COMPARISON OF DAMAGE ASSESSMENT METHODS

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COMPARISON OF METHODS TO EVALUATE THE PRESENT VALUE OF LOSSES;
FORWARD-LOOKING VS BACKWARD-LOOKING; RELIANCE VS EXPECTATION

Juliette Fortin
Senior Managing Director FTI Consulting

Introduction

Good afternoon everyone, I am very pleased to start this conference on the comparison of damage assessment methods. I would like to thank Béatrice Castellane and the Société de legislation comparée for the very kind invitation.

Today, I will first introduce the topic of full compensation, from an expert point of view (to be clear, I do not intend to speak about law, which is outside my expertise). I will then explore two related questions:

1. Can we use both forwards-looking approach and backwards-looking approach to assess expectation losses that ensure full compensation?
2. Is the assessment of damages using backwards-looking approach challenged in the same way in a claim for expectation losses and in a claim for reliance losses?

The universal standard of compensation is the full compensation principle. As mentioned in the famous Chorzow factory judgement, the "*reparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed.*[1]

The standard framework for the assessment of damages applied by the quantum expert consists of the comparison of the financial situation of the injured party in two scenarios:

- a but-for scenario that corresponds to the financial situation that should have prevailed; and
- an actual scenario that corresponds to its actual financial situation, i.e. a financial situation less favourable than the one in the but-for scenario.

Beyond this very general principle of full compensation, legal considerations affect the implementation of this principle, in various ways.
For instance:

- Is a causal link established between (i) a party's breach (in commercial arbitration) or actions/inactions of a State (in investment arbitration) and (ii) the damages suffered by the injured party?
- In commercial arbitration, was the loss claimed foreseeable at the time the parties entered into the agreement?

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[1] Factory at Chorzów (Merits), PCIJ Series A. No 17.

- When common law is applicable, did the injured party mitigate its losses?

Today's topic is at the border of law and finance, exploring the connections between different legal claims (expectation and reliance) and different assessment methods.

Now, I will turn to my first question: Can we use both forwards-looking approach and backwards-looking approach to assess expectation losses that ensure full compensation?

In my experience, the most frequently used framework to meet the full compensation principle is the claim of expectation damages. Expectation damages aim at putting the injured party in the same position it would have been in had the contract properly performed in commercial arbitration, or had the BIT not been breached in investment arbitration.

The objective of expectation damages differs from reliance damages that aim at putting the injured party back in the position it would have been in had it not entered into the contract in commercial arbitration, or had it not invested in the project/company covered by the BIT in investment arbitration.

First, what are forwards-looking and backwards-looking approaches?

These forwards-looking approaches determine the value of a business based on its forecasted performance and they are traditionally seen as the best approaches to assess the fair market value standard, i.e. the price of a business in an arm's length transaction.[2]

Forwards-looking approaches include income-based approaches (the principal approach being the discounted cash flow method) or market-based approaches (using multiples of comparable transactions or share prices of comparable companies).

Backwards-looking approaches are those based on the wasted cost of the investment.

Forwards- looking approaches are sometimes seen as the only possible approaches to assess expectation damages and to meet the full compensation standard. I don't agree with that.

Indeed, forwards-looking approaches can be inappropriate for the assessment of damages in some circumstances while backwards-looking approaches are more suited. For example, in the absence of track record that could prevent projecting cash flows with a sufficient level of confidence, the DCF method might be disregarded. It is also possible that market-based approaches might be irrelevant, for example in the absence of comparable transactions or comparable listed companies.

Assessment of expectation damages using backwards-looking approaches can sometimes be seen as "a floor value" that would not correspond to the fair market value of the damages and, as such, would not fully compensate the injured party for its damages. Again, this is not necessarily the case.

In the investment treaty case Copper Mesa and Ecuador, an investment treaty arbitration about three expropriated copper mines, the Claimant sought to recover the fair market value of its

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[2] The World Bank Guidelines, Definition of Fair Market Value : "*an amount that a willing buyer would normally pay to a willing seller after taking into account the nature of the investment, the circumstances in which it would operate in the future and its specific characteristics, including the period in which it has been in existence, the proportion of tangible assets in the total investment and other relevant factors pertinent to the specific circumstances of each case*".

investment, i.e. a claim for expectation damages. The Claimant's expert primarily presented forwards-looking approaches (income-based and market-based approaches), and a backwards-looking approach (cost-based) in the alternative. The Tribunal found that forwards-looking methods were "*too uncertain, subjective and dependent upon contingencies*" and only accepted the Claimant's cost-based approach, which relied on audited financial statements.[3]

Similar to the case I just mentioned, tribunals might reject forwards-looking approaches on the ground of uncertainty and the fact that they are too speculative.

How does this translate from a financial expert's perspective?

A quick reminder on the discounting of profits: profits expected in the future are discounted back to a date of assessment using a discount rate (usually the weighted average cost of capital of the business) to account for (1) the time value of money (one dollar today has more value than one dollar tomorrow) and (2) the risk associated with these expected profits. This risk-adjusted value (ie using the forwards-looking approach) could be:

- equal to the investment (ie using the backwards-looking approach) if the projects generates a return (IRR) which perfectly compensates for the risk taken (WACC)
- superior to the investment if the projects generates a return (IRR) which overcompensates for the risk taken (WACC)
- inferior to the investment if the projects generates a return (IRR) which undercompensates for the risk taken (WACC)

A first comment here, let's be clear, claiming for wasted costs **does not** imply that the failed project would generate no return BUT merely that the project's return would perfectly compensates the risk taken (i.e. IRR = WACC).

Conversely, if a claimant seeks to claim for lost profits that exceed wasted costs, this claimant should be able to demonstrate that the actual cost of risk borne is lower that the remuneration it receives from its counterpart for taking that risk.

Intuitively, one can see that this demonstration is dependent on the status of the project.

If the breach occurs at the outset of the project (shortly after the signing of the contract or the investment decision): the above condition implies that the investor could put forward specific facts showing that it would have been overcompensated for its risk taking (i.e. that the contract's terms were overly favourable). Indeed, intuitively, you would expect that on day 1 of an investment, the price paid by the investor equals the value of this investment. In order to claim lost profits that exceed wasted costs, the situation would have to be that:

- the contract has been negotiated at favourable conditions that caused the investor's counterpart to overcompensate the risk => it could be the case if there was no other bidder. Conversely, it is less plausible if the contract resulted from an auction with multiple bidders;

- the investment's opportunity was particularly attractive/lucrative (low-competitive market, etc.)

[3] PCA Case No. 2012-02.

In this case, the mere fact of signing the contract gives it an additional value compared to the price paid.

Irrespective of whether the project's return initially perfectly compensated the risk taken, a disconnection between the return and the cost of capital is more likely to arise with the passing of time because some of the risks taken ex-ante by the investor did not materialise.

For instance, investments projects often have significant upfront risks (construction phase, market testing phase). With hindsight (i.e. track-record), it becomes possible to show that some to these upfront risks, for which the investor has been remunerated, did not materialise. It this is the case, the project's return (IRR) could overcompensate the **actual/residual** risk as of the valuation date (despite the fact that the project's return initially perfectly compensated the ex-ante risk), therefore justifying that lost profits exceed investment/wasted costs.

In summary, both FWD looking and BCK looking approaches can ensure full compensation. The appropriateness of each approach in fact depends on the claimant's ability to show that the contract/investment overcompensates it for the residual risk borne as of the valuation date. Such demonstration is easier with the passing of time when hindsight allows to show that some ex-ante risks did not materialise in actuality.

Now turning to my second question: Is the assessment of damages using backwards-looking approach challenged in the same way in a claim for expectation losses and in a claim for reliance losses?

The answer is yes, and I will explain the difference in the way the approach can be challenged.

1.
If wasted costs are claimed as a compensation for expectation damages, the underlying assumption is that the wasted costs are a good proxy to assess the fair market value of the lost profits that would have been generated **from the investment**. That means that the injured party should be able to demonstrate that the expected profits from the project would have recouped the initial investment.

However, this is not always the case. For example, if the costs incurred for a project were over-priced or in case the investment expenditures were extravagant, the expected profits might not recoup the initial investment. The same applies for an assessment of expectation damages for stranded assets: in case of exceptional depreciation not yet recognised in the company's accounts, an asset-based approach might overestimate the expected profits from the project.

This demonstration that the expected profits from the project would have recouped the initial investment is not required when wasted costs are claimed for compensation of reliance damages. The underlying assumption here is that wasted costs should simply put the injured party back in the position it would have been in had it not entered into the contract, or had it not invested in the project/company covered by a BIT.

In a recent investment treaty case I worked on, the claimant invested in a 10-year concession to operate in a certain sector. Because of the COVID pandemic and associated measures taken by the

State, the Claimant considered that a portion of the investment it made was wasted, because, at the time of its initial investment it did not anticipate that it would be deprived from one year and half of operations. When claiming wasted costs under an expectation basis, the injured party is exposed to the criticism that a BIT is not an insurance against bad bargains.

2.
Wasted costs claimed as a compensation for expectation damages might also be challenged when the contract includes provisions that specifically exclude claims for lost profits. As discussed earlier, in an expectation framework, wasted costs are used as a proxy for lost profits. It can then be argued by the other party that the wasted costs are not claimable because of the exclusion of liability for lost profits.

In the case of CIS vs IBM, CIS made a claim for wasted costs in respect of the alleged wrongful termination of an IT contract.[4] The Court held that although CIS's claim was calculated under a wasted costs methodology, its losses were nonetheless anticipated savings, revenues and profits that could have been achieved had the IT solution been successfully implemented, i.e. expectation losses, which were excluded under the agreement between the parties.

It is then important that the recoverable damages sought by the injured party (expectation or reliance damages) are properly articulated from a legal perspective to maximise the chance of being compensated for the wasted costs claimed. In my experience, the party's positions regarding the recoverable damages are often overlooked which can then put the quantum expert in difficult position. These are obviously legal issues on which I will let Tsegaye Laurendeau and Catherine Kessedjian provide their views.

Conclusion

The use of backwards-looking or forwards-looking approaches for the assessment of expectation damages depends on the circumstances of the case. One important thing to remember is that backwards-looking approaches can, in some instances, provide the fair market value of a project and consequently meet the full compensation standard.

It is also important that a claim for wasted costs is properly articulated from a legal perspective, i.e. whether the damages are recoverable as expectation or reliance damages. Depending on the recoverable damages sought, the injured party's assessment will not be exposed to the same criticisms. If the damages sought are expectation damages, the wasted costs assessment might be challenged on the fact that future profits would have not recouped the initial investment or on the existence of a clause that might prevent claiming lost profits (and by extension, wasted costs used as a proxy for expected profits).

[4] England and Wales High Court case No. HT-2018-000154.