What About Wasted Costs?

In both breach of contract and investment treaty claims, the injured party often claims for the reimbursement of its costs as an alternative to a lost profits claim. Though seemingly straightforward, at least compared to a lost profits approach, wasted costs analysis raises a number of practical questions, both in terms of principle and implementation.

- Wasted costs can be assessed by analysing financing inflows or operating and investing outflows. Both approaches should yield consistent results and can therefore be used alternatively or in combination.
- It is often not feasible to compile an ideal set of supporting documentation due to limitations of access, time and cost. However, cross-referencing general accounting records with a reasonable number of more detailed documents is an effective way of increasing confidence in the assessment.
- Wasted costs may be claimed as 'expectation damages' or 'reliance damages'. The framework choice, which is a legal question, may have significant implications for quantum and in particular on the effectiveness of the 'bad bargain' defence.
- The framework choice can also have implications in relation to the recoverability of certain costs, such as pre-contractual costs or employee time.

Loss of Profits or Wasted Costs?

Injured parties can claim loss of profits or wasted costs in cases of both breach of contract and investment treaty claims.[1] Often, the injured party will primarily seek to obtain the profits that it would have made had the contract been properly implemented, with recovery of its wasted costs presented as an alternative claim.

Lost profits are typically assessed by comparing the claimant's actual profits, or losses, with those expected 'but-for' the breach. The but-for scenario intrinsically requires conjecture on the future outcome of the contract. Whether this projection is sufficiently reliable or too speculative is a matter for the tribunal to decide based on the facts and information available – including evidence of the nature of the business, its track-record, availability of relevant benchmarks and the existence of contemporaneous forecasts.

The injured party may therefore make an alternative claim for wasted costs, where it claims only for reimbursement of the costs incurred in implementing the contract. Despite sounding straightforward, at least compared to a lost profits approach, wasted costs analysis raises many interesting questions for lawyers and experts.

What are the different ways of assessing wasted costs? What evidence is needed to substantiate the claim? What are the legal frameworks under which wasted costs can be claimed? Do costs need to be reasonable in order to be recoverable? Are pre-contractual costs or internal employee time recoverable?

Assessment and Substantiation of Wasted Costs

Wasted costs can be assessed in two different ways, by analysing financing inflows (the “top-down approach”) or operating and investing outflows (the “bottom-up approach”).

The Top Down Approach: Analysis of Financing Inflows

The top-down approach is applicable when the contract or project was handled by a special purpose vehicle, which is often the case for large international investments subject to arbitration. This approach relies on the basic idea that the cash spent by a dedicated company on a project equates to the financing it received, less any residual cash. Costs wasted can therefore be straightforwardly assessed as the difference between cash injections made by equity sponsors and lenders into the project company and the residual value of assets, such as tangible assets, working capital and cash.

The main benefit of this approach is that it is easier to trace cash injections made by stakeholders than all the individual expenditure. Financing inflows are usually concentrated in a few large payments, whereas operating outflows can cover hundreds or thousands of payments in the case of large or long-term projects. In general, the latest balance sheet shows cumulative cash injections (share capital plus the principal amount of loans) and residual cash, allowing a quick order of magnitude calculation of the amounts at stake.

Where necessary, a deeper analysis can be carried out to adjust for dividend payments, debt write-offs, interest capitalised in the principal amount of loans, and to exclude the non-cash impact of foreign exchange rates.

The downside is that the approach does not show how the cash was spent – whether through the purchase of assets or running costs for example. This raises two questions:

— Does all of the expenditure relate to the contract or project that is the subject of the dispute?

— Are the costs incurred reasonable?

The Bottom-Up Approach: Analysis of Expenditure

The bottom-up approach consists of summing all the individual outflows in relation to the contract or project. This approach is appropriate when the project is not located in a special purpose vehicle, meaning that project expenditure is mixed with unrelated costs.

The main benefit is that the approach details all expenditure, including asset purchases, salaries and rents and can also serve as a cross-check of the top-down approach and vice versa as, in theory, the two approaches should yield consistent results to corroborate one another.

However, in most cases practical limitations will prevent this sort of detailed analysis. It is often practically impossible, or too costly, to trace every single expense when dealing with thousands of individual expenses over a potentially long period of time – the expert must define a relevant level of granularity to be able to perform an analysis that is both practical and useful to the tribunal.

Supporting Documentation

In the top-down approach the question of supporting documentation is relatively simple, as the only requirement is that the documentation reliably establishes that cash has been transferred from the financing entity to the entity performing the contract or project.

In the bottom-up approach the purpose of supporting documentation is to establish a causal link between cost and contract or project and to prove that the cost has been paid. In a perfect world, a causal link would be demonstrated by a purchase order and/or an invoice, with proof of payment demonstrated by bank statements.

In practice, it is often not feasible to compile an ideal set of evidence for all expenditure, which would amount to redoing the company's accounting for the entire duration of the project – the set of transactions may be too large or the original records may have been lost or may be difficult to access. The compilation of this full documentation is often limited to the most significant expenditure items such as the acquisition of large assets or to a sample of cost items. Experts can also rely on annual reports, in particular when they have been verified and certified by external auditors.

The financial statements, and in particular the statement of cash flows, together with the accompanying notes often provide a fairly detailed view of expenditure – covering capital expenditure, salaries, admin costs, financing costs and taxes. The combined analysis of the profit and loss statement and the balance sheet identifies the costs accrued and whether they have been paid or remain as accounts payable.

If necessary, any analysis of the financial statements can be refined or supplemented with additional accounting records such as payable subledgers or management accounts, which would ideally reconcile with the general ledger. Depending on the circumstances, bank statements can also be used to buttress the other evidence presented on expenditure.

Economics Underlying Wasted Costs Claims and Their Implications

Wasted costs can be claimed under two legal frameworks: 'expectation damages' or 'reliance damages'. The framework choice, which is a legal question, can have implications for quantum and analysis.

Economics of Wasted Costs as Expectation Damages Versus Reliance Damages

The generally recognised standard of compensation in investor-state arbitrations is the full compensation principle, which aims to put the claimant in the position it would have been but-for the breach of the relevant treaty or contract.[2] In line with this overarching principle, damages are typically assessed by comparing the injured party's actual position with the position that would have occurred if the breach had not occurred – the so called 'but-for scenario'.

How does the but-for scenario vary depending on whether the claimant is seeking expectation damages or reliance damages? Expectation damages examines a scenario where the contract is executed, or the treaty not breached. In contrast, reliance damages examines a scenario where there was no contract, or no investment made.

Wasted costs can be claimed under either framework. However, although the quantum may be similar in each case, the underlying economics differ.

Under the expectation framework, wasted costs are used a priori as a proxy for the profits that would have been made, when future profits cannot be assessed with enough certainty. The implicit assumption in this approach is that a rational investor who invested €100 would reasonably expect to recover profits having a net present value of at least €100 as at the date of the investment. From an economic perspective this does not mean that the project would have generated no return at all. Rather, it means that the project would have yielded an expected rate of return (IRR) that is equivalent to its weighted average cost of capital ("WACC").

As an illustration, consider a company having a cost of capital of 10%, which invested €100 in a one-year contract that was wrongfully terminated. Wasted costs would be assessed at €100 as at the date the investment was made. This implicitly assumes that the contract would have generated a profit of €110 in year one, the present value of which is €100 once discounted using the 10% cost of capital. Therefore, a wasted costs claim implies that the project's expected net return is €10, or 10%, not zero.

Put differently, at the date the initial investment was made the discounted lost profits could be:

- Equal to the investment if the project generates a return (IRR) which perfectly compensates for the risk taken (WACC).
- More than the investment if the project generates a return (IRR) which overcompensates for the risk taken (WACC).
- Less than the investment if the project generates a return (IRR) which undercompensates for the risk taken (WACC).

In practice, it is rarely – if ever – the case that the date of loss assessment is the same as the date of the original investment. Nonetheless, the point remains that an award of wasted costs cannot simply be construed as meaning no return was expected to be made on that investment.

Under the reliance framework, wasted costs have a literal meaning. They correspond to the costs incurred to implement the contract or project. The award of wasted costs aims to put the injured party back to the position where there was no contract or investment. In such a claim there is no relationship with future profits, as the but-for scenario considered is one in which the contract or investment was never made.

The Bad Bargain Defence

When calculating wasted costs under the expectation framework there is an assumption that the performance of the contract, or adherence to the treaty, would have generated profits and yielded a return equal to (at least) the cost of capital – but is that assumption correct? Perhaps the investor would have recouped less than its initial investment. As a result, respondents can sometimes raise the 'bad bargain' defence, arguing that litigation or arbitration should not be an insurance against bad investments.[3]

However, this defence is not effective if wasted costs are claimed as reliance damages, as there is no relationship to future profits or losses. If the purpose of damages is to put the claimant back in the position they would have been in if the contract had never been entered into, then all costs are claimable, notwithstanding the bargain of the contract.

Reasonableness

One question that can sometimes consume a significant amount of expert attention concerns whether or not costs engaged by the claimant are reasonable. Whilst this is a matter of judgment which will depend on the specific characteristics of a case, the practical implications of this question may vary depending on whether the claim is made for expectation or reliance damages.

An investor seeking to recover its costs under the expectation framework is implicitly assuming that in the but-for scenario it would have made profits consistent with the amount invested. If costs are deemed unreasonable, in order for them to be recoverable, profits must have been sufficient to more than cover those unreasonable costs. This may be harder for a claimant and their experts to substantiate.

For claims made under the reliance framework, the purpose of damages is to put the claimant back in the position they would have been in without the contract or investment. Therefore, the question of the reasonableness of costs may be less relevant, because irrespective of their reasonableness the costs would not have been incurred in the but-for scenario.

However, even when claiming under a reliance framework, there are situations in which it could be argued that costs deemed to be unreasonable may be judged to be unrecoverable. For example, because of a breakdown in causation where there is not sufficient relation between the respondent's conduct and the claimant's injury, or alternatively failure to mitigate where the injured party contributed to its loss by spending money excessively.

Recoverability

Pre-Contractual Costs

In the context of contractual relationships, significant costs often arise prior to the signing of a contract, either during negotiation or preparation for performance of the contract. Are such costs claimable? Again, the answer may depend on the damages framework employed.

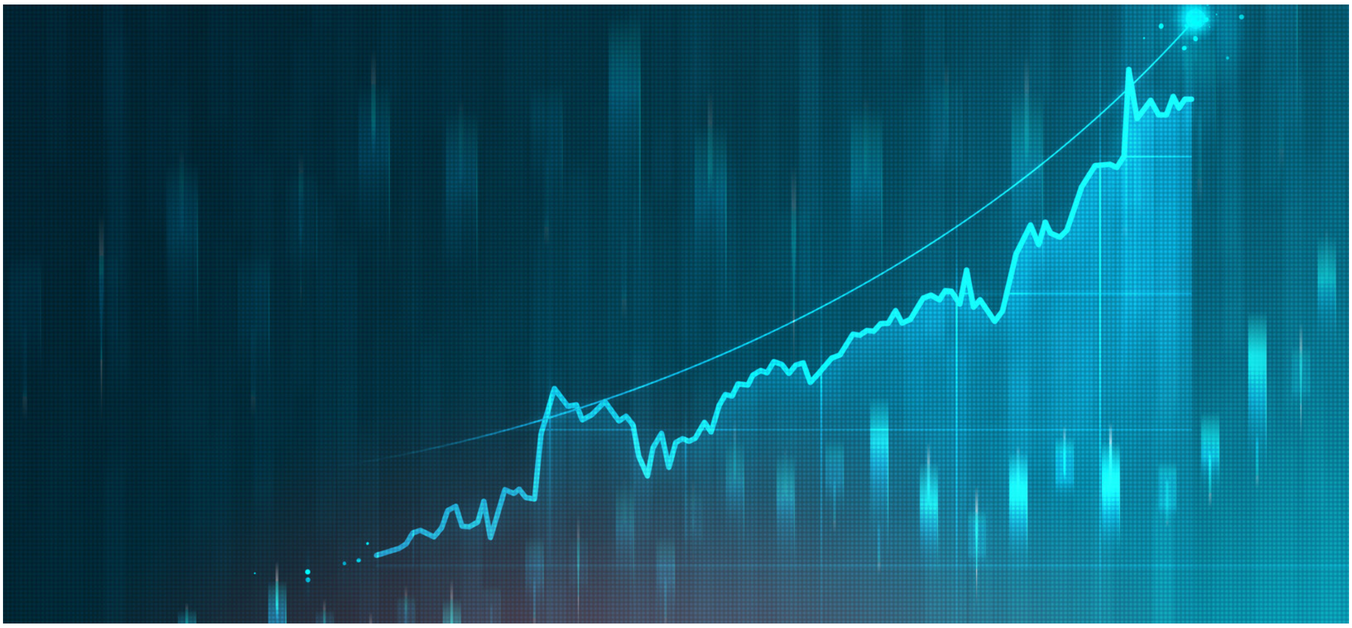
For claims made under the expectation framework, the applicable but-for scenario is one in which the contract is performed. An injured party would have expected to recover at least all of its costs, including its pre-contractual costs, in performing the contract, which would suggest these costs are claimable.

For claims made under the reliance framework, the applicable but-for scenario is one in which the contract had not been signed. As a result, any pre-contract costs would therefore still have been incurred in the but-for scenario, meaning they are typically not claimable.

Internal Employee Time

Internal employees can spend significant time on a project. Can the cost of this time be included in a wasted costs claim?

Salaries are fixed costs for the company. Thus, the time spent managing the failed project does not entail any marginal cost, in the absence of overtime or the hiring of additional employees. Absent extra-cash outflow, it is sometimes argued that these costs are not recoverable because the costs would have been incurred by the injured party even absent of the existence of a breach (in the but-for scenario). For example, the tribunal in *Pope & Talbot v Canada* found that management time was not



recoverable as management's salaries were a fixed cost, payment of which did not depend on which work-related activities were performed by the employees.[4]

It is interesting to consider whether the tribunal would have reached a different conclusion if the work had been outsourced to contractors. Further, it can be argued that, in the but-for scenario, the time spent in vain by employees on the project could have been used for other tasks which would have created value for their company. The claim would therefore be for the profits expected from these other tasks, which could be proxied to at least equate to the salaries paid by the employer.

This approach has been applied in English commercial law in the case of Pegler v Wang, where the court awarded damages for lost management time, noting that *"when the time of a director or manager is taken up with remedial measures, that person is diverted from his proper job of managing the company."*[5]

The French Cour de cassation has expressed a similar view in various decisions. Citing the principle of full compensation, the court noted that *"the mobilization of employees to repair damage caused to the company by a third party constitutes a compensable loss."*[6]

If the costs are claimed under the expectation framework, one might alternatively argue that the company expected that the completion of the project would enable it to recover not only its direct costs but also its indirect costs as a result of the expected profits. Whilst companies incur both direct and indirect costs, in order for a company to continue trading, its activities must necessarily generate enough revenue to contribute to the full recovery of direct and indirect costs alike – including salaries.

Beyond the question of principle, the possibility of substantiating a claim also depends on the documentary evidence available to verify the time spent by employees – this can prove complicated if the claimant has not set up a system for tracking employee time.

Final thoughts

Wasted costs claims can be substantiated using either the top-down approach, by taking the difference between the investments made in a project or contract vehicle from the residual value, or the bottom-up approach, by summing all the individual outflows in relation to the project or contract. Each approach has its pros and cons, but should lead to consistent results.

Which framework is chosen can have implications, as the two have different underlying economic principles. When wasted costs are claimed under the expectation framework, the relevant but-for scenario assumes that the project or contract was performed, meaning the wasted costs represent a proxy for lost profits. When wasted costs are claimed under the reliance framework, the relevant but-for scenario assumes that the project or contract never took place, and wasted costs correspond to the costs incurred in vain to implement the contract or project.

The distinction between expectation damages and reliance damages ultimately informs the consideration of other practical questions. Whether costs need to be reasonable may be less relevant under the reliance framework but may be debated under the expectation framework. Pre-contractual costs are typically claimable under the expectation framework, but not the reliance framework. The question of whether internal employee time is recoverable remains the subject of debate.

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Endnotes

1 Throughout this article, we refer without distinction to breach of contract or of investment treaty.

2 “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. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear.” - Factory at Chorzów (Merits), PCIJ Series A. No 17

3 Recent cases before the High Court of England and Wales have confirmed the Court’s approach to uphold the bargain intended by the terms of a contract, including Mott MacDonald Ltd v Trant Engineering Ltd [2021] EWHC 754 (TCC).

4 https://www.italaw.com/sites/default/files/case-documents/ita0686.pdf

5 https://www.casemine.com/judgement/uk/5a8ff76060d03e7f57eabe13

6 Case 3e civ., 10 mars 2016, n° 15-10.897. Original French: “…alors que la mobilisation de salariés pour la réparation de dommages causés à l’entreprise par un tiers constitue un préjudice indemnisable.”