

Approaches to the Award of Interest by Arbitration Tribunals

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Abstract

This paper addresses approaches for arbitral tribunals to use in the award of interest. We address various aspects of this from both a legal and financial perspective, including the appropriate interest rate, the period over which interest should be calculated, the question of simple or compound interest, pre-award and post-award interest and the interaction between the discount rate used to reduce future cash flows to their present value and the interest rate used to augment past amounts to bring them to present-day values.

Because justice necessarily lags the events for which that justice is sought – often times by many years – tribunals routinely face questions about the amount of interest needed to fully compensate a claimant. Historic practice has varied widely, with resulting uncertainty. We hope to suggest approaches that may help to reduce the variability and its resultant uncertainty in the future.

In doing so we will first look at the legal principles underpinning the grant of interest by arbitral tribunals in the hope of receiving guidance as to the purpose behind the award of interest, and then turn to the financial and economic theory in the award of interest – with the aim of discovering how best to meet the legal goal of its award.

The Legal Perspective on Interest

As recently noted by one of the world's leading arbitrators:

In all international commercial arbitrations where a claim for the payment of money is advanced, whether debt or damages, it is highly probable that the claimant has also suffered a financial loss resulting from late payment of the principal amount. That loss can amount to a significant proportion of the total claim; and in certain cases, it can exceed the principal amount. In a modern arbitration régime, it is unthinkable that a claimant should not have the right to recover that loss in the form of interest.²

In other words, there is a general expectation, regardless of forum, governing law (save for those arbitrations concerning *Sharia* law), nature or seat of arbitration, that interest will be awarded.

On one level this expectation may be a little surprising, at least in the common law world, where the fight to obtain interest (and arguably full compensation) has been a battle with the stigmata of usury.

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² V V Veeder, 'Whose Arbitration is it Anyway – The Parties' or the Arbitration Tribunal's?: An Interesting Question?' in Lawrence W Newman and Richard D Hill (eds), *The Leading Arbitrators' Guide to International Arbitration* (2nd ed, 2008) 344.

Indeed, under the English common law, there was a general refusal to award interest (save in limited statutory exceptions) as late as 1893.³

On the other hand, the development of recent arbitral practice has been much shaped by international law principles, which have received an ever more obvious airing by way of the investment treaty arbitrations which have exploded across the arbitral scene during the last ten years, bringing not only a new focus to an age old discipline⁴ but also new transparency given the near daily publication of awards in contradiction to the general policy of arbitral confidentiality.

One such key principle to come out of the field of investor state arbitration is the idea that the measure of damages should be such as to ensure that the parties should receive *restitution in integrum*, which, as explained in the oft-cited (and rarely read) case of *The Factory at Chorzów*⁵ equates to ‘the obligation to restore the undertaking and, if this be not possible, to pay its value at the time of the indemnification, which value is designed to take the place of restitution which has become impossible.’ In other words, the goal is to make the wronged party entirely whole – and as such it should come as no surprise that it is generally recognised that where a party has been deprived of the use of its money and assets, then the time value of money is such as to require a larger sum to be paid today in compensation than would have been payable if the wronging party had settled the dispute the day before. Or, as more artfully put by the tribunal in *Vivendi v Argentina*:

*The object of an award of interest is to compensate the damage resulting from the fact that, during the period of non-payment by the debtor, the creditor is deprived of the use and disposition of that sum he was supposed to receive.*⁶

Such principles have now become embedded conceptually throughout the international arbitral community, and save where contract provisions exclude its application (including in cases where there are waivers of indirect or special damages), the point is generally not argued, with the real battle being the question of what rate should be awarded and for what period.

From where, however, do tribunals receive their grant of power to award interest? The first place to start the enquiry is in the contract which has given rise to the dispute (presuming of course that we are in the world of commercial arbitration and not treaty disputes). It is increasingly common in modern sophisticated contracts and arbitration agreements to find that the parties have specifically provided for the award of interest, sometimes going as far as setting rates and periods ahead of time. Given that the tribunal is nothing if not a creature of contract, it should go without saying that the tribunal should consider itself bound by this direction, unless of course it would be contrary to a mandatory law requirement of the seat.

(To take a detour into the world of investment treaty arbitration, clear recognition of the principle that interest should be awarded can be found in the Draft Articles on State Responsibility at Article 38).

Presuming that there is no express provision in the clause itself, the next logical place to look for

3 *London, Catham & Dover Ry v S.E. Ry* (1893) AC 429.

4 Noting, in passing, that arbitration was alive and well in the days of Ancient Rome, although such tribunals did not award interest – see Derek Roebuck and Bruno de Loynes de Furnichon, *Roman Arbitration* (2004).

5 PCIJ Rep, Ser A, No 17 (1928) 48.

6 ICSID Case No ARB/97/3, Award of 20 August 2007, ¶ 9.2.3.

a power is in the arbitration rules selected (presuming of course that the proceedings are not entirely ad-hoc). Taking a random sample of these:

- Article 26.6 of the LCIA Rules gives a power to the tribunal to award interest at its discretion, with such discretion extending to rate, compounding methodology and period.
- The ICC Rules are entirely silent on the subject.
- Article 27.6 of the SIAC Rules mirrors the LCIA position.
- The SCC Rules are silent.

If the rules are silent (or there are no rules), as would be the case in a large number of cases, then the next step is to look at the laws of the seat. The UK Arbitration Act 1996 at section 49 does grant a general and entirely discretionary power. The relevant provisions of the French New Code of Civil Procedure do not deal with the question. Accordingly, two of the most commonly used legal seats have very different express empowerments. However, this may not make as much difference as might otherwise be thought.

There is a school of jurisprudence which takes the view that no express empowerment is required at all, that there is simply an *inherent* power for a tribunal to make an award of interest. This view has found judicial expression in the decisions of the US-Iran Claims Tribunal:

Claims for interest are part of the compensation sought and do not constitute a separate cause of action requiring their own independent jurisdictional grant. ... [The Tribunal] has regularly treated interest, where sought, as forming an integral part of the 'claim' which it has a duty to decide. The Tribunal notes that the Chambers have been consistent in awarding interest as 'compensation for damages suffered due to delay in payment'. ... Indeed, it is customary for arbitral tribunals to award interest as part of an award for damages, notwithstanding the absence of any express reference to interest in the compromis. Given that the power to award interest is inherent in the Tribunal's authority to decide claims, the exclusion of such power could only be established by an express provision ...⁷

In other words, the US-Iran Claims Tribunal recognised a jurisprudential view of interest not as a separate head of claim in itself, but simply as a species of damages. Accordingly, given that there is rarely an express power contained in the relevant contract or rules to award damages, but there is a general expectation that an arbitral tribunal should be able to award damages, there should also be a *sui generis* power to award interest.

In short – there is a working presumption that if you can claim damages, you are able to claim interest, and tribunals will seek out such authority as they can find to justify that position (by hook or by crook in some cases). However, what remains entirely unclear, even in those circumstances where an institutional rule or law expressly empowers a tribunal to award interest, is the question of the methodology the Tribunal should adopt.

Inevitably, this is a matter for discretion (and should be an area for detailed argument from counsel), with the aim being to ensure that a party receives full compensation for its loss. In order to achieve this, the tribunal has a number of variables it can employ to achieve justice: the question of whether to award simple or compound interest, the question of rate and the question of period.

⁷ Case No A19 (*Iran v USA*), Decision of 30 September 1987, 16 Iran-US CTR 285, 289-90.

We now examine each of these factors from a financial perspective, in the hope of understanding how they can each be employed by a sophisticated arbitral tribunal to ensure that full and effective compensation is afforded. This exercise is made necessary by the incredible diversity of approaches taken by tribunals of varying levels of financial sophistication and also the unfortunate reality that because some tribunals are unfamiliar with such concepts and haven't been helped by counsel, awards have been rendered where the interest component becomes either an unrealistic pittance, or a major windfall, or is given with one hand and taken away with the other. Any of these outcomes is clearly undesirable, and a more structured and scientific approach should be preferred.

The Financial Perspective on Interest

The textbook calculation of interest is a simple one that will be familiar to everyone, namely:

$$I = P * R * T$$

where I = interest
P = principal
R = interest rate
T = time

When interest calculations extend over multiple time periods (however so defined), the question of compounding comes into play, as well. We discuss these factors below, with the objective of proposing practices for tribunals that are justified from the standpoint of current financial theory and practice.

A Simple or Compound Interest?

The question of simple versus compound interest has been one of the most contentious and vexing problems arbitrators face. Bringing the legal treatment of interest into agreement with the financial realities of a contract or investment has proven very challenging. In discussing the now nearly century-old *Norway v United States*,⁸ Mann noted, '[h]ere, at least, there is an indication that *if proper reasons had been advanced*, the Tribunal might have awarded compound interest.'⁹ Mann ultimately concluded that compound interest *should* be the norm, absent special circumstances that would dictate otherwise.¹⁰

As recently as 2004, Gotanda described the ongoing dichotomy between economic reality and the state of the law in international disputes:

*In today's economic world, compound interest, and not simple interest, is the norm in both third-party financing and investment vehicles. Yet, in disputes between transnational contracting parties, simple interest awards are the norm.*¹¹

8 1 R Int'l Arb Awards 307 (1922).

9 F A Mann, 'Compound Interest as an Item of Damage in International Law' [1987-1988] 21 *U C Davis L Rev* 578 (emphasis added).

10 Ibid 586.

11 John Yukio Gotanda, 'Compound Interest in International Disputes' (2004), *Oxford U Comparative L Forum* 1 <ouclf.iuscomp.org> at 27 Aug 2009, text after n 1.

Some may wonder whether this historic reluctance to award compound interest might stem from a more general aversion (by both tribunals and counsel) to matters outside the law (and particularly to numbers). In any event, more recently, though, tribunals have been increasingly inclined toward the award of compound interest. Just three years after writing that simple interest awards were the norm, Gotanda called to the attention of the British Institute of International and Comparative Law the changes that were afoot regarding the award of interest:

The third development of note is the award of compound interest. This is a major change. Up until recently, the longstanding and well settled rule was that awards of interest were to be on a simple as opposed to a compound basis.

...

Starting in the early 2000s, however, there was a trio of cases – Santa Elena, Maffezini, and Wena Hotels – in which the tribunals awarded compound interest. These decisions have been followed most recently by the tribunals in PSEG Global Inc, Siemens [sic] and Azurix. As the tribunals noted in the latter two cases, compound interest “reflects the reality of financial transactions [today] and best approximates the value lost by an investor.”¹²

Thus, the modern tribunal has come to the realisation that most of the world operates on a compound interest basis, and that full, fair and effective compensation to reflect that economic reality includes the award of compound interest. From the standpoint of a finance professional, one can say ‘better late than never.’

As accounting professors Kimmel, Weygandt and Kieso note in their widely used text on financial accounting, ‘[m]ost business situations use compound interest. Simple interest is generally applicable only to short-term situations of one year or less.’¹³ The typical arbitration action, whether commercial or treaty-based, is rarely (if ever) one in which the time from cause of action to payment of compensation is less than one year.

Let’s look at a few everyday examples to illustrate the ubiquity of compound interest. Consider the typical corporate or government bond, which pays investors interest semi-annually. While a casual observer may be tempted to suggest that the bond reflects simple interest – since the amount of principal remains constant, and the interest payment is steady, as well – the fact that the interest is *paid* every six months makes it a compound interest transaction. Simple interest would be accrued, without adding it to the principal until the time of repayment. This would not deprive the bond issuer of the use of funds with which to pay interest. The economic reality, however, is that the issuer *does* fund interest payments semi-annually, losing the use of funds and the ability to earn interest on them. (And, similarly, the investor receiving the interest payment has the ability to reinvest it to earn additional return.) Thus, corporate and government bond borrowings reflect compound interest.

12 John Y Gotanda, ‘Assessing Damages in International Commercial Arbitration: A Comparison with Investment Treaty Disputes’ (2007) 4(6) *Transnational Dispute Management*, 10 (citations omitted).

13 Paul D Kimmel, Jerry J Weygandt and Donald E Kieso, *Financial Accounting: Tools for Business Decision Making* (5th ed, 2009), Appendix C, ‘Time Value of Money’ C-2.

Next, consider a revolving account, such as a line of credit a business might have for managing its working capital needs, or a consumer's credit card account. As funds are drawn, interest begins to accrue. If left unpaid, the accrued interest is added to the principal balance. This, of course, indicates that the interest is compound – in this case, monthly, rather than semi-annually as in our first example. When payments are made, they are applied first to interest, with any residual applied to principal. Just as was the case with the corporate or government bond, the payment of interest deprives the borrower of the use of the cash, so once again, we have a compound interest transaction.

Both of these examples are from the standpoint of the borrower. But for every borrower, there is a lender or investor. And just as the corporate and government borrowers in our first example pay interest on a compound basis, the lenders who invest in those bonds receive interest that is effectively compound. They either receive cash that they can reinvest, or they accrue the interest and add it to the principal balance upon which future interest is calculated. The same holds for the lender who provides working capital funding or credit card advances in our second example. They, too, receive compound interest.

Investor companies have other options for their excess cash. They can repay debt, which saves them future interest payments. Those savings can be reinvested, again making the transaction one which involves compounding. Or the company could invest its excess cash balances. It may, for example, invest in short-term commercial paper issued by other companies. These transactions typically involve *simple* interest. But if the company's history reflects a string of back-to-back commercial paper investments, the combined transactions still have a compounding effect. The interest earned from the first commercial paper investment is reinvested into the next commercial paper investment, and those earnings, in turn, are reinvested in the subsequent transactions.

The company may also invest its excess cash in time deposits or similar banking instruments. These pay interest at stated intervals, and that interest is available to the company to reinvest. This, of course, is another example of a compound interest transaction.

Finally, the company might invest in fixed assets (e.g., for expansion, or for undertaking a new project) or in the shares of another company. In the latter case, the investor may receive a dividend stream that can be reinvested, which makes the transaction compound. But let's focus on the non-dividend-paying investee, where the investing company's interest is in the underlying cash flows of the investee in the future, much the same as its interest would be in undertaking a new project itself.

These transactions are ones that would typically involve some sort of discounted cash flow ('DCF') analysis of the likely future inflows and outflows of cash. Kimmel et al. set out the basic formula for discounting a future amount to its present value:¹⁴

$$PV = FV / (1 + R)^n$$

where PV = Present Value
 FV = Future Value
 R = interest rate
 n = number of periods

14 Ibid C-7.

This calculation utilises *compound* interest, resulting in a present value that is *smaller* than it would be using simple interest. To illustrate this, let's take the above equation and solve it for the future value. We have:

$$FV = PV * (1 + R)^n$$

The exponent in the above equation indicates that each year's interest factor is multiplied by the other years' interest factor, which is the definition of compounding. In contrast, simple interest would eliminate the exponent that multiplies each year's interest by the next year's interest (i.e., the compounding effect). The formula for calculating simple interest is:

$$FV = PV * (1 + n * R)$$

What happens, then, when a tribunal takes a DCF model that has used compound interest to discount future cash flows, but then applies simple interest to the result? This is an issue that has historically been missed by many tribunals – namely, that by discounting (reducing) future cash flows at compound rates, then adding interest at simple rates, the result will necessarily undercompensate the claimant, since the future cash flows are discounted by more than the amount of interest that is added. This will always yield a lower result than the original cash flow.

To demonstrate, consider a \$10 million cash flow that is ten years into the future. We will discount that future cash flow at 15% for ten years, for a present value of \$2.47 million. (The calculation is the future value of \$10 million divided by the quantity [(1 + 15%) to the tenth power].) But if we now add interest at a 15% simple rate for ten years, we will have our principal of \$2.47 million multiplied by 15% for ten years, for a total of only \$6.18 million, not the \$10 million we started with.

There is, then, no logical support for the awarding of simple interest, unless the time from the cause of action to the payment of the award is very short, which it inevitably is not. Today's arbitrations typically involve facts that occurred years in the past, and compensation that will be paid at some point in the future. From the perspective of economic and financial realities, the tribunal should award compound interest without any requirement of specific proof, unless there is specific evidence (e.g., agreement of the parties) to the contrary.

As a footnote to the analysis of compound interest, we should briefly address the appropriate period for compounding, or 'rests.' Tribunals have, again, been all over the map here, from monthly compounding to annual compounding. Sénéchal writes that '[t]he choice of the compounding period is crucial. The shorter the compounding period, the faster the principal amount will grow.'¹⁵

That is true if the interest rate is the same in all cases. But many benchmark rates, such as LIBOR, EURIBOR or Treasury rates are available for varying durations. The yield curve generally (but not always) gives us a lower rate for shorter durations. In such a case, the more frequent compounding is offset by the lower interest rate.

When the tribunal sets a rate for post-award interest, it cannot know the duration that will pass from the date of award to the future date of payment. In such cases, the tribunal should be careful to ensure that the benchmark rate and the compounding period match, by specifying, for example, which

15 Thierry Sénéchal, 'Time Value of Money: A Case Study' (2007) 4(6) *Transnational Dispute Management* 5.

LIBOR rate will be used. This will help to avoid situations such as that described by Gotanda in discussing the *Siemens v. Argentina* claim, where he notes that the tribunal awarded interest based on six-month U.S. certificates of deposit, but compounded it annually, not semi-annually.¹⁶

The Choice of an Interest Rate

‘The current practice of awarding interest in international commercial arbitration is riddled with inconsistencies.’¹⁷ With those words, Gotanda introduced a model approach for the awarding of interest, which we discuss below. Subsequent efforts have been made in an attempt to bring some uniformity to the practice, yet there still remain significant differences from case to case and tribunal to tribunal.

To some degree, these differences reflect the underlying investments and the facts that give rise to the arbitration. But that is not the whole story. Even when faced with relatively similar fact sets, tribunals may come to divergent decisions on the rate of interest to be awarded, with some preferring a risk-free rate and others choosing rates that reflect a higher level of risk. While that may, in some instances, represent compromises made to achieve a unanimous award,¹⁸ it may also reflect a relative scarcity of guidance and/or specific data on which to base the award.

From a financial standpoint, there are several possible data points that a tribunal may find relevant and helpful to its determination of an appropriate interest rate. The obvious starting point is the investment itself. As Sénéchal notes, ‘an investor is right in asking for a rate of return commensurate to the risk undertaken.’¹⁹

The investment agreement, concession contract or other controlling document may set out the rate to be used in calculating interest. In this case, the parties’ wishes should, of course, be respected (absent some compelling reason to do otherwise). Even if not set out contractually, there may still be a project hurdle rate used in the pre-investment evaluation and business plan. Like the contractual provision, such a rate would embody the investor’s expectations. While some may counter that business plans and forecasts are simply optimistic ‘pie-in-the-sky’ projections, the reality is that they are serious business documents that are used to evaluate projects and on which to base decisions that may commit millions of dollars of shareholder money. Successful companies take these projections seriously, and many use financial models and statistical methods to help ensure they have addressed foreseeable contingencies.

The investor’s expectation can be corroborated by reference to other data, such as its historic returns, its weighted average cost of capital, and third-party data on the cost of equity investment in the host country. An oft-cited source for the latter is Roger Ibbotson’s scholarly research on historic rates of return, including calculations of international cost of capital, which is published annually by Morningstar, Inc.

16 John Y Gotanda, ‘A Study of Interest’ (2007) *Villanova University School of Law, Public Law and Legal Theory Working Paper* No 2007-10 25.

17 John Y Gotanda, ‘Awarding Interest in International Arbitration’ (1996) 90 *AJIL* 55.

18 See, eg, Charles N Brower and Jeremy K Sharpe, ‘Awards of Compound Interest in International Arbitration: The Aminoil Non-Precedent’ (2006) 3(5) *Transnational Dispute Management*, 159. The authors state, ‘the Award reflects an evident compromise by the Tribunal (or perhaps the parties) that served to mask the Tribunal’s unwillingness to characterise Kuwait’s taking of Aminoil’s concession as an unlawful expropriation.’

19 Sénéchal, above n 15, 3.

Alternatively, we can look from the perspective of the other uses to which the claimant might have put the funds. Again, its historic returns can be of some help here, as can its policy for the use of excess cash. Perhaps the claimant typically invests its cash balances in deposit instruments. Or it may have a historic preference for paying down debt, particularly if it has high-cost debt that does not preclude prepayment and/or early retirement of principal.

But the claimant's perspective paints only half the picture. The respondent who delays payment for harm it has caused retains the use and enjoyment of the funds, and can earn interest (or avoid paying interest on additional indebtedness) until the time the damages are paid. This reality has been acknowledged by Mann:

*it is completely wrong to attach any significance to the fact that the award of interest or compound interest may lead to the payment of a sum exceeding the capital due from the wrongdoer. This may happen in many cases as a result of the wrongdoer's delaying tactics or the court's work load. But during that period the wrongdoer has enjoyed the fruits of the money withheld.*²⁰

Wälde and Sabahi echo this position:

*The proper response – applied anyway by tribunals with less detailed reasoning in the past – is to let the tribunal adjust the principal of the award in line with equitable principles; these will inevitably take into account the claimant's additional harm by being paid with delay and any unjust enrichment of the respondent because of the delay.*²¹

Gotanda, too, has repeatedly raised the issue of unjust enrichment of the respondent as a reason for tribunals to award interest:

*it [limiting interest awards] would confer a windfall on the respondent, who likely had the use of the claimant's money for less than the cost of borrowing it.*²²

*The second reason for awarding interest is to prevent unjust enrichment of the respondent. Respondents that retain the use of money owed to the claimants during the resolution of the dispute are said to have unfairly benefited from its use. They are receiving the earning capacity of the borrowed money without compensating the claimants for the loss of its use.*²³

20 Mann, above n 9, 585 (emphasis added).

21 Thomas W Wälde and Borzu Sabahi, 'Compensation, Damages and Valuation in International Investment Law' (2007) 4(6) *Transnational Dispute Management* 48 (emphasis added). While the authors' comment appears in a section discussing interest under Islamic law, it seems equally applicable to the determination of an interest rate in non-Islamic law circumstances.

22 Gotanda, above n 11, text after n 10.

23 Ibid text after n 22 (citations omitted).

[A]n award of interest prevents unjust enrichment of the respondent by requiring it to pay compensation to the claimant for the benefit that the respondent received by using the money it wrongfully withheld.²⁴

Tribunals have generally not addressed the question of enrichment of the respondent as a measure of the interest to award. In the few instances in which they have addressed unjust enrichment, tribunals have tended to dismiss such considerations. The exception is the *Santa Elena* tribunal, which stated, ‘the taking state is not entitled unjustly to enrich itself by reason of the fact that payment of compensation has been long delayed.’²⁵

Legal scholars and practitioners will, of course, debate the legal basis for consideration of unjust enrichment and the public policy considerations that support its use. From a financial standpoint, we should focus on what a ‘rational debtor’ would do, if presented with the opportunity to avoid or minimise expensive borrowing by delaying payment, for which it would potentially be assessed interest at a comparatively low rate.

Consider a hypothetical individual who has a low-cost loan – say, a car loan, mortgage, or student loan – and credit card debt that bears a very high rate. What will a rational individual do in this circumstance? He or she will defer payment of as much low-cost debt as they can and pay down as much of the credit card debt as they can.

Next, consider a similar situation, but in the corporate world. What happens when companies have excess cash with which to pay down debt? Do they pay down their low-cost obligations, while leaving intact their high-rate debt? Of course not. The rational corporate treasurer will minimise interest expense by paying down high-cost obligations, or refinancing them to obtain a lower rate.

Why, then, should things be any different for a respondent in arbitration? If offered the opportunity to avoid or defer some high-cost borrowing by keeping the claimant’s funds (and paying the claimant a relatively low interest rate), the rational respondent debtor may well do just that. As a result, we risk seeing expropriations go uncompensated, and arbitral awards go unpaid for an extended time, with the respondent benefiting from the delay in payment of compensation to the claimant.

Colón and Knoll reflect similar concerns, focusing on the respondent’s financial position in discussing the calculation of prejudgment interest:

The most important risk to which an award is subject is the risk that the respondent will default. The rate of return that compensates for both the risk of default and the delay in paying the award is the respondent’s borrowing rate. To the extent that the holder of an unsatisfied judgment would be treated in a bankruptcy action like the holder of unsecured debt, the proper interest rate is the respondent’s unsecured borrowing rate.²⁶

There is no financial reason to justify exclusion of the unjust enrichment of the respondent from consideration in the calculation of interest. If the law exists to serve the ends of society, should it not find room to accommodate the financial realities within which that society functions?

24 Gotanda, above n 16, 4.

25 *Compañía del Desarrollo de Santa Elena, SA v The Republic of Costa Rica*, ICSID Case No ARB/96/1, Final Award (Feb 17, 2000) ¶ 101.

26 Jeffrey M Colón and Michael S Knoll, ‘Prejudgment Interest in International Arbitration’ (2007) 4(6) *Transnational Dispute Management* 11 (citations omitted).

These varied factors may, of course, complicate to a degree the calculation of interest in arbitral awards. That risks *increasing*, rather than decreasing, the inconsistency from case to case. But is it the inconsistency in the rate itself about which Gotanda complained, or the inconsistency in how tribunals have arrived at a rate?

In one of the earlier writings to address interest in international arbitration, Professor Gotanda suggested a model approach in which, as a threshold question, the tribunal would ascertain whether the parties have specified the mechanism for calculation of interest. If they have not, Gotanda would presume liability starting from the date of default, with the rate reflecting ‘that of a commonly used savings vehicle in the country of the currency in which payment is to be made,’²⁷ with quarterly compounding. He continued, ‘[t]he savings vehicle could be, for example, a certificate of deposit, money market account or commercial savings account.’²⁸

The difficulty is that the rate is unlikely to reflect the anticipated level of risk and reward embodied in the investment that is at issue. Businesses invest to earn more than they can earn by simply parking their funds in a bank account. Indeed, the bank that pays interest on a certificate of deposit or investment account takes the funds that are on deposit, *and invests them to earn a higher return*. While there is something to be said for simplifying the arbitral process and bringing a degree of consistency to the practice, it should not be at the expense of the aggrieved claimant.

A more risk-weighted alternative was offered a decade later by Sénéchal. He proposed using ‘a rate derived from a risk-free instrument to which is added an average market risk premium. Such rate would include all risk factors (systematic, regulatory, and inflation), plus the time value of the money itself.’²⁹ Like Gotanda, Sénéchal would calculate interest on a compound basis.

Sénéchal was not alone in suggesting that the claimant’s alternative investment opportunities could be better measured with a risk-weighted market rate. Gotanda, too, had reached this conclusion during the intervening decade, writing that ‘awarding compound interest at the claimant’s opportunity cost would be the most appropriate way to compensate it for the loss of the use of its money.’³⁰

The two joined forces soon thereafter, tracing the evolution of the treatment of interest by international tribunals from the application of national laws providing for simple interest to the relatively recent practice of awarding compound interest at market rates in matters under the International Centre for Settlement of Investment Disputes. But still they saw problems with the tribunals’ handling of the issue:

Although these changes were designed to more fairly compensate claimants for the loss of the use of money, in practice they fail to do so. This failure occurs because they do not acknowledge that businesses typically invest in opportunities that pose a significantly greater risk than the risk reflected in such commonly used standards as U.S. T-bills and LIBOR rates. The fault, however, does not lie with tribunals alone. Claimants also must share the blame because they may not set out well-constructed claims for interest.

27 Gotanda, above n 17, 56.

28 Ibid 59.

29 Sénéchal, above n 15, 10.

30 Gotanda, above n 16, 34.

*Nevertheless, even when claimants do so, tribunals often award damages at statutory rates or at rates reflecting a nearly risk-free investment because they are unfamiliar with modern economic and financial principles.*³¹

They noted, as well, that the use of risk-free rates – which some experts justify on the (mistaken) basis that the respondent's taking of the claimant's assets has relieved the claimant from the ownership risk – will undercompensate the claimant. This, of course, is true. What the proponents of a risk-free rate do not acknowledge is that while the risks associated with ownership of the assets may have been relieved, the potential rewards of ownership of the asset have been taken away, too. Furthermore, a potentially riskier investment has been substituted – a coerced 'loan' of funds to the respondent, repayment of which depends on the filing and successful prosecution of an arbitral action. Even worse, that coerced loan does not come with the protections a lender would require in a conventional loan transaction – minimum required coverage ratios, cross-default provisions, default interest rates, or other contractual protection.

Gotanda and Sénéchal conclude that the claimant's opportunity cost should be the determinant of the interest rate, stating '[a]n ideal award of interest as damages would call for interest to be calculated at the opportunity cost of capital.'³² Acknowledging that this rate may be difficult to ascertain for privately-held claimants, they propose an alternative calculation based on the risk-free rate plus an average market risk premium.³³

This is a substantial step toward full compensation for the effects of a respondent's actions. At the margin, however, there are still some loose ends. The Gotanda-Sénéchal proposal would apply the same rate of interest to investments in a highly developed economy and those in less developed economies, where the risks may be much higher. We believe claimants should be compensated for the risks undertaken and, to that end, that the rate of interest suggested by Gotanda and Sénéchal should be determined with reference to not only the claimant's cost of capital, but with reference to the risk level of the country in which the investment is made, as well.

One way to estimate the effect of host country risk is by reference to Ibbotson's International Cost of Capital Reports. These annual reports use several different cost of equity models to estimate the costs of equity from the standpoint of a U.S. investor with equity investments in different markets around the world. Comparing the cost of equity in the host country to the costs of equity in the major markets in which the claimant operates (and on which the claimant's cost of capital is based) gives the tribunal a way to adjust the interest rate to reflect the specific risk profile in the host country.

Another factor that is indicative of the relative country risk is the sovereign cost of debt. This is particularly relevant to investment treaty claims, where the sovereign is the party benefiting from the delay in compensating the claimant. This, of course, allows the tribunal to consider the unjust enrichment aspect discussed above.

31 Thierry J Sénéchal and John Y Gotanda, 'Interest as Damages' (2009) 47(3) *Columbia J of Transnational L* 493-4.

32 Ibid 536.

33 Ibid 529.

The Period for Interest Calculation

As Gotanda noted in his early model for the calculation of interest, some jurisdictions require the claimant to give notice of default in order to trigger interest.

*For a claimant to receive interest, the debtor must be given some notice of default. Otherwise, the debtor is free to assume that either the claimant is suffering no injury as a result of the delay or the claimant has impliedly given permission for the debtor to delay performance.*³⁴

From a financial perspective, this might be reasonably termed the ‘free lunch’ approach. While there may be some historic legal rationale for the requirement of notice, the economic rationale is suspect. The claimant is deprived of the use of its funds, and the respondent enjoys the free use of those same funds.

Colón and Knoll take a more economically-justified approach, and one that finds support in consideration of basic principles of equity, as well:

*there is some controversy when the prejudgment interest period begins. Both courts and tribunals have used several dates, including the date of incident, the date of harm, and the date of filing. Because the goal of the prejudgment interest is to place the parties, especially the successful claimant, in the same position they would have been in had the respondent immediately paid the claimant, the best choice is the date of harm.*³⁵

Investment treaty cases frequently involve claims of expropriation, in which the claimant’s investment is taken at a point in time. The valuation date under the typical bilateral investment treaty is immediately prior to the taking (ignoring for the moment the possibility of creeping expropriation). That valuation date would serve as the starting point for the calculation of interest, as pointed out by Wälde and Sabahi:

*It is essential that the starting date for interest to be aligned with the ending date of the calculation of the principal of the compensation/damage. Visualising the compensation mechanism as a hypothetical buy-out of the claimant helps: the moment a fictitious buy-out price is agreed (i.e. the principal of the compensation payment), then an interest rate can and should be added onto that principal.*³⁶

In a creeping expropriation, or similar situation in which there are multiple actions complained of, culminating in the expropriation or destruction of the asset, the tribunal will need to be sensitive to the prospect that there may be multiple dates for the start of interest on the various portions of damages. One way to address this is to prepare a unified damages/valuation model that enables the tribunal to focus on the valuation impact of each of the events as of a common date, typically the date of final destruction or expropriation.³⁷

34 Gotanda, above n 17, 42 (citations omitted).

35 Colón and Knoll, above n 26, 7.

36 Wälde and Sabahi, above n 21, 48.

37 See Leonardo Giacchino and Richard E. Walck, ‘Damages Models to Accommodate the Necessity Defense,’ *The International Litigation Quarterly*, Vol 27, Issue 1, Fall 2010.

Pre-Award and Post-Award Interest

The distinction between pre-award and post-award interest has been used by some to attempt to justify differential interest rates in the calculations. As noted above, the argument that liquidating the claim and awarding damages takes away the claimant's investment risk (and thereby justifies a lower interest rate going forward) is misplaced. It takes away the claimant's potential upside, as well, and substitutes a forced loan to the respondent on terms that are likely to exclude the standard protections a lender would receive in a negotiated loan.

Wälde and Sabahi address the pre- and post-award question simply:

National laws often distinguish between pre-judgement and post-judgement interest. There is no particular reason to distinguish between these concepts in investment arbitration. At most, the investor is somewhat more certain of payment after the award (though not absolutely certain) than before the award. But one should not over-complicate interest issues by complex risk theory. In general, the pre-award interest rate should therefore be the post-award interest rate.³⁸

Keeping the pre- and post-award rates constant serves another purpose. It helps to keep one of the parties to the arbitration from using interest and discount rates to achieve a strategic objective of minimising or maximising the amount of the award, as we discuss immediately below. Avoiding the introduction of bias keeps the system fair for all users.

The use of a consistent rate also recognises that the simple fact that an award has been rendered does not make the claimant whole. The *payment* of the award is what makes the claimant whole. There is no reason to arbitrarily subdivide the period from the date of harm to the date of payment into pre- and post-award segments with different rates of interest. To do so would suggest that a claimant who takes three years to get an award and a fourth year to secure payment is somehow better or worse off than if it had gotten the award in only two years, but required two more years to enforce payment.

The Interaction of Interest and Discount Rates

Interest and discount rates are two sides of the same coin. The interest rate a borrower pays is the same interest rate that a lender receives. Either party can discount future cash flows using the agreed rate of interest and get to the same present value at a particular point in time. The interest rate is a rate at which the 'market clears,' that is, a rate at which the benefit to one party from having money now and the loss of use and default risk taken on by the counterparty meet.

A discount rate is used to convert a stream of future cash flows to their present-day value. The fact that discounting is needed reflects the time value of money: a dollar today is worth more than a dollar a year into the future. The choice of discount rate should reflect the risk that is inherent in the cash flows that are being discounted. As the International Valuation Standards Committee states in its *Guidance Notes*:

38 Wälde and Sabahi, above n 21, 48.

*3.1 Discount Rate. A rate of return used to convert a monetary sum, payable or receivable in the future, into present value. Theoretically it should reflect the opportunity cost of capital, i.e., the rate of return the capital can earn if put to other uses having similar risk.*³⁹

The interest rate takes the cash flows that have been present valued by the discount rate, and brings them forward to a value at the time of the award, or at the time of payment. It is reflective of the same cash flows, with the same underlying risk profile. There is no compelling reason to use different rates.

In fact, there is a strong reason *not* to use different rates for discounting and for interest. Differential rates introduce an element of arbitrage that one party can use to the detriment of the other. A respondent can, for example, argue that the future cash flows of an expropriated investment should be discounted at a rate reflecting substantial risk, thereby minimising the present value of the investment, with the result brought forward at a lower rate. The respondent pockets the difference.

This is what one economist has termed an ‘invalid round trip.’⁴⁰ It discounts a monetary sum back in time at a high rate, and then brings it forward at a low rate, resulting in a potentially significant decrease in the amount of compensation. The reverse, of course, can also happen, when a claimant makes arguments to suggest that the interest rate used to bring past losses forward should be higher than the discount rate, perhaps because of events that have transpired since the date of the original investment.

Consider the following illustrative example.⁴¹ An event in 2000 causes a loss of \$1,000 several years later in 2009. Assume that the amount of the loss in 2009 is established with the certainty of hindsight to have been \$1,000. Using the flawed logic of the ‘invalid round trip,’ the defendant/respondent would urge the Tribunal to discount the sum back to 2000 at a high rate, say 15%, yielding a present value in 2000 of only \$284.26. The defendant/respondent in our hypothetical would then ask the Tribunal to add interest at a low rate, say 5%, to bring the amount forward to 2009. Even with compounding, the 2009 value would be only \$440.98. Our hypothetical defendant/respondent would then have the Tribunal believe that an award of \$440.98 would fully compensate the plaintiff/claimant for its proved \$1,000 loss. Common sense tells us otherwise.

Using a single rate for discounting and for interest serves another purpose. It makes the estimation of damages less sensitive to the choice of the valuation date. When the interest and discount rates are the same, the valuation date can be changed without affecting the value as of the time of award. Of course, there may be circumstances in which specific case facts require that to be equitable to the parties, the discount or interest rate should be adjusted independently of the other, but as a general proposition, tribunals should be very careful that such adjustments do not result in undercompensation or overcompensation of the claimant.

39 *International Valuation Guidance Note No 9: Discounted Cash Flow Analysis for Market Valuations and Investment Analyses (Rev 2007)*, International Valuation Standards (8th ed, 2007) § 3.1.

40 Pablo T Spiller, ‘Economic Principles of Damages’ (Speech delivered at the Permanent Court of Arbitration and Houston International Arbitration Club seminar on *Remedies in Commercial, Investment and Energy Arbitrations*, Houston, 17 April 2008.

41 While the example is purely hypothetical, the desire of some parties to engage in this type of financial manipulation is not. The issue was faced by the Tribunal in a commercial ad hoc arbitration between a Singapore claimant and a US respondent, where the respondent argued for just such treatment. The Tribunal saw the faulty logic and did not embrace the respondent’s theory. *Sumber Co Pte Ltd v Johnson Diversey Co*, Ad Hoc Arbitration (2008).

Reconciling the Legal and Financial Perspectives – A Suggested Approach

The general consensus is that one way or another, arbitral tribunals are empowered to grant awards of interest, and in doing so, the object should be not to penalise defendants, but to ensure that a claimant gets fair compensation – ie, not only the award of the sum it was previously due, but also compensation for the delay in the claimant having access to such money.

In order to achieve this, we would propose the following rules of thumb to ensure that the best effort is made to do real justice to a party's claims:

- As a general rule, if time has passed between harm and award, then interest should be awarded.
- If the parties agree to contractual treatment of interest, the contract should control.
- In the absence of an agreement, tribunals should look to a few key guideposts, such as we suggest:
 - Interest should be compound; 'rests' can vary with the circumstances, but the rate needs to be one appropriate to the rests (eg, don't use a 30-day rate and then compound annually – either use a 30-day rate compounded monthly or the higher 1-year rate compounded annually).
 - Tribunals should be sure their award of interest fully specifies the rate or index to be used. An award of interest at LIBOR does not specify which LIBOR rate should be used (the 1-month, 3-month, 6-month or longer rate; the rate for Sterling, Euros or US dollars).
 - Interest should accrue from the time of the action or event that gives rise to the cause of action. The notion of interest running from the time notice is given ignores the true question of when a party should have performed its obligations.
 - Tribunals should consider a variety of indicators of the appropriate rate, rather than simply defaulting to a risk-free or nearly risk-free rate. The alternative uses the claimant has for the monies (whether to reinvest or to pay down debt) are relevant, as are the investment returns and/or borrowing costs of the respondent who has enjoyed the use of the money. Public policy grounds should allow tribunals to reverse the unjust enrichment that a respondent has enjoyed.
- Tribunals and counsel should ensure that they or their experts actively address the question of interest, so that the Tribunal is sufficiently versed in the appropriate mathematics and the underlying support.
- Tribunals should be very careful to avoid an 'invalid round trip' by keeping discount rates and interest rates related to one-another, and requiring the parties to justify any departures from that treatment. Otherwise, parties may be tempted to structure calculations to their benefit by arguing for a high discount rate to get to the NPV of damages, then a low interest rate to bring it forward, or vice-versa.

While the above are simply suggested rules of best practice, we do believe that the field of the methodology of the award of interest has been largely ignored in the development of arbitral practice to date, joining (until recently) prospective damages as a black art best left for dueling experts only. While the implementation might sometimes be complex, the basic principles discussed herein are not. But unless they are applied, the award of interest will remain a hit-and-miss affair, sometimes meeting its intended aims, but at other times either penny-pinching or producing significant windfalls.