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The Prevailing Party Clause

Bad News for Design Firms?

By Tom Owens | PLAN

The so-called "prevailing party" contract clause is one of the most controversial additions to an agreement between a design consulting firm and its clients. Indeed, historically, many design consultants, their attorneys, and even some of their professional liability insurance carriers favored these clauses as a way to deter frivolous lawsuits from clients or other parties to a contract. Today, that favoritism has taken an about face by most design professionals, their attorneys, and their insurers as it has proven to create a substantial, and largely uninsured, liability for design consultants.

What Exactly is a Prevailing Party Clause?

It's common-law principle in the U.S. and Canada (outside of a few statutory causes of action) that each party to a dispute is responsible for paying its own costs of litigation and legal defenses. That includes the expense of attorney fees, expert witnesses, and other court related costs.

About the only exception to this principle is when the parties to a written or oral contract agree to change responsibility for these liabilities. In these cases, one party may find itself liable for part or all of the legal costs incurred by the other party.

A "prevailing party" clause states that the loser in a lawsuit, or other dispute resolution settlement, must pay all or part of the winner's (in other words the “prevailing party's”) legal costs. Here is sample language that you might find in a design consultant/client contract:

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, attorney fees and all other related expenses incurred in such litigation.

At first glance, this does not seem to be a particularly onerous contract clause. It is, after all, a bilateral agreement where both parties are subject to the clause's conditions. Certainly, a unilateral clause where only the design professional takes on such a liability would be extremely unfair and likely a deal breaker.

The bilateral prevailing party clause also seems to have the potential of being effective in discouraging frivolous claims by any party to the contract. After all, who would file a claim they are likely to lose if they knew they would have to pay for the prevailing party's legal expenses?

Some design firms argue that a prevailing party clause is especially beneficial for disputes over fees. They say such a clause makes it financially feasible to attempt to collect unpaid fees from a client. Without such a clause, the legal costs you accumulate trying to collect project fees may outstrip the fees you are trying to collect.

What are the Drawbacks?

What is the major disadvantage of a prevailing party clause to the design professional? Simply put, your agreement to pay the client's legal expenses in either a written or oral contract is likely uninsurable and can present a substantial, disproportionate financial liability for the design professional.

Professional liability insurance is specifically written to cover damages incurred should a design professional cause loss to a client, or others, due to negligence while performing its professional services. For instance, an architect could make an error or omission in its building envelope design that results in water intrusion, damaging to the building's exterior walls. In this case, professional liability insurance would cover that error or omission, and pay for correcting the damages (as well as the architect's legal costs of defense) based on policy terms and conditions (such as deductibles and coverage limits).

Now, consider a contract that includes a prevailing party clause. Again, using our example, errors or omissions in professional services leading to the water damage would be covered according to policy terms and conditions. The architect's legal expenses defending the claim would also be covered according to policy terms. However, if a judge, jury, arbitrator, mediator, or other trier of fact declares the client the prevailing party, the design firm would be liable for the client's legal expenses. As these legal fees are not part of the architect's professional services, and the liability only exists because of a voluntarily assumed contractual obligation (in other words, the architect's liability for the client's legal fees would not exist were it not for the architect voluntarily taking them on contractually), the insurance company would likely deny coverage for payment of the client's legal costs and not defend the design firm against the imposition of such costs due to contractual liability exclusions in the policy. The architect likely pays that liability for the client's legal costs in their entirety out of pocket.

Let's take this scenario a little further. Suppose the client and its attorneys are very confident that the architect will be held liable for the design error or omission leading to the water-damaged walls. Knowing that they are likely to win this claim, they will come out with all guns blazing, regardless of legal costs expended. In many cases, clients have substantially greater assets than design firms and can better afford highly-paid attorneys, expert witnesses, and so on. So, the design firm is much more likely to pay (again, out of pocket) a very large bill for the client's high-cost legal team -- the same team that also leads the charge for having the architect held liable for the expensive damages to the building.

Not only is the payment of the client's legal fees uninsured, it's likely those legal fees will be much higher than those incurred in the design firm's defense. The result is the design professional taking on a larger exposure than the client, an exposure that is potentially uninsurable.

What Should I Do if Faced With a Prevailing Party Contract Clause?

Let's start with the deal breaker: We generally advise that you do not accept a client contract with a unilateral prevailing party clause. Such a one-way clause where you accept liability for paying your client's legal expenses while the client accepts no such liability in return is unacceptable. Beyond that, what type of a client would insist on such a thing? Probably not one that you want to work for.

As far as the bilateral prevailing party clause, do your best to negotiate it out of your contract. Explain to your client that this is an uninsurable liability for your firm. Chances are, they are not aware of that fact and may be willing to remove the clause.

If the client insists on having a bilateral prevailing party clause, try your best to limit the potential uninsured losses. For instance, suggest a dollar cap on the expenses that the losing party would have to pay: $10,000, for example. Or you might try to limit the clause to cover only certain types of litigation, such as disputes over payment of fees.

Another way to limit the potential scope of a prevailing party clause is to insist upon a narrow definition of "prevailing party." Otherwise, the client may try to paint any compromise reached in a settlement as a prevailing-party victory, insisting their legal fees be paid regardless of the dispute resolution's method. This scenario could discourage the parties from trying to reach any type of settlement or compromise.

Contract language might define the prevailing party as a claimant that receives more than 50% of its claim, or a defendant who only has to pay less than 50% of the claimant's claim. Work with your attorney on drafting an appropriate definition.

Another approach to negotiate away a prevailing party clause is to suggest alternate contract clauses that can help reduce the chances of frivolous lawsuits. These include:

Certificate of Merit Clause. Here, any party to the client/consultant contract cannot file a claim unless it first receives a written certificate from a qualified professional practicing the same discipline as the defendant that such a claim has merit. (Investigate to determine whether your state or province has its own certificate of merit requirements.)

Alternative Dispute Resolution (ADR) Clause. This contract clause requires a party first submit to an alternative dispute resolution (ADR) technique, such as nonbinding mediation, prior to filing a claim against the other party. This can dramatically lower the legal costs incurred by both parties to the claim, not just the prevailing party, and help reach an amicable resolution.

In Conclusion:

Should a client present you with a contract that contains a prevailing party clause, we recommend that you speak with your attorney about taking these steps:

- If it's a unilateral clause where only you would be liable for the prevailing party's legal costs, reject it. Do all you can to get the clause removed. See if your state or province has statutes regarding unilateral clauses and whether they have generally been overturned or upheld when challenged.

- If it's a bilateral prevailing party clause, educate the client on the uninsurability issues. Work to get the clause removed. Offer alternative solutions for achieving the client's objective to avoid frivolous lawsuits, such as certificate of merit or ADR clauses.

- If the client won't remove the prevailing party clause, work with your attorney and insurance agent or broker to add contract language that will limit the exposure. This could include a dollar cap on the amount of legal fees, or paying only for a few named liabilities (such as fee disputes). Also, ensure the clause clearly defines "prevailing party" in a manner where you won't be dinged for simply negotiating a mutually acceptable resolution.

- If the client won't budge, seek advice from counsel regarding whether you should sign this contract or forego the project. Sometimes, there are business reasons for accepting a level of risk that otherwise may seem unacceptable. This is a call only you can make.

- Check with us on the availability of contract litigation insurance (also called attorney fee insurance) which, as the name applies, covers legal expenses paid on behalf of a prevailing party. Premiums are usually set as a percentage of the limits purchased.

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