Scrutiny Creeps In On Damages In Investment Arbitration

By Caroline Simson

Law360 (July 12, 2019, 9:17 PM EDT) -- Arbitral tribunals have become more comfortable awarding billions of dollars in damages by estimating lost future profits, leading to increased attention among stakeholders on a practice that can appear inscrutable.

It's become more common for investors to claim in investment arbitration that they're owed huge sums for profits they could have collected had it not been for the acts of a foreign government, particularly when that government is accused of expropriating an investment.

Some awards have raised eyebrows, including one for $6.6 billion in a claim against Nigeria brought by engineering and project management company Process and Industrial Developments Ltd. over a gas-refining plant that had not yet been built.

"The fundamental problem is that it's junk science," said New York University international law professor Robert Howse. "How do we predict how a particular business is going to do in 20 years? Do we take into account climate change? What presumptions do we make about technology and how it will change? When these experts are brought in from each side, they argue about it, but the fact of the matter is that nobody knows."

Economists like Jeff Cohen, managing principal of the economics consulting firm Analysis Group, dispute this characterization, saying that a correctly performed valuation will take into account all the different risks and liabilities in lost profits.

"A good model will presuppose all the ways you could think about profit in the future," Cohen told Law360. "All outcomes are supposed to be built into the model."

But investment arbitration is a dispute resolution regime notorious for its lack of transparency: Awards may only be published if both parties agree, and then usually months after the fact. Moreover, briefs and expert reports in which damages calculations are discussed are often kept under wraps.

That's not something that escapes Cohen, who acknowledged that the lack of transparency in investment arbitration can sometimes mean that experts don't face the same scrutiny they might in a publicly litigated commercial dispute. To understand if an award is fair or whether it's applicable to future matters, he said it's necessary to look at the underlying data and to see how it was modeled.
"Unless you're a participant in that arbitration matter, in most cases you won't have access to this data," he said, adding that transparency can add credibility to an expert's work through a natural peer review process.

Ultimately, however, it's not the economists who award damages — that's left up to the arbitrators, who may or may not be as comfortable sifting through stacks of economic data as they are at sorting out complicated legal concepts.

"The deciders are the arbitrators, and some of them are ... very well-qualified, but there are a certain number of arbitrators who are very good in legal principles ... but when it gets to the numbers, you can see they don't like dealing with them," said Daniel Flores, an economist and managing director of Quadrant Economics who has appeared as an expert economist in more than 50 arbitrations. "They feel uncomfortable, and the result is that decisions are not very well grounded in economic and financial principles."

Among those who practice in investment arbitration, the idea of awarding claimants lost profits is — for the most part — not considered controversial. The World Bank Guidelines on the Treatment of Foreign Investment say that compensation on future lost profits is reasonable for a "going concern," or enterprise, with a proven record of profitability.

And many international investment agreements, including bilateral investment treaties, specify that compensation if an investment is expropriated should be "fair market value," which is generally considered to equal the expected value of future profits, according to Emma Aisbett, a fellow at the School of Regulation and Global Governance at Australian National University.

So it should come as no surprise that investors are likely to include a claim for lost future profits in an arbitration.

"Based on my own experience, I have yet to see an investor not claim lost future profits," said Foley Hoag LLP's Christina L. Beharry, who recently edited a book on damages in investment arbitration. "The question is more whether the tribunal will grant them."

Experts use different ways to try to estimate how much in lost future profits investors are owed, typically combining different methods to "provide some triangulation" of the award, according to Beharry. In one popular method, called the discounted cash flow method, the value of an asset or business is calculated based on projected future cash flows, which are then discounted back to the present-day value.

In calculating the net present value of an asset or business, the discounted cash flow method relies on assumptions relating to potential revenues, expenses, growth rates and risks that may be considered by some tribunals to be too uncertain or speculative, Beharry noted.

Another method is to use so-called comparables, where experts look at a group of successful similar companies or transactions to calculate the value of an expropriated investment.

But there are potential problems with both methods, Beharry says. Experts and counsel may argue about what constitutes the appropriate discount rate when using the discounted cash flow method, a figure that can make a significant impact on the value of a potential award.
On the other hand, the comparables method embeds a survival bias since it doesn’t consider similar businesses that have failed, and the comparable companies or transactions may not be sufficiently comparable to the disputed investment, she said.

Compounding these issues is a problem particular to international arbitration: If the tribunal does make a mistake in determining how much in damages to award, there are very few avenues for an aggrieved party to challenge that determination. In the International Centre for Settlement of Investment Disputes system, for example, awards may only be annulled in very limited circumstances, such as if the tribunal “manifestly” exceeded its powers or if a tribunal member was corrupt.

"In the U.S. court system, if you get a judge giving you an award that doesn’t make any sense, then you can appeal," Flores said. "In U.S. litigation, you have the chance to correct errors or misapplications of economic principles. International arbitration is not such a mature system."

So as the practice of awarding lost future profits has become more commonplace, it has prompted many in the investment arbitration community to take notice and to even begin questioning how the numbers are calculated. Arbitrators themselves have begun taking more time to explain their damages calculations — likely in an attempt to head off potential criticism or the possibility of the award being set aside.

Lawyers and scholars in the field have similarly begun devoting much more ink to the topic.

"I think we’re seeing much more literature on valuation and damages in international investment arbitration," Beharry said. "There are entire conferences dedicated to the topic, and there are even arbitrator trainings being devised at the moment. I think everyone wants there to be a little more rigor in the way we treat damages, because that’s what these cases are about."

"It's incumbent on those of us in the field to educate ourselves about damages because it really goes to the legitimacy of the system," she continued. "If they’re not adequately calculated or supported, the system will continue to face a backlash."

--Editing by Breda Lund and Jill Coffey.