



Contract litigation insurance:

A weapon that can help prepare your company for battle



Sonoma Risk Insurance Agency™



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Today's real estate industry is under siege. Multiple issues threaten to reduce profitability, including high material costs, terminated or delayed projects and availability of financing. Sometimes, owners with dwindling funds and doubts about the future of the economy may simply fail to pay as agreed, leaving real estate companies few options other than contract litigation.

Civil litigation in the United States has increased by an average of over five percent over the last three years. According to the Bureau of Justice and Statistics, the most common form of civil litigation in the United States is contract litigation. The impact of litigation on a business can be devastating. In fact, the Institute for Legal Reform conducted a survey on the impact of litigation on businesses and reported that:

- 74 percent said lawsuits could cause an increase cost of their products or services
- 73 percent said lawsuits hurt their reputation
- 73 percent said lawsuits could hurt their ability to get credit
- 71 percent said lawsuits could impact/delay the ability to hire new employees

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These risks faced by businesses enthralled in litigation become heightened in contract disputes when parties to a lawsuit also are exposed to paying their adversary's attorneys' fees. The risk of paying an adversary's attorneys' fees typically arises from a provision in a contract that provides that if a lawsuit arises from the agreement the winner will be paid their attorneys' fees from the loser. In the real estate industry, this risk typically arises in contract disputes arising out of purchase and sale agreements, construction agreements, development agreements, leases, and financing/loan agreements. The added risk of "loser pays" provisions in contract litigation can prove devastating for all but the deepest pockets.

When preparing for your next litigation, we suggest you consider the practice points identified below to help ensure the most favorable litigation outcome.

1. Minimize your litigation downside.

Prior to engaging in costly litigation, it is important to understand your total risk exposure. For example, because "loser pays" provisions are so common in the real estate industry, it is important to determine if there is an exposure to paying your adversary's attorneys' fees if unsuccessful in your suit. If faced with a "loser pays risk," you should consider obtaining Contract Litigation Insurance to insure against this significant litigation risk.

A large residential home building company, who did not have the benefit of contract litigation insurance, recently learned this lesson the hard way when it lost its litigation and had to pay \$1.4 million in legal fees to another developer. The company's purchase and sale agreement for a 147-acre development property in California included a "loser pays" provision in the event of any legal proceedings.

Numerous “mini” loser pays systems are emerging in Alaska, California and Texas, which expose real estate and general businesses alike to the risk of paying their adversary’s attorneys fees – even in the absence of a “loser pays provisions”. As a result, a company with a regional footprint needs to be aware of the full extent of its liabilities if it loses a lawsuit.

Being exposed to millions of dollars in legal liabilities, particularly after the sting of an adverse ruling, is a level of risk exposure few, if any, business owners can afford in today’s economy. Many times legal fees far exceed the damages, so managing this risk with insurance can be an invaluable tool.

2. Hedge your litigation exposure with the latest risk management tools.

In addition to hedging your bet with Contract Litigation Insurance, it is important to consider the wave of new risk management tools that have emerged over the past few years to help companies and individuals better manage litigation exposure. One popular innovation is third-party litigation funding. Insurance companies, banks and hedge funds now provide litigation funding to plaintiffs in exchange for a percentage of the litigation outcome. This third party litigation funding can help companies better manage cash flow and invest in growing the business rather than paying legal fees — giving them an important edge over the competition.

3. Incorporate risk management in legal strategy.

Generally speaking, the longer a lawsuit takes, the greater the company’s liability and, most likely, the less cash it will have on hand to run its business. Real estate companies and their attorneys must adjust their legal strategy to elevate the importance of risk management. Understanding the legal landscape can make all the difference. When moving forward in litigation it is important to discuss with your counsel the following questions:

- If you bring a suit, is there a choice of where to file the case?
- Which courts are congested?
- What is a reasonable time estimate for proceeding to trial?
- When staffing a case, how many attorneys are necessary?
- Are there contractual provisions or state laws that create “loser pays” exposure?

Any opportunity that allows for an expedited and efficient prosecution and resolution greatly reduces risk exposure.

4. Manage labor issues.

Another common area that requires a different risk management approach is labor. With national unemployment continuing to hover around nine percent, many municipalities are being pressed to review all development deals to ensure they support job growth, which is a very subjective term.

In one example, the Lansing Michigan City Council tried to go back on a deal with a developer because his plan did not include union labor. The developer was forced to sue and received a favorable ruling, but he incurred significant legal expenses and project delays as a result.

5. Never assume.

As any great general will attest, one should never go into battle without understanding the risks. Too often real estate companies think they are exempt from certain liabilities. Consider the case of *Martel v. Lovebirds Café & Bakery, Inc.* (2010).

Fran Martel, a general contractor, was hired to construct two eateries. To control costs and prevent delays, the project owner hired a project manager, who required Martel to submit all work orders and only go forward with those that received approval. But, as is often the case, Martel's final construction costs far exceeded the original budget.

The owner made the mistake of assuming he was only responsible for paying the work orders approved by his project manager. In fact, many of the work orders Martel completed were not approved by the owner, but rather requested by city inspectors — making the owner's approval irrelevant. Furthermore, the owner provided no documentation for why some orders were approved and others were not.

As a result, the court ruled against the owner, who had to pay more than \$80,000 in expenses to Martel on top of the \$200,000 of approved work orders. This added a 40% cost increase to the project, something small developers can ill afford.

Conclusion

Taking into account all the factors involved in litigation — from the strengths of the claim to the potential liability and from the legal strategies to the unpredictability of various courts — it becomes clear that choosing to move forward with litigation is an enormous commitment. By drawing on best practices, new innovations and core principles, a company stands the greatest chance to success.

If you would like to learn more about the insurance that provides coverage for adversary attorney's fees, please visit www.sonomarisk.com.

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1400 American Lane, Schaumburg, Illinois 60196-1056
800 382 2150 www.zurichna.com

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