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SEVEN STEPS TO EFFECTIVE RISK MANAGEMENT FOR DESIGN PROFESSIONALS

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One of the primary services provided by design professionals to owners is the management of the numerous risks inherent in any project. At the same time, design professionals must be attentive to their own risks. Usually, the risk management objectives of the owner and design professionals are compatible. However, there may be instances where the risk management interests of the owner and design professionals collide. The purpose of this paper is to lay out a general framework for risk management and loss prevention, and then to discuss some of the major issues relating to professional construction services.

THE RISK MANAGEMENT PROCESS

Nothing is more important to the long-term success and survival of any design professional than consistent and effective risk management and loss prevention. Risk management is both a part of the client service and a key to economic survival. When properly performed, risk management and loss prevention not only prevent and control losses and claims, but also develop more business, more profit, and better client relationships.

In order to effectively evaluate and improve risk management and loss prevention practices, it is useful to first identify the objectives of risk management and loss prevention. Although the specific objectives will vary by the nature of the services being provided to the

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project, the general goals of risk management and loss prevention may be characterized as follows:

- Identify risks.
- Allocate risks to the party best able to control the risk.
- Manage those risks which cannot be transferred.
- Reduce internal and external costs of resolving disputes.
- Limit financial exposure.
- Improve profitability.

Realization of these objectives may be approached as a sequential seven-step process.

Step One: Selection of Projects, Clients, and Teams

Project Selection. Before accepting any project, careful consideration should be given to the nature and size of the proposed project to make certain that the design professional possesses the capacity and qualifications to successfully complete the proposed project. Experience demonstrates that many construction claims and lawsuits result from situations where a party to the project somehow lacked the tools to handle their project responsibilities. Relevant considerations in this regard include experience with similar projects, familiarity with the subject matter, appropriate training, licensing, available time and manpower, and financial considerations.

Team Selection. Obviously, primary consideration should be focused on the capacity and qualifications of the design professional itself. However, at least some attention should also be focused on the capacity and qualifications of the other proposed members of the project team, including other design professionals, subconsultants, contractors, suppliers, developers, and owners. This analysis should also consider the reputation and work style of the team member. Like a chain, the ultimate success of the project for each of the parties is only as strong as, and therefore depends on, the weakest link.

Client Selection. Once it has been determined that the firm and the design team possess the appropriate capacity and qualifications to undertake the proposed project, the next consideration should be whether the proposed client poses risks in excess of the benefits of the project. The primary concern here is with the ultimate owner/developer of the project.

It is amazing how many design professionals will become involved with a new client on projects valued at millions of dollars without making any real effort to investigate or evaluate that client. It is equally amazing how many firms will return to do business with an existing client who has burned them in the past. Obviously, such an approach is shortsighted, particularly

as it relates to the subject of getting paid and making a profit. The most important considerations for client selection should be the following:

1. **Client Expertise/Expectations.** The most important factor in evaluating any prospective client is to establish the client's relative expertise and corresponding expectations. The key is communication. Making certain that the client and design professional share common expectations and that those expectations are realistic **before** beginning work on the project is the greatest key to avoiding later problems on the project. Differing and unrealistic expectations are among the most frequent bases for a client's refusal to pay.
2. **Client Track Record.** Whether it is a new client or an existing client, any design firm should investigate the client's track record for payment and litigation. For a subconsultant, this analysis should obviously include both the prime consultant and the owner.

For new clients, as part of getting to know them, their expectations and expertise, ask them about past projects and their experience on those projects. Ask them about both their positive and negative experiences. Such experiences will necessarily impact upon their relationships on a new project, and just as necessarily impact upon how the design professional should proceed. Armed with this information, the design professional can also conduct its own recognizance. Appropriately diligent firms will contact past project participants to ascertain their experiences. Similarly, with the locating of the past projects, a quick electronic search of Court and County records will often reveal if there was litigation on the past projects and if there were problems getting paid.

For existing clients, design firms should review past projects before agreeing to another retention. Was the client fair, and did they make timely and complete payments? If not, why not and what steps can be taken to avoid similar issues? These issues should be resolved before the project gets underway. Similarly, design professionals should not automatically assume that because one project went well, others have as well. Design professionals should revisit the original due diligence and make any appropriate updates.

Step Two: Risk Identification & Analysis

Once an design professional determines that the project and the client are acceptable, and before negotiating any Agreement or definitively committing to a project, the design professional should pause to identify and analyze the potential risks of the project. Such an

analysis is necessary to intelligently approach the process of contract negotiation, determine fair compensation, and plan for the efficient execution of the project.

All construction projects share some common risks such as delays, increased costs, job site injuries, and the like. However, each project will also necessarily have its own peculiar set of risks which must be anticipated and addressed. To make certain that all risks are identified and addressed, the design professional should consider the potential risks in light of the following questions:

1. What services/deliverables will be provided?
2. What project authority does the design professional have?
3. Who will interact with and have expectations of the design professional?
4. What is the likelihood of various risks occurring and the likely damages if they do?

If risk identification, allocation, and management are viewed from each of these perspectives, the design professional is far more likely to have identified and been prepared to deal with the risks of the project.

The culmination of this process should be the preparation of at least an initial project delivery plan. Experience shows that the most successful contract negotiations and project deliveries include such a plan as one of the earliest steps. As a result, such early planning ultimately leads to more profitable jobs.

Step Three: Appropriate Contractual Agreements

The next building block in the foundation of effective risk management and loss prevention is the negotiation and execution of an appropriate Services Agreement. The negotiation of the Agreement also provides the first step in providing quality services in that the communications regarding the terms of the Agreement lay the foundation for everything which is to follow. The importance of a well-reasoned, well-drafted, detailed Agreement cannot be overstated. Accordingly, the Agreement should always be completed and signed prior to, *not after*, beginning the project services.

The essence of a contract is risk allocation. By defining the rights and responsibilities of the parties, a contract determines who will bear what risks and what the resulting consequences will be. Accordingly, in negotiating a contract, particular attention should be focused on

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identifying the various risks and determining which party, if any, is in a position to control those risks. In general, the party with the greatest ability to control a risk should bear that risk. Parties should exercise extreme caution in accepting *any* risks which are outside their exclusive control.

Of course, each contract should be created based on the unique demands of each particular project. Nevertheless, there are some key contractual issues which apply to virtually any Service Agreement. Some of the most important issues are discussed below.

Scope of Work. The single, most important provision of any Service Agreement is the scope of work. More than any other provision, the scope of work statement defines the parties' expectations and establishes parameters around the services to be provided. Accordingly, the scope of work should be as complete and detailed as possible. Ambiguity and open-ended descriptions should be avoided wherever possible.

To preserve the benefits of a properly drafted scope of work statement, the Agreement should also provide that no additional services will be provided absent a written amendment to the Agreement signed by both parties. Such a provision avoids claims that additional services were promised, but not delivered. However, such a provision requires diligence on the part of the design professional to make certain that any additional services are documented by a written amendment. Absent such a written amendment, the design professional may face claims that it is not entitled to payment for the services regardless of whether or not they were actually provided.

Change In/Additional Services. A necessary corollary to determining the scope of services is defining when, how, and why the scope of services will change. In this regard, it is very important to provide as detailed a list as possible of those services which are not included in the basic Agreement, as well as those services which will be treated as additional. Such lists should be preceded by the words "including, but not limited to" as a means of making the list non-exclusive. Such changes are usually required in writing. However, the problem arises when the project timing or owner delay does not allow for this process. Accordingly, additional services provisions should include a self-executing mechanism to avoid unnecessary delay. For example, the owner may be given a certain time period to object to additional services proposed by the design professional. If the owner does not respond, the owner will be deemed to have agreed to the change..

Owner Rights & Responsibilities. Generally, a Service Agreement focuses on the obligations of the design professional. Typically, the only obligation of the owner defined in the contract is the duty to pay for the services. However, depending on the nature of the project, other rights and responsibilities of the owner should be identified. For example, what information is the owner expected to provide and what right does the design professional have

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to rely on that information? Similarly, what project input and authority is the owner entitled to have and when is that input to be provided? Consideration of these issues can be invaluable in clarifying the expectations of the parties and can greatly assist the design professional in providing a quality, cost-effective service.

In the new age of mold-related concerns, it is also important to make the owner aware of and responsible for repair and maintenance of the project. If properly performed, such maintenance should preclude any mold growth. The design professional should not be responsible for any failure to do so.

Parties to the Agreement. Although it seems obvious, the Agreement should also carefully define the parties to the Agreement. Such provisions are necessary to determine who is entitled to modify or control the terms of the Agreement, who is obligated to make payment under the Agreement, and who is entitled to claim the benefits of those services. Ideally, the Agreement will also provide that it is for the sole benefit of the owner and not any third party. (See below.)

Assignability. Provisions regarding each party's right to assign the Agreement may seem inconsequential, but may have significant ramifications for the design professional. For example, if the design professional structures its fee and approach to the project based on the assumption that it is dealing with a sophisticated and cooperative owner and construction team, and later the owner assigns the contract to a less sophisticated and/or cooperative party, the design professional may be left in a difficult position. Accordingly, the Agreement should provide that the Agreement is not assignable. If that approach is not workable, the Agreement should provide that any assignment constitutes a change in scope with an appropriate change in compensation.

Standard of Care. Absent implied or express provisions to the contrary, design professionals are required only to provide their services with the degree of skill and care ordinarily exercised by reputable practitioners of the profession practicing in the same locality under similar circumstances. Perfection is not typically required. However, design professionals often expressly or impliedly increase the applicable standard of care. Frequently, clients attempt to include contractual language indicating that the services will be provided "in accordance with the highest professional skill and care", or some similar language. While it is difficult to tell a client that such a provision is unacceptable, the design professional must recognize that such a provision may raise the standard of care to a level of near perfection.

In addition to express contractual language, the standard of care may be elevated by implication. In pursuing the project, design professionals and others will frequently describe outstanding qualifications to provide the services. Some clients would argue that such overtures elevate the design professional's obligations beyond the ordinary standard of care. Similar

implications may arise through the incorporation of a response to a request for proposal into the Agreement. Such implications can be avoided by including an integration clause in the Agreement which provides that all representations and obligations are set forth in the written Agreement.

Finally, design professionals should approach contractual obligations to comply with “all applicable laws and codes” with great caution. Ideally, the specific Code should be identified with that qualification, and it is subject to the interpretation and authority of the applicable building official. Changes in the Code or its interpretation should be the bases for additional compensation for the design professional.

Ownership of Documents. Ownership of the design documents has become an increasing point of controversy. Such concerns are increased by the proliferation of electronic design mediums and owners’ frequent requests to receive electronic design documents. (See related paper on *Building Towards the Paperless Project: Risks, Rewards, and Safeguards.*) Whenever possible, the design professional should retain all ownership of its design documents and simply grant the owner a limited license for use solely with respect to the project which is the subject of the contract. If the owner insists on ownership of the documents, the right to use those documents should be narrowly defined such that the documents may not be misused to the professional’s detriment. The Agreement should also provide that any electronic design documents are provided solely as a courtesy, with a disclaimer as to the future usefulness.

Electronic Communications. Electronic communication has also substantially affected the way that project participants communicate. Although often treated in a casual way, an e-mail message becomes a “written direction” with the click of a button. Accordingly, the Agreement should specifically identify (a) the anticipated electronic communications; and (b) the reliability and authority of such communications. This is particularly true if the project includes a project website.

Warranties & Guarantees. A warranty is an express or implied promise or guarantee that services or a product will satisfy certain criteria. Express warranties and guarantees can arise in various forms. In addition to express warranties clearly set forth in the Agreement, express warranties may also arise from a number of other sources including the description of the scope of work, review of shop drawings and as-built drawings provided by the contractor, and certifications of contract compliance and payment requests. Similarly, management of a project with a guaranteed maximum price may create an implied warranty that the price will not be exceeded. Accordingly, the Agreement should state that the only warranties and/or guarantees established by the Agreement are those expressly set forth and identified as such in the Agreement.

Limitation of Liability. Limitation of liability provisions seek to limit the design professional's potential liability to some finite amount proportionate to the benefit of the project. Although such provisions have been repeatedly attacked in the Courts, the current law recognizes them as valid tools of risk allocation. To promote the effectiveness of limitation of liability clauses, they should be prominently set forth in the Agreement such that the client can not claim surprise, mistake, or duress. Ideally, a limitation of liability clause limits the design professional's liability not just to the owner, but also to any contractors, suppliers, or other third parties. The limitation of liability should also exclude liability for consequential damages, such as lost profits and loss of use.

Indemnity. Indemnity is the companion to limitation of liability. An indemnity provision seeks to have one party indemnify the other for claims of liability asserted against the party to be indemnified. Clients will often seek to have design professionals indemnify them from all claims except those caused solely by the client. Obviously, such indemnity provisions carry tremendous risk in that they expose the design professional to substantial liability beyond the risks the design professional can control. The preferable approach is a mutual indemnity provision requiring each party to indemnify the other to the extent they are responsible for the subject matter of the claim. The indemnity provision should also clearly define who is covered by that indemnity provision.

Insurance. Indemnity obligations are only as useful as the resources available to back them up. Accordingly, the design professional should recommend and require that all project participants have and maintain adequate insurance coverage.

Dispute Resolution Provisions. Of course, no one ever enters into a contract expecting it to result in litigation. However, the original contract is the best opportunity to create a mechanism to cost-effectively resolve any eventual claims. Mediation and arbitration are the two Alternative Dispute Resolution provisions most often used to manage claims. However, the effective use of either approach depends on the project, the parties, and the type of claim.

Limitation of Third-Party Reliance. Recently, one of the greatest sources of claims against design professionals has come from third-party strangers to the contract. Typically, such claims arise either from a party who has received a copy of the project documents and somehow come to rely on them, or from a party who believes it was an intended beneficiary of the services. To prevent and/or defeat such claims, the Agreement should expressly identify the intended beneficiaries of the services and provide that the services are not to be used or relied on by any other party without the express written consent of the affected design professional.

Consistency with Other Agreements. Finally, once an appropriate Agreement has been negotiated between the design professional and the owner, the design professional must make

certain that contractual obligations of other project participants are consistent with that Agreement. All subconsultants should be bound by the same obligations. This can be accomplished by creating mirror Agreements with subconsultants, or by simply incorporating the Master Agreement into the Subconsulting Agreement. Similarly, care should be taken to make certain that specific parties not in privity with the construction manager (e.g., contractors, separately retained design professionals, etc.) are bound by similar obligations.

Payment Terms. Engineering Service Agreements often provide that the engineer is to be paid after the architect has been paid by the owner. Such a provision puts an engineer in a helpless secondary position without ordinary tools of recourse for payment. Such provisions may also often be unenforceable in California. A preferable approach is to provide that payment is due upon receipt of the invoice, but not late until after the architect has been paid by the owner. This approach will generally preserve the engineer's lien rights and other collection remedies.

Step Four: Performance Consistent with Applicable Standards of Care and Agreements

Selection of appropriate projects and clients and execution of a well-drafted contract provide the foundation for effective risk management and loss prevention, as well as quality project delivery and profits. The process is then completed by delivering the project in a manner consistent with the applicable standard of care and contractual obligations.

Ideally, each project team member will be familiar with the firm's contractual obligations and those of other key parties. These Agreements should be the guide to the delivery of services.

Beyond ordinary errors and omissions in providing the services, several other areas present frequent problems in meeting the professional and contractual obligations. For example, during the course of providing the services, the contractual scope of work must be kept in mind so that all the services called for are provided and no additional services are expressly or impliedly promised. Similarly, notwithstanding contractual provisions to the contrary, a design professional may become aware that persons or parties other than the client are receiving and relying upon the services provided. Such knowledge may lead to claims by such third parties unless steps are taken to disclaim any third-party reliance.

Step Five: Communication

Many projects which result in claims do so simply because the parties failed to communicate during the project. Consistent, thoughtful, and detailed communication with clients, subconsultants, and contractors is imperative to the successful completion of a project. In addition to coordination and ordinary project communication, the design professional should respond promptly to any criticisms, complaints, or issues of dispute, and seek a rapid resolution.

Such potential problems seldom just go away by themselves, but may often be resolved quickly through a prompt response and communication on the issue.

Step Six: Documentation

The creation of complete and well-organized project records is the glue which holds an effective risk management and loss prevention program together. Should a dispute or claim ever arise, the applicable maxim states: "If you can't prove it, it does not exist." Memories fade and oral recollections may often be modified through the influence of self-interest. The result is a "he said/she said" dispute which is expensive, time consuming and, worst of all, uncertain as to its outcome. The key is the maintenance of contemporaneous written records during the critical phases of the project.

In particular, the professional should consistently document telephone calls and meetings, both formal and informal. Such records should then be confirmed to the other party if the communication included an agreement, a notification, or a request. Careful procedures should also be applied to the project-related e-mail communications.

Step Seven: Project Closeout

The final step to secure a lasting quality management model is to close out the project. At least four steps are critical to this process:

- Secure final payment in a timely fashion using available enforcement tools such as liens, stop notices, and final releases.
- Document completion of services to terminate any implication of ongoing obligations.
- Consolidate and archive project records.
- Post-project evaluation.