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By Seth Fliegler, MBA, CFE; and John Duvoisin

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VALUATION

Valuation by a Monday Morning Quarterback

By Seth Fliegler, MBA, CFE; and John Duvoisin

Hindsight. The Monday morning quarterback. 20/20 vision. In the world of valuation, these terms are often met with skepticism. The topic of hindsight in retrospective valuations is a reoccurring issue in court cases particularly when economic conditions subsequent to the valuation date often alter the perceived value of the company. This has become relevant once again, for example, in a recent ruling by Judge Peck of the Bankruptcy Court S.D.N.Y. *In re: Lehman Bros. Holdings Inc.*, which brought to light the very issues of hindsight that can arise in retrospective valuations.[1] The court found that the plaintiff's experts' valuation of the assets in dispute was based on hindsight and *not* on the prevailing market conditions at the time they were acquired. By relying on hindsight, rather than contemporaneous projections, the plaintiff's experts' opinions were found to have reflected strong litigation biases.

Valuation professionals are once again reminded by *Lehman* that it is critical to understand the contemporaneous economic climate and conditions surrounding any transaction. By bringing hindsight into a retrospective analysis of a transaction, an expert runs the risk of ascribing a value that is inconsistent with contemporaneous market views as of the date of the valuation. As detailed in this article, the courts have shown that they are often leery of a valuation that is inconsistent with prevailing market opinion. Yet if court opinions were so clear that hindsight should not be applied, why should there be any debate as to its use in valuations? The reason is that hindsight has also been permitted (and even encouraged in some instances) in various situations as a means to support analyses, opinions, and the calculation of damages in areas such as intellectual property disputes. This article briefly defines hindsight in the context of determining valuation and damages, reviews precedent court cases that addressed (and largely rejected) the use of hindsight, and presents areas where hindsight has been more openly welcomed by the courts.

APPLYING HINDSIGHT

According to *Webster's Dictionary*, hindsight is the "perception of the nature of an event after it has happened." Thus, inherent in the application of hindsight in any valuation analysis is the fact that "perceptions" derived *after* the fact are influencing contemporaneous events. Very few professional valuation associations, however, provide guidelines regarding the application of hindsight in valuation analyses, instead offering only definitions of hindsight rather than practical considerations for its applications. One exception is the Statement on Standards for Valuation Services issued by the American Institute of Certified Public Accountants (AICPA), which states:

> Generally, the valuation analyst should consider only circumstances existing at the valuation date. An event that could affect the value may occur subsequent to the valuation date; such an occurrence is referred to as a subsequent event. Subsequent events are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date. The valuation would not be updated to reflect those events or conditions.[2]

Such standards apply to AICPA members who are engaged to estimate value "that culminate in the expression of a

1 *In re: Lehman Bros. Holdings Inc.*, 445 B.R. 143 (Bankr. S.D.N.Y. 2011).

2 *Statement on Standards for Valuation Services*, AICPA, June 2007, page 20.

conclusion of value or a calculated value."[3] Aside from these standards, the use of hindsight by valuation professionals in analyses is largely guided by commentary and a disjointed set of guidelines established by judicial opinions.

THE COURTS AND THE USE OF HINDSIGHT

Several court cases have been decided based on the issue of incorporating hindsight into a valuation. In *Lehman*, the plaintiff (the Unsecured Creditors Committee of Lehman Brothers) alleged that the fire-sale value of certain Lehman assets sold to the defendant (Barclays) in the turbulent days after the Lehman Brothers bankruptcy filing was compromised by conflicts of interest among the Lehman employees performing the appraisal of Lehman's assets during the very limited due diligence process.[4] At trial, the plaintiff introduced six valuation experts who asserted that the purchase price paid by Barclays was below the fair market value for those assets at the time of the asset sale.[5] In particular, the plaintiff argued that Barclays's financials reflected multi-billion dollar negative goodwill as a result of the purchase of Lehman Brothers, which, according to plaintiff, was a clear indication of the significant windfall achieved through Barclays's acquisition.[6]

The court, however, found that the plaintiff's experts' valuation of Lehman's assets purchased by Barclays was benefited by hindsight and not driven by the perspectives of market participants operating in September 2008. Specifically, Judge Peck concluded that, "the opinions, reflecting an unsurprising litigation bias, came across as having been designed and manufactured for the trial and were not at all persuasive."[7] The court believed that employees of both Lehman and Barclays acted in good faith in marking down the assets held by Lehman. Judge Peck rejected the assertion that the employees "breached their duties of loyalty to the estate because of the prospect of future employment or as a consequence of signing lucrative employment contracts with Barclays."[8] Given the distressed nature of the sale, the courts found that there was no reason to regard this transaction as being characterized by equal bargaining power. Since there were no other buyers at the time and the seller had no leverage, the courts dismissed the plaintiff's experts' assumption that Barclays ascribed "low-ball" values to the assets.[9]

As the court opined, "the proceedings have illuminated the factual background of the largest, most expedited and probably the most dramatic asset sale that has ever occurred in bankruptcy history" and that it was "the most momentous week of the greatest financial crisis of our lives."[10] The court asserted that the extreme uncertainty in the market caused most market participants to have increased sensitivity to the downside risk of contemporaneously purchasing financial assets. The court further emphasized that the plaintiff's experts' *de novo* after-the-fact valuation analysis, done in a litigation setting, is less persuasive than the perspectives of "those actively participating in the market in September 2008."[11]

The finding in *Lehman* was consistent with Judge Peck's ruling in another earlier precedent setting case in which there was significant focus on the use of hindsight in valuation analysis. In the case of the bankruptcy proceedings of Iridium, LLC, the court also found disfavor with the plaintiff's expert's use of hindsight in his retrospective solvency analyses.[12] Iridium was a business spun off by Motorola to establish a network of low-altitude satellites that would allow those travelling for business to have telephone connectivity in remote locations. Iridium's stock had an initial public offering at $20 per share in June 1997 and rode the wave of positive market sentiment to an all-time high of $72.19 per share on May 1, 1998.[13] The product launch failed and Iridium subsequently filed for bankruptcy in August 1999. Plaintiff (the Statutory Committee of Unsecured Creditors) brought suit against Motorola for, amongst

3 *Id* at 5. The use of hindsight is, to some degree, a judgment call with respect to certain accounting analyses such as purchase price allocations. SFAS 141(R) issued in December 2007 states that, "The acquirer must consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. This determination requires judgment…Decisions made by the combined company and economic events occurring after the acquisition, do not result in an adjustment of the provisional amounts." Financial Accounting Standards Board. Statement of Financial Accounting Standards No. 141. December 2007. Other examples of guidance regarding hindsight include IRS Revenue Ruling 59-60 Section 3.03, which states, "Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of the appraisal." The ruling highlights the fact that there is a difference between unexpected and probable or reasonably foreseeable (*i.e.*, through prophesy) future events.

4 *In re: Lehman Bros. Holdings Inc.*, 445 B.R. 143, 148-149 (Bankr. S.D.N.Y. 2011).

5 *Id.* at 184.

6 *Id.* at 152, 159.

7 *Id.* at 159.

8 *Id.*

9 *Id.* at 182.

10 *Id.* at 148-149.

11 *Id.* at 187.

12 *In re: Iridium Operating LLC,* 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

13 Bloomberg L.P. (2013).

other issues, constructive fraudulent conveyance and preference claims, due to Iridium's alleged insolvency at the time of certain transfers from Iridium to Motorola.[14]

In support of its insolvency claim, the plaintiff presented analyses from two valuation experts. One of the experts created revised bottom-up projections of the company instead of relying upon the numerous contemporaneous projections prepared by Iridium management and various other parties at the time that the contested transactions were completed. The expert created his own assumptions and applied them to consultant reports rather than the company's internally developed models. The expert's projections significantly reduced the projected revenue streams created by market participants at the time, "believing that his analysis of the information was superior to the analysis done at the time."[15] Judge Peck, however, found that the analysis leaves "the distinct impression that [the Expert's] work was carried out with litigation bias and for the express purpose of showing that Iridium was insolvent."[16] The court determined that due to the expert's application of hindsight, the expert's work product was not a reliable valuation analysis; instead it emphasized that financial projections should be consistent with both how the market views the industry as well as how the company has historically met its projections. This is often determined by the robustness of the projections and the substantiation of the methodologies used by management.

An expert must be cognizant of the motivation behind the projections provided to him or her so as to not assume that management's assertions at the time of a transaction were, in fact, what the actual market was signaling. In some instances, it is not post-transaction market data that influences the analysis, but, rather that of management or a third party that has an interest in, and as a result, a bias in the underlying data. In these cases, it is necessary to adjust management projections based on the true contemporaneous market sentiment. This problem was illustrated in the case *In re: Yellowstone Mountain Club*.[17] The *Yellowstone* case focused around the borrower, Blixseth Group Inc., receiving substantial loans from the lender, Credit Suisse, based on inflated projections of the Yellowstone Mountain Club (a resort development near Yellowstone National Park majority owned by Blixseth Group); ultimately Yellowstone Mountain Club and the borrower (Blixseth Group Inc.) filed for bankruptcy.

Prior to the funding, Yellowstone had missed its projections continually by a wide margin and thus it was argued by the plaintiff's expert that the projections were never an accurate reflection of the company's outlook. As such, the projections were deemed excessive due to management's belief that, no matter what, the company would succeed. In contrast, the plaintiff developed its own set of projections that incorporated the financial outlook based on past history, as well as its perception of the business, which trended the projections down significantly. The court found that the lower projections that the plaintiff developed for trial reflected the true value of the business whereas the original contemporaneous projections developed by management were artificially inflated given its bias to have the company succeed.

The Delaware Chancery Court, widely seen as the nation's preeminent business court, has similarly limited experts' use of hindsight in valuation testimony. In *Agranoff v. Miller*, the court was tasked with opining on the fair value of Defendant Agranoff's warrants acquired by the plaintiff, Miller, in an attempted takeover bid.[18] To support his opinion, the plaintiff's valuation expert created projections as of the valuation date based on conversations with business managers who knew what the *actual* results of the company were and therefore had inherent hindsight bias. The court compared this process to the following example:

> Suppose there was an interview with Sir George Martin from 1962 in which he opined as to how many number one songs he thought would be released by his new protégés, the Beatles. Could one fast-forward to 1971, interview Martin, and revise Martin's earlier projection in some reliable way, recognizing that Martin would have known the correct answer as of that date? How could Martin provide information that would not be possibly influenced in some way by his knowledge of the actual success enjoyed by the Beatles and his recollection of his earlier projection?[19]

The court refused to give any weight to this expert's valuation analysis, indicating

14 *In re: Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).
15 *Id.* at 340.
16 *In re: Iridium Operating LLC*, 373 B.R. 283, 342 (Bankr. S.D.N.Y. 2007).
17 *In re* Yellowstone Mountain Club, LLC, 436 B. R. 598 (bankr. D. Mont. 2010).
18 *Agranoff v. Miller* 791 A.2d 880 (Del. Ch. 2001).
19 *Id.* at 892.

that the "possibility of hindsight bias and other cognitive distortions seems untenably high."[20]

APPLYING HINDSIGHT IN A VALUATION

Although the previous examples have highlighted that hindsight is rarely permitted by courts, there have been instances where courts have indirectly relied on hindsight to support their opinion. The difference in these matters is that hindsight was used solely to provide emphasis and context on analyses that, on a standalone basis, had already sufficiently supported the expert's opinion using contemporaneous data. In other instances, the courts have allowed the principle of retrojection, which states:

> Where a debtor is shown to be insolvent at a date later than the date of the questioned transfer, and it is shown that the debtor's financial condition did not change during the interim period, insolvency at the prior time may be inferred from the actual insolvency at the later date.[21]

A prime example in which (1) hindsight was deemed inapplicable (and that contemporaneous market prices were a true representation of the firm's value), and (2) the use of retrojection was allowed as relevant support, was *VFB LLC v. Campbell Soup Co*.[22] Vlasic Foods was spun off from the Campbell Soup Company in a leveraged transaction in 1998. The transaction involved the creation of Vlasic as an independent company (VFI), the assumption by Vlasic of $500 million in debt, and the issuance of stock in Vlasic to Campbell shareholders as an in-kind dividend. The company subsequently filed for bankruptcy in 2001. VFB, LLC (an entity established to prosecute claims of Vlasic's shareholders and creditors against Campbell) sued on the basis that the spin off was a constructive fraudulent transfer and that Campbell aided and abetted a breach of fiduciary duty regarding Vlasic's directors. Such a breach, VFB argued, included the preparation of operating results of certain corporate divisions included in the newly spun-off Vlasic that were artificially inflated and should have been trended lower at the time of the spin off.

In its decision with respect to the solvency of Vlasic at the time of the transfers, the court simultaneously rejected the use of hindsight, but supported the use of data *after* the relevant transactions in its opinion. Based on the defendant's expert's valuation, which reflected contemporaneous market values, the court determined that Vlasic was solvent at the time of the transaction and the spin off was not a fraudulent transfer. Of note, however, is that the court relied in part on the price of Vlasic's stock, which remained high *after* the truth of the manipulated operating figures was publicly disclosed, to further validate Vlasic's solvency. In supporting the opinion of the district court, the Court of Appeals stated that despite the issues disclosed to the public, "VFI did not fold. The price of its shares on the New York Stock Exchange remained essentially steady…More than a year after the spin, in June 1999, VFI successfully completed its required issue of $200 million in unsecured debt to institutional investors." The court concluded that "nobody claims that VFI's fortunes were improving, so the market's valuation of VFI as solvent in FY 1999 was strong evidence that VFI was solvent at the time of the spin, and therefore received reasonably equivalent value of its $500 million."[23] As such, an analysis using contemporaneous data proved solvency, while market data subsequent to the transactions provided additional emphasis.

In contrast, the court rejected plaintiff's argument and its experts' valuations on the basis that the opinions were primarily based on hindsight evaluations and did not reflect the true value of the company at the time of the spin-off. Specifically, the court determined that the market price is, "a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."[24] In Vlasic, we see a court rejecting the use of hindsight by plaintiff's experts, but concurrently allowing the inclusion of *post-transaction* data (*i.e.*, Vlasic's market price after the spin-off) as a means of concurring with the solvency of the company at the time of the transaction.

THE BOOK OF WISDOM

While the application of hindsight in retrospective valuation analyses is tenuous, some level of hindsight by experts has been permitted by courts where the value of damages is in question. In particular, hindsight has been allowed to various degrees in patent infringement disputes. Where data subsequent to the point of infringement (*i.e.*, *ex-post*) may benefit a more precise estimate of the value of damages, some courts have permitted the use of post-infringement data.

20 *Id.* at 892.

21 *In re Arrowhead Gardens, Inc.*, 32 B.R. 296, 301 (Bankr.D.Mass.1983).

22 *VFB LLC v Campbell Soup Co.*, 482 F. 3d 624 (3d Cir. 2007).

23 *Id.* at 633.

24 *Id.* at 633.

For example, in the precedent setting 1933 case of *Sinclair Refining Co. v. Jenkins Petroleum Process Co.*, the Supreme Court ultimately confirmed that hindsight was permissible in calculating damages asserted by the plaintiff.[25] In *Sinclair*, the plaintiff loaned to the defendant certain experimental stills used for cracking petroleum oils to produce gasoline. Per executed agreements, any improvements made by defendant to the apparatus or process belonged to the plaintiff. Defendant, however, was issued patents for the improvements and plaintiff brought suit for patent infringement. Upon reaching a decision, Supreme Court Justice Cordozo wrote in the opinion:

> This is not a case where the recovery can be measured by the current prices of a market. A patent is a thing unique. There can be no contemporaneous sales to express the market value of an invention that derives from its novelty its patentable quality…But the absence of market value does not mean that the offender shall go quit of liability altogether…At times the only evidence available may be that supplied by testimony of experts as to the state of the art, the character of the improvement, and the probable increase of efficiency or saving of expense…This will generally be the case if the trial follows quickly after the issue of the patent. But a different situation is presented if years have gone by before the evidence is offered. Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within.[26]

In its opinion, the Supreme Court opened the possibility of using post-infringement (*ex-post*) data to help in evaluating the value of the patent, and, hence, damages to be paid by the infringing party.[27] That is, unlike the valuation of a company, a plaintiff can concretely determine, with the benefit of hindsight, the number of items sold using the alleged infringing patent. The opinion further states that allowing such information "is not to charge the offender with elements of value nonexistent at the time of the offense. It is to bring out and expose of light the elements of value that were there from the beginning."[28]

More recent decisions have emphasized the use of hindsight in patent disputes as initially stated in *Sinclair*. For example, in 2008, the Eastern District of Texas held in *Ariba Inc. v. Emptoris, Inc.* that "the jury may consider the infringer's actual sales and revenue up to the date of trial as part of the 'book of wisdom.'"[29] Furthermore, in its 2009 decision regarding *Lucent Technologies, Inc. et al. v. Gateway, Inc.*, the U.S. Court of Appeals for the Federal Circuit reaffirmed that considering "evidence of usage after infringement started can, under appropriate circumstances, be helpful to the jury and the court in assessing whether a royalty is reasonable."[30] As such, in instances where an infringement suit is filed years after a patent is awarded, hindsight may be permitted by the courts.[31]

CONCLUSION

Valuation professionals must be diligent in determining when and where hindsight is applicable in analyses. When creating retrospective valuations, it is necessary to understand the nature of the projections as well as the economic conditions surrounding the time that the projections were created in order to fully capture the true value. It is paramount to remove the biases that occur when there is knowledge of what transpired post-valuation date. The case of *In re: Lehman Bros. Holdings Inc.* is a reminder and continues to highlight the fact that courts are skeptical of analyses laden with hindsight. By analyzing the projections in terms of who initially created the projections and their inherent biases as well as incorporating the prevailing economic conditions, the ultimate valuations will be viewed more favorably by the courts.

At the same time, the use of hindsight may be appropriate when providing context and analytical support to a valuation, or in calculating damages. In the former instance, conclusions of value (or solvency) are reached based on contemporaneous data while hindsight is used simply to emphasize those

25 *Sinclair Refining Co. v. Jenkins Petroleum Process Co.,* 289 U.S. 689 (1933).

26 *Id.* at 697-8.

27 Damages can be assessed through the calculation of a reasonable royalty rate, the specifics of which are not covered in this article. Professionals often determine the royalty through evaluation of a hypothetical negotiation between the patentee and the alleged infringing party at or around the time of infringement. The Supreme Court, in *Sinclair*, allowed the possibility to use post-negotiation facts in determining the royalty.

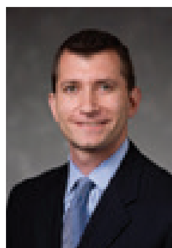
28 *Sinclair Refining Co. v. Jenkins Petroleum Process Co,* 289 U.S. 689, 698 (1933).

29 *Ariba, Inc. v. Emptoris, Inc.*, 567 F. Supp. 2d 914, 917 (E.D. Tex. 2008).

30 *Lucent Technologies, Inc. et al. v. Gateway, Inc. et al*, 580 F.3d 1301, 1333-4 (Fed. Cir. 2009).

31 While the focus here is on patent infringement matters, there continues to be debate as to the use of *ex-post* (after the fact) versus *ex-ante* (before the fact) analyses in economic damage disputes in general.

results. The latter scenario is not simply the application of hindsight, but the use of historical data to accurately determine a plaintiff's monetary loss. Analyzing events that happened after the date of an alleged source of damages may be the only way to effectively make a party whole. Knowing when a valuation professional is aptly using hindsight or is playing the role of the Monday morning quarterback, however, may determine the winning or losing team at trial. VE



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