Advocate's Edge

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The value of time

Discounting future damages to today's dollars

Plaintiffs often seek damages for future losses — such as lost profits — expected to flow from a defendant's alleged wrongdoing. Because a dollar today is worth more than a dollar tomorrow, however, future damages must be discounted to their present value.

In other words, what amount of damages, invested today at an assumed rate of return, would produce an amount equal to the future loss? Typically, future damages are discounted further to reflect business risk — that is, uncertainty over whether claimed lost profits would actually have been earned.

Selecting an appropriate discount rate involves an element of subjective judgment, which can lead to dramatically different damage calculations depending on the discount rates experts use. Nevertheless, the courts have provided slim guidance on the issue. An understanding of the basics of discounting will help you build a strong case in support of your damage positions.

The discount rate

The discount rate is the most critical component of the discounting formula. The rate is used to calculate a discount factor, which is multiplied by the projected loss to arrive at present value. The discount rate itself generally includes two components: 1) an assumed rate of return that recognizes the time value of money, and 2) a risk factor that recognizes the uncertainty of achieving profit expectations.

An expert might apply a lower discount rate, for example, if damages are based on profits that are less risky than the plaintiff's normally anticipated profits. A higher discount rate might be appropriate if damages represent profits that carry a higher-than-normal risk.

Reconciling discount rates

Some experts advocate minimizing the difference between opposing parties' discount rates by modeling future damages. Modeling takes into account the variables that can affect future income. An expert projects the plaintiff's desired income stream and modifies it to a reasonable expectation by factoring in future risks. The adjusted future loss is then discounted to present value at a relatively low, risk-reduced discount rate. Modeling differs from those approaches where experts project the intended income stream and then apply a higher discount rate to reflect risk.

The key to modeling is to identify the risks that might cause the plaintiff to achieve less-than-desired results and adjust lost profits accordingly. The goal is to generate a stream of undiscounted lost profits that reasonably approximates the most likely outcome but for the alleged wrongdoing. Once this is accomplished, the present value can be determined using a risk-abated discount rate.

Under the traditional approach, an expert starts with a risk-free interest rate and develops a discount rate that takes into account subjective risks — such as those related to the market, finances, management, products, company sales, and business environment — and systematic risks such as general equity risk. The modeling method minimizes the need for modifications to the discount rate.

Selecting a rate

Financial experts use several methods to determine an appropriate discount rate:

Safe rate. Also known as the Treasury rate method, this approach may be suitable for well-established businesses with relatively stable and predictable profits. The expert examines trends specific to the business to project lost profits for the relevant time period and assign a comparable rate — usually based on a T-bill rate.

Buildup. The buildup method is frequently invoked for newer businesses with inadequate earnings histories. Losses are typically projected based on

industry trends, but a higher discount rate is used to reflect increased risk. An expert using the buildup method may start with the Treasury rate and adjust it based on industry- and company-specific risks.

The Capital Asset Pricing Model (CAPM), cited in the Federal Judicial Center's (FJC's) *Reference Guide on Damages*, is one example of a buildup method. Under CAPM, the expert calculates a risk-adjusted discount rate based on factors including the historical average risk premium for the stock market.

Rate of return. This approach relies on pertinent industry statistics to obtain an average rate of return (ROR) for a business in the industry. The ROR becomes the discount rate.

Capitalization factor. The FJC reference guide defines a capitalization factor as "the ratio of the value of a future stream of income to the current amount of the stream," usually derived from market values of comparable companies. To determine the discounted value, the current annual loss in operating profit is multiplied by the capitalization factor.

Using multiple rates

In some cases, it may be appropriate to use multiple discount rates rather than one, constant rate. Some experts use different rates, for example, to account for potential increases in risk due to anticipated market changes.

Others note that T-bills carry different rates depending on their maturity dates. Thus, they assert, a different rate should be used for each year in a forecast, with the first year's income discounted with the rate on a one-year T-bill, the fifth year's income discounted at the rate paid on a five-year T-bill, and so on.

Know your case

Ultimately, the right discount rate hinges on a specific case's facts and a thorough analysis of the risks associated with future losses. Keep in mind that a defendant who fails to challenge a plaintiff's claim for undiscounted future damages might waive the argument altogether. ✧

Carefully drafted settlement can minimize bankruptcy risks

The peace of mind that comes with settlement can quickly be extinguished if the defendant files for bankruptcy, even if full payment has already been received. The plaintiff may not receive any or all of the settlement — or may have to pay back all or a portion of it, at least temporarily.

To avoid this result, attorneys should take bankruptcy laws into account when drafting settlement agreements. A preemptive agreement should address collectibility and preference exposure, as well as preservation and dischargeability of the original claim.

Protecting collectibility

Collectibility is a risk with all settlements, especially structured settlements. After all, defendants that push for extended payments may already be in a shaky financial position. One way to reduce the risk is to take a security interest in collateral sufficient to compensate the plaintiff for any future nonpayments. Of course, a security interest may still fall prey to a preference challenge in bankruptcy. Another option is to take an assignment of the defendant's accounts receivable.

If the plaintiff seeks a structured settlement — to ensure a regular income stream, for example — it might ask the defendant to purchase an annuity to secure its future payment obligations.

Even when a defendant has fulfilled its obligations under a single-payment settlement, the plaintiff can face difficulties under Section 547 of the Bankruptcy Code. This section requires creditors to pay the bankruptcy estate an amount equal to payments received in the 90 days prior to the bankruptcy filing. These payments generally are treated as voidable preferences — that is, transfers of a debtor's property to a creditor in satisfaction of a pre-existing debt at a time when the debtor is insolvent. So plaintiffs should take payment as early as possible to start the 90-day clock running.

Preserving the original claim

A plaintiff that releases the defendant from all claims and dismisses the suit with prejudice is in for a rude awakening if the defendant later files for bankruptcy. If the plaintiff pursues its claim in bankruptcy, the claim will be valued at the settlement amount, not the original claim amount. At pennies on the dollar, any actual recovery will represent only a sliver of the original claim.

To protect itself, a plaintiff should incorporate a claim preservation clause in the settlement agreement. Under a preservation clause, a plaintiff is not required to dismiss its claim until the bankruptcy court rules that the settlement is not a voidable preference. If the court finds that the settlement payment is a preference, the original claim is reinstated in full. The clause deters the bankruptcy trustee from bringing a preference action against the plaintiff because it may reduce the net recovery available to other creditors.

Another option is to persuade the defendant to stipulate to the entry of judgment or sign a confession of judgment for the full amount of the original claim. The plaintiff agrees not to execute for 90 days and to file a satisfaction of judgment at that time, provided the defendant hasn't filed for bankruptcy. If the defendant does file, the plaintiff can assert the full claim, supported by the judgment, in bankruptcy.

At the very least, a settlement agreement should provide that the original claim is preserved if the plaintiff fails to receive and retain the full amount of cash consideration that it bargained for.

Building a case for nondischargeability

Smart settlement agreements also address the dischargeability of debts in bankruptcy. Absent an explicit reservation of the right to object to discharge, the plaintiff may inadvertently waive that right. Plus, the right to assert nondischargeability may be lost if the settlement agreement is viewed as a novation that creates a new obligation.

To protect itself, a plaintiff should incorporate a claim preservation clause in the settlement agreement.

The agreement should state the grounds for the payment and make clear that the debt is not dischargeable, tracking the language of the applicable bankruptcy law exception. It should preserve the right to assert nondischargeability and state that it does not create a new obligation.

Countering the defendant's claims

In addition to the protections discussed above, a settlement agreement should include a waiver of all potential claims against the plaintiff. Favorable settlements can blow up if a defendant claims the plaintiff violated the Fair Debt Collection Practices Act, the Truth in Lending Act or other laws related to creditor practices. ✧

Law firm's contingency fees were marital property

In a recent case, *Stageberg v. Stageberg*, a Minnesota appellate court found that unpaid contingency fees earned by a husband's personal injury law practice were marital property. But the court rejected the historical average income approach used to value the fees.

Marital status

The husband argued that the contingency fees did not qualify as marital property, because 1) they were merely an expectation interest, not an enforceable contractual right; 2) they represented future income; and 3) they were too remote, speculative and uncertain.

The court disagreed, analogizing the husband's work-in-progress to pensions and incentive stock options, which are enforceable contractual rights. The court observed that Minnesota and several other states grant attorneys a compensation lien on any money involved once a legal proceeding starts.

As to the future income argument, the court held that treating contingency fees as income was inconsistent with state authority on the characterization of contract rights. What's more, such treatment would preclude the wife from receiving a portion of the fees as part of the property division.

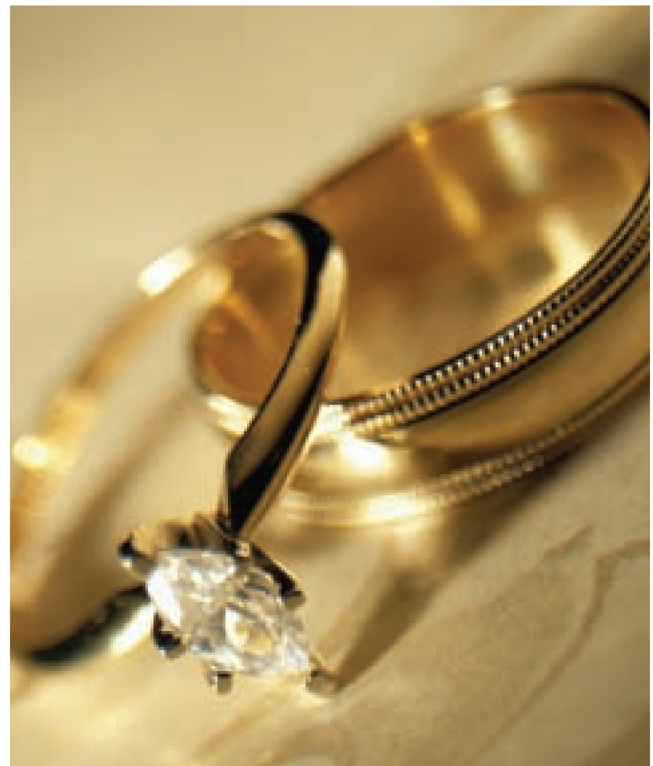
The court conceded that the husband's third argument found support in a minority of jurisdictions, but concluded that the fees' contingent nature was more appropriately addressed in a valuation context.

Valuing judgments

The trial court valued the fees using the historical average income approach, treating all of the cases-in-progress as a single asset and assuming a 40% tax rate. The court calculated the husband's average annual net profit over the previous five years and reduced it by 50% to reflect the average declining percentage of marital effort in cases concluded during the course of a year. It awarded the wife half of the remaining after-tax marital share.

The appellate court rejected this approach on three grounds:

1. The trial court failed to provide any authority for its method,
2. By using the annual income figure and applying the formula to only one year of the husband's practice, the trial court assumed that all of his contingency fee cases-in-progress on the valuation date would be resolved within one year, which the appellate court found unsupported either by evidence or general experience, and
3. The trial court's approach overstated the wife's interest in fees not yet received because it failed to reduce her interest to present value.



The appellate court reversed and remanded the case to the trial court for revaluation of the fees. It advised the trial court either to value the marital interest in a legally supportable manner or retain jurisdiction and divide the marital interest in the fees as they are received.

Guidance but no real answers

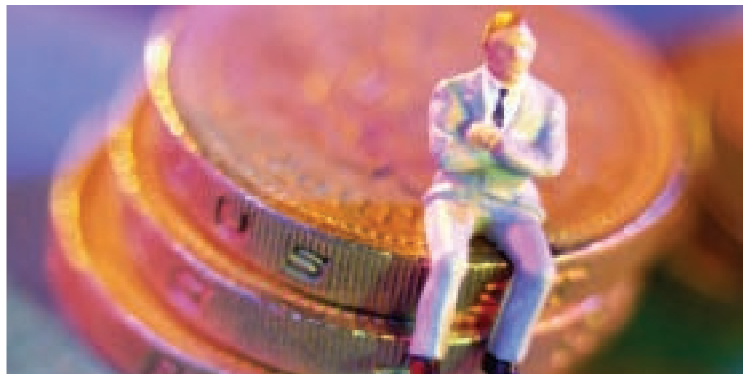
Although it clarifies the inclusion of contingency fees in marital property under Minnesota law, *Stageberg* leaves some thorny questions unanswered. By retaining jurisdiction over the fees and dividing the marital interest as they are paid, a court could stretch out the case for an uncertain length of time and potentially generate additional litigation.

On the other hand, valuing future contingency fees could prove tricky, as well, and would depend on difficult estimates of the value of pending cases. And how does a valuator determine the marital and nonmarital portions of future recoveries? Perhaps future decisions will provide guidance. ✧

You make *how* much?

Evaluating owner compensation

One of the perks of owning a closely held business is controlling the purse strings when it comes to compensation. An owner might take an artificially large salary to reap tax benefits or a smaller salary to enhance the company's earnings. But when a business is valued — for sale, divorce or other purposes — owner compensation is likely to come under the microscope. Generally, valuators consider only "reasonable compensation" — that is, the amount the business would need to pay a nonowner to provide comparable services.



Compensation factors

Valuators examine a variety of factors in determining reasonable compensation for a particular owner, including:

Role/job description. Valuators look beyond the owner's title to the actual roles he or she fulfills. If the owner of a small business truly functions as CEO, CFO, COO and salesperson, the compensation should reflect all of those roles. On the other hand, if the owner is CEO in name only, and an employee handles most of the related duties, the compensation will be downgraded.

Valuators also determine the qualifications necessary to perform the owner's job. What training, education, licensing and experience are truly required? A master of fine arts degree may be impressive, but it likely isn't relevant to compensation in a business outside the art world.

External comparables. Valuators may also use compensation surveys to compare an owner's compensation to that of similarly situated employees at similar companies. Sources of compensation data have proliferated in recent years and include the Bureau of Labor Statistics, the Economic Research Institute, numerous Web sites and corporate recruiters. When using compensation surveys, it's critical to understand the structure of the compensation under comparison to ensure you're comparing apples to apples. For instance, does it include benefits? Stock options? Taxes?

Internal comparables. An owner's compensation can also be compared to compensation of nonowner employees within the business. If the company consistently pays above-market rates for other employees, an above-market rate for the owner becomes more acceptable. Ideally, the business will employ a rational and consistently applied compensation formula for every position.

Company characteristics. A business's size, industry, competitive position, financial standing and history all affect the reasonableness of compensation. Companies that boast high sales numbers generally can afford (and justify) high compensation, but size isn't necessarily determinative. Companies with larger market share often pay well to prevent employees from jumping ship, but smaller companies may also pay handsomely to poach those same employees.

Industry characteristics. Reasonable compensation for an owner may further depend on the industry's economic conditions and cycle, as well as the availability of comparable employees.

Location. A technology company in Silicon Valley will have greater access to comparable employees than a similar company in Montana. Cost of living also plays a role: An owner in New York City requires more compensation than an owner in Topeka to maintain a similar lifestyle.

To each, its own

Every business is different, and the decisive factor that drives the reasonableness of owner compensation may be one not listed above. Evaluating owner compensation requires a fact-intensive inquiry and an open mind. ✧

Working together to dissolve a marriage

The stress, time and costs involved in protracted divorce litigation are increasingly leading couples to turn to a new approach known as collaborative process. Collaborative process lets spouses stay in control and resolve their disputes without going to court.

The benefits

Instead of fueling contention, collaborative process encourages everyone involved to work together, share information and solve problems. The parties communicate in a safe environment, assisted by counsel and financial experts in weighing all settlement options.

Unlike mediation, power imbalances melt away and the parties don't take adversarial stances. In contrast to litigation, collaborative process costs much less. The lawyers don't need to make court appearances or conduct endless rounds of discovery, and the parties jointly hire neutral experts.

The collaborative process benefits lawyers as well. It allows the lawyers, rather than a judge, to control the outcome. Plus, because lawyers focus on problem-solving rather than "winning," the process can be more satisfying and less stressful than litigation. The lawyers still owe their primary allegiance to their individual clients, but the collaborative process allows them to work together to do what's best for the family as a whole.

The role of the financial expert

Aside from the attorneys, the financial expert may prove the most indispensable member of the collaborative team. Initially, he or she oversees the gathering of relevant financial information. The expert reviews all assets, liabilities, income and expenses, including stock options, bonuses, insurance, retirement plans and other benefits. From this information and meetings with the spouses, the expert develops tax and financial planning options.

The financial expert educates both parties so that each possesses a complete understanding of their current financial condition and the short- and long-term consequences of their options. Financial experts also can work with the spouses to develop their own financial plans based on the assets or support they will receive.

Proven savings

According to the Collaborative Law Institute of Texas, a collaborative divorce takes an average of 18 weeks and $9,000, vs. 18 months and $14,000 to pursue litigation. With such significant savings, clients might be willing to drop their court plans.

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