Approaches to assessing damages

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In summary

For lawyers involved in the world of litigation and arbitration, claims for damages of all kinds are a common (if not daily) occurrence. However, as the quantification of such damages falls to experts in the fields of accounting, valuation and economics, many legal practitioners can find it difficult to sense-check points put forward by experts on both sides of the debate.

This article was drafted with exactly this intent in mind: to provide legal practitioners with a straightforward introduction to the main concepts and methods adopted in the assessment of damages.

Damages frameworks

1

In common law jurisdictions the theory and principles underlying damages claims are well established. Although the specific application of whether certain types of claims are allowed may differ in civil law jurisdictions such as China, the underlying principles of assessment set out in this article should still apply.

One of the key documents for this discussion is Fuller and Perdue's classic article, *The Reliance Interest in Contract Damages (1937)* [1], which elucidates 3 key principles of contract damages, namely:

(i) The Expectation principle;

(ii) The Reliance principle; and

(iii) The Restitution principle.

The Expectation principle holds that damages following breach of contract should put the claimant in the economic position in which they would have been, if the respondent had fulfilled its promise.

The Reliance principle holds that damages for the breach should make the claimant as well off as it would have been had the promisor never made its promise at all.

The Restitution principle holds that damages for breach require the respondent to return any benefit conferred on them by the claimant as a result of the promise.

The first of the 3 principles (Expectation) is doctrinally dominant in discourse about damages and is regularly cited in expert witness reports regarding damages, hence it will form the focus of this article.

One important elaboration of this principle was clarified in the Chorzow Factory case (1928), wherein the Permanent Court of International Justice (PCIJ) established the reparation standard for intentionally wrongful acts under customary international law as follows:

"The essential principle contained in the actual notion of an illegal act… is that 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." [2]

Practically for the expert, this typically means assessing the economic position of the claimant under two situations: the actual situation, in which the "illegal act" occurred, and a counterfactual (the "But For") situation in which it did not. Reparation, or damages, would then equal the difference between the two, thereby re-establishing the economic position in the counterfactual situation.

Notes

1) Fuller & Perdue, The Reliance Interest in Contract Damages (Pts. 1 & 2), Yale Law Journal Vol 46 No.3 (Jan 1937)

2) Factory at Chorzow (Germany v. Poland), Merits, 1928 Permanent Court of International Justice

2 Types of damage suffered

There are several types of damage which can be suffered by the claimant, depending on the exact illegal act involved:

Additional costs

This type of damage is commonly encountered in construction disputes where a contractor has incurred additional costs beyond its tender price due to action (or inaction) by the owner, or conversely, rectification / remedial costs if the subcontractor's work has been delayed or substandard.

Lost profits

This is one of the most common types of damage claims encountered in commercial disputes. An example would be where a supplier has failed to supply a key, hard-to-source component of a product leading to a loss of sales and therefore profits.

Loss of use of an asset/investment

One potential example would be where the claimant (a manufacturer) loses the ability to produce and sell its products due to damaging acts by the respondent, such as expropriation of or intentional damage to a manufacturing plant.

Loss of opportunity

This type of damage can often be encountered in claims against professional advisors, where for example incorrect advice or inaction by an advisor leads to the claimant losing out on an opportunity to invest in a redevelopment project.

Reputational harm

An example would be in cases where an action or allegation by the respondent has damaged the image or reputation of the claimant's business, leading to concrete economic loss.

3 Common bases for claiming damages

Two common types of legal dispute where expert assistance is often required to assess the quantum of damages are (i) commercial contract disputes and (ii) investment-treaty disputes under Bilateral Investment Treaties (BIT).

Commercial contract disputes can arise wherever a contracting party has not fulfilled its part of a contract, whether that be in terms of providing certain products or services, or completing agreed work to a certain standard within an agreed duration, etc. Investment treaty disputes, by definition, arise between a state (or State-Owned Entity) and an investor, which can be an individual or a company, often when assets or enterprises operated by said investor are expropriated by the state. The Chorzow factory case referred to in Section 1 could be considered a typical case as it involved a nitrate factory where the factory in question was expropriated by the Polish government from its German owner(s).

Although from a legal standpoint there are many differences between the two types of claim (not least procedural), from an economic valuation perspective the applicable principles are very similar. Hence examples of both types of case will be covered in the sections below.

Except in extremely straightforward cases – possibly where a claimant has been deprived of an asset whose value is standardised – most damages claims will involve some kind of valuation process. These claims can be classified as either direct or indirect losses. Direct losses refer to instances where the claimant has suffered the loss of access to or use of an income-generating enterprise or asset, and therefore would include shareholder disputes, divorce cases and certain types of expropriation claims. Indirect losses, as usually defined in contract law, arise from a special circumstance of the case and are only recoverable if the party knew or should have known of the circumstance of the loss when entering into the contract.

Approaches to valuing losses can broadly be divided into three main categories, namely (i) Income, (ii) Market Multiples, and (iii) Cost-based approaches. In very simplistic terms, the income approach values an asset based on the income it will generate; the market multiples approach values an asset by comparing it to other comparable assets or businesses in the market; and the cost-based approach values an asset based on the current replacement or reproduction cost of an asset, whilst taking into account any deductions required for deterioration or obsolescence of the asset.

Income Approach

The income approach is strongly preferred in valuing losses due to its flexibility and wide applicability. In theory, some form of the income approach can be used for valuing any income-generating asset [3]. This approach converts the expected future economic benefits from the asset – generally, cash flows – into a single, present value. Because this approach bases value on the ability to generate revenue and profits, it would be well-suited to valuing established, profitable businesses, as well as, say, new mining assets where the income streams are well defined. In comparison, it would be more challenging – but not impossible – to reliably apply this method to an early-phase high-tech start-up company as the range of valuations produced would be extremely wide due to uncertainty as to the size and timing of cash flows.

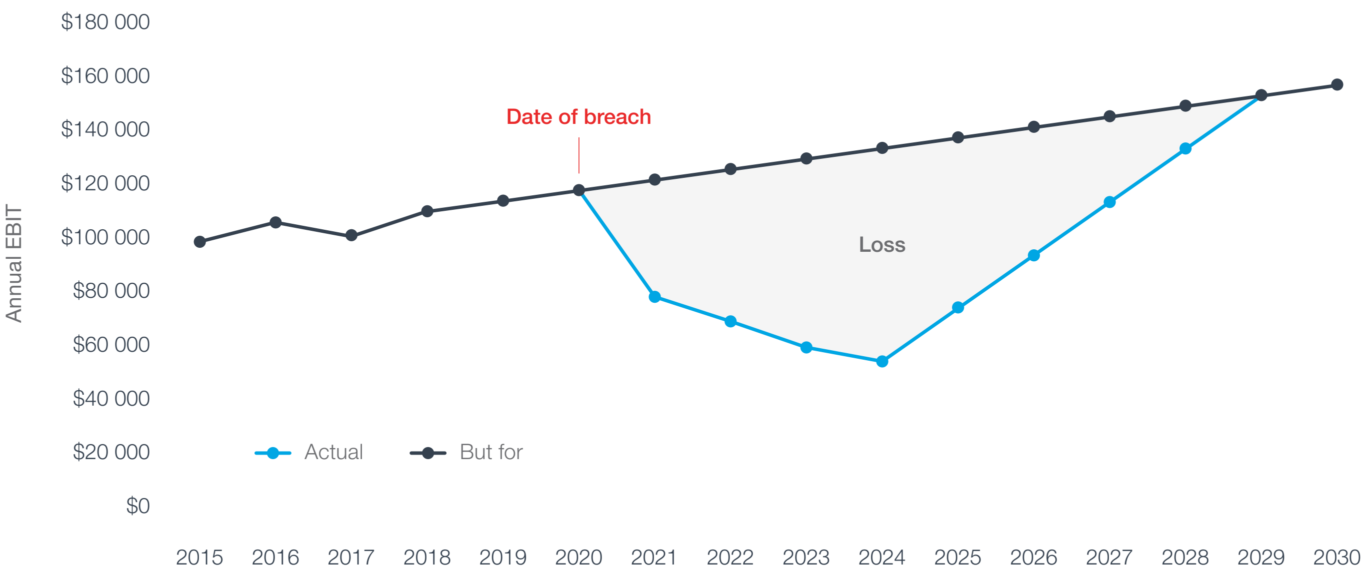
Types of claim in which income approaches could be adopted include:

I. Breach of contract disputes where a management or distribution contract has been terminated. Common situations where these are seen involve long-term hotel management and pharmaceutical distribution contracts;

II. Unfair competition disputes where, for example, a competitor may have diverted business or orders away from the claimant company;

III. Advance Loss of Profit claims where an incident has led to either delayed start-up or interruption of production, such as at a power plant or cement factory.

But For v. Actual



Note

3) As opposed to non-income generating assets (often collectibles) such as fine wine, art, jewellery and gold

In our experience of disputes, the historical actual situation is generally a matter of factual evidence and agreed upon between the parties (although they may not agree on the 'forecast' actual situation). One of the key tasks of the expert is rather to determine what the counterfactual situation would have been (the But For scenario). The loss is effectively the difference between the Actual and But For situations, as shown in the diagram on the previous page.

In all the examples listed above, an expert would need to examine the historical books and records of the company, as well as its internal budgets and business plans, and also take into account any relevant industry research as to future trends, in order to form an opinion as to what a reasonable But For scenario would have been. We discuss establishing a reliable But For scenario further below.

The income approach can also take into account common litigation issues such as offsetting mitigation of losses by the claimant, and/or discounts for minority holdings, etc. Once an income approach is decided upon there are two main methods of arriving at a present value, namely Discounted Cash Flows ("DCF") and capitalised earnings, with DCF being much more common.

One well-known published example of a case where the income approach was adopted is the matter of Suez v. Argentina [4], being an investor-state ICSID dispute arising from Argentina's termination of the concession granted to a consortium of claimants led by Suez S.A. ("Suez") to provide water distribution and waste water treatment services to the city of Buenos Aires. The Suez consortium had been granted a 30-year concession as part of the privatisation of said services in 1993 and had run the concession relatively smoothly for the first 7 years of the concession. Tensions arose between Suez and the Argentine government during the Argentine financial crisis of 2001 – 2003, leading to the eventual termination of the concession by Argentina in 2006. Suez claimed US$1.09 billion in lost management fees, unpaid dividends and losses on equity investments, all of which were assessed using the income approach.

Although the final award by the ICSID tribunal was substantially less than that originally claimed (US$404.5 million), the tribunal agreed with the use of the income approach by the claimants' expert.

Market Multiples Approach

The underlying logic of the market multiples approach is that the value of an asset or business should be similar to the value of another comparable asset or business, for example a business of a similar size in the same industry. An easily understood analogy would be that the price of a 10-year-old Ford sedan should be similar to the price of another Ford sedan of the same model and age.

The market multiples approach is often used in cases involving loss of use, loss of opportunity and reputational harm, as it relies on valuing an asset as a whole, rather than the additional costs or loss of profits arising from a specific action.

This approach is typically used (both in damages contexts and in the investment world) in the valuation of the equity of non-listed companies, for which a share price is not directly attainable but prices for similar, listed companies are. For the market approach to be appropriate, it is crucial that there be a sizeable pool of companies which are similar in terms of product and scale to the subject company and for which there are sufficient observable data points regarding their value. However, the market approach can be used for any assets for which there are sufficient comparators with observable prices.

Applied to the valuation of non-listed companies, the expert (i) identifies recent, arm's length transactions involving comparable public or private businesses, and then (ii) develops pricing multiples which can be applied to the subject company's normalised earnings or other relevant metrics of value. These pricing multiples can be based either on the market price of comparable listed companies on a stock exchange, or alternatively on real-world transactions involving entire comparable companies or operating units which have been sold.

The advantages to the market multiples approach are that it is simple to understand, widely used in the investment industry, is based on objective, observable third-party data and does not rely on internal business plans which can often be over-optimistic or biased.

The most common limitation to the use of this method is the lack of sufficient comparable companies, particularly in the case of high-tech start-up companies where there may be few, if any, other listed companies offering the same product or service.

An example where this approach was applied was in the ICSID arbitration case of Crystallex International Corp. ("Crystallex") v. the Republic of Venezuela, in which Crystallex – a Canadian mining company – launched a claim arising from Venezuela's expropriation of a gold mine being developed by Crystallex in that country. In that case, the tribunal rejected the respondent's cost-based valuation approach, and

Note

4) ICSID award in the matter of Suez et al. v. The Argentine Republic dated 9 April 2015, https://www.italaw.com strongly preferred the approach of the claimant's expert, which was a market multiples approach using the gold reserves of the mine as a metric of value, leading to a damages award of US$1.2 billion in Crystallex's favour.

Cost Approach

The cost approach is based on the assumption that most or all of the value of a company is in its assets. In this method, the expert determines the overall enterprise value by calculating the value (whether that be Book value or Fair Market value) of the company's assets net of its liabilities.

The advantages of this method are that it is simple to understand, is based on the current situation of the company and is arguably less subjective in that it does not involve projecting the future performance of the company. It can be an appropriate method when valuing holding companies, companies in liquidation or asset-intensive businesses where cash-generating operations tend to contribute less of the overall value. An assessment of sunk/additional costs, which are typically based on the claimant's historical financial records, would also fall under the cost approach umbrella.

However, for the majority of companies where cash-generating operations do contribute most of the value, it would not be appropriate. Also it does not directly value intangible assets such as brands or Intellectual Property (IP), and so the expert would have to assess that value separately.

An example of an investment dispute where the cost approach was applied is Asian Agricultural Products ("AAP") v. Sri Lanka. AAP was a Hong Kong-based company which had a minority shareholding in Serendib Sea Foods ("Serendib"), which engaged in prawn farming in the eastern region of Sri Lanka. Serendib's prawn farm sustained severe damage during a major domestic insurrection between a separatist guerrilla group and government forces. Subsequently, AAP alleged that it suffered a total loss of its investment and claimed compensation of US$9 million. In the final award, the tribunal awarded US$460,000, being compensation purely for the tangible assets of the business, as Serendib was loss-making, and had only made two shipments of its single product (prawns) to its target export market (Japan) at the time of the incident.

5 Establishing a reliable but for

One of the most important aspects in arriving at a robust calculation of loss under the income method is establishing a reliable But For scenario.

First, the expert must show that he or she has correctly identified the impact of the breach. Many contemporaneous factors can affect a company's performance in a given year, and failing to correctly identify these other factors can lead to the expert overestimating the loss. For example, imagine a hypothetical dispute where an auto component manufacturer had failed to supply the required components in time to a well-known car manufacturer. However, the breach coincided with depressed demand for cars in multiple countries due to the impact of the Covid-19 virus. In such a case it would clearly be wrong to forecast loss purely based on pre-Covid-19 historical performance as the overall market conditions at the time of the breach were materially different.

Second, the expert needs to demonstrate that rather than unquestioningly accepting the company's projections at face value, he or she has critically examined historical performance and any forecasts of the company to arrive at an opinion.

This process involves not just looking at the company's financial statements, management accounts and internal forecasts, but also external evidence such as broker forecasts and market research reports. These external information sources can be very helpful in highlighting areas where the company has been overly optimistic, and pointing out market-wide trends which may have impacted on the company's performance during the loss period.

It is at this juncture that benchmarking has a large role to play: a company's forecast sales prices for a commodity can be benchmarked against broker projections, or the entire valuation using the DCF approach can be benchmarked against alternative methodologies such as market multiples or a cost-based approach.

6 Conclusion

The above is a general layman's introduction to the main valuation approaches used in assessing damages in litigation cases. The particular valuation method(s) adopted in any given case must be rooted in the type of loss claimed and the facts of the case.

Finally, it should be noted that the methods listed above are not mutually exclusive, and it is common for experts to use a secondary method (e.g. market multiples) as a sense-check for their primary valuation method (often an income approach).

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Jon Nicklin

Director

jon.nicklin@accuracy.com

Accuracy

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