THE LAWYER'S DAILY

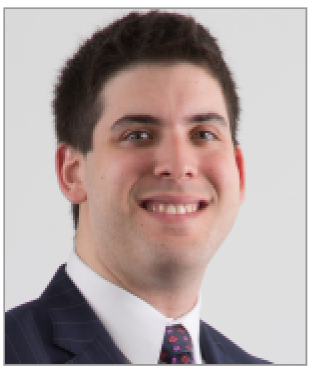
The Lawyer's Daily | 111 Gordon Baker Road, Suite 900 | Toronto, ON M2H 3R1 | www.thelawyersdaily.ca

Intellectual Property

What full cost accounting means in Nova v. Dow

By **Paula Frederick and Jacob Martin**

Paula Frederick



Jacob Martin

(February 11, 2021, 11:24 AM EST) -- The Federal Court of Appeal decision in *Nova Chemicals Corp. v. Dow Chemicals Co*. [2020] F.C.J. No. 928 released on Sept. 15, has garnered a lot of attention and created much discussion in the intellectual property space. One of the primary reasons for this is because the decision deviated from past cases regarding the appropriate costs to be deducted from an infringer's revenues under an accounting of profits remedy.

In estimating a defendant's profits, one can use an incremental cost approach or a full cost approach. Prior to the Federal Court of Appeal decision, case law generally supported the use of an incremental cost approach except in certain circumstances (e.g., *Teledyne Industries, Inc. v. Lido Industrial Products Ltd. (F.C.T.D.)* [1982] F.C.J. No. 1024). However, diverging from this, the Federal Court of Appeal decision stated "… the 'full costs' approach should always be available to the infringer. Indeed, absent some exceptional and compelling circumstance or persuasive evidence in a particular case, the 'full costs' approach is the preferred method for deducting costs." (para. 145).

This is a two-part article. In this first part of this article, we will:

- describe the incremental cost approach and the full cost approach to calculating an infringer's profits;
- provide background information on the *Dow* case and decision, which led to the Federal Court of Appeal decision; and,
- describe the reasons provided by the Federal Court of Appeal in coming to the conclusion that the full cost approach is the preferred approach in an accounting of profits analysis.

In part two of the article, we will explore the issues and considerations that are likely to arise in the application of the full cost approach in an accounting of profits analysis.

Incremental cost approach vs. full cost approach

A company's expenses are generally classified into the following groups based on whether they fluctuate, or vary, with the level of production and/or sales of the company:

- Variable expenses fluctuate with changes in a company's production and/or sales (e.g., the cost of raw materials to manufacture products or the cost to purchase finished products);
- Fixed expenses do not fluctuate with changes in a company's production and/or sales, but rather remain constant or fixed (e.g., rent, property taxes, salaries for plant supervisors and head office departments such as human resources, legal, finance and IT); and,
- Step-variable expenses remain constant over certain levels of production and/or sales but increase or decrease when a certain production/sales threshold is met (e.g., the need to rent more factory space after a certain increase in production).

The classification of a company's expenses is important in applying the different approaches that can be used to quantify a defendant's profits from infringement, which are as follows:

- The incremental cost approach, under which the defendant's profits are quantified as the revenues earned from sales of the infringing product, less any costs that increased due to the manufacture and/or sale of the infringing product. Therefore, the costs that can be deducted from the revenues from infringement are the variable costs attributed to the infringing products plus any incremental step-variable and/or fixed costs; and,
- The full cost approach (also known as the absorption cost approach) under which the defendant's profits are quantified as the revenues from sale of infringing products less applicable variable costs and a proportion of fixed costs, regardless of whether or not they increased as a result of the manufacture and sale of the infringing product.

These two approaches can yield significantly different results with the full cost approach resulting in a lower profit since it allows for the deduction of non-incremental fixed costs.

As an illustrative example, suppose Company A earned $100 of revenues from infringing a patent and incurred $30 in variable costs and $10 in incremental fixed costs to do so. This would result in profits under the incremental cost approach of $60 (i.e. $100 of revenues less $40 of incremental costs).

However, under the full cost approach, the defendant would also be allowed to deduct a portion or allocation of its non-incremental fixed costs (assumed to be $20), which would result in full cost profits of $40 (i.e., $100 of revenues less $40 of incremental costs and $20 of allocated fixed costs). The exhibit seen here illustrates the calculation of profits under the two approaches and provides illustrative examples of how some costs may be classified .

The Federal Court of Appeal decision in *Dow Chemicals Co. v. Nova Chemicals Corp.* 2017 FC 350 related to an accounting of Nova's profits from its infringement of Dow's patent for metallocene linear low-density polyethylene (mLLDPE). Prior to the Federal Court decision on the accounting of Nova's profits, Nova's sales of its mLLDPE, SURPASS, were found to have infringed Dow's patent and Dow had elected for its remedy to be an accounting of Nova's profits (*Dow*, paras. 3 and 4).

One of the considerations in estimating Nova's profits from its infringing SURPASS products was whether Nova could deduct fixed costs and capital depreciation from its SURPASS revenues (i.e., whether a full cost approach could be adopted). Nova argued that its PE2 plant, where it produced its SURPASS products, was at full capacity during the relevant time period and, had it not manufactured the SURPASS products, it would have manufactured or sold other non-infringing products. The profit from the sale of these other products would have been sufficient to cover the fixed and capital costs at the PE2 plant that had been allocated to the infringing SURPASS products (*Dow*, paras. 147 and 149).

Based on the above, and referencing the Australian case, *Dart Industries Inc. v. Décor Corporation Pty Ltd*, the Federal Court allowed a full cost approach to be adopted and consequently, allowed a proportional amount of the fixed and capital costs at the PE2 plant to be deducted in calculating Nova's profits (*Dow*, paras. 160 to 165).

Federal Court of Appeal decision

The court considered the following four issues (para. 83):

- Did the Federal Court err in rejecting Nova's apportionment claim?
- Did the Federal Court err in awarding Dow "springboard profits"?
- Did the Federal Court err in selecting the "full cost" method for deducting costs?
- Did the Federal Court err in converting the currency at the date of judgment?

The court concluded that the "Federal Court committed no reviewable error when it dismissed NOVA's apportionment arguments, awarded springboard profits, applied the "full cost" method for deducting costs, and converted the foreign currency at the date of judgment" (para. 182). However, the court concluded that the "full cost" method was appropriate for reasons different from those of the Federal Court.

The decision stated the following with respect to the Federal Court's reasons for concluding the full cost method was appropriate (paras. 146 to 148):

"The Federal Court recognized that an infringer is typically entitled to deduct only its incremental costs. In choosing the "full cost" approach, the Federal Court relied on *Dart Industries*. In my view, while *Dart Industries* provides a helpful summary of accounting of profits principles, its rule for deducting full costs should not be adopted in Canada.

"The rule in *Dart Industries* can be explained as follows. Where an infringer but for the infringement would have been able to replace the infringing product with another profit-producing, foregone alternative, it should be permitted to deduct a portion of its fixed costs. The idea is that had the infringer not infringed, its foregone opportunity would have absorbed a portion of these fixed costs.

"The principled error in this logic is easy to spot: *Dart Industries* allows an infringer to deduct a hypothetical opportunity cost which is not a cost actually incurred. As explained above, accounting of profits occurs in the real world. Actual profits must be disgorged which means only actual costs can be deducted."

The Federal Court of Appeal decision also discussed the *Teledyne* case, which it described as the "seminal case rejecting the full costs approach in Canada" (para. 156). The decision indicated that in *Teledyne* "the Federal Court expressed the view that the full costs approach would 'constitute in effect unjust enrichment of the infringer' because those fixed costs 'would have been incurred had the infringing operation not taken place' "(para. 156).

The decision indicated that the Federal Court's reasoning in *Teledyne* "falls into the trap of using hypotheticals.*Teledyne* requires a 'but for' analysis to determine what 'would have been incurred had the infringing operation not taken place' (at 213). The reality is that the infringer did incur those costs. Without incurring certain overhead costs (e.g., property taxes, lighting, heating), the infringing product could not be produced. While the fixed costs did not increase as result of the infringement, it does not mean that they are not causally attributable." (para. 157).

The Federal Court of Appeal decision further stated, "The fear that allowing a deduction of fixed costs would permit an infringer to, in effect, subsidize its non-infringing products is unfounded. An infringer would only be entitled to deduct a proportion of its fixed costs. For example, if an infringing product occupies 1% of a factory's production capacity or volume, only 1 % of the fixed costs will be deducted." (para. 161).

In summary, the decision concluded that the full 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) because the hypothetical world should not be considered and only actual expenses should be deducted.

In part two of this article, we will explore the issues and considerations that are likely to arise in the application of the full cost approach in an accounting of profits analysis.

Paula Frederick, CPA, CA, FCBV, CFF is a principal at Cohen Hamilton Steger & Co. *and has practised exclusively in the areas of loss quantification (including in intellectual property cases) and business valuations for over 26 years. She has been qualified as an accounting expert by the Federal Court, the Ontario Superior Court of Justice and in private arbitrations. She can be contacted at 416-304-7019 or* pfrederick@cohenhamiltonsteger.com*. Jacob Martin, CPA, CA, CBV is a senior manager at Cohen Hamilton Steger & Co. who has practised in the areas of loss quantification (including in intellectual property cases) and business valuations for over five years. He can be contacted at 416-304-7033 or* jmartin@cohenhamiltonsteger.com*.*

Photo credit / Dilok Klaisataporn ISTOCKPHOTO.COM

Interested in writing for us? To learn more about how you can add your voice to The Lawyer's Daily*, contact Analysis Editor Peter Carter at* peter.carter@lexisnexis.ca *or call 647-776-6740.*
