Lost Profit and Capital Investment

By Michael Pryles[1]

1. Introduction

The aim of damages is to compensate a claimant for the loss it has suffered at the hand of the respondent. In expropriation cases, the claimant must be provided with the pecuniary value of the asset(s) taken[2]. For breaches of contract, unless specific performance is awarded, claimants are compensated by an award of damages which aims to place them in the same pecuniary position they would have been in had the contract been performed[3]. Limitations are imposed on the award of damages. Damages which are not foreseeable or are too remote will not be awarded. As stated by Alderson B in the famous case of *Hadley v Baxendale*:[4]

> "[w]here two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, ie, according to the usual course of things, from such breach of contract itself, or such as may be reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."

Between direct damages, which can be recovered, and 'remote', 'unforeseeable' or 'speculative' damages, which can not, there may be grey areas.

In ascertaining the damages to be awarded, tribunals may be required to determine the profits the claimant would have made if not for the expropriation or breach of contract. As any lawyer involved in dispute resolution can attest, this can be a difficult task. In particular in cases concerning capital investments, tribunals may have to look thirty to forty years into the future, consider interest rates, inflation and other risks, often with little evidence of likely income. Complex calculations are usually required and expert evidence is invariably involved. In

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[2] The formulation for compensation has been restated over the years. The famous Hull declaration requires "prompt, adequate, and effective" compensation. There have been other formulations including the simple requirement of "appropriate" compensation. However it is generally recognised that the compensation must be sufficient to fully compensate the affected party and to eliminate the consequences of the Government's actions. In cases brought against States for breaches of obligations under bi-lateral investment treaties, but not involving expropriation, various standards of compensation have been formulated. Sometimes tribunals have applied the standard applicable in expropriation cases and in other instances this has been departed from.

[3] *Sapphire International Petroleums Ltd. v. National Iranian Oil Co.,* 35 I.L.R. 136 (1967); 13 Int'l & Comp. LQ 1011 (1964).

[4] (1854) 156 ER 145.

addition, claims are often of hundreds of millions of dollars. Therefore even small changes in the variables significantly affect the amount of the award.

The aim of this paper is to highlight some of the difficulties that can arise in lost profits calculations. Cases concerning capital investments will be given particular attention as these often provide the most difficult problems for tribunals. The particular issues that will be examined are double counting, determining lost profit when a business has no track record and the role of the abuse of rights doctrine in damages awards.

2. Double Counting

It is common to find statements on the law on damages such as the following:

> "According to the generally held view, the object of damages is to place the party to whom they are awarded in the same pecuniary position that they would have been in if the contract had been performed in the manner provided for by the parties at the time of its conclusion. They should be the natural consequence of the breach. This rule is simply a direct deduction from the principle *pacta sunt servanda*, since its effect is to substitute a pecuniary obligation for the obligation which was promised but not performed. It is therefore natural that the creditor should thereby be given full compensation. This compensation includes the loss suffered (*damnum emergens*), for example the expenses incurred in performing the contract, and the profit lost (*lucrum cessans*), for example the net profit which the contract would have produced."[5]

On the basis of such a statement one might presume that the correct method for determining damages is to:

(a) calculate the amount spent by the claimant in performing the contract;

(b) calculate any profit the claimant expected to receive; and

(c) add the two together.

Indeed it is not uncommon to find legal argument advocating such an approach. However, it is in fact the cause of one of the fundamental errors committed in damages calculations: double counting.

[5] Supra n.3.

The principle is best demonstrated using an example. A high profile case that has attracted significant criticism for double counting the *Karaha Boda*s decision.[6] This case arose out of an agreement to generate electric power in Indonesia. In 1994 a US and a Japanese company made an agreement to develop Indonesian geothermal sites to produce up to 400 mw of electricity. The Karaha Bodas Company ("**KBC**") was incorporated to undertake the project. KBC operated as contractor to a state-owned Indonesian oil company with authority over geothermal energy, named Pertamina. KBC was to deliver and sell the electricity produced to the state owned electricity company, PLN, on behalf of Pertamina. PLN agreed to buy the electricity on a take-or-pay basis.

When the Asian currency crisis hit in 1997 demand for power fell sharply and it became apparent that PLN did not need the power it had agreed to purchase. In addition, because the contract price was in US currency, repayments became four to six times greater (in rupiah) than when the agreement was reached.

The parties ended up in arbitration. The tribunal found that Pertamina and PLN had breached their contract with KBC. KBC sought US $96 million in damages for its expenditures, and US $512.5 million in lost profits.[7]

Ultimately, the tribunal awarded the claimants US $ 111.1 million for its expenses and US $150 million in lost profits, reasoning as follows.

> "Indonesian Law, like numerous other legal systems, provides for the recovery of lost profits ("*lucrum cessans*") as a component of the damages to which the innocent party is entitled in case of inexcusable breach of contract, in addition to the other damages component, the "*damnum emergens*".
> As in other legal systems, recovery is limited to damages that were foreseeable when the contract as made and that are the immediate and direct result of the breach.
> There is no doubt in the Arbitral Tribunal's opinion that the Claimant is entitled to obtain the benefit of its bargain in addition to recovering the expenditures it has incurred."

The double counting problem arises from the tribunal's decision to award *damnum emergens* in addition to *lucrum cessans*. This is problematic because, in projects such as this, from an economics perspective, the real value of an investment is usually its ability to generate a stream of profits over the lifetime of the project. Once the contract has lived its natural life, the expenses incurred in reliance on the contract are rarely recovered. Rather, they form part of an

[6] Summarised in *Karaha Bodas Co v Perusahaan Pertambangan Minyak Das Gas Bumi Negara* 364 F.3d 274 (5th Cir. 2004)

[7] US $437 million in lost profits under an alternate calculation

investment that is considered worthwhile in light of expected profits. If assets can be sold, they usually attract only a fraction of their initial value.

This is explained by the *Himpurna*[8] and *Patuha*[9] tribunal[10] as follows:

> "[when awarding compensation for expropriated business ventures], there is generally no basis to apply the *contractual* reliance damages (*damnum emergens*), but only the expectancy damages (*lucrum cessans*). An undertaking has been expropriated; the prejudice suffered by its former owner is simply the worth of the venture as a going concern. That worth is crystallised in an analysis which discounts the future revenue stream of the enterprise to establish its present value. Leaving aside special considerations justifying higher recovery in the case of *wrongful* expropriation, there is no separate evaluation of sunk costs, whether or not represented by physical assets. That the Claimant has been dispossessed of the walls and machinery of a factory does not lead to a separate recovery on that account. Had there been no expropriation, past investments would have been recovered through subsequent revenues. Since those revenues are fully accounted for in the DCF going-concern evaluation, an award of lost investment as well would be an unacceptable double recovery.

In *Karaha Bodas* there was in fact a provision in the contractual documents expressly requiring all project assets to be transferred to the respondents at the end of the contract. So, if there had been no breach and the contract had been allowed to terminate naturally after 30 years, the claimant would clearly have been left with *nothing*, except its profits. However, as a result of the tribunal's award, the claimant was able to take its initial capital and re-invest it in, for example, some other business, in some other country. Assuming the capital was put to good use, the claimant would have received two sets of profit from the same investment. Thus it would have received double recovery.

However there may be cases where lost capital could be awarded as well as lost profits. Take, for example, an investment comprising the purchase of land and the construction of a factory. If the investment is expropriated the claimant will be entitled to either its capital costs or its loss of profits. However even if lost profits are awarded based, let us say, on an anticipated life of the factory of 30 years, the land at the end of that period will have a residual value

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[8] *Himpurna vPLN* Final Award of May 4 1999, published in 14 Mealey's International Arbitration Report (December 1999) pp. A-1 - A 58.

[9] *Pathua v PLN* 14 Mealey's International Arbitration Report (December 1999) pp. B-1 - B-49

[10] Both cases were heard by the same arbitral tribunal and resulted in identical awards, save for the amount of damages claimed and awarded. The cases are discussed further below.

which should be awarded as well as the lost profits. Strictly speaking it may be the value of the land less the cost of demolishing the factory and cleaning up the site.

In breach of contract cases, not involving any expropriation, the value of the loss will often be computed on the basis of loss of profits or consequential liability to a third party. The alternative of capital expenditure will not be relevant. Thus in the case of a sale of goods, a purchaser who has not received the goods will be entitled to the loss of profits which he could have made from the resale. If the purchaser had already entered into a contract to resell the goods the measure of loss may be its liability to the sub-purchaser. However in some breach of contract cases there may be considerable capital expenditure for failure to supply the goods as well as its loss of profit. Take the example of an exclusive distributor of motor cars. Such a distributor may establish facilities throughout its territory, for the marketing, sale and servicing of vehicles. If the distribution agreement is wrongfully terminated, the measure of damages could be computed on the basis of the capital expenditure invested or the loss of profits. But care must be taken to ensure that there is no double counting.

As noted by the tribunal in the *Himpurna* and *Patuha* arbitrations:

> "In contractual cases such as this, it is usual that the claimants seek recoupment of their entire investment as a discrete element of compensation. Claimants are on solid ground when they ask to be reimbursed monies they have actually spent in reliance on the contract; recovery of lost future profits is less certain. The value of the asset taken in an expropriation case may be higher or lower than the amounts the claimant expended in developing the asset. (Positive subsequent developments such as improved market conditions, or successful exploration campaigns, may have resulted in a higher value; negative developments such as failed exploration campaigns, or a fall in price, may have had the opposite effect.) In the case of a breach of contract, the wasted cost is what the claimant has spent in reliance on the agreement, without reference to how judicious or providential those expenditures turned out to be. No further explanation is necessary to understand why victims of contractual breaches tend first and foremost to articulate a plea for *damnum emergens*.
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> On this footing, however, the quantification of lost profits must result in a lower amount to avoid double counting. This is so because future net cash flow generally includes all the amortisation of investment there will ever be. To ask for the full amount of the future revenue stream when also claiming recoupment of all investments is wanting to have your cake and eat it too. If the DCF method is applied in a contractual scenario to measure nothing but net cash flows (thus excluding the accrual accounting notion of "income" which may cover non-cash items such as depreciation), there is no room for recovery of wasted costs. In other words, when the victim of a breach of contract seeks recovery of sunken costs, confident that tit is entitled to its *damnum*, it may go on to seek lost profits only with

the proviso that its computations reduce future net cash flows by allowing a proper measure of amortisation."

3. New Businesses

Another situation that is notoriously difficult for damages calculations is when the claimant is a new or unestablished business. In such a case there may be insufficient earnings history or other evidence on which to quantify the lost profit. In such a situation, what should a tribunal do? Can it deny the claimant relief on the basis that calculating the damages would be overly speculative? Or if the claimant has already established that it has suffered loss, must the tribunal find a way to determine an appropriate level of compensation? The answer, in most common law countries, is that difficulty of assessment of damages is not a bar to recovery.[11] As stated by the US Federal Court:

> "[e]vidence to establish [lost] profits must not be uncertain or speculative. This rule does not apply to uncertainty or speculation as to the *amount* of the profits which would have been derived, but to uncertainty or speculation as to whether the loss of profits was the *result* of the [breach] and whether any such profits would have been derived at all."[12]

An example of this principle in practice is the decision of *Yusuf Ahmed Alghanim & Sons WLL v Toys "R" Us Inc*[13]. The dispute concerned a Supply Agreement and a Licence and Technical Assistance Agreement through which the claimant, a privately owned Kuwaiti business opened a Toys "R" Us store in Kuwait and 13 other countries located in and around the Middle East. A dispute arose between the parties which led to the termination of the agreement and arbitration. The respondent was found to be at fault and the tribunal was required to determine the appropriate level of damages to award the claimant.

While in this case the claimant did have an operating history, the business had to date operated at a loss. However, the arbitral tribunal found that it would have expected profits in the future, and therefore that it had suffered a loss for which it should be compensated. Given the lack of profitable operating history this meant that the tribunal had to quantify the claimant's loss using alternate means. It was submitted by the claimant, and accepted by the tribunal, that an

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[11] See, for example, *Fink v Fink* (1946) 74 CLR 127. The same is true in ICSID arbitration: "[i]t is well settled that the fact that damages cannot be settled with certainty is no reason not to award damages when a loss has been incurred." *SPP v. Arab Republic of Egypt*, ICSID award of 20 May 1992, Yearbook XIX (1994) p. 84.

[12] *Kyocera v. Prudential-Bache*, 299 F. 3d 769, 790 (9th Cir 2002).

[13] *Yusuf Ahmed Alghanim & Sons WLL v Toys "R" Us Inc; TRU (HK) Ltd* 126 F.3d 15

appropriate basis for quantifying the claimant's loss would be to look at the profitability of *other* Toys "R" Us stores. A US Court of Appeals, approving of the decision, summarised the tribunal's reasoning as follows.

> "[Claimant] is forced into the estimating posture because of [Toys "R" Us's] breach, bases its damages not on its own experience but on [Toys "R" Us's]. [Toys "R" Us] has hundreds of toy stores worldwide. Since it has been found that the Agreements require [Toys "R" Us] to provide a wide variety of services, similar to what it provides its own toy stores, I find that [Claimant's] method of estimating damages is reasonable and believable, and provides a sound basis on which to fashion the award."

On this basis the claimant was awarded US $46.44 million for lost profits.

This case is an example of the creativity that can be necessary in order to ensure that a successful claimant is adequately compensated when the quantum of loss is uncertain. However, it is important to distinguish between cases such as this where the *quantum* of loss is uncertain, and cases where the *existence* of loss is uncertain. While uncertainty as to the quantum of loss will not preclude recovery, if it is not clear that loss has in fact been suffered, the claimant will be unable to recover damages.

An example of the latter situation is *Levitt v Islamic Republic of Iran*[14]. This case concerned a contract between International Construction Company (Iran) Ltd ("**ICC**"), a Bahamian company owned and operated by a US national (Mr Levitt), and the Housing Organisation of Iran ("**HO**"). The contract was for the construction of a housing development in Iran. Work had progressed to the point at which the site had been cleared and graded for construction of 950 units. At this point the project broke down due to a failure by HO to gain approval for construction of a water supply and provide other services. The Tribunal held that HO had breached its obligations under the contract and awarded ICC damages for the expenses it had incurred as a result of the breach. The Tribunal stated that:

> "[i]n principle, loss of profits constitutes a proper head of damages for breach of contract provided the Claimant can establish to the Tribunal's satisfaction that such profits would have accrued if the contract had proceeded to completion."

Despite this, the tribunal denied recovery of lost profits on the basis that the claim was highly speculative. This was because:

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[14] 14 Iran-U.S. Cl. Trib. Rep. 191, 209-10 (1987).

> "By the time the Contract came to an end only the initial stages of clearing and grading had been completed, and no construction work had begun on the buildings. The project had therefore reached only a very early stage."

ICC had claimed lost profits on the basis of an 18 per cent profit margin. The tribunal noted that the prospects of achieving such a profit initially looked favourable as there was strong interest shown by prospective purchasers, and government approval had been given for the grant of the mortgage financing. However, the evidence indicated that ICC would have experienced considerable difficulties in proceeding with the major phases of the construction due to the civil unrest that was occurring at the time, particularly in view of the fact that it was the first such project Mr Levitt had undertaken in Iran. The Tribunal considered it most unlikely that the project would have been completed on time, or that the cost would not have been greatly increased by difficulties in caused by the civil unrest.

The claim for lost profits was therefore dismissed on the basis that ICC had not shown with sufficient certainty that the project would have resulted in a profit due to its lack of earnings history.

Yet another clarification of the certainty principle must be made in the context of compensation for expropriation. As mentioned above, the purpose of compensation in expropriation cases is to return to the claimant the full value of its investment. One of the most popular methods for determining this value is the discount cash flow method ("**DCF**"). This determines compensation by estimating the cash flow which an asset would be expected to generate over the course of its life, and then discounting that cash flow by a factor which reflects the time value of money and the risk associated with such cash flow. The DCF method is generally considered the preferred method of determining compensation in expropriation cases. However, what happens if the expropriated asset is new business with a limited track record? How is the future cash flow determined? As with other breach of contract cases, once it has been established that the claimant has suffered a loss, must a tribunal nevertheless find a way to determine the likely lost profit?

A case in which this issue arose is the well known ICSID case of *Metalclad Corp v The United Mexican States*[15]. In this case the tribunal considered that the claimant's business did not have a sufficiently established place in the market or a sufficient history of earnings to use those profits as a basis for determining the appropriate level of compensation. The tribunal stated that:

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[15] ICSID Case No. ARB (AF)/97/1, Award of August 2000, 16(1) ICSDID Rev. - Foreign Inv. L.J. 168, 197-99

> "where the enterprise has not operated for a sufficiently long time to establish a performance record or where it has failed to make a profit, future profits cannot be used to determine going concern of a market value. In *Sola Tiles, Inc. v. Iran* (1987) (14 Iran-US C.T.R. 224, 240-42;83 I.L.R. 460, 480-81), the Iran-US Claims Tribunal pointed to the importance in relation to a company's value of "its business reputation and the relationship it has established with its suppliers and customers". Similarly in *Asian Agricultural Products v Sri Lanka* (4 ICSID Reports 246 (1990) at 292), another ICSID Tribunal observed, in dealing with the comparable problem of the assessment of the value of good will, that its ascertainment "requires the prior presence on the market for at least two or three years, which is the minimum period needed in order to establish continuing business connections".

Accordingly, the tribunal held that it would be inappropriate to use future earnings as the basis for awarding compensation.

This decision has been criticised. One professor has said in regard to this case that:

> "[i]t is a fundamental aspect of contract law in most, if not all, countries that a party that has been injured as a result of a wrongful breach is entitled to the benefit of its bargain, including any gain of which it was deprived. Denying lost profits simply because the injured business is new would leave the injured claimant less than whole and would fail to achieve the goal of full compensation."[16]

While cases hold that difficulty of assessing lost profits is no bar, it does not follow that the DCF method has to be used. It will be recalled that when dealing with expropriation cases the aim is not to provide the claimant with the profit it lost, but rather to compensate for the value of the lost business. Using lost profits is but one, albeit the most popular, way of achieving this. There are, however, various methods of calculating compensation, some of which do not require consideration of future lost profit. There are economic models that allow compensation to be based on, for example, the net book value of the investment. For example, in the *Metalclad* case, because the Tribunal considered itself unable to calculate compensation on the basis of lost profits, it did so by reference to the claimant's actual investment in the project. This, from an economics perspective, should produce a similar result to compensation calculated on this basis of future profits, unless the claimant argues that the project would have experienced exceptionally high or low profitability.[17] And, if a claimant does claim it would

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[16] John Gotanda, "Recovering Lost Profits in International Disputes", 36 Georgetown Journal of International Law (Fall 2004), p 100.

[17] Thomas Stauffer, "Valuation of Assets in International Takings", 17 *Energy Law Journal* 459

have received unusually high profitability, its unproven track record gives incentive to avoid profits as the measure for assessing compensation.

Another example is provided by the case of *Sapphire Int. Petroleum Ltd v National Iranian Oil Company*[18]. There the National Iranian Oil Company and a Canadian Company entered into an unincorporated joint venture to prospect for oil in a concession area amounting to some 3,000 square kilometres in the south east of Iran. The agreement also provided for the exploitation of oil resources when discovered. The claimant, who was the assignee of the original joint venture party, commenced to carry out its prospecting obligations under the agreement. It incurred substantial costs in prospecting work but, before any oil drilling activities commenced, disputes arose between the joint venture parties. The respondent, National Iranian Oil Company, then drew down on a security which had been lodged by the claimant.

In an award dated 15 March 1963, the Swiss arbitrator held that the respondent's behaviour amounted to a breach of contract which released the claimant from carrying out its own obligations under the contract and entitled it to damages.

The arbitrator held that the claimant was entitled to compensation for the loss suffered (*damnum emergens*), for example the expenses incurred in performing the contract, and the loss of profit (*lucrum cessans*).

As to the former, the claimant sought to recover the following sums:

1. US$350,000 being the amount the letter of credit cashed by the respondent;
2. Payment of compensation for the expenses incurred in the conclusion of the joint venture agreement amounting to US$165,175;
3. The registration fees of the claimant company in Iran amount to US$3,500;
4. The share capital subscribed by the claimant in an Iranian company which, under the terms of the joint venture agreement, was to act as the claimants agent in relation to prospecting obligation composed on the claimant under the agreement and, in relation to the extraction and sale of oil, was to act as the agent of both parties;
5. US$1,018,932 being the cost of prospecting work carried out by the claimant.

The arbitrator held that the claimant was entitled to all these sums up to the date that they ceased performing their obligations under the agreement with the exception of no. 2 being compensation for the expenses incurred in the conclusion of the agreement. The arbitrator

[18] Supra n.3.

ruled that this claim could not be allowed by way of positive damages because damages could only be awarded to put the claimant in the same pecuniary position as it would have been in if the contract had been performed. But the repayment of the expenses incurred in concluding the contract would tend to put the claimant in the position it would have been in if the contract had never been concluded (negative damages).

In relation to the claim for loss of profit the arbitrator noted that the claimant had sought payment of damages in the sum of US$5 million. Although no oil had yet been found the arbitrator recognised that in appropriate circumstances damages could be awarded for the loss of the opportunity to discover oil:

> "(a) Since the question concerns the concession of an area which has not yet been prospected and where therefore the presence of oil-bearing beds in commercially workable quantities was and still is today uncertain, the existence of damage is not without doubt. No one today can affirm that the operation would have been profitable, and no one can deny it. But if the existence of damage is uncertain, it is nevertheless clear that the plaintiff had an opportunity to discover oil, an opportunity which both parties regarded as very favourable. Does the loss of this opportunity give the right to compensation? It is not necessary to prove the exact damage suffered in order to award damages. On the contrary, when such proof is impossible, particularly as a result of the behaviour of the author of the damage, it is enough for the judge to be able to admit with sufficient probability the existence and extent of the damage.
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> Thus the French courts have awarded damages for 'loss of opportunity' when the victim had lost the opportunity of making a profit as a result of what someone else had done. Although in such cases the existence of damage is uncertain, case law has looked at the position at the time when the opportunity was lost and has accepted that this opportunity itself has a value whose loss gives rise to compensation. (Cf. Esmein, loc. cit., vol. VI No 452, 2; Savatier, Traite de las responsabilite civile en droit francais, vol II, 2nd ed. (Paris, 1951), No. 461; Mazeaud and Tunc, Traite theorique et pratique de la responsabilite civile, 5th ed. (Paris 1957), No 219; and the cases cited by these authors. Similarly, an English decision: Chaplin v Hicks [1911] 2 K.B. 786.) A particularly rich source of information on this subject is the American case law, in which several decisions deal with the determination of compensation for loss of land or unprospected mining or oil concessions. In such cases, there is no need to prove the success of the search; it is sufficient to establish a reasonable probability of success. This fact alone gives the land or the concession a market value, which the courts estimate by considering the following factors: transactions relating to neighbouring territories, the appraisal of experts, and especially geologists, concerning the probability of profit, and the comparison with neighbouring areas."

In concluding that there was a serious chance of discovering oil the arbitrator relied on expert evidence from a geologist and certain other factors:

> "(b) In the present case the plaintiff has put in evidence an expert report by G. Meyer, a geologist from Dallas in the state of Texas, who is a specialist in the prospecting and appraisal of oil-bearing concessions. Mr Meyer was also heard by the arbitrator.
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> It emerges from his report, which is summarized in the part of the judgment headed 'Facts", and from his verbal explanations that it is highly likely that the geological characteristics common to every oil-bearing territory are to be found in the territory granted to Sapphire under the concession, which is situated in a region very rich in oil. The geological conditions of this territory make it possible to affirm that there is a very strong chance, but not a certainty, that deposits of commercially workable oil exist in the concession area. The expert supported his evidence by reference to similar conclusions formulated by other

> geologists and other oil companies (in particular: Stahmer, in World Petroleum, June 23, 1952: Fohs, in Bulletin of American Association of Petroleum Geologists, 31 (1947), II, p 137; an unpublished report of NIOC entitled 'Geology of districts', III and IV, documents which were put in evidence before the arbitrator).
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> Finally, the expert mentioned that the surveys which Sapphire International had started were likely to confirm these conclusions.
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> Undoubtedly, as the expert Meyer has also stressed, such an appraisal is not free from uncertainty. But it is difficult to see what other proof could reasonably have been required of the plaintiff.
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> Another factor to be considered is that NIOC, who certainly have an extensive documentation available and possess great experience, would not have made a concession of an area where they did not think that there was a serious chance of discovering oil. It is reasonable to suppose that they would not have required a minimum investment of $US8,000,000 from a company if they did not think that these investments had a serious possibility of being turned to a profit, of which they and the Iranian Government would take the largest share.
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> Moreover, in the arbitrator's judgement the plaintiff has satisfied the legal requirement of proof by showing a sufficient probability of the success of the prospecting undertaken, if they had been able to carry it through to a finish. The plaintiff can therefore claim compensation for 'loss of profit'.

The arbitrator determined the amount of profit on the basis of the evidence before him but discounted for the risks involved:

> "(c) So far as the amount of this compensation is concerned, it cannot be established exactly. It is the arbitrator's task to decide it *ex aequo et bono* by considering all the circumstances.
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> While he refuses to give anything more than a rough estimate, which shows the simple order of magnitude, the expert Meyer considers that the maximum workable reserve would be 25,000,000 cubic metres, which means that, if everything goes as well as possible for the plaintiff, they would receive a net income of $US46,000,000. On the other hand, in case of failure, the minimum loss Sapphire would suffer would be the investment of $US8,000,000 which they had undertaken in the contract, and to this should be added certain expenses of the company in addition to the investments provided for in the contract.
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> All the same, however useful they may be, the preceding appraisals do not take into account all the risks inherent in an operation in a desolate region, to which it is difficult to gain access and which has unfavourable climate, nor the troubles - such as wars, disturbances, economic crises or slumps in prices - which could affect the operation during the several decades - 25 years at least under the contract - during which the agreement was to last. Another plausible consideration is that, now that they are released from the present contract, the plaintiff company can employ its resources, its organisation and its strength in other profitable activities which it could probably not have kept on hand at the same time as the prospecting and exploration of the concession areas, which required investments and important personal obligations.
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> Finally, the judge is given a wide discretion when he has to decide *ex aequo et bono* the compensation for damage whose extent and existence are not certain even though a sufficient probability has been established, and when his assessment rests upon conjecture.
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> Therefore, in the arbitrator's judgement it is reasonable and equitable to fix the amount of compensation for loss of profit at $US2,000,000.

A number of observations can be made about this interesting case. In the first place it might be doubted whether it was appropriate to award both the costs incurred in carrying out the contract and the estimated loss of profits. This would appear to be a case of double dipping. It is certainly arguable that the claimant was entitled to either the costs of carrying out the contract or loss of profits but not both. If we assume that the contract had been performed to the end of the concession period and that oil resources had been found, exploited and sold, the claimant would have received the profits from the transaction. It would not also have recovered its sunken costs which would have simply been relevant in determining the amount of profits obtained.

The alternative basis of computing compensation was simply to pay the claimant its sunken costs. The claimant had expended significant amounts in prospecting but much greater expenditure was expected in the future when drilling operations were to commence. With regard to these amounts, the claimant did not actually expend them and, of course, could use the sums allocated for other projects which would presumably have resulted in a similar return.

In relation to the calculation of the loss of profit the arbitrator was forced to make a rather broad judgment call. The claimant had sought \$5 million, the geological expert considered that the maximum workable reserves which might be recovered could amount to some US\$46 million and the arbitrator also applied a very heavy discount factor to take into account all the risks inherent in the operation which was after all in a desolate region, with an unfavourable claimant and political troubles. Presumably the discount also took into account the possibility that the concession would not turn out to be as profitable as the geologist anticipated it could be.

The arbitrator also referred to the fact that the claimant could employ its resources in other profitable activities and therefore the arbitrator discounted the award to reflect the time value of money. As the claimant had sought \$5 million is loss of profits and the arbitrator awarded \$2 million, the arbitrator allowed the claimant 40% of the loss of profits claimed.

4. Abuse of rights

Another issue, that has become topical of late, is the role of the abuse of rights doctrine in damages awards. The abuse of rights doctrine precludes the exercise or enforcement of a legal right where to do so would create unacceptable injury to the opposing party or broader societal interests. For example, claimants have sought to rely on the doctrine in arbitrations against State entities, where the State entity raises jurisdictional objections on the basis that its own law does not allow it to submit disputes involving it to arbitration.

In a series of investment arbitrations arising out of the Asian economic crisis the doctrine has been invoked by the host State. Most controversially, it was applied in the *Himpurna* and

Patuha arbitrations to deny the claimants damages for lost profits to which they would otherwise have been entitled.

Both cases arose out of an arrangement by which two companies, Himpurna California Energy ("**Himpurna**") and Patuha Power Ltd. ("**Patuha**"), both indirect subsidiaries of a US company, entered into contracts with the Indonesian state electricity corporation, PT (Persero) Perusahaan Listruik Negara ("**PLN**"), to explore and develop geothermal resources in Indonesia. The contracts entitled the project companies to build two power plants in Indonesia and sell the power to PLN.

Indonesia was subsequently struck by an economic crisis and PLN failed to purchase the energy generated. The disputes were submitted to arbitration, with Himpurna and Patuha seeking damages of US $2.3 billion and US $1.4 billion, respectively. Both cases were heard by the same arbitral tribunal and resulted in identical awards, save for the amount of damages claimed and awarded.

The tribunal found that PLN was in breach of contract, and that Himpurna and Patuha were entitled to damages, including for lost profit. The tribunal restricted damages to less than 10% of the amount claimed due to the changed economic circumstances and the belief that to allow the damages to be calculated to impoverish Indonesia would constitute an "abuse of rights".

By a 2:1 majority, the tribunal held that:

> "In [these] circumstances, it strikes the arbitral tribunal as unacceptable to assess lost profits as though the claimant had an unfettered right to create ever increasing losses for the state of Indonesia (and its people) by generating energy without any regard to whether or not PLN had any use for it …. to extract the full benefit of the hard terms of the ESC with respect to investments not yet made, in a situation where that benefit will clearly exacerbate the already great losses of the co-contractant, strikes the arbitral tribunal as likely to constitute an abuse of rights inconsistent with the duty of good faith which is fundamental to the Indonesian law of obligations."
>
> ...
>
> "[T]his is a case where the doctrine of abuse of right must be applied in favour of PLN to prevent the claimant's undoubtedly legitimate rights from being extended beyond tolerable norms"

This conclusion has been the subject of considerable concern. The most obvious concern is the decision's "disregard" for the principle of *pacta sunt servanda*. Indeed many would argue that economic downturns are simply a contractual risk that, like any other, parties should take into account when negotiating their contracts. In this regard it should be noted that one of the arbitrators in the case attached a Statement to the Final Award in which he stated his agreement with his co-arbitrators on the issue of liability, but noted his dissent on the issue of damages. In his opinion:

> "[t]he imposition of a concept described as 'abuse of rights' in the absence of findings of malicious intent or lack of good faith on the part of the claimant to further reduce the entitlement to damages is in my opinion an inappropriate and unwarranted penalising of the claimant."

The decision of the majority has been criticised by others, as well. According to one professor, it has the tribunal misapplied the law:

> "[i]t is not, as the tribunal stated, a general principle of private international law that precludes the awarding of lost profits whenever awarding such profits would cause a severe financial hardship to the party that has breached the contract."[19]

According to others, however, such criticism goes too far. In an unpublished paper presented at the 25th Annual Meeting of the ICC Institute of World Business Law, Jan Paulsson argued that this criticism ignores the fact that the doctrine was only applied in regard to *future* profits. The part of the contract in respect of which the doctrine was applied was purely executory; there had, at the stage of the dispute, been no investment in relation to this aspect of the claimant's request for relief. In this regard, the tribunal stated as follows.

> "The Arbitral Tribunal believes that this is a case where the doctrine of abuse of a right must be applied in favour of PLN to prevent the claimant's undoubtedly legitimate rights from being extended beyond tolerable norms, on the grounds that it would be intolerable in the present case to uphold claims for loss of profits *from investment not yet incurred*." (emphasis added)

Accordingly, Mr Paulsson suggests, the reasoning in this case may not be applicable when awarding lost profits would cause a severe financial hardship to the party in breach. This, however, may be open to argument, as it is not entirely clear in the tribunal's reasoning that a different decision would have been reached had the investment relating to the claimed profits already been made.

In any event, in other cases that have considered the abuse of rights doctrine, the *Patuha* and *Himpurna* reasoning has not been followed. In the *Karaha Bodas* arbitration, the doctrine had not been discussed in the arbitration, but it was raised - and rejected - when the case was

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[19] John Gotanda, *supra* note 11, p. 105.

reviewed by the US District Court and Court of Appeals for the Fifth Circuit.[20] In this case, the Court of Appeals held that an action can only violate the abuse of rights doctrine if one of the following three factors is present:

- the predominant motive for the action is to cause harm;
- the action is totally unreasonable given the lack of any legitimate interest in the exercise of the right and its exercise harms another; or
- the right is exercised for a purpose other than that for which it exists.

It is therefore clear that opinions on this issue vary significantly. In any event, the future of the doctrine will certainly be one to watch with interest. If one considers the number of pending ICSID cases that have arisen because of financial difficulty encountered by the host State (think of Argentina, for example), the doctrine may yet have a significant role to play in the field of international arbitration.

5. Conclusion

The principle behind damages awards is well understood by most. If a claimant can prove that it has suffered loss due to the respondent's breach of contract or other wrongful act, he, she or it is to be put in the same pecuniary position as if the wrongful act had not occurred. However, putting the principle into practice is less simple. In particular in cases involving expropriation or long-term contracts, claims may rise to hundreds of millions of dollars and require complex calculations with much data, and much speculation. This paper has considered three of the difficulties that can arise when making such calculations. There are, of course, many more. One that will certainly be of interest in the coming years is the abuse of rights doctrine. With the increase in bilateral investment treaties and the inevitability of disputes arising out of financial crises, this doctrine is one with which international arbitration lawyers may soon have to become very familiar.

[20] *Karaha Bodas Co v Perusahaan Pertambangan Minyak Das Gas Bumi Negara* 364 F.3d 274 (5th Cir. 2004). This case was discussed above in section 2. The arbitral tribunal granted the claimant, Karaha Bodas Co, damages of US $111.1 million for investment expenses and US $150 million for lost profits.