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ICC Institute Advanced Level Training, Assessment of Damages by Arbitrators

15th ICC Miami Conference, 5 November 2017

Damnum emergens, lucrum cessans and moral damages

How to avoid double counting?

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OVERVIEW

I. BASIC CONCEPTS

- Alternative approaches to pecuniary damages
  - The expenditure-revenue
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    - *Lucrum cessans*
    - Loss of opportunity
  - The asset value approach
    - Inputs vs Outputs
    - When to use the DCF approach
    - Sunk investment costs
    - Adjusted investment costs
- Non-pecuniary damages (“moral damages”)
  - *Desert Line*
  - *Lemire*

II. CASE LAW

- *Karahas Bodas* (2000)
- *Rusoro Mining* (2016)
- *Caratube II* (2017)

ALTERNATIVE APPROACHES TO PECUNIARY DAMAGES

Approach	Components of damage	Example	Effect of breach on revenue producing - asset	Are "sunk costs" relevant?
Expenditure-Revenue Approach	• Increase in costs (*damnum emergens*) • Reduction in revenue (*lucrum cessans*)	Supply of defective equipment, which has to be repaired and leads to reduced sales	Temporary	No
Asset Valuation Approach	Value of asset or contract being expropriated, destroyed or terminated	• Expropriation • Illegal termination of contract (e.g. JV between commercial bank and insurance company)	Complete and permanent	Maybe, depending on the valuation methodology

THE EXPENDITURE-REVENUE APPROACH

Damnum emergens

- Pecuniary damages
  - Incremental out-of-pocket expenses (e.g. repair works) resulting from breach of contract or non-performance
  - Not to be confused with "sunk costs" (i.e. purchase price or investments already made).
- Non-pecuniary damages ("moral damages")
  - Non-pecuniary harm (e.g. physical or mental suffering, loss of moral reputation…) resulting from wrongful behavior

Lucrum cessans

- Decrease in revenue (e.g. loss of sales while the machine is being repaired) resulting from breach of contract or non-performance
- **What if the foregone benefits were likely, but not certain, or are difficult to quantify?**

Loss of opportunity (or ***Loss of chance***)

- A partial recognition of *lucrum cessans*:
- Enshrined in Unidroit Principles:

  "Compensation may be due for the loss of chance in proportion to the probability of its occurrence" (Unidroit Principles, 7.4.3-2)

THE ASSET VALUE APPROACH

Item	How to determine value		Observations
	Inputs	Outputs	
Goods	Labor theory of value (Classical Economists: Ricardo, Marx…)	Utility theory (Marginal Revolution: Jevons, Walras, Menger)	In Alfred Marshall's famous analogy, costs (supply) and utility (demand) determine the market price jointly, as the upper and lower blades of a scissors
National Accounts: GDP components	Government-provided services (e.g. health services, education)	Market-provided final goods and services (i.e. excluding "intermediate transactions")	• UK's Atkison Report made an effort to develop output-based measures for government-provided services
Accounting Standards (e.g. IAS, IFRS…) Valuation of balance sheet items	Historic Value Accounting (i.e. historic value less amortization)	Fair Value Accounting (i.e. "mark-to-market" valuation)	• Gradual shift towards Fair Value Accounting. • Some items can still be valued at "book value", even if sometimes subject to "impairment tests"
Legal services (including arbitrators' fees)	Hourly rates	• Success fees • Ad valorem fees (e.g. X% of amount in dispute)	
Investment	• Investment costs ("sunk costs") • Book value	• Discounted Cash Flows (DCF) • Market approaches (multiples, comparable transactions/companies…)	"Liquid investments": an especial case?

"LIQUID INVESTMENTS": THE THALER-SHAFIR EXPERIMENT

*"Suppose you bought a case of a good 1982 Bordeaux in the futures market for **$20** a bottle. The wine now sells at auction for about **$75** a bottle. You…*

[…have decided to give one bottle of this wine to a friend as a gift] Scenario 1
[…have decided to drink a bottle of this wine with dinner] Scenario 2
[…inadvertently dropped the bottle and broke it] Scenario 3

What amount best captures your feeling of the cost to you of [giving away/drinking/breaking] this bottle?

Subjective cost		Giving away	Drinking	Breaking
Amount	**Rationale**			
0	The bottle is already paid	30	30	8
+20	Amount I paid years ago	26	25	35
+75	Amount needed to replace it	30	30	**55**
-55	What I'm saving (i.e. $75-$20)	14	25	2

WHEN IS DCF APPROPRIATE?

Rusoro vs Bolivarian Republic of Venezuela (2016)

- The enterprise has an established historical record of financial performance
- There are reliable projections of its future cash flow, ideally in the form of a detailed business plan adopted in tempore insuspecto, prepared by the company's officers and verified by an impartial expert
- The price at which the enterprise will be able to sell its products or services can be determined with reasonable certainty
- The business plan can be financed with self-generated cash, or, if additional cash is required, there must be no uncertainty regarding the availability of financing
- It is possible to calculate a meaningful WACC, including a reasonable country risk premium, which fairly represents the political risk in the host country
- The enterprise is active in a sector with low regulatory pressure, or, if the regulatory pressure is high, its scope and effects must be predictable: it should be possible to establish the impact of regulation on future cash flows with a minimum of certainty

SUNK INVESTMENT COSTS

When a DCF or market approach to valuation is not practical, arbitrators are frequently forced to rely on "inputs", i.e. on the investment made in the project or the book value of its assets.

Potential limitations:

1. Overvaluation

- Over-invoicing and extravagant investment expenditures
- Post-investment adverse changes: when "sunk costs" become "*stranded costs*":
    - Regulatory changes (e.g. liberalization of previously regulated markets)
    - Emergence of disrupting technologies and new competitors ("Schumpeterian innovation" and "The alchemist's fallacy")
    - Unexpected adverse market trends

2. *Undervaluation*

- The investor, working in a risky environment against adverse odds, overcame barriers and faced significant risks before achieving economic success
- Post-investment favorable market changes (e.g. increased sale prices) produced a significant upside

    The *ex post* rate of return on the initial investment may be exceptionally high, which may induce the host Government to claim that those exceptionally high, "unfair" benefits should be taxed away or, alternatively, the business should be expropriated, at a price not in excess of the initial investment cost.

ADJUSTED INVESTMENT COSTS

In order to overcome the limitations of the raw investment costs, arbitrators may occasionally introduce adjustments, including:

- Negative adjustments
  - Wasteful investment (e.g. lack of competitive bidding or efficient procurement)
  - Transfers to cover operating losses
- Positive adjustments
  - Post-investment upward trends in sale prices (e.g. gold, oil…)
  - Loss of opportunity, when the amount of foregone profits was uncertain, but the likelihood of profits very high.

NON-PECUNIARY DAMAGES ("MORAL DAMAGES")

International recognition

- Umpire Parker's 1923 Opinion in the Lusitania cases (resulting from the sinking by Germany of the UK ship):

  "Mental suffering is a fact as real as physical suffering, and susceptible of measurement by the same standards. The courts of France under the provisions of the Code Napoleon have always held that mental suffering or "prejudice moral" is a proper element to be considered in actions brought for injuries resulting in death. A like rule obtains in several American States, including Louisiana, South Carolina, and Florida. The difficulty of measuring mental suffering or lost mental capacity is conceded, but the law does not refuse to take notice of such injury on account of the difficulty of ascertaining its degree".

- Article 31 of the ILC Articles reads:

  1. The responsible State is under an obligation to make full reparation for the injury caused by the internationally wrongful act.
  2. Injury includes any damage, <u>whether material or moral</u>, caused by the internationally wrongful act of a State".

Moral damages are <u>compensatory</u> in nature, and cannot be conceived as punitive damages in disguise.

MORAL DAMAGES: *DESERT LINE V. YEMEN*

Basic Facts

- Desert Line Projects (DLP), an Omani construction company, built roads in Yemen, but the Government failed to pay.
- Under pressure from its own subcontractors, DLP threatened to suspend further work and sued the Government.
- In May 2004 DLP interrupted the work at one of the sites. A few days later, the Yemeni Army put DLP's personnel and equipment under military siege.
- In June 2004, the President of Yemen asked DLP to complete its construction program and instructed DLP to submit the evaluation of the work done by two construction experts, under an Arbitration Agreement, which both parties signed later that month.
- In early August 2004, the Yemeni Arbitral Tribunal issued its award.
- Later that month, there was an "altercation" between DLP's personnel and the Yemeni Army, which resulted in three employees (including the son of DLP's chairman) being arrested for three days.
- In September 2004, the Yemeni Government applied to the Yemeni courts for the annulment of the award. During this and subsequent months, DLP complained about "harassment, threat and theft" committed by armed groups.
- In October 2004, the chairman of DLP received a phone call urging him to leave Yemen, since his life was in danger. He abandoned Yemen and left his son in charge.
- In the same month, the Government offered DLP to pay less than half the amount set out in the award, as part of a "settlement". DLP complained about the arbitrary conditions and unfairness of the offer, but in December 2004 it signed the "settlement agreement".

MORAL DAMAGES: *DESERT LINE V. YEMEN* (II)

<u>The ICSID Arbitration under Yemen-Oman BIT</u>

DLP claimed

- The true price of the work carried out (well in excess of the price determined by the Yemeni Arbitral Tribunal)
- More than US$100 million as compensation for moral damages.

The Award

- The December 2004 settlement agreement was signed under physical and financial duress: it ordered the Yemeni Government to pay the amount determined in the Yemeni Arbitral Award.

- Moral damages:

  - "Even if investment treaties primarily aim at protecting property and economic values, they do not exclude, as such, that a party may, in exceptional circumstances, ask for compensation for moral damages. It is generally accepted in most legal systems that moral damages may also be recovered besides pure economic damages."

  - "A legal person (as opposed to a natural one) may be awarded moral damages, including loss of reputation, in specific circumstances only."

  - "The violation of the BIT, in particular the physical duress exerted on the executives of [DLP], was malicious and is therefore constitutive of a fault-based liability (…). [DLP]'s prejudice was substantial since it affected the physical health of the [DLP]'s executives and the [DLP]'s credit and reputation."

But the Tribunal considered the amount requested exaggerated and granted US$ 1 million, an amount "more than symbolic yet modest in proportion to the vastness of the project."

MORAL DAMAGES: ***Lemire VS Ukraine***

Basic Facts

Mr. Lemire, a US citizen, was first invited into Ukraine as a leading investor in the nascent radio industry and then suffered an unlawful treatment by the Ukrainian regulator.

Mr. Lemire based his claim for moral damages in the following factors:

- The disrespect he and his team suffered during the procedures.
- Ukraine eroded his image, turning him from a “great pioneer” into a “loser incapable of expanding his business and playing in a bigger league”, thus depriving him of the first mover advantage and a promising leadership position in the radio industry.
- His radio station, Gala Radio, suffered many inspections by the State regulator, the National Council.

The ICSID Arbitration

Conditions which should be met for moral damages to be granted (“Lemire test”):

- The State’s actions imply physical threat, illegal detention or other analogous situations in which the ill-treatment contravenes the norms according to which civilized nations are expected to act;
- The State’s actions cause a deterioration of health, stress, anxiety, other mental suffering such as humiliation, shame and degradation, or loss of reputation, credit and social position; and

- Both cause and effect are grave or substantial.

It concluded that the moral aspects of Mr. Lemire’s mistreatment by his regulator “have already been compensated by the awarding of a significant amount of economic compensation [i.e. US$ 8.7 million], and that the extraordinary tests required for the recognition of separate additional moral damages have not been met in this case.”

II. CASE LAW

1. *Karaha Bodas Company (KBC) vs. Pertamina & PLN* (2000)

Basic Facts

- KBC was set up to build, own and operate a 400 MW geothermal electricity-generating facility in Indonesia.

- It signed a take-or-pay energy 30-year sales contract with two State-owned companies (Pertamina and PLN), with the price set in US$.

- Under the Contract, acts of the Indonesian Government could not be considered force majeure by Pertamina and PLN.

- In 1997-1998, in the wake of the East Asian financial crisis, when the project was not yet in operation (but KBC had invested US$ 94 million) three Presidential decrees ordered Pertamina and PLN not to perform their contractual obligations, as
  - the demand for electricity had slumped; and
  - the devaluation of the rupiah made it impossible to pass on to Indonesian electricity users the agreed US$ price of the electricity

The Claim

- Claimant (KBC) asked for US$ 94 million in *damnum emergens*, plus US$512 as the present value, discounted at 8,5%, of the lost profits associated with the "loss of geothermal development opportunities".

The Award

- The Award granted KBC US$93 million in *damnum emergens* and US$ 150 as lost profits

Karaha Bodas vs Pertamina & NLP: Assesment

- Louis T. Wells: a case of "double dipping":

  "Consider an individual saber whose bank account is covered by deposit insurance. Say the saver's bank fails, and <u>deposit insurance pays both the amount of the deposit and foregone interest for 30 years into the future</u>.

  The large award, parallel to the apparently awarded in the KBC case, leaves the saver better off with bank failure than without, because it can deposit the principal elsewhere and earn interest again, ending up with principle plus twice the interest. Of course, the US Federal Deposit Insurance Corporation does not pay future interest when a bank fails."

- My own view:

  - Mr. Well's analogy is unfair: a bank deposit yields a low short term variable rate, with no potential upside.

    A better comparison: the expropriation of an old 30-year Treasury bond with a high coupon, well in excess of market yields.

  - *Karaha Bodas* seems a case of "adjusted investment costs" (i.e. historical costs + add-on for the "loss of opportunity" for KBC owners of making significant profits over a 30-year period).

    It took into account that decisions by the Indonesian Government could not be considered *force majeure*.

***Rusoro Mining vs Venezuela* (2016)**

Basic Facts

- During 2006-2008, Rusoro, a Russian-owned company listed in the Toronto Stock Exchange, bought 5 gold mines in Venezuela.

- Rusoro's investment (acquisition costs and new investments, net of funding for operating losses) amounted to US$ 774 million.

- Starting in 2009, the Chávez Government introduced measures (e.g. gold export restrictions) which affected adversely foreign mining companies.

- In September 2011, with gold at ts all-time peak of US$1,838/oz., Venezuela nationalized Rusoro's mines.

The Claim

- Rusoro fundamentally asked for US$ 2.23 billion as the FMV of the nationalized investment, calculates as a weighted average of the prices resulting from comparable public traded companies (50%), comparable transactions (30%) and a partial DCF analysis (20%).

The Award

- "The Tribunal must thus calculate the fair market value of an Enterprise which no well-informed purchaser would buy, at a fair price".

- "The effect of the increased export restrictions must be excluded from the valuation of Rusoro's Enterprise –otherwise the State would be deriving advantage from its own wrong"

- The Tribunal valued the company as the weighted average of three concepts

Rusoro Mining vs Venezuela: the Tribunal's methodology

Concept	Explanation	Value (US$ million)	Weight (%)
1. Adjusted Investment Valuation	Historical investment in each company, adjusted for increase in Gold Index Value from purchase date up to September 2011	1,128	50
2. Net book value of investments		908	25
3. Rusoro's Maximum Market Valuation)	The maximum valuation was reached in mid-2008, before Venezuela's Measures	700	25
Result		**966.5**	

Thus, the Tribunal considered the DCF and market approaches (e.g. use of comparable companies) as too speculative and uncertain, and preferred to use instead a very sensible "adjusted sunk investment" methodology.

***Caratube vs Republic of Kazkhastan* (2017) ("Caratube II")**

Basic Facts

- In 2002 Caratube, a company owned by the Palestian, US-based Devincci Hourani and his family, spent US$9 million in a Contract with Kazakhstan's Ministry of Energy and Mineral Resources (MERM) to explore and develop the Caratube fields.

- A 5-year Exploration Period was foreseen (which the Contractor could extend twice for up to 2 years each time), with the Production Period extending for 25 additional years once the Contractor made a "commercial discovery".

- <u>July 2007</u>: a 2-year extension of the Exploration period was agreed and signed.

- <u>May 2007</u>: Mr. Aliyev, son-in-law of President Nazarbayev and brother-in-law of one of the Hourani brothers, was sacked as Kazakstan' Ambassador to Austria and accused of two kidnappings. He had criticized Mr. Nazarbayev's declared intention to change the Constitution and run again for President, and announced his own intention to run for such office.

- According to the Claimants, this was followed by a harassment campaign against all those perceived as assisting Mr. Aliyev, including the Hourani family.

- <u>September</u> 2007: the Prosecutor's Office issued a "Recommendation on elimination of disregard of the rule of law" and invited the MERM to terminate its contract with Caratube. On 1 October 2007, the MEMR sent a "Notice of Termination of Operations".

- During the 2002-2008 period Caratube invested US$ 39.2 million (out of which US$ 20.8 million were out of pocket expenses).

Caratube vs Republic of Kazkhastan (2017) ("Caratube II"): Claim

Claimants requested:

- US$ 941 as the FMV of Caratube at the time of expropriation, calculated using the DCF methodology.
    - Claimants argued that if the Tribunal rejected such claim for absence of the required degree of certainty, then they were entitled to the "loss of opportunity" to obtain profits from the field (which they assess at 99% of FMV!).
    - They rejected compensation based on "sunk costs", as they would not only be contrary to the principle of full reparation, but also to any business rationale in the oil industry where the field had been de-risked and reserves confirmed". "An award of sunk costs would also create an incentive for states to transfer all risks of the exploration stage to the investor".
- US$ 50 million in compensation for the moral damages caused by:
    - The pain, stress, shock, anguish, humiliation and shame that Mr. Devincci Hourani has suffered as a result of Kazakhstan's acts and omissions in relation to his investments, which forced him to leave the country for his own safety and the subsequent harassment and threats to Mr. Devincci Hourani and his family;
    - The harm to Mr. Devincci Hourani and Caratube's reputation;
    - The harassment of Caratube' employees.

Caratube vs Republic of Kazkhastan (2017) ("Caratube II"): Award (by majority)

- The investor was "substantially deprived of the value of its investment", as a result of a "sovereign act" (e.g. the actions and recommendations of the Prosecutor's Office) which amounted to an "unlawful expropriation"

- "Sunk investment costs best express in monetary terms the damages incurred by Caratube as a result of the unlawful expropriation."

  Reasons for rejecting FMV:

  - Caratube was not a going concern with a proven record of profitability
  - It had been in existence and performed the Contract for just over 5 years.
  - Caratube was still in the exploration phase and did not dispose of a long-term contract that guaranteed a certain level of profits. The majority of the investment was yet to be made.
  - The Claimants have not established with a sufficient degree of certainty the oil reserves.
  - Caratube's contractual performance was sub-standard from the early stages of Contract performance.
  - Lack of reliable oil price estimates for a cash-flow projection over a a period of 37 years.

  Reasons for applying the "sunk costs" criterion (i.e. compensation of US $ 39.2 million):

  - "The breach deprived the sunk costs of purpose for the Claimant".
  - Caratube reinvested into the Project all of the revenues generated from trial production, and such investment also is part of Caratube's investment.

- The Tribunal "was troubled by the 'conspicuous timing' of some of the alleged acts of harassment".

  However, "Claimants have not satisfied their burden of proof with respect to the Respondent's [i.e. State's] alleged involvement in any acts of harassment against the Claimants."

III. CONCLUSIONS: PECUNIARY DAMAGES

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<tr><td rowspan="2">Expenditure-Revenue Approach

(Flow approach)</td><td rowspan="2">Supply of defective equipment, which
• Has to be repaired
• Leads to reduced sales</td><td>Increase in costs
(damnum emergens
+</td><td>Only additional costs
(no sunk costs)</td><td rowspan="2">No</td></tr>
<tr><td>Reduction in revenue
(lucrum cessans)</td><td>Only reduction in revenue
(no total flows)</td></tr>
<tr><td rowspan="3">Asset Valuation Approach

(Stock approach)</td><td rowspan="3">• Expropriation
• Illegal termination of contract (e.g. JV between commercial bank and insurance company)</td><td>DCF (and market approaches)</td><td>Sunk costs, irrelevant</td><td>No</td></tr>
<tr><td>Sunk investment costs</td><td>It may underestimate or overestimate FMV</td><td>No</td></tr>
<tr><td>Adjusted investment costs</td><td>Adjustments for…
• Favorable market trends
• Loss of opportunity</td><td>Yes
(e.g. excessive adjustment for loss of oppportunity)</td></tr>
</table>

III. CONCLUSIONS: MORAL DAMAGES

- Compensatory in nature, not punitive
- Additional, in principle, to pecuniary damages
- In practice, very seldom awarded:
  - Companies

    - Loss of reputation should be considered a pecuniary damage

    - If compensation for pecuniary damages has been granted, Tribunals always wary of “double dipping”.
  - Individuals (including company owners and executives)

    Tribunals may require convincing proof of

    - Their relation with the BIT-protected investments
    - Causal direct link with State’s actions.

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