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Business

Issues, considerations of full cost accounting in Nova v. Dow

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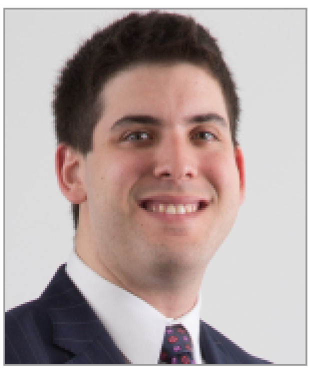

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(March 2, 2021, 9:34 AM EST) -- As discussed in part one of this article, prior to the Federal Court of Appeal decision in *Nova Chemicals Corp. v. Dow Chemicals Co.* [2020] F.C.J. No. 928, the incremental cost approach was the preferred method in calculating the profits earned by an infringer, except in certain circumstances. Therefore, there was no need to allocate the non-incremental fixed costs of the infringer to the infringing products.

As such, detailed information and documents related to the drivers of non-incremental fixed costs was not solicited during the discovery phase of litigation and no consideration was given to the appropriate bases to use in allocating the fixed costs of the infringer.

The Federal Court of Appeal decision, however, concluded that the full cost approach (also known as the absorption cost approach) should be used to calculate an infringer's profits, "absent some exceptional and compelling circumstance or persuasive expert evidence to the contrary in a particular case" (para. 164). Accordingly, the non-incremental fixed costs of the infringer must now be allocated to the infringing product in an accounting of the infringer's profits. As discussed below, this is not a straightforward exercise and a number of issues and differences of opinion may arise in doing so.

Allocating non-incremental fixed costs

The causal connection between incremental costs and the infringing product is much stronger and more easily identified than the causal connection between non-incremental fixed costs and the infringing product. As discussed in part one of this article, incremental costs include such things as the costs to manufacture and/or purchase the product and product-specific advertising, while the non-incremental fixed costs of a company include expenses such as rent, utilities, property taxes, interest, executive salaries and salary costs for the human resources, legal and other corporate departments. As a result, incremental costs can be directly attributed to the infringing product, while non-incremental fixed costs are generally common to all products and must be allocated to the various products manufactured by the company, including the infringing product.

The following four criteria can be used to guide cost allocation decisions (*Cost Accounting: A Managerial Emphasis* (14th edition), p. 505):

a) Cause and effect — Under this criterion, variables that cause the cost to be incurred are identified. For example, hours of testing may be used when allocating the costs of a quality-testing area to products;

b) Benefits received — Under this criterion, the products/divisions that benefit from the expenditure are identified. The cost is then allocated among those products/divisions in proportion to the benefits each receives. For example, the cost of corporate-wide advertising that promotes the general image/brand of the company rather than an individual product may be allocated on the basis sales revenues. The rationale being that the product/division with the higher revenues apparently benefited more from the advertising than the product/division with lower sales revenues and, therefore, ought to be allocated more of the advertising costs;

c) Fairness or equity — This criterion is often cited in government contracts when cost allocations are the basis for establishing a price satisfactory to the government and its suppliers. For most allocation decisions, fairness is a matter of judgment rather than an operational criterion; and,

d) Ability to bear — This criterion advocates allocating costs in proportion to the ability of the product/division to bear the costs allocated to it. An example is the allocation of corporate executive salaries on the basis of a product/division's operating income. The presumption is that the more profitable products/divisions have a greater ability to absorb corporate overhead costs.

The cause and effect and benefits received criteria are the preferred methods for allocating costs as there is a more direct connection between the base used to allocate the cost and the cost itself. The fairness and ability to bear are less frequently used and are more problematic criteria. Parties can have different views as to what is fair/equitable and, under the ability to bear criteria, products/divisions that use more of the corporate overhead services may not be able to bear their fair share of the costs.

In addition to the different criteria that can be used to allocate fixed costs, the allocation of fixed costs to a company's products/divisions can be a complex exercise for the following reasons:

e) Companies normally only track gross profit (i.e., revenues less variable costs) on a product-by-product basis, and do not allocate fixed costs to individual products. Therefore, the infringing company may not have contemporaneously had to consider the most appropriate bases to use in allocating its fixed costs and as a result, may not have the necessary information/documentation to do so readily available;

There are a number of bases that may be used to allocate the fixed costs of the infringing company to the infringing product, including (but not limited to):

- the sales revenues or volumes of the infringing product compared to the company's overall sales revenues or volumes;
- the gross profit of the infringing product compared to the company's overall gross profit;
- the percentage of plant capacity utilized in the manufacture of the infringing product; and,
- the number of products manufactured and sold by the infringing company (i.e., a company would allocate an equal share of the fixed cost to each product, including the infringing product);

f) There may be multiple drivers or causes for a single fixed cost and therefore, the accounting expert will have to make a determination as to the most appropriate allocation base(s) for each cost; and,

g) The drivers or causes of each fixed cost may be different and therefore, different bases may be appropriate in allocating the various fixed costs of the infringing company (i.e., the same basis will not always be appropriate for all fixed costs).

Concluding thoughts

As indicated in part one of this article, the Federal Court of Appeal decision has created much discussion in the intellectual property space regarding the appropriateness and application of the full cost approach in an accounting of profits. No doubt, this discussion and debate will continue as current and future intellectual property cases make their way through the judicial process.

From a practical viewpoint, the Federal Court of Appeal decision dictates that the full cost approach is the preferred method for deducting costs "absent some exceptional and compelling circumstance or persuasive evidence in a particular case" (para. 145). Accordingly, the appropriate bases upon which to allocate a company's fixed costs must be explored during the discovery phase of litigation. If a company does not allocate its fixed costs to its products/divisions in the regular course of its operations, the accounting expert will be required to do so as part of their quantification of the company's profits from infringement.

As a result of the decision, it will be more important now than ever, to involve an accounting expert early in the litigation process to ensure that the relevant information and documents necessary to allocate fixed costs are produced. Even with the appropriate information however, the allocation of fixed costs will likely be a contentious issue in cases going forward due to the various methods that can be used to allocate the fixed costs, and the differing conclusions as to the profits earned under each method.

This is part two of a two-part article. Part one: What full cost accounting means in Nova v. Dow.

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