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The Guide to Damages in International Arbitration

Editor
John A Trenor

Fourth Edition

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Part III

Approaches and Methods for the Assessment
and Quantification of Damages

10

Assessing Damages for Breach of Contract

Karthik Balisagar and Tim Battrick¹

Introduction

Contracting parties usually expect to obtain an economic benefit from the contracts that they enter. Where those contracts are breached, the remedy claimed often (but not always)² takes the form of compensatory damages. One common measure of compensatory damages is ‘expectation damages’, which aim to put the claimant, so far as money can do it, back in the position in which it would have been had the contract been performed.³

Expectation damages can be calculated by comparing:

- the financial position which the claimant would have been in absent any breach (i.e., if the respondent had performed the contract) (the ‘but-for position’); and
- the financial position in which the claimant is actually in given the effects of the breach (the ‘actual position’).

Financial experts often carry out a significant amount of work to construct these two sets of circumstances. Before an expert performs this work, certain steps must be taken in coordination with the legal team to identify the analysis to be performed.

1 Karthik Balisagar and Tim Battrick are managing directors at FTI Consulting. The authors thank Marco Shek, a senior director at FTI Consulting, for his assistance in the preparation of this chapter.

2 Other remedies include specific performance and non-compensatory damages such as restitutionary damages, nominal damages, exemplary damages and liquidated damages.

3 Under English law, this principle is set out in *Robinson v Harman*: ‘The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed’. *Robinson v Harman* (1848) 1 Exch. 850 (154 E.R. 363) at 855.

In this chapter, we discuss some common issues that financial experts, lawyers and tribunals may need to consider when assessing compensatory damages:

- the importance of establishing causation in assessing damages;
- the limit to damages based on the foreseeability principle;
- the date of assessment and use of hindsight;
- the period over which the loss should be assessed and the relevance of mitigation;
- the implementation of the loss calculation;
- dealing with uncertainty in financial information; and
- one alternative measure of loss: reliance damages.

We refer to our own experience in disputes and to publicly available decisions in litigation and arbitration cases to illustrate these issues. Given the confidential nature of arbitration awards, many of our examples are drawn from litigation, in particular English litigation. In our practical experience, as financial experts who are not lawyers, different legal systems or jurisdictions can have much in common when it comes to measuring compensation, despite using different terminology. That said, the devil can be in the detail of the differences that do exist, and different approaches in law pertaining to, for example, the effects of uncertainty or the burden or standard of proof, can have significant effects in some cases on possible outcomes for claimants and respondents. It is vital that financial and other experts involved in claims for compensation for breach of contract seek, and obtain, appropriate instruction on factors that depend on questions of law. It may also be important to understand any effects of terms in the contract relevant to the assessment of damages, such as limitations on damages.

To illustrate our discussion, we sometimes refer to the following hypothetical example. An investor engages a construction company to build a hotel. The hotel is not built to the agreed specification and, when open and operated, is significantly less profitable than the investor had expected it to be. The investor claims the construction company breached its contract. When quantifying the investor's loss, the financial experts and lawyers will have to ask the following questions:

- Did the contractor's failure to stick to the agreed specification cause the investor to suffer any losses at all?
- Were profits lower than expected due (solely) to the actions of the construction company or due to other factors, such as an overly ambitious forecast or an unexpected decline in tourism in the region?
- Did the claimant take any responsive measures to reduce its loss, such as remedial works or a change in pricing strategy?
- Is the contractor liable for the loss of profits resulting from the hotel being denied a specific business opportunity that the contractor was unaware of?

Causation

In our hotel example, the breach of contract might be easily observable and proven, but the investor will still need to demonstrate a causal link between the breach and the losses it has suffered. If the defect resulted in poor ventilation, this may result in poor reviews and fewer guests; however, if the defect meant that the aesthetics of the building were changed in an unnoticeable manner, the breach may not have resulted in any loss. Establishing causation

is an important step in assessing damages in many breach of contract claims. The relevant standard of causation depends on the applicable law. Businesses operate in complex environments and their financial performance is affected by multiple factors, so isolating the effect of the alleged breach will not always be straightforward.

One example of a case where the court found that a breach did not result in any loss to the claimant is *Marathon Asset Management LLP v Seddon*. Two former employees of the claimant had breached their contractual duties by taking confidential information, but the court awarded only nominal damages of £2 because the employees' actions had not caused their former employer any financial loss.⁴

If the relevant causation is not proven to the requisite standard, then any quantification of damages may be irrelevant to the outcome of the dispute. Extreme instances of this are akin to the proverbial loss of a battle 'for want of a nail'. In these cases, the loss claimed may be too remote to be recoverable.

Foreseeability

The law in many jurisdictions limits damages for breach of contract to losses that could be reasonably foreseen. This principle of foreseeability may be relevant when damages flowing from the breach are associated with very specific circumstances of the parties. To return to our hotel example, suppose the hotel lost the opportunity to host an unusually profitable fashion show (that was not contemplated by either the investor or the contractor when the contract was made) as a result of its exhibition halls not being built to the specified dimension. Is the construction company liable for such a loss of opportunity?

Depending on the applicable law, different tests of foreseeability may apply to determine whether such loss of opportunity is recoverable. Financial experts should understand from their instructing counsel whether particular circumstances of the claimant should be considered when assessing damages. In the example above, whether the loss of opportunity should be considered may depend on whether the respondent had knowledge of such opportunities (or could reasonably foresee such losses arising from the breach).

Date of assessment and the use of hindsight

The correct date of assessment is a legal issue that may depend on the facts of the case. In our experience, the appropriate date of assessment is one of the first and most important issues that financial experts should discuss with their instructing counsel when constructing the actual and but-for positions. The date of assessment determines the information that should have been known and reasonably knowable by the parties with respect to both the subject company (such as financial forecasts based on contemporaneous business information) and wider market conditions (such as expectations of future commodity prices, interest rates, etc.)

The date of assessment can have a significant impact on the amount of damages assessed. Various legal considerations affect this decision. For example, in investment treaty disputes, differences between lawful or unlawful expropriation of assets may be an important legal consideration when considering the appropriate date of assessment. Consider *Yukos v*

⁴ *Marathon Asset Management LLP & Anor v Seddon & Ors* [2017] EWHC 300.

Russia. In this case, the tribunal found that the appropriate date of assessment should either be the date of expropriation (December 2004) or the date of the award (which it deemed to be 30 June 2014) and that the claimant should be entitled to the higher of the valuations at the two dates. The choice of the date of assessment was found to affect the amount of damages by a factor of three.⁵

In breach of contract claims, a general starting point is that damages are assessed as at the date of breach.⁶ However, this is not a strict rule, and courts and tribunals have taken into account subsequent events when they deem it appropriate to do so. In the case of *Golden Victory*, the date of assessment was a key matter because a war broke out after the repudiation of the contract. The court took this subsequent information into account as it found it ‘necessary or just to do so in order to give effect to the compensatory principle’.⁷

In some cases, it may be difficult to identify a single date of breach. In our hotel example, construction may have taken place over multiple years and it is possible that a series of breaches took place on multiple dates. In other situations, it may be difficult to assess losses reliably given the information set available to the parties at the date of the breach and the great uncertainty at the time of the breach of its effects.

Losses up to the date of assessment are considered past losses, and any losses beyond that date are considered ‘future losses’. A discounted cash flow (DCF) approach is often applied to calculate the present value of future losses using an appropriate discount rate. Further, pre-award interest may be applied to past losses and losses assessed on a past date, up to the date of award. The following diagrams illustrate the different mechanics of discounting and interest calculations when assessing lost profits at two different dates of assessment, with the simplistic assumption that no external factors materially affected the actual and but-for positions between the two dates. However, in reality, the relevant information sets available on these two dates may differ significantly, for example due to significant movements in commodity prices or a global pandemic. These are all reasons why the appropriate date of assessment is one of the first and most important issues that financial experts should discuss with their instructing counsel when constructing the actual and but-for positions.

5 Based on the tribunal’s calculation, damages assessed at 19 December 2004 were US\$21.988 billion, whereas damages assessed at 30 June 2014 were US\$66.694 billion. *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, PCA Case No. AA 227, Final Award dated 18 July 2014, at 1763 to 1769 and 1819 to 1826.

6 *Miliangos v. George Frank (Textiles) Ltd* [1976] AC 443.

7 *Golden Strait Corporation v. Nippon Yusen Kubishika Kaisha* [2007] UKHL 12 at 13.

Figure 1: Illustrative diagram using date of breach as date of assessment

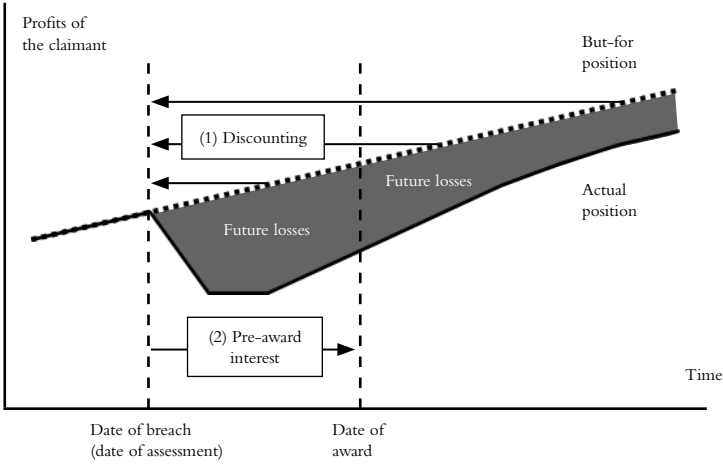
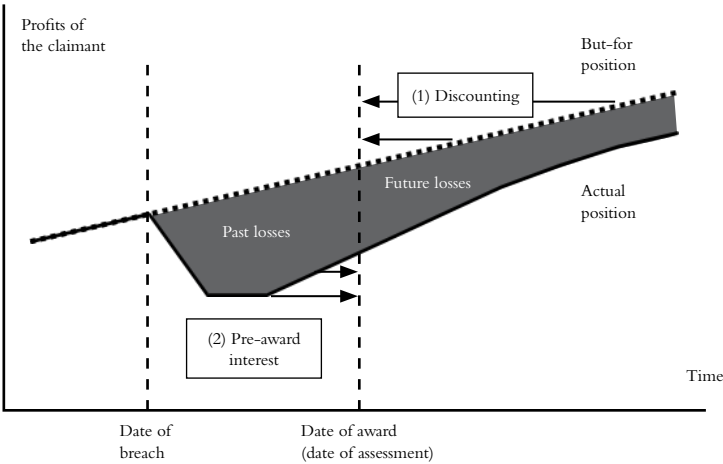


Figure 2: Illustrative diagram using current date (date of award) as date of assessment



Period of loss and mitigation

Depending on the effects of the breach, the period of loss may be disputed by the parties. Take an example where a licensee of a luxury retail brand breaches the terms of the licensing agreement by selling goods below an agreed sales price. The experts have been asked to assess the loss that the claimant (the licensor) suffered as a result of the respondent's actions, which tarnished the claimant's reputation as a luxury brand. A key question will be the period of loss, which may depend on the time needed for the claimant to 'rebuild' its brand.

In many cases, the injured party will not be compensated for losses that it could have avoided by taking reasonable steps in mitigation. It is sometimes reasonable to assume that, after a certain period, the performance of the injured party will recover to what it would have been in the absence of any breach, as a result of the mitigating actions. In our hotel

example, the hotel may be able to generate the same profits as if it had been constructed to different specifications as soon as appropriate remedial works have been completed. Alternatively, the effect of the breach will persist indefinitely.

As an aside, the remedial costs required (or spent) to cure the breach may sometimes be relevant in assessing the losses suffered by the claimant. Taking our hotel example, if the only effect of the breach was to cause remedial costs of US\$1 million to be incurred to reconstruct the hotel to the contracted specification, then this sum may reflect the amount of the claimant's loss. Whether this is an appropriate measure of damages will depend on the facts and appropriate law. In *Ruxley Electronics & Construction Ltd v. Forsyth*, Forsyth claimed costs to rebuild a swimming pool that was shallower than specified. The House of Lords found that, as the pool was safe to dive into, the cost of cure was not proportionate to the loss in value. It awarded a small sum of damages to cover the claimant's reduction in amenity.⁸ The law may take a different approach to this situation in different jurisdictions.

In rare instances, the act of mitigation may eliminate entirely any loss suffered. In *British Westinghouse Electric and Manufacturing Co Ltd v. Underground Electric Rlys Co of London Ltd*, the claimant purchased steam turbines from the defendant, which were found to be defective, and sought damages to recover the cost of substitute turbines. The House of Lords held that the savings from the more effective substitutes that the claimant bought exceeded their costs, so the claimant recovered nothing under this head.⁹

Implementing the loss calculation

When performing a loss assessment, it is not necessary to consider explicitly all aspects of the actual and but-for positions. Where aspects of the claimant's financial position are identical in these two positions, these aspects will cancel out when the actual and but-for scenarios are compared. As an example, if the hotel owner in our example also has hotels in other countries whose performance has not been affected by the events surrounding the one hotel in question, then these properties need not be considered explicitly in any loss calculation.

If the breach has an isolated effect on a single aspect of the business's performance, then the loss can be calculated by examining this incremental effect of the breach on the business's performance. Where the breach has a more extensive effect on different aspects of the claimant's business, it may be preferable to calculate the actual and but-for positions explicitly and only then to calculate the loss as the difference between the two. This ensures clarity on the expert's view on the effect of the breach on the claimant's individual revenue and cost streams, which could be affected by the breach to different extents and in differing ways across time. By way of example, the authors have seen claims that identify the revenues that the claimant has lost as a result of the breach but which are silent on the effect (if any) of the breach on the claimant's costs. Such calculations will often result in an incorrect estimate of the loss amount.

⁸ *Ruxley Electronics & Construction Ltd v. Forsyth* [1996] AC 344.

⁹ *British Westinghouse Electric and Manufacturing Co Ltd v. Underground Electric Railways Co of London Ltd* [1912] AC 673.

Dealing with uncertainty in financial information

There is necessarily a degree of uncertainty in estimating the but-for position because it represents a hypothetical situation. There is often also uncertainty associated with the future element of the actual position.

One factor affecting the reliability of a loss assessment is the amount of relevant information available. The authors have advised on cases where the information available has been limited by factors that one of the parties has argued have been outside of its control. These include the loss of documents due to war, water damage, fire and the passage of time. The parties in these cases disagreed on whether the weight to be placed on the quantum analysis was affected by the availability of the information.

To assist them in developing financial projections, financial experts may seek to understand the markets in which the relevant business operates (sometimes with the aid of an industry expert), to review contemporaneous indications of expectations, and to apply cross-checks to their assumptions and conclusions. Financial experts often make use of business plans and forecasts made by the parties as starting points when assessing financial performance in the but-for position. The parties may disagree, however, on whether a given forecast presents a balanced view of the prospects of the business. This is particularly likely to be the case where the forecast anticipates a marked change in the business's historical performance, or where the forecast performance relies on factors outside of the control of the parties.

To reflect the uncertainty in their assessment, experts may present multiple scenarios for the but-for position or conclude on a range of loss figures. As we explain below, parties and tribunals sometimes consider the assessment of reliance damages when it is not possible to present a well-supported assessment of expectation damages due to the uncertainties involved.

Reliance damages (wasted costs)

Reliance damages are another form of compensatory relief. Reliance damages are assessed based on the costs wasted by the claimant in reliance on the contract. In effect, reliance damages return the claimant to the position it would have been in had the contract never been made.

Due to the difference in the premise of the but-for position, reliance damages are a strict alternative to expectation damages. Parties should be mindful not to 'double count' wasted costs in claims for expectation damages. As put by the tribunal in *Himpurna v. Indonesia*, 'To ask for the full amount of the future revenue stream [expectation damages] when also claiming recoupment of all investments [reliance damages] is wanting to have your cake and eat it too'.¹⁰

If claimants cannot present a well-supported assessment of their expectation losses (for instance because the business has little track record or an unproven business model) they may claim as an alternative for reliance damages.¹¹ In many circumstances, the expected

¹⁰ *Himpurna California Energy Ltd v. PT (Persero) Perusahaan Listrik Negara*, Final Award, dated 4 May 1999, at 242.

¹¹ *Metalclad Corporation v. The United Mexican States*, ICSID Case No. ARB(AF)/97/1, Award dated 30 August 2000, at 119 to 122.

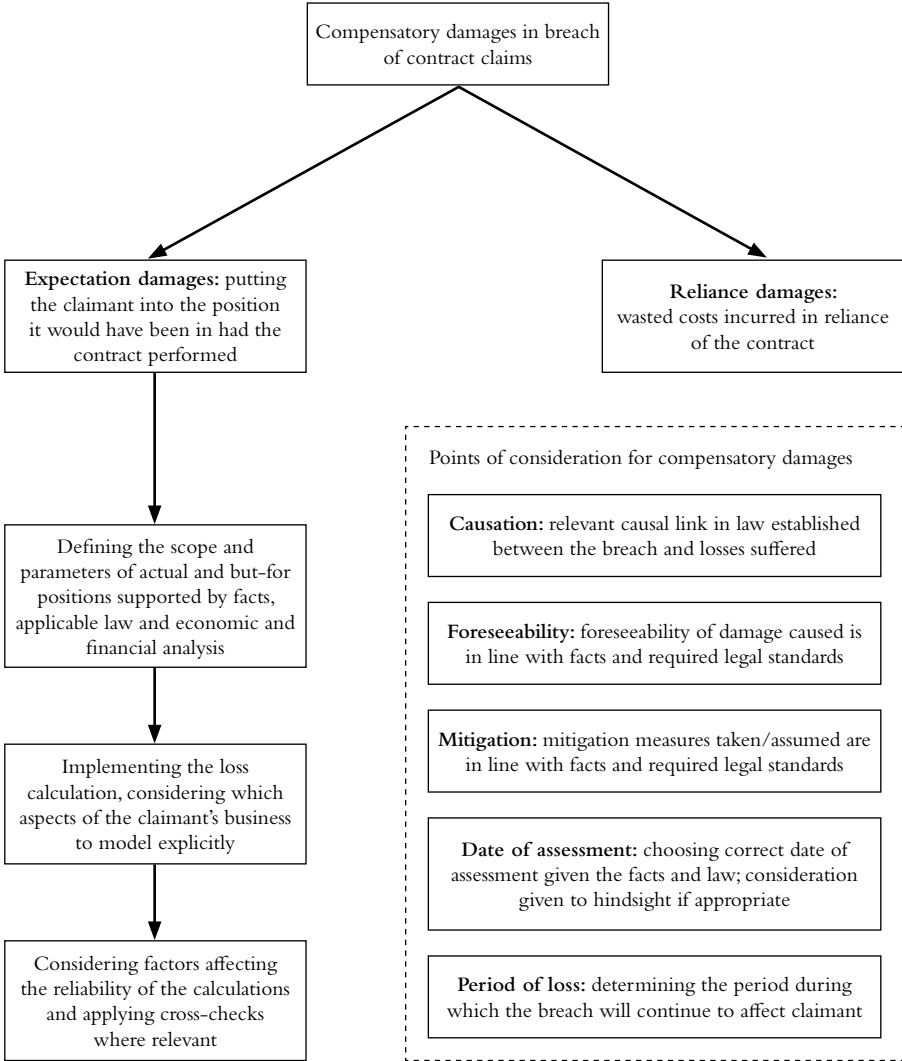
benefit to the claimant of performing the contract will be at least as great as the costs incurred in reliance on the contract. This is because a claimant will not typically have entered a contract unless it expected to profit from doing so. Where that is no longer the case by the time of the breach, the claimant may be prohibited (as a matter of law) from making a claim for wasted costs.

In cases where a claimant seeks reliance damages, key questions for the expert and legal team can include the following:

- Is it possible to isolate those costs incurred in reliance on the contract rather than relating to other activities?
- What accounting evidence is required to confirm that a cost has been incurred? Is it sufficient to reconcile costs to an accounting system or is it necessary to trace costs back to bank statements and cash outgoings?
- Were the costs incurred excessive?
- Is there any evidence to suggest that the claimant would not have (at least) recovered all of its costs if the contract was performed?
- Has the claimant received any benefit as a result of its expenditure? As an example, the costs claimed may include the cost of acquiring an asset which could be sold. Should credit be given for this benefit?

Conclusions

Every case will have specific circumstances and the issues for the expert and legal team to address will be informed by the facts and the relevant law. In this chapter, we have covered a series of questions that legal teams may need to consider with their experts when quantifying the damages in a breach of contract case. We offer a flowchart below that may provide a starting point (but not an exhaustive list) when quantifying a claim for damages:



The views expressed in this article are those of the author(s) and not necessarily the views of FTI Consulting, its management, its subsidiaries, its affiliates, or its other professionals.

Appendix 1

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Karthik Balisagar is a managing director at FTI Consulting. He has 15 years' experience in valuation and transaction consulting. He specialises in valuation issues in the context of international arbitration and litigation. During the past decade, Karthik has advised banks, private equity firms, institutional investors and corporates in both contentious and non-contentious valuation matters. He is a member of the International Valuation Standards Council Europe Board, where he assists in setting and harmonising international valuation standards across jurisdictions.

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