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EDITORIAL

Quantifying Loss: The Importance of the 'Counterfactual'

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When one party ('the claimant') claims that it has suffered a loss as a result of the actions of another party ('the defendant'), it may seek to recover damages for consequential losses – for example, lost profits or opportunities – that arose as a consequence of those actions. Depending upon the circumstances of the case, such a claim for consequential loss may be for many multiples of the direct costs of those actions. This is particularly true for insolvency and other restructuring cases, where a claimant may seek to recover damages to compensate them for the profits lost as a result of curtailed or abandoned projects.

In the case of *Al-Kharafi v Libya*, an arbitration panel awarded the claimant $5 million to compensate for wasted costs, but a further $900 million to compensate for the lost profits of not being able to build a tourist development. The values which can be involved in such cases demonstrate the importance of being able to robustly quantify, and importantly evidence, the impact of the defendant's alleged actions.

An assessment of such losses will consider what the outturn of events would have been had the defendant not behaved in the alleged manner. Such an assessment requires the creation of a *'counterfactual scenario'*, or consideration of the so-called *'but for'* test.

This article will focus on the importance of creating a robust counterfactual scenario when assessing the losses claimed to have been suffered. We will first highlight some of the considerations and types of evidence which may be appropriate in such an assessment, and then, through an example of a case in which we were engaged, explore their relevance and impact in the context of an insolvency proceeding.

Constructing the counterfactual scenario

A key concept in the assessment of damages is the comparison between the 'actual' scenario; the actual out turn of events following the defendant's actions, and a 'counterfactual scenario'; what would have happened had it not been for the actions of the defendant. Each of these two scenarios is quantified in monetary terms and the difference (if any) between them represents the amount of loss suffered.

The counterfactual scenario is by definition a hypothetical scenario. Therefore in order to construct this scenario, an assessment is required to be made as to what would have transpired had the defendant not acted in the alleged manner.

Such an assessment can often require a number of assumptions be made. In order to make sound commercial and professional judgements about events which did not occur (and be able to evidence them), it is important to identify what information is available to inform these assumptions. We consider below some of the typical information and evidence which may be relevant

In order to create a realistic hypothetical scenario, and one that appropriately identifies the impact of the defendant's actions, it is important that the counterfactual scenario is rooted in the claimant's contemporaneous knowledge and intentions, rather than a retrospective analysis of what actions or projects could theoretically have been undertaken. A claim which clearly establishes what was known to the claimant, and the likely course of action which *would have* been undertaken, will often be more credible than retrospective non-contemporaneous analysis of what *could have* been done.

Contemporaneous documentation – such as budgets, cashflow forecasts and projections, and business plans – are likely to provide such an understanding of the claimant's knowledge and intent, and therefore be relevant to an assessment of how a business would have performed 'but for' the actions of the defendant.

However, claims which uncritically incorporate contemporaneous business plans and forecasts may face challenge. The reliability of this documentation as a basis for projecting the likely outturn of events should be assessed, for example, by considering whether the claimant's forecasts prepared in previous years were in fact reasonable predictors of subsequent performance. Such an assessment of reliability is likely to need to consider factors such as the nature of the products sold and the market in which the business operates. For example, the forecasts of a company with a track record of accurate forecasting in a stable market, and with a credible path to market, are likely to be considered a better basis for constructing a counterfactual scenario than those of a company with a history of over-optimistic projections, or one with an undeveloped product in an emerging market.

The counterfactual scenario may also be constructed with reference to the historical results of the business, for example, by assessing whether the assumed performance appears reasonable in light of previous trading. That said, historical results may not always be a reliable indicator of future performance and a simple extrapolation of past results may not be appropriate. For example, where the business would have been operating in different economic conditions or competitive environment than had been in place in the past.

Where the claimant continues to trade after the alleged actions of the defendant, the subsequent trading performance may be considered and compared against the constructed counterfactual. However, in the context of a company that entered administration after the actions of the defendant, any such comparison would also have to assess whether the original management would have operated the business in the same way, and achieved the same financial results, as the administrators did, had that management remained in control of the business.

The counterfactual may also need to give consideration to the likely actions of applicable third parties such as banks and suppliers. Even though a 'but for' scenario begins with changing only a single variable – that of the defendant's actions – it may be unsound to assume that all other involved parties would have acted in the same way as they actually did. For example, the actions of creditors of a company in difficulty – such as loan restructuring, bank forbearance or the extension of credit terms by suppliers – might have been different in the counterfactual scenario where the company would not have been in any, or such severe, financial difficulties.

The basis on which the counterfactual is constructed will often depend upon the evidence that is available in any given case. Regardless of the evidence which is applied, in order to construct an appropriate counterfactual scenario, and hence identify the impact of the defendant's actions, it is important to give sufficient consideration as to the reliability and validity of the data as a basis for projecting how events would have transpired.

Case Study

We were engaged on a matter in which a commercial bank ('the Bank') was defending a claim made by one of its customers ('the Customer') who was alleging mis-selling of a financial product. The Customer was a property developer who claimed that as a result of the alleged mis-sold product it had fallen into arrears on its loan payments, which led the Bank to appoint a LPA Receiver over its property portfolio. The Customer claimed that absent the alleged mis-selling of the financial product, it would have been able to meet its loan obligations and the LPA Receiver would not have been appointed.

In addition to claiming for damages against the Bank, the Customer also obtained an injunction preventing the LPA Receiver from selling the property portfolio whist this matter was resolved.

The Customer quantified its claim for damages on the basis of the rental profits that it had been denied following the appointment of the LPA Receiver – due to a number of case specific factors, the LPA Receiver appointment, and hence the claimed loss period, extended to a number of years. The Customer also sought the removal of the LPA Receiver and a return of the property portfolio to its control.

We were engaged to construct a counterfactual cash flow analysis in order to assess what the likely outturn of events would have been had the Customer not entered into the alleged mis-sold product.

We found that the impact of the alleged mis-sold product was not as significant as was claimed by the Customer. Specifically, the analysis showed that whilst the payments made under the alleged mis-sold product did lead to a deteriorated cash flow position, and that 'but for' these payments the LPA Receiver would not have been appointed when it actually was; the Customer would still have suffered from cashflow constraints and missed loan payments at a later date. Hence, we found that the business would still have failed, and the LPA Receiver would have been appointed, albeit at a later date than was actually the case. As a result, we calculated that the Customer suffered a loss which was significantly less than the amount claimed. We discuss the basis of the conclusion below.

As noted in the earlier section, a counterfactual scenario can be constructed by considering a number of different data sources. In this case, the Customer had conducted its analysis and quantified its loss by extrapolating historical financial performance. This was based on the assumption that if the Customer had remained in control of the properties, the portfolio would have generated the same level of profits that it always had.

However, in this case, based upon other evidence which was available, we considered an alternative basis to be more appropriate. In particular, the Bank's own contemporaneous records and the portfolio's performance after the LPA Receiver's appointment suggested that the portfolio would not have been as profitable under the Customer's control as the historical data suggested. For example, a number of properties were in a dilapidated state and required a greater level of repairs expenditure than had been incurred in the past in order to return them to a lettable condition going forwards. Further, the contemporaneous documentation referred to a tenancy dispute shortly before the LPA Receiver appointment. Due to the timing of this dispute, the historical data did not identify that there were concerns over the ongoing income stream generated by this property.

Due to these factors we considered the portfolio's performance under the LPA Receiver's control as a better starting point for constructing the counterfactual analysis. In adopting this approach, we firstly identified what we felt to be the key actions and decisions taken by the LPA Receiver which affected the portfolio's performance, and then assessed whether the Customer would have taken those same decisions, and thereby generated the same financial performance as the LPA Receiver.

By considering the contemporaneous documents available, we identified that during the early stages of its appointment the LPA Receiver was attempting to sell certain of the properties. In support of this strategy, the LPA Receiver left these properties vacant in order to maximise the sales price that could be obtained under auction.

We considered that the contemporaneous documents showed the Customer's long term strategy was to hold and rent (rather than to sell) properties, therefore in our view, it would have been unlikely that the Customer would have been seeking to sell these properties had the properties remained under its control. Likewise, given the high historical occupancy rates of these properties, we assumed that the Customer would have been able to secure tenants for these properties. For these reasons, we calculated that for certain of the properties the Customer would have generated a higher level of rental income than was generated by the LPA Receiver during the early stages of the claim period.

The contemporaneous documents also demonstrated that once the Customer had obtained an injunction to prevent the LPA Receiver from selling the properties, the LPA Receiver's strategy shifted from a sales strategy to one of maximising rental profits. Therefore in our calculations we assumed that from this point onwards, the LPA Receiver's strategy was aligned with how the Customer would have operated the portfolio, therefore in general terms, the portfolio's performance under the LPA Receiver's control was a reliable indicator of its performance had it been under the Customer's control.

The counterfactual cashflow analysis described above demonstrated that the payments made under the alleged mis-sold product resulted in a deteriorated cashflow, and that 'but for' the payments, the Customer would have been able to meet its loan payments for a longer period before going into arrears. In the actual scenario, when the Customer missed loan payments and encountered arrears, the Bank provided a level of forbearance in order to reduce the Customer's monthly loan payments, and then, when payments continued to be missed, transferred the Customer to a customer support team for a period of time before appointing the LPA Receiver. When it came to constructing the counterfactual scenario, we felt that it was unlikely that the Bank would have taken exactly the same actions as it did. For example, as we had calculated that the Customer would not have missed the loan payments that it did in the actual scenario, we considered it unlikely that the Bank would have offered the loan forbearance when it did. Rather, we considered the actions taken by the Bank in the actual scenario as indicative of the steps that it would have likely taken at the applicable time in the counterfactual scenario (i.e. when the Customer would have missed loan payments in that scenario). In addition, the steps taken in the actual scenario were also reconsidered (and amended where we felt necessary) in light of factors, such as economic conditions, that would have been prevalent during the relevant period in the counterfactual scenario.

Based upon our analysis of the counterfactual scenario, we concluded that had the Customer not been required to make the payments under the alleged mis-sold product, the improved cashflow position would have allowed the Customer to have met its loan payments for a longer period. However, the cashflow would not have been improved sufficiently as to secure the long term viability of the business. Loan payments would still have been missed at a later date, and the LPA Receiver would still have been appointed, albeit at a later date.

Therefore, whilst the Customer claimed for the rental profits it was denied for the period following appointment, we concluded that the business would have failed in any event, and by which point the Customer would not have generated any retained profits. That said, during the longer period in which the Customer could have traded, the Customer could have continued to make its loan payments, thereby amortising its debt with the Bank. The loss suffered by the Customer was therefore, in our view, the difference between the outstanding debt when the LPA Receiver was actually appointed, and the debt which would have been outstanding had the appointment occurred at a later date.

This case emphasises the importance of constructing a robust counterfactual scenario as the basis for quantifying the impact of, and hence the losses caused by, the defendant's actions. An unrealistic counterfactual scenario will either exaggerate or underestimate the impact of the defendant's actions, and therefore will not appropriately quantify any losses suffered.

As noted above, the counterfactual scenario is by definition a hypothetical scenario which did not occur. Therefore a number of assumptions are likely to be required as to how events would have transpired had the defendant not acted in the manner alleged. A combination of sound professional and commercial judgement will be required to construct an appropriate counterfactual scenario based upon the evidence which is available in that case.

International Corporate Rescue

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