

# A Subject of Interest: Pre-award Interest Rates in International Arbitration

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Different pre-award interest rates can have a significant impact on damages awards. The potential impact of different pre-award interest rates goes up as the legal process rumbles on. For instance, suppose that it took five years to obtain a damages award. A 10% pre-award interest rate would turn a \$100 million claim into \$160 million of damages, whereas a 2% pre-award interest rate would turn the claim into only \$110 million.<sup>1</sup>

However, pre-award interest was considered “a vastly under-pleaded area” during a recent Global Arbitration Review (GAR) meeting.<sup>2</sup> The recent GAR discussion revealed that the economics behind the choice of pre-award interest are not always well understood. In this article, we discuss the economic principles that should underlie the choice of a pre-award interest rate and draw out several implications.

## WHAT IS INTEREST FOR?

Once the tribunal has found for the claimant, the respondent usually owes the claimant money. Hence the claimant becomes a lender or creditor, and the respondent is a borrower. Interest compensates lenders (claimants) for two things: 1) the time value of money and 2) risk. A dollar today is worth more than a dollar tomorrow because we could simply deposit the dollar in the bank and earn a deposit rate.<sup>3</sup> To motivate a loan to someone else, we need the loan to generate a return at least as good as we could obtain on a deposit at the bank.

At the same time, a safe dollar is worth more than a risky dollar. Any loan involves the risk that the borrower will not repay the full amount due. The larger the risk, the higher the corresponding interest rate needed to compensate.<sup>4</sup> Put differently, no rational investor would lend to a risky prospect at 5%, if they could lend to a safe prospect at 10%.

These simple observations provide the economic framework for any discussion of pre-award interest and carry important implications:

1. *It is the riskiness of borrowers/respondents that determines interest rates.* Interest rates compensate lenders for the risks associated with borrower default, not for the risks or costs associated with a lender’s own capital raising activities.
2. *Interest rates reflect the actual risks born by lenders/claimants.* Interest rates do not compensate lenders for the returns available to them on hypothetical projects with a different risk profile to the actual borrower.

<sup>1</sup> We assume interest is compounded annually in these examples.

<sup>2</sup> See GAR 12 May 2015; An unexpected interest in interest.

<sup>3</sup> The time value of money also reflects the impact of inflation. In the presence of inflation, the purchasing power of a dollar declines over time. If a lender foregoes the use of her money today, then she must be compensated for the expected decline in purchasing power during the term of the loan.

<sup>4</sup> For a more detailed discussion of the economic role of pre-award interest see Gotanda, John Yukio; Compound Interest in International Disputes. *Law and Policy in International Business*, Vol. 34 (2003), pp. 397-398.

## PRE-AWARD INTEREST IN ARBITRATION

The fundamental question for pre-award interest is: what should it compensate claimants for?

Tribunals should at least compensate claimants for the time value of money. Otherwise, violators would end up benefiting from the delay inherent in the legal process, and claimants could never be made whole. Claimants would be subject to the erosion of the dollar value of their claims by inflation during litigation and the attendant delay in compensation, with no ability to obtain even the interest compensation normally obtained by risk-free assets.

A return on a “risk-free” asset will compensate the claimant for the time value of money. Government debt is usually taken as the best proxy for a risk-free asset, but one must exercise care with this assumption. US or German government debt is as close to risk-free as we are likely to see in the real world, but the debt of many Eurozone States currently attracts substantial risk premia. Even interest rate benchmarks like LIBOR or EURIBOR have at times been affected by concerns about counterparty default.

The term of the debt is another question – in other words, what is the duration of the government bond from which we should derive an interest rate? The US Treasury issues debt with terms varying from 30 days to 30 years, and these different issues attract different interest rates. Short-term bills attract lower interest rates, while long-term rates compensate investors for the likely path of interest rates and the risk that inflation and interest rates turn out different from expectations. Determining the most appropriate choice will depend on the inflation risk that the tribunal thinks the claimant should be awarded for, which in turn will depend on the legal and fact pattern of the case.

A broader view of pre-award compensation is also possible. In addition to the time value of money, pre-award interest could also compensate claimants for payment risks attached to the respondent. During the course of the litigation, there is always a risk that a respondent might default and go bankrupt, long before the claimant could obtain an award and collect on damages.

Under this view, a claimant in effect becomes a “forced lender” to a respondent, and deserves some compensation for the associated payment risks borne during the course of the litigation. Indeed, claimants at least deserve compensation in line with other lenders to the respondent.<sup>5</sup> Otherwise, they would be forced to bear the risk of a respondent default during the arbitration process without receiving offsetting compensation.

The broader “forced loan” perspective has the added benefit of giving the respondent incentives to behave efficiently. If respondents paid a lower pre-award interest rate than on their other debt, then they could obtain cheaper financing through improper conduct than by borrowing through normal channels. Respondents would have an incentive to drag out legal proceedings as long as possible, to continue profiting from the cheap loan from claimants.<sup>6</sup> Ensuring that respondents pay the full costs of the forced loan also ensures that they will take appropriate precautions to avoid the situation that led to the award in the first place.<sup>7</sup>

The risk of a respondent’s default is distinct from the claimant’s chance of a successful legal outcome. The legal process exposes claimants to the risk that their claim may be denied. Claimants and litigation funders logically take such chances into account when deciding whether or not to pursue claims. However, granting pre-award interest at the respondent’s borrowing cost does not compensate for the risk of an unsuccessful legal outcome. It simply compensates for the risk that respondents may not be able to pay even when found liable.

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<sup>5</sup> For more on the “forced creditor theory” see Epstein, Roy J.; Prejudgment Interest Rates in Patent Cases: Don’t Compound an Error. *IPL Newsletter*, Vol. 24, No. 2 (2006), p. 9.

<sup>6</sup> For further discussion on this point see Sénéchal, Thierry J. and John Y. Gotanda; Interest as Damages. *Columbia Journal of Transnational Law*, Vol. 47, No. 3 (2009), p. 496. Available at SSRN: <http://ssrn.com/abstract=1116384>.

<sup>7</sup> Knoll, Michael S.; A Primer on Prejudgment Interest. *Texas Law Review*, Vol. 75 (1996), p. 296.

Whether a tribunal adopts the narrow risk-free or broader forced loan perspectives ultimately comes down to legal considerations. The narrow “risk-free” view presumes that respondents’ liability arises only at the moment awards are rendered,<sup>8</sup> and treats the risk of a respondent payment default as one more of the many risks associated with the litigation process for which the claimant is not compensated. Under this theory, the risk that a respondent fails financially prior to an award is viewed as part of the risk of arbitration rather than a financial risk. The broader “forced loan” view compensates the claimant for the risk of a respondent payment default, consistent with the idea that the amount owed was a forced loan made at the time of the breach.

## HIGH PRE-AWARD INTEREST RATES?

The GAR discussion on pre-award interest raised an alternative argument, which we paraphrase here: *“The breach deprived the claimant of the ability to undertake alternative investments, which would have generated returns, close to the (high) equity return actually achieved by the claimant on other activities. Respondents should provide compensation for such foregone investment returns.”* This argument is simple, intuitive, and wrong.

Recall that interest rates depend on the risks attached to the borrower of the funds, and that they are linked to the extent of risks run. The use of a claimant’s return on alternative investments would sever the fundamental links between the pre-award interest rate, the borrower and the extent of risks the claimant bore during the arbitration.

The claimant’s return on an alternative investment has nothing to do with the respondent, even though interest rates should relate to borrowers/respondents. At the same time, the claimant never undertook the alternative investments nor did it run the associated risks, yet pre-award interest at the claimant’s return would provide compensation on the presumption that the claimant did and that the investments turned out as expected.

Put another way, the claimant may have *hoped* to earn higher rates of return on alternative investments. But we will never know, since the claimant never undertook the alternative investment or ran the associated risks. Like anything else, the alternative investments could have gone well or poorly, and the claimants could have gained or lost money. By depriving the claimants of the ability to undertake the alternative investments, the violations have deprived the claimants of both the chance to win and the chance to lose. Pre-award interest at the claimant’s cost of capital would compensate the claimants for a favourable outcome to the alternative investment, while ignoring the chances that they could have lost.

Moreover, if the alternative project was really so fantastic, then the claimant should have been able to find sources of funding for it other than the amounts owed by respondent. To claim that the respondent’s tardiness in paying up has deprived the claimant of an investment opportunity asks us to believe that there are no other sources of funding – a situation that is rarely likely to occur.

This brings us to the limits of what pre-award interest can compensate for. In real life, violations may have undermined the claimant’s ability to pursue other valuable investment opportunities, and forced them to lend money to respondents instead. Even if pre-award interest at the respondent’s borrowing rate gave a fair return for the risks actually run during the arbitration process – the risks of a respondent default – it would still not compensate the claimant for the loss of freedom to invest their money as they would have wished. It is the return that the claimant deserves, but not the return that they want. However, quantifying and compensating for this “inconvenience” would be difficult from an economic perspective, since the damage depends on the claimant’s risk preferences, which are not observable. But whatever the correct compensation for this inconvenience, the claimant’s cost of capital is unlikely to give the right answer.

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<sup>8</sup> See, for example, Franklin M. Fisher and R. Craig Romaine; Janis Joplin’s Yearbook and the Theory of Damages. *Journal of Accounting, Auditing & Finance*, Vol. 5, Nos. 1/2 (1990), pp. 145-157.

## CONCLUSIONS

The pre-award interest can lead to very significant differences to the final award, yet the debates on interest often reveal misunderstandings about the economic fundamentals.

In arbitration, the claimant takes the role of a lender to the respondent, who is the borrower or debtor. Interest rates compensate the lender for the time value of money, and also for the risk that the borrower might default on the loan. Hence, it is the riskiness or creditworthiness of the borrower or respondent that should determine the pre-award interest rate.

Whether a tribunal decides to compensate the claimant only for the time value of money, or also for the risk of respondent default, is ultimately a legal issue. It depends on whether the damages are viewed as a “forced loan” from the claimant that arose at the moment of breach, or whether the liability only arose as of the award date.

Regardless of which perspective the tribunal adopts, the final choice of pre-award interest will require careful economic consideration with respect to the choice of market data used, and any adjustment that may be required. The claimant’s expected return on alternative investments is not an appropriate pre-award rate. The tribunal should not reward the claimant for a risk that they never took. This perspective fails to compensate the claimant for the inconvenience of being forced to lend to the respondent, but quantifying such compensation will rely on judgement as much as economics.

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