Compound Interest as an Item of Damage in International Law

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I.

In 1943 Miss Marjorie M. Whiteman wrote:

> There are few rules within the scope of the subject of damages in international law that are better settled than the one that compound interest is not allowable. Although in rare cases compound interest, or its equivalent, has been granted, tribunals have been almost unanimous in disapproval of its allowance.[1]

Forty years later, in 1983, Professor Charles Rousseau wrote:

> Arbitral tribunals generally reject this method [compound interest] of calculating damages, because they feel that the solution may only be adopted on the basis of the parties' express or implied intent.[2]

Numerous decisions, mainly arbitral awards, support both these statements. At the same time, however, it should be recognised that, as an item of damage, the problem of compound interest apparently has never been fully analyzed. Most learned writers ignore it[3] or fail to give any reason for their conclusions that compound interest is or is not payable.[4] Jean-Luc Subilia is the only author who has dealt with the prob-

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[1] 3 DAMAGES IN INTERNATIONAL LAW 1997 (1943).

[2] The original text stated: Les tribunaux arbitraux écartent généralement ce mode de calcul de l'indemnité, estimant qu' une telle solution ne peut résulter que de la volonté expresse ou tacite des parties. DROIT INTERNATIONAL PUBLIC V § 242 (1983).

[3] *See* I. BROWNLIE, STATE RESPONSIBILITY 227-29 (1983), which in n.82 has an almost complete bibliography that confirms the statement in the text. *See also* L. OPPENHEIM, INTERNATIONAL LAW 353 (H. Lauterpacht, ed. 8th ed. 1963); D. O'CONNELL, 2 INTERNATIONAL LAW 1122 (2d ed. 1970); A. VERDROSS & B. SIMMA, UNIVERSELLES VÖLKERRECHT 876 (3d ed. 1984); L. SOHN & R. BAXTER, CONVENTION ON THE INTERNATIONAL RESPONSIBILITY OF STATES FOR INJURIES TO ALIENS; DRAFT NO. 12 WITH EXPLANATORY NOTES, art. 38 (1959).

[4] *See, e.g.*, H. LAUTERPACHT, PRIVATE LAW SOURCES AND ANALOGIES OF INTER-

lem of compound interest a little more carefully.[5] Subilia discusses all the relevant cases[6] and concludes:

> As far as compound interest is concerned, it seems that one cannot go further than to state that such recovery generally is not granted by international tribunals. Beyond that, the few precedents favorable to compound interest, which have been mentioned in chapter VI, do not support the existence of a case law rule which would preclude them as a matter of international law.[7]

The position is similar when one looks at decisions. Some cases allow compound interest when awarding damages, although usually without any discussion. Thus, compound interest has been allowed in *Fabiani*'s case,[8] in the *Affaire des Chemins de Fer Zeltweg-Wolfsburg*,[9] and more recently in the *Aminoil* case.[10] On the other hand, compound interest has been disallowed in a larger number of cases, in particular in *France v. Peru*[11] and *Norway v. United States*.[12] In *Norway*, the tribunal stated:

> The claimants have asked for compound interest with half-yearly adjustments, but compound interest has not been granted in previous arbitration cases, and the Tribunal is of the opinion that the claimants have not advanced sufficient reasons why an award of compound interest, in this case, should be made.[13]

Here, at least, there is an indication that if proper reasons had been advanced, the Tribunal might have awarded compound interest.

NATIONAL LAW 146 n.1 (1927); G. DAHM, VÖLKERRECHT III 236 n.9 (1961).

[5] L'ALLOCATION D'INTÉRÊTS DANS LA JURISPRUDENCE INTERNATIONALE (Lausanne 1972).

[6] *Id.* at 99, 163.

[7] The original text stated:

> Quant aux intérêts composés, il ne semble pas que l'on puisse aller au-delà de la constatation que la capitalisation n'est généralement pas admise par les tribunaux internationaux. Pour le surplus, les quelques précédents favorables à l'admission des intérêts composés que nous avons rapportés dans le chapitre VI nous interdisent de poser l'existence d'une règle jurisprudentielle qui les exclurait en droit international.

Id. at 124.

[8] J.B. MOORE, DIGEST OF INTERNATIONAL LAW 4878-4915 (1906).

[9] Affaire des Chemins de fer Zeltweg-Wolfsburg et Unterdrauberg-Woellan (Austria and Yugoslavia), 3 R. Int'l Arb. Awards 1795, 1808 (1934).

[10] Kuwait v. American Indep. Oil Co., 66 I.L.R. 518, 613 (Arb. Trib. 1982).

[11] Affaire des Réclamations Françaises Contre le Pérou (France v. Peru), 1 R. Int'l Arb. Awards 215, 220 (1920).

[12] Norwegian Shipowners' Claims (Norway v. United States), 1 R. Int'l Arb. Awards 307, 341 (1922).

[13] *Id.*

Perhaps the most significant decision on compound interest is the ruling given by Max Huber in *Great Britain v. Spain (Spanish Zone of Morocco).*[14] The eminent jurist attempts an explanation and an analysis:

> As regards the choice between simple and compound interest, the *Rapporteur* should first of all point out that the arbitral case law in matters involving compensation of one State by another for damages suffered by the nationals of one within the territory of the other — after all a particularly rich case law — is unanimous, as far as the *Rapporteur* knows, in disallowing compound interest. In these circumstances, very strong and quite specific arguments would be called for to grant such interest in this case. It seems, however, that such arguments do not exist, given the fact that the circumstances of the claims put before the *Rapporteur* do not differ in principle from those in the matters that have given rise to the pertinent case law.
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> This is true in certain circumstances when compound interest would, because of the case presented, be more appropriate than simple interest, for instance in cases in which the goods that the damages awarded are supposed to replace increase by geometric rather than arithmetic progression, as with respect to herds of cattle.[15]

The reference to "herds of cattle" is a little farfetched, and, as we shall see, less telling than a claim to money, for such claims pre-eminently "s'augmentent par progression géométrique."[16]

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[14] Affaire des Biens Britanniques au Maroc Espagnol (Great Britain v. Spain (Spanish Zone of Morocco)), 2 R. Int'l Arb. Awards 615, 650 (1924).

[15] The original text stated:

> En ce qui concerne le choix entre les intérêts simples et les intérêts composés, le Rapporteur doit tout d'abord constater que la jurisprudence arbitrale en matière de compensations à accorder par un État à un autre pour dommages subis par les ressortissants de celui-ci sur le territoire de celui-là — jurisprudence pourtant particulièrement riche — est unanime, pour autant que le Rapporteur le sache, pour écarter les intérêts composés. Dans ces circonstances, il faudrait des arguments particulièrement forts et de nature toute spéciale pour admettre en l'espèce ce type d'intérêt. Pareils arguments ne sembleraient cependant pas exister, étant donné que les circonstances des réclamations dont le Rapporteur se trouve saisi ne diffèrent pas en principe de celles des cas qui ont donné lieu à la jurisprudence dont il s'agit.
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> Cela est vrai entre autres de certaines éventualités où les intérêts composés sembleraient par ailleurs mieux correspondre à la nature des choses que les intérêts simples, savoir les cas où les biens que les indemnités accordées ont pour but de remplacer s'augmentent par progression géométrique plutôt qu'arithmétique, ce qui arrive par exemple pour les troupeaux de bétail.

Id. at 650.

[16] "[I]ncrease by geometric progression."

Recently, the problem acquired great practical importance in Arbitration Tribunal decisions dealing with the settlement of claims between the United States and Iran.[17] The issue arose for the first time in *R.J. Reynolds Tobacco Co. v. Iran*[18] which stated: "The Tribunal, however, does not find that there are any special reasons for departing from international precedents which normally do not allow the awarding of compound interest."[19] The word "normally" is one of the unfortunate expressions which often occurs in the cases and gives rise to many unanswered questions.[20] In *Sylvana Technical Systems*[21] (Chamber I, Chairman: Professor Böckstiegel) it is stated that "the Tribunal has never awarded compound interest."[22] This is a purely factual statement which is of little weight, because we do not know whether or on what legal grounds compound interest was claimed in previous cases and because the claimant in *Sylvana Technical Systems* sought only simple interest.[23] Further, the Tribunal announced its intention to

> derive a rate of interest based approximately on the amount that the successful claimant would have been in a position to have earned if it had been paid in time and thus had the funds available to invest in a form of commercial investment in common use in its own country. Six-month certificates of deposit in the United States are such a form of investment for which average interest rates are available from an authoritative official source.[24]

It is not certain whether the Tribunal realised that investment in six-month certificates of deposit involves earning compound interest. *Anaconda-Iran v. Iran*[25] (Chamber III, Chairman: Virally) dealt with the point more fully:

> 139. The Tribunal notes that there are several reasons why judicial authorities, be it on a national or international level, generally do not award compound interest.
> 140. First of all, the inherent and essential effect of a contractual provision for compound interest is to dissuade the other party from defaulting in

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[17] This Article is based on an opinion that the author rendered to the claimants in *Starrett Housing Corp. v. Iran.*

[18] Iran-United States Claims Tribunal Reports 7, 181, 191 (Chamber III, Chairman: Mangard) [hereafter Iran-United States Tribunal].

[19] *Id.*

[20] What does it mean? Which are the abnormal cases? Why does this particular case come within the general rule rather than the exception?

[21] Iran-United States Claims Tribunal Reports 8, 298, 320.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] Not yet reported.

> fulfilling its contractual obligations. Such an effect is particularly relevant in the context of a continuing contractual relationship. If, however, a dispute emerges as to the scope and content of the contractual obligations and if, as in the present case, such a dispute leads to a termination of the contract in question, this purpose is mooted. Secondly, the mathematical result of a full application of contractual provisions such as Section 7.04, particularly in view of the delays that any adjudication of a dispute involves, is that the interest due could, by far, exceed the principal awards awarded. This is particularly relevant in the context of the proceedings before this Tribunal, as the great number of cases simultaneously under consideration causes the individual parties to incur additional delays. Consequently, to implement such a contractual clause would cause a benefit, and indeed a profit, to accrue to the successful party, which would be wholly out of proportion to the possible loss that the successful party might have incurred by not having the amounts due at its disposal.[26]

Contrary to the impression that these words conveyed, the contract did not include a provision relating to compound interest. It provided for simple interest at a defined rate plus two percent, but the Tribunal did not attribute to it the full effect which it seems to contemplate.[27]

Finally, in an expropriation case, *Starrett Housing Corp. v. Iran* (Chairman: Lagergren),[28] the majority of the Tribunal, having received detailed arguments on the point, ignored all reasoning and simply stated that it was "not persuaded to depart from" the practice referred to in *Sylvana Technical Systems*.[29] There was, however, a well-reasoned dissent by the American arbitrator, Mr. Holtzmann.[30] Holtzmann pointed out that an award of compound interest was necessary "to make Starrett whole for the actual damage it suffered," since

> the Respondents were fully aware that Starrett was borrowing money from its U.S. banks on a compound basis in order to finance the Project. . . . Starrett, like most contractors, operated on the basis of back-to-back loans and a substantial line of credit with their banks. It is normal commercial practice that banks customarily charge compound interest to finance credit facilities.[31]

Moreover, an award of compound interest was "in conformity with the Expert's valuation methods," and was also "consistent with international law."[32] If a rule against compound interest existed in 1943, "it is no longer appropriate or justifiable. . . . Modern economic reality, as

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[26] *Id.*
[27] *Id.*
[28] Not yet reported.
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*

well as equity, demand that injured parties who have themselves suffered actual compound interest charges be compensated on a compound basis in order to be made whole."[33]

II.

The solution of the compound interest problem in international law is made more difficult because the general principles of law recognised by civilised nations do not yield an unequivocal guidance. When a statute provides for the payment of interest, it is frequently expressly stated that such interest does not carry interest or, in other words, that the statute does not authorise (but does not prohibit) the payment of compound interest. This is the position in England,[34] France,[35] Germany,[36] Switzerland,[37] and the United States, where the point is usually dealt with by state legislation. However, the question is whether, independently of such provisions, compound interest may not become payable. First, authority exists for the proposition that compound interest is payable when the parties have by contract so stipulated.[38] Second, in the common law system the breach of a fiduciary duty may lead to the award of compound interest.[39] Third, compound interest may be an item of damage which, if not too remote, may be recoverable. This, in practice, is the most important case which in some countries, for instance in Germany, is dealt with by express provision for the payment of damages of any type flowing from the default.[40] In other countries, particularly the United States, it is frequently stated that compound interest is not allowed as damages for breach of contract or tort.[41]

However, the latter conclusion is not free from doubt. The specific compound interest problem occurs when the plaintiff could have earned such interest if the defendant had paid punctually or if the plaintiff has had to pay compound interest which, in the event of defendant's punctual payment, would have been avoided. The same result should follow

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[33] *Id.*

[34] LAW REFORM (MISCELLANEOUS PROVISIONS) ACT 1934, s.3(1).

[35] CODE CIVIL [C. CIV.] art. 1153 (Fr.).

[36] Section 289, first sentence of the Civil Code.

[37] Schweizerisches Obligationenrecht [OR] art. 105 (Switz.).

[38] *See, e.g.*, CORBIN ON CONTRACTS § 1047 (1964).

[39] For an explanation of the United States system, see WILLISTON ON CONTRACTS § 1417 (W. Jaeger ed., 3d ed. 1968); for England's system, see Wallersteiner v. Moir, 1975 Q.B. 373 (C.A.).

[40] Section 289, second sentence of the Civil Code.

[41] Cherokee Nation v. United States, 270 U.S. 476, 490 (1926); *see also* CORBIN, *supra* note 38 and WILLISTON, *supra* note 40.

in both alternatives from the general law of damages as it is understood in most countries: the failure to pay a debt when due is a breach of contract.[42] In practice, the two alternatives are likely to call for a distinction.

The former alternative must be treated with great care because it is usually highly speculative. Only when the plaintiff is a depositor of money which carried compound interest will a court find it possible to hold (and should hold) that the money due from the defendant also would have been deposited and would have earned interest and compound interest with clearly provable rests. By way of example, there is evidence in Canada that the principle according to which interest is payable when the payment of a just debt has been improperly withheld[43] was extended to cover the case of compound interest that could have been earned.[44]

The latter alternative is more easily proved and is exemplified by an important English Court of Appeal decision.[45] A building contract provided that if in the event of a variation of work the contractor has been involved "in direct loss and/or expense" the amount of such loss or expense shall be recoverable from the building owner.[46] To finance this additional work, the contractors had borrowed money from their bank and paid interest and compound interest for the loan. Lord Goff, then

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[42] In civil law systems this is likely to be undoubted, but the solution is probably the same in England, where Lord Brandon of the House of Lords recently stated that "claims to recover . . . losses as damages for breach of contract, whether the breach relied on is late payment of a debt or any other breach, are subject to the same rules as apply to claims for damages for breach of contract generally." *See* President of India v. Lips Maritime Corp., [1987] 3 W.L.R. 572, 580. This is in line with Lep Air Servs. v. Rolloswin Ltd., 1973 App. Cas. 331. *See generally* F.A. MANN, THE LEGAL ASPECT OF MONEY 67, 68 (4th ed. 1982).

[43] This is the test for the award of interest, which was formulated by Lord Macnaghten in the Canadian appeal of Toronto Ry. Co. v. City of Toronto, 1906 App. Cas. 117 and which seems to have been accepted in Canada. *See* the Supreme Court of Canada in Prince Albert Pulp Co. v. The Foundation Co. of Canada Ltd., 68 D.L.R.3d 283 (1976).

[44] Roman Catholic Diocese of Calgary v. Century Insurance Co. of Canada, 8 D.L.R.4th 435, 441 (1984), which extended the test mentioned in note 43 to compound interest. In British Columbia the Law Reform Commission has suggested that prejudgment interest should be compounded. REPORT ON THE COURT ORDER INTEREST ACT 31 (1987). The English Law Commission rejected this suggestion as being "either too crude to be fair in all cases or too intricate to be practicable." *See* Cmnd. 7229 paragraph 85.

[45] Rees and Kirby Ltd. v. Council of the City of Swansea, 30 Building L.R. 8 (1985).

[46] *Id.*

Goff L.J. with whom O'Connor and Slade L.JJ. agreed, stated:

> There remains to be considered the question whether the respondents are entitled to recover their financing charges only on the basis of simple interest, or whether they are entitled to assess their claim on the basis of compound interest, calculated at quarterly rests, as they have done. Now here, it seems to me, we must adopt a realistic approach. We must bear in mind, moreover, that what we are here considering is a debt due under a contract. . . . The respondents, like (I imagine) most building contractors, operated over the relevant period on the basis of a substantial overdraft at their bank, and their claim in respect of financing charges consists of a claim in respect of interest paid by them to the bank on the relevant amount during that period. It is notorious that banks do themselves, when calculating interest on overdrafts, operate on the basis of periodic rests; on the basis stated by the Court of Appeal in *F.L. Minter Ltd. v. Welsh Health Technical Services Organization*, 13 Building L.R. 1, which we here have to apply, I for my part can see no reason why that fact should not be taken into account when calculating the respondents' claim for loss or expense in the present case. It follows that, in order to calculate the respondents' contractual claim, it will be necessary to calculate it with reference to the total sum of £156,762.19 . . ., taking into account . . . the rates of interest charged by the bank to the respondents at various times over that period[,] and . . . the periodic rests on the basis of which the bank from time to time added outstanding interest to the capital sum outstanding for the purposes of calculating interest thereafter.[47]

It should be clear that "direct loss and/or expense" is, independently of a contractual provision, also the prerequisite of a claim for damages flowing from a breach of contract or tort. It follows that even in the absence of a clause indemnifying a contracting party against "direct loss and/or expense," compound interest reasonably incurred by the injured party should be recoverable as an item of damage. This, it is submitted, should not only be English law,[48] but should be accepted wherever damages are allowed and should, therefore, be treated as a general principle of law.

III.

The present uncertain state of international law described in part I, and the unsettled practice of municipal courts described in part II, render it necessary to base a decision applying international law on legal principle, that is, on reasoning derived from a rational appreciation of legal rules, and (in the words of the savant to whom these lines

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[47] *Id.* at 23.

[48] It is at present uncertain whether the submission made in the text will be accepted in England. On English law relating to interests, see Mann, *On Interest, Compound Interest and Damages*, 101 LAW Q. REV. 30 (1985).

are dedicated in memory of more than sixty years of friendship) thus to inaugurate "a new conception of justice in accord with the highest knowledge and truest insight perceptible to the human mind."[49]

In this spirit it is necessary first to take account of modern economic conditions. It is a fact of universal experience that those who have a surplus of funds normally invest them to earn compound interest. This applies, in particular, to bank deposits or savings accounts. On the other hand, many are compelled to borrow from banks and therefore must pay compound interest. This applies, in particular, to business people whose own funds are frequently invested in brick and mortar, machinery and equipment, and whose working capital is obtained by way of loans or overdrafts from banks. The practice as to rests varies considerably. Monthly, quarterly, half-yearly, yearly rests occur, and in a specific case it may be necessary to investigate local practices. But it is likely that a judge who would award quarterly or half-yearly rests would not go far wrong.

If, in accordance with the usual formula, damages are intended to afford *restitutio in integrum* (complete compensation for the wrong suffered) such items of damage should not be excluded. One is not dealing with the payment or repayment of liquidated sums such as the price of goods or a loan or even arrears of agreed interest due in respect of a loan; in such circumstances the general practice of municipal laws or courts does not normally allow the payment of more than simple interest. But as soon as any liability for damages arises, different considerations apply and demand the elimination, by the payment of money, of all foreseeable injuries.

Nor can it be material that one function of a contractual provision for the payment of compound interest may be to deter the debtor from defaulting. This is certainly not necessarily or usually so. In fact it is an inappropriate idea in most cases because no contract exists in the case of damages, and when parties validly agree on compound interest, it is actually in the nature of liquidated damages.

Finally, it is completely wrong to attach any significance to the fact that the award of interest or compound interest may lead to the payment of a sum exceeding the capital due from the wrongdoer. This may happen in many cases as a result of the wrongdoer's delaying tactics or the court's work load. But during that period the wrongdoer has enjoyed the fruits of the money withheld. Moreover, the classical Roman law doctrine forbidding the payment of interest *supra duplum* or, as it

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[49] These are the concluding words of E. BODENHEIMER, JURISPRUDENCE: THE PHILOSOPHY AND METHOD OF THE LAW 386 (1st ed. 1967).

is put nowadays, *ultra alterum tantum*[50] has been long obsolete. On the international scene this idea made its sole appearance in the case of *Yuille Shortridge & Co.* in 1861[51] when under the influence of the then prevailing Roman law, the Senate of Hamburg as sole arbitrator stated: "Since according to Roman law, the only one applicable here, cumulative back interest may not exceed the principal (Dig. de cond. indeb. 12.6), the interest in this case had to be limited to £2589."[52] It is almost paradoxical that this was said in the very year in which the Universal German Commercial Code appeared. The Code applied in Hamburg and provided in Article 293: "In the case of commercial transactions interest may exceed the total amount of the capital."[53]

More modern systems of municipal law to which one must resort know nothing of restrictions that were revived, with inadequate reasoning, by Chamber III of the Iran-United States Arbitration Tribunal in 1985.[54] Of course, if the claimant is responsible for a delay, or if there is room in international practice for a doctrine corresponding to limitation of actions or prescription, any judge or arbitrator will disentitle the claimant from the interest or compound interest that is due. No such facts existed in *Anaconda-Iran*.[55] There was, therefore, no room for the revival of a principle peculiar to classical Roman law.[56] In conclusion, it is submitted that, on the basis of compelling evidence compound interest may be and, in the absence of special circumstances, should be awarded to the claimant as damages by international tribunals.

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[50] Digest XII.6.; C.4.32. *See generally* WINDSCHEID-KIPP, PANDEKTENRECHT II 82 (8th ed. 1906). For a general discussion of the problem, see L. SOLIDARO, ULTRA SORTIS SUMMAM USURAE NON EXIGUNTUR, LABEO 28, 164 (1982).

[51] (Great Britain v. Portugal) Lapradelle-Politis, Recueil des arbitrages internationaux II 108 (1924).

[52] The original text stated: Comme d'aprés le droit commun, seul applicable ici, le cumul des intérêts arriérés s'arrête lorqu'ils atteignent le principal (Dig. de cond. indeb. 12.6.), on a du restreindre les intérêts de ce chef à £2589. *Id.*

[53] Universal German Commercial Code art. 293.

[54] Iran-United States Tribunal, *supra* note 18.

[55] *See supra* note 25.

[56] Against the present recognition of the doctrine of *ultra alterum tantum*, see J. SUBILIA, *supra* note 5, at 101, 117.