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AVOIDING WINDFALLS: THE BASIC ECONOMICS OF PREJUDGMENT INTEREST

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Courts and tribunals are commonly faced with two challenges when determining an appropriate amount of damages to award to a claimant. The first challenge is simply determining the quantum of damages, often required to put the aggrieved party in the position it would have been at the time of the offence, absent the issue in dispute. Typically, this is an area of great focus and contention, involving testimony from company personnel and experts, demonstrative exhibits, and written submissions. The next challenge is translating a damages award for conduct that occurred in the past into present-day value as of the date of the award. This side of the damages exercise often receives relatively little attention, even though the careful and considered determination of damages can be substantially undermined if this second step is not done correctly.

The mechanism for translating past damages to present-day value is known as 'prejudgment interest'.

In simple terms, prejudgment interest is computed by applying an appropriate interest rate (or rates) to the amount of past damages. There is no question that the choice of the prejudgment interest rate makes a meaningful difference in the total award inclusive of prejudgment interest. Consider an example of a damages award of €10m for harm incurred 10 years ago. This amount is to be brought forward to the present. The two candidate prejudgment interest rates are annual rates of 4 percent (yielding €4.8m in interest) and 10 percent (yielding €15.9m in interest). (Note that interest amounts are computed using annual compounding. In the absence of some statutory or contractual directive to the contrary, it would not be appropriate to base prejudgment interest on simple interest.) In this example, like many actual arbitration awards, the amount of interest can approach or even become the largest component of the total damages award.

While prejudgment interest rates can sometimes be set by statute or stipulated by contract, often they are not. In our view, selection of the appropriate prejudgment interest rate is an economic issue deserving serious attention during the damages phase of the proceedings. Since parties to a dispute commonly spend considerable resources addressing other economic issues in damages analyses, it makes sense to get the economics of prejudgment interest right, especially given the consequences.

This article addresses several of the most significant economic issues involving prejudgment interest under the assumption that a damages award (and thus the prejudgment interest component of the award) is intended to make the claimant whole. If prejudgment interest exceeds the amount needed to make the claimant whole, we say the claimant has received a windfall. Prejudgment interest insufficient to make the claimant whole leads to a windfall to the respondent. Arbitrators should be provided with the information they need to ensure that neither side gains unduly from the prejudgment interest consideration. This means that the parties need to be prepared to offer a prejudgment interest rate that accurately accounts for the economic risks associated with the harm at issue in the dispute,

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as well as other issues that affect the rate, such as taxation or exchange rates.

A motivating example

Let's continue the example involving €10m in damages awarded based on harm that occurred 10 years before the hearing date. How can this amount be brought forward to the present day without providing either the claimant or respondent with a windfall?

In our hypothetical case, let's assume that the claimant argues for prejudgment interest computed at the average rate of return its investors expect for money invested in the company. This is a common argument: claimants often aver that but for the harm caused by the respondent, the claimant would have had access to funds in the amount of the damages award on which it would have expected to earn returns at this rate. Superficially, the argument that the conduct at issue deprived the claimant of the opportunity to earn expected returns at its normal rate has a simple intuitive appeal.

In this scenario, the claimant is arguing, in effect, for a prejudgment interest rate equal to its asset-based cost of capital. The asset-based cost of capital represents the average expected return earned on assets invested in the company's operations. Let's suppose that in this case, the company's asset-based cost of capital averaged 10 percent over the period. In this situation, prejudgment interest would amount to €15.9m, as above.

The respondent in turn proposes that prejudgment interest should be computed at the short-term interest rate paid by government bonds. This can be referred to as the 'risk-free' rate, so-called because there is normally little to no risk that the investor will not get his or her money back after maturity of the bond. As justification, the respondent may argue: why should the claimant be entitled to a rate higher than this? The issue here is damages, not a risky investment, and accordingly we are interested in accounting for the time value of money over the period in question and not rewarding the claimant's investors by bolstering damages.

Risk-free rates on short-term government investments are relatively low in most major developed countries, especially in recent years. Suppose the average rate over the 10-year period in question has been 1.5 percent. In this situation, prejudgment interest damages would amount to €1.6m, or about 10 percent of the claimant's number.

Analysis

Who is right? In the above example, neither the claimant nor the respondent is quite right. As implied in the above discussion, the appropriate focus of the analysis is on risk. What risk did the claimant actually bear, and what is the appropriate compensation for that risk?

Consider the claimant's proposal first. At the date of the hearing, the arbitral panel has no reliable means of ascertaining the actual return the claimant would have obtained had it not suffered damages. Some investments that the claimant might have made may have yielded high returns; others may have generated a loss. Due to risk, there is no way to know what specific return would have been obtained absent the conduct in dispute.

It is apparent that setting the prejudgment interest rate at the asset-based cost of capital would result in overcompensation. Awarding prejudgment interest at the average expected rate of return earned on the company's operations would compensate the company and its investors for risk that was not actually incurred. If the €10m had been available (instead of lost due to the respondent's conduct) it might have been invested to earn a return equal to that earned on the company's operations. But to do so the funds would have been exposed to the average level of business risk that all of the company's other investments incur. Because the funds were not exposed to this risk, awarding prejudgment interest at the asset-based cost of capital would be inappropriate.

Now consider the respondent's proposal. Assuming the respondent is a company (and not a government), this is not quite right, either. The damages incurred by the respondent's conduct are economically equivalent to a forced investment by the claimant in the respondent, with the investment maturing at the date of the award. Prejudgment interest at the risk-free rate implies that this investment is as safe as an investment in a government bond. But in general, investing in companies is not as safe as investing in the government. There is always some default risk that a company will go out of business or will otherwise be unable to repay the investment. For this reason, yields on corporate bonds are typically higher than yields on government bonds.

So to be made whole, the claimant should be compensated for the default risk it incurred in investing in the respondent's business, where such risk incorporates the possibility the respondent will go out of business or otherwise be unable to pay the damages award when it comes due. This risk can be approximated by the rate of return on the respondent's corporate debt.

Sometimes, a respondent's debt rate might not be available. Financial information for privately-held companies, for example, is often difficult to obtain. In these cases, appropriate rates can be calculated based on public information on market rates of return on debt for companies in the same industry and broadly the same risk class. Suppose, for this example, that the respondent's return on debt was 5.2 percent. In this situation, prejudgment interest would amount to €6.6m – not surprisingly, an amount between the result of the rates proposed by the claimant and the respondent.

Other issues

Risk is not the only factor that affects the value of an investment. Companies pay taxes on earnings. Unless a jurisdiction provides for a statutory approach to prejudgment interest, the prejudgment interest rate should account for the tax obligations that the claimant would have incurred had the damages caused by the conduct at issue been paid over time. The examples above are oversimplified in that they do not account for taxes.

Whether and how to account for taxes is an area that often generates bitter contention between claimants and respondents. Claimants sometimes suggest that the damages award should be treated like a one-time investment that provides a lump-sum payment upon maturity. In this situation, it is suggested that the claimant will pay the taxes to the government when the damages award is paid. Therefore, there should be accounting for taxes in the calculation of the total damages award, including the prejudgment interest.

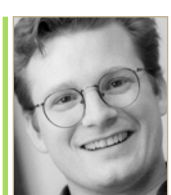
This is only partially correct. In general, there need not be an accounting for taxes in the calculation of the base damages, but the impact of taxes does need to be considered in the appropriate calculation of prejudgment interest. The correct approach is to calculate prejudgment interest by removing the effect of the taxes that would have been paid had the damages been awarded at the time of injury and then invested in debt of the respondent. It is apparent that in this situation, the claimant would earn interest each year, but part of those interest earnings would be remitted to the government as taxes. Only the annual after-tax interest payment would be compounded over time. Accordingly, to account for the loss in compound value due to taxes, the correct prejudgment interest rate is the after-tax debt rate of the respondent. With the same respondent debt rate used above, 5.2 percent, and a corporate tax rate of 30 percent, the accurate calculation would generate €4.3m in prejudgment interest. Following the claimant's proposed approach would have generated a substantial windfall to the claimant.

Another challenge that arises more often in international arbitration than in other venues for dispute resolution is the issue of exchange rates: which currency should provide the basis for the damages award, and what exchange rate should be used? In general, it is preferable to determine prejudgment interest using the currency of the base damages award. This may require converting the respondent's debt rate for the calculation of prejudgment interest, typically denominated in the respondent's home currency, into the currency of the base damages award.

Modifying our basic example, suppose the claimant is an American company and suffered losses of $10m due to the conduct of the respondent, a European company. The respondent has incurred an obligation of $10m as of the date of harm, and it would be appropriate to use the respondent's after-tax debt rate (as denominated in dollars) to compute prejudgment interest. It will almost certainly be the case that the actual exchange rate as of the date of the award differs from that as of the date of harm. However, evaluated ex ante (i.e., as of the date of harm), neither party can expect to receive a windfall from this approach.

Conclusion

Disputes involving arbitrators seldom involve disputed behaviour that started only recently; instead, they often focus on issues and alleged harm that precedes the arbitration by years. This means that not only do arbitrators need to determine an appropriate amount of damages, but also a way to compensate the claimant for lack of access to damages during the period of dispute. Taking seriously the risks actually borne by the claimant, as well as other fundamental economic considerations, will help ensure that the prejudgment interest component of the damages award does not unduly favour either party. CD



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