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Pre-award Interest, and the Difference Between Interest and Investment Returns

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Even in these times of historically low interest rates, it is often the case that a significant part of any award rendered by an arbitral tribunal in favour of a claimant is interest. This is particularly the case where the tribunal only arrives at its award many years after the events that gave rise to the claim, and the tribunal quite rightly has a duty to compensate the claimant for not having had the use of the award monies over the period from the valuation date to the award. Indeed, in some cases the claim for interest can be the single largest element of damages.

The interest rate, and therefore the amount of interest awarded, was traditionally regarded as being something that was simply left to the tribunal to determine, with very little submission by the parties' counsel or by the quantum experts even though, when base rates everywhere were above 5%, interest could have such an enormous impact on the quantum of the award.

However, interest has now become much more a subject of submission and argument. After all, an award for compounded pre-award interest at a rate of 7% will be four times greater than an award at 2% after five years and nearly five times greater after 10 years.

Interest is part of the award in favour of the claimant and, as such, its purpose is to place the claimant in the same position as it would have been absent the breach or expropriatory event that gave rise to the claim. The underlying logic of interest is that "a dollar today is worth more than a dollar in a year's time".

In this article, we consider various approaches to calculating pre-award interest and, in particular, we explain the difference between interest and an award based on investment returns.

Rates of Interest

Various different bases are often put forward for calculating interest. The first is that the rate of interest should be based on the claimant's borrowing rate. This rate is supported by the Chartered Institute of Arbitrators' Guideline on Drafting Arbitral Awards which states:

> "*the amount of interest should be designed purely to compensate a receiving party for being kept out of its money and provide it with a form of commercially realistic restitution without punishing the paying party*".

The basis for using this interest rate is effectively that, if it had received the award at the time it suffered its loss, the claimant would not have had to borrow as much money as it did in fact borrow – it thus assumes a fairly normal scenario in which the claimant company borrows money to invest in its activities.

Thus, the claimant should be compensated with the rate of interest which it actually had to pay as a result of being kept out of its money. This interest rate should be able to be established as a matter of fact by the parties – it may be disclosed in the claimant's accounts or it may be simply a matter of submission by the claimant. A reasonable proxy for this rate of interest may be LIBOR plus a margin of say 2% – which is also a rate of interest commonly awarded in the English High Court in commercial cases. A very large multinational may, in fact, be able to borrow at a lower margin of say LIBOR plus 0.5%, and a smaller company may have to pay LIBOR plus 4% or more to borrow money from a bank.

Alternatively, if the claimant was never in a net borrowing position, and a reasonable assumption is that what it would have done with the award money if it had received it at an earlier date is to have placed the money on deposit, then the rate of interest may be based on the rate of interest it could have earned on a bank deposit.

Investment Rates and Opportunity Cost

Interest is sometimes claimed based on the claimant's Weighted Average Cost of Capital ("WACC") or the investment rate that the claimant states it would have earned on alternative investments to the project on which its claim is based. The WACC reflects the cost to a company of financing its operations with debt and equity, i.e. the return it needs to pay to compensate investors for investing in companies of comparable risk. The WACC, therefore, is a measure of the opportunity cost to a company of investing in one project rather than another.

Stepping back from the legal arguments regarding using a WACC rate, there is one overall reason for claimants to use this rate – it will always lead to a higher and, indeed, a much higher claim. Shareholder equity commands a higher return than debt and while the WACC is a blend of the costs of debt and equity, the lower the gearing of an entity the higher its WACC will be.[1] It is also important to bear in mind that the reason equity has a higher cost than debt is because, from the point of view of the lender/investor, it is riskier.

The WACC is not, however, a measure of interest, and it should not generally be used, in our opinion, as a proxy for pre-award interest. This is because it does not compensate the claimant for the losses which an award of interest should be compensating claimants for.

The reasons why opportunity cost or the WACC should not be used for the calculation of pre-award interest, in our opinion, include the following:

1. It would result in the elimination of investment risk over and above any borrowing cost, and thus would provide the claimant with a guaranteed return equivalent to an investment return. A company may hope to make high investment returns on some of its projects, but it is also likely to make lower returns on other

projects – and it would be wrong to compensate the claimant solely on the basis of its above-average investment returns.

2. It assumes that there are, in fact, alternative projects that would have yielded the WACC that the claimant could have invested in – whereas in reality there may have been all sorts of other limitations on the company's ability to win and carry out work profitably on alternative projects, including the company's failure to win particular tenders simply because competitors won them for whatever reason.
3. It would have the result that a claimant that invests in higher risk ventures, some of which fail, receive a higher interest rate than a well-managed claimant that invests in a portfolio of high and low risk projects, and thus has a lower WACC. Indeed, a company with poor corporate governance and therefore higher risk would receive far greater compensation than a company with good corporate governance.
4. Where a company can borrow money on the capital markets, it over-compensates the claimant for its loss. This is because, if the assumption is that the claimant would have been able to generate profits from its alternative investment, logically it should simply have borrowed money anyway and invested in those projects. Compensating a claimant on the basis of its WACC even though it did not actually borrow money to invest in such potentially profitable projects would be to over-compensate the claimant.
5. There is insufficient causal nexus between the event giving rise to the claim, and the alleged loss of opportunities.

Similar arguments apply to claims for interest based on specific returns that could have been earned on projects, actual returns on projects generally, or other measures of corporate performance such as return on equity or returns on assets.

One rare situation in which we would agree that the WACC or a similar measure might be appropriate as a measure of the pre-award interest rate is where there is some element of guarantee or warranty of returns by the respondent. But clearly this is some way from a claim for interest.

Coerced Loan Theory

The "coerced loan" theory or "forced debtor" approach is an economic approach to interest, based on the concept that the funds subject to delay have not been subject to any risk associated with the claimant's projects; rather the risk to which the funds have been exposed is the default risk of the respondent. According to this theory, the appropriate pre-award interest rate to apply becomes the respondent's unsecured borrowing rate.

There is logic in using a coerced loan theory rate of interest for post-award interest, where the claimant may still be at risk of the respondent's bankruptcy or other inability to pay, and thus arguably should be compensated for this risk. While the economic theory may be attractive, tribunals may baulk at awarding amounts of interest on this basis. Developing countries will have a higher borrowing rate than more developed countries and in investor-state disputes tribunals may prefer to exercise their discretion and use a LIBOR-based interest rate.

There is less logic in using a coerced lender interest rate for pre-award interest. This is because, once the tribunal has reached its award, the risk of the respondent going bankrupt or defaulting is no longer there. The award wipes out this risk and the reality is known, whatever might or might not have happened.

Ultimately, this is a legal issue – if the tribunal intends to compensate the claimant on the basis that the award was a "forced loan" from the claimant from the time of the breach, it may be right for interest to be based on the coerced loan theory.

Other Rates of Interest

Other rates of interest we have seen claimed include a risk-free rate or a statutory rate.

The argument for a risk-free rate is that all the risks to which the claimant is exposed are taken into account by the arbitration itself, so that by the time of the award, the only remaining requirement to be covered by interest is simply the cost suffered by the claimant for not having had its money earlier, and this can be calculated by using the risk-free rate of interest, such as a US Treasury bill rate.

A statutory post-award interest rate may exist, which may be used as the interest rate for a claim, depending on the applicable law and on the jurisdiction. For example, in England, the High Court post-judgment interest rate is currently 8%, whilst in New York it is 9% – which currently is likely to be a far higher rate than any other interest rate the claimant can use. Bank rates have been low since the financial crisis in 2008, whereas these judgment interest rates have not been adjusted to follow the decline in actual interest rates. Clearly, it may benefit a claimant if it is able to claim interest based on a New York statutory interest rate. However, it needs to be recognised that the purpose of these judgment interest rates is different, in that they are high partly to encourage losing respondents to actually pay the award quickly, as a matter of public policy – and thus they should not be used as proxies for pre-award interest.

Compound Interest

There has long been a debate over whether interest should be calculated on a simple basis or a compound basis, with the latter resulting in a higher award. Traditionally, the accepted view was that interest should only be awarded on a simple basis, and this was set down in the law of many countries, and it still remains the statutory basis of interest in a number of jurisdictions.

However in our experience, tribunals generally now award interest on a compound basis, as this more properly reflects the economic interest rate that the claimant would actually have had to pay to its bankers in the real world.

The Impact of Currency

There is a fundamental economic relationship between a currency and the interest rate on loans and deposits in that currency, and this must not be ignored when calculating interest. In simple terms, the value of a currency takes account of the interest rate offered on bank deposits in that currency and anticipated inflation, so that a country with a high interest rate is associated with a depreciating currency.

Consequently, it would be wrong for a tribunal to make an award in US Dollars and then to add interest based on the interest rate in, for example, Venezuela – as this would over-compensate the claimant, and would not take account of the fact that the US Dollar is expected to have appreciated against the Venezuelan Bolivar over the period of the claim.

Other Points

It may be the case that a commercial contract actually specifies an interest rate or interest rate basis in the event of a breach – and in those circumstances, that interest rate may well be the most reliable rate to use in an award based on such a contract.

We have referred to interest commonly being awarded on the basis of LIBOR or EURIBOR plus a premium, which is because these are

the benchmarks most commonly used as the basis for commercial interest rates, rather than other benchmarks such as Base rate in the UK. However, if US Prime rate is used as the basis for commercial interest rates, then logically that could be used for the pre-award interest rate. It is also the case that LIBOR has been tainted by well-known scandals in the last five years, so that some tribunals (for example, the Yukos tribunal) decided to choose a different benchmark simply because of concern that LIBOR may have been manipulated.

Finally, we do accept that interest is one of those aspects of an award that remain clearly within the control of the tribunal, and it may use its discretion on the rate of interest as part of the subjective element of an award, which may be designed to compensate a claimant in a way which the tribunal actually considers is most fair. So, for example, in the Yukos award, the tribunal considered the evidence in favour of compound interest in other awards, but then decided to award interest on a simple interest basis.

Endnote

- Ignoring the implications of optimal gearing.

Acknowledgment

The authors would like to acknowledge the third author of this chapter, Andrew Maclay.

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