PERSPECTIVES

VALUATION ISSUES WHEN QUANTIFYING ECONOMIC DAMAGES FOR INTERNATIONAL ARBITRATION PROCEEDINGS

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

Introduction

Economic damages are seen as the Holy Grail of any international arbitration. The amount of compensation for financial losses is the ultimate goal of the Claimant, who seeks to be compensated for the damages suffered, but that amount is also the main concern for the Respondent, who may be responsible for the losses.

Despite those two conflicting objectives, damages experts assist the parties and the tribunals to reach a fair determination relying on the principles of independence and impartiality. In our experience, although party-appointed experts respect both principles during the overall proceeding, disagreements repeatedly arise over specific economic aspects.

This article highlights key valuation issues that are debated during arbitrations which we have faced on numerous occasions. Some of the most important ones that come up during the quantification of economic damages in international arbitration are biases in financial projections, questions about discount rate, and some secondary concerns.

Biases in Financial Projections

Arbitration disputes often involve breach of contract claims, ambiguity of terms, performance issues, or early termination, among others. Financial projections in these cases are used to illustrate the financial impact of the claim on the company or asset by showing lost profits or increased costs.

Both performance issues and early termination disputes entail estimates of future financial projections, which have a subjective element, and could lead to biased valuations. The damages expert may fall into the forecast bias of overestimating future financial projections compared to past results.

So, how may the parties and the tribunal be influenced by forecast bias and how can they avoid that? Here are some considerations:

- Capital expenditures (Capex) may be closely linked to a company's growth prospects. If the business is expanding productive capacity and revenue without capex growth, the damages expert should consider how this is possible.
- Corroborate that financial projections are consistent with industry peers. This would show consistency. The damages expert should consider taking a hybrid approach (combining top-down[1] plus bottom-up[2]) to anticipate contrarian trends.
- Constructing extremely complex and detailed financial projections brings up the so-called illusion of control bias, which is verestimating the accuracy of the valuation model by the expert. In financial modeling, the more complex, the more likely something is going wrong. So, keep it simple.

Finally, it is important to keep the big picture in mind and not get lost in the details. Upon completion of the financial projections, the damages expert should consider taking a step back and ask whether the figures are precise or just look precise.

Discount Rate

A common question faced during international arbitration proceedings is whether the discounted rate applied by the damages experts fairly represents the investors' required return given the assumed risk.

Usually, many considerations surround the discount rate, but it is important to keep in mind that the primary goal of the damages awarded is to compensate – not overcompensate – the Claimant for their losses.

The appropriate discount rate will be determined from the perspective of the damages assessed:

» When estimating damages suffered by the company, consider using the weighted average cost of capital (WACC).
» However, if the quantification is about the amount suffered by the shareholders, the Cost of Equity (Ke) more appropriately represents the time value of money and risk borne by the shareholders.
» The most widely deployed approach in international arbitration is Capital Asset Pricing Model (CAPM) that calculates the expected rate of return for the company or asset. However, Expanded CAPM and Build-Up Approach are more suitable to private companies, as both include specific risk premiums beyond systematic risk.

In all three of the above approaches, there are some common limitations and challenges related to discount rate, which tend to be debated. They are:

» The risk-free rate may suffer volatility in periods of market stress. In those situations, it may be better to use a normalized or average risk-free rate to mitigate volatility (as long as it is representative of actual economic conditions).
» A two-stage or multi-stage discounted cash flow model will use "high-growth" and "stable" periods. Using different discount rates for each stage may be appropriate.
» The discount rate should be consistent between asset and liability valuations. The expert should consider taking a closer look if liabilities are consistently valued at a higher discount rate than assets.

Beyond the previous challenges, the true cost of capital is always reflected by market value, whereas book values may not. Using book values is a quick shortcut, but it will distort the discount rate.

Secondary Issues

While financial projection bias and discount rate dominate the debate in damages quantification and valuation in international arbitration, there are other secondary issues that also arise.

» Terminal value – which is the value of a company beyond the period for which future cash flows can be explicitly estimated; and can sometimes represent an outsized proportion of the total present value in a five-year financial projections model. This requires ensuring that the terminal growth rate (*g*) is capped by (1) the steady-state growth rate of the country where the business operates, and (2) the sustainable growth rate of the company. Also note that terminal value is estimated upon when a steady state of growth for the company is reached, not before this happens.

» It is common practice to account for the increased risk of small-sized companies via a size premium, which can sometimes exceed even the equity risk premium. In 1981, Rolf W. Banz[3] found that smaller companies tend to have greater return than larger firms because the former are riskier. Since then, adding size premium has been widely used in the industry. However, authors like Professor Aswath Damodaran of New York University argue that size premium is based only on intuition, inertia and bias, but not in data since *"the small cap premium drops to zero with any time period that starts in 1970 and beyond"*.[4]

Conclusion

The valuation aspects in international arbitration may look complex, but the most common issues are easily solved by following what logic dictates.

Our aim in this article is not to provide a damages quantification handbook, it is to empower tribunals, lawyers, and other experts by revising the usual "what if's" that are critical to maintain the spirit of fairness and impartiality of the tribunal's award.

It seems difficult to find a consensus on damages issues, since one of the main elements of the quantification of damages is the counterfactual scenario, which by its nature is hypothetical. Therefore, as long as subjectivity remains part of damages quantification, there will be room for debate; and differences of opinions and approaches will persist among damages experts in international arbitration.

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[1] Top-down approach first looks at the broader economy, then at the industry and to the company level.
[2] Bottom-up approach begins at the individual asset or company level and builds up toward the overall financial outlook.
[3] Journal of Financial Economics, Volume 9, Issue 1, March 1982, Rolf W. Banz, https://doi.org/10.1016/0304-405X(81)90018-0.
[4] https://aswathdamodaran.substack.com/p/data-update-3-for-2025-the-times


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