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A New Player: Contract Litigation Insurance

By Cynthia J. Larsen

What risk most worries both plaintiffs and defendants in contract litigation? When a group of litigation attorneys were asked this question, the most common answer was the risk of having to pay for an army of adversary lawyers under contractual attorneys' fees clauses if the litigation is unsuccessful. This gnawing possibility often results in a party surrendering claims for very real monetary losses or accepting or paying a disproportionate settlement to avoid uncontrolled attorneys' fees exposure. The recent arrival of a new player on the American insurance stage, however, may change all that. The new player, an insurance product known as "contract litigation insurance" ("CLI"), provides insurance coverage for an adversary attorneys' fee award, thereby removing a significant source of litigation stress and financial loss.

Setting the Stage

In the United States, the general rule (known as the "American Rule") is that each party shoulders its own attorneys' fees, win or lose. The basis for this rule is that a plaintiff should not be discouraged from seeking redress in the courts by the threat of having to pay the adversary's legal expenses. This approach, at odds with what is known as the "English Rule," under which the losing party pays the prevailing party's attorneys' fees and costs, has been questioned repeatedly through the years on the basis that it encourages meritless lawsuits because the high cost of defending against weak cases gives defendants a strong incentive to settle even a nuisance suit. Notwithstanding such criticism, the American Rule has survived largely intact in federal and most state jurisprudence in the United States.

Under the American Rule, the litigation price tag for both plaintiffs and defendants has mushroomed as attorneys' fees and costs associated with discovery and trial have multiplied. At the same time, the uncertainty of a predictable outcome in litigation continues to increase. To attempt to gain a modicum of certainty as to litigation costs, contracting parties in the United States have made use of contractual clauses providing that if litigation arises under the contract, the prevailing party in that litigation will be entitled to reasonable attorneys' fees and costs. In recent years, some companies have eliminated prevailing party attorneys' fees clauses from their standard contracts, believing such clauses impose more uncertainty than they resolve. The more common practice in most parts of the United States, however, has been to continue to include them, on the supposition that such clauses dissuade both sides from engaging in protracted litigation. In addition, many parties view attorneys' fees clauses in standard form contracts as virtually nonnegotiable.

Thus, while the costs of other types of litigation, such as commercial tort, strict liability, professional liability and employment litigation can generally be insured against, commercial contract disputes have remained a stubborn outpost of uninsured litigation, generally excluded under most liability policies. As a result, litigants in the United States have not had the ability to insure against paying adversary attorneys' fees in contract litigation.

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In contrast, products to address the threat of being charged with adversary attorneys' fees have long existed in other countries following the English Rule (which is really the rule almost everywhere but the United States). England and Wales, for example, have a robust litigation insurance market, which provides a variety of products such as "litigation expense insurance" purchased before a specific need arises, "after the event" (ATE) insurance and litigation funding mechanisms to spread the costs of litigation among investors. ATE insurance, which is purchased after the dispute arises, can be purchased in other countries for not only contract litigation, but other types of litigation as well. In practice, the premium is often not paid until the conclusion of the litigation and may be recoverable from the opposing party if the insured is victorious. The insured may also purchase coverage for its own attorneys' fees and costs in the event the insured is not victorious. There is generally no interim coverage for a party's own fees, which are paid only at the end of the litigation when the losing party has been identified.

ATE insurance is widely viewed in other countries as ensuring access to the courts by litigants of modest means with good legal cases who purchase the insurance at relatively low cost at the time of filing of the lawsuit and are thus protected against the eventuality that they may be ordered to pay adversary party attorneys' fees. Such an approach is also viewed as discouraging meritless cases because the costs of ATE insurance are higher for suits of questionable merit.

Certain scholars studying the American Rule have suggested that the adoption of the English Rule in the United States, if combined with a strong litigation insurance program, would greatly reduce the number of meritless cases while aiding those of modest means to gain access to the courts for resolution of meritorious disputes. While such a sea change is unlikely to occur, there are nonetheless areas of litigation subject to a "loser pays" rule for which insurance products are useful. A prime example is contract litigation involving prevailing party attorneys' fee clauses.

CLI Enters the Scene: The Specifics of Coverage

CLI was first introduced in the United States in California in 2010 by Sonoma Risk Insurance Agency. Available now in all fifty states, CLI may be purchased by either plaintiffs or defendants, whether corporate or individual, for specific contract litigation. In some states, it may even be purchased to cover statutory attorney fee awards, in addition to contractual attorney fee awards. Typically, CLI must be applied for by plaintiffs within a set number of days after the lawsuit is filed or, if applied for by defendants, within the same number of days after service. The CLI policy covers any obligation of the insured to reimburse or pay out adversary's attorneys' fees in the identified lawsuit. CLI is sold on a "surplus lines" basis, which means that it is usually not backed by the state insurance guaranty funds. The one-time premium is generally between six and ten percent of the amount of the coverage limits, and customary levels of coverage are in the $200,000 to $400,000 range. At least one CLI policy has been written in the United States with coverage limits of $3.5 million.

CLI has four significant exclusions: 1) an exclusion for portions of attorney fee awards that arise from punitive or exemplary damages; 2) an exclusion for adversary attorneys' fees incurred after the insured rejected a statutory offer in compromise; 3) an exclusion for any suit determined by a court to have been brought by the insured in bad faith or prosecuted in a frivolous, wanton or malicious manner; and 4) an exclusion for suits terminated by settlement and by any other type of termination except trial on the merits or summary judgment.

CLI policies typically give the insurer the right to require the insured to oppose an attorneys' fee motion, to hire its own counsel to oppose the award, or to require the insured to appeal the award. If the insurer requires the insured to oppose or appeal an award, the insurer will generally pay as supplemental payments (not reducing policy limits) all reasonable expenses incurred in such efforts and any interest required to be paid on the adversary fee award.

The Next Act for CLI

CLI has the clear potential to be a game-changer in contract litigation. First, it is likely that every party will seek to learn in discovery whether the other parties have CLI and the extent of their CLI coverage. Once knowledge of coverage is obtained, it will likely affect the parties' litigation and settlement strategies, for example, by instilling in an insured party the stomach to continue litigating, notwithstanding settlement discussions seeded with threats of dire adversary fee awards if settlement does not occur. Thus, an insured party with significant confidence in its legal position, and knowing it is protected by insurance from downside risks, is unlikely to be forced into a premature or deflated settlement because of escalating attorneys' fees on the other side. A less well-heeled litigant with CLI will be placed on a more equal litigation playing field with a wealthier litigant, having removed the risk of suffering an adversary award while enjoying the potential upside of such an award if victorious.

CLI may also become an important consideration for litigation decision makers who are fiduciaries or otherwise acting in representative capacities. For example, an ERISA fiduciary or bankruptcy trustee bringing or defending a contract claim may become concerned about the possibilities of future criticism or second-guessing if judgment is entered against him or her. To add insult to injury, adversary attorneys' fees are awarded and must be paid out of corporate funds or the corpus of an estate. While such fiduciaries and trustees are protected from personal liability by the business judgment rule, it would likely be prudent for them to have at least considered whether CLI might be appropriate to protect against the risk of an adversary attorney fee award.

CLI will likely continue to expand in order to provide coverage in other types of cases where a party has exposure to adversary attorneys' fees. As currently written, such policies cover attorney fee awards by a court after trial or summary judgment. It is unclear at this juncture whether the product will be expanded to cover prevailing party attorneys' fees awarded as the result of a binding arbitration and, if so, under what circumstances. Currently, CLI does not typically cover adversary fee awards in a suit voluntarily transferred to arbitration. In addition, CLI may become available upon request on a case-by-case basis for lawsuits pending longer than 60 days at the time the application is filed.

In the long run, availability of such insurance could be part of an important effort to enable litigants of modest means to withstand the costs of bringing meritorious contract claims while discouraging frivolous litigation by reducing the motivation of parties subjected to them to settle quickly to avoid mounting defense costs. In the short run, CLI is a welcome new player in the arena of contract litigation.