Kluwer Arbitration Blog

A Black Swan Event? Implications of COVID-19 for Damages and Valuations in International Arbitration

Lucy Martinez (Martinez Arbitration), James Nicholson (FTI Consulting), Noah Rubins (Freshfields Bruckhaus Deringer LLP), and Hafez Virjee (Delos Dispute Resolution, Virjee Arbitration) · Monday, March 15th, 2021

The onset of COVID-19 has brought significant volatility to financial markets and increased uncertainty for investors and businesses of all classes. In the arena of international arbitration, where stakes can be in the multibillions, the ability to assess damages despite this uncertainty is of paramount importance.

This post will address some insights from the webinar organised by FTI Consulting and Freshfields Bruckhaus Deringer, as part of the Delos Guide to Arbitration Places (GAP) Symposium 2020, in navigating damages and valuations amidst COVID-19, specifically:

- COVID-19 as a Black Swan or force majeure event;
- Shifts in dispute strategy in response to COVID-19;
- Challenges in valuation resulting from COVID-19; and
- Lessons and parallels to be drawn from the Great Financial Crisis (GFC), in 2008.

Black Swans and Pandemics

"Black Swan" is a term coined by Lebanese author and former NYU professor Nassim Taleb to describe an event with extreme impact that defies regular expectations, but that is, in hindsight, rationalised as predictable rather than an outlier. When the onset of COVID-19 took most of the world by surprise early in 2020, many were quick to label it as the Black Swan of the decade.

Taleb dismisses this notion. He points to individuals, such as Bill Gates, who have long discussed the possibility of a global pandemic. Indeed, large pandemics have occurred regularly throughout history, and most governments have had some form of pandemic response plan for many years.

COVID-19 is perhaps better viewed through legal lenses as a force majeure event. Notwithstanding the lack of definition of force majeure under most common law jurisdictions, COVID-19 could fall within standard force majeure provisions in commercial contracts.

The key question is one of legal causation: how immediate or remote is the chain of events leading from the onset of COVID-19 to the losses suffered by the claimant? The question may arise more

particularly in claims relating to (1) breaches due to parties pulling out of M&A transactions, joint ventures, or supply agreements; (2) delays in construction projects; or (3) price adjustment in long-term supply contracts.

Bilateral investment treaty (BIT) claims may also be brought by foreign investors who have been impeded by restrictions put in place by governments in reaction to COVID-19, although tribunals are likely to give significant leeway to governments for actions perceived to have been taken in the public interest (see prior discussion on the Blog of possible investment claims here and here).

COVID-19 and Disputes Strategy

Traditionally, damages are assessed at the date of breach, disregarding events arising after that date. However, due to the high degree of uncertainty in markets brought about by COVID-19, the value of the assets at the heart of a dispute may have changed in significant and unexpected ways by the time of an award.

Tribunals may therefore prefer to consider all available information and apply their judgement in selecting the right mix of data and inputs to produce a reliable assessment. This may imply a shift in the date of assessment away from the date of breach and towards the date of award, thereby incorporating full knowledge of the pandemic, actual events post-breach, and current expectations of future developments.

This approach to the date of assessment is not without legal precedent. The *Chorzów Factory* (1928) case is seminal in international law for articulating a principle of full reparation for unlawful expropriation – that is, damages must wipe out all actual consequences of the illegal act and are not limited to just the value of the dispossessed asset at the date of breach, plus any interest to the date of award. On the basis of this principle, tribunals evaluating certain BIT claims have ruled for damages to be assessed at the date of award, first in *ADC v Hungary* (2006), and recently in *ConocoPhillips v Venezuela* (2013).

An analogue is found in English contract law in the form of the *compensatory principle* – the principle that damages should only be awarded for losses *actually* suffered. Despite an accepted practice of valuing damages at the date of breach, the compensatory principle often prevails in limiting damages when events arising after the date of breach have the effect of reducing or erasing the claimant's losses. In *Golden Strait Corp v NYKK* (2007), NYKK repudiated its contract with Golden Strait Corp before it was certain that the Iraq War would break out in March 2003, but was liable for no damages after March 2003 on the basis that the Iraq War would have allowed NYKK to exercise an early termination clause (for a relevant analysis of *Golden Strait see, e.g., Bunge SA v Nidera BV* (2015), at paras. 64 *et seq*., which refers to the *Golden Strait* case as *The Golden Victory*).

The legal approach of assessing damages at the date of award may therefore compensate claimants more fully under the scenario in which COVID-19 leads to larger losses after a date of breach, and protect respondents against compensating for temporary losses that have been reversed by the date of award. However, this may introduce additional strategic complexity when negotiating the procedural calendar of an arbitration. For example, claimants may choose to delay initiating a claim until there is greater visibility of the long-term financial impacts from COVID-19 (e.g., insolvency triggered by delays or failed agreements), in contrast to the typical preference to

proceed quickly. Tribunals may choose to bifurcate proceedings, so that issues of quantum can be addressed separately once more information has emerged.

There are also implications for the giving of expert evidence. Uncertainty amidst COVID-19 implies that expert assessments and opinions will evolve over the course of a case. To streamline expert evidence under such variability, it may be desirable to have experts draw up an initial joint report setting out their areas of agreement, and liaise privately with tribunals to resolve residual disagreements. The use of a single tribunal-appointed expert may further reduce the procedural inefficiencies. Such procedural innovations, however, involve parties giving up control and may be resisted.

COVID-19 Infected Valuations

In valuing a business, the three classical approaches are: (1) the income approach, which considers future cash flows the business can generate; (2) the market approach, which considers the valuations at which comparable businesses are traded; and (3) the asset approach, which considers the value of its constituent assets, or the cost to replace them. In light of COVID-19, there are increased difficulties to applying these classical valuation approaches in an uncontroversial manner.

Claimants may project a quick recovery in their businesses' cash flows and suggest immunity to various sources of risks, while respondents may take a view that the adverse effects of COVID-19 will drag on and reduce the claimants' losses to a minimum. Such arguments imply that valuations based on the income approach will be even more hotly contested than usual. There may also be few transactions in comparable businesses that occurred under market conditions sufficiently similar to those on the date of breach to act as reference points for the market approach.

Despite these difficulties, tribunals arguably have a mandate to arrive at a reasonable quantum of damages, and may consider lowering the bar for what can be considered reasonable certainty in the current environment. After all, stock market participants and investment bank analysts have continually valued businesses even amid such uncertainty. There is no doubt, of course, that assessing damages under such circumstances requires hard thinking. Given that losses may extend beyond a date of assessment, there is the need to have a reasonable forecast for the post COVID-19 world, as well as to model the scenario that would have materialised in such a world but-for the occurrence of a breach.

The use of normalised performance metrics, such as normalised earnings, has been proposed as one answer to the above challenges. The idea is that the valuer would 'strip out' the effects of COVID-19 from the business's current performance, to estimate how it will perform in a post-COVID-19 world. Such metrics are sometimes used in other valuation contexts including post-acquisition disputes following allegations of fraud. They should be employed with caution, however, as they represent an approximation that may not be warranted if the business in question is pending restructuring or even liquidation, or if the pandemic's effects are longer-lasting and more severe than assumed in the valuation.

Finally, there is evidence that, in the face of significant uncertainty, tribunals exhibit *anchoring bias*. That is, tribunals are influenced by the reference points provided in each party's damages assessment. Such bias could be reduced however, if and as tribunals provide more detailed

explanations for the rationale behind their decisions.

Financial Crisis and COVID-19 Crisis

Some parallels can be drawn with the situation during and after the Global Financial Crisis (GFC), in 2008. For example, in their initial phases, there were similar delays in initiation of claims given that potential claimants were occupied with more immediate issues in their businesses.

The spike in volume of claims reported since by various arbitral institutions also mirrors the experience of the GFC. Another similarity is the apparent tendency for a greater proportion of disputes to proceed to a final award. These trends can be explained by claimants being less willing to walk away from a dispute when they are cash-constrained and see the values of their other assets in decline. As with the GFC, however, there will likely be difficulties in securing payment of an award amidst the financial distress caused by COVID-19.

Another parallel with the GFC is that state and corporate actors have taken advantage of the rapidly changing circumstance to modify their contractual and commercial relationships. For example, both after the GFC and in response to more recent events, various governments reduced their financial support for renewable energy projects to manage public spending. After the GFC, these changes triggered a series of disputes in which investors challenged the validity of the states' changes to their renewable energy regimes. It seems likely that similar issues will arise in relation to state actions amidst COVID-19.

Both crises have also given rise to an environment of extensive governmental support. While there is typically no need to factor such governmental support into a damages calculation, there are instances where the level of support received by a business may become relevant, for example, if a business received a government bailout to address impending insolvency resulting from a failed contract which it would not have received had the contract been performed. Here too, careful thinking is required.

The Only Certainty is Uncertainty

Despite the uncertain and difficult context that COVID-19 has presented, the usual principles for valuation and damage quantification continue to apply. The fact is, uncertainty has always been present in damages and valuations, and the scale of COVID-19 has merely highlighted the need for more thoughtful and rigorous attention to issues of quantum. Perhaps wisdom requires accepting that uncertainty is the only certainty for those dealing in damages.

This article draws on insights from a webinar organised by FTI Consulting and Freshfields Bruckhaus Deringer, as part of the Delos Guide to Arbitration Places (GAP) Symposium 2020. The webinar was moderated by Hafez Virjee (Delos Dispute Resolution / Virjee Arbitration, London / Paris). Speakers included Lucy Martinez (Martinez Arbitration, Australia / UK), James Nicholson (FTI Consulting, Asia), and Noah Rubins QC (Freshfields Bruckhaus Deringer, Paris). The speakers thank Oliver WATTS and Quan Wei KOA of FTI Consulting Singapore for their

excellent help in preparing this post.

To further deepen your knowledge on damages and valuation in international arbitration, a summary introduction, important considerations, practical guidance, suggested reading and more, please consult the Wolters Kluwer Practical Insights page, available here.

To make sure you do not miss out on regular updates from the Kluwer Arbitration Blog, please subscribe here. To submit a proposal for a blog post, please consult our Editorial Guidelines.

This entry was posted on Monday, March 15th, 2021 at 7:52 am and is filed under COVID-19, Damages, Force majeure
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.