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A CASE STUDY APPROACH FOR THE LITIGATION DECISION: EMPLOYING DECISION ANALYSIS TO DETERMINE WHEN A BUSINESS SHOULD SETTLE OR GO TO COURT

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ABSTRACT

For a business, exposure to a lawsuit represents substantial costs. Although the court costs and attorneys' fees are obvious expenses, the business manager must face the additional costs litigation imposes upon a business. For example, such costs include the amount of time company employees will be required to spend in preparation for the suit through their testimony or through the furnishing of documentary evidence. Also, there are the costs to the business in the form of damage to the business reputation. To date, no organized method of cost analysis has been developed for use by the manager or the business student in a case study. In this paper, such a revolutionary model is introduced.

INTRODUCTION

Business and Litigation The High Stakes

In the past few years, there have been phenomenal reports regarding the costs businesses have experienced in carrying both governmental and private suits to trial. When Litton Systems tiled an antitrust suit against AT&T in 1976, both sides began seeking documents. A team of 69 AT&T attorneys, paralegals and clerks and six microfilm technicians spent six months (2,910 working hours) to collect 1.8 million pages. The total cost to AT&T was \$532,000, \$376,000 for attorneys' fees, lodging and travel, with the balance of \$156,000 constituting the cost of microfilming.

American Electric Power's antitrust suit against GE and Westinghouse cost them \$10 million in just pretrial discovery work.

A major New York law firm estimates that the daily cost of a deposition in a major company law suit is \$3,000 per day.

The cases have provided interesting news reports and perhaps attracted attention for the businesses involved, but the decisions to litigate these cases all the way to the trial stage may not have been the most cost-effective nor the decision most helpful to the business, its employees and the morale of both. For example, Arthur Andersen & Co. spent \$71,000 in pretrial motions alone in an antitrust case.

In legal environment and business law courses, students are given a great deal of information regarding the law on the topics of white collar crimes, torts, contracts and administrative regulations. However, students are given no information on items such as: (1) the cost of filing suit; (2) the costs of various discovery tools in litigation such as depositions, interrogatories and records requests; (3) the attorneys' fees particularly for trial; and (4) the cost of an appeal if one is filed even in the event of a trial victory.

In the other areas of business study, including the area of policies,

students are given cases in which they are required to employ the tools of accounting, finance, marketing, management and computer systems to analyze and propose solutions for business problems. Although some of these cases may have minor legal issues, business students are not exposed to the case study in which the major problem facing a business is a lawsuit against it or one to be initiated by it. In areas such as antitrust, with triple recovery damages, suits may be devastating to a business or even mean the demise of the business. To further exacerbate the problem, many of the legal problems facing businesses are not insurable risks and the full cost of suit and litigation is actually borne by the business.

If a student is furnished with a decision analysis formula, the costs and risks may dictate differing results such as settlement or full trial or eventually an appeal. This formula will vary depending on the legal issue involved but should provide the student and the business person with a thinking process to be used in the determination of the appropriateness of litigation or some stage thereof versus settlement. Such a process is one far superior to the one currently used by most people - that of reliance of their attorney's statement that there is a 50-50 or 75% chance of success.

The purpose of this paper is to set forth various formulae to be used in the determination of when to proceed with a lawsuit and to provide case study examples in which the various formulae may be applied. The areas to be discussed will be tort, contract, and government suits in the areas of antitrust, advertising and securities.

DECISION ANALYSIS FOR LITIGATION

Contracts

In the contracts area, the business is in a creditor position faced with a defaulting debtor. The formula to be applied deals with the following factors:

- (1) the amount of the debt
- (2) the judgment quality of the debtor i.e. even if we win, can we collect?
- (3) the court costs
- (4) the attorney's fees
- (5) the amount of time - in terms of final payment and company time in terms of records procurement, etc.
- (6) the location of the debtor and his property
- (7) the net recovery vs. the tax benefit of a bad debt write-off
- (8) the business reputation of the creditor

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- (9) chances of success/default
- (10) settlement possibilities

For each of these factors, a number is associated - 1-10. The higher the number, the more positive the factor. For example, if the debt is small, the factor (1) gets a 1. If the debt is large, factor (1) is assigned a larger number. After each factor is assigned a number, all of the factors are totaled and the higher the score the greater the indication is for the business to pursue the matter. With the ten factors, the final total can be expressed as a percent -i.e. a 90% chance of success. This same process can be employed once the suit is filed to determine whether to settle or continue by considering the factors at a new stage of the litigation. This process is easily applied to the following factual situation.

CASE STUDY I CONTRACTS

LaMar Window Fashions, Inc. operates a window dressing manufacturing firm in Salt Lake City, Utah. LaMar's annual gross income is approximately \$250,000. LaMar extended an open credit line to Phoenix Window Designs. Phoenix received \$1000 in merchandise on credit four months ago and after repeated demands has paid nothing on the account.

Phoenix Window Designs is a sole proprietorship owned by Walter Thomas. The attorney for LaMar has learned that Thomas recently moved the business from a commercial building to his home. The attorney has also learned that Thomas owns a home and a car. Further, Thomas owes at least ten other creditors similar or greater amounts.

For application, the following notes should be made in the framework of the 10 point system.

- (1) For one debtor, the amount is large, but in relation to the amount of gross revenue, the amount is small - a 3 factor is assigned.
- (2) With no salary and only property to put liens against, the chances of collection seem slim - 2.
- (3) Filing fees and service of process will run between \$70 and \$100. Since this is a large portion of the debt, this factor should be given a 5 or more.
- (4) If the attorney bases the fee on an hourly basis, the cost will be about \$250-350. If the attorney takes a percentage, the cost will be between 25 and 35% or approximately the same. Such a high cost is rated at less than 5 or 3.
- (5) Company time will not be great - only a copy of the credit agreement and invoice will be necessary. If, as is the case with many debtors, there is a default, there will be virtually no company suit costs - a 9 is appropriate.
- (6) An out of state debtor requires moving a judgment or retaining Arizona counsel to sue in Arizona. These factors will increase the costs and a 2 should be assigned.
- (7) If costs and attorney's fees are subtracted, the net recovery is about \$600. This figure should be balanced with the company's tax rate and the possibility of tax benefits in a write-off. Considering the company's bracket, a 2 should be assigned here.

(8) If other creditors are in the same position and the debt is small, failure to collect through suit will not damage the creditor's reputation on handling debtors and a 2 is appropriate.

(9) The chances of default with small sole proprietorships is significant the rate is over 75%. In light of these factors, factor 9 is given a 9.

(10) Settlement possibilities are remote since collection procedures have failed and a 1 is given.

After adding all the assigned variables, a total of 38 is reached. Translated, this means there is a 38X chance of success. At times the number assignments will be arbitrary, but the model does work in that it forces managers and students to examine all cost and risk factors which exist in the litigation decision and process.

Tort Suits

Very often, a business is on the other end of litigation in that they are being sued for some wrong they have committed. Consider the following case:

CASE STUDY 2 - TORTS

Don's Flower Shop, Inc. is a small florist operating in Tempe, Arizona. Don, the principal shareholder of the family corporation and founder of the business has hired several high school students to handle deliveries. Don owns two vans and carries insurance on both. While one of the students is delivering flowers on a Friday, he stops for lunch. While pulling out of the fast food franchise, the young student collides with a bicycle rider. The rider of the bicycle is severely injured with medical bills totaling \$12,000. In addition, the rider has been out of work for 3 months (he is a CPA with one of the big eight firms).

For this type of liability action, the following factors should be considered.

- (1) The amount of insurance carried.
- (2) The effect recovery will have on insurance and future coverage.
- (3) Criminal liability Was either party cited for a traffic violation?
- (4) The amount of damages including medical, lost wages, permanent injury and pain and suffering.
- (5) Attorney's fees.
- (6) Litigation/court costs.
- (7) Settlement possibilities.
- (8) Business reputation.
- (9) Amount of time required from the business and its personnel.
- (10) Jury appeal of case.

This method of analyses can be used for product liability cases by simply substituting for factor #3, the substitute question of whether any state or federal agencies have taken action or whether prior similar suits are pending.

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In applying the ten factors to the case, the following result can be reached.

(1) In this case, Don is well insured. This factor is weighed against the decision to proceed with litigation so a one is assigned.

(2) However, settling the case may cost Don in terms of future insurance coverage and premium costs so a number between 6 and 10 should be assigned depending upon the potential increase - in this case an 8 is assigned. The insurer's position should also be considered.

(3) If the van driver was cited a one is assigned, if the bicyclist is cited, a 10 is assigned and if both are cited a 5 is assigned.

(4) In this case the medical bills and lost wages alone are substantial. If pain and suffering awards are 3 to 5 times as much as actual damages, the amount could approach \$100,000. In light of factor 2, this amount may be significant and a 6 is assigned.

(5) In this type of case, the attorney will be furnished by the insurer but will be billing at an hourly rate adding to #2 difficulties so a 1 is assigned to keep these fees at a minimum.

(6) Litigation costs in this type of case will be substantial because of medical exams, expert testimonies, etc. A factor of one is assigned.

(7) Settlement possibilities are extremely high in this type of case with an 80% settlement rate on these types of cases. Since the settlement rate is high, a one is assigned.

(8) Depending upon the type of case - product liability or in this case a bicyclist, public sympathy may be great and a one is assigned.

(9) In a case such as this, a great deal of time will be spent in documentation of employment, purpose of the trip, etc. More business time is required than was in case 1 but it is not extensive a 6 is assigned.

(10) The jury appeal of a case is usually directly tied to Factor #8 If there is public sympathy in 8, there will be no jury appeal and a one is assigned here.

Totaling the analyses, there is a 27% chance of success. In this case, Don's may wish to settle. However, the analysis may be used in a different way in that Don's may decrease the ultimate cost by pursuing litigation to a certain point and then running through the analysis before the settlement decision is

Government Litigation

Currently, many businesses face litigation from federal and state agencies for violation of various securities, antitrust and advertising laws and regulations. As in the prior cases, there is a time to fight a case and a time to settle. The following case study can be used for application of the governmental litigation factors.

CASE STUDY 3 GOVERNMENT REGULATION

Skin Care, Inc. is a company engaged in a mail order business of selling an antiacne skin creme. Skin Care conducts substantial TV ad campaigns and has paid Star X to endorse the product by

claiming his daughters have used the product. Star X, as dictated by the ad script, claims the creme cures acne with use over a two week period.

The FTC has issued a citation against both Skin Care and Star K for deceptive advertising.

The factors to be considered are as follows:

(1) Availability of consent decree remedy

(2) Cost of consent decree

(3) Cost of private suits/settlement

(4) Cost of government suit/attorneys fees

(5) Business reputation/publicity

In this analysis, each factor is weighed on a 1-20 basis and application to Case Study 3 would be as follows:

(1) Government agencies involved in any of the areas listed (SEC, FTC, Justice Dept., FCC) have all developed consent decree procedures. The effect of entering into a consent decree is to dispose of the government citation without any admission of guilt on the part of the business. If the agency is offering such a remedy, a one is assigned since further pursuit would not be as efficient as a consent decree.

(2) However, factor 2 forces the manager to weigh the cost of the consent decree. Part of the willingness of an agency to settle through the decree stems from the fact that the company will be required to pay restitution to those who have purchased products, sold stock or been harmed by manipulative business conduct. Further, the agency may require the company to halt certain procedures or change methods of operations or advertising.

Since the agencies are concerned with protection, the costs in the decree will be substantial and a factor of between 10 and 20 should be assigned depending upon the terms of the decree.

(3) In relation to Factor #2, the company must also consider the costs of private suits if the decree is not signed. Suits could be brought individually against the company and the suit analysis employed earlier (torts) would be used. The costs will be more, even if settled, than those costs of a consent decree and a number between 1 and 10 should be assigned -again dependent upon consent decree terms.

(4) If the decree is not signed, then the government will file suit. Since government attorneys are salaried, the pursuit of the matter will not be as costly as the cost of hourly fees to the private business. Further, the documentary evidence in such cases is substantial and there will be significant business time cost in producing such evidence. Again, depending upon the cost, a factor between 1 and 10 should be assigned.

(5) If litigation is pursued, the publicity will be detrimental. The case study used is patterned after a 1976 FTC case in which the citation, negotiation and consent decree were publicized in nearly every news source from the Wall Street Journal to Time. Such adverse publicity is costly to the business and should be rated between 1 and 5. made.

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In this case, the litigation success rate could be between 14 and 46% depending upon the terms of the consent decree.

CONCLUSIONS

Although it is true that many managers will still base the litigation decision on intuitive feelings, these models are designed to force managers and students to list and quantify all factors. Indeed, each business may vary the factors and their weight but the models enable the decision maker to employ a method of analysis which holds far more hope for correct outcome than a guess as to who will win.