

A/E RISK REVIEW

A PUBLICATION OF THE PROFESSIONAL LIABILITY INSURANCE NETWORK



FINANCE INSURANCE, LTD.
Quality Service For Your Insurance Needs

VOLUME 130, 2014

For More Information Contact:

Karen Hong

Tel: 522-2095

Fax: 522-2082

email: khong@financeinsurance.com

Prevailing Opinions on Prevailing Party Contract Clauses

The following material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with a qualified professional who can provide guidance that considers your own unique circumstances.

A “prevailing party” contract clause is a provision that requires the losing party of a lawsuit, claim or other litigation to pay the legal expenses incurred by the prevailing party, including attorney fees. In the absence of such a contractual stipulation, each party typically bears responsibility for its own legal costs.

Prevailing party clauses can be unilateral (applied to only one party to the contract) or mutual (applied to both parties). A typical mutual prevailing party clause includes language such as:

In the event of any litigation arising from breach of this agreement, or the services provided under this agreement, the prevailing party shall be entitled to recover from the non-prevailing party all reasonable costs incurred including staff time, court costs, attorneys fees, and all other related expenses incurred in such litigation.

Historically, many in the insurance industry and the legal professions recommended that mutual prevailing party clauses be included in design professional contracts. The logic was that such clauses make each party think twice before bringing a frivolous or otherwise questionable claim against the other. The

prospect of paying the defendant’s legal bills in the event the plaintiff does not prevail can be a sizable deterrent to filing a lawsuit.

Prevailing party clauses were especially attractive to design firms who may be forced to sue a client for nonpayment of fees. The prospect of spending thousands of dollars in legal costs in an attempt to collect fees for services without the possibility of recovering those legal costs has caused many firms to throw up their hands, forget about recovering the fees and chalk the loss up to experience. With a prevailing party clause, a design firm is more apt to keep its resolve and fight for the fees for services it deserves.

Why You Should Think Twice

Recently design professionals and their advisors have begun to think twice as to whether prevailing party clauses are, in fact, in their best interest. First, there is the fact that if a court or other trier of fact finds you negligent as alleged, you have to pay the other party’s legal expenses in addition to the damages you caused. Making matters worse, this voluntary contractual assumption of liability for the other party’s legal defense costs may not be covered by your professional liability policy! The money may come right out of your pocket.

Put simply, professional liability insurance covers your legal liability arising out of your negligent acts, errors or omissions. However, it does *not* generally cover contractual assumptions of liability unless you would be legally liable for the negligence, error or omission in absence of the contract clause. Since you would not normally be liable for another party’s legal expenses in absence of a prevailing party contract stipulation, chances are those costs are not covered by your insurance unless specifically stipulated in your policy.

For years, the insurance industry has been divided on its opinion regarding the use of prevailing party clauses. Some companies believe that these clauses effectively discourage frivolous claims. They encourage their usage and, for the most part, will cover prevailing parties' legal costs unless a unique circumstance prohibits it.

A growing number of insurers, however, see the clause as a double-edged sword and hedge their support of usage. They say they have had situations in which a prevailing party clause has been used to an insured's advantage, but warn that it can also result in significant costs should a plaintiff prevail against a design firm. They say a clause may or may not be covered by their professional liability insurance policy, depending on the specific language of the provision and the circumstances of the situation.

Other insurers are clearly against the prevailing party provision. In fact, some take the position that any contractual assumption of another's defense costs will not be covered under their PL insurance policies. While they acknowledge that prevailing party clauses can be a deterrent to a lawsuit, if the insured design firm is in fact the loser in a claim then the defense costs incurred by the plaintiff would be excluded contractual liabilities and uninsured as such. A liability assumed by contract that would not otherwise be a liability, they argue, would not be covered.

Interestingly, attorneys who represent design firms are also split on the value of the prevailing party clause. Attorneys in favor of the clause say they recommend them because they discourage frivolous claims. More specifically, these attorneys say that without a prevailing party clause, a design firm typically cannot afford to pursue fee claims.

Attorneys opposed to the provision state they may be a trap for design professionals, actually encouraging owners to sue if they think they have a strong case. This is particularly true, they say, for large clients who can extend a substantial (and expensive) effort to win their lawsuit. Plus, these attorneys recognize that prevailing party legal expenses are uninsurable under a growing number of professional liability policies. They contend that the "American Rule" is that parties bear their own attorneys' fees in litigation and prevailing party clauses

are far from typical. They argue these clauses can actually promote litigation when the proper thing for the parties to do is to work out their difficulties through alternative dispute resolution such as mediation.

Some attorneys who draft contracts for design professionals say they always discuss the pros and cons of a prevailing party clause. They advise clients that such a clause can deter a plaintiff from filing a claim out of fear of an award of attorneys' fees. They remind their clients, however, that most claims settle before going to court and the settlement rarely includes a recovery for fees and costs.

Who Has Prevailed?

There is another sticking point regarding the use of prevailing party clauses. Specifically, who has prevailed?

Obviously, if a party files a lawsuit and a judge or jury rules completely in their favor, that party has prevailed. Or if a claim is completely dismissed by an arbitrator, the defendant has clearly prevailed. But what if the two parties reach a mediated settlement? If a design firm agrees to contribute to partially rectifying a project error, has the client prevailed? If a design firm succeeds in defending itself from multiple claims but losses on a single issue, has it prevailed? If a firm dismisses its action before reaching a mediator or arbitrator, has the other party prevailed? What if a plaintiff wins its case, but the defendant wins a counterclaim? Clearly, there are numerous instances where identifying who has prevailed will not be a black-and-white affair. Outside of including a lengthy and all-comprehensive definition of "prevailing party" in the contract itself, disputes over who won will only complicate matters.

What to Do

So what should a design firm do if a client presents a contract with a prevailing party clause? If the clause is unilateral in favor of the client, ask that the clause be removed. Explain to the client that the clause is not only unfair since it is being imposed unilaterally, but it is likely uninsurable.

Even if your insurance company agrees to cover a prevailing party clause at the time the contract is entered into, there is no guarantee that clause will be covered at the time a claim is made. Remember: professional liability insurance is a claims-made and reported policy and the insurance policy that is in effect is the insurance in place when the claim is made and reported. At that time, your insurance company may have changed its policy toward prevailing party clauses or you may have a different insurer.

If the client refuses to remove the clause, then, at a minimum, design firms and their lawyers should push hard for a mutual prevailing party clause so that it applies to the client as well as the design firm. After all, if it's fair for the client to ask for such a clause it should be equally fair that the design firm have one. Also, your attorney may want to make sure that the clause specifies "reasonable" legal costs – otherwise, a client could pull out all the stops in mounting an extravagant claim and your design firm could be obligated to foot the entire legal bill. Some attorneys also recommend that the language specify that the clause only applies to "breach of contract" matters, rather than broader language such as matters "arising out of" or "related to" the contract. This will limit the application of the clause.

It's advisable to have your legal counsel check for court cases regarding prevailing party clauses in the jurisdictions that apply to your contracts. Previous rulings will reveal how these clauses have been interpreted and applied, and oftentimes address the definition of "prevailing party" that is applied in that jurisdiction. This information will provide insight as to how hard you should push to remove the clause or how you might want to define prevailing party in your contract.

Should a design firm ever present a prevailing party contract clause to a client? As a general rule, such an action is not recommended unless there are extenuating circumstances that call for one. For example, if a client has a sketchy credit history, a design firm might want to negotiate a limited prevailing party clause in the contract's billing and collection provisions only. Such a clause would be limited to suits for fees, where such a clause makes it financially feasible to attempt to collect unpaid amounts. Such a clause might include language such as:

In the event legal action is required to enforce the payment terms of this agreement, the consultant shall be entitled to collect from the client any judgment or settlement sums due plus reasonable attorneys' fees, court costs and other expenses incurred by the consultant for such collection action.

As a final means of protection, if your client insists on a prevailing party contract clause that presents you with substantial liabilities, we might be able to help you find litigation insurance to cover this risk. Attorney's fees risk insurance may be available via annual policies with standard limits up to \$100,000. Policies are also available for design firms already facing litigation.

Alternative Solutions

The primary purpose of a prevailing party clause is to reduce the number of frivolous claims and protect innocent parties from having to pay huge legal fees to defend themselves. Fortunately, there are two other types of contract clauses that can better achieve these aims:

Certificate of merit clause. This clause requires that before a party to the contract can file a claim against the other party, it must obtain a written certificate from a qualified professional practicing the same discipline as the defendant that such a claim has merit. Note that many states have their own certificate of merit requirements.

ADR provision. This contract clause requires that before a party can file a formal lawsuit against the other, it must first submit to an alternative dispute resolution (ADR) technique such as mediation. An ADR clause can dramatically lower the legal costs incurred by both parties to the claim and, more importantly, help reach an amicable resolution.

The inclusion or exclusion of a prevailing party clause – or any alternative clause intended to achieve similar objectives -- should be discussed thoroughly with your attorney. We welcome the chance to answer any related insurance questions that you might have regarding coverage for this liability.

Can We Be of Assistance?

We may be able to help you by providing referrals to consultants, and by providing guidance relative to insurance issues, and even to certain preventives, from construction observation through the development and application of sound human resources management policies and procedures. Please call on us for assistance. We're a member of the Professional Liability Agents Network (PLAN). We're here to help.