Judicial Independence – Professional Service Providers

Fortune 500: The Total Cost Of Litigation Estimated At One-Third Profits

John B. Henry

ELAWFORUM

Editor's Note: *This article sets forth findings based on litigation data compiled by eLawForum over the last eight years. The high cost of litigation and small percentage of cases that actually go to trial is to some degree attributable to litigation delays and uncertainties resulting from under-funded court systems and the failure of some states to consider merit in the selection of judges.*

No one knows exactly what the *Fortune* 500 spend on litigation. Being privy to information from a significant number of *Fortune* 500 corporations in a wide range of businesses, eLawForum estimates the total cost of litigation to be $210 billion, equivalent to one-third of the after-tax profit of the *Fortune* 500, dwarfing CEO compensation. *(See Chart A.)*

Traditional cost accounting hides the full cost of litigation. Defense cost is expensed annually by the law department, while liability cost is expensed in the business unit at the time a payment is made to a plaintiff. The only way to know the cost of a case is to add years of accumulated defense cost to the payout. Corporations need to adjust their accounting systems to capture the total cost of litigation.

Since its founding in 2000, eLawForum has systematically compiled litigation data on the top twenty practice areas of its *Fortune* 500 clients – the defense cost and the liability cost for more than 20,000 cases. eLawForum has unique and valuable insight into the nature of litigation in the largest corporations across a wide range of different industries.

Fortune 500 corporations spend an average of three years to resolve litigation. This is true across practice areas. In general, *Fortune* 500 corporations employ a delayed resolution business model for litigation. *(See Chart B.)*

Fortune 500 corporations *increase* total cost by delaying case resolution. They prepare each case as if it were going to trial, but end up settling to avoid trial, only trying 3% of cases. *(See Chart C.)*

Chart A: Comparison to *Fortune* 500 Profit (2006) *(in billions)*

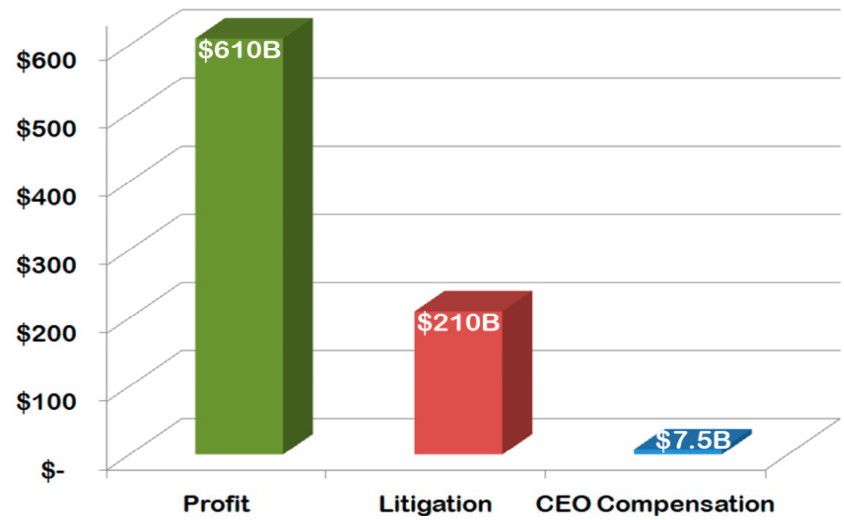


Chart B: Case Life

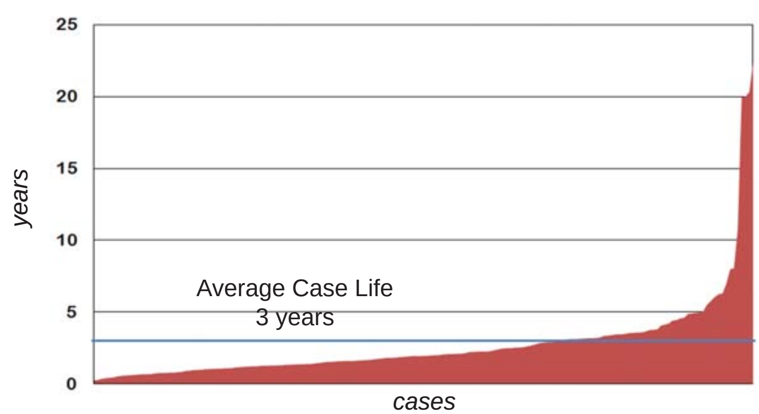
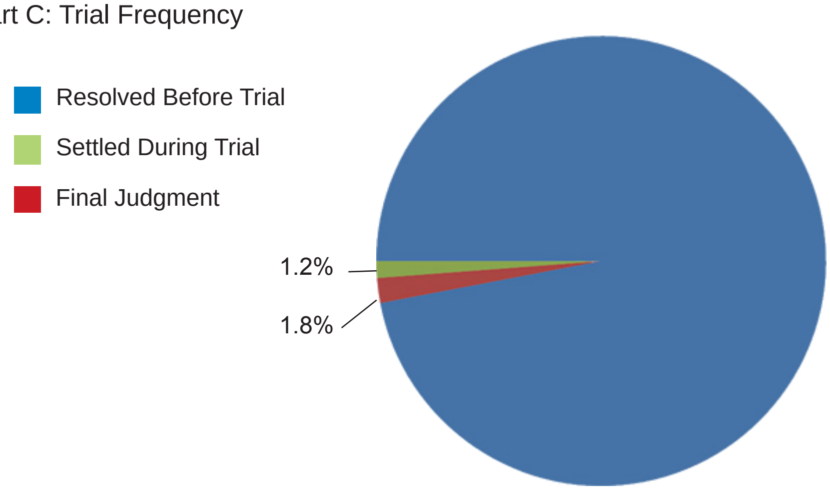


Chart C: Trial Frequency



Incentives drive delayed resolution. Paying outside counsel by the hour encourages more hours. Engaging in exhaustive discovery and aggressive motion practice increases the time it takes to resolve the litigation. Longer cases mean more hours.

Annual law department budgets encourage delay. Delaying resolution spreads defense costs into next year's budget. A case with a defense cost of $75,000 per year for three years actually looks better than a case resolved in one year with a $100,000 defense cost. Short-term focus results in the corporation paying higher total cost.

Delayed resolution leads to inconsistent positions over the life of a case – tough upfront, but paying up in the end. Disputes with legitimate value are treated the same as disputes with little or no merit. As trial approaches, disputes with legitimate value are settled at a premium.

This behavior teaches the plaintiffs' bar that holding out increases the settlement. If priced realistically, many of these disputes could be resolved early, and more amicably, at a discount. A combative approach may alienate key constituencies: employees, customers, suppliers, government agencies, shareholders, local community, etc.

Negotiating discounts on hourly rates with outside counsel encourages still more hours, and does not translate into real savings. Negotiating fixed fees for individual cases can also be problematic: The law firm usually either receives a windfall or renegotiates to avoid a loss.

No Benchmarks

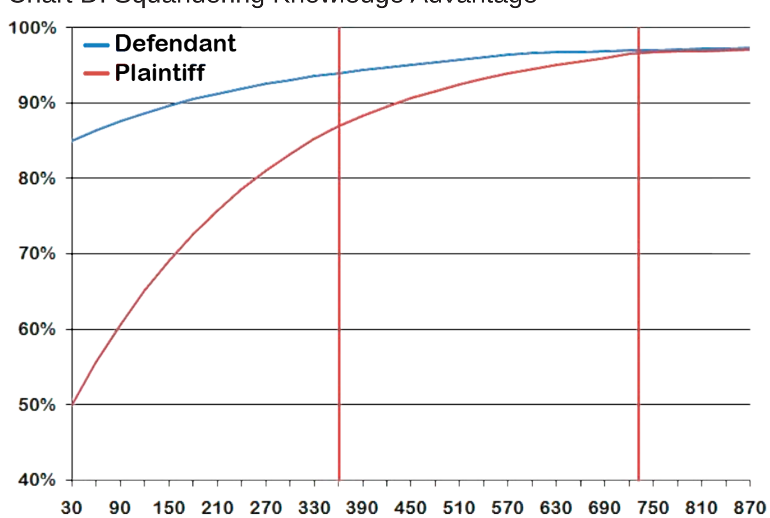
Because law department budgets do not take into account liability cost, corporations have no benchmark to judge overall effectiveness. Neither outside counsel nor law department compensation can be tied to results. No one is rewarded for recommending a reasonable early settlement. Liability cost seldom becomes important until the eve of trial. Then pressure mounts to pay a premium in order to avoid blame for an adverse judgment.

Delayed resolution not only increases defense cost but leads to higher liability cost. Longer case life means more discovery. More discovery squanders corporate defendants' knowledge advantage. As defendant, corporations should know most of the pertinent facts within thirty days. At the outset of the case, the plaintiff is at a disadvantage, usually only knowing about half of what it will learn from discovery. In effect, corporate defendants prepare plaintiffs' lawyers for trial. After spending three years on average telling the plaintiff about the case – when the plaintiff finally knows everything the corporation knows – the corporation settles. *(See Chart D.)*

Another reason delayed resolution leads to higher cost is that the longer a case goes unresolved, the higher the cost to the plaintiff's lawyer. When the corporation settles, the cost of the plaintiff's lawyer is covered in the settlement. eLawForum's database shows that different practice areas have very different ratios of liability to defense cost. In employment and asbestos litigation, the ratio is approximately one-to-one. In commercial and environmental litigation, the ratio is three-to-one. In personal injury and product liability, four-to-one, and in medical malpractice as much as eight-to-one. For intellectual property, the ratio can be ten-to-one or more. When the cost of the plaintiff's lawyer's contingency fee and expenses are added to the corporation's defense cost, lawyers usually receive more than half the money. The transaction costs of resolving a case exceed its value.

John B. Henry *is President of eLawForum. Further information about eLawForum can be found at www.elawforum.com.*

Chart D: Squandering Knowledge Advantage



Please email the author at jhenry@elawforum.com with questions about this article.