

WHITE PAPER
BUSINESS LITIGATION AS A MANAGED INVESTMENT
THE DEFENSE CASE
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It is always difficult to wrap your thinking around the fact that getting sued is an investment. It is, however, and we find the answer in the definition of invest. To “invest” is “to commit (money or capital) in order to gain profit or interest.” The difference between defending a case and a more traditional form of investment is simply that the defendant in a lawsuit is making a compelled investment.

As we discussed at more length in the first installment of this White Paper, *Business Litigation as a Managed Investment – the Plaintiff’s Case*, litigation is a process in which we invest resources in order to gain some benefit or return. In defending the case, resources are invested in order to reduce the amount that the defendant will collect through a judgment or settlement.

To see how this works, consider the do-nothing alternative. Plaintiff brings a lawsuit in which damages of \$2,000,000 are claimed. The defendant does nothing, meaning that the lawsuit is ignored. Ultimately a default judgment is entered in the amount alleged by the plaintiff.

How much is the investment in this case? Two million dollars or the value of whatever assets the plaintiff can seize to satisfy the judgment. On the other hand, if the case is defended – money is invested in litigation expenses – and the case is forced to trial and a verdict is entered of \$1 million, then the investment has yielded a benefit in the form of a savings of \$1 million. The amount that was spent to secure that reduction in the judgment is the investment and the return on investment, or ROI, is the percentage return on the investment made.

Suppose, for example, that the defense costs \$500,000. For an investment of \$500,000, the defense yielded a \$1 million savings. The ROI is 100 percent. Because

defending a case requires an investment of money and because it produces a monetary benefit as a result of that commitment of money, it truly is an investment.

In defending the business lawsuit, the only issue that we really face – because the investment truly is compelled – is whether resources are wisely committed to yield this benefit. We will do better for our business when we examine litigation unemotionally and view it as another aspect of our business to be managed effectively. Whether our business is the plaintiff or defendant, the approach is the same.

We look once again at the same set of set of illustrative facts. Assume that your business has decided to purchase new manufacturing equipment as part of a complete overhaul of production line. (A word of warning: the numbers I am about to use are not supposed to necessarily reflect reality, but to make it easy to do the arithmetic.) A specialty consulting firm was engaged to build and configure the system at a cost of \$1,000,000 and will provide support, training and maintenance a cost of \$100,000 a year for seven years. Ninety days into the contract, it is clear that the consultant is unable or unwilling to perform; you fire the consultant and bring in a new consultant.

In the scenario that is the subject this discussion, the consultant sues your business, claiming claim loss of the \$1,000,000 consulting fee revenue, loss of the \$700,000 maintenance contract and throws in some other claims of questionable merit (fraud and breach of the covenant of good faith and fair dealing) and for good measure alleges \$1,000,000 in lost opportunity costs. The summons and complaint lands on your desk with a \$2 million damages demand. This is where we start our analysis.

The do-nothing alternative costs \$2 million. Ignore the lawsuit and the consultant will get a default judgment for that amount and ultimately the local sheriff will show up to start auctioning assets and seizing bank accounts.

The Defense Case Seeks to Reduce Liability

The first step is to secure a realistic value on the case and to consider the likely costs of litigation. You do this through a careful evaluation of the facts and circumstances. Defense clients frequently will refuse to consider any liability, or to make only nuisance value offers in compromise. A realistic assessment of liability – there is rarely zero liability– is necessary to manage defense cases as an investment.

Again, we also need to consider the costs of commercial litigation and that in all likelihood the expenses for attorneys, experts and other incidentals will end up costing 40 percent of the value of the claim. (For some commentary on how we arrive at the 40 number, see our materials on The 40 Percent Factor.) And, of course, we are always cognizant of the fact that 95 percent of all cases settle, including ours. The probability of a compromise is much greater than the probability of trial on the merits.

We use the same assumptions for our defense case as we did when considering the plaintiff's case in our analysis from the plaintiff's point of view. Assume that after your lawyer has evaluated the facts and the law, you conclude that the case, if tried to a verdict, has an 80 percent probability of a verdict of \$1,300,000, but recognize that there is a 95 percent probability that the case will settle. You also make an educated guess that the defendant will accept \$1,000,000 to compromise the claim, although not before there is enough discovery to impress the other side that your cause has substantial merit.

Remember, what is important is not the numbers that we put on the case, but the method by which we analyze the investment. The same analysis is true for a claim in any amount.

You budget the litigation fees to run \$25,000 a month, except for the months right before trial and during trial, when the legal fees will run \$50,000 a month. The budget is \$425,000 to get the case ready for trial and \$625,000 if the case has to go to a full-blown trial. This is the input side of the equation, the commitment of money for which you might hope to secure a return.

Where does this analysis lead? We must add the litigation costs to the amount paid to calculate the return. If \$425,000 is spent over 17 months to secure a \$1,000,000 reduction, the cost of the claim is \$1.435 million, or a net of \$575,000 from the do-nothing alternative. That's a return on your investment of 135 percent over 17 months. If the case goes to trial, however, you likely will pay \$1.3 million plus litigation expense of \$625,000, for a total of \$1.975 million. That's a poor investment. And when you consider the real value of the case (the likely verdict at trial), it is a financial disaster.

What is most to be avoided is the very typical scenario in which the defendant refuses to acknowledge significant exposure until after substantial discovery and motion practice weakens the case. This is great for the lawyers, but not so good for the client. The defendant in this scenario either takes a no-pay position or makes a nuisance offer, which the plaintiff ignores.

Consider the following scenario, which is fairly typical. Both sides avoid settlement discussions and fail to acknowledge the weaknesses in their positions. The parties slog through discovery, trying to expose the weaknesses in the other side's case.

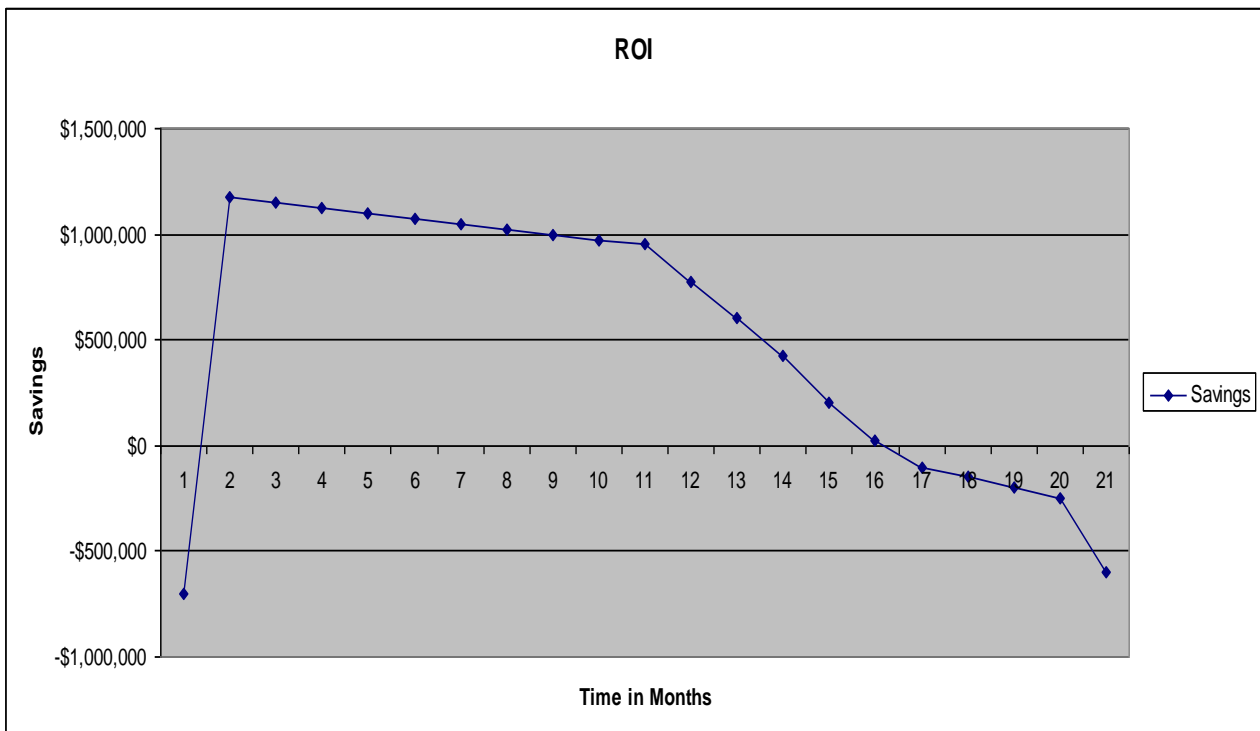
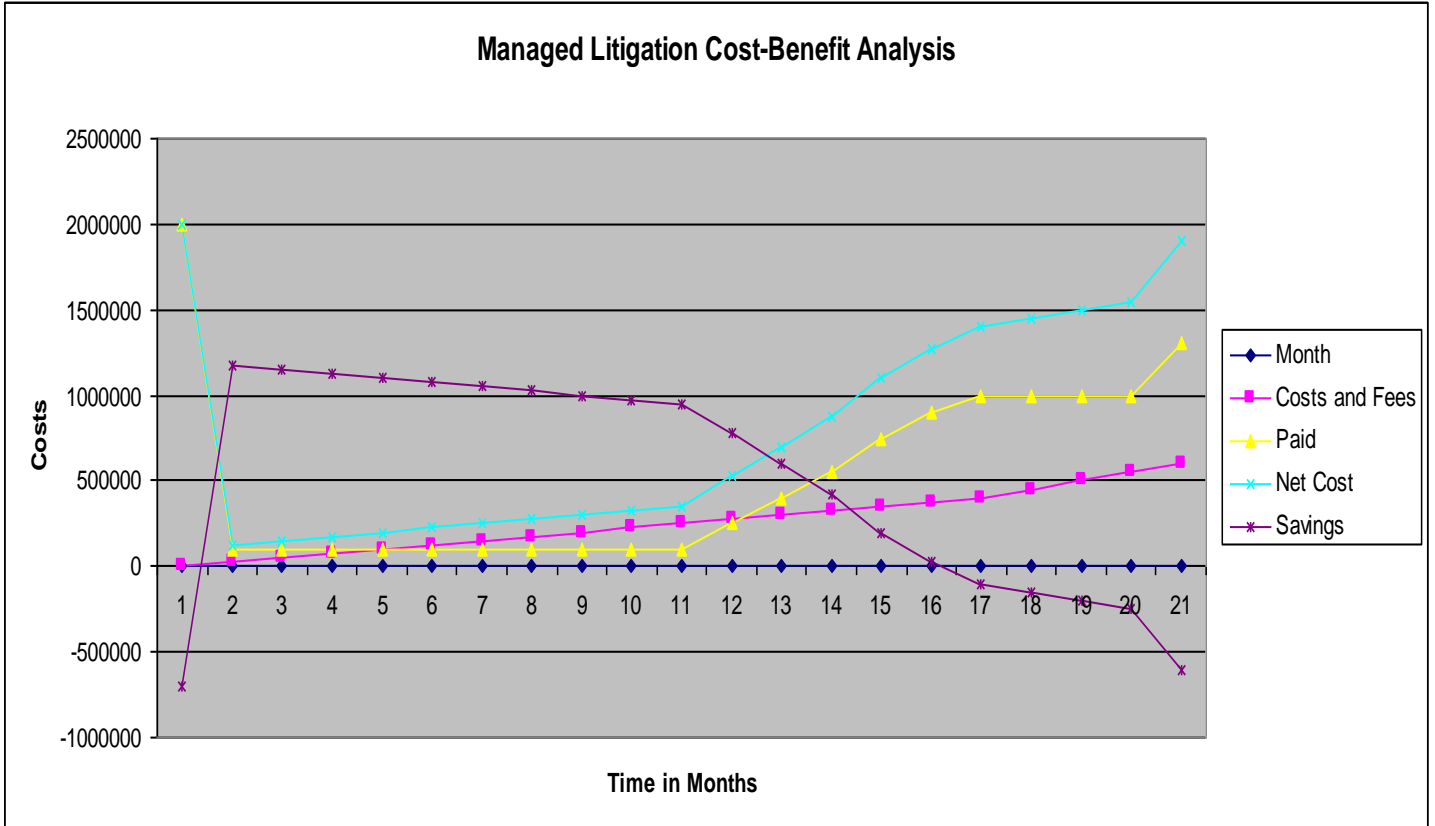
Somewhere near the end of discovery, and after significant expenditures on both sides, the two sides try to settle the case. Consider the following expenditures. Note that we use the real value of the case here. Once we decide to defend the claim, the default judgment value of the case is no longer a real consideration. Rather, the better measure is the exposure that we face at trial.

Month	Costs and Fees	Paid	Value of the Case	Net Cost	Savings	ROI
1	\$0	\$2,000,000	\$1,300,000	\$2,000,000	-\$700,000	-53.85%
2	\$25,000	\$100,000	\$1,300,000	\$125,000	\$1,175,000	90.38%
3	\$50,000	\$100,000	\$1,300,000	\$150,000	\$1,150,000	88.46%
4	\$75,000	\$100,000	\$1,300,000	\$175,000	\$1,125,000	86.54%
5	\$100,000	\$100,000	\$1,300,000	\$200,000	\$1,100,000	84.62%
6	\$125,000	\$100,000	\$1,300,000	\$225,000	\$1,075,000	82.69%
7	\$150,000	\$100,000	\$1,300,000	\$250,000	\$1,050,000	80.77%
8	\$175,000	\$100,000	\$1,300,000	\$275,000	\$1,025,000	78.85%
9	\$200,000	\$100,000	\$1,300,000	\$300,000	\$1,000,000	76.92%
10	\$225,000	\$100,000	\$1,300,000	\$325,000	\$975,000	75.00%
11	\$250,000	\$100,000	\$1,300,000	\$350,000	\$950,000	73.08%
12	\$275,000	\$250,000	\$1,300,000	\$525,000	\$775,000	59.62%
13	\$300,000	\$400,000	\$1,300,000	\$700,000	\$600,000	46.15%
14	\$325,000	\$550,000	\$1,300,000	\$875,000	\$425,000	32.69%
15	\$350,000	\$750,000	\$1,300,000	\$1,100,000	\$200,000	15.38%
16	\$375,000	\$900,000	\$1,300,000	\$1,275,000	\$25,000	1.92%
17	\$400,000	\$1,000,000	\$1,300,000	\$1,400,000	-\$100,000	-7.69%
18	\$450,000	\$1,000,000	\$1,300,000	\$1,450,000	-\$150,000	-11.54%
19	\$500,000	\$1,000,000	\$1,300,000	\$1,500,000	-\$200,000	-15.38%
20	\$550,000	\$1,000,000	\$1,300,000	\$1,550,000	-\$250,000	-19.23%
21	\$600,000	\$1,300,000	\$1,300,000	\$1,900,000	-\$600,000	-46.15%

In this scenario, we have the nuisance numbers in the offer/recovery column, which signifies the typically entrenched positions of the parties in the early months of litigation. The amount offered in compromise moves up slowly in response to the approaching trial date and litigation costs.

Finally, after 16 months of litigation, the defendant puts \$900,000 on the table, but it is too late, any savings approaching the targeted settlement amount. The following

month the offer is upped to \$1 million, and the case settles after 17 months. The ROI is 135 percent... I graphed out this sequence of events as follows:



Looking at the graphics, we can make the following key observations:

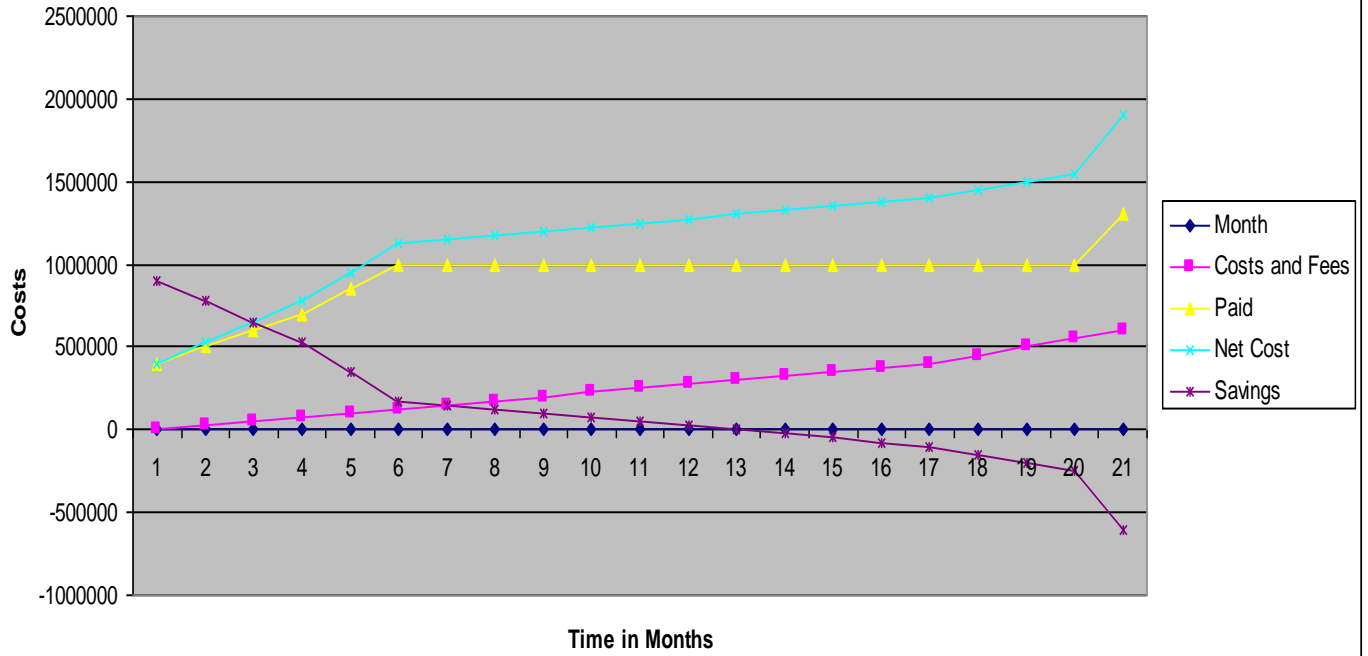
- The legal expenses are consistent and only increase with time. They are a drag on the ROI and need to be reduced as much as possible. Because they are a function of the time that the litigation continues, the lawsuit needs to be ended as early as possible.
- The savings, which equates to ROI, peaks early in the case and declines consistently during the litigation.
- Trial is a financial loser, turning the potential for positive return on our investment into an overall loss of principal.

Now consider the following graphics, in which the litigation is managed.

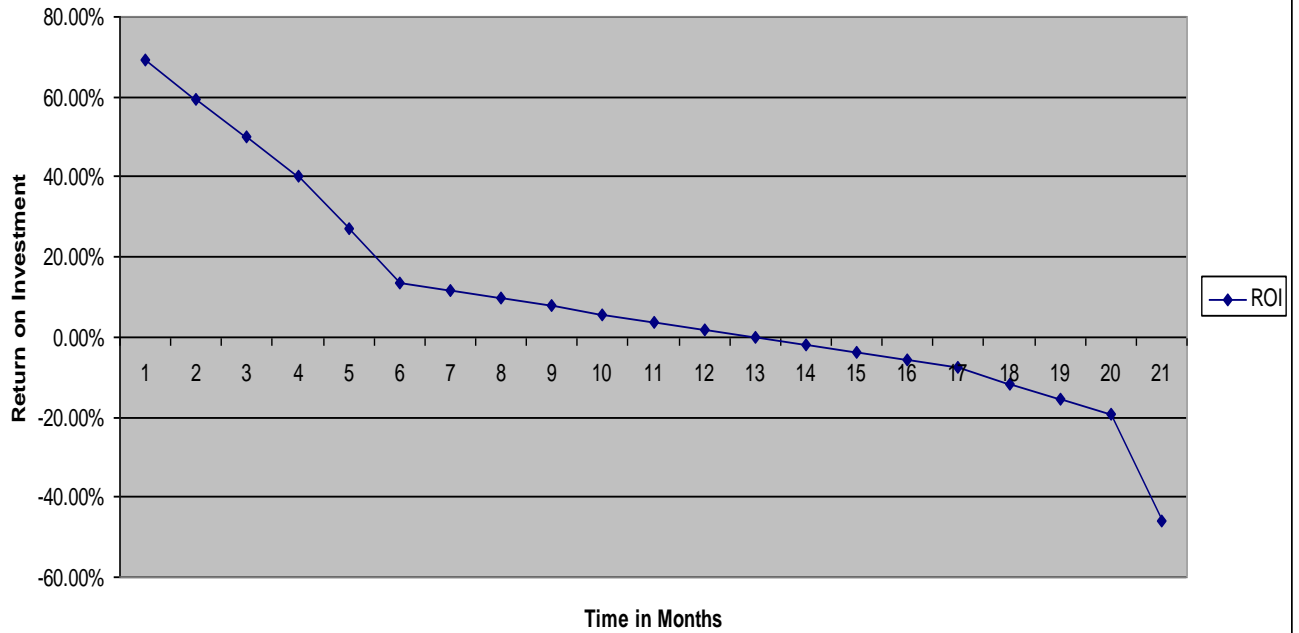
Month	Costs and Fees	Paid	Value of the Case	Net Cost	Savings	ROI
1	\$0	\$400,000	\$1,300,000	\$400,000	\$900,000	69.23%
2	\$25,000	\$500,000	\$1,300,000	\$525,000	\$775,000	59.62%
3	\$50,000	\$600,000	\$1,300,000	\$650,000	\$650,000	50.00%
4	\$75,000	\$700,000	\$1,300,000	\$775,000	\$525,000	40.38%
5	\$100,000	\$850,000	\$1,300,000	\$950,000	\$350,000	26.92%
6	\$125,000	\$1,000,000	\$1,300,000	\$1,125,000	\$175,000	13.46%
7	\$150,000	\$1,000,000	\$1,300,000	\$1,150,000	\$150,000	11.54%
8	\$175,000	\$1,000,000	\$1,300,000	\$1,175,000	\$125,000	9.62%
9	\$200,000	\$1,000,000	\$1,300,000	\$1,200,000	\$100,000	7.69%
10	\$225,000	\$1,000,000	\$1,300,000	\$1,225,000	\$75,000	5.77%
11	\$250,000	\$1,000,000	\$1,300,000	\$1,250,000	\$50,000	3.85%
12	\$275,000	\$1,000,000	\$1,300,000	\$1,275,000	\$25,000	1.92%
13	\$300,000	\$1,000,000	\$1,300,000	\$1,300,000	\$0	0.00%
14	\$325,000	\$1,000,000	\$1,300,000	\$1,325,000	-\$25,000	-1.92%
15	\$350,000	\$1,000,000	\$1,300,000	\$1,350,000	-\$50,000	-3.85%
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20	\$550,000	\$1,000,000	\$1,300,000	\$1,550,000	-\$250,000	-19.23%
21	\$600,000	\$1,300,000	\$1,300,000	\$1,900,000	-\$600,000	-46.15%

What is clear is that when the case settles early, the defendant achieves both a larger savings on litigation costs and significant ROI. Here are the graphics.

Managed Litigation Cost Benefit Analysis



ROI



The conclusions are clear.

- Put enough money on the table early in the case to entice a settlement. The defendant achieves the maximum return on its investment by compromising the claim as early as possible for as little as possible.
- Keep negotiations going until you find the number that will resolve the claim. The sooner you find the number that the plaintiff will accept, the less the case is going to cost.
- Your ability to achieve any ROI depends on how quickly the case can be settled. Note that even if the \$1 million placed on the table right away, you are still better off that you are with excessive merits discovery.
- Trial is a waste of resources.

Defense clients often react to lawsuits with emotion and denial. As the graphics above show, the longer the litigation continues, the more the defendant loses. Knowing that the case is going to settle, the fundamental question is how to get to that number as quickly as possible. The smarter move is to make a substantial offer very early in the case in an amount that the defendant will have difficulty refusing. The settlement number is likely to increase as the parties become more invested in the litigation, so get rid of the case early.

A final word. A defendant who is not prepared is likely to have to pay more to entice the plaintiff. Discovery does serve a purpose in that it educates both parties about the weaknesses of their positions. For defendants, early and aggressive discovery of the plaintiff may be necessary for the plaintiff to realistically assess its own prospects at trial. But whatever has to be done, the defendant needs to keep the negotiations open.