Current issues of damages evaluation

KYIV ARBITRATION DAYS 2023

8 December 2023

pwc

Types of damages in Ukraine

Damages we observe in Ukraine

Local clients have suffered different types of damages caused by the war:

- lost control over the assets (for the occupied territories);
- destroyed production and storing facilities (direct damages);
- business interruptions;
- recovery costs (for example demining); and
- lost profits.

Types of claims

Based on the previous similar matters, types of claims in Ukraine likely to arise:

- **Individual claims for forced departure from Ukraine**
- **Personal injury claims** – general (injury and psychological impact) and special damages (including quantification of loss of earnings, pension, care requirements etc)
- **Business interruption** – loss of profits during interruption to normal business, increased costs incurred to reinstate normal business operations
- **Property** – damage and destruction of commercial and residential properties, State-owned enterprises
  and infrastructure (Ukrainian Railways, Ukrainian TV and Radio, Port of Sevastopol etc)
- **Environmental** – loss of habitats and disturbance to ecological equilibria, water and marine contamination
- **Government** – costs of evacuating citizens

Damages methodologies

Damages methodologies

Which damages methodologies are most frequently used?

Income approach:
Converts anticipated economic benefits/losses into a net present value at the valuation date. Most common form of this approach is the discounted cash flow (“DCF”) methodology.

Market approach:
Assesses value by comparing the business or asset being valued to similar, comparable businesses or assets in the market.

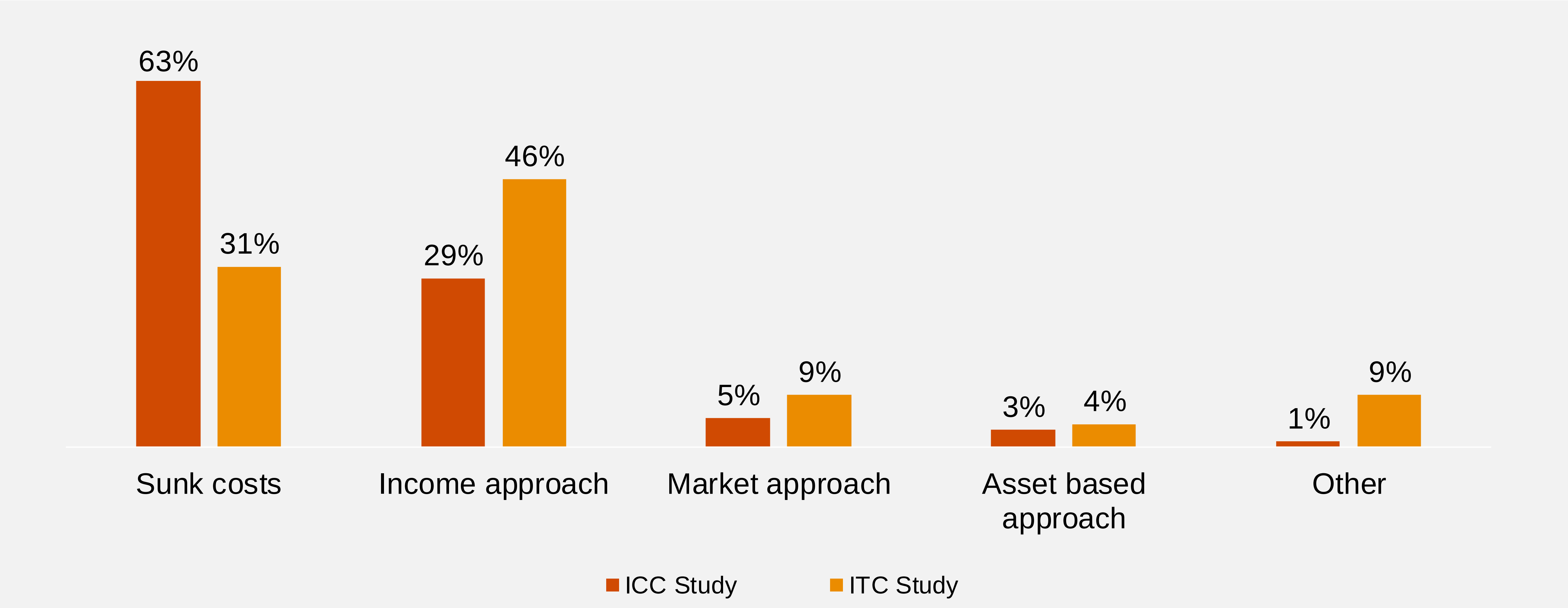
Asset approach:
Assesses the market or book value of assets, net of liabilities.

Cost approach:
A variety of methods to capture historic costs, cash flows, or invested amounts (often referred to as ‘sunk costs’).

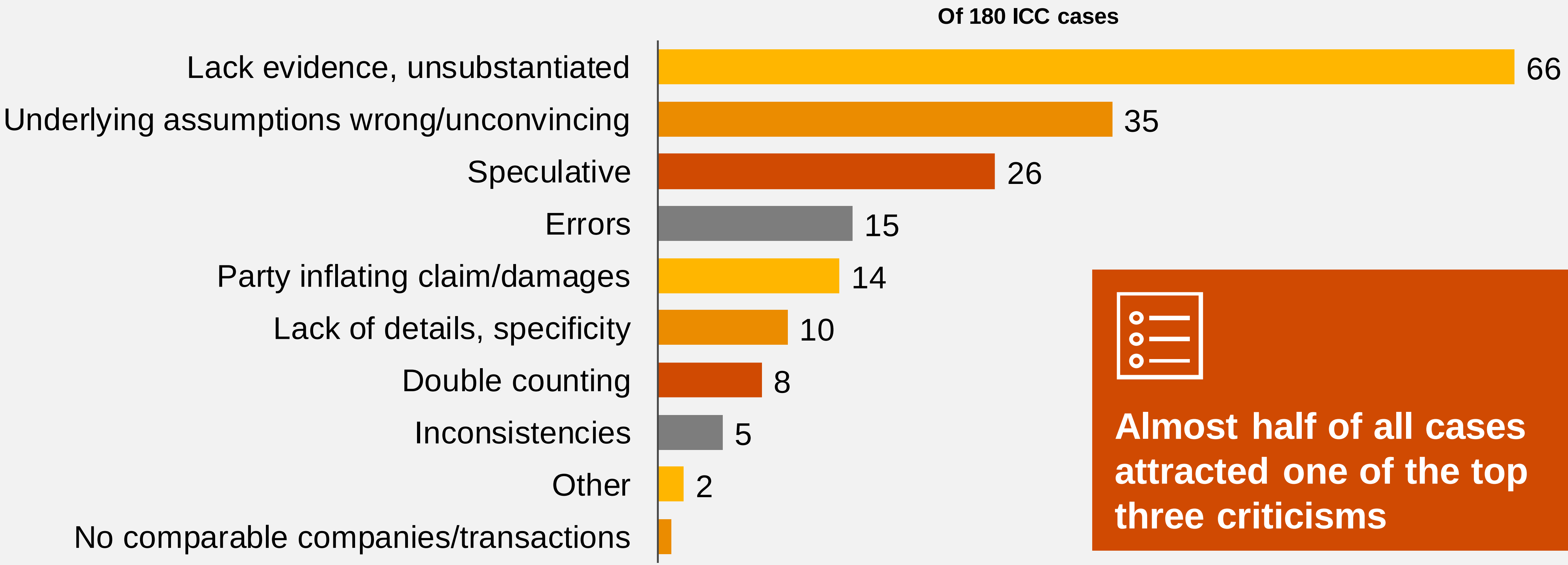
Other:
Approaches not covered by the above-referenced categories, for example contractually-specified calculations or a “reasonable return” approach.

Methodologies adopted by Tribunals

ICC and ITC Study cases



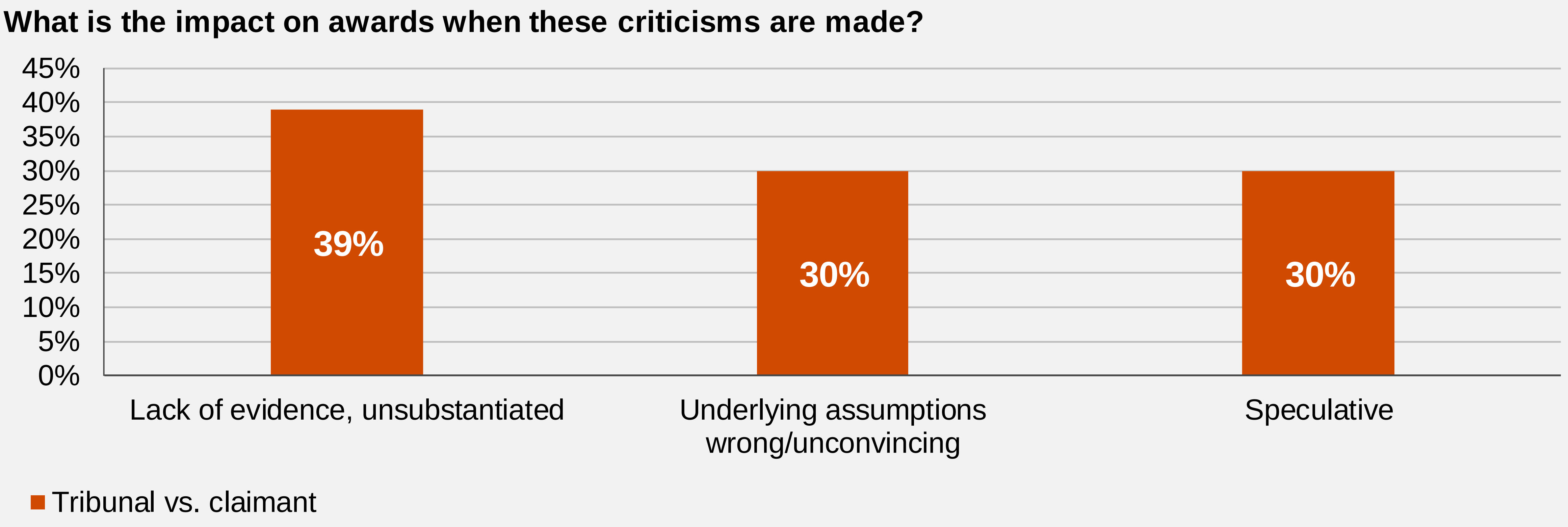
Common Tribunal criticisms of the quantum approach



Almost half of all cases attracted one of the top three criticisms

Common Tribunal criticisms of the quantum approach

What is the impact on awards when these criticisms are made?



Tribunals approaches to damages methodologies

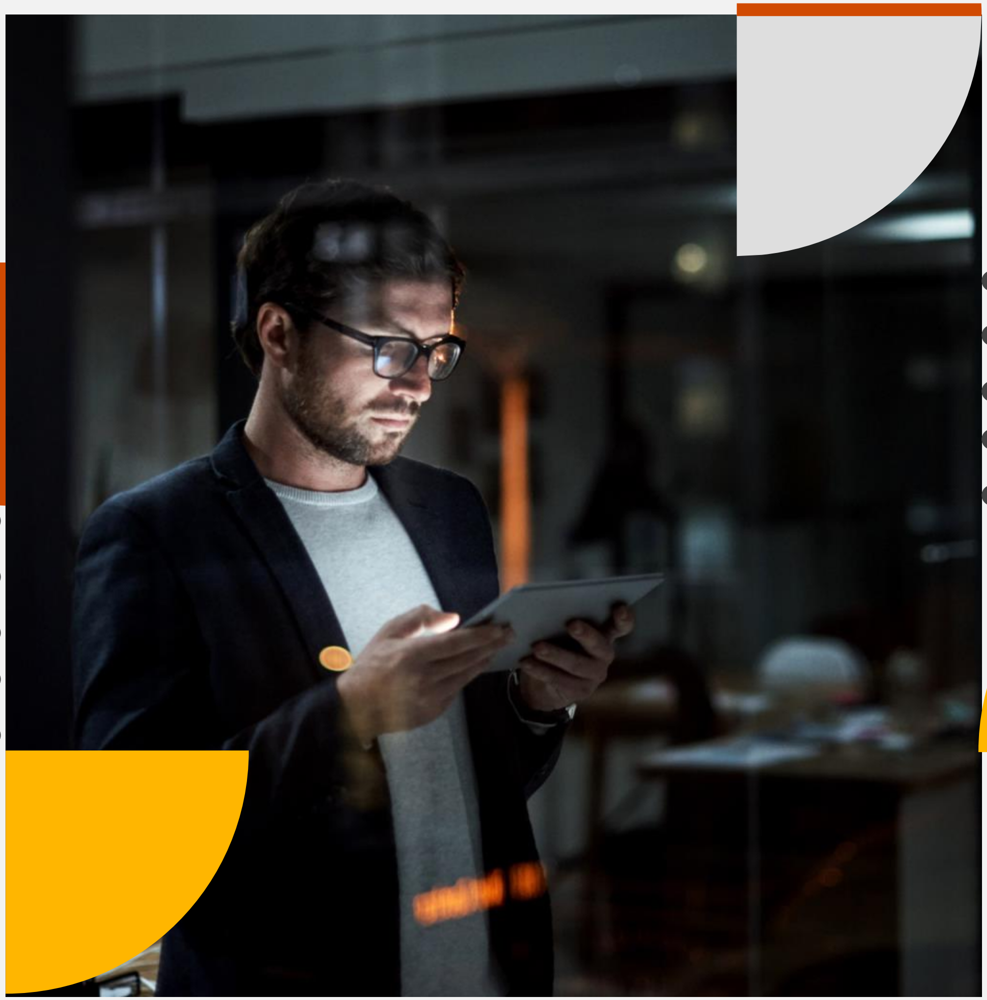
Based on our International Arbitration Damages Study, 2023:

Tribunals often base damages awards on an **income approach**. They also regularly consider the cost approach.

Over time, tribunals have become **increasingly comfortable with the income approach**, and have consequently decreased their usage of the cost approach.

Typically where we see tribunals reject the income approach, it is because the tribunal has considered the approach to be too **uncertain or speculative**, for example because the company or asset in question is a **new venture** or does not have a sufficient **track record of operations**.

Evidence



Evidence for the various types of damages

- **Individual claims for forced departure** – In the case Uganda vs Democratic Republic of Congo data estimates coming from the United Nations Office for the Coordination of Humanitarian Affairs (OCHA)
- **Personal injury claims** – Kuwait v. Iraq was an example of mass claims processing techniques applied, including clearly defined evidentiary standards and fixed amounts of damage for various forms of injury.
  In Ethiopia-Eritrea Claims Commission estimated the resultant injury as a certain percentage of the total average lifetime lost earnings
- **Business interruption** – standart type of evidence for lost profit including the financial reports, accounting records and business plans
- **Property damage** – may require results of the surveying/technical expertise
- **Environmental** – will require environmental / climate change specialists

Evidence for Lost profit calculations

For standard lost profit calculations (quantum) for the property which is still under client's control:

- detailed description of the damaged property, technical/construction surveyance reports;
- costs incurred by the client due to the invasion, such as: employees reallocation costs, demining, reconstruction/rebuilt costs, for the period of electricity shut downs: heaters, electricity generators;
- expenses incurred during the disruptions: salaries to the key personnel, idle time compensations;
- contractual penalties on the sales contracts as a result of business disruptions; and
- business plans/recovery plans or expectations after the war ends.

For the property which is in the temporary occupied territories it might be difficult to get access to the documents, however, it is very helpful to have at least:

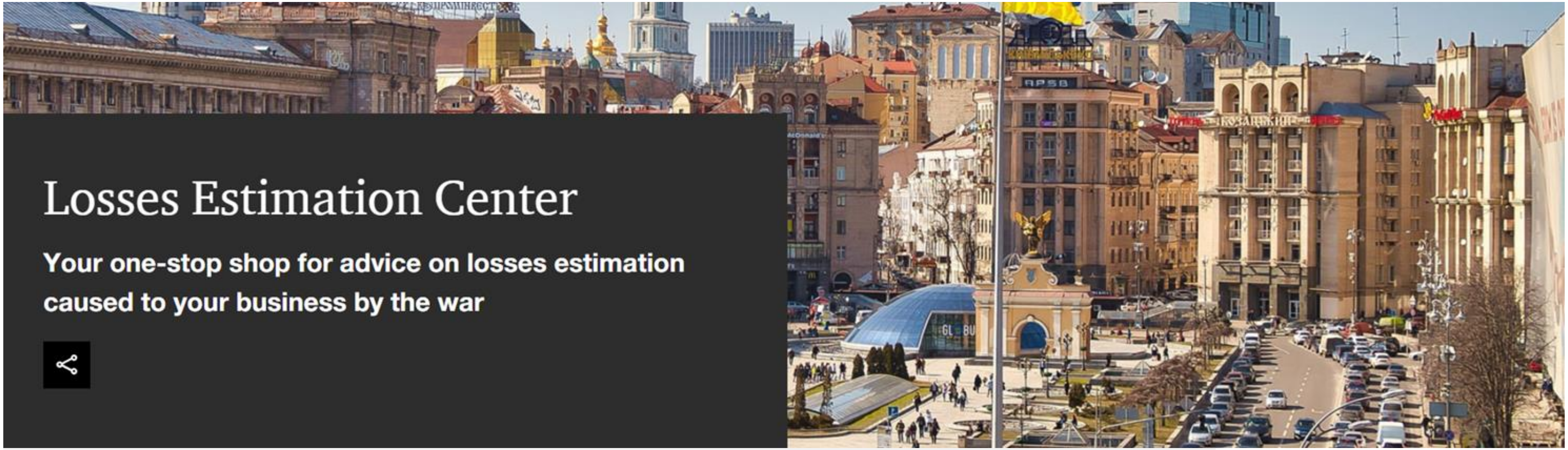
- exact list of assets/ property which is located on the occupied territories and which is not accessible and the assets which are still at the possession of the client;
- knowledge on the status/condition of the occupied property and assets (destroyed/damaged or not); and
- price/cost of such assets.

Other relevant data

- photo-documentation; or
- police reports

Key Tips on Evidence collection

- ✓ **React quickly and act now**
- ✓ **Set up internal processes so that the information you need to prove the loss is stored in one place and arranged properly**
- ✓ **Seek guidance/support for assistance with the documentation/evidence collection**
- ✓ **It is important to have a local team/presence**



Losses Estimation Center

Your one-stop shop for advice on losses estimation caused to your business by the war

- Initial Case Assessment
- **Discovery and evidence collection**
- Losses estimation
- Communication of the Results
- Expert Witnessing

Discovery and evidence collection

Providing support in collecting due evidence of losses. We have special knowledge of the financial and other record-keeping instruments and tools. Additionally, our forensic technology experts have necessary automated tools that enable us to search for information in the electronic records, if this level of discovery is available.

Current issues related to damages evaluation

Current issues related to damages evaluation

Higher inflation.

- Different inflation based on industry sectors – it may not be appropriate to use the standard 'average' inflation based on a consumer basket of goods
- How to best reflect inflation in loss assessment:
  - inflating revenues and expenses in the DCF model, use nominal discount rate; or
  - keeping cash-flow forecasts unchanged but reflect inflation in the discount rate
- Actual annual inflation may fluctuate significantly, however, the long-term inflation projections may remain nearly unchanged

Current issues related to damages evaluation

Higher Interest rates

- Different interest rates based on currencies (regions)
- Volatility in interest rates can be related to volatility in foreign exchange rates (if the currency can be freely traded)
- In times of uncertainty, risk-averse investors usually flee from "developing" currencies / their currencies. This could mean that for investments in developing countries (possibly including CEE), US investors will require higher 'equity risk premiums' to compensate them for the higher perceived risk. This may increase discount rate (additional premium in CAPM)
- In the past, increases in the interest rate (arguably to slow down overheating economies) were followed by economic recessions in 2001 and 2008. It is still unclear if the pattern will repeat in 2024.

Current issues related to damages evaluation

Importance of the assessment date, and retrospective valuation

- **In common law**, in general, damages are to be assessed at the date of breach. However, there are limited circumstances where hindsight information may be considered, for example, in the case of anticipatory breach.
- **In civil law**, in general, in the case of variable damages (such as continuing loss of profit), assessment is made at the date of the award. However, where the damage is invariable, the general rule is that damages are assessed on the date that the damage was suffered.

Implication for damages assessment

- From a damages assessment perspective, hindsight information should typically be disregarded. This means that, when **a date of breach** is adopted as the assessment date, information that became known after this date should be disregarded
- From a damages assessment perspective, where **the date of award** is adopted, experts may be entitled to adopt all information known at the date of assessment to inform their calculations.

Current issues related to damages evaluation

Implications of recent developments for companies' valuations

- Unlike Inflation, where long term expectations have not changed much, long-term bond yields increased in the recent years. This means that:
  - when assessing losses based on DCF, we should expect higher discount rate, and lower present value; and
  - if pre-award interest is determined based on market rates, it will be higher than in previous years.
- Higher volatility in interest rates (along with expectations that interest rates will decrease once inflation gets under control) make it even more important to properly assess the valuation date as of which the loss should be calculated

Thank you!

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