ICC Institute of Advanced Training, Dubai, 6 May 2018: Assessment of damages

*Damnum emergens, lucrum cessans,* and moral damages – How to calculate without double-counting?

Noradèle Radjai
Roadmap

1. The object and purpose of compensatory awards
2. Calculating *damnum emergens* and *lucrum cessans*
3. The problem of double-counting
4. Moral damages
The object and purpose of compensatory awards

*Damnum emergens* and *lucrum cessans* are components of direct damages requiring compensation.

“place the party to whom they are awarded in the same pecuniary position that they would have been if the contract had been performed in the manner provided for by the parties”

*Sapphire International v National Iranian Oil Company*

Principle of *pacta sunt servanda*
Calculating *damnum emergens* and *lucrum cessans*
Factors to be taken into account

1. Fullness of the compensation
2. Certainty of the loss
3. Direct character
4. Foreseeability

*ICC Award Case No. 10346 (2000)*
Broad discretion of tribunal

Under both heads of compensation (especially lucrum cessans), approximations are inevitable

➢ Considerations of fairness and equity often impact on the assessment

“It is well known that any estimate in purely monetary terms of amounts intended to express the value of an asset, of an undertaking, of a contract, or of services rendered, must take equitable principles into account”

*Aminoil v Kuwait* (1982)
Damnum emergens
**Damnum emergens**

Definition: expenses incurred due to the wrongful act – “out of pocket expenses”

- Costs actually incurred or to be incurred
- May include “wasted costs”: e.g. expenses incurred in having to hire alternative production equipment, not putting employees to productive use due to reduced capacity

Assessment usually straight-forward and easy to prove: invoices, receipts etc
Awarding damnum emergens is a “relatively simple operation” and “previous arbitral tribunals … have overwhelmingly favoured the award of lost investment costs”, as opposed to lucrum cessans.

**LETCO v Republic of Liberia (ICSID Case No. ARB/83/2, 1986)**

“Claimants are on solid ground when they ask to be reimbursed monies they have actually spent in reliance on the contract; recovery of lost future profits is less certain … [V]ictims of contractual breaches tend first and foremost to articulate a plea for damnum emergens.”

**Himpurna v PT (Persero) Perusahaan Listruik Negara (UNCITRAL, 1999)**
Polling Question

In the case of sale of equipment that turns out to be defective, which of the following do you think would fall under the category of damnum emergens?

- Replacing equipment
- Repairing equipment
- Hiring alternative equipment

**Answer:** All of the above
Polling Question

In case of a cancelled project, do you think time spent on negotiating, planning and organizing the project would be covered?

Answer – Yes

*SPP (Middle East) Ltd. v Arab Republic of Egypt*
Damnum emergens, lucrum cessans and moral damages

How to calculate without double counting?

ICC Dubai Conference
7 Mai 2018
How to assess Damnum emergens and Lucrum cessans?

**Damnum emergens**

☑️ Usually the easiest of both components to assess, as it corresponds to incremental costs actually incurred or to be incurred.

It includes, among others:

☑️ External costs, easy to measure and support (invoices)

☑️ It may also include work performed by employees of the injured party (more difficult to assess and support):

☑️ How many hours have been spent because of the wrongful act?
- For instance: repairing a defective product, regaining customers, or even designing a replacement machine

☑️ What is the hourly rate to use to value these hours?
- Wages only?
- Wages + a share of the company’s fixed costs?
Lucrum cessans
Lucrum cessans

Definition: profits that were lost or foregone due to the wrongful act

✓ Calculated based on but-for assessment of cash flow as compared to actual cash flows – i.e. what profits would the party have made but for the wrongful conduct and what cash flows exist now due to the wrongful conduct

✓ Difference between actual financial position and the counterfactual situation as defined by the but-for world

✓ Example: in the case of defective equipment, the lucrum cessans would be the lost margin as a result of the diminution or stop in production
Lucrum cessans

Assessment can be highly speculative and is mostly hypothetical in nature

“such a computation made in advance on the basis of purely theoretical date cannot hope to be absolutely accurate but only comparatively likely”

Delagoa Bay and East Africa Railway Co (1900)

BUT not a reason per se to reject awarding such losses

“[i]t is well settled that the fact that damages cannot be settled with certainty is no reason not to award damages when a loss has been incurred”

SPP (Middle East) v. Arab Republic of Egypt (ICSID Case No. ARB/84/3, 1992)
Lucrum cessans – The uncertainty of new businesses
Polling Question

In case of a new business that had so far operated at a loss, do you think lost profits should be awarded?

✓ Yes: see e.g. *Yusuf Ahmed Alghanim & Sons v Toys “R” Us*

✗ No: see e.g. *Metalclad Corp v The United Mexican States and Asian Agricultural Product v Sri Lanka*
Lucrum Cessans – The uncertainty of new businesses

Problem: Lack of sufficient earning history or other basis to predict lost profits

Need to differentiate between uncertainty as to

1. Quantum of lost profit
2. Existence of lost profit
How to assess Damnum emergens and Lucrum cessans?

**Lucrum cessans**
- More difficult to assess as it implies measuring profits that would have been made (“but for” scenario)
- Implies making predictions about earnings…

- The but for scenario may cover a historical and a prospective period

- What is the impact on earnings:
  - Loss in sales volume?
  - Decline in prices?
  - Impact on other indirect products or activities?
  - Change in the market (facilitating penetration of competitor)? **Loss of opportunity**?

- How long has the victim been considered to be deprived of earnings?
How to assess Damnum emergens and Lucrum cessans?

Difficulties in assessing the loss of profits are common in certain income approaches used to assess financial damages.

Some of them are:

- Identify all earnings of which the victim has been deprived.
- Integrate potential market cycles, competitor growth, or.
- Check with third party information (market research, broker reports etc…) that future revenue is consistent with market expectations.
- Etc…

Back to predicting future cash flows!
The problem of double-counting
General repercussions

**The obvious**
- One party pays more than it should
- One party gets more than it is entitled to

**The indirect**
- Creates incentives for inappropriate corporate behaviour

**The government side**
- May discourage “efficient breaches”
- An interference with sovereign right to nationalize an industry
Avoiding double-counting

**General idea:** Once there is an award of *damnum emergens* there must be a corresponding discount before *lucrum cessans* can be awarded.

**Reason:** Any future lost profits (i.e. *lucrum cessans*) naturally includes all the amortisation of the investment.

“when the victim of a breach of contract seeks recovery of sunken costs, confident that it is entitled to its damnum, it may go on to seek lost profits only with the proviso that its computation reduce future net cash flows by allowing a proper measure of amortisation”

*Himpurna v PT (Persero) Perusahaan Listruik Negara* (UNCITRAL, 1999)
Damnum emergens and Lucrum cessans: double counting?

In practice

- Assessing damages through the difference between:
  - Cash flows in the But for scenario
  - Actual cash flows

really helps avoid any double counting.

Example 1

Wrongful act: destruction of the machine

Cash flows (past and future)

New machine expected to start
Damnum emergens and Lucrum cessans: double counting?

Example 1

Investment

<table>
<thead>
<tr>
<th>In mUSD</th>
<th>Cash flows (past and future)</th>
</tr>
</thead>
<tbody>
<tr>
<td>But for cash flows</td>
<td>(100)</td>
</tr>
<tr>
<td>Actual cash flows</td>
<td>(100)</td>
</tr>
</tbody>
</table>

Damages = But for cash flows minus Actual cash flows

Damages (B-A) | - | 30 | 30 | 30 | 30 | 30 |

Sum = 120

Covers both the recovery of investment AND the recovery of the lost future profits!
**Example 1**

Investment Cash flows (past and future)

<table>
<thead>
<tr>
<th>But for cash flows</th>
<th>30</th>
<th>30</th>
<th>30</th>
<th>30</th>
</tr>
</thead>
<tbody>
<tr>
<td>(100)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Actual cash flows</th>
<th>-</th>
<th>-</th>
<th>-</th>
<th>-</th>
</tr>
</thead>
<tbody>
<tr>
<td>(100)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Damages (B-A)</th>
<th>30</th>
<th>30</th>
<th>30</th>
<th>30</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(B-A)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Sum = 120**

Covers both Damnum Emergens and Lucrum Cessans

- **Cost of the investment = 100**
- **Profits had the wrongful act not taken place = 120 – 100 = 20**
Example 1 – Another way of computing damages

Investment

Net accounting profit

But for net result * - 5 5 5 5
Actual net result (100) - - - -

Damages = But for cash flows minus Actual cash flows

100 - 5 5 5 5

Damnum Emergens? Easy to identify

Sum = 120

Lucrum cessans? 4 X 5 = 20

Same result! BUT.....

* Amortization of the machine acquisition cost of 100 over 4 years i.e. amortization of 25 per year => net result = 30 -25 = 5
Damnum emergens and Lucrum cessans: double counting?

Example 1

..... Different after discounting!

1 - Damages computed as difference in cash flows

<table>
<thead>
<tr>
<th>Investment</th>
<th>Before discount</th>
<th>After discount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>28,3</td>
<td>26,7</td>
</tr>
<tr>
<td></td>
<td>25,2</td>
<td>23,8</td>
</tr>
</tbody>
</table>

Value = 104 at a 6% discount rate

2 - Damages computed as difference in net accounting profit

<table>
<thead>
<tr>
<th>Investment</th>
<th>Before discount</th>
<th>After discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>100</td>
<td>4,7</td>
<td>4,4</td>
</tr>
</tbody>
</table>

Value = 117 at a 6% discount rate
Damnum emergens and Lucrum cessans: double counting?

Why?

Example 1

This difference reflects the fact that but-for cash flows include the recovery of the investment over time (25/year over 4 years).

Value = 104 at a 6% discount rate
It takes in account the risk and time value attached to the recovery of the initial investment.

But for the damage, this risk would have still been present.

Investment

Damages computed as difference in cash flows

- 28,3 26,7 25,2 23,8

Value = 117 at a 6% discount rate
It does not take in account the risk and time value attached to the recovery of the initial investment. The net lost profits are solely consider at risk.
Damnum emergens and Lucrum cessans: double counting?

**DCF – The easiest and safest way**

Damage = 104 at a 6% discount rate
It takes in account in one single figure the risk and time value attached to the recovery of the initial investment and the NPV of the lost future profits

Could be presented for simplification purpose only (and despite misleading!):
- Damnum Emergens 100
- Lucrum cessans 4

Only the sum (104) is an accurate measurement of the damage. Is the distinction really necessary?

Make it simple!

**Example 1**

**Discounted Accounting results**

Damage = 117 at a 6% discount rate

Requires a correction:

<table>
<thead>
<tr>
<th>Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 - Depreciation</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>100</td>
</tr>
<tr>
<td>2 - Net present value @ 6%</td>
<td>24</td>
<td>22</td>
<td>21</td>
<td>20</td>
<td>87</td>
</tr>
<tr>
<td>Impact of discount (1-2)</td>
<td>1</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>13</td>
</tr>
</tbody>
</table>

Could be presented as:
- Damnum Emergens 100
- Lucrum cessans 4 = 17 – 13

In any case: wrong computation leads to
- Damnum Emergens 100
- Lucrum cessans 17
Marketer is the victim of defective products made by Manufacturer; Marketer’s business fails as a result.

Marketer’s quantification of damages adds together:

- the out-of-pocket costs of creating the business and
- the total projected profits of the business had there been no defects

Is this assessment of damages correct if the projected profits are computed as “but for” cash flows i.e. cash flows the Marketer would have made without the defects?
Marketer is the victim of defective products made by Manufacturer; Marketer’s business fails as a result.

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**Example 2**

Manufacturer’s loss assessment = difference between the cash flows that the Marketer would have made minus the defects and the cash flows it actually made

- No double counting
Assessment of Damages: damnum emergens, lucrum cessans and moral damages

Case Example of Potential Double-Counting: Karaha Bodas Company v Pertamina (UNCITRAL, 2000)

Background: take-or-pay contract with Indonesian state-owned oil and electricity utility companies – KBC brought arbitration after the Indonesian government had repeatedly suspended the project

Damages sought:

- Damnum emergens: $96 mill
- Lucrum cessans: $512.5 mill

Award:

$111.1 mill for damnum + $150 mill for lucrum cessans
In some cases, assessing lost profits may be equivalent to assessing the lost value of a business.

In some cases, the victim may have purchase offers for its business/activity that was subject to the wrongful act. The business/activity thus lost part of its profits (and therefore its value).

It is highly probable that:

- The business/activity’s business plan prepared internally before the wrongful act, and thus the implied “but for” value will not be equal to the proposed price in purchase offers.
WHY?

And is it really an issue?
Business plan and real purchase offers – any conflicts?

Not necessarily an issue as:

- A business plan reflects what the business expects in the current situation, before any transaction

while...

- ...the price of purchase offers will reflect:
  - The buyer’s view on the business and its underlying market,
  - The prevailing political and regulatory environment at the time of the purchase,
  - Potential synergies (partly) retroceded to the seller,
  - Other arrangements between the buyer and the seller on other activities (partnership, joint venture, distribution agreements etc.),
  - Control premium (or minority discount).
Business plan and real purchase offers – any conflicts?

- An auction of collection watches of famous brand, GoldWatches.
  - Noradèle is an experienced collector of GoldWatches. She already owns all GoldWatches… except for one.
  - Nicolas is a novice in collection watches.
- Both want to buy the same watch at the auction.

Who is going to win the watch?
Business plan and real purchase offers – any conflicts?

• An auction of collection watches of famous brand, GoldWatches.
  • Noradèle wants to buy it because it is the only one missing from her collection.
  • Having a full collection would significantly increase its value.
  • Nicolas only relies on market data (past transactions)

• Noradèle is therefore ready to pay more than the market value of the watch:

• She is ready to give part of the increased value of her collection to get the watch.

Example 3

(Fair) MARKET VALUE ≠ FAIR VALUE (TRANSACTION PRICE)
The same issue as transaction multiples!

Make sure that purchase offers are consistent with the context of the claim and the damages claimed.

- What were the buyer’s intentions for the business?
- Is the buyer a competitor of the business? In which case it would benefit from synergies
- Is the buyer a new entrant?
- Is the business strategic in the buyer’s operations?
- Etc...

Also, keep in mind that fair market value is not one single figure, but most of the time corresponds to a range.
Moral Damages
Moral Damages

Definition: non-pecuniary harm that falls within the category of *damnum emergens*

- Includes:
  - ✓ Pain and suffering
  - ✓ Emotional stress and anguish
  - ✓ Humiliation
  - ✓ Injury to reputation and creditworthiness
  - ✓ Loss of business opportunities

- Well-established in principle, but rarely awarded in practice
  - ✗ Fails mostly due to lack of sufficient evidence or failure to properly plead
Moral Damages: *Desert Line Projects v Yemen* (ICSID Case No. ARB/05/17, 2008)

- **Background:** road construction contract with Yemen – upon coerced settlement, Desert Line brought arbitration

- **Moral damages** sought $104 mill

One clear case where moral damages have been awarded

$1 mill
Moral damages

- A hotel group is building a new hotel in Dubai to replace an ageing one in the same area.
- The construction of the new hotel is being delayed due to defects in the foundations, and the group must continue to operate the old one several years longer than what was planned.
- The feedback from clients on the old hotel are poor, and the group notices a decrease in the occupancy rate of other hotels.
- The group claims for loss of image due to the delay in the construction of the new hotel.
- In this case, the loss of image is estimated as the difference between
  - profits of other hotels but-for the delay in the construction of the new Miami hotel (what would have been their occupancy rate?) **Obviously difficult to assess**!
  - actual profits of other hotels.
Be careful not to double count

A risk is to double count with damages already captured in the loss of profit.

☑ For example, loss of leadership could already be captured in the but for scenario used to compute the loss of profit.

☑ The but for scenario could indeed already imply a leadership position of the claimant, but-for the wrongful act.
• Always back to basics: think in terms of cash flows.

• What would have been perceived vs actuals?

• What does my cash flows take into account and what they don’t (image, other opportunities, consequences on other business, etc...)
THANK YOU
Thank you

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