

# What's Your Interest? Determining Value on Arbitral Awards

In determining the value of an award, an arbitral tribunal will seek to determine the loss, if any, that flows from the events which are the subject of the dispute, as well as the associated interest, the purpose of which is to provide compensation to the injured party for the loss of use of its funds.

One of the perceived attractions of arbitration is that the authorities with oversight of proceedings consciously seek not to overburden parties and arbitrators with rules. As a result, arbitrators are allowed significant discretion in determining how the value of interest on an award should be calculated, if at all. Nevertheless, even though the value of interest can amount to a large proportion of the overall damages awarded (sometimes even greater than the value of the principal award), it can often be treated as an afterthought. The effect can decrease the amount ultimately recovered by a successful Claimant or, alternatively, inflate an already unfavourable award, from the perspective of a Respondent.

With this in mind, the early consideration of interest in arbitral awards – and the preparation of relevant supporting evidence by parties, advisers or retained experts – can put a successful Claimant at a considerable advantage or an unsuccessful Respondent in a position to minimise losses.

## At the Tribunal's Discretion

In the UK, the Arbitration Act 1996 gives little more guidance than to say, *"The tribunal may award simple or compound interest from such dates, at such rates*



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*and with such rests as it considers meets the justice of the case...*" (s49). This guidance is scant, but at least the issue of interest is addressed. In contrast, the Model Law on International Commercial Arbitration prepared by the United Nations Commission on International Trade Law ("UNCITRAL") is silent on the application and calculation of interest on awards.

Further, the international institutions and rule-making bodies provide only broad guidance on the application of interest. The LCIA arbitration rules prescribe that a Tribunal *"may order that simple or compound interest shall be paid by any party on any sum awarded at such rates as the Arbitral Tribunal determines to be appropriate, without being bound by legal rates of interest imposed by any state court..."* (Article 26.6). Similarly, Article 28 of the International Dispute Resolution procedures of the AAA provides, *"the tribunal may award such pre-award and post-award interest, simple or compound, as it considers appropriate, taking into consideration the contract and applicable law."*

There is no guidance on the subject of interest on awards within the ICC's Arbitration and ADR Rules, the UNCITRAL Arbitration Rules or the ICSID Convention Rules of Procedure for Arbitration Proceedings. In other words, after the parties have pleaded what they think is appropriate, it is up to the Tribunal to decide whether or not interest ought to be applied and, if so, how it should be calculated.

## **Cycling Through: The Impact of the Economic Growth Cycle**

As everyone knows, the world economy, including the larger economies of the developed world, recently experienced a sustained period of economic stagnation.

One feature of this downturn has been a lengthy period of low base interest rates. In the UK, for example, the Bank of England's base rate has now been at 0.5%, the lowest ever level, for more than six years. How should we expect the current period of sustained low base rates to affect the interest awarded by arbitral tribunals?

On the one hand, base rates are sometimes used to provide a benchmark for the likely level of return available to companies on their financial investments (especially those with significant cash reserves).<sup>[4]</sup> In applying interest to such investments, it is common practice to assume a return of base rate plus a certain fixed percentage. By simply applying the same approach to assessing the returns foregone on those losses suffered by means of the disputed events, we should expect the interest rate applied to arbitral awards to be lower during periods in which the base rate is also historically low. This would ensure that Claimants are not unjustly enriched by the award of monies that could not realistically have been generated with the principal sums lost.

However, base rates are a blunt tool and do not, in all circumstances, provide a strong indicator of the returns available to an injured party. For example, one who had planned to do something other than invest funds in a bank, may have been seeking higher returns in riskier investments precisely because of weak economic circumstances. As a result, it might be appropriate to entertain the prospect of higher returns than those available to the typical financial investor.

Ultimately, the arbitrators' approach will depend on the factual circumstances at hand and the available evidence. Arbitrators should perhaps apply additional focus in those circumstances where an injured party seeks to claim high interest rates within a period of

general economic downturn, but some practical enquiries and/or evidence (e.g., well researched business plans, retrospective statistics on market/sector/product performance, contemporaneous correspondence or board minutes referencing the investment strategy in question) may persuasively suggest that a higher rate of interest is justified.

## **Practical Matters: Supporting the Assessment of an Interest Award**

In the absence of prescriptive guidance, what are the practical steps that a Claimant and its advisers may take in order to strengthen a submission on interest (and for which a Respondent should be prepared)? Without delving too deeply into the mathematics, the quantification of interest on an award is dependent upon a number of factors, each of which may be assessed or established with different enquiries.

### **1. Date of Loss (or Profile of Losses)**

The point(s) in time at which the injured party suffered its loss (and the ensuing period of time that has passed up until the date of the award) ought to be wholly informed by the circumstances of the dispute and the arbitrators' finding on the principal award.

There are, nevertheless, points to watch out for in practice. For example, in the case of a party that has been denied payment of an invoice, the parties may debate the merits of applying interest from the date of the invoice, but if the funds that are due would not have been paid for, say, three months in the ordinary course of business, then to apply interest from before that point may unjustly enrich the Claimant. In such

circumstances, it may serve the Respondent to prepare an analysis of the delay typically applied between the receipt and payment of invoices from the Claimant.

### **2. Method of Calculating Interest**

Compounding can make a significant difference to the value of interest generated on principal losses. As shown in the illustrative example below, where the principal loss amounts to £10 million and the applicable interest rate is determined to be 8%, the value of interest generated over just six years by means of compounding with an annual rest is more than 22% higher than the equivalent interest calculated on a simple basis. Where compound interest is calculated using a quarterly rest, the value of interest generated over the same period is nearly 27% higher, and where the Claimant's loss has been sustained over a much longer period, the effect is even more pronounced.

### **3. Appropriate Interest Rate**

The appropriate interest rate is a matter for legal determination that will depend, to a significant degree, on the Tribunal's interpretation of the facts of the case, as well as the underlying rationale for awarding damages. For convenience, and in the absence of a convincing alternative, the Tribunal may welcome submissions on the Claimant's weighted average cost of capital (or "WACC"). This metric represents the weighted average of the cost of debt (i.e., the effective interest rate at which the Claimant borrows funds) and the cost of equity (i.e., the rate of return expected by equity shareholders). However, whilst the WACC represents the overall cost of funding the business, it does not necessarily match the rate of interest or return forsaken on losses incurred as a result of the wrongful act. The actual returns that would have been generated by the lost funds could be either higher or lower than

the WACC for many different reasons. Further, the Tribunal may consider use of the WACC inappropriate in principle, since it is often assessed by means of incorporating risks that, in the circumstances of a guaranteed interest payment from the Respondents, have not actually been assumed by the Claimant.<sup>[2]</sup>

In a simple scenario, if the Tribunal established that the lost funds would merely have been banked for a rainy day (or used to reduce bank borrowings), then the relevant interest rate may logically be that which would have been generated from the bank (or saved against outstanding borrowings).

If, however, the Tribunal concludes that the funds would successfully have been invested in the equity of a risky overseas start-up venture, it may be appropriate – particularly if circumstances permit the use of hindsight – to increase the rate of interest applied to the principal losses and to adjust the compounding interval to reflect dividend returns that would have been generated only

once every one or two years. Even where hindsight is not permitted, the Claimant’s reasonable expectations of return at the time might still be higher than bank borrowing rates.

In order to prepare and present a convincing argument that the lower rates should be avoided, and to counter the Respondent’s likely counterargument that if higher returns were available, funding for the investment may have been available from elsewhere, it would likely serve the Claimant and its advisers to make some practical enquiries and to gather evidence on how the funds representing the principal award would have been invested had they not been lost. This may involve locating and presenting documents referencing particular projects or investments that were abandoned or deferred from which a rate of return could reasonably be predicted. Further, it might serve the Claimant to provide documents evidencing unsuccessful efforts to secure funding for the project in question from elsewhere.

### ILLUSTRATIVE EXAMPLE – SIMPLE VERSUS COMPOUND INTEREST

	Year 1 £000	Year 2 £000	Year 3 £000	Year 4 £000	Year 5 £000	Year 6 £000	Total £000
Simple Interest	800	800	800	800	800	800	4,800
Compound Interest – Annual Rest	800	864	933	1,008	1,088	1,175	5,868
Compound Interest – Quarterly Rest	824	892	966	1,045	1,132	1,225	6,084

## Key Questions to Consider

In the absence of specific, abandoned projects or investments, the following enquiries might help to define the level of return lost by the Claimant during the period in which it was denied the use of lost funds:

- 1.** How was the business funded during the period of loss in question? What cash, if any, was available to the business, how was it used, and what return did it generate?
- 2.** What rate of return is typically generated by the business? Could the business have been developed or expanded using the funds lost during the period in question? If so, was the market sufficiently large to support those plans? If not, how would the funds have been used?
- 3.** Did the Claimant enter into any one-off projects or investments similar to those it might have been denied through lack of funds during the period of loss in question? If so, how did the investment perform?

## Conclusion

Although the value of interest can amount to a large proportion of the overall damages awarded, it can often be treated as an afterthought with the effect of depressing the amount successfully recovered by a Claimant or, alternatively, inflating an already unfavourable award, from the perspective of a Respondent. By appropriately focusing on the quantification of interest and key related questions while the claim or response is being prepared, one party's outcome may be significantly improved.

- [1] Although, it should be noted that base rates are purely indicative. In practice, firms may invest in a mixture of financial products and, even in the case of simple savings products, the interest rate generated will be subject both to the base rate and the spread applied to it.
- [2] For similar reasons, there may arise disputes (particularly those involving an element of valuation), where the discount rate applied in the process of valuing a business or opportunity for the purposes of determining the principal award, differs from the rate applied in determining the interest associated with that award.

## Leaving no stone unturned.

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