

VALUATION OF LITIGATION

Ross Spence

**TABLE OF CONTENTS**

A. Introduction . . . . . H-1

B. Estate Taxes . . . . . H-1

C. Valuation Of A Business . . . . . H-2

D. Difficulties In Valuing Litigation . . . . . H-5

E. Valuation Of Personal Injury Cases . . . . . H-6

F. Business And Contract Litigation . . . . . H-7

G. The Decision Tree Analysis . . . . . H-7

H. Conclusion . . . . . H-13

## VALUATION OF LITIGATION

### A. Introduction

Placing a value on litigation is a difficult but useful exercise. The valuation process is difficult because there is generally no marketplace where legal causes of action or defenses to causes of action are bought and sold. The difficult work of placing a value on a lawsuit is useful, however, because it gives the client and the litigation attorney a reference point for making crucial decisions. This paper discusses various ways to place a value on a client's position in a lawsuit. The "decision tree" analytical tool will be discussed in some detail.

### B. Estate Taxes

Estate tax laws require that a value be placed on every asset, including every legal cause of action, owned by a decedent at the time of his death. The "fair market value" of the lawsuit, or even the not yet filed chose in action, is defined as "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell." *Bank Of California v. Commissioner*, 133 F.2d 428, 433 (9th Cir. 1943). The fact that a claim would be impossible, or even illegal, to sell in the real world makes no difference. It is still required to be included in the gross estate for tax purposes. *Estate of Baldwin*, TCM 1961-89. The IRS and the courts are required to assume the existence of a willing buyer and a willing seller, and to assume that the property could and would change hands, even though such a change could not, in fact, occur. *Id.*

The mere assumption of the existence of a hypothetical marketplace for lawsuits, in and of itself, does very little to help the preparer of an estate tax return or the Tax Court assess the "fair market value" of a lawsuit. Nor is it helpful to say "the finder of fact simply is obliged to do the best he can with the evidence available and arrive at a valuation as fair as possible." *Id.* In some of the cases, the tax courts just seemed to pull a number out of the air. See *e.g.*, *Estate of Baldwin*, TCM 1961-89; *Estate of Houston*, TCM 192-362.

Interestingly, the value actually received upon the settlement or conclusion of a piece of litigation after date of death is not determinative of the value of that litigation on the date of death. *United States v. Simmons*, 346 F.2d 213, 216 (5th Cir. 1965). The valuation must be based on the facts that are reasonably

foreseeable at the date of death, not on the amount of the judgment subsequently received. *Estate of Davis*, TCM 1993-155.

In *Estate of Davis*, the Tax Court noted that "the valuation process for lawsuits does not appear to be as objectively achievable as other types of assets." TCM 1993-155. The court went on to rely heavily on opinion testimony given by the taxpayer's lawyer, expressly approving of his methodology. The lawyer's method was to begin with the amount of the claim as if there were no contest and then discount it for: (1) costs of litigation, (2) hazards of litigation, and (3) time delay in receiving funds. The court discounted the plaintiff's ability to recover compensatory damages by only five percent but discounted the ability to recover punitive damages by a significant percentage.

### **C. Valuation Of A Business**

There are a number of situations in which analysis of the value of a business is required, such as in a buy-sell agreement, the preparation of a balance sheet, preparation of a prospectus, and selling shares in a closely-held business.

It is not uncommon for a business to have one or more litigation matters pending at the time of a valuation of the company. Thus, one would think it is a common occurrence for accountants, management and lawyers to place values on litigation.

Standards for reporting on litigation, claims that have been asserted but not filed, and unasserted claims in the audited financial statements of a company are set forth in *Statement of Financial Accounting Standards No. 5*, titled *Accounting for Contingencies*. Under FAS 5, loss contingencies must be reported when: (1) unfavorable outcome is, "probable" (2) an unfavorable outcome is, "remote" or (3) an unfavorable outcome is "reasonably possible." FAS 5 contemplates that the lawyer handling the matter will be asked to give his opinion on this subject. The commentary to FAS 5 states:

If the lawyer cannot advise that an unfavorable outcome is "probable" or "remote," he should state that he is unable to form such a judgment. Because of possible prejudice to the client, in terms of admission or waiver of privilege, the lawyer should not advise that an unfavorable outcome is "reasonably possible."

The American Bar Association has issued a Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The ABA states:

In view of the inherent uncertainties, the lawyer should normally refrain from expressing judgments as to the outcome except in those relatively few clear cases where it appears to the lawyer that an unfavorable outcome is either "probable" or "remote;" for purposes of any such judgment it is appropriate to use the following meanings:

(i) *probable*-- an unfavorable outcome for the client is probable if the prospects of the claimant not succeeding are judged to be extremely doubtful and the prospects for success by the client in its defense are judged to be slight.

(ii) *remote*--an unfavorable outcome is remote if the prospects for the client not succeeding in its defense are judged to be extremely doubtful and the prospects of success by the claimant are judged to be slight.

As one can see, it is only in extremely rare cases that, for purposes of an audit, a lawyer will render an opinion to the client that the chances are "probable" or "remote" that the client will lose. The ABA confirms that "in most situations, an unfavorable outcome will be neither "probable" nor "remote" as defined in the Statement of Policy" and "the amount or range of potential loss will normally be as inherently impossible to ascertain, with any degree of certainty, as the outcome of the litigation." As explained by the ABA:

Generally, the outcome of, or the loss which may result from, litigation cannot be assessed in any way that is comparable to a statistically or empirically determined concept of "probability" that may be applicable when determining such matters as reserves for warranty obligations or accounts receivable or loan losses when there is a large number of transactions and a substantial body of known historical experience for the enterprise or comparable enterprises. While lawyers are accustomed to counseling clients during the progress of litigation as to the possible amount required for settlement purposes, the estimated risks of the proceedings at particular times and the possible application or establishment of points of law that may be relevant, such advice to the client is not possible at many stages of the litigation

and may change dramatically depending upon the development of the proceedings. Lawyers do not generally quantify for clients the "odds" in numerical terms; if they do, the quantification is generally only undertaken in an effort to make meaningful, for limited purposes, a whole host of judgmental factors applicable at a particular time, without any intention to depict "probability" in any statistical, scientific or empirically grounded sense. Thus, for example, statements that litigation is being defended vigorously and that the client has meritorious defenses do not, and do not purport to, make a statement about the probability of outcome in any measurable sense. . . .

In light of the foregoing considerations, it must be concluded that, as a general rule, should it not be anticipated that meaningful quantification of "probability" of outcome or amount of damages can be given by lawyers in assessing litigation.

Even if a lawyer goes out on a limb and opines that his client's prospects for successfully defending a case are "extremely doubtful," under FAS 5 a loss contingency will not be accrued in a client's financial statements by a charge to income unless **both** of the following conditions are met:

- (i) information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or liability had been incurred at date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- (ii) the amount of loss can be reasonably estimated.

As stated by the ABA, it is an extremely rare occurrence for both of these standards to be met.

The accountants tend to agree with the ABA. The AICPA's Statement on Accounting Standards No. 12, paragraphs 6 and 14, states:

6. An auditor ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom they

consulted concerning litigation, claims, and assessments....

14. A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation. If the effect of the matter on the financial statements could be material, the auditor ordinarily will conclude that he is unable to express an unqualified opinion.

The result of these pronouncements by lawyers and CPAs is that, in a typical scenario, the outside lawyer states that he is unable to give an opinion as to the probability that a given case will be won or lost or as to the amount of damages that may ultimately be assessed. The company's financial statements then state that the company will vigorously contest the various litigation matters that are pending, the ultimate outcome cannot be ascertained at this time, and results of legal proceedings cannot be predicted with certainty, but it is the opinion of management that the litigation will not have a material adverse effect on the financial condition or the results of operations of the company. None of this is of any real use to the client in trying to place a value on litigation.

#### **D. Difficulties In Valuing Litigation**

Clients often find it difficult to get their lawyer to place a dollar value on their exposure or expected recovery. There are many reasons for this. A lawyer's knowledge of and conclusions about a case evolve over time as more facts are learned, as claims and defenses are added to the pleadings, and as various pretrial matters are completed by the lawyers and decided by the court. Lawyers are understandably reluctant to place a dollar value on a case after the initial client interview because it is a rare case

that can be fully evaluated that quickly and with no discovery. The lawyer may continue to be reluctant later on, however, because once a dollar figure has been discussed, the client develops expectations and the lawyer is forced to articulate all of his thought processes if his opinion of the case changes. Also, it is considered to be an ethical violation for a lawyer to guarantee a result in a case. While it is very unlikely that a lawyer would guarantee a result, a client may come to expect certain results based on opinions given by the lawyer and may construe the lawyer's opinions as guarantees.

In addition to lawyer reluctance, valuation is difficult due to a host of factors out of the lawyer's control. Trial court rulings on motions prior to trial can have serious consequences at trial. Rulings made during trial on evidence and on the questions to be presented to the jury can be outcome determinative. Witnesses may not be able to give live testimony at trial, or may not be able to appear at all. Witnesses may make mistakes or forget crucial facts on the stand. The pertinent law may change or be developed further during the pendency of a particular lawsuit. A client may not have the resources to properly defend or prosecute a case. Jurors may be biased or prejudiced. Jurors may make mistakes about crucial facts in the case or may be confused by the court's charge.

The foregoing are just problems associated with trial of the case. There are, of course, other hurdles and difficulties. The risk of collection is always an issue. Will the debtor transfer his assets to a new entity? Will he file for bankruptcy protection? To these risks must be added the risk of losing all or a portion of the judgment on appeal.

#### **E. Valuation Of Personal Injury Cases**

Personal injury cases are notoriously difficult to value because damages for pain and suffering, mental anguish, disfigurement, loss of consortium and the like are not subject to precise quantification by anyone. The jury is free to rely on "its good sense and common knowledge" to determine a fair and just compensation for the plaintiff. *Lee v. Andrews*, 545 S.W.2d 238 (Tex.Civ.App.--Amarillo 1976, writ dismissed). Lawyers are understandably reluctant to express any opinion as to the monetary outcome of many of these cases. On the other hand, certain personal injury lawyers have seen enough of these cases that they have developed a good feel for where a jury could end up and whether a pending settlement offer is reasonable or not.

## **F. Business And Contract Litigation**

Lawsuits concerning contracts, real property and commercial dealings are more amenable to a valuation analysis than many personal injury cases. This is because most of such business litigation concerns fixed sums of money ascertainable from a contract, invoices, or valuation of some assets. Even business torts are usually subject to valuation, such as a valuation of the benefit of a lost contract in a tortious interference with contract case.

Where there is some quantifiable amount of money that is being sued for, one might think the valuation process can be as simple as the methodology approved in *Estate of Davis*. One begins with the amount of the claim as if there were no contest and then discounts it for: (1) cost of litigation, (2) hazards of litigation, and (3) timely delay in receiving funds. Determining the cost of litigation can be difficult not only because it is very difficult to predict all of the work that will be necessary to prosecute or defend a case, but also because many attorneys are reluctant to establish a budget in case. Nevertheless, there are techniques available to assist the attorney and client in establishing a realistic, though not binding, budget for a case. Estimating the time delay of litigation is also fraught with uncertainty, but most legal practitioners have a pretty good feel for the likely duration of a case. Discounting for the hazards of litigation can be an extremely difficult task and is one that many attorneys do not want to undertake. The *Estate of Davis* case gives no guidance as to how one would determine a discount for the hazards of litigation. What is needed is a methodical approach to placing a value and probability on each major event that can occur in a lawsuit.

## **G. The Decision Tree Analysis**

There are a number of methodologies for probability analysis and statistical analysis, but the "decision tree" methodology may be the most useful for placing value on a lawsuit. A decision tree begins at point in time and proceeds into the future until an event or decision, or multiple events or decisions can occur or must be made. At each of the event or decision points, probabilities are assessed for the likelihood of the event and then a value is placed on the final outcome of the case if that event or decision occurs. An overall valuation of a case is made by multiplying the probability of each event or decision by the value of the event or decision and then summing each of these totals. If an event is dependent on prior events which themselves are uncertain, then the likelihood of the final event is determined by multiplying the

percentage probabilities for all the events preceding it on its branch of the decision tree. The sum of all the conditional probabilities for all the branches must equal 100 percent.

The values and probabilities associated with events in litigation should be assessed by the litigator handling the litigation if at all possible. The decision tree format will be foreign to most litigators, so the client or the client's accountant may need to meet with the lawyer, sketch out a preliminary decision tree, and refine it by getting the lawyer to comment on and handicap each significant branch on the tree.

A picture is worth a thousand words. On the next few pages are examples of decision tree analyses in several actual cases.

## DRILLING CASE

(1) Liability	(2) Damages Amount (with Accrued Interest and Attorneys Fees)	(3) Exemplary Damages	(4) Monetary Outcome	(5) Conditional Probability	(6) Valuation (4) x (5)	Possibility of Overturning Adverse Judgment on Appeal	Value
YES 45%	HIGH (2,900,000) 10%	YES (1,000,000) 15%	3,900,000	0.675%	26,325.00		
		NO 85%	2,900,000	3.825%	110,925.00		
	MEDIUM (1,500,000) 70%	YES (500,000) 10%	2,000,000	3.15%	63,000.00		
		NO 90%	1,500,000	28.35%	425,250.00		
	LOW (500,000) 20%	YES (250,000) 5%	750,000	0.45%	3,375.00		
		NO 95%	500,000	8.55%	42,750.00		
NO 55%			0	55.00% 100 %	0.00 \$671,625.00	25%	503,718.75

## CONTRACT CASE WITH COUNTERCLAIM

Existence of Contract	Breach by Defendant	Breach by Plaintiff	Damages (With Accrued Interest and Attorneys Fees)	Probability	Value
YES	YES		High (470,000) 25%	15.75%	74,025.00
70%	90%		Medium (385,000) 50%	31.50%	121,275.00
	NO		Low (100,000) 25%	15.75%	15,750.00
			PLUS 30% =	<u>7.00%</u>	0.00
	10%			100.00%	
			High (100,000) 10%	1.40%	- 1,400.00
		YES	Medium (50,000) 30%	4.20%	- 2,100.00
	20%		Low (10,000) 60%	8.40%	- 840.00
		NO		<u>56.00%</u>	<u>0.00</u>
		80%	PLUS 30%=	100.00%	
NO					
30%					\$ 206,710.00

## FRAUDULENT TRANSFER CASE

(1) <u>Liability</u>	(2) Damages Amount (Plus Attorneys Fees and Accrued Interest)	(3) <u>Exemplary Damages</u>	(4) <u>Monetary Outcome</u>	(5) <u>Probability</u>	(6) Value <u>(4) x (5)</u>
YES 90%	HIGH (1,270,000) 60%	YES (100,000) 40%	1,370,000	21.60%	295,920.00
	NO 60%	YES (50,000) 30%	1,270,000	32.40%	411,480.00
	MEDIUM (850,000) 30%	NO 70%	900,000	8.10%	72,900.00
NO 10%	LOW (425,000) 10%	YES (25,000) 20%	850,000	18.90%	160,650.00
		NO 80%	450,000	1.80%	8,100.00
			425,000	7.25%	30,600.00
			0	10.00%	0.00
				100 %	\$979,650.00

**FRAUDULENT TRANSFER CASE Cont.d**

(6) Value <u>(4) x (5)</u>	(7) Joint and Several Liability	(8) Collectibility	(9) Collectible Value
	D1 only	D1 only	19,593.00
	40%	5%	
	D1 + D2	D1 + D2	58,779.00
	30%	20%	
\$979,650.00	D1 + D2 + D3	D1 + D2 + D3	58,779.00
	20%	30%	
	D1 + D2 + D3 + D4	D1 + D2 + D3 + D4	44,084.25
	10%	45%	181,235.25

## H. Conclusion

A decision tree analysis of a lawsuit has a number of benefits. It forces the litigator to think through all of the possible outcomes of the lawsuit and to place a value and probability on each. This thought process should greatly improve the lawyer's and client's ability to place a budget on the case. It also allows the lawyer and client to discuss candidly the costs versus benefits of various strategies in the litigation. Likewise, it provides a starting point for discussions of changes in strategy during the course of a case. Perhaps most importantly, it gives the client a sense of the value of a case. This enables the client to make sound business decisions about settlement offers to make or accept, and the amount of resources to invest in a case. In litigation with the IRS concerning estate taxes or business valuation issues, the decision tree goes well beyond the methodology set forth in *Estate of Davis* and should provide a strong defense to a contrary valuation by the IRS. The few hours spent preparing the decision tree should more than pay for themselves during the course of the litigation.