Dealey, Renton & Associates, *Insurance Brokers*

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Prevailing party contract clauses: Yes or No?

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A "prevailing party" contract clause (also commonly called an attorney's fee clause) is a contract provision that requires the loser of a lawsuit or claim to pay the winning party's legal fees. In the absence of such a contractual provision, each party typically bears its own legal costs.

Prevailing party clauses can be unilateral (applied to only one party to the contract) or mutual (applied to both parties). Under California law, a unilateral clause will typically be interpreted to be mutual so a truly unilateral clause is nearly impossible to create in California. 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 and environmental professional contracts. The logic was that such clauses make a client think twice before bringing a frivolous or otherwise questionable claim against a firm. The prospect of paying the defendant's legal bills in the event the plaintiff does not prevail makes a prospective plaintiff reconsider filing a lawsuit.

Prevailing party clauses were especially attractive from a firm's prospective when forced to sue a client for nonpayment of fees. The prospect of spending thousands of dollars in legal fees to collect receivables without the possibility of recovering legal costs 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 it deserves.

Pros and cons

Recently there has been much discussion as to whether or not a prevailing party clause is, in fact, in a professional's best interest. First, there is the fact that if your contract has such a clause and 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

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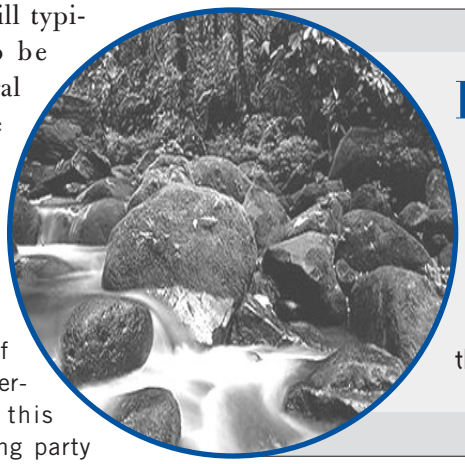

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contractual assumption of liability for the other party's legal defense costs almost certainly will not be covered by your professional liability policy.

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 in absence of the contract clause.

Because of this, the insurance industry remains divided on its opinion regarding the use of prevailing party clauses. Some companies continue to 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. However, these insurers do not necessarily agree to cover such costs should their insured be the non-prevailing party.

Other insurers 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 an environmental or design firm. They say a clause may or may not be covered by the professional liability insurance policy, depending on the specific language of the clause and the circumstances of the situation.

Other insurers are clearly against the prevailing party provision. In fact, they take the firm position that the contractual assumption of another's legal fees 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 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 and environmental 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 firm typically cannot afford to pursue fee claims.

> "Our experience has been that more attorneys experienced in representing professional consultants now recommend against the use of such [prevailing party contract] provisions."

Our experience has been that more attorneys experienced in representing professional consultants now recommend against the use of such provisions. Attorneys opposed to the provision state they may be a trap for 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 nearly all 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 environmental and 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.

Your course of action

So what should a 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 the prevailing party legal costs at the time the contract is entered into, there is no guarantee these costs will be covered at the time a claim is made and reported.

Remember: professional liability insurance is a claims-made and reported policy and the insurance 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, firms and their lawyers might try to negotiate a mutual prevailing party clause so that it applies to the client as well as the firm. 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 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.

Should a 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 may call for one. For example, if a client has a less-than-stellar credit history, a firm might want to negotiate a limited prevailing party clause in the contracts 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.

Confirm with your attorney that such a provision would not be also applied to other types of disputes.

Alternative contract clauses

The primary purpose of a prevailing party clause, most proponents claim, 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 that such a claim has merit.
- **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 or arbitration. Such a clause can dramatically lower the legal costs incurred by both parties to the claim and 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. The bottom line may well be that if your chief priority is to avoid taking on uninsured liability, such provisions should be avoided. We

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How does the new Healthcare Reform legislation affect my business in the near future? Here's how it's likely to affect you:

✔ **No later than your next renewal or contract change date:**

• Dependent children of your employees will be allowed to stay on the group plan until age 26. Student status is not required. Some insurers are implementing this as early as June 1st for all currently insured dependents.

• Lifetime Benefit maximums (which are now typically several million dollars per person) will be eliminated. Note that CA HMO plans already do not have lifetime maximums.

• Preventive Care services (to be further defined by government agencies) must be covered with no cost sharing.

• Coverage for Emergency Services must be paid at the "in-network" level regardless of provider.

• Plans that currently impose pre-existing condition clauses (already not allowed on HMO plans in CA) cannot apply them to children under the age of 19.

✔ **On January 1, 2011:**

• Over the counter drugs can no longer be purchased with FSA, HRA or HSA dollars.

• Must report cost of health benefits on W2's (not to be taxed but as information on cost)

✔ **On January 1, 2013:**

• FSA medical spending account (Section 125 Flex plan) dollar deferrals cannot exceed $2500 per year.

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