The Investment Treaty Arbitration Review

Third Edition

Editor
Barton Legum

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THE INVESTMENT TREATY ARBITRATION REVIEW

THIRD EDITION

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For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
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PREFACE

The past year has confirmed the usefulness of *The Investment Treaty Arbitration Review*'s contribution to its field. The biggest challenge for practitioners and clients over the past year has been to keep up with the flow of new developments and jurisprudence in the field. There was a significant increase in the number of investment treaty arbitrations registered in the first years of this decade. These cases have come or are now coming to their conclusions. The result today is more and more awards and decisions being published, making it hard for practitioners to keep up.

Many useful treatises on investment treaty arbitration have been written. The relentless rate of change in the field rapidly leaves them out of date.

In this environment, therefore, *The Investment Treaty Arbitration Review* fulfils an essential function. Updated every year, it provides a current perspective on a quickly evolving topic. Organised by topic rather than by jurisdiction, it allows readers to access rapidly not only the most recent developments on a given subject, but also the debate that led to and the context behind those developments.

This third edition adds new topics to the *Review*, increasing its scope and utility to practitioners. It represents an important achievement in the field of investment treaty arbitration. I thank the contributors for their fine work in developing the content for this volume.

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Part V

DAMAGES

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Chapter 21

OTHER METHODS FOR VALUING LOST PROFITS

Gervase MacGregor and Andrew Maclay[1]

I INTRODUCTION

In this chapter, we set out the basic principles of a loss-of-profits calculation, together with some of the specific issues that commonly arise and need to be considered by the quantum expert, the lawyers and the arbitration panel. We do not consider damages in the context of an expropriation or damages calculated on the discounted cash flow basis, as these commonly used approaches are covered in other chapters.

Any damages claim needs to be calculated on the basis of the law that applies to the loss, and this may vary depending on the loss that is claimed or the jurisdiction that governs the claim; for example, some legal systems may not permit loss-of-profit or *lucrum cessans* claims at all. The basic starting point for the quantum expert is to put the claimant back into the position in which it would have been but for the intervening event that caused loss, whether that is a breach of contract, an expropriation, or a fire or flood. This means that a loss of profit is calculated as the difference between:

a the profit that would have been generated in the absence of the intervening event. Quantum experts commonly refer to the profits the company would have generated as the 'but-for' or counterfactual scenario; and

b the profit actually generated.

The profit the company actually generated should be quite straightforward to calculate. However, calculating the profit in the but-for scenario may be rather more complicated, and may require a combination of legal analysis, accounting skill and industry knowledge, in terms of forecasting what would have happened if the contract had not been breached or what may happen in an uncertain future.

II THE LENGTH OF THE LOSS

A key issue is the length of time the damages last for, or for which one can claim. In practice, this may depend on the legal principles in the jurisdiction or the length set out in a business interruption insurance policy. But, theoretically, it is simply the length of time from the breach of contract or other event until the company is once again earning the profits it would have earned had the event not taken place. In the case of a supermarket that is closed for a

1 Gervase MacGregor is international head of advisory, risk and quality, and Andrew Maclay is a forensic services principal at BDO LLP.

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certain number of weeks, it is reasonably clear that the loss lasts for the period of closure plus a lesser loss for some weeks after it reopens while it is rebuilding its sales to the level it would normally have expected. In other cases, the breach may have caused a factory never to be able to operate at capacity, in which case the damages may continue in perpetuity.

III THE BASIC CALCULATION

While in theory one can calculate the overall loss of profit in the but-for scenario directly, in practice, it is usually easier to break the calculation down into its constituent parts, namely:

a loss of revenue;
b gross profit margin;
c variable overheads; and
d fixed overheads.

We also find it helpful to carry out an overall reasonableness check on the loss calculated, by adding the loss to the actual profits earned, and comparing the resulting figure to the company's profits before and after the period of loss. It may be useful to illustrate this check on a graph, which may also bring the loss calculation to life for the arbitral tribunal. For example, such an overall reasonableness check may illustrate an error if the recalculated profit spikes up or down during the period of the loss.

IV CALCULATING THE LOSS OF REVENUE

The key driver of a loss-of-profit calculation tends to be the company's revenue. This is because the gross profit margin and the overhead costs generally vary less over time, and so are easier to calculate. The loss of revenue also tends to be the most tendentious parameter in the calculation because it may be subject to major fluctuations depending on whether the company wins a particular contract or not, and by its very nature it involves forecasting what would have happened in the future, which is simply unknown and speculative. At this point, it is worth emphasising that estimating what would have happened or forecasting the future is not an exact science, and the goal of the quantum expert is to calculate the most likely outcome, but without normally being able to say that that outcome is the only possible outcome.

For this reason, some arbitrators find it difficult to award damages for loss-of-profit claims. Equally, however, it is necessary for the quantum expert to work out the most reliable way of calculating what the revenue would have been absent the breach of contract or other intervening event. There are various ways of doing this, such as those detailed in the subsections below.

i Identified contracts lost

For a construction or engineering company, the most reliable way of calculating future revenue may be by identifying specific contracts that the company is likely to have won or identifying specific contracts that it did actually win, but that it would probably have won at an earlier date.

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ii The company's own forecast

If the company had its own forecast of the future profits it expected to make, this may be the best data to use to estimate what would have happened but for the breach. However, before relying on a forecast, one needs to consider the purpose for which it was prepared, and how accurate it is likely to be. If the forecast was prepared for the company's bank, which had carried out due diligence and lent the claimant money based on this forecast, and if the company's actual results over the past five years had always been within 5 per cent of its forecasts, then one could feel reasonably confident in relying on the forecast. If, on the other hand, the company's forecast was limited to a single sheet of paper prepared by the directors after the breach of contract occurred, and it had never actually achieved its budget in the past, one would not feel confident in relying on the forecast without first making serious adjustments to it or discounting it for uncertainty.

iii Extrapolating from the past to the future

Where a company has been operating for many years, and has a track record of always achieving a certain level of sales and profit, and where profits have grown consistently at, say, 5 per cent per year, the best estimate of future profits may be an extrapolation of past profits. This may be based on professional judgement or it may be based on a statistical regression line, which estimates the future based on the past.

iv Comparison with what actually happened to a similar company or retail outlet

If one can find a similar company operating in the same field and show that the claimant's results have closely correlated with the results of that company in the past, the best way of estimating what would have happened may be to consider what actually happened to the comparator company in the same period.

In circumstances where the loss of revenue is uncertain, it may be appropriate to calculate it by calculating the loss on a number of scenarios, and then applying a percentage likelihood to each scenario to calculate an overall estimate of the loss of revenue.

There are particular statistical tools that one can use in estimating the loss of revenue. These include:

a Regression analysis. This is a statistical tool that estimates unknown results based on historic data and relationships, and also generates an indication of the reliability of the projections. So, if a company has been growing over the previous five years, one might be able to take its revenues for the previous five years and project those into the future. Alternatively, one might be able to estimate the relationship between sales and the size of a supermarket, and use the trend of these to project the sales lost by a different supermarket store.

b Seasonal adjustment. If one is estimating the loss of profit for a short period of time, it may be important to consider the impact of seasonality on sales. So, for example, sales for a retailer may be much higher in the run up to Christmas, or sales by a heating company may be much higher in winter. In such circumstances, it will be necessary to adjust the damages calculation to take account of seasonality, for example, by using an adjustment factor calculated from previous Christmases or winters.

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V CALCULATING THE GROSS PROFIT PERCENTAGE

The reason for calculating the gross profit separately and after the revenue is that the gross profit of many companies tends to remain fairly constant over time. For example, a retailer may always reckon on marking up its purchases by 30 per cent, and it is common to find that companies' gross profit margins, as set out in their published financial statements, do not vary greatly from year to year. Alternatively, if they do vary, this may be because of the breach of contract or interruption itself, and so a comparison of the gross profit margin over time may itself help to indicate the loss of profit.

For a company that is dependent on a small number of very large contracts, the profitability of which varies, one may instead need to base the estimated gross profit margin on the estimated gross profit margin in the company's bid documents when it tendered for the contract.

Alternatively, for a natural resources company, the costs of extracting the minerals may be relatively fixed, but the revenue may fluctuate dramatically based on world prices; so the most reliable calculation of the loss of gross profit may be based on the quoted futures market price for the commodity less the cost of mining it. And, in a period of low commodity prices, if the selling price is lower than the cost of extraction, it may be that an interruption to a mine actually saves the mining company from losses that it might otherwise have incurred.

VI FIXED AND VARIABLE OVERHEADS

It is very important to understand the difference between fixed and variable costs in loss-of-profit claims and how to treat them, as this is an area where errors and misunderstandings frequently occur. It is important to understand the distinction between costs that a company does not incur during the period in which it suffers a loss of profits, and costs that continue in any event.

If costs continue irrespective of the interruption, then the company's position would have been the same in the but-for scenario as in the actual scenario, so there is no basis for any claim for loss of these fixed costs in a loss-of-profits claim. Examples of fixed costs may be head office costs, which continue to be incurred irrespective of the closure of any factory or the loss of any particular contract, or rent that continues to be incurred even if a factory or supermarket is closed.

On the other hand, variable costs are costs that are directly linked to revenue, and so may be saved when the breach of contract occurs; such saved variable costs, thus, need to be deducted from the loss-of-profit claim. Examples of variable costs may be employee overtime, which is not incurred when the factory is closed, heating and lighting, or transport costs if no vehicles are used in the period of closure.

VII SUNK COSTS

A similar cost that causes confusion is sunk cost – for example, the cost of building a factory. If a factory is idle as a result of a breach of contract, it may be tempting to claim for the cost of building that factory as part of the loss-of-profit claim because the factory is not making anything or generating any income. However, to do so would be to double count the loss of profit; this is because the company cannot generate any profits at all or suffer any loss of profits if it has not incurred the cost of building a factory (i.e., the cost of building the factory would have been incurred in both the but-for and the actual scenarios).

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VIII OTHER ISSUES THAT ARISE

i Overhead recovery rates and intra-group charges

An issue that often arises is the definition of what a cost exactly is. For example, the cost of employees may be measured as the amount actually paid to them (e.g., overtime, pension) divided by the number of hours they work, or as their hourly 'charge-out rate' (which may be equal to direct salary cost multiplied by a factor of three or four, to take account of the general and administrative and other fixed cost overheads of the company) or the rate that is charged by a service company in the group.

Related to this is the impact of costs recharged between companies in the same group at a mark-up, sometimes to move profits around a group. Thus, where the company has been charged employee costs based on a mark-up over direct costs, it may be important to consider whether the variable costs that have been suffered as damages should be based on the costs charged to the company or the original lower costs actually suffered by another group company.

ii Management time

The principles here may vary between jurisdictions, but generally the rule is that one can only claim damages for lost management time if the claimant can demonstrate that this management time would otherwise have been spent on generating profits on other projects (i.e., it is an opportunity cost). This is because management time is a fixed cost that would have been incurred whether or not the event causing the loss had occurred.

iii Tax

If the goal of a damages award is to place the claimant in the same position as it would have been in if the relevant breach had not occurred, the damages calculation needs to take account of tax. Thus, both the actual and the but-for calculations need to be carried out on a post-tax basis. If the tax rates have changed considerably over time, or if damages awards are taxed on a different basis to income, or if dividends from a project would have been subject to withholding tax but a damages award is not, the impact of tax may be considerable. Consequently, care must be taken to make sure that tax has been treated consistently in the loss-of-profit calculation.

iv Currency

The choice of which currency a claim is made in may have a considerable impact on the size of the claim, particularly in developing economies or economies with hyperinflation. Again, legal principles may vary between jurisdictions, but the general principle is that the claimant should be compensated for what it has lost. Thus, the loss should generally be calculated in the currency in which the loss of profit has been suffered. A claimant generally also has a right to be compensated in a freely convertible currency – so, even if the damages are calculated in a local currency, the tribunal may translate the award into US dollars or euros at the rate of exchange on the date of the award.

v Discounting

If the loss of profits continues into the future, into a period after the date of the award, it will be necessary to discount the future losses back to the date of the award, to take account of risk and the time value of money. There may be different rates that could be used to discount

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the claim, depending on the circumstances – the most common approach is to calculate the discount rate on the basis of the company's weighted average cost of capital, which includes consideration of the risk suffered by the company, but if there is no risk premium needed, the appropriate discount rate may be the company's borrowing rate or some other rate of interest.

IX CONCLUSION

Throughout this chapter, we have set out in detail the normal approach for calculating loss of profits in damages claims. However, we conclude by touching briefly on two very different methods that may be used to calculate damages.

i Loss-of-chance claims

The first method is the loss of a chance method. This method is commonly used in litigation in the United Kingdom, but is not so prevalent elsewhere. It is based on the principle that losses of profits are uncertain, and that it is up to the judge or arbitrator to assess the degree of uncertainty and to take this into account in awarding damages. Thus, the approach assesses the loss of profits on the assumption that the company would have been able to make the profits claimed – but then reduces the damages by a percentage to take account of the fact that in reality the company might not have made those profits as some other event might have impacted on its ability to generate the profits or simply that the calculation of loss of profits is by its very nature uncertain.

ii Wasted cost claims

Finally, although it is not really a method for calculating loss of profits, a method commonly used by tribunals in assessing damages, particularly in circumstances where the loss of profits is very uncertain or speculative, where the company has never in fact traded or generated any profits or where the future projections are unreliable, is for damages to be awarded on the basis of wasted costs.

This method compensates the claimant for the costs it has incurred, but from which it has not benefited, but does not award any additional damages to the claimant on the basis of its expected future profits. It is, thus, an alternative claim to a claim for loss of profits, rather than a claim in addition to a loss-of-profits claim; so, for example, a company may claim for the sunk costs of building a factory as a wasted costs claim as an alternative to a loss-of-profits claim, but not in addition to a loss-of-profits claim.

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Appendix 1

ABOUT THE AUTHORS

GERVASE MACGREGOR

BDO LLP

Gervase MacGregor is the head of international advisory, risk and quality at BDO LLP. Gervase is one of the most experienced accounting expert witnesses in the UK and has extensive experience of international arbitrations. He has worked on cases in London (LCIA and ICC), Stockholm (SCC), Geneva (ICC), Paris (ICC, ICSID), Zurich (ICC, *ad hoc* Cantonal) and Rotterdam (NAI). He has also worked on cases before the Court of First Instance of the European Communities, the High Court in London, the Copyright Tribunal and the Restrictive Practices Court.

He is the author of various books, including *Expert Accounting Evidence*, *Solicitors Accounts*, and *Surveyors, Architects and Estate Agents*. He has also written numerous articles for *Accountancy* and other technical publications. His main areas of expertise are in the fields of natural resources, particularly oil and gas claims; state/operator disputes; takeover disputes; regulatory matters; and valuing companies and damages.

Prior to joining BDO, he worked as a petroleum geologist in the North Sea, Australia and West Africa. He has investigated and reported on the affairs of the MG Rover Group and Phoenix Venture Holdings on behalf of the Secretary of State and DTI.

ANDREW MACLAY

BDO LLP

Andrew Maclay is a forensic accountant who specialises in the quantification of damages in international arbitration, asset tracing and investigations, and has worked on disputes in many jurisdictions, particularly France, Switzerland, West and East Europe, Africa, the Middle East and the CIS. Between 1991 and 1994 he worked in Burundi, Africa and is fluent in French.

He is a Chartered Accountant, a Certified Fraud Examiner, an accredited Accountant Expert Witness and a member of the Chartered Institute of Arbitrators. He is the forensic accounting officer of the International Bar Association's Asset Recovery subcommittee. He has an MA in economics from the University of Cambridge.

He has given evidence in ICC and ICSID tribunals, the English High Court, a criminal court and by way of deposition in US proceedings.

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BDO LLP

55 Baker Street
London W1U 7EU
United Kingdom
Tel: +44 20 7486 2570 / +44 20 7486 3487
gervase.macgregor@bdo.co.uk
andrew.maclay@bdo.co.uk
www.bdo.co.uk

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