Dispute perspectives Tribunals' conflicts on interest

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We analysed nearly 100 tribunal awards over a 25 year period to identify the key themes in damages awarded[1]. In this article, we delve deeper into the last issue on a tribunal's agenda – interest.

[1] Our original article can be found at http://bit.ly/IAdamages.

Introduction

It has been noted in a 2015 GAR article that interest is ‘extremely important’ from an economic perspective, but ‘tribunals often give very little consideration’ to the issue of interest.[2] This is certainly true of our population of awards: whilst interest forms 24%[3] of the value of the award (on average), only 11.4% of pages are devoted to it. The absolute amount of interest awarded ranges from $6,000 to $3.7 billion in our sample, with an average of $82 million. In several cases, the amount of interest awarded exceeded the amount of damages to which it was added.[4]

The GAR article also points to (explicitly noted and implicit in comments) considerable differences in approaches to interest, both pleaded and awarded. Our research confirms this. This article explores and identifies some of the reasons for these differences and asks, given the varied nature of the cases, should we expect the treatment of interest to be the same in each case?[5]

[2] ‘An unexpected interest in interest’, Clemmie Spalton, 12 May 2015.

[3] This is a conservative percentage as in most cases our calculation of interest assumes the amount owing is paid the day after the date of the award.

[4] For example, see Ioannis Kardassopoulos and Ron Fuchs v The Republic of Georgia.

[5] This article explores the approaches taken and does not comment on whether the theory behind the approaches is sound.

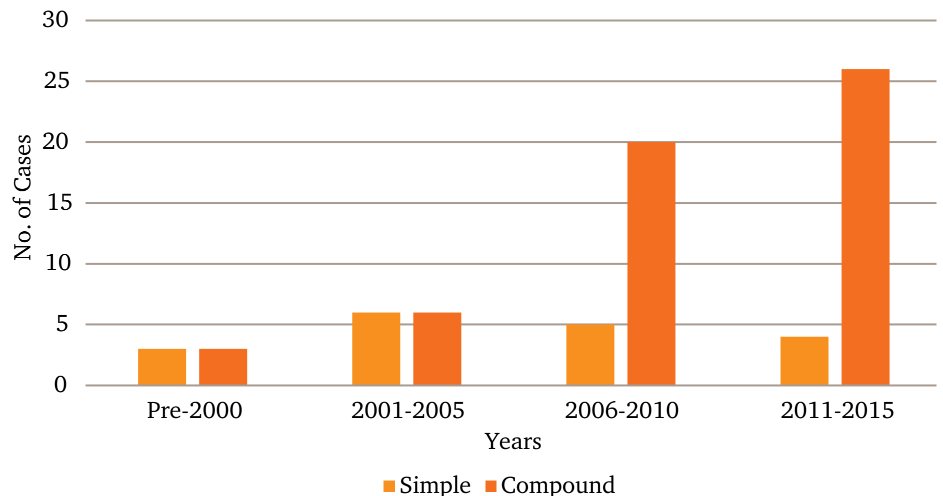
On what issues do tribunals agree?

A common area of agreement between tribunals is that full reparation is generally expected to include an award of interest.[6] Tribunals increasingly also now agree on the issue of compounding. The graph to the right shows that, for our sample of cases, before 2005 the split of cases awarding simple versus compound interest was 50:50, but in the last five years, the split has moved to 13:87.

The *Compañia Del Desarrollo De Santa Elena SA v The Republic of Costa Rica* award, published in February 2000, is often cited by tribunals to explain that the use of compounding is not punitive in nature, but rather reflects the economic reality of investment – that of an investment opportunity being denied to the claimant by the respondent.[7]

Citing various reasons, 25% of tribunals in our population viewed simple interest as the correct approach. In one case, the tribunal found that losses based on 'abstract' future profits should only attract simple interest whilst actual cash losses, such as incremental costs incurred, would, in that tribunal's mind, justify compound interest.[8]

Simple v compound interest



[6] For example, see paragraph 183 of SGS Société Générale de Surveillance SA v The Republic of Paraguay, ICSID Case No ARB/07/29.
[7] See paragraph 104, Compañia Del Desarrollo De Santa Elena SA v The Republic of Costa Rica.
[8] Ceskoslovenska obchodni banka as v Slovak Republic, ICSID Case No ARB/97/4.

Differences in approach

There was less consistency in approach in other areas: what the concept of interest represents, the appropriate rate to apply, whether interest should be linked to the currency of award, the impact on interest of the length of the period between breach and award, and the application of pre-award and post-award interest.

We explore the reasons for these differences in approach below and explain the different rates and approaches adopted by tribunals.

Nature of the case

The individual circumstances of the case will (and potentially should) drive the interest rate decisions. For example, a case regarding unpaid invoices will likely attract a different interest rate to that of an illegal expropriation. This is an important factor and is likely to explain some of the differences in approach described below.

Application of different theoretical concepts

In order to assess the correct interest approach and rate that will appropriately compensate the claimant, tribunals must first consider what it is they are seeking to compensate for. Articulating the concept of interest is key to quantifying the applicable interest rate.

Of the cases examined where interest was awarded, only 40% of awards commented explicitly on what the payment of interest represents conceptually. Although the remaining 60% awarded interest, there was no explicit discussion in the award as to why interest was awarded and what it was seeking to represent or compensate. Where the award is silent on the conceptual approach, it is difficult for the reader to understand the applicability of the interest rate chosen.

The following table sets out the concepts attached to interest by the tribunals in our sample:

Theory/concept of interest	Percentage of total(%)
Unknown	60
Return on investment	19
Cost of borrowing	8
Contractual	5
Statutory/legal	5
Coerced loan	2
Multiple	1
Total	**100**

(a) Measurement of rate

As stated previously, the measurement of the rate will flow from the nature of the case and the theory of interest applied. Many tribunals also use their discretion to select a rate. In our sample population, there is much variety in the interest rates chosen by tribunals.

Overall, 42%[9] of the cases in our sample applied a cost of borrowing rate (an interbank rate or a cost of debt rate); 27% of cases a return on investment rate (a risk-free rate or bank deposit rate); 20% stated an absolute value (including statutory rates) and 11% gave other rates (including contractual rates).

Our analysis shows that although tribunals *applied* a cost of borrowing rate more frequently, they *talked* more about return on investment rates. But what do these rates represent and what rates are tribunals applying?

Return on investment

Awarding interest at a return on investment rate inherently assumes that, if the respondent had not deprived the claimant of the relevant sum, the claimant would have invested it to generate some sort of return. How did tribunals quantify this return?

[9] This is based on the rate awarded for a pre-award interest rate. The results for post-award rates are similar as most tribunals award the same rate for both.

Risk-free rate

Calculating interest by reference to a risk-free rate implies that the claimant would have invested the sum in risk-free instruments such as US Treasury securities, which were the most commonly referenced risk-free rates in our sample. This approach offers some compensation to a claimant for the time value of money, but at the relatively low rate of return that you would expect from making a risk-free investment.

When awarding risk-free rates, it was common for tribunals to stress that rates should be 'conservative' or 'prudent', although we have not seen an explanation as to why this should be the case. In one example, the Bilateral Investment Treaty (BIT) in question allowed for interest at a 'commercially reasonable rate', which the tribunal felt could be represented by a risk-free rate.[10]

Interbank rate

Many tribunals quantified interest using an interbank rate, typically the US dollar LIBOR rate. LIBOR is the return that banks in London earn when they lend money to each other for periods ranging from overnight to one year. The US dollar LIBOR was cited by tribunals as representing both a return on investment and a cost of borrowing rate. Often, an interbank rate was awarded without reference to the theoretical concept being applied.

Tribunals will often then apply an uplift to the US dollar LIBOR rate to give, for example, LIBOR +2%. Tribunals often appear to place a degree of reliance on jurisprudence and on their own discretion when selecting an appropriate rate, as opposed to specific evidence to justify the percentage point uplift chosen.

Weighted average cost of capital (WACC)

Relatively few tribunals in our sample decided that interest should be quantified using the claimant's WACC, being the average of all its funding costs. This would be the appropriate rate if the tribunal was seeking to award compensation that reflected the return that the claimant would have made from investing the money in expanding its normal operations. The return on its normal operations would typically be expected to cover the claimant's standard cost of financing its business, its WACC.

Regulatory return on investment

Another, less common, approach was to quantify interest using a regulatory return on investment. Some regulated industries, for example, telecommunications, have prescribed rates built into their pricing models to regulate the level of return made. As with awarding at the WACC, awarding at this rate assumes that the claimant would have invested the money in expanding its normal operations and garnering the permissible return.

Cost of borrowing

After return on investment, cost of borrowing was the next most popular choice of interest theory for tribunals.[11] What does this cost of borrowing represent? It is either the cost of funding a financing or cash gap (by taking on new debt) or it is the cost associated with the inability to pay off existing debt.

Commercial lending rate

In terms of quantification, many BITs include a clause that interest should be paid at a 'normal commercial rate', presumably assuming that, in lieu of actual borrowings undertaken, the claimant would have incurred a cost of borrowing on this basis.

Claimants and tribunals often interpret a 'normal commercial rate' to mean something like LIBOR + 2%, but does this reflect the loss to the claimant? In one case, the claimants argued that the relevant company was not a large company and that LIBOR + 2% was not a suitable rate in these circumstances. The tribunal agreed with the claimants' assessment that 5% (rather than the usual 2%) should be added to the interbank rate as the claimants 'are not international companies and cannot borrow at only 2 points above the interbank offer rate.'[12]

Claimant's own borrowing rate

A more direct measure of a claimant's cost of borrowing may be to use the interest rate it would have paid had it borrowed the sum involved (this is the firm's cost of debt). This could be calculated either by observing the interest it paid on actual borrowing, or with reference to the cost of debt of analogous businesses.

Of the awards applying a cost of borrowing rate, just under one third used a cost of debt rate whereas just over two thirds favoured an interbank rate. It is difficult to say with certainty why this is the case, but reasons for this would include availability of cost of borrowing information, jurisprudence and the rates requested by the claimants themselves.

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[10] Occidental Petroleum Corporation et al v The Republic of Ecuador, ICSID Case No ARB/06/11.
[11] This refers to the 40% of awards where the tribunal explicitly talked about interest theory.
[12] Ioan Micula et al v Romania, ICSID Case No ARB/05/20.
[13] For example, see White Industries Australia Limited v The Republic of India.
[14] For example, see Continental Casualty Company v Argentine Republic, ICSID Case No ARB/03/9.

Other rates

For some tribunals, legal considerations determined the interest rate to be applied. For example, interest was determined by a particular contract that was the subject of the breach, or national laws set a statutory rate which determined the approach.

In 13 awards, it is not clear on what basis interest is awarded – there is no record of the concept or measurement.[13] In some cases, the tribunal explicitly states that it has used its discretion to award interest, thereby circumventing any explanation.[14]

(b) Pre-award and post-award

Another theoretical concept that led to differences in approach was the consideration of pre-award and post-award interest.

We found that in most cases the tribunal did not comment upon or distinguish between pre-award interest and post-award interest. However, some awards were explicit in their view that the two tranches are the same theoretically and should attract the same interest methodology.[15] Conversely, others took the view that the two are theoretically compensating for different scenarios and should therefore be measured differently.[16]

(c) Currency of rate

We found that in the few instances in which the currency of rate was specifically addressed by tribunals, there were different theoretical approaches applied: some tribunals felt that the currency of rate must equal that of the award currency,[17] whereas others stated that the rate and award currencies did not have to match.[18]

Methodological differences

Methodological differences also accounted for some of the differences between tribunals.

When determining the method of calculation, tribunals must make an assumption as to the nature of the funding. For example, if the 'but for' scenario is that the claimant would have reinvested at LIBOR, what period of investment would the claimant have chosen? One month, three months, one year? Any of these tenors is feasible, and tribunals have chosen a variety of approaches.

Similarly, tribunals direct the parties on the compounding interval. If a one-year tenor is assumed, the economic corollary is that the compounding interval will be one year. However, tribunals often consider the tenor and the compounding interval separately. For example, we have seen a tribunal choose a six-month rate and instruct that interest be compounded annually.[19]

When selecting at which point in time a rate is taken, a tribunal might replicate the commercial method of taking the rate at the beginning of each compounding period or alternatively, a tribunal will determine that average rates should be used to calculate interest.

Another example of differences in approach relates to the impact the length of period will have on interest calculated. For example, one tribunal reduced the compounding frequency because it felt that the resulting absolute amount of interest would be too high. Conversely, another tribunal felt that a more frequent compounding interval was appropriate given that the claimant had been without their money for so long.[20]

15 For example, see Ioan Micula et al v Romania.
16 For example, see Gold Reserve Inc v Bolivarian Republic of Venezuela.
17 For example, see SD Myers Inc v Government of Canada.
18 For example, see CME Czech Republic BV (The Netherlands) v The Czech Republic.
19 Continental Casualty Company v Argentine Republic, ICSID Case No ARB/03/9.
20 See Occidental Petroleum Corporation et al v The Republic of Ecuador and Ioannis Kardassopoulos and Ron Fuchs v The Republic of Georgia.

Summary

Despite the potential importance of interest in determining the overall award made to a claimant, on average proportionally little space is dedicated to exploring the question of interest. Further, in 60% of cases, there was no explicit discussion of what interest represents.

Our research has highlighted that differences exist. Some of these are to be expected for good reasons such as the particular circumstances of the case and the variety of reasonable assumptions available.

However, our research also shows that there are areas where tribunals can reduce inconsistency, for example, the methodologies employed could be more aligned to the commercial application of interest.

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