

WHITE PAPER
BUSINESS LITIGATION AS A MANAGED INVESTMENT
THE PLAINTIFF'S CASE

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The business that has never been involved in litigation is a rare creature. We all get sued, or have to bring a lawsuit, at one time or another. The question to consider is not whether we will be a litigant, but when and how we invest our resources in the process.

The American Heritage Dictionary defines invest as “to commit (money or capital) in order to gain profit or interest.” Too often, the entrepreneur sees litigation solely as a cost to be avoided or suffered. There is another approach, however. Manage litigation as an investment in which resources are committed to yield some benefit or return, just as you would any other asset that can yield a profit or cost savings.

This approach requires that we adopt a different mindset about litigation – that it is simply another aspect of our business to be managed effectively so as to yield the greatest return. And this approach works equally well whether we are plaintiff or defendant.

Consider the following set of illustrative facts. Assume that your business has decided to purchase new manufacturing equipment as part of a complete overhaul of the 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 has been 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, and after paying the initial \$250,000 deposit, it appears that the consultant is unable or unwilling to perform, so you fire the consultant. You engage a new consultant that will cost \$1,500,000 to do the same work plus a support contract of \$100,000 a year for seven years. The project, which was to

generate revenue of \$250,000 per month, is delayed for 90 days. Here is an overview of the damages caused by the first consultant's breach of contract:

	Original Contract	Replacement Contract	Difference
Construction	\$1,000,000	\$1,500,000	\$500,000
Maintenance	\$700,000	\$700,000	\$0
Additional Cost			\$500,000
Deposit			\$250,000
Delay Costs			\$750,000
Total Damages			\$1,500,000

You believe that you have been damaged by the consultant for the \$750,000 difference between the contract price and the price that you will ultimately pay, (\$500,000, plus the \$250,000 that has already been paid) as well as for the damages caused by the delay in completing the project of \$750,000. The total amount of the claim is \$1,500,000.

The Plaintiff's Case to Recover \$1.5 million (Scenario One)

This is a substantial commercial litigation and you will need to recognize that litigation expenses will most likely amount to 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.)

Let's 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. You also recognize, however, that there is a 95 percent probability that the case will settle. You also make an educated guess that the defendant will pay \$1,000,000 to resolve the claim, although not before there is enough discovery to impress the other side that your cause has substantial merit.

Finally, 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. Now you need to calculate the return on investment.

We do the math as follows: \$425,000 invested over 17 months to secure \$1,000,000, or a net of \$575,000, if the case settles. That's a profit on your investment of 135 percent over 17 months. Not bad. If the case goes to trial, you likely will get \$1.3 million on an investment of \$625,000, of a profit of \$675,000. That's a profit of 108 percent. Whether that is a good investment depends on individual circumstances, such as whether you have the case and can put it to better use elsewhere and accurately assessing the risks for trial.

You might think that was the end of it, but it is not. You can manage litigation expenses and settlement discussions to either maximize your total return or to maximize your return on investment. The two are usually not the same thing.

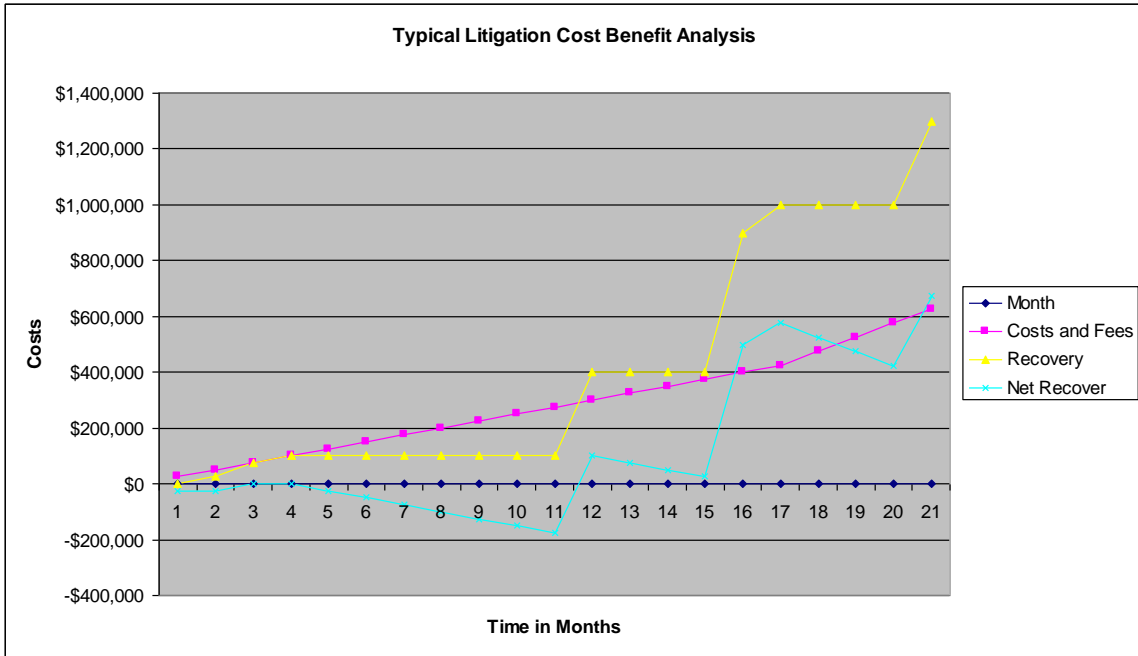
Consider the following scenario, which is fairly typical. Both sides avoid settlement discussions and fail to acknowledge the weaknesses in their positions. The defendant throws out a low-ball offer, which the plaintiff ignores. The parties slog through discovery, trying to expose the weaknesses in the 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.

Month	Costs and Fees	Offer/ Recovery	Net Recovery	ROI
1	\$25,000	\$0	-\$25,000	
2	\$50,000	\$25,000	-\$25,000	-50.00%
3	\$75,000	\$75,000	\$0	0.00%
4	\$100,000	\$100,000	\$0	0.00%
5	\$125,000	\$100,000	-\$25,000	-20.00%
6	\$150,000	\$100,000	-\$50,000	-33.33%
7	\$175,000	\$100,000	-\$75,000	-42.86%
8	\$200,000	\$100,000	-\$100,000	-50.00%
9	\$225,000	\$100,000	-\$125,000	-55.56%
10	\$250,000	\$100,000	-\$150,000	-60.00%
11	\$275,000	\$100,000	-\$175,000	-63.64%
12	\$300,000	\$400,000	\$100,000	33.33%
13	\$325,000	\$400,000	\$75,000	23.08%
14	\$350,000	\$400,000	\$50,000	14.29%
15	\$375,000	\$400,000	\$25,000	6.67%
16	\$400,000	\$900,000	\$500,000	125.00%
17	\$425,000	\$1,000,000	\$575,000	135.29%
18	\$475,000	\$1,000,000	\$525,000	110.53%
19	\$525,000	\$1,000,000	\$475,000	90.48%
20	\$575,000	\$1,000,000	\$425,000	73.91%
21	\$625,000	\$1,300,000	\$675,000	108.00%

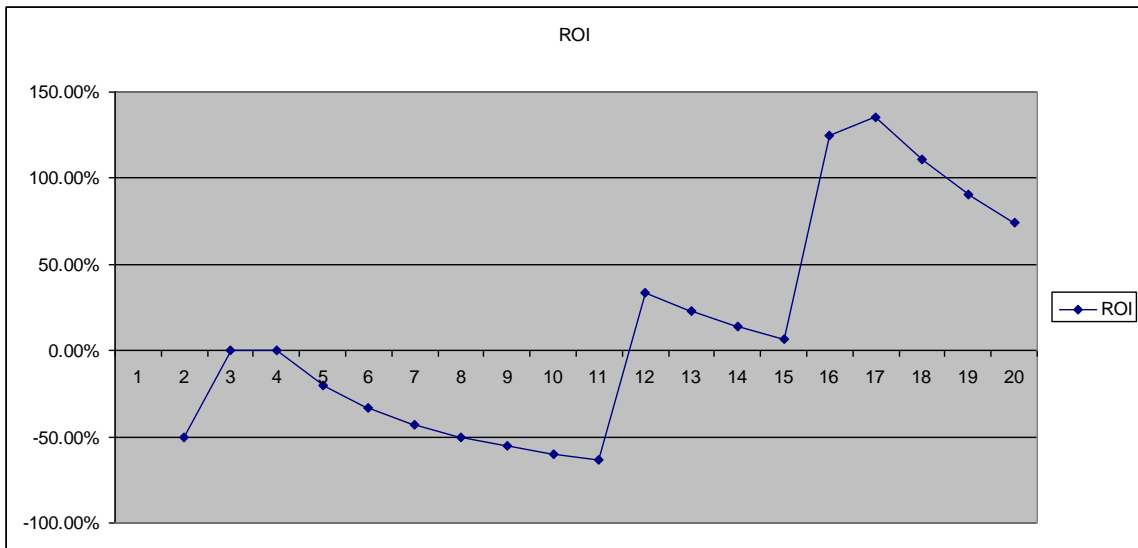
In this scenario, we have nuisance numbers in the offer/recovery column during the early months of the case, which signifies the typically entrenched positions of the parties in the early months of litigation. The defendant makes a couple of nuisance offers, and then becomes entrenched at \$100,000. The defendant ups the amount to \$400,000, which is still not adequate to entice the plaintiff. Note that by the time the \$400,000 is put on the table after a year of litigation, the recovery is a modest \$100,000. But even that return deteriorates quickly over the next few months due to legal fees.

Finally, after 16 months of litigation, the defendant puts \$900,000 on the table, 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:



There is a significant amount of money to be recovered. But assuming that your lawyer doesn't work for free – we don't and neither do the lawyers we know – the net recovery is very much dependent on the timing. Here is a graph of Return on Investment (ROI) over the same period.



There a couple of items worth noting here.

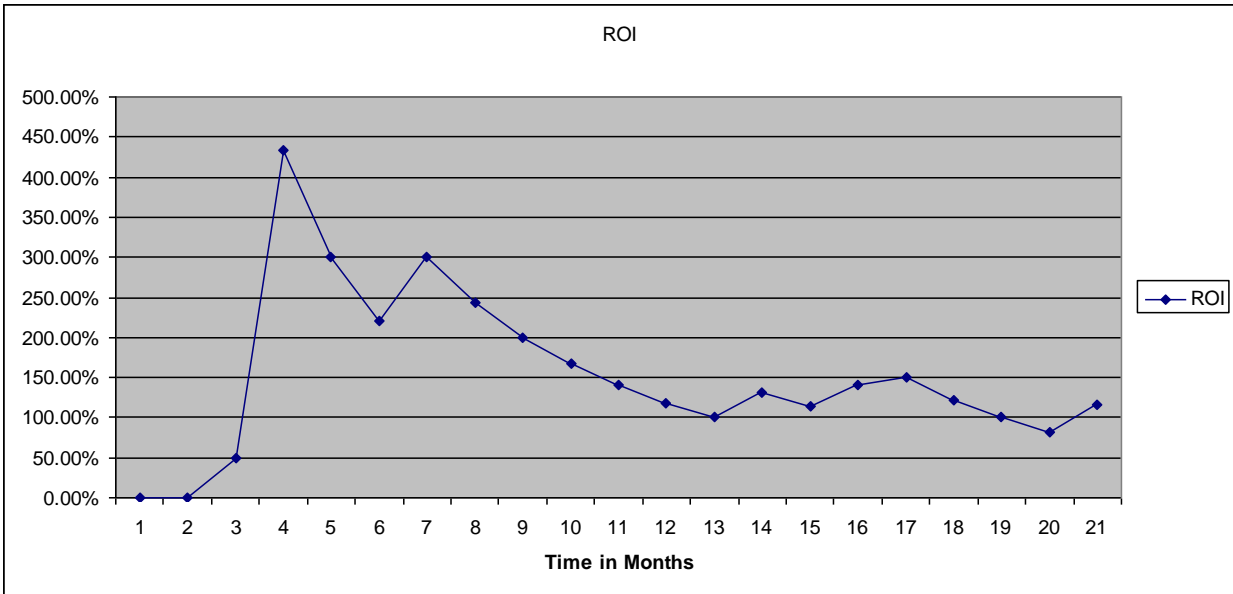
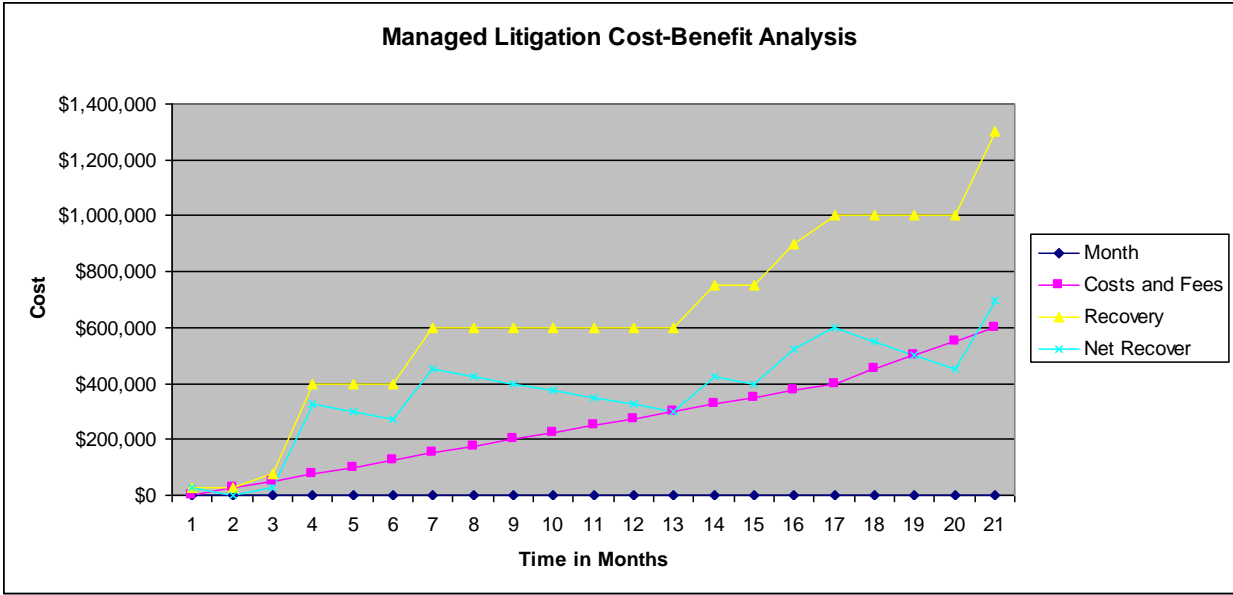
- The ROI peaks when the case settles for the target amount and then decreases as the parties prepare for trial and try the case.
- In ROI terms, there is almost no difference between the “almost good enough” settlement of \$900,000 and the target settlement of \$1 million.
- It takes the plaintiff a year to wrangle an offer that does little more than compensating for legal fees.

Managing the Plaintiff's Case

Consider what happens when you start to look at legal fees as an investment, made with the intent to maximize return. What happens, for example, when the plaintiff makes an attractive offer to settle early in the case? Suppose for, example, that the plaintiff decided early on to make the not-so-insubstantial demand of \$400,000 to settle the case.

Month	Costs and Fees	Offer/ Recovery	Net Recover	ROI
1	\$0	\$25,000	\$25,000	0.00%
2	\$25,000	\$25,000	\$0	0.00%
3	\$50,000	\$75,000	\$25,000	50.00%
4	\$75,000	\$400,000	\$325,000	433.33%
5	\$100,000	\$400,000	\$300,000	300.00%
6	\$125,000	\$400,000	\$275,000	220.00%
7	\$150,000	\$600,000	\$450,000	300.00%
8	\$175,000	\$600,000	\$425,000	242.86%
9	\$200,000	\$600,000	\$400,000	200.00%
10	\$225,000	\$600,000	\$375,000	166.67%
11	\$250,000	\$600,000	\$350,000	140.00%
12	\$275,000	\$600,000	\$325,000	118.18%
13	\$300,000	\$600,000	\$300,000	100.00%
14	\$325,000	\$750,000	\$425,000	130.77%
15	\$350,000	\$750,000	\$400,000	114.29%
16	\$375,000	\$900,000	\$525,000	140.00%
17	\$400,000	\$1,000,000	\$600,000	150.00%
18	\$450,000	\$1,000,000	\$550,000	122.22%
19	\$500,000	\$1,000,000	\$500,000	100.00%
20	\$550,000	\$1,000,000	\$450,000	81.82%
21	\$600,000	\$1,300,000	\$700,000	116.67%

. What you see here are substantial recoveries without the same level of expenditures for legal fees (which also means less risk of loss of principal) and substantial, if incomplete, recoveries. Depending on the other investment alternatives available for the money that would be spent on litigation, early settlement to achieve maximum ROI may be the best alternative. (And it is also important to remember the time value of the money tied up in the litigation, which by my rough calculations in this case could run \$50,000-\$70,000.) Consider the following two charts.



The economics of the managed litigation are significantly different. Here are some of the key differences.

- The ROI from the investment is significantly higher and, in fact, it spikes early in the case and declines over time.
- Settling the matter as soon as it makes sense in economic terms reduces risk, not only of an adverse take-nothing verdict, but also the risk inherent in investing in

something that has a real risk of loss of principal (any lawsuit can be won or lost despite the merits).

There are some key issues as a result of this analysis that should always be kept in mind before a lawsuit is commenced, however meritorious.

You Always Start at Zero. The business contemplating a lawsuit must remember that it has nothing of value other than the potential to recover on a claim. The defendant has the money, and will continue to have the money, until the defendant pays. Period. Many, many plaintiffs make the costly mistake of viewing litigation from the perspective of the past – what they lost or what should have been paid. They wrongly believe that there is some right or possessory interest in what is not theirs. If you would not recommend the lawsuit to a complete stranger as an investment, you should not consider it for yourself.

Realistic Assessment and the Do Nothing Option, We should begin by rationally and realistically assessing the likely recovery and the cost of getting there. Only when this is done can we give *real* consideration to the do-nothing option. If there is somewhere better to put the money that would otherwise be invested in the litigation, that alternative should be given serious thought. Too often lawsuits are based on emotion, not economic considerations. Consider the return, the risk profile and capital required. Save your principles for politics, commercial litigation is always about redistributing money.

Choose Between ROI and the Net Recovery. They are not the same. Traditional business litigation is a process in which the parties slug it out with motions and discovery until the defendant increases the settlement offer to something that is acceptable. It is a

war of attrition. Many defendants avoid settling as long as possible, preferring to pay litigation expenses instead of the settlement amount. As plaintiff, it is important to decide what is most important: the total recovery or the return on your investment,

If the return on your investment is most important, make a substantial offer discounting the amount claimed early in the litigation. Clients are often surprised just how quickly a defendant will settle when there is an attractive discount available. The offer should be difficult to turn down. The return on litigation costs that is achieved through a quick settlement will always be much greater (in percentage terms) than the return achieved after substantial litigation. Moreover, keep negotiating throughout the litigation until you find the number that entices the defendant.

If the total amount of the recovery is what's most important, recognize that nothing brings a defendant to the table more quickly than a trial that is imminent. Stay on top of the case and avoid extending deadlines.

Face the Reality: 95 % of All Cases Settle. That includes your case. The probability that your business lawsuit will be tried is small. Meanwhile, the costs of trying the case are always significant. On the other hand, the best way to get a case settled is to be ready for trial and there are still a substantial number of cases that do go to trial. The case has to be ready to go. If it's not ready, the defense will know and will lower its offer accordingly.