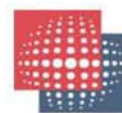


CPR PROTOCOL

CPR Protocol on Determination of Damages in Arbitration

CPR INTERNATIONAL COMMITTEE
ON ARBITRATION



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for Conflict Prevention
& Resolution

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ABOUT CPR

The International Institute for Conflict Prevention & Resolution is a membership-based nonprofit organization that promotes excellence and innovation in public and private dispute resolution, serving as a primary multinational resource for avoidance, management, and resolution of business-related disputes.

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CPR PROTOCOL ON DETERMINATION OF DAMAGES IN ARBITRATION

Introduction

The Protocol on Determination of Damages in Arbitration has as its purpose providing guidance to arbitrators, counsel and their clients concerning the efficient and fair development and presentation of damages evidence in arbitration proceedings. Too often damages are not dealt with early enough in arbitral proceedings, with the presentation of damages evidence left until near the end of the case. In such situations, the damages evidence that is presented may be based on theories that have not been previously articulated by the parties presenting them. Moreover, the presentation of damages evidence has frequently been left to accounting, financial and econometric experts whose presentations often fail to communicate with clarity to the arbitrators.

The Damages Protocol addresses these difficulties in two ways. First, it prescribes that arbitrators address, in or about their initial conference with the parties, the subject of damages, having the parties articulate their theories of compensation and their defenses, including mitigation of damages. Addressing these matters early in the proceeding, instead of leaving them in the background for presentation at later stages, enables the arbitrators to have a greater understanding of the relevance of evidence presented to them and may enable both parties and arbitrators to understand better the legal and factual aspects of the dispute.

Second, the Protocol sets out prescriptions for the presentation by experts of their damage calculations, requiring that they make their presentations in a way that permits the arbitrators to understand not only the results, but also the methodology by which the experts reached their conclusions and how different assumptions may alter the calculations.

The Protocol is the result of more than two years' work by the CPR Arbitration Committee, in the course of which it has been considered by its national and international members over several meetings. A subcommittee headed by the undersigned was responsible for the drafting and was aided by many other members of the committee, including Greig Taylor of FTI Consulting, who provided guidance and ideas with respect to the portion of the Protocol that deals with expert presentations.

Those of us who were involved in the creation of this Protocol hope that it will be a useful tool to assist arbitrators and counsel in assuring that the important subject of damages in arbitration is given careful consideration and that presentations concerning the calculation of damages communicate theories, methodology and conclusions clearly and coherently.

Lawrence W. Newman
Chairman of the CPR International
Committee on Arbitration



CPR PROTOCOL ON DETERMINATION OF DAMAGES IN ARBITRATION

INTRODUCTION

Once arbitrators have made a determination as to liability they have considerable discretion in assessing damages. Although arbitration rules contain provisions referring to such elements of relief as costs and interest, they say nothing about damage determinations. The parties may, however, have imposed limits in their arbitration clauses by ruling out the awarding of certain types of damages, such as consequential or punitive, and they may prescribe limitations on the amounts of damages that may be awarded. But, in the absence of such contractual guidance, arbitrators are left to determine, through the application of their own standards (assuming no overriding public policy or legal standards), the nature and extent of the damages they award. The purpose of this Protocol is to provide guidelines for arbitrators in making damage determinations.

The determination of damages is important and should be done with considerable care by arbitrators. Therefore, arbitrators should, in their award of damages, apply a consistently reasoned approach and procedures that are fair, efficient and not overly costly.

1. DAMAGES EVIDENCE

Some kinds of damages are relatively easy for arbitrators to assess. For example, if a contractor fails to complete a job at a fixed price and a replacement contractor is hired to complete the work, the difference between the cost of the second contractor – assuming the charges are reasonable – and the price agreed on by the first contractor constitutes the damages, together with the incidental costs of finding and hiring the second contractor. As another example, if the dispute between the parties is whether certain new products sold by the respondent are within or outside the terms of a license agreement between them, there may be a contractually specified formula for determining the royalties owed once coverage determinations are made.

On the other hand, some breaches of contractual commitments give rise to greater uncertainty as to the appropriate level of damages. A claimant may seek damages based on what would have happened in a hypothetical world in which the breach or wrongful activity did not occur. For example, contracts for the acquisition of a business often produce claims by the buyer based on breaches of warranties, or even fraudulent inducement, in which damages are sought for the difference between what was expected in terms of future earnings and what was obtained. Similarly, acquisition agreements with earn-out provisions often generate claims by the seller that the buyer failed to operate the business in the contractually specified manner during the earn-out period, giving rise to asserted damages for the difference between what was actually earned and what should have been earned. Claims can also arise where capital goods, process controls or business methods fail to perform as advertised.

In such cases, the arbitrators are requested to make determinations of what might, or should, have happened but did not. Determining damages in these cases involves at least two important considerations: the assumptions that are to be made as to what might have happened and the models that are to be used that will lead to the assessment of the appropriate level of damages.

a. Achieving Fairness In Determining Damages Without Speculating

If a tribunal determines that damages have been incurred, it should award them, even if they are difficult to establish with precision. Most common-law systems require the award of damages reasonably calculated to make the claimant whole, but also caution that speculation by the decision-maker is impermissible. There is a difference, however, between damages that are difficult to determine and damages that are so imprecise as to give rise to doubt as to their existence -- for example, as to whether the consequences of the respondent's actions were positive or negative for the claimant. Where assessing damages would require speculation, they should not be awarded. Thus, a contract broken by the owner of a site where the claimant had, or expected to have, a business may or may not result in damages – depending on whether the business was reasonably likely to be profitable in the future in the absence of the respondent's conduct.

An area of speculation that arbitrators should be alert not to venture into is the realm of remote consequential damages. In determining damages, arbitration tribunals should be able to ascertain an appropriate level of damages based on such evidence as the parties' negotiations, their prior course of dealing and the course of performance under the contract, as well as the extent to which the respondent knew and understood the consequences of a failure by it to perform as agreed.

b. Mitigation of Damages

It is generally understood that damages may not be recovered to the extent that they could have been avoided or minimized through commercially reasonable conduct by the claimant with respect to the purpose of the contract. The arbitrators should be able to obtain a good understanding of the factual issues relating to mitigation of damages through a review of evidence from the respondent in this regard. If the respondent makes a sufficient showing that there was a likely failure by the claimant to mitigate damages, the tribunal should consider granting requests from the respondent for the claimant to supply information concerning its activities following the breach, including other dealings or potential dealings the claimant may have had with respect to the subject matter of the contract, so that the arbitrators will be aided in determining the financial impact of mitigation measures that were taken, or that could have been taken, as well as any benefits derived by the claimant from the breach.

c. The Use of Experts to Prove Damages

Since many lawyers and arbitrators do not have extensive training or experience in economics, accounting or financial analysis, experts are often employed to play important roles in the presentation of evidence concerning damages. Frequently, evidence of damages is presented through claimants' experts, who present calculations of damages, sometimes through the use of abstruse economic models. Each such model is invariably based on various assumptions, differences in which can change radically the amounts of damages derived from application of the model. It can therefore be difficult for arbitrators to understand how they may use, or even interpret, such models in determining damages.

The task of the arbitrators in assessing econometric and similar evidence is made more challenging when the parties present, as they often do, experts with markedly different conclusions as to the appropriate levels of damages. If the presentations by the experts

do not present analyses that can be readily compared, or even understood on their own, the arbitrators will have to struggle to deal with them in granting appropriate relief.

Parties to arbitration proceedings and their counsel should therefore be aware that the production of prodigious amounts of expert analyses of damages can be unproductive, or even counterproductive, in persuading arbitral tribunals, especially where the assumptions underlying the experts' models differ from evidence of the parties' own activities and understandings of the contracts or businesses in question.

2. STEPS THAT ARBITRATORS MAY TAKE

There are various steps that arbitrators may take to make their and the parties' task of dealing with damages less complex, time-consuming and expensive. These include the following:

a. Early Identification of Damages Issues

One of the most important and effective steps arbitrators can take is to address damages issues early in the tribunal's administration of the case, ordinarily in the initial scheduling conference among the arbitrators, counsel and possibly also the parties themselves.

This conference is an appropriate occasion for an initial examination of damages issues including, if practicable, preliminary damages calculations. The disclosure of information on damages soon after commencement of the case can be important for the development of other legal and factual aspects of the dispute by, for example, helping to explain why the parties took, or should have taken, particular actions such as termination, mitigation or the attempted application of contractual default provisions such as penalty clauses.

Having a discussion on damages early on also helps to give the arbitrators a sense of various aspects of the damages aspect of the case, including: (1) the strength of the evidence that the claimant will present on liability—including the crucial issue of whether the claim appears to be sufficiently meritorious for damages to be likely to be awarded; (2) the extent to which the liability evidence is organically linked with evidence of damages and (3) the theories presented by the parties as the bases for their positions on damages. The arbitrators' objective in this discussion should be to obtain at least a fundamental understanding of the factual and theoretical bases for the damage claims and the opposition to them.

Thus, at the initial and subsequent discussions of damages, the tribunal, the parties, their counsel, and, as appropriate, the parties' experts, should examine ways to refine and narrow the damages issues. Such discussions will enable all concerned to explore the possibility of structural or consensual means of providing to the arbitrators and the parties --before the preparation of elaborate and costly presentations and models concerning damages -- an understanding of the theories on which the parties will be seeking (or resisting) damages. Such discussions may also be used by the arbitrators to communicate to the parties the kind of presentations on damages issues that they will find helpful.

Arbitrators should make clear that such discussions are not intended to stifle the parties' ability to take different positions on damages at later stages, but rather to facilitate the arbitrators' understanding of, and ability to administer, the case. The tribunal should, however, deal severely later in the proceedings with presentations by a party of damage

positions that have misled an adversary or increased its costs, or the failure of a party to disclose positions for purposes of lulling or misleading an adversary. The tribunal should direct the parties to bring to the tribunal's attention new issues relating to damages should they arise in the course of the proceedings.

i. Possible bifurcation of proceedings

One of the approaches to damages that is sometimes taken is to separate those issues from the merits, through bifurcation of the proceedings. This is an approach that frequently appeals more to respondents than to claimants. Claimants may oppose bifurcation because they sense that they will have a more persuasive case if they can show not only the wrongful conduct of the respondent but the harm that that conduct has caused. Conversely, the respondent may well favor bifurcation because he or she hopes to defeat the claimant's case on the merits and never have to address the issue of damages. Possible bifurcation of the proceedings should, in appropriate cases, be one of the topics to be discussed among the parties and the arbitrators early in the proceedings.

ii. Initial Procedural Order

Following these initial discussions with the parties, the tribunal should issue a procedural order that includes provisions setting out the order and scope of presentations of damages evidence, including expert opinions. In framing such an order, as an alternative to bifurcation, the tribunal should consider arrangements for the presentation of damages evidence and argumentation separately from presentations on the merits, especially testimony by damages experts (see 2(b) below). The arbitrators may wish to include in their order a requirement that the claimant specify, in writing, as early in the subsequent proceedings as may be feasible, the theory or theories on which it will rely in pursuing its damages, and a good faith estimate of such damages.

The tribunal's initial procedural order should communicate to the parties, how it expects them to address the damage theories that will be pursued, how damages evidence will be presented and the role to be played by experts.

b. Expert Reports

i. Summaries

Arbitrators should encourage experts to summarize their calculations in easy-to-understand exhibits, rather than causing the arbitrators to deduce them from the narrative portion of the expert report.

ii. Assumptions

Assumptions made by experts should be separately identified and disclosed, to allow quicker and easier comparison of positions taken by opposing experts. A sensitivity analysis should be included with each expert's report to demonstrate the impact of variations in key assumptions (this could also be performed by a tribunal-appointed expert; see 2(e) below). The inclusion of such components in reports affords a logical structure for exchanges made in an expert witness conference (see 2(c) below) and may, in any event, be used by the arbitrators to help them decide the value of damages based on their determinations of the points of law or facts in dispute.

iii. Reconciliation of damages models

Where an expert provides more than one damages model, such as a reliance damages calculation and a loss of profits model, the arbitrators should consider requesting reconciliation between the two approaches. When opposing experts have adopted the same methodological approach, the tribunal may wish to request a reconciliation showing the key differences between the models. In this way, the arbitrators may be assisted in understanding the areas of disagreement between the opposing experts, and confirm areas of agreement. This step could be logically taken before a witness conference (see below).

c. *Expert Witness Conference*

The tribunal should consider, after having obtained the kind of information described above from the opposing experts, ordering them to confer, outside the presence of the parties' counsel and the arbitrators, for the purpose of eliminating the areas of disagreements between them.

d. *Testimony of Experts on Damages*

Whether or not damages issues are narrowed and defined by any of the measures described above, the arbitrators should take steps with respect to presentations by damages experts that enable the parties fully to explore the bases for the opinions expressed. Ample time should be afforded in hearings for the cross-examination of expert witnesses, and the arbitrators should allow themselves sufficient time to conduct their own examinations of the experts, with or without the assistance of a tribunal expert (as referred to below). The tribunal may also wish to arrange for the testimony of all damages experts at or around the same time so that their positions can be more readily compared. The tribunal may, in this context, wish to bring the expert witnesses together before them in a procedure sometimes known as "witness conferencing," for the purpose of permitting the arbitrators to obtain an understanding of the areas of agreement or disagreement between the experts.

e. *Tribunal Damages Expert*

The tribunal should consider with the parties the advisability of retaining its own damages expert in place of, or as a supplement to, the experts presented by the parties. Should it determine to appoint its own expert, the tribunal should consider such matters as the extent of the participation of the tribunal expert in the hearings, the form of the assistance to the tribunal by its expert, the opportunities to be afforded to the parties to provide information to and examine the tribunal's expert and how the cost of such an expert will be borne.

f. *The Damages Award*

The goal of the arbitrators should be to include in their award a careful analysis of how the quantum of damages awarded was determined. Arbitrators should make determinations of damages on a fair and reasoned basis and avoid providing support for the criticism, often expressed, that they reached a compromise result based on considerations other than the merits. The tribunal should be careful in its award to explain the extent to which it has accepted or rejected theories and other damage presentations by the parties. It should not base its award on damage theories that were not the subject of prior discussion with, or exposure to, the parties.

3. NON-MERITS DAMAGES

a. Costs

The same care and attention should be paid by the arbitrators to all elements of damages, not only those relating to compensation for breaches of contract or other forms of legal liability, but also claims for assessments of legal fees, consultants' fees, and the determination of interest, including amounts and the extent of compounding. In certain cases, these kinds of damages can constitute the bulk of the total damages awarded. The tribunal should also give careful consideration as to whether and to what extent it has the authority to award or otherwise apportion various costs and expenses among the parties.

Once they recognize that there will be issues to be dealt with as to the determination of costs, the arbitrators may wish to discuss with the parties how and when in the proceedings evidence of such costs is to be presented. In this way, the parties will not be left to wonder whether or not, or when, they will be expected to address the issue of legal fees—whether, for example, they should plan on including a discussion of legal fees in their post-hearing submissions or whether they will be expected to make separate submissions later on. If the claim for costs is expected to be high or if a dispute is anticipated as to the justification and reasonableness of the costs claimed, the arbitrators may wish to provide for the separate consideration of costs. Thus, the arbitrators may—perhaps with the consent of the parties—issue a non-final award setting out their determinations concerning the outcome of the case on the merits, leaving for briefing later on questions of whether or how, in view of the arbitrators' findings in the non-final award, legal fees should be awarded and their reasonableness determined.

The costs elements of damages should therefore not be dealt with summarily or cursorily, but set out in the award with the same kind of rigorous analysis as is applied to the other elements of damages.

b. Interest

Where much time has passed since the occurrence of the events that gave rise to liability, or at times of high interest rates, pre-award interest may comprise a significant portion of the total relief granted. To the extent feasible, interest awarded should arise out of the parties' contractual relationship. Thus, contractual interest rates could be an appropriate measure of applicable interest – although caution should be exercised with respect to the application of default or penalty interest rates.

CONCLUSIONS

Arbitrators should take the necessary steps, as early in the proceedings as may be practicable, to have the parties address and make known the theoretical bases on which damages will be presented and opposed. Arbitrators should deal with damages issues in a focused and disciplined way that enables them to obtain a clear understanding of both the theoretical and factual support for all the elements of damages. In doing so, they should assure that the parties' damages presentations, especially those of the parties' experts, communicate damages evidence in a clear, understandable and comprehensive manner.

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