Damage Calculation

Costs, Lost Profits, Value

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Aim

Introduction

Damage and its award – Aim

To put the claimant into the position but for the breach:

- Stop intervention, replace in natural form
- Replace in pecuniary terms

Punitive

Expenses

Expenses
Introduction

Terms: „actual investment“, „actual expenses“, „historic costs of investment“, „investment expenditure”

Eligibility of expenses:

- Expenses are linked to the investment;
- Expenses are linked to the investor;
- Expenses are reasonable;
- Expenses are supported by sufficient evidence.

Expenses

Expenses are linked to the investment

Incurred expenses usually monetary and therefore do not pose significant valuation issues.

Types of expenses:

- Negotiation and planning costs (feasibility study)
- Capital contributions and loans
- Financial costs (debt servicing and bank guarantee fees)
- Marketing costs
- Costs of particular assets contributed to the investment (car, office equipment, machinery, land)
- Costs of recruiting or relocating personnel
- Travel and accommodation expenses
- Insurance, sometimes consulting services

Expenses

Expenses are not manifestly unreasonable

Consider whether the expense was:

- Necessary,
- Reasonable, and
- Was not excessive.

Situation:

- Azurix v Argentina. Water concession. The value (FMV) was based on actual investment made by the investor. Azurix acquired the concession in a public tender for USD 438m. Tribunal found out that the offers of other bidders were ten times lower than the offer submitted by the claimant. Stated that no well-informed investor would have paid the price USD 438m and decided the FMV of the concession was USD 60m. ("cannot claim bad bargain"/inadequate assessment of business risk)

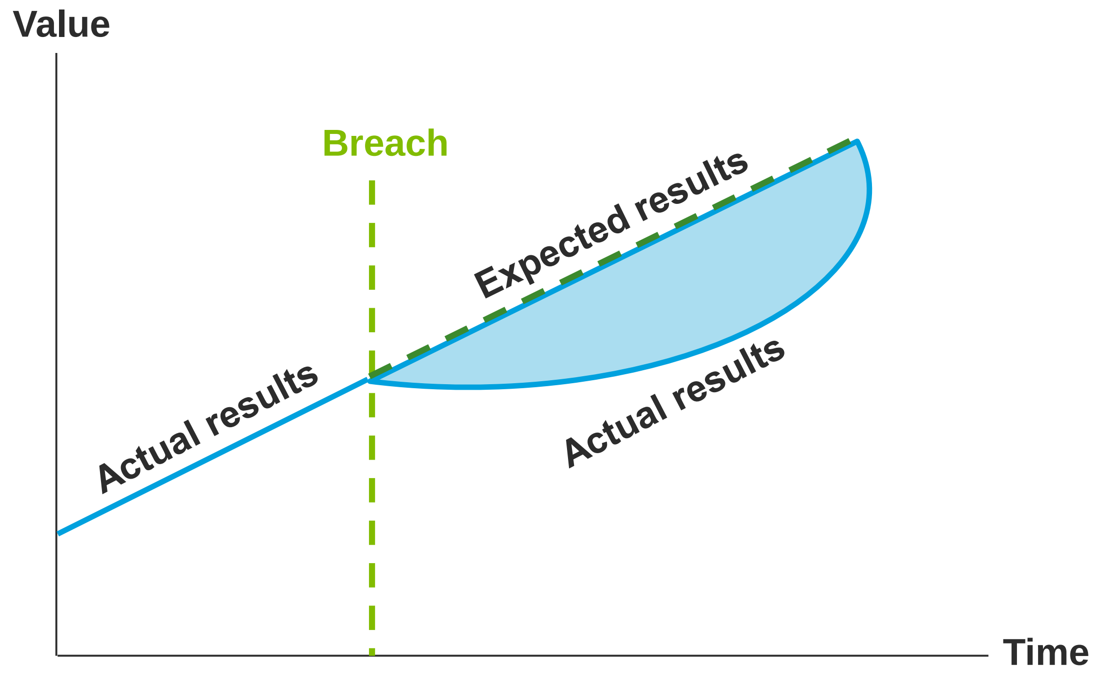
Lost Profits

Lost profits

Introduction

The activity of a company is interrupted for a certain period and/or the damage relates to a specific contract.

The difference between the expected earnings and actual earnings (incremental approach).



Lost profits

Eligibility of lost profit – reasonable certainty of forecast

Existing company:

- Sufficiently long record of profitability? (going concern)
- Tecmed v Mexico. Tribunal considered 2 years of business operation as insufficient historical period for deriving reliable cash flow projections for future 15 years.
- Reliability of forecasts? Success in meeting them in the past?

Start-up company / new project / loss making company. Consider:

- To what extent is the investment finished at the date of the breach (e.g. construction completed and started testing)
- Level of success and earnings in other investments made by the investor
- Is there a specific contract?
- Level of historical profit and/or decreasing loss

Lost profits

Eligibility of lost profit – evidence

Estimate, not an exact calculation to the last dollar

The fact that the lost profit cannot be measured exactly ought not to benefit the wrongdoer

Examples of evidence:

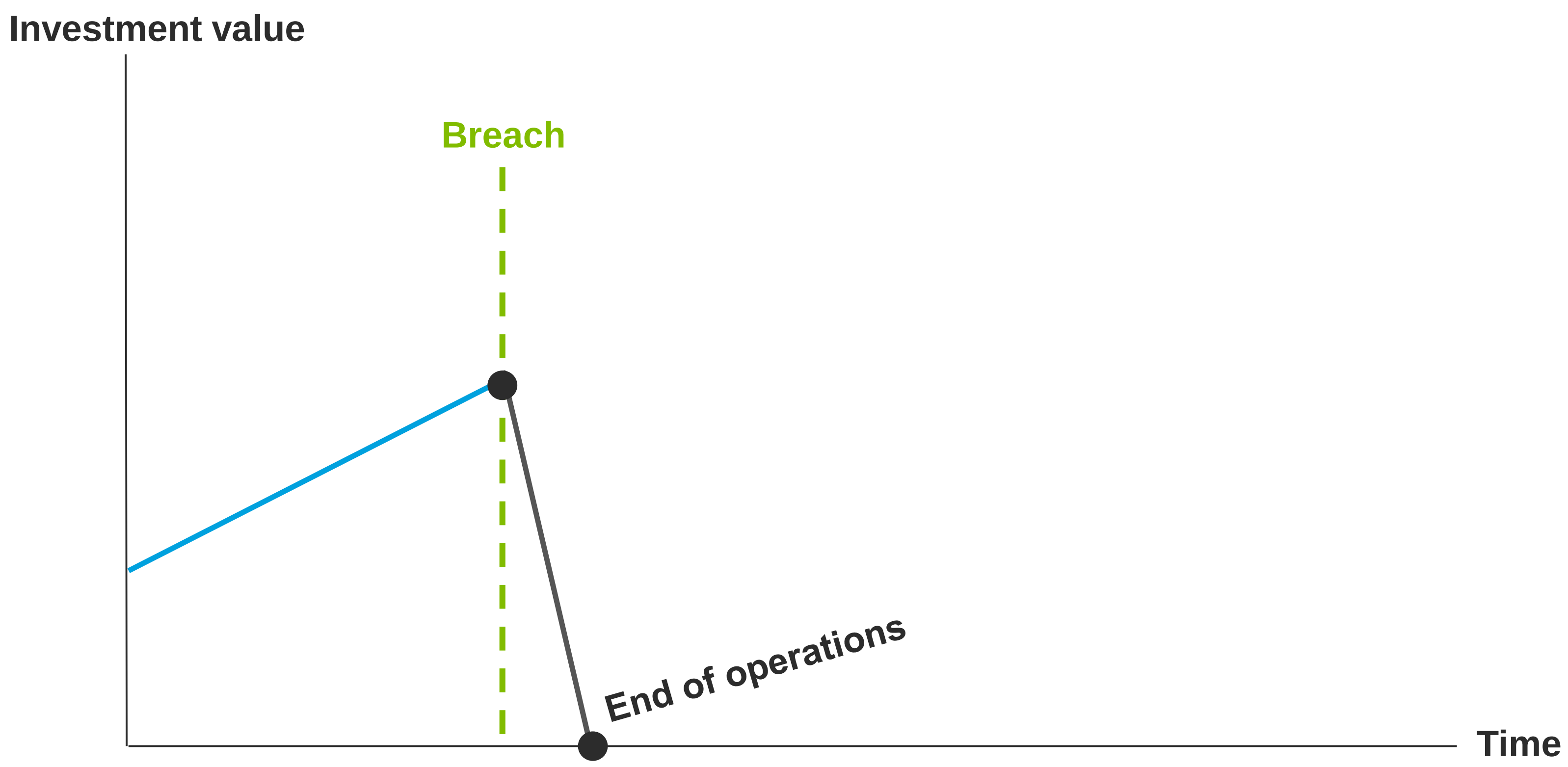
- Prior experience of the plaintiff / historical financial results of the plaintiff
- Plaintiff’s subsequent experience / financial results after breach abolished
- Plaintiff’s experience at other locations
- Comparable experience of others
- Defendant’s subsequent experience
- Industry averages
- Pre-litigation/arbitration projections
- Computation from the contract

Investment Value

Lost profit v. investment value

Complete end to operations of a company

If the company was destroyed completely, take into account market value of a company before its destruction netted of residual value.

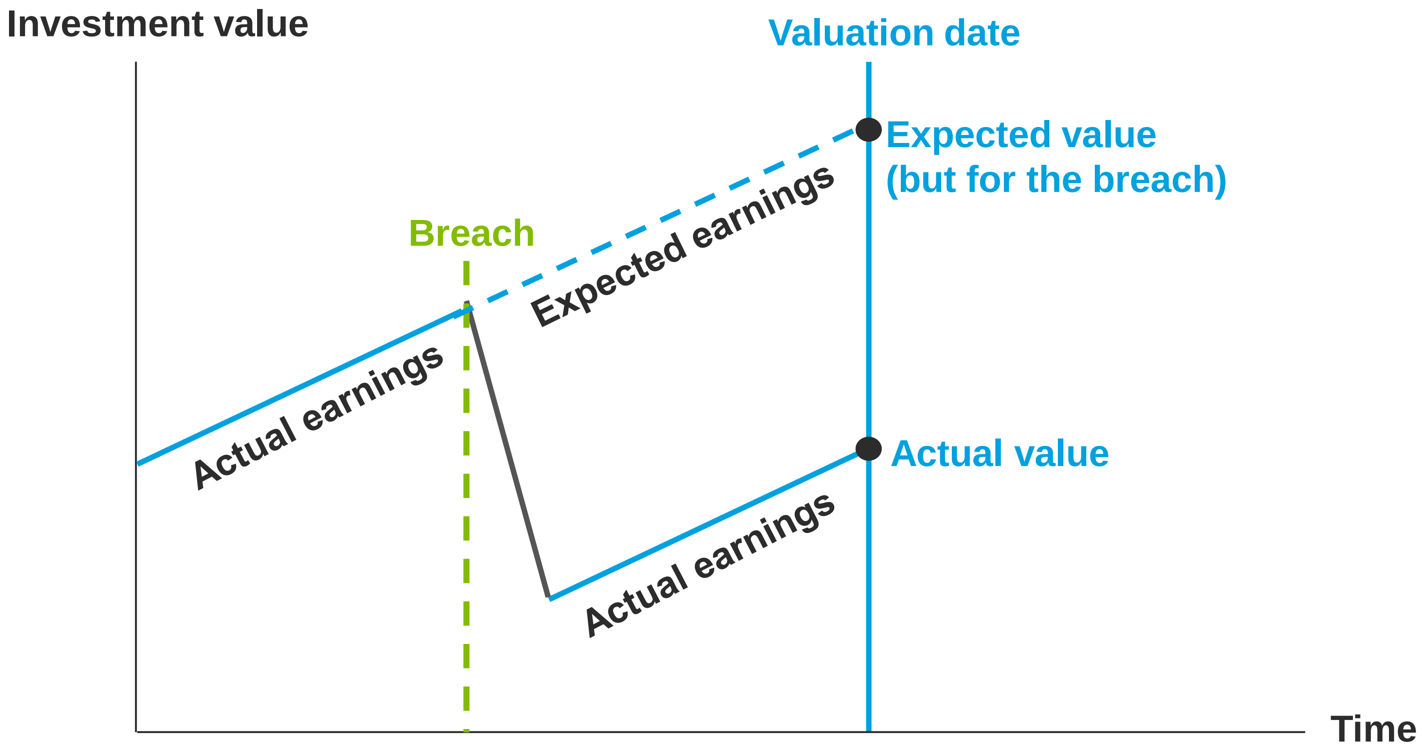


Investment value

Calculation – operations interrupted with permanent impact

Investment permanently damaged. Compare the actual value and the value but for the breach. The value reflects future results.

When: acquisition disputes, damage to brand.



Investment value

Value of a company and value of the assets owned by the company

Without costs there would be no profits. Cannot claim both costs to build your factory and its investment value.

Investment value

Valuation methods

- Income approach (e.g. discounted cash flows, dividend yield)
  - Forecasts and their reliability
  - Generally future income discounted to the date of the breach
- Capital market approach (e.g. similar companies that are traded)
  - Reasonably comparable companies
- Cost approach (net asset value)
  - Difference between value of assets and liabilities

Taxation

Taxation

Damages pre-tax

- Awarded amount usually subject to income tax
- Therefore damage should be calculated prior income tax (to avoid double taxation)
  - Earnings from operations (consider application of financial expenses)
  - EBIT => apply income tax
  - Discount, if applicable
  - Result is after tax => add income tax on top of it

Mitigation

Mitigation

Basis

- Prevent and minimize the damage
- Make reasonable effort (must be within means of the party)
- Earnings from “alternative” operation/investment to be deducted

Valuation Date

Valuation date

Diverse approaches

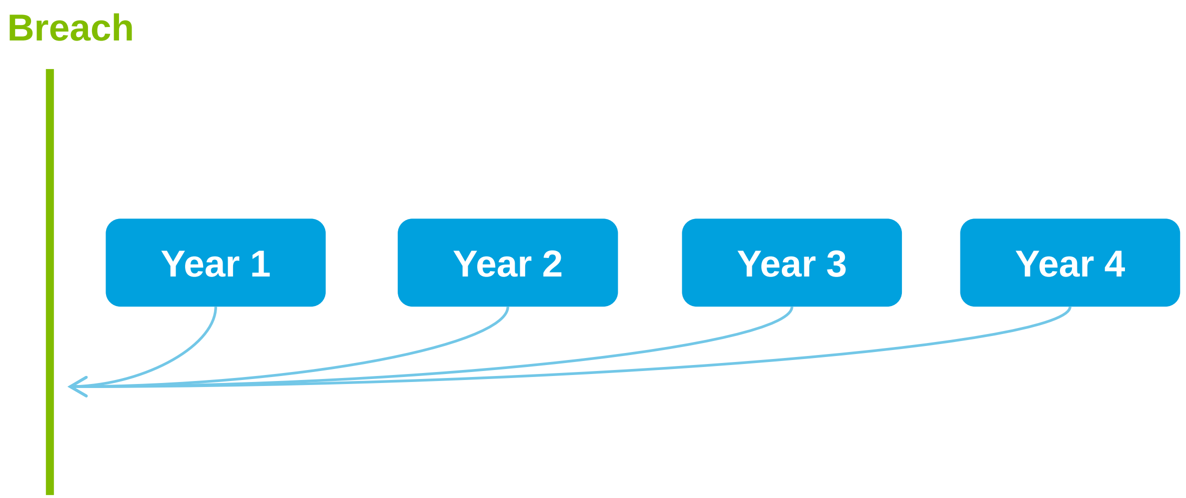
	Ex-ante	Ex-post
Date	Date of breach.	Date of calculation/Date of court proceedings.
Information to be reflected	Information known or foreseeable as of the date of the breach. Information that became available after the date of breach excluded.	All available information, i.e. hindsight.
Discounting	Projected cash flows discounted back to the date of the breach. Interest from the date of the breach to the date of the court proceedings/award.	Only future lost profits discounted. Past lost profits (prior date of court proceedings) – interest incurred.
Applicable in:	**Business valuation** • **The investor decided to make the investment based on conditions prevalent as of them time. If he is deprived of the investment, he is entitled to the value he envisaged at that time.**	**Lost profit calculation** • **Hindsight is often allowed and information after the date of breach can often be applied.**

Discount Rate

Discount rate

Rationale

- Time value of money
- Risk associated with the project, investment



Interest Rate

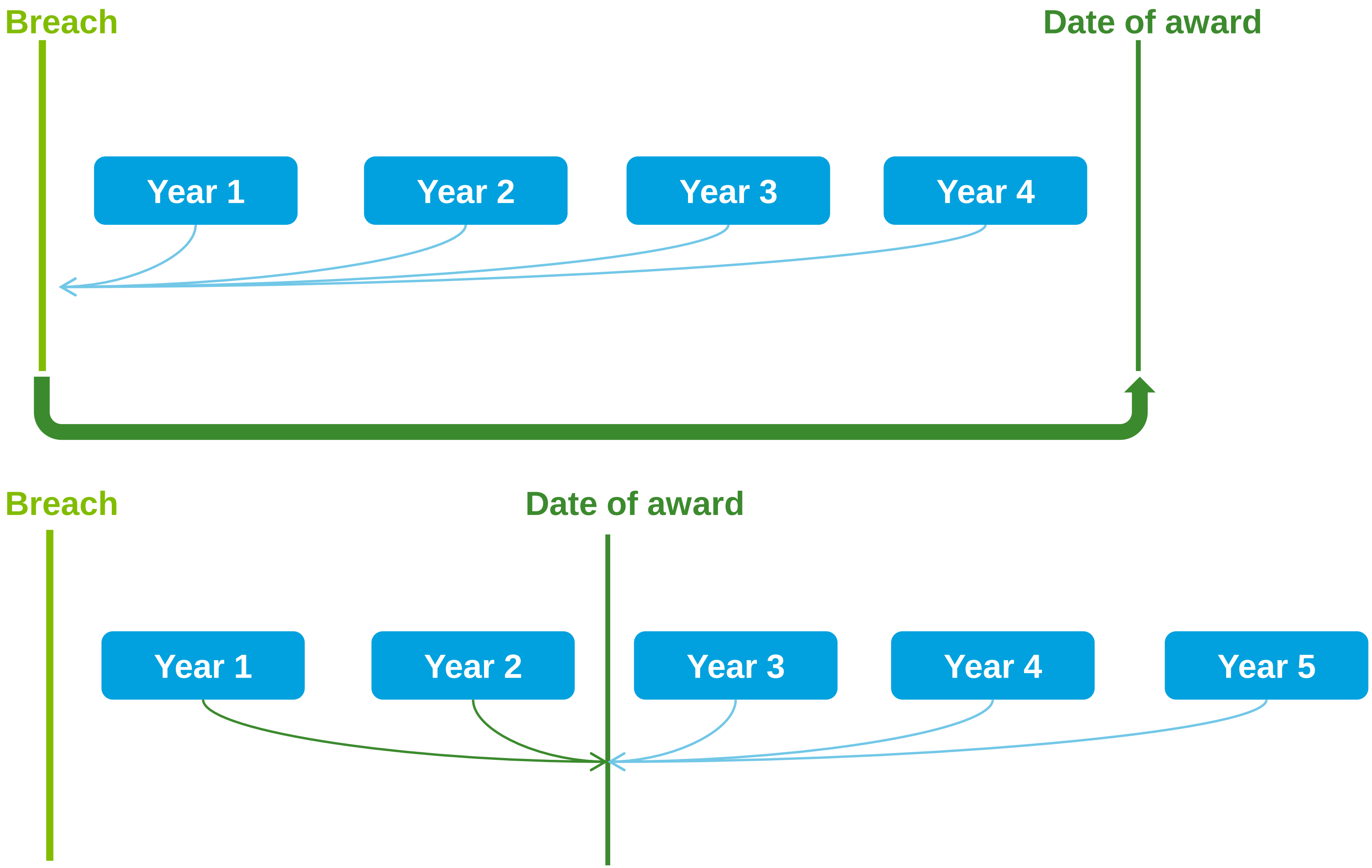
Interest

Rationale

- Lost opportunity to invest the amount
- Harms the claimant:
    - Lost opportunity to increase / grow the amount
    - Has to borrow the amount in order to continue its operations

Interest

Function



Recently awards and methods applied

Damages

Valuation methods applied

Methods (frequency)

1. Investment costs (Siemens vs. Argentina, Azurix vs. Argentina, Vivendi vs. Argentina, Waguih Elie George Siag and Clorinda Vecchi vs. Egypt)
2. DCF (Occidental vs. Ecuador, EDF, Saur and Leon vs. Argentina, CMS Gas vs. Argentina, Sempra vs. Argentina, ADC vs. Hungary, Abengoa y COFIDES v. Mexico)
3. Lost profit (Cargil vs. Mexico, Archer and Tate & Lyle vs. Mexico)

Other methods

- Loans, unpaid invoices, lost dividends, taxes

ICSID damages

Interest on award

Interest

1. Majority on floating basis, predominantly LIBOR or U.S. Treasury rates (highest rate 10%)
2. Since 2008, mainly compound interest

Yukos – damage calculation

YUKOS damages

UNCITRAL, Energy Charter Treaty

- July, 2014: an Arbitral Tribunal held unanimously that the Russian Federation breached its international obligations under the ECT by destroying Yukos Oil Company and appropriating its assets.
- Damages awarded in excess of USD 50 billion.
- Plus reimbursement of the Claimants USD 60 million in legal fees and of EUR 4.2 million in arbitration costs.
- Expropriation of assets achieved gradually, starting in December 2004 with rigged auction of Ukos’s largest production unit Yuganskneftegaz and ending with the company’s liquidation in November 2007.

YUKOS damages – calculation

UNCITRAL, Energy Charter Treaty

Valuation Date

- Claimant asserted: either on the date of expropriation – said to be Nov 2007, the date that Yukos was struck off the register in Russia – or on the date of the award, whichever amount higher
- Arbitral Tribunal: ECT specified the date of a taking as the proper valuation date, this was only relevant to lawful expropriations and did not necessarily apply to an unlawful expropriation. Compensation from whichever date more favourable to the claimants
- Arbitral Tribunal: Expropriation occurred on Dec 2004, the “substantial and irreversible deprivation” arose – the auction date of Yuganskneftegaz
- Arbitral Tribunal proceeded to calculation the damages based on each valuation date

YUKOS damages – calculation

UNCITRAL, Energy Charter Treaty

Two Heads of Damages

- Value of Yukos shares on each date; and
- Value of unpaid dividends that the Yukos shareholders should have received until each valuation date

Certain features of the compensation analysis rejected

- Claimants argued they had a 70% chance of successful listing on the NYSE, leading to an increased valuation. Tribunal ruled this too uncertain
- Claimants argued the planned merger between Yukos and Sibneft would have positive effects that should be taken into account. Tribunal was not convinced that Sibneft would have proceeded with the merger given Yukos' situation

YUKOS damages – calculation
UNCITRAL, Energy Charter Treaty

Value of shares

- Claimant's expert put forward 3 methods: DCF, Comparable companies, Comparable transactions. All resulted in value at around $ 90 billion as of Nov 2007
- DCF rejected – expert conceded the model was **"influenced by his own pre-determined notions as to what would be an appropriate result"**
- Comparable transactions rejected – no comparable transactions available
- Comparable companies chosen. Corrected as the claimant weighted Rosneft too strongly yet it had very different **"market matrics"** => Reassessed value from $92.9 bn to 61.1 bn in 2007.
- Adjusted figure using the Moscow Stock Exchange RTS Oil and Gas Index for each valuation date => Reassessed value to $21.1 bn in Dec 2004 and to $42.6 bn in Jun 2014 .

YUKOS damages – calculation
UNCITRAL, Energy Charter Treaty

Lost dividends

- Justified – value of shares captured expected future profits yet it did not capture the lost past profit
- Starting point, the Claimant's cash flows in DCF. Yet convincingly criticized by Russia (certain costs ignored, others overestimated, certain aspects based on Rosneft that was a state owned company and could avoid many business risks)
- Next, complex offshore structured implemented by the Claimants to divert Yukos profits out of Russia. Tribunal could "not exclude the possibility" the Claimants would have continued this practice, i.e. decreasing the formal dividends paid by the company
- Tribunal settled on discretionary, round numbers representing dividends lost each eat from 2004 to 2014
- Estimated at $ 2.5 bn in Dec 2004 and at $ 45 bn in Jun 2014

YUKOS damages – calculation

UNCITRAL, Energy Charter Treaty

Mitigation

- Russia claimed that the Claimants could have mitigated the losses by paying the taxes
- Tribunal held paying the taxes would have changed little
- Russia claimed any compensation paid would be a windfall given that the Claimants had already earned an unreasonable return from Yukos due to their tax evasion and asset stripping
- Tribunal held that any prior benefits were not relevant to valuation

YUKOS damages – calculation
UNCITRAL, Energy Charter Treaty

Interest

- Tribunal reviewed four possible approaches:
  - ‘Investment Alternative Approach’ (lost opportunity)
  - ‘Borrowing Rate Approach’
  - Rate applicable in domestic law
  - ‘Fair’ rate
- LIBOR “discredited”, yield on Russian sovereign bonds would overcompensate, US Prime rate + 2% acceptable, was a borrowing rate, yet no evidence that claimants were forced to borrow
- ‘Investment Alternative Approach’ favoured, average 10-year US Treasury bonds rate from 2005 to 2014 (3.3389%)
- Applied to value of unpaid dividends due since 2004
- Applied only simple interest, even though compound interest was “just and reasonable”

YUKOS damages – calculation

UNCITRAL, Energy Charter Treaty

Final calculation

2004	2014
$ 21.1 bn in share value	$ 42.6 bn in share value
$ 2.4 bn in dividends	$ 45 bn in dividends
$ 7.6 bn in interest	$ 6.9 bn in interest on dividends only
70.5% shareholding	70.5% shareholding
$ 21.9 bn	$ 66.6 bn

YUKOS damages – calculation

UNCITRAL, Energy Charter Treaty

Reduction due to own conduct

- Tribunal took into account the objection that certain actions of Yukos of the Claimants had contributed to the Claimants' injury
- Contributory fault, three categories:
  - Cases on duty to mitigate losses
  - Cases where the investor's fault increased its losses but was unrelated to the state's wrongdoing
  - Cases where the investor provoked or contributed to the state's wrongdoing
- Two instance the Claimants had contributed to the prejudice that they suffered: Yukos' conduct in certain low-tax regions in Russia and utilization of the Cyprus Russia Double Taxation Agreement
- Damages reduced by 25% from approx. $66.6 billion to $ 50.2 billion

Summary

Summary

Damages calculation: Expenditure, Lost Profits, Business Value

Taxation

Mitigation

Valuation date and information to be used

Discount rate and interest rate

Frequency of methods used

YUKOS case