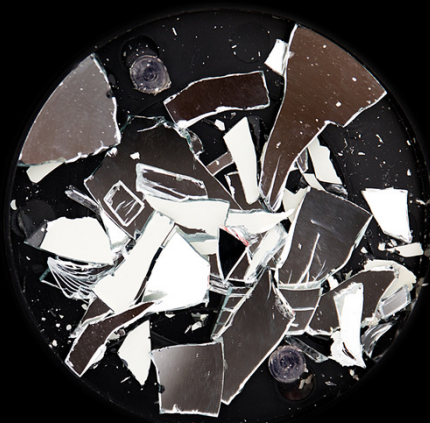


Deloitte.



Doing the Math: Approaches and Methods for the Assessment and Quantification of Damages
 Joint UNCITRAL-LAC Conference on Dispute Settlement

dr. Yuri Sidorovich, 9 April 2019

Your presenter



dr. Yuri Sidorovich
Forensic Leader
Deloitte Adriatic Region
 Mobile: +386 51 371 808
 ysidorovich@deloitteCE.com

Career Summary

Over 20 years of experience in conducting financial crime investigations, providing dispute consulting and expert services in various industries and jurisdictions, and performing external and internal audits.

Education and Professional Qualifications

- Certified Fraud Examiner, member of ACFE
- Certified Public Accountant, member of AICPA
- Certified Internal Auditor, member of the IIA
- Certified Auditor, Slovenia
- Diploma in International Financial Reporting, ACCA
- PhD, Belarussian National Technical University
- MBA (Hons), Hofstra University

Expertise

Has managed complex investigations at various entities into allegations of fraud, including financial statement fraud, misappropriation of assets, and breach of fiduciary duties by individuals acting alone or collusively. He has also managed and participated in numerous projects requiring the analysis and quantification of economic damages, prepared expert opinions for the purposes of both local and international judicial and arbitration courts, and assisted clients manage the risk and regulatory compliance requirements of financial crimes such as money laundering, fraud and corruption.

Introduction to damages

© 2019 Deloitte Central Europe

3

Introduction to damages

Definition

In general, damages are "... **the sum of money which a person wronged is entitled to receive from the wrongdoer as compensation for the wrong**" (Frank Gahan, "The Law of Damages" (1936), as noted in Black's Law Dictionary).

Damage analyses are prepared to provide an estimate of the detriment suffered by the claimant as a result of a wrongful act of the defendant.

In order to prove damages the claimant must show that:

- the wrongful act of the defendant caused a loss; and
- the amount of the loss can be estimated with reasonable certainty.

In addition, for contract claims, the claimant must show that the loss incurred was foreseeable at the time the contract was entered into by the parties.

"... the sum of money which a person wronged is entitled to receive from the wrongdoer as compensation for the wrong"

© 2019 Deloitte Central Europe

4

Introduction to damages

The governing principle

Tribunals in international arbitration have not often commented on the theory of damages. An exception is the classic case of the factory in Chorzów, Poland (Germany v Poland, PCIJ 1928 Ser A, No 17) in which the tribunal stated:

"The essential principle contained in the actual notion of an illegal act – a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals – is that reparation 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. Restitution in kind, or, if this is not possible, payment of a sum corresponding to the value which a restitution in kind would bear; the award, if need be, of damages for loss sustained which would not be covered by restitution in kind or payment in place of it – such are the principles which should serve to determine the amounts of compensation due for an act contrary to international law."

Introduction to damages

The challenge of estimating damages

- Loss is an estimate, not an exact calculation
- Uncertainty is inherent in an estimate
- Reliability and accuracy of an estimate depends on input data available
- Input requires support by evidence from:
 - Computation from the contract (if applicable)
 - Pre-litigation/arbitration projections (business plans) for the disputed matter (contract/investment)
 - Prior experience/performance of the target/claimant
 - Claimant's/target's subsequent experience/performance after breach abolished
 - Claimant's/target's experience at other locations
 - Respondent's subsequent experience
 - Comparable experience of others
 - Industry averages

Key aspects of quantification of damages

© 2019 Deloitte Central Europe

7

Key aspects of quantification of damages

The but-for scenario

- It is critical in damages work to have a clear view of the scenario against which damages are being measured: "What would have happened if the wrongful act had not taken place?"
- This is the counterfactual or the but-for scenario
- Without a clear idea of the but-for scenario, much confusion can be created in preparing submissions
- What would have happened "but for" the alleged illegal act(s) or omission(s) is ultimately a matter for the tribunal to determine
- In our experience, tribunals are (rightly) sensitive to the overall plausibility of the but-for scenario, as well as its legal relevance, and will focus on this as part of considering any award
- A persuasive but-for scenario must
 - Be plausible and sense-checked against available measures/benchmarks
 - Generally, take account of opportunities for the claimant to mitigate its losses

© 2019 Deloitte Central Europe

8

Key aspects of quantification of damages

Measuring damages by expenditure incurred

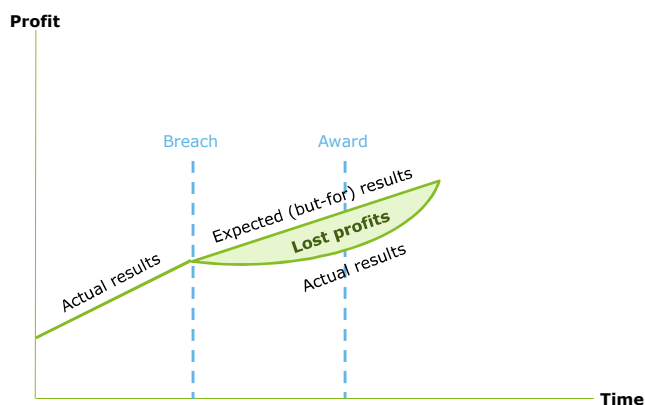
- Different terms used: „actual investment“, „actual expenses“, „historic costs of investment“, „investment expenditure“
- Expenditure incurred is often viewed as:
 - Separate head of damage
 - Expensed costs in contractual cases, often together with lost profits
 - A proxy to determine the value of an investment
- Eligibility criteria:
 - Linked to the investment (planning costs, equity contributions and loans, interest and fees, in-kind contributions, marketing, recruitment and relocation, travel and accommodation costs, insurance)
 - Linked to the investor
 - Reasonable (necessary and not excessive)
 - Supported by sufficient evidence

© 2019 Deloitte Central Europe

9

Key aspects of quantification of damages

Measuring damages by lost profits



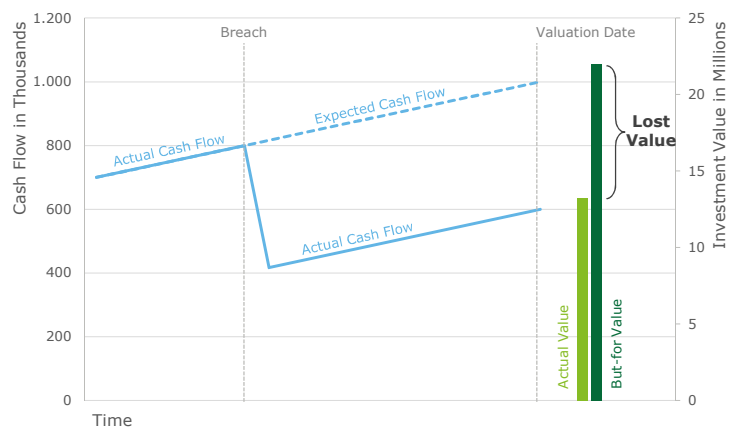
- Typical rationale: the activity of a company is interrupted for a certain period and/or the damage relates to a specific contract
- Approach: the difference between expected (but-for) profits and actual profits

© 2019 Deloitte Central Europe

10

Key aspects of quantification of damages

Measuring damages by lost value



- **Typical rationale:** investment destroyed (nominal residual value) or permanently damaged (unrecoverable significant decrease in value)
- **Approach:** the difference between expected (but-for) value and actual value

© 2019 Deloitte Central Europe

11

Primer on valuation

© 2019 Deloitte Central Europe

12

Primer on valuation

How is quantum linked to valuation

- **Quantifying damages can involve business valuations in a number of circumstances**

- The claimant's losses relate to the entirety of a business (e.g. an expropriation)
- The claimant is affected so materially that the loss is most easily considered as a loss of overall business value

- **Quantifying damages may involve valuations of particular assets of a company, such as:**

- Brand damaged by unfair competition
- Client databases stolen by a former manager who then sets up a competing business
- Proprietary R&D (formulae, application code)

- **Quantifying damages may not involve valuation at all but may still use valuation techniques:**

- Developing market forecasts
- Discounting in lost profit assessments

© 2019 Deloitte Central Europe

13

Primer on valuation

Valuation methods overview

Income approach

- What is the most likely future stream of net economic benefits worth to the owner?
- Requires reasonable estimates of future economic benefits (income, cash flows, etc.)
- Best suitable for predictable businesses/assets, esp. where track records exist
- Discounted cash flow (DCF) method is the most widely used method under the income approach

Market approach

- How much did others pay for similar assets?
- Requires identification of comparable assets that have been recently traded
- Best suitable for homogeneous assets with characteristics already known to the market (e.g. FMCG)
- Guideline public companies (GPC) and merger and acquisitions (M&A) methods are the most widely used

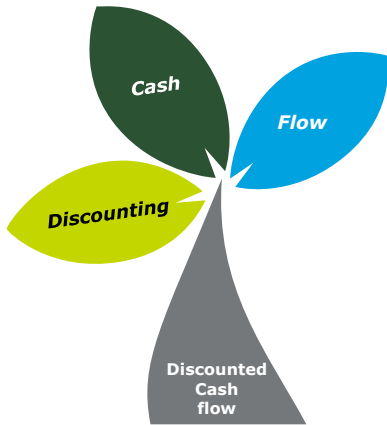
Asset-based/cost approach

- What did it cost to create/by the asset? What would the cost be to replace it?
- Starts from historical costs / book value of assets
- Most suitable to value businesses with predominantly liquid assets (e.g. financial sector)
- Adjusted net asset value (ANAV) is the most widely used in business valuation

© 2019 Deloitte Central Europe

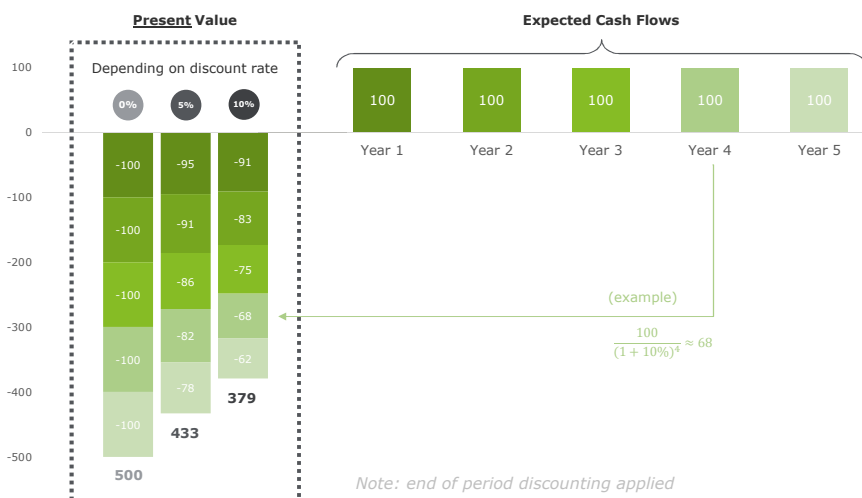
14

Primer on valuation
Income approach – the principle of DCF



- **Discounting**
Discounting is a means stating the value of future cash flows as a lump sum on the valuation date or date of assessment of loss
- **Cash**
Uses *cash*, where the starting point is EBITDA, which is then adjusted for CAPEX, WC movements and tax
- **Flow**
Focuses on *flows* of cash over time – the cash flow forecasts are a critical input to any DCF analysis

Primer on valuation
The income approach – the mechanics of discounting



Arbitration practice on damage quantification

© 2019 Deloitte Central Europe

17

Arbitration practice on damage quantification Income approach

- Generally, awards made on the basis of DCF valuations have occurred when the perceived degree of speculation in the forecasts is low
 - Forecasts rooted in contemporaneous documents
 - Substantive history of profitability
 - Well reasoned and conservative assumptions underpinning calculation
- Contrast with business practice...
 - DCF used as most common investment appraisal tool
 - Uncertainty and speculation common challenges for businesses; dealt with by adjusting cash flows and using an appropriate discount rate
 - DCF often the core valuation approach, triangulated with other methods (e.g. market multiples)
- Importance of track record can vary by industry

© 2019 Deloitte Central Europe

18

Arbitration practice on damage quantification

Market approach

- Limited evidence of a market multiples approach applied in awards by tribunals
 - Possibly surprising given its prominence in valuation practice
 - Practical difficulties in application appear to be the main reason – in particular a lack of good comparables; these difficulties can sometimes be overstated in our experience
 - Perhaps seen more commonly in commercial arbitration where comparable assets are more likely to exist
- Where practical difficulties are surmountable (i.e. comparables are available), multiples approach can be popular with tribunals
 - Market-based data
 - Important to determine maintainable earnings
 - On the face of it, not sensitive to arguments between experts regarding growth and uncertainty
 - However, even if it is the comparables that give a tribunal the confidence to make an award of a certain magnitude, Tribunals may feel tempted to express their findings as relying on a DCF-based analysis with comparables used as a cross-check

© 2019 Deloitte Central Europe

19

Arbitration practice on damage quantification

Cost/expenditure approach



- That tension manifests in the rejection of DCF when unaccompanied by a long track record of performance
 - *"future profits are uncertain and have not been adequately proven"*
 - *"little more than 2 years of business operation is an insufficient historical period from which reliable projection cannot be derived"*
 - *"because of the absence of any history of profitable operations, a DCF analysis would be speculative"*
- In the absence of a forward looking valuation free from speculation, tribunals appear attracted to an award based on historical expenditure
- Effectively, this puts the claimant back in the position it would have been in absent the investment, rather than absent the harm

© 2019 Deloitte Central Europe

20

Arbitration practice on damage quantification Supporting quantum assessment

- Experts often disagree on valuation issues, and tribunals and judges often have to decide between two experts positing very different valuation conclusions
- Critical that your expert:
 - Bases his/her valuation on a plausible, well supported but-for position, drawing on experts in other disciplines where appropriate
 - Is rooted in contemporaneous forecasts, and is consistent with any other indicators of value
 - Wherever possible, uses more than one valuation method
- Particularly important given the tendency for arbitrators to reject a forward looking valuation in favour of a wasted expenditure approach
- Therefore also important to explain:
 - The key characteristics and competitive advantages that make the business valuable and / or the challenges the business faces
 - That wasted expenditure is not 'value reflective' and would not properly compensate the claimant

Questions



Deloitte.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/sj/about to learn more about our global network of member firms.

Deloitte provides audit, consulting, legal, financial advisory, risk advisory, tax and related services to public and private clients spanning multiple industries. Deloitte serves four out of five Fortune Global 500® companies through a globally connected network of member firms in more than 150 countries and territories bringing world-class capabilities, insights, and high-quality service to address clients' most complex business challenges. To learn more about how Deloitte's approximately 263,900 professionals make an impact that matters, please connect with us on Facebook or LinkedIn.

2019. For information, contact Deloitte Touche Tohmatsu Limited