnetX's damages expert to testify regarding the proper royalty rate based on six allegedly comparable licenses.¹¹

Licenses relied upon by the patentee to prove damages must be "sufficiently comparable to the hypothetical license at issue in the suit."¹² But, the Federal Circuit has "never required identity of circumstances."¹³ To the contrary, any reasonable-royalty analysis "necessarily involves an element of approximation and uncertainty."¹⁴ Thus, district courts act properly when they exercise vigilance in considering licenses to technologies other than the patent in suit¹⁵ and account for differences in the technologies and economic circumstances of the contracting parties.¹⁶

Rejecting Apple's arguments, the Federal Circuit noted that four of the six comparable licenses were to the actual patents-in-suit, while the other two were drawn to closely related technology. All of the other differences Apple noted were fully presented to the jury, thus allowing them to evaluate the relevance of the licenses.¹⁷ As the Federal Circuit succinctly noted, "No more is required in these circumstances."¹⁸

The Federal Circuit distinguished the *VirnetX* facts from *ResQNet* and *Lucent* by saying, "the licenses in this case – though not immune from challenge – bear a close relationship to the hypothetical negotiation that would have occurred."¹⁹ Rather, the Federal Circuit considered the comparable licenses offered by VirnetX in light of *Finjan* and *ActiveVideo* where factual differences between the comparable licenses and the hypothetical licenses were addressed by cross examination, and the jury was allowed to hear expert testimony to decide for itself what to accept and reject.²⁰

Royalty Rate – Nash Bargaining Solution

Rejecting reliance on the NBS in this case, the Federal Circuit ruled that use of the NBS without sufficiently establishing premises for the Nash theorem is an inappropriate "rule of thumb."²¹ In light of the extremely limited likelihood that the "idealized" methodology underlying the NBS will apply to a patent damages case, the Federal Circuit effectively sounded the demise of the NBS as a means for determining patent damages.

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

11 *Id.* at 1331.

12 *Id.* at 1330 quoting *Lucent Tech., Inc. v. Gateway, Inc.*, 50 F.3d 1301, 1325 (Fed. Cir. 2009).

13 *Id.* at 1330.

14 *Id.* at 1330 quoting *Lucent Tech., Inc. v. Gateway, Inc.*, 50 F.3d at 1325.

15 *Id.* at 1330 quoting *ResQNet.Com, Inc. v. Lansa, Inc.*, 594 F.3d 860, 869 (Fed. Cir. 2010).

16 *Id.* at 1330 quoting *Finjan, Inc. v. Secure Computing Corp.*, 626 F.3d 1197, 1211 (Fed. Cir. 2010).

17 *Id.* at 1330.

18 *Id.*

19 *Id.*

20 *Id.* at 1331.

21 *Id.* at 1332.

The Federal Circuit's Opinion

The Nash theorem follows a set of idealized premises. Anyone seeking to invoke the theorem must establish that the premises in the Nash theorem fit the facts of her or his case.²² VirnetX's expert failed to establish that fit, making his testimony insufficiently tied to the facts of the case.²³

In any event, use of the NBS runs a significant risk of inappropriately skewing the jury's verdict because a patentee may not be able to balance out an unreasonably high royalty base simply by asserting a low enough royalty rate.²⁴

While the NBS was an improvement over the now-rejected "25% Rule of Thumb" because it focuses on incremental profits rather than the entire profits, "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."²⁵

Finally, merely using the NBS as a starting point for the *Georgia-Pacific* analysis makes no difference. Beginning from a fundamentally flawed premise and adjusting it still results in a flawed conclusion.²⁶

A Closer Look at the Nash Bargaining Solution

John Nash, a co-winner of the 1994 Nobel Prize in Economics, first published the NBS in 1950.²⁷ Dr. Nash developed a theorem to resolve a question long faced by economists: "How do economic surpluses get divided up in the real world?"²⁸

Note that the surplus is "not the total benefit from the sale of the patented product, it is the total benefit from the patented product *minus* the total benefit each side could receive if it chose not to enter the license."²⁹ Thus, if the total benefit from the patented product is \$10, but the accused infringer could make \$8 by offering a non-infringing product, and the patent owner could license someone else for \$1, the surplus subject to the NBS is \$1, not \$10.³⁰

The theorem that Dr. Nash developed sets forth a number of premises and states a conclusion following from those premises.³¹ As Dr. Nash said:

In general, we idealize the bargaining problem by assuming that the two individuals are highly rational, that each can accurately compare his desires for various things, that they are equal in bargaining skill, and that each has full knowledge of the tastes and preferences of the other.³²

Under the conditions stated in the premises, where two persons bargain over a matter, there is a "solution" to the negotiation problem satisfying stated conditions for a

²² *Id.* at 1326.

²³ *Id.* at 1332.

²⁴ *Id.* at 1333, citing *See Uniloc USA, Inc. v. Microsoft Corp.*, 632 F.3d 1292, 1312-13, 1315 (Fed. Cir. 2011).

²⁵ *Id.* at 1334.

²⁶ *Id.*

²⁷ John Nash, "The Bargaining Problem," 18 *Econometrica* 155-62 (Apr. 1950).

²⁸ Kidder, Doug and O'Brien, Vince, "The Nash Bargaining Solution," *Les Nouvelles* 1 (March 2014).

²⁹ *Id.*

³⁰ *Id.* at 2.

³¹ *VirnetX, Inc. v. Apple Inc.*, 767 F.3d 1308, 1325 (Fed. Cir. 2014).

³² John Nash, "The Bargaining Problem," 18 *Econometrica* 155-62 (Apr. 1950).



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desirable result (bargain).³³ That solution has come to be called the Nash Bargaining Solution.³⁴

Why the NBS Is a “Bad Fit” for Patent Cases

In an excellent article in *Les Nouvelles*, two economists took a closer look at the NBS and explained some of the reasons why the theory is a bad fit for patent damages cases:

- The economic community has never accepted the NBS as an accurate predictor of accurate outcomes. Thus, it fails the Rule 702 test for admissibility.³⁵
- NBS relies on assumptions (“premises”) demonstrably false in the real world.³⁶
- *Georgia-Pacific* and the NBS are methodologically opposed. *Georgia-Pacific* seeks to replicate a real-world negotiation, while the NBS is “idealized.”³⁷
- The royalty from the hypothetical negotiation spans the remaining term of the patent; the NBS does not address the long-term consequences of cooperation.³⁸
- In fact, none of the broader implications of the license, such as other licenses and strategic considerations of the parties, are considered by the NBS.³⁹
- The NBS does not consider relative risks of the parties.⁴⁰

Conclusions

Two key takeaways from *VirnetX*:

- Challenges in finding a “comparable license” may have eased a bit in light of this case. Patentees seeking to identify sufficiently comparable licenses will look to *VirnetX* for support and direction.
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- The Nash Bargaining Solution is dead as a basis for calculating royalty rates. Prerequisites for application of the idealized NBS simply do not exist in the real/hypothesized world of reasonable royalty damages.

³³ *VirnetX, Inc. v. Apple Inc.*, 767 F.3d at 1325.

³⁴ *Id.*

³⁵ Doug Kidder and Vince O'Brien, “The Nash Bargaining Solution,” *Les Nouvelles* 4 (March 2014).

³⁶ *Id.* at 1.

³⁷ *Id.* at 4.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*