KING & SPALDING

Quantum Quarterly

The Damages Newsletter

A publication of King & Spalding's International Arbitration Group

Issue 03 | 3Q 2011

We are pleased to present the latest edition of *Quantum Quarterly*, a publication of King & Spalding's International Arbitration practice group. This edition includes a guest column by Dean Graves and Aaron Stai of Alvarez & Marsal, summaries of recent damages awards and our *Old But Still (Very) Useful* section, this time focusing on the renowned *Kuwait v. AMINOIL case* (1982). As always, we welcome any feedback you may have.

All the best.

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Sensitivity Analysis and its Role in International Arbitrations

By R. Dean Graves, CFA, CPA, and Aaron J. Stai, CFA, FRM, both with Alvarez & Marsal

International arbitration has been criticized in recent years for not living up to the promises of a quick and cost-effective resolution to international disputes. Many feel international arbitration is morphing into a United States-style litigation process, with many disputes taking years to resolve at significant legal and professional costs. How can experts assist the arbitration tribunal, counsel, and their clients in efficiently understanding the quantum of damages?

While quantum experts are only a relatively small fraction of the total cost of an international dispute resolved through arbitration, there are opportunities for improvement that can assist inside counsel and their external legal advisors in managing costs and directing

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their legal arguments. Arbitrators may also have an opportunity to rely upon quantum experts to provide a key as to the drivers of the damages and resulting impact that certain changes in the underlying assumptions may have on the damages calculations.

This article will first quickly address the role of financial experts and then identify areas where financial experts can assist in the international arbitration process through the use of sensitivity analyses.

Role of a Quantum Expert

While the complete role of financial experts in international arbitrations is beyond the scope of this article, a brief discussion of the responsibilities and duties is worth mention. The primary role of the quantum expert in an international arbitration is to prepare an independent and objective analysis of the financial impact resulting from the alleged bad acts.[1] Recently the objectivity of some financial experts has come under criticism. Some financial experts, such as Certified Public Accountants in the U.S., are bound by a code of conduct such as that promulgated by the American Institute of Certified Public Accountants, which requires integrity and objectivity, due professional care, and sufficient relevant data.[2] Additionally, tribunals will typically either swear the witness or ask the witness to affirm that the opinions being offered are in accordance with his or her sincere beliefs, offered to assist the arbitral tribunal, and formed independently from the party appointing the expert. However, tribunals are often confronted with two significantly different calculations from the opposing experts. Although two experts may be significantly divergent in their quantum calculations, the source of the difference can typically be narrowed to being due to a difference in methodology or to certain assumptions the expert has included in his or her analysis. This paper will speak only to differences in assumptions. These differences may include not only financial assumptions embedded in the quantum calculation, but also broad legal assumptions, which the tribunal may be deciding.

“Often, due to the complexity of financial models and systems, the expert can assist by providing an understanding and articulating the nuances of the quantum calculation either through scenario analysis or interactive modeling.”

Damage models and financial analysis can be complex and detailed, and they can ultimately vary widely depending on the inputs and the disputed legal claims. Counsel and the arbitration tribunal may request additional information from the financial experts to help them understand the complexity, relationship, and sensitivity of the underlying damage model assumptions. Often, due to the complexity of financial models and systems, the expert can assist by providing an understanding and articulating the nuances of the quantum calculation through either scenario analysis or interactive modeling. Both have been employed successfully with very large data sets, allowing counsel and the tribunal to “depose the data” in real time. This simply means the analysis and underlying data can be manipulated and adjusted with a relatively quick recalculation of the resulting damages or valuation, allowing follow-up questions from counsel or the tribunal. This information may ultimately assist the tribunal in determining the appropriate amount of monetary damages to award based on its legal interpretation and decisions of the underlying claims and its decision regarding the most reliable inputs into the calculation.[3]

[1] In many instances this assignment involves the calculation of the fair market valuation for an asset or group of assets operated as a business unit. However, in some instances the measure of damages may not be the fair market valuation but instead the lost profits suffered by a party. In this instance it may be necessary to prepare a but for analysis which may employ financial theory and valuation methods similar to a fair market valuation.

[2] American Institute of Certified Public Accountants Professional Code of Conduct. *See also* The Code of Practice for Experts, Guidelines for Expert Witnesses in proceedings in the Federal Court of Australia, and EuroExpert Code of Practice for similar requirements of independence and objectivity.

[3] While providing the tribunal a “live” valuation model may be viewed as risky by some, the resulting award may be worth the additional time and expense of walking the tribunal through the model. This is especially true when considering some of the alternative methodologies tribunals have employed to determine awards when they have not accepted certain assumptions of either Claimant’s or Respondent’s experts. Investing the time and effort to produce a thorough and user friendly valuation model may help provide the tribunal an objective framework in determining the quantum of the award.

Role of Sensitivity Analysis

Part of the expert’s role is to explain the inputs included in the damage model as well as the impact of these inputs on the damage calculation.[4] Sensitivity analysis is a useful tool to demonstrate the impact (and often the interrelationship) of the changing variables and to assist the tribunal in providing understanding and context of the different variables and assumptions underlying a particular analysis. Utilizing different permutations to determine the hierarchy and importance of the inputs on the calculation can be useful in focusing the time and effort spent on a particular argument, input, or issue. By prioritizing the inputs to the damage model, the various analyses prepared by the financial experts can be focused, thereby assisting the parties within the arbitration process and potentially reducing costs.

It is worth noting that a sensitivity analysis should not be viewed as a range of damages, because ultimately an economist or financial expert attests to his or her view of the appropriate inputs for the purpose at hand. What the “sensitivity analysis” does provide is an indication of the power or weight associated with a particular input. Ultimately, it is up to the tribunal to ascertain which of the experts has convincingly supported his or her assumptions and bases for opinions in preparing their respective calculations. Once this is done, the tribunal can adapt its decisions in creating a hybrid valuation model or updating one or both experts’ models with the new inputs.

A sensitivity analysis can also provide a unique perspective and understanding of an expert’s damage model. Choosing a key variable and performing a sensitivity analysis across a range of values for that variable (while leaving all other variables constant) can reveal flaws in any underlying assumptions or calculations performed by an expert. For example, if damages are based on a widget price of $X per widget, then the arbitration tribunal will, most likely, have two different quantum calculations based on two different opinions of the appropriate widget price (presumably one damage model from the Claimants and an alternative damage model from the Respondents). The two different price assumptions provide a limited amount of information (i.e., the range) to the tribunal and as a result may not prove to be entirely suitable, possibly leading to the perception that the damages experts are each advocates for their clients. However, damage provisions in contracts may be complex and include tiers or other contractual limitations which directly impact the calculation and assumptions embedded within the calculation methodology. With a single point of reference, it can be very difficult, if not impossible, for the tribunal to completely understand the impact of the damages calculation for either party. By preparing a sensitivity analysis across a range of widget prices (or quantities), it may be clear that one of the damages expert’s calculations fails to be financially valid or fails to make economic sense across a range of prices (or quantities).

Damage calculations can be sensitized across a range of inputs and variables yielding potentially hundreds of reference points. Ultimately, instead of becoming helpful, exhaustive data analysis and excessive sensitivity analyses can quickly become overwhelming and burdensome, particularly if the information is not packaged effectively. We refer to this type of approach as “analysis paralysis,” meaning that overanalysis of the data and inputs overwhelms the user and ultimately provides limited to no value, typically with excessive costs to the parties. A balance must be struck by the damages experts in identifying which inputs are key to the calculation and which are not. Both the key and secondary inputs should be communicated to the client

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[4] While the role and standards of conduct can differ significantly between various jurisdictions, ultimately the expert should be viewed as a resource and must be independent and objective in his or her work and testimony. See “Valuation for Arbitration, Compensation Standards, Valuation Methods, and Expert Evidence” by Mark Kantor published by Kluwer Law International BV, The Netherlands 2008.

Sensitivity Analysis

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and counsel. Narrowing down the sensitivity analysis to a few key inputs and variables can provide the tribunal and the parties with useful, valuable information to guide the case strategy and ultimately determine the appropriate award based on the tribunal's decisions on the legal merits.

Below we explore some of the benefits to the parties, legal counsel, and ultimately the arbitration tribunal.

In-house Counsel
Sensitivity analyses provided by the expert can assist in-house counsel in several areas. Through an understanding of how the damage calculation is affected across different ranges of inputs, the key inputs can be identified and highlighted for the legal team. By identifying the key inputs up front and developing a legal strategy emphasizing those inputs, the professional and legal fees can potentially be estimated and managed more efficiently. Management can be kept better informed as to the expected recovery and potential range of recoveries depending on the tribunal's rulings, allowing more informed decision-making regarding the costs involved.

Legal strategy can also be shaped by understanding the

impact of various inputs into the damage model. Cost-benefit decisions can be made regarding the pursuit of certain claims or additional claims; arguments could potentially be identified through the sensitivity process. Identifying the key drivers to a damage calculation and overlaying the legal arguments can prove to be valuable in setting the course for the legal arguments and damage claims. In other words, it may become apparent that spending significant time arguing a particular legal theory linked to an input or variable may not prove to be cost-effective if that variable has minimal impact on the ultimate damage calculation.[5] Alternatively, it may be discovered that the damage calculation can be simplified significantly by accepting certain assumptions which may not be disputed, thus saving significant legal and professional costs.

Outside Counsel
By understanding the sensitivity of the damage model across various inputs and identifying the key inputs, outside counsel can better prepare and budget the professional and legal fees. Furthermore, outside counsel may be better equipped to manage client expectations through a better understanding of the value drivers and sensitivity of those drivers on the ultimate damage calculation. This knowledge may ultimately influence the legal strategy and allow the legal and professional teams to more efficiently allocate their time and the client's resources.

In guiding the quantum exerts, the Demand for Arbitration and the Terms of Reference become the guideposts by which the financial experts prepare their analysis. Accordingly, the planning and budgeting of the assignment as well as the resulting expert report have a framework that matches up with the legal questions being arbitrated. The sensitivity analysis can have a direct impact on the crafting of these important documents.

Arbitration Tribunal
Sensitivity analyses of the damage models can assist the arbitration tribunal in rendering its decision. By understanding the inputs into the calculation, the tribunal is able to make an economically informed award by understanding the impact of its legal conclusions on the damage amounts. While ultimately the arbitration tribunal may not agree with one expert on every conclusion or input required for the calculation of damages, the tribunal should be able to take certain inputs and, if it so chooses, create its own (composite or hybrid) damages calculation using the building blocks provided by the experts. This may be viewed as risky by some, because arbitration tribunals may lack the modeling and financial expertise to effectively develop their own stand-alone damage model.[6]

There are alternatives to the tribunal preparing its own financial model. Tribunals sometimes request that opposing experts meet and conference over the outstanding financial issues in order to minimize the amounts or issues in disagreement. We have seen this done before, during, and after the hearing on the merits. For our purposes here, we will assume such conferencing occurs before the hearing. Expert conferencing focuses initially on describing the methodology used and the inputs into the calculation. Next, the experts determine the parts of the methodology and inputs upon which they can agree and those upon which they cannot agree. The results of these meetings may be memorialized through a joint expert report, which may identify the areas where the experts have agreed to certain methodologies and inputs and continue to disagree on certain other aspects of their calculations. Ultimately, this exercise may narrow the range of financial dispute, thereby allowing the parties and tribunal to focus on the remaining disputed financial issues. By narrowing the issues and agreeing on the methodology and as many inputs as possible, the experts may narrow the damage calculation range, potentially assisting the tribunal with determining an award if appropriate.[7] A sensitivity analysis can also provide incredible insight and ultimately may be used to create a "menu" of damage amounts from which the tribunal can select as it makes decisions regarding the relevant legal and financial issues.

By utilizing the existing experts in the arbitration, the tribunal can avoid the costs of a third-party expert and the associated costs with that expert ramping up his analysis and understanding the underlying facts and disputes of the case. Open and frequent communication with both parties' experts can be extremely useful to the arbitration tribunal and ultimately help in the determination of the award based on its decisions.

Conclusion
While not appropriate in all instances, sensitivity analyses can prove helpful to the client, counsel, and the arbitration tribunal. Sensitivity analyses can provide considerable value in the context of understanding the key value drivers of a financial model, and potentially assist all parties in an arbitration proceeding. However, should an expert conduct a sensitivity analysis focusing on a particular calculation input, this should not provide any indication that he or she has doubt (nor should it be construed as such) as to the correct input value to use in the financial model. Sensitivity analyses are tools that may demonstrate the variability of a model, the economic consequences of selecting one input over another, and the underlying logic embedded within a particular damage methodology. ✦

About the Authors

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[5] We recognize that it may be important for legal reasons to make an argument that has little economic effect. Sensitivity analysis may provide counsel with insight to be more explicit in making such decisions.

[6] Arbitration tribunals have also hired their own financial experts to assist them in creating a third damage model that incorporates their legal conclusions and conclusions regarding the resulting inputs into the damage model. This can be a costly endeavor and may not always be necessary if the tribunal is allowed to adapt one (or both) expert models and change the inputs into the model. This of course assumes the models were properly prepared and built to be dynamic in nature, which tends to be the case when a model has been prepared for the purposes of demonstrating the sensitivity to various changes in inputs. In any event, it is incumbent upon the financial expert to provide the tribunal, or its expert, with the tools to render a quantum decision.

[7] For this process to work efficiently the experts must be intellectually honest and prepared to concede a point if demonstrated to be simply wrong.

Recent Damages Awards

Cargill, Inc. v. United Mexican States

Date of the Award:
18 September 2009

The Parties:
Cargill, Inc. (Claimant), United Mexican States (Respondent)

Sector:
Soft drinks

Applicable Treaty:
NAFTA

Members of the Tribunal:
Michael Pryles (Chair), Donald C. Caron and Donald M. McRae

Introduction:
Claimant is a food company incorporated in the United States which brought a claim against Mexico for breach of legal obligations under NAFTA Chapter 11. Cargill had undertaken to sell high fructose corn syrup ("HFCS") in Mexico through its subsidiary Cargill de Mexico S.A. de C.V. ("CdM") and alleged that Mexico's imposition of a tax on soft drinks containing HFCS coupled with its failure to issue import permits for HFCS violated NAFTA Chapter 11 provisions and resulted in damages to Cargill's investment.

Claimant also alleged that antidumping duties imposed by Respondent, although later revoked after a NAFTA Chapter 19 proceeding, drove it, and CdM, out of the Mexican HFCS market between 1998 and 2001.

On December 31, 2001, Respondent enacted an amendment to the *Law on the Special Tax on Production and Services,* which imposed a 20% tax on the internal transfer or importation of carbonated soft drinks and certain other beverages, syrups, powders and concentrates. Claimant alleged that as a result of this tax, known as the IEPS tax, the use of HFCS became prohibitively expensive for Mexican beverage producers, who then canceled their HFCS orders and switched back to sugar. In addition, the Mexican Executive published a decree that required importers from the U.S. to obtain a permit, failing which the importer would be subject to an MFN tariff. Claimant alleged that its application for a permit was rejected every time it applied and that the tax and tariff measures operated to shrink the HFCS market in Mexico.

After Hurricane Katrina, imports of HFCS into Mexico from the U.S. were partially resumed and Claimant was allocated 34.52% of the total quota available – however, it alleged that it had been shut out of the market for so long it was unable to take advantage of this opportunity for re-entry.

In 2002, Claimant invested in Zucarmex, Mexico's third-largest sugar producer.

Claimant's Position on Damages:
A damages award should reflect the "overall damage to the economic success of the investor arising from the measure adopted by the host state…" Damages should therefore be awarded for the net lost cash flows that Cargill and CdM "would have garnered from Cargill de Mexico's HFCS sales in Mexico from January 2002 – 2007 but for Mexico's illegal conduct."

Claimant's gross "but for" cash flows were derived from the quantity of HFCS that CdM would have sold in Mexico multiplied by the per-unit profit that Cargill and CdM would have earned. This calculation relied on total HFCS sales in Mexico, projections of CdM's market share and the price of HFCS in Mexico. Claimant admitted uncertainty in determining future lost profits but asserted that an "appropriate methodology" like the discounted cash flow ("DCF") could produce a "rationally justified" result.

"Claimant admitted uncertainty in determining future lost profits but asserted that an 'appropriate methodology' like the discounted cash flow ("DCF") could produce a 'rationally justified' result."

From this gross cash flow, the net cash flow was calculated by subtracting costs such as plant costs, depreciation, shipping, transportation, etc., and then calculating the present value of the result. Claimant's final claim thus amounted to U.S. $123.81million, allocated 46.77% to CdM and 53.23% to Cargill.

Respondent's Position on Damages:
In the absence of guidance in NAFTA on damages not related to an expropriation, the calculation of damages for breaches of Chapter 11 should be based on the amount of loss or damage "that is adequately connected to the breach." Damages should therefore be limited to those that can be linked causally to a breach of a Chapter 11 article, i.e., the harm must not be too remote or the breach of the NAFTA provision must be the proximate cause of the harm. Claimant's choice of net cash flow as the basis for damages violates these tenets because it relies on speculation.

Respondent further argued that while Cargill and CdM were experienced and profitable companies, they had been out of the Mexican market for a long time so there was no reliable track record on which to base the cash flow assumptions. It instead proposed using an alternative method of applying a reasonable rate of return on Claimant's business in Mexico during the time which the Mexican HFCS business was impaired by the IEPS tax and/or permit requirement. Further, Respondent proposed that damages should be limited to Claimant's investments in Mexico and in its calculation of damages focused only on CdM to reach a total value of $6.654 million. This value was reduced to $4.276 million after making deductions for the IEPS tax and Claimant's contributory fault.

The Tribunal's Findings
The Tribunal agreed with Claimant that the appropriate method of assessing damages was the present value of net lost cash flows. It acknowledged that there were problems in projecting (i) the overall market for HFCS (ii) Claimant's market share and (iii) the appropriate price and demand for HFCS considering Claimant's four-year absence from a competitive market, but did not find these difficulties enough to make the method itself inappropriate.

However, while the Tribunal accepted Claimant's approach to assessing damages, it found that some of the figures used by Claimant had to be discounted because they had not been sufficiently established by the evidence. The issues were the following:

Antidumping Issues:
According to Claimant, whether or not antidumping duties could be included in the damage analysis was a legal question for the Tribunal. In the scenario where the Tribunal did not include the antidumping duties, Claimant proposed an alternative damage model. The Tribunal concluded that it was not for a NAFTA Chapter 11 Tribunal to impose consequences for the illegal imposition of antidumping duties, as this was the responsibility of the WTO. Had Mexico only enacted the antidumping duties without following them with either the IEPS tax or permit requirement, Claimant would not have been entitled to recover any damages or calculate any "but for" growth during the period in which the antidumping duties were in place. Therefore, the analysis of net cash flow should begin with Claimant's market share when antidumping duties were lifted.

Compensable Period of Loss:
Using Claimant's alternative damage model, both parties agreed that the appropriate start date for the compensable period of loss was June 2002. However, they disagreed on the end date of the period. Respondent proposed December 31, 2006, the date when the IEPS tax was removed, but Claimant proposed December 31, 2007, to take into account the fact that the impact of the IEPS tax did not cease instantaneously. The Tribunal agreed with Claimant and set the end date of the period at December 31, 2007.

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The Mexican HFCS Market over the Compensable Period:
Claimant based its projections of the HFCS adoption rate in the Mexican beverage market on the HFCS adoption rate in the United States market. Claimant acknowledged that while the U.S. was a deficit sugar producer, Mexico was an excess producer and while the product was nationally produced in the U.S., it was an import in Mexico. Respondent argued that it was untenable to propose that soft drink producers would ignore social issues such as the traditional role of sugar in Mexico and simply act on the basis of price to substitute sugar with HFCS. It pointed to the fact that Mexico's Coca-Cola and Pepsi bottlers, who accounted for 100% of the cola soft drink market in 2001, had a voluntary maximum adoption level of 50% HFCS.

The Tribunal, in reaching its determination, was influenced by both price and social issues. It noted that considering the economic and social constraints, the rapid adoption rate of HFCS projected by Claimant was unlikely. It therefore rejected Claimant's projection of an 80% adoption rate and instead proposed a two-part rate, first reaching 60% of the total beverage market in June 2005, and then continuing at a linear annual rate to reach 74.3% of the total beverage market by December 31, 2007. The Tribunal also noted that Claimant's damage calculations for 2002 ran to the full calendar year but should only have started in June 2002, so it made adjustments to the damages claim accordingly.

The Claimant's Share of the Mexican HFCS Market:
The Tribunal held that given that the beginning of the compensable period was June 2002, all calculations of the growth of Claimant's share of the Mexican HFCS market would be made on the basis that the share was zero on June 1, 2002. The figures are redacted, but the parties were apparently in agreement on Claimant's market share.

Mexican Market Price of HFCS over the Compensable Period:
Both parties agreed that the price of HFCS would be based on a percentage of the sugar price in a representative year. Claimant chose 2002, but Respondent objected that the price at that time was too high due to the IEPS tax.

Respondent chose 2001, which Claimant rejected for being unsustainably low due to market turmoil. The Tribunal proposed using the average price from 2001-2002 so as to smooth out any distortions. It also accepted Claimants' proposal to adjust the price of HFCS to track changes in the U.S. market.

Scope of Loss to Claimant:
The Tribunal divided the claim into "upstream losses," i.e., lost profits attributable to Cargill's inability to sell to CdM, and "downstream losses," i.e., direct losses to CdM. It held that the "downstream losses" were clearly compensable due to violations of Articles 1102, 1105 and 1106 of NAFTA and noted that NAFTA Chapter 11 covered only investments that were in the territory of the state party enacting the measure. However, it observed that the definition of investment is very broad and inclusive so it had no difficulty determining that business income, "particularly income so closely associated with a physical asset in the host country and not mere trade in goods, is both an element of a larger investment and an investment in and of itself."

The Tribunal therefore determined that Claimant should be compensated for its net lost profits for both CdM's lost sales to the Mexican market and Cargill's lost sales to CdM.

Accounting for the Effect of the Katrina Swaps and the Zucarmex Investment:
Respondent argued that the limited trade in sugar and HFCS after Hurricane Katrina was a new regime that ended the sweeteners dispute. However, the Tribunal agreed with Claimant that the Katrina Swaps simply served as mitigation to damages and were not an end to the sweeteners dispute.

Respondent also argued that the investment and profits resulting from Claimant's investment in Zucarmex should be subtracted from Claimant's total damages. The Tribunal held that Claimant's investment was a distinct investment, separate from Claimant's investment in CdM, and was not relevant to the appropriation of damages.

Final Determination on Damages:
The Tribunal's final figure for damages owed to the Claimant, after making the adjustments to Claimant's alternative damage model as listed above, was U.S. $77,329,240.

Interest:
The Tribunal determined that Claimant was entitled to interest at a rate based on the U.S. monthly bank prime loan rate, as Claimant had effectively loaned the amount of the award during the dispute. This interest would be compounded annually and paid from January 1, 2008 until full payment was received.

Rosinvest v. Russia

Date of Award:
December 22, 2010

The Parties:
RosInvestCo UK Ltd (Claimant) and the Russian Federation (Respondent)

Sector Involved:
Oil & Gas

Applicable BIT:
UK – Russia BIT

Members of the Tribunal:
Prof. Dr. Karl Heinz Böckstiegel (President), The Right Honourable Lord Steyn and Sir Franklin Berman KCMG QC

Case Overview:
Claimant was an investment company, incorporated under English law, which purchased a total of 7 million ordinary shares of OAO NK Yukos Oil Company OJSC ("Yukos"), a Russian oil company. Claimant sought compensation under the UK-Russia BIT for the alleged expropriation of all Yukos assets by Respondent through a series of measures carried out between December 19, 2004, and August 15, 2007.

> "Respondent argued that the limited trade in sugar and HFCS after Hurricane Katrina was a new regime that ended the sweeteners dispute."

Claimant's Position:
The claim for compensation was based on Claimant's proportionate ownership of Yukos' expropriated assets, represented by its shareholding in Yukos. In the absence of a standard of compensation for unlawful expropriation in the BIT, Claimant requested compensation based on the customary international law standard, alleging that the expropriation was unlawful, not in the public interest, discriminatory and without payment of compensation. Claimant therefore proposed the standard formula in *Chorzów Factory*, i.e., that "[r]eparation must, as far as possible, wipe out all the consequences of the illegal act and re-establish the situation which would, in all probability, have existed if that act had not been committed."

The *Chorzów Factory* standard required the Tribunal to look at what Yukos would have been worth at the date of the award had its assets not been unlawfully expropriated. A valuation at an earlier point would be tantamount to compensating Claimant as if it had liquidated its investment in Yukos and transferred the proceeds to a fixed-rate security. Claimant thus sought compensation equal to its share of the real value of the assets that the Russian Federation expropriated from Yukos as of the date of the final award, equivalent to U.S. $183.2 million as at August 31, 2009.

In addition, Claimant alleged that as the expropriation took place over a period of almost three years, the breach of Respondent's duty may be deemed to have occurred when the process was completed.

Respondent's Position:
Claimant was not entitled to damages because by the time it became a beneficial owner of the Yukos shares in 2007, all the alleged wrongful acts had already occurred.

Legitimate Expectations:
An investor could not have a general legitimate expectation of the nonenforcement of a host state's tax law, or of the reversal of tax and court decisions already taken. Expectations on such matters could be legitimate only if based on clear and unambiguous representations given

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"The Tribunal was prepared to accept that Claimant had purchased shares when the market had overreacted to transient events and therefore that the share price was unjustifiably low, which as Claimant acknowledged, was a business strategy of the company."

by the host State. Claimant should have been aware, at the time of purchasing its shares in 2007, that it was purchasing shares in a company that was already in the advanced stages of receivership which would inevitably lead to its liquidation, and should bear the consequences of its bad business judgment.

Quoting *Duke Energy v. Ecuador,*[8] Respondent proposed that the time to assess the legitimacy of Claimant's expectations was at the time of making its investment.

Business Risk:
Claimant's losses were a direct result of unreasonable and risky business judgment in not selling the Yukos shares it had initially purchased and by purchasing additional shares in December 2004.

Therefore, compensation for Claimant's losses should be reduced or excluded because the loss was a result of the investor's own contributory negligence. Respondent cited *MTD v. Chile,*[9] which had held that an investor which continues to invest despite clear signs that a project was in difficulties ought to have damages reduced because of that unreasonableness.

Duty to Mitigate Damages:
Claimant should be precluded from claiming damages because it did not discharge its duty to mitigate damages under public international law. The value of the shares had continued to decline before Claimant purchased additional shares in 2004, and Claimant could have sold its shares at this time and made a profit. The only explanation for not selling the shares was that Claimant wanted to pursue a treaty claim which was consistent with the investment-by-way-of-litigation strategy pursued by Claimant's parent, the Elliott Group. Claimant did not deny its duty to mitigate damages under public international law but countered that there was no obligation for an investor to abandon its claim under the pretext of mitigation.

Claimant Not Entitled to a Windfall:
Awarding Claimant the damages that it claimed would amount to a windfall. Claimant's approach to the damages calculation relied on ex-post analysis and it should not be allowed to claim damages that occurred before it became an investor. Respondent's expert explained that Claimant did not suffer damage from the alleged expropriatory acts as they occurred before Claimant acquired ownership of Yukos shares and as such had already been incorporated into the share price. The most that Claimant could claim was U.S. $3.5 million, the price of its shareholding at the time it gained beneficial ownership in 2007, plus interest.

Conclusions of the Tribunal:
The effects of the Russian Federation's actions with respect to Yukos were already known by the market when Claimant purchased its shares on November 16, 2004 and December 1, 2004. The Tribunal was prepared to accept that Claimant had purchased shares when the market had overreacted to transient events and therefore that the share price was unjustifiably low, which as Claimant acknowledged, was a business strategy of the company. However, the Tribunal could not accept Claimant's optimistic expectations regarding the future development of the value of its investment. Yukos itself announced that it would likely enter bankruptcy before the end of 2004. According to the Tribunal, Claimant had made a speculative investment in Yukos shares and this would be taken into account when awarding damages.

The Tribunal criticized the "but for" approach in Claimant's expert report as not fully taking into account the speculative nature of Claimant's investment (which was consistent with the modus operandi of Claimant and its parent, the Elliott Group).

The Tribunal therefore held that any award of damages that rewards Claimant's speculation with an amount based on an ex-post analysis would be unjust. The Tribunal went on to say that assessment of damages using Claimant's expert report would only reflect the small possibility of upward risk and not the risk of no return – which would be inconsistent with the BIT.

The Tribunal concurred with Respondent and criticized Claimant's expert report for making two inconsistent assumptions in calculating damages. The first was that the Russian government had taken certain tax-related measures which had reduced the Yukos share price at the time that Claimant bought the shares. The second was that after Claimant had bought the shares these events would not have taken place and therefore the value of Claimant's return on its investment would have been higher.

The Tribunal then turned to the question of when Claimant had assumed the risk of the investment. While Claimant was an investor according to the BIT from the time that it purchased shares in Yukos on November 16, 2004 and December 1, 2004, it only bore the risk of the investment at the time when the Participation Agreements[10] were terminated on January 24, 2007.

This should therefore be the alternative date of calculation for the purchase of shares by Claimant, as proposed by Respondent's expert. Respondent submitted damages amounting to U.S. $3.7 million as of March 3, 2009 but this amount already included interest up to March 3, 2009. The Tribunal proposed an approach that established the principal amount of damages due and then calculated interest separately. Therefore, the best reflection of damages without interest is what Claimant paid to Elliott as the purchase price of the shares at the time the Participation Agreements were terminated, which was U.S. $3.5 million.

Interest:
Claimant requested interest compounded on all amounts awarded. The BIT contemplates interest "at a normal commercial rate" for cases of expropriation. Claimant proposed that this normal commercial rate should be compounded at an appropriate interval to reflect the element of risk associated with the investment. Claimant suggested a standard commercial rate such as LIBOR +4%.

Respondent suggested a risk-free rate such as the U.S. Treasury rate. It argued that if the Tribunal made an award for compensation, the "normal commercial rate" should be the normal commercial rates prevailing in Europe, e.g., one-year LIBOR or EURIBOR. No compounding should be awarded because this would provide Claimant with a windfall. The Tribunal noted that the BIT states that "interest at a normal commercial rate shall accrue until the date

of payment" on the amount of "adequate and effective compensation." This refers to a lawful expropriation. In the present case, however, the expropriation is unlawful, therefore requiring the customary international law standard for the calculation of interest. However, both parties had referred to the interest provision of Article 5(1) and the Tribunal found it acceptable that a normal commercial rate would also be due on the sum awarded as damages. The Tribunal chose the LIBOR rate starting from March 24, 2007, which takes into account the two-month grace period expressly provided in Article 5(1) of the BIT.

Costs:
In determining costs, the Tribunal noted that Claimant had been successful on jurisdiction and liability but that Respondent had been successful on damages. Bearing this in mind and taking account of the circumstances of the case and its discretion under the SCC Rules, the Tribunal concluded that each party should bear its own costs and that the arbitration costs should be borne in equal shares by both parties.

Impregilo S.p.A. v. Argentine Republic (ICSID Case No. ARB/07/17)

Date of the Award:
June 21, 2011[11]

Sector Involved:
Water and Sewage Concession

Applicable BIT:
Italy-Argentina BIT

Members of the Tribunal:
Judge Hans Danelius (President), Judge Charles N. Brower, and Professor Brigitte Stern

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[8] *Duke Energy Electroquil Partners and Electroquil S.A. v. Republic of Ecuador* (ICSID Case No. ARB/04/19), Award of August 18, 2008.

[9] *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile* (ICSID Case No. ARB/01/7), Award of May 25, 2004.

[10] The Participation Agreements were an intra-group investment arrangement between Claimant and its parent company, the Elliott Group, by which Claimant was the nominal owner of the shares and the Elliott Group was the beneficial owner of the shares.

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Measures Complained Of:
Expropriation and related measures regarding a water-and-sewage concession in Buenos Aires Province.

Case Overview:
Impregilo was a minority owner in AGBA, to which the Province of Buenos Aires granted a 25-year concession to provide water and sewage service in a section of the Province. The BIT claims concerned a series of government measures that culminated in the Province's termination of AGBA's concession in 2006. The Tribunal rejected several claims but held that Argentina breached the BIT's fair and equitable treatment provision when it pesified and froze AGBA's tariffs at an unsustainable level, imposed a new regulatory framework that negatively affected AGBA, and then failed to provide AGBA a reasonable adjustment to its obligations under the Concession Contract.[12] The Tribunal rejected Argentina's defense of necessity, holding that Argentina contributed to the circumstances creating the alleged necessity.[13] Professor Stern disagreed with the award's reasoning regarding Argentina's necessity defense but agreed with the holding because the wrongful measures continued after the alleged necessity period ended.[14]

Valuation Method Advocated by Claimant:
Claimant assessed its damages using a combination of two methods: an income method and an asset-based method. Its experts attached two-thirds weight to the income method and one-third weight to the asset-based method.[15]

Valuation Method Advocated by Respondent:
Argentina argued that the concession had no economic value and thus no compensation could be justified.[16]

Tribunal's Decision Regarding Valuation Method:
The Tribunal held that the concession entailed considerable risk because its success depended in part on procuring substantial financing and on increasing payment-collection rates in the area. The Tribunal found that some of the financing and collection issues that AGBA suffered were due to business risks and the general economic conditions and thus were not attributable to Argentina. Thus, it found that Impregilo had failed to prove that AGBA would have been profitable but for Argentina's breach of the BIT.[17] As a result, the Tribunal blamed both Argentina and Impregilo for the concession's failure: "The failure of the concession can therefore be ascribed partly to events for which AGBA stood the risk and partly to acts or failures by the Province."[18] Because of this "shared responsibility," the Tribunal refused to calculate damages based on an asset or income-based method.[19] Instead, the Tribunal set damages at the amount that Impregilo contributed to AGBA (U.S. $21,294,000) with interest.[20] Judge Brower dissented regarding damages. In his opinion, Argentina's measures destroyed the concession.[21] In addition, he believed that the concession was a going concern, and therefore, the proper approach to damages would be to use an income method and use an appropriate discount rate to eliminate any business risk from the compensation.[22]

Interest:
The Tribunal set the rate at 6% compounded annually beginning from the date of the termination decree.[23] Judge Brower believed that the date from which interest would run should have been set earlier in time.[24]

Costs:
The Tribunal also ordered each side to bear its own legal costs and half of the ICSID fees and Tribunal costs.[25] ✦

[11] King & Spalding was counsel for Claimant in this case. The award is available at http://italaw.com/documents/Imgregilov.ArgentinaAward.pdf (last visited Aug. 22, 2011).
[12] Award ¶¶ 325–30.
[13] *Id.* ¶¶ 353, 358–59.
[14] *Id.* ¶ 360.
[15] *Id.* ¶ 372.
[16] *Id.* ¶ 372.
[17] *Id.* ¶ 370.
[18] Award ¶ 377.
[19] *Id.* ¶ 378.
[20] *Id.* ¶ 381.
[21] Award, Brower Dissent ¶ 39–40.
[22] Award, Brower Dissent ¶ 36–38.
[23] Award ¶¶ 382–83.
[24] Award, Brower Dissent ¶ 39–40.
[25] Award ¶ 385.

Our "Old But Still (Very) Useful" Section

Kuwait v. AMINOIL

The famous *Kuwait v. AMINOIL* case[26] arose out of the Kuwaiti government's efforts, beginning in the early 1970s, to renegotiate AMINOIL's 1948 concession, which Kuwait eventually terminated in 1977. The main issue in the arbitration was the amount of compensation due to AMINOIL in light of the termination. The case's significance, however, stems primarily from the Tribunal's discussion of the legal effects of several sets of pretermination negotiations between the parties, including one that resulted in a definitive written agreement in 1973 and others in 1976–77 concerning the "Abu Dhabi Formula," which did not result in a written agreement. The Tribunal placed both these negotiations in the context of the parties' "legitimate expectations," which it deemed relevant to determining appropriate compensation for the 1977 termination.

As for the 1973 definitive agreement, AMINOIL argued that the Tribunal should disregard it for purposes of determining compensation because the government had effectively coerced AMINOIL to sign it by threatening to shut down the concession altogether if AMINOIL refused. The Tribunal emphasized, however, that the 1973 agreement stated: "We [AMINOIL] accept the 1973 Agreement as drafted in July of this year with the language changes agreed at the aforementioned meetings and with the following amendments requested by the Ministry..."

"The AMINOIL case is of particular relevance today in an era where States increasingly pressure private investors, especially in natural resources sectors, to 'renegotiate' contracts in light of changed circumstances..."

In the Tribunal's view, "[b]y these words the Company seems definitively to have accepted the July 1973 Agreement." The Tribunal also found that "the illicit character of the threats directed against AMINOIL has not been fully proved." But even if they had been proved, the Tribunal concluded:

> AMINOIL gave way without even making the qualification that the Company was conscious that something illicit was being imposed upon it. It is understandable that it avoided resorting to arbitration because of the delays, risk and costs of arbitral proceedings – but AMINOIL entered neither reservations of position nor protests. In truth, the Company made a choice: disagreeable as certain demands might be, it considered that it was better to accede to them because it was still possible to live with them. The whole conduct of the Company shows that the pressure it was under was not of a kind to inhibit its freedom of choice. The absence of protest during the years following upon 1973 confirms the non-existence, or else the abandonment, of this ground of complaint.

Accordingly, the Tribunal refused to allow AMINOIL to avoid the 1973 agreement, and it determined compensation on the assumption that the agreement was fully valid and reflected the parties' legitimate expectations as from the date of its execution forward.

As to the oral negotiations in 1976–77 concerning the "Abu Dhabi Formula," although no definitive agreement was ever reached, the Tribunal stated that "the negotiations between the parties about the application of the Abu Dhabi Formula involved a recognition of the principle of a monetary obligation to the Government, and of a modification for the future of the financial relations of the Parties." According to the Tribunal, the negotiations constituted a recognition

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[26] *Government of the State of Kuwait v. American Indep. Oil Co. (AMINOIL), Ad Hoc* Award (March 24, 1982), 21 ILM 976 (1982).

Recent Damages Awards

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by AMINOIL that it was entitled to a "reasonable rate of return and not speculative profits which, in practice, it never did realize." The Tribunal concluded on this point:

> It is correct to say that the attitudes taken up by a party over the long course of a negotiation that eventually breaks down cannot be made the basis of an arbitral or judicial decision. But there is no question here of facing AMINOIL with the latest proposals it made in 1977 in a final effort to come to terms. The point is simply to register the fact that, over the years, AMINOIL had come to accept the principle of a moderate estimate of profits, and that it was this that constituted its legitimate expectation.

The Tribunal thus awarded damages on this basis. In short, the negotiations were considered to be evidence (in part) of AMINOIL's legitimate expectations concerning its future profitability for the remaining life of the concession. This in turn informed (and from AMINOIL's perspective, reduced) the Tribunal's award of damages.

The *AMINOIL* case is of particular relevance today in an era where States increasingly pressure private investors, especially in natural resources sectors, to "renegotiate" contracts in light of changed circumstances (such as increased commodities prices or the State's desire to partially or fully nationalize such sectors). These negotiations can often drag on for several years, and States may seek to oblige investors to sign "interim" agreements in which the investor effectively abandons its existing contract rights pending further negotiations on a definitive new agreement (which may never materialize in the end). The AMINOIL case imparts at least five lessons to investors in such circumstances (and from which States can take the contrary lessons).

- First, investors must be careful to reserve their rights in all written communications with the host State.

- Second, in the event an investor signs an interim agreement but wishes to continue to reserve its rights under the existing (i.e., pre-interim-agreement) contract in the event that the interim agreement does not result in a definitive new contract, the interim agreement should explicitly include a recognition by both parties of a return to the status quo ante if no definitive agreement is reached.

- Third, investors should document any coercion or duress to avoid the proof problem that AMINOIL faced (although some recent decisions under bilateral investment treaties have held that a truly forced renegotiation may violate fair and equitable treatment).

- Fourth, investors should be sensitive to the fact that their negotiating positions may shape the "legitimate expectations" analysis that an arbitral tribunal may later employ in awarding damages, even if no definitive new agreement results from those negotiations.

- And fifth, investors should ensure that any positions or claims they may eventually wish to make in a later arbitration are expressly asserted in the negotiations; otherwise, a tribunal may consider those claims to be weak or even abandoned.

Following these steps can help an investor protect itself from the fate that befell AMINOIL some 30 years ago. States, on the other hand, can draw lessons from the successful strategy Kuwait employed to limit its eventual exposure. ✦

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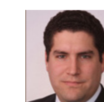

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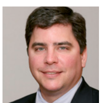
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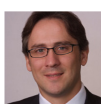
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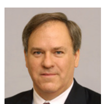
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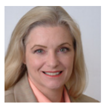
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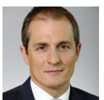
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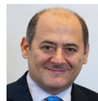
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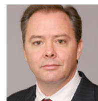
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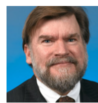
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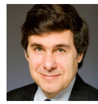
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