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## THE COLLECTIONS-CLAIM CONNECTION: GETTING PAID WITHOUT GETTING SUED

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While money isn't everything, it is the measure and fuel of any business, including a design firm. Without payment for services firms suffer, starve, and even die. Payment issues are also often the single greatest warning sign of a project in trouble.

In reality, a proper approach to collections closely resembles a proper regimen for your personal health. Firms which get paid become and remain healthy and strong. Firms which do not get paid regularly and on time become malnourished and increasingly susceptible to disease. Just as health is a life-long process, financial success is a project-long process. The following discussion tracks the relevant phases and provides analyses and strategies for those various phases. Those phases are:

- Preparing for the Client and Project.
- The Contract.
- The Project.

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- Staying Current and Heading Off Trouble.
- Collection Resolution.
- Post-Project Evaluation.

## **I. PREPARING FOR THE CLIENT AND PROJECT**

In reality, the best collection strategies begin before a single hour is billed to the project. The pre-project strategy should involve three components. The first two are purely preparatory: client selection and project selection. The third is client education and should continue for the duration of the project.

### **A. Client Selection**

As the old saying goes, you cannot get blood from a turnip. Accordingly, appropriate client selection is one of the most important steps in ensuring payment for services. Client selection is also one of the first and most important steps in any appropriate risk management plan for a design professional. Nevertheless, it is amazing how many design professionals will become involved with a new client on projects valued at millions of dollars without exerting any genuine 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. Some of 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 are the two greatest keys to avoiding later problems on the project. Differing and unrealistic expectations are among the most frequent bases for a client's refusal to pay.

The only realistic way to establish common ground is to spend actual and significant time discussing the project with the prospective client. Many firms find that a client interview is the best way to accomplish this. Regardless of whether a formal interview is used, some of the key components to the evaluation and building of common expectations are:

- Client Background.
- Project Background.

- Client Goals and Intended Outcomes for the Project.
- Expected Project Players and Participant.
- Hoped-For Project Rewards.
- Possible Project Risks

2. **Client Track Record.**

Whether it is a new or an existing client, any design firm should investigate the client's track record for payment and litigation. This can and should be part of the client interview referenced above. 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 new 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 check out their experiences. Similarly, with the location 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? 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 also. Design professionals should revisit the original due diligence and make any appropriate updates.

3. **Financial Stability.**

Unfortunately, many design professionals somehow feel it is unprofessional to ask a client how a project will be funded and for verification of that funding. On the contrary, the failure to investigate such issues is actually the unprofessional conduct. It is both unwise and unprofessional to get into a project which lacks solid funding to see the project through to completion.

In evaluating such financial stability, design professionals should be wary of unfunded development companies (Limited Liability Companies, Limited Partnerships, etc.) where the contracts are with one company, but the funds reside with another. The design professionals should also investigate the actual ownership of the property. Failure to do so may hamper lien rights and make ultimate collection of payment more difficult. Where multiple entities are involved, the design professional may wish to have those other parties added to the agreement, at least for payment purposes, or seek guarantees from such parties.

**B. Project Selection**

Different projects may also present different collection challenges. Some of the more relevant considerations are the following:

**1. Defined and Realistic Scope of Work.**

Although it is ultimately a contract issue (see below), the first key to project selection is whether it is susceptible to a scope of work which is both definable and realistic. The reasons are obvious. If a project cannot be defined with clarity, how will the firm prove it is complete and entitled to full payment? Even more importantly, if the project is terminated early and the scope is generic or vague, the firm has no controlling means to establish entitlement to fees. Even worse, an unrealistic scope of work almost guarantees a lack of both payment **and** a claim for breach of contract and negligence.

There are two keys to a sufficiently-defined scope of work for collection purposes:

- a. Detailed description of the total project and service sufficient to enforce final payment.
- b. Identification of project milestones and related fees sufficient to enforce incremental payments. This will also help define the project process and schedule.

If such a scope of work cannot be achieved at the outset, it is acceptable to proceed on a time-and-materials basis if it is of a limited duration and commitment, and sufficient protections are provided (see below).

**2. Funding and Financing.**

For collection purposes, the next greatest consideration is the project funding/financing. The most relevant considerations include the following:

- a. How is the project to be funded and financed? Is it fully funded now or is some portion contingent deferred? If it is contingent or deferred, the firm's obligation and exposure should be limited accordingly.
- b. What access does the firm have to the project funds? If the project is funded, but the funds are held by third parties such as investors, banks, or holding companies, the firm should have a path of direct access to those funds.
- c. Is payment dependent on the review and approval of a third party, such as a bank officer, construction manager, or inspector? If so the process, standards, and timing should be defined in advanced.

3. **Limitations on Collection Tools.**

Some projects may have limitations on collection rights and procedures. Those should be evaluated carefully. For example, public projects typically have no lien rights. Contracts may also limit collection rights by waiving lien rights, requiring alternative dispute resolution procedures, or requiring continuing services during a dispute.

4. **Other Claims on Project Funds.**

The final consideration is other possible claimants to the project funds. The key considerations here are timing and priority. That is, while others have prior or prevailing claims which would relegate the firm to secondary status. If so, procedures should be implemented in the contract and in practice to minimize those risks.

C. **Client Education.**

Client education should be a project-long undertaking. It should and must begin with the very first client meeting. Informed clients tend to be happy and satisfied clients. Happy and satisfied clients are most likely to pay on time and in full.

While client education can involve many issues, three areas are most important for collection purposes and avoidance of claims:

1. **Process and Schedule.**

Regardless of a client's sophistication, the design professional should review the expected process and schedule for the project with the client. In doing so, the design professional should be realistic or even conservative. Most importantly, the client should be taught that expected events or conditions may arise **and** the design professional is not in control of many elements of

the process and schedule. These conversations should be documented and, ideally, reduced as part of the contract.

**2. Mid-Project Changes.**

The client should and must be advised that delayed decisions or client changes during the project can impact the schedule and cost of the project. This should be reiterated each time the client delays or changes during the project.

**3. Standard of Care.**

The client must be educated as to the design professional's standard of care. Specifically, the client should be advised that there is never a perfect set of plans or specifications, and that no design can fully anticipate every contingency. The client should be advised that there will be expenses associated with design clarifications and corrections during the project. This advice should be oral and in writing and, ideally, will even be a part of the contract. However, the design professional should be very cautious before providing any recommendation or commitment as to a specific design contingency.

**II. CONTRACTUAL PROVISIONS**

Pre-project interviews and investigation are only a preparatory education. The true starting point to protect and secure payment of fees is obviously the Service Agreement. First and foremost, if you do not have a written Agreement signed by both sides, you will often have an almost impossible task in securing payment. To be binding, that Agreement should reflect the key elements of the pre-contract education and exchange. Otherwise, that information is not binding on the client and is of no ultimate benefit to the design professional. Assuming that a written Agreement is in place, several key provisions have proven critical to securing prompt and appropriate payment.

**1. Specific Payment Procedures.**

Either in the contract itself or by separate written confirmation, establish who needs to receive the invoice at what location and the required content and backup for the invoice. This avoids later excuses that the invoice was sent to the wrong location or lacked sufficient detail or backup. Often, this can best be resolved by including an exemplar invoice to the Agreement as an Exhibit. Experience indicates that it is best to include this in the Agreement where it is more likely to be binding and can less readily be disputed later. By including the clause in the Agreement, the firm may also impose a short duration for the client to request additional information.

2. **Early Identification of Disputed Issues.**

The Agreement should provide that the client has a very short time period after receipt of an invoice to identify any disputed portion. For example, the Agreement could provide that the client must identify any disputes with the invoice within ten days of receipt or shall be presumed to be in agreement with all portions of the invoice.

3. **Short Payment Durations.**

Keep the period between receipt of invoice and the date for payment as short as possible. Ideally, payment should be due before the next scheduled invoice to avoid a mounting series of unpaid invoices.

4. **Payment of Undisputed Portions.**

In the event the client does dispute a portion of an invoice, the Agreement should provide that they will make prompt payment of all undisputed portions.

5. **No Set-off.**

Provide that the client may not back-charge the professional or reduce payments as a set-off to perceived damages arising out of the professional's services. Such set-offs frequently subject the professional to the double impact of lost fees **and** liability payments. Provide that the client may only withhold fees for that portion of the services improperly performed.

6. **Right to Suspend.**

Include a provision which provides that, in the event payment of an invoice is not received within the prescribed time period, the professional may suspend services at their option until payment is received, and shall be compensated for the expenses of the disruption. However, such a provision is only useful if the professional is willing use it, or at least threaten to use it. Often, design professionals do not use such provisions because they are fearful of liability from the project impacts. Solve this by providing a release for any claims caused by such a suspension. Furthermore, the professional should protect against these risks by providing that the client shall defend, indemnify, and hold harmless the design professional from any and all claims, damages, or losses arising out of such a suspension. In this way, the professional is protected not just from the client, but from third parties (such as contractors) as well.

7. **Non-Payment Precludes Right to Use Documents.**

The Agreement should make the client's right to use the design professional's work product contingent upon timely and full payment of all fees and costs payable under the

Agreement. In the final analysis, such provisions are often the last and best means to compel an otherwise recalcitrant owner to live up to his or her obligations and make payment to the design professional.

8. **No Assignment.**

As indicated above, good client selection is one of the most important steps towards securing collection. That entire process can be lost if the selected client can assign the project and the design professional's obligations to a third party. Accordingly, the Agreement should provide that the Agreement and the design professional's duties and responsibilities may not be assigned to a third party without the design professional's **subsequent** written consent. Where lenders require an assignment, make it contingent upon an assumption of all client obligations under the Agreement and a contract amendment as necessary to protect the design professional and the project in light of the assignment.

9. **Parties To The Agreement.**

If a third party holds the project funds, consider adding it as a party obligated under the Agreement. Alternatively, require a guaranty of the payment of the fees and costs. Either way, the key is to have the party with the money bound to the design professional.

III. **THE PROJECT**

Once the project begins, collection issues cannot be forgotten as the services are delivered.

A. **Statutory Lien Protections**

In addition to the contractual provisions, any design professional working on a construction project also has statutory lien protections. Such provisions may often be the most useful tools for securing payment in that it can invoke pressure from third parties such as lenders, investors, and buyers who may demand a "clean title" on the project. Such provisions will vary from State to State. However, the procedures in California are somewhat typical.

In California, design professionals have two possible sources for such liens: the design professional-specific lien laws set forth in Civil Code §§3081, *et seq.*, and the more generic Mechanic's Lien laws set forth in Civil Code §§3082, *et seq.* Which scheme applies and provides the greater tools will vary depending on the project and the circumstances (*i.e.*, what type of project is it and who is the professional's immediate client). Accordingly, each set of statutes should be analyzed within the context of a particular project. However, **this analysis should always be performed at the outset of a project** since some rights may be foreclosed if certain steps and notices are not accomplished at the very outset.

A related “statutory” tool often available to protect design professionals is copyright, patent, and professional licensing provisions which limit unauthorized use of a professional’s work product.

**B. Non-Contracted Additional Services**

The best contract and the most strict adherence to lien laws often cannot protect the professional against the self-inflicted damage of providing non-contractual additional services. Most often, such services arise in one of two ways: the professional falls victim to “scope creep” and unilaterally provides services beyond the contracted scope, or the professional provides what he or she perceives to be “additional” services, often even at the client’s request, without reducing the Agreement to provide those additional services (and the related payment obligation) to writing. When such events occur, the professional and its attorney are often left with few arguments but equity and mercy in order to secure payment. Accordingly, any professional must strive for two standards during the course of a project:

1. Strict adherence to the contractual scope of work.
2. Consistent and thorough written documentation of requests for **and agreements to** additional services. Often, this effort is aided by self-executing provisions which put the onus on the client to say that such additional services are not requested or to be provided.

**C. Finding Leverage for Bringing Payments Current**

During the course of a project, there will frequently be those times when a client needs an extra service or favor. These are the times to make sure all payments are verified. Common opportunities for leverage include the following:

- Additional Services.
- Reduction in Services.
- Acceleration in Services.
- Requests for Services on a New Project.
- Change in Project Financing.
- Assignment of Project.
- Change in Project Ownership.

- Providing Value-Added Services or Courtesies. (Here, there should also be a limitation or release of liability as well.)

#### **IV. STAYING CURRENT AND HEADING OFF TROUBLE**

Experience shows that many firms fall behind in their collection efforts and accrue large, overdue receivables because they find discussions of such issues with clients to be awkward, uncomfortable, and even “unprofessional”. In reality, it should be seen as unprofessional to **not** address the issues. There are professional ways to pursue such issues without their becoming a point of conflict with the client. If they do become a point of conflict, it is better to know sooner rather than later.

A good collection procedure will typically follow a rational path of escalation. Such a procedure may include some or all of the following:

1. Even if a payment is not technically “due”, consider sending a reminder notice. For example, if an invoice has a thirty-day payment period, it may go to the bottom of the pile. A reminder fifteen days before the due date will often move the invoice back to the top of the pile.
2. If a payment is not received by the due date, a prompt written reminder should be sent. It should be succinct, courteous, and professional.
3. If payment is not received within a short time of the reminder letter (*e.g.*, 10-15 days), it is time for a personal contact. It may be in person or by telephone. Avoid asking questions such as: “Is there a problem?” Rather, ask: “Is there a reason we did not receive payment on time?” This is less likely to suggest a vulnerability. Confirm the conversation, any explanation, and the commitment to pay in writing. The explanation and the commitment may often be useful in a later collection effort and to defeat any differing excuses offered later. Even if no explanation is offered and no commitment made, the conversation should be documented for later use in establishing notice and the lack of any criticism.
4. No later than thirty days after a payment becomes overdue, all strategic options and requirements should be considered. This would include contractual options such as suspension of services, enforcement of guaranties, and notifications to owners and lenders. It would also include statutory remedies, such as lien notices and stop notices. Again, none of these measures is unprofessional, but are simply tools to be used to keep a project on track.

## V. COLLECTION RESOLUTION

Ideally, any collection effort will be held separate from any claim resolution. This avoids unnecessary entanglement and the almost inevitable counter-claim for negligence and breach of contract. This is also, quite candidly, one of the most difficult separations to make. Nevertheless, there are some procedures which have demonstrated themselves to be useful. Those procedures include the following:

### 1. Statutory Remedies.

Statutory remedies, such as liens and stop notices, often have much shorter time tables and durations for resolution than do client claims for breach of contract and negligence. Accordingly, these protections should be expressly retained and never waived. Such procedures often also create pressure points with third parties, such as lenders, which prompt clients to make payment.

### 2. Third-Party Guaranties.

If a third party holds the project funds and is guaranteed payment, the design professional may often take its fee claim directly to the guarantor without any threat of a counter-claim, since the third party is not the client.

### 3. No Set-Off on Related Claims.

The provision for no set-off referenced above can often also avoid an intermingling of claims.

### 4. Waiver of Fee Disputes.

A provision requiring immediate notice of disputes over fees can preclude intermingled claims.

### 5. Short Duration of Fee Disputes.

The Agreement may provide that all fee and cost disputes will be resolved within a short duration (*i.e.*, within sixty days) and that during the dispute the client will place the disputed funds into a trust fund. Experience demonstrates that design professionals are much more likely to receive their fees if the funds are out of the client's account.

Where a discount or a free service is provided, seek to obtain a release for any services related to the discounted fee. Such releases are most easily obtained during the project and often have a value far in excess of the discount, since they may preclude future claims.

## **VI. POST-PROJECT EVALUATION**

The end of one project should be viewed as a critical opportunity for preparation for the next project. While the project is fresh, the design professional should review all aspects of the project, including the financial performance. Relevant considerations include:

- Was the project profitable? If not, why not?
- Were payments made in full and on time? If not, why not?
- What project risks were encountered and avoided, and how?
- Were all aspects of the contract closed out and documented?
- What steps can be taken on subsequent projects to avoid or minimize negative experiences identified above?