Global Arbitration Review

The Guide to Damages in International Arbitration

Editor
John A Trenor

Second Edition

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The Guide to Damages in International Arbitration

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Editor

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Part III

Approaches and Methods for the Assessment and Quantification of Damages

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Overview of Methodologies for Assessing Fair Market Value

Philip Haberman and Liz Perks[1]

Fair market value is frequently referred to by tribunals as a relevant measure in their consideration of damages. This chapter introduces the concept of fair market value, discusses when it is used, and considers the critical question of the valuation date at which it is assessed. It then outlines the three general approaches to assessing fair market value (income, market and cost approaches), explaining their uses, advantages and disadvantages, before considering the need for adjustments in circumstances where the party concerned does not own an asset wholly. It ends by summarising the process that most valuers use to assess fair market value, and how they balance the three approaches to reach an opinion.

Meaning of FMV

Probably the most authoritative source of definitions related to valuation is the International Valuation Standards (IVS), which is issued by the International Valuation Standards Council and widely referred to by valuers all over the world. The most recent standards were issued in January 2017 and are more comprehensive than previous versions, but still do not define 'fair market value'. Instead, the IVS offers six alternative bases of value, the three most common of which are:[2]

1 Philip Haberman is the founder and senior partner of Haberman Ilett LLP, and Liz Perks is a partner at the firm.

2 The other bases of value are market rent, synergistic value and liquidation value.

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Equitable value*	The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.
Market value	The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
Investment value	The value of an asset to a particular owner or prospective owner for an individual assessment or operational objectives.
* In the previous (2013) version of IVS, this was called 'fair value'.	

The term 'fair market value' is defined by the US Internal Revenue Service and in OECD guidance (both for tax purposes) in terms similar but not identical to 'market value' in the IVS. Both incorporate the idea of a willing buyer and willing seller in a hypothetical transaction, rather than specific, identified parties, as in the equitable or investment value bases.

The discrepancy between authorities means that there remains an uncertainty as to exactly what is meant by 'fair market value' in the context of the measurement of damages in international arbitration.

In the remainder of this chapter, the term 'FMV' will be used in its US sense, corresponding to the IVS-defined 'market value'.

It is important to recognise that, when assessing FMV, a valuer is seeking to assess the various positions of the population of hypothetical sellers and buyers of the asset concerned, and arrive at an average that represents the likely price at which a transaction would be expected to take place. In an actual transaction, the price might well differ – possibly substantially – because of the circumstances of the actual parties, in which case the price would represent what the parties themselves actually decided was an equitable value.

When does FMV come into play?

The most common circumstances when a tribunal may be required to decide the FMV of an asset are:

- when a party has been deprived of an asset (for example, an expropriation) – the damage may be measured as the FMV of the lost asset;
- when an asset has been harmed – the damage may be measured as the FMV of the undamaged asset less the FMV of the damaged asset; and
- when a party has been misled (caused, for example, by a breach of warranty) – the damage may be measured as the difference between the FMV of the asset in the condition promised and its actual FMV.

In other cases, it may be appropriate for a tribunal to depart from FMV and move towards equitable value as a basis for assessing damages. A common example would be a quasi-partnership company, where several owners are cooperating under a shareholders' agreement; while an individual shareholding might have a modest FMV (because no external market participant would want to purchase it), its equitable value as between the existing shareholders may be substantial. Similarly, the FMV of a shareholding that carries a swing vote between two equal larger shareholdings may not be the same as its equitable value.

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There may also be circumstances where a tribunal reaches the view that the FMV of an asset is not a suitable measure of the damages to be compensated. An extreme example might be as follows:

- Suppose the asset concerned is a specialised and irreplaceable piece of equipment that makes a highly profitable product.
- Suppose the equipment is destroyed by fire.
- The owner's loss would normally be measured at the moment the fire occurred, so would be the FMV of the equipment on the day of the fire.
- But suppose the product was banned globally a week after the fire, because it was discovered to be carcinogenic. Had the equipment not been destroyed, its FMV would now be zero.
- What is the appropriate measure of damages? A tribunal may not wish to compensate the owner with damages that would appear to be a windfall, even though that seems to be theoretically correct.

Valuation date

FMV is determined at a particular date (the 'valuation date'). Choosing a valuation date imposes a requirement that information emerging after that date must not be taken into account in arriving at the valuation. In effect, valuers put themselves back in the past and pretend that they are standing at the valuation date and assessing the value of the asset concerned so, by definition, they cannot know what is in the future at that date and can only forecast it.

There are times when adherence to the valuation date seems to carry the danger of not achieving 'justice' in the circumstances of a dispute (for example, the situation described above). There are no fixed guidelines for how to treat such a situation: much will come down to argument and pragmatism rather than theoretical niceties. Some courts, for example, tend to justify looking at subsequent events by regarding it as a check that a valuation is giving a reasonable result – from a theoretical point of view that is unjustifiable, even if, from a pragmatic point of view, it helps to produce a fair result.

The choice of valuation date is important from a pure quantification perspective, because an asset is likely to have different values at different times. We see obvious examples of this every day, in the fluctuations of share prices on stock markets, and movements in property values. Some of these changes are driven by underlying movements in the market and competitive position, others by changes in the supply or demand for the product or service being sold, but all are a function of timing.

Deciding on the date for a valuation is primarily a legal issue, depending on the underlying legal basis of a claim, and requires careful analysis. The most frequently encountered dates used for valuations in the context of damages claims are:

- the date when the cause of action arose – this is the usual basis for investment treaty expropriation cases, where compensation may be defined by the treaty as the FMV of the asset immediately prior to the action being complained of;
- the date when the damage occurred – this will often be the same as the cause of action date but might be more appropriate in circumstances where the cause of action did not have an immediate impact;

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- the date a claim is made – this is argued on the basis that it is the date when the damage crystallises;
- the date submissions are made – this does not seem to have any sound theoretical basis, but is often seen as a more comfortable basis than estimating a value at an unknown future date when the award is likely to be issued; and
- the anticipated date of award – this is argued on the basis that it measures the loss at the point when the loss will be compensated.

Any choice of date raises complexities, so it might be argued that tribunals should give some early indication of their view as to the appropriate date for the assessment of loss, without committing themselves on liability.

Examples of timing issues include:

Investment treaty cases where the asset is appreciating (such as a natural resource)	A claimant may argue that fair compensation requires the respondent to compensate it for the increase in value that it is unable to benefit from, hence requiring a valuation at the anticipated date of award. A claimant might also justify this on the basis that the respondent will otherwise benefit from an unjust enrichment.
Cases where external circumstances changed in an unexpected way after the loss was caused	Either party may argue that valuing at the date of breach does not give appropriate compensation because it fails to take account of the subsequent external event that has actually occurred.

Dealing with these issues might require a tribunal to depart from a theoretically correct valuation at a given date, or to require that specified assumptions should be used in arriving at FMV, even though those assumptions might not have been made at the time.

Approaches to FMV

There are three valuation approaches to arriving at FMV of an asset: the income approach, the market approach and the cost approach. We will outline each of these approaches in turn, explaining what they mean and their basic characteristics, before discussing when to use each method and how to reconcile their sometimes different results.

All three approaches rely on two fundamental principles:

- that the owner of an asset has no special reason to want to own the asset apart from its ability to generate a return, whether that comes in the form of income from the asset, the eventual sale of the asset, the saving of cost through ownership of the asset, or a combination of these factors; and
- that the owner is impartial about the assets if they are all capable of generating the same expected income with the same likelihood.

In practice, this is not always the case: some owners (collectors, for example) are not wholly rational about the assets they own, and some assets (such as works of art) are valuable for non-financial reasons (in addition to the ability to sell them in due course). Such assets may not be susceptible to a rational valuation approach, or it may be necessary to limit the use of the approaches that follow.

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Income approach

The income approach relies on the underlying financial theory that the value of an asset is equal to the value of the future income that the rational owner can expect to obtain from the asset. The two underlying themes of the income approach are (1) that it relies on information on the asset itself, in the form of views as to the likely future income that an asset can generate, and (2) that all value is assumed to arise from the ability to generate future income.

In an ideal world, there would always be a sound basis for the assessment of future income, over a reasonable period of prediction. The reality might be different (few businesses are entirely predictable), but that is not the same as saying that it is too uncertain or speculative to form a reasonable basis for the assessment of value.

The most common form of the income approach is to focus on cash (rather than an accounting measure like income) and use a discounted cash flow (DCF) method. This sounds, and is sometimes interpreted, as though it requires a long history of past performance, but that is not necessary. A DCF valuation is based on the valuer's assessment of two fundamentals:

- the expected future cash flows to be generated by the asset being valued (whether that is an entire business, an individual asset, a project, shares, etc.); and
- the appropriate discount rate that allows for risk and uncertainty (the probability that the future cash flows will not turn out exactly as expected) and the time value of money.

Both of these can be arrived at from detailed underlying information (in the same way as businesses plan for the future), or can be assessed with more limited information (as public company shareholders do).

Where there is an absence of a historical track record, it is often argued that the DCF method (or the income approach in general) is inappropriate because it is too speculative. From a valuer's perspective, this is not true: while a track record may give the valuer greater confidence that a similar level of expected future cash flows will be achieved, it is not a necessary requirement for a reasonable valuation because it can be compensated for through the discount rate. Indeed, perhaps the most important aspect of a DCF valuation is the selection of a discount rate that takes account of the degree of uncertainty in the underlying cash flow projections.

Market approach

The market approach is based on the underlying theme that the wider market has already done the work of valuing companies and businesses of all kinds, using all the information available, so the valuer simply needs to find a quoted company (or a company that has been sold) that is the same as the company being valued, and then use its quoted valuation (or the sale price) as the value of the subject company.

In reality, of course, no two companies are identical, so there is a never a quoted company, or a company that has been sold, that is an identical twin of the company or business being valued. The valuer, therefore, seeks 'comparables', companies that are similar enough to the entity being valued to allow for meaningful comparison, in the knowledge that adjustments may need to be made to take account of the differences between the entity and the comparables. This gives rise to the two forms of the market approach:

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- trading comparables, based on contemporaneous quoted share prices of comparable companies; and
- transaction comparables, based on the sales prices of comparable companies that have been sold and acquired around the time of the subject valuation.

The search for comparable companies is usually based on companies operating in the same industry sector as the subject entity, at a similar scale, in the same part of the world, with similar profit margins, diversification, leverage and perhaps at a similar stage of development, because those are the companies that are exposed to the same business risks as the subject entity. While there are unlikely to be any comparables that meet all these requirements, the individual aspects of comparability can be considered separately by the valuer and assessed appropriately.

Once comparable companies have been identified, the valuer considers which statistics to use as a basis for comparison, focusing on those that the market uses as a guide when valuing companies in the sector, and arrives at relevant multiples of those statistics (whether trading multiples or transaction multiples). The most commonly used statistics include:

- profit after tax (which might be referred to as 'earnings' or 'net income') – the amount generated each year for the benefit of shareholders;
- earnings before interest, tax, depreciation and amortisation ('EBITDA' or 'operating profit') – the amount generated by the business before taking account of its financing, the replacement of fixed assets and tax (which is affected by non-operating decisions);
- turnover – the total amount generated from sales, before taking account of any costs; and
- book value of assets.

The statistics for each comparable company might need to be adjusted to remove the impact of non-recurring matters, as might the corresponding statistic for the subject entity.

Whichever statistics are used, it is common to find a wide range of relationships between the values of comparable entities and their statistics, so valuers usually focus on an average of some kind as a basis for a market valuation. While this might be thought to cast some doubt on the entire premise of comparability, because it implies that the comparables are not in fact comparable with one another, the usual approach is to remove the most extreme relationships by using the median (the specific number for which there is an equal number of values higher and lower) rather than the mean (the average of the values).

This process provides an initial view of value but the valuer then considers (to the extent feasible) the reasons why the subject entity might be different from the comparables. This is a judgemental process and might include the consideration of qualitative matters, such as brand name and reputation, and quantitative matters measured through statistics such as rate of growth, sales per square foot or gross margin.

Probably the most important aspects of the market approach are the existence of comparables (many cases involve entities that are arguably unique), the degree of their comparability to the subject entity and how the differences should be interpreted.

Cost approach

The cost approach rests on the principle that a buyer would not pay more for an asset than the cost of replicating that asset, either by buying an alternative or by recreating it. This

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is not the same as the historical cost of the entity or business – historical cost tells us the amount actually spent buying or building the asset at some past date or over a period of time, rather than the cost of buying or replicating the asset on the valuation date, which is better thought of as replacement cost.

A valuation based on the cost of buying alternative assets might also be thought of as a variation on the market approach, because it is based on the availability of similar (or comparable) assets in the wider market.

When the cost approach is considered, historical cost is of little significance: more important are replacement cost and break-up value (which is realisable value rather than cost).

Most businesses are more than just the sum of a series of individual assets – they include some know-how on the use of those assets, management skill, or unique intellectual property. Where that know-how is readily replicable, and there is no unique intellectual property, the replacement cost of the individual assets (including management) represents a ceiling on the valuation of the business – after all, no buyer would pay more for an easily replicated business than the cost of replicating it.

Any entity always has an implicit choice between continuing in business or winding up, so the cost approach can also be used to find a floor value of the entity, based on the break-up value of its assets – after all, no owner would continue to run a business if he or she could realise more by breaking it up.

Thus, the most usual purpose of the cost approach is to provide a ceiling or floor on the valuation of an operating business.

Choosing the approach

Each of the three approaches to valuation has its advantages and disadvantages, and the choice of approach will, therefore, depend on the balance between these various factors.

Income approach

The income approach is the usual starting point for the valuation of an entire or controlled entity, whether that entity is a company, a business or a project. This is because the owner or controller of the entity is likely to have the detailed information needed to undertake a realistic assessment of expected future cash flows.

It is also useful for unique assets, where market-based comparables are difficult to find, because the unique features of the asset can be taken into account in the valuation.

From a theoretical point of view, the income approach is almost always suitable, provided there is some reasonable basis for forecasting future cash flows and assessing risk. This is because it enables the valuer to make assumptions that are explicit and capable of being both varied and separately considered.

When an asset is not wholly owned or controlled, the valuer is likely to have less detailed information available from which to project future cash flows, with the result that there may be less certainty about the forecast and, hence, a need to reflect the risk that the expectations might be wrong.

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Market approach

The market approach rests on the use of comparables, whether trading or transaction, so the critical issue to consider is the availability of such comparables. When dealing with a common type of asset, such as a business operating in a well-established sector, there may be a wide selection of comparable companies to use as a basis, along with extensive research on the features of each company that enable the valuer to pinpoint reasons for differences and hence arrive at a well-founded valuation.

The difficulty with the market approach lies in its reliance on implicit rather than explicit assumptions, which makes it difficult for the valuer (and, in due course, a tribunal) to understand what is really influencing the result. Rather than focus on the key features of the business being valued, the market approach assumes that all businesses operating in the same sector are subject to the same influences and that the entity being valued is likely to perform in future in a similar way to the average of other businesses. There is less scope to take account of why some businesses perform better than others, and less scope to recognise entity-specific features such as faster growth, lack of growth, new developments or the need for restructuring.

Cost approach

The cost approach is suited to more limited circumstances, especially asset-based (rather than trading) entities and those that own readily replicable assets.

Apart from those cases, its most common use is as a check on the reasonableness of the valuations derived from the income and market approaches.

Adjusting the approach

The discussion so far has focused on the valuation of assets as a whole, but there are many situations where the FMV of part of an asset is needed, such as shares in a company, part of a joint venture or an interest in a project. Adjustments are needed to take account of the differences between valuing the whole of an operating business and valuing only part.

Control

Before looking at the adjustments, it may be helpful to consider why the ownership of part of a business is not necessarily valued at its proportionate share of the whole; this can be thought of as the premium for control, or the discount for being a minority, which are two sides of the same coin.

The owner of the whole of a business has unfettered control of the business itself, the cash flows that the business will generate, and the decisions as to how those cash flows will be used. The owner can decide the balance between reinvesting cash flows and extracting them as dividends, whether to expand or contract the business, which opportunities to pursue, and which efficiencies to exploit. These are all benefits of control, for which the owner is entitled to a premium.

In contrast, the partial owner or shareholder is dependent on decisions made either by others or by consensus, may have limited influence on those decisions and may be at the mercy of others when it comes to the opportunity to realise some cash flow (in the form

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of dividends) from the investment. This lack of control is the reason why owners are willing to pay a lower price, reflecting a minority discount.

The most obvious place to see this in action is when an offer is made for all the shares in a quoted company. Prior to an offer, the share price represents the price for a small ownership share in a larger organisation; when an offer is made for all the shares, the buyer is expected to (and does) offer a higher price including a premium for control; if the offer fails, the share price often falls back to reflect the individual shareholders' inability to obtain the control premium.

All three approaches discussed above (income, market and cost) focus on entities as a whole, so automatically take into account a premium for control, with one exception: the market approach based on trading multiples. This uses data based on the quoted share prices of comparable companies, and those share prices represent the market's assessment of the value of a small minority holding in a quoted company, so the result is the value of a small minority in the subject entity, not the whole. Moving from there to the value of the whole may require the addition of a control premium.

If the valuer is dealing with a non-controlled asset, such as a partial shareholding in a larger entity, any valuation arrived at as a proportion of the entire entity will need to be reduced by a discount for lack of control.

In practice, control is not always an absolute. It is common to find situations where control is shared, or where a minority owner is protected by limitations on the control exercised by the majority, usually achieved through a shareholders' agreement of some kind. In such case, judgement is required as to the extent of any discount for sharing control.

Marketability

Another factor that is widely recognised as influencing FMV is a lack of marketability; in other words, an inability of the asset's owner to realise its value at any chosen time.

Marketability is related to control, in that a controlling owner always has the right to dispose of the asset, and it is therefore marketable in his hands. Some non-controlling owners, especially those with relatively small shareholdings in quoted companies, also have marketability, as they can realise value by disposing of shares in the market at the market price (larger shareholdings need separate consideration and may have a value below or above the quoted market price, depending on the wider share ownership structure). Other non-controlling owners, however, are unable to realise value, perhaps because they cannot dispose of shares without approval from others, or because there is no ready market for the shares. This lack of marketability depresses the FMV of the partial ownership.

All the valuation approaches discussed above assume that the owner of the asset has the ability to realise it, either because they are based on controlling ownership or because they are based on the share prices of quoted companies, which are normally (by definition) marketable. If the valuer is dealing with a minority shareholding in a private company, its owner will probably have little or no opportunity to realise its value, and a discount is therefore required to take account of this lack of marketability.

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Equitable value compared to FMV

The adjustments discussed above are one of the key areas where equitable value may diverge from FMV. FMV is focused on the value that the external market would put on an asset, whereas equitable value considers the value of the asset as between the parties concerned.

Equitable value is commonly required in situations where parties share control, or where parties use a corporate entity as the body through which they trade, with no intention or need to realise value from it. In such circumstances, it may be inappropriate to apply any discount for lack of control or marketability, even when dealing with a minority shareholding.

Reaching a conclusion

Having considered the different approaches to valuation, most valuers will reach a conclusion on FMV from a combination of approaches.

Provided sufficient information is available on the subject entity, most valuers will begin with the income approach, using DCF, to reach a valuation of the entire entity, and will regard this as their primary valuation. They will then use the market approach as a secondary valuation, to check that the income-based valuation falls within the range that the market approach would expect.

If there is too little information on which to base a DCF valuation, most valuers will use the market approach as their primary valuation, recognising the approximations that it entails, and then use a simplified DCF as a secondary valuation approach to check that the value given by the market approach is reasonably supported by the business's expected future cash flows.

When dealing with trading or operating businesses, most valuers will make little reference to the cost approach, other than to use it as a sense check on the results obtained from the income and market approaches.

Some valuers reach a conclusion by taking the results of each approach (or of the approaches they have selected) and averaging them, rather than trying to understand why the value indications differ and choosing what they believe to be the most appropriate approach and then using the others as checks. This might be regarded as indecisive and a means of avoiding expressing a view; it is also not generally considered appropriate according to IVS.

Having reached a view on the value of an entity as a whole, the valuer then moves on to deal with any issues of lack of control (or shared control) and lack of marketability, in order to arrive at the FMV of the specific asset concerned.

Finally, the valuer should review the conclusion alongside any other relevant data, to check that the valuation arrived at makes sense in the light of the wider market and in the context of alternative investments, and to rationalise the result by explaining why it is higher or lower than might have been expected.

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Appendix 1

About the Authors

Philip Haberman
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Philip Haberman is the founder and senior partner of Haberman Ilett LLP, the leading independent firm specialising in providing accounting and financial expert evidence in international arbitration and litigation. For the past three years, he has been *Who's Who Legal*'s 'expert witness of the year'.

He has been actively involved in over 300 matters, including commercial and contractual disputes, investment treaty disputes, transaction-related disputes, competition matters, disputes arising out of accounting and financial irregularities, and valuation disputes. He has given oral evidence and been cross-examined more than 60 times in the past 27 years. He has carried out expert determinations to resolve disputes, has advised clients in CEDR-led mediations, and is a successful mediator.

Philip has a degree in mathematics from Cambridge University. He is a fellow of the Institute of Chartered Accountants in England and Wales, a member of the Chartered Institute of Arbitrators, a founder member of the Expert Witness Institute, a professional member of the Royal Institution of Chartered Surveyors, and a CEDR-accredited mediator. He is also a trustee of the British Institute of International and Comparative Law and a member of the board of the London Court of International Arbitration.

Liz Perks
Haberman Ilett LLP

Liz Perks is a partner in Haberman Ilett LLP. She is listed in *Who's Who Legal 2017* as a consulting expert for quantum of damages, where she is described as 'outstanding', and in *Who's Who Legal: Arbitration* as an expert witness, described as 'calm, measured, hardworking and extremely reliable. Her work ethic and responsiveness are unparalleled'.

Liz has been working in the forensic accounting field since 2000 and has acted as the accounting expert in claims for breach of contract and breach of warranty, and has been

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