Blueprint

for Design Professionals

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Navigators
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Welcome to our Spring 2013 edition of Blueprint For Deisgn Professionals. This issue re-visits the topic which has the greatest impact on client relationships - your contract. The first article discusses the importance of having a written contract and the second discusses the ten contract clauses you need to know about. Let us know your thoughts as it helps us to deliver to you information relevant to your practice. Send us article ideas, risk management questions, and any other comments you might have to David Soltero at dsoltero@navg.com. While we may not be able to respond to you directly, we will do our best to incorporate the answers and ideas in future issues.

"…As a result, soon a lawsuit is filed against the Engineer, the Contractor and everyone else who touched the project…."

INSIDE THIS ISSUE

You Will Look Better on Paper -Why You Should at Least Try to Get that Contract in Writing

By Phil Cardi

A common scenario for Architects and Engineers goes like this: an Engineer e-mails his lawyer a Notice of Claim letter that he's received from an Owner's lawyer. The lawyer's letter says there are drywall cracks in the Owner's new building, that the foundation is settling and therefore unstable, and there are a dozen other problems with the building

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TOP TEN DROP-DEAD CONTRACT CLAUSES DESIGN PROFESSIONALS CANNOT IGNORE

By Jean Weil

Statutory Overview

In days long gone by, design professionals routinely submitted a brief, bare-bones proposal outlining the scope of their proposed services and the anticipated fee. Such proposals, when accepted, formed the contract. The objective was to ensure that the design professional's risk in taking on the project was commensurate with the fee to be earned.

Unfortunately, with the evolution of the construction industry, the short-form contract is virtually extinct.

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As a result, soon a lawsuit is filed against the Engineer, the Contractor and everyone else who touched the project. The lawsuit claims that each and every defendant was partly responsible for design and construction, in other words, everything that happened on the project.

The Engineer meets with his lawyer and reports that he was hired to design the foundation and structural framing for the Owner, whom he considered to be a good client based on the fact that they had done two or three projects together without problems. But because he was a "good client," the Engineer didn't propose a written contract. Thus, there is no written contract between them describing the specific scope of work, the fee, the Contractor's responsibilities, or any of the other recommended terms for a design professional's contract. This article talks about what the Engineer now faces because he didn't have a written contract.

First, let's address a common misconception lay people have about contracts, and that is the notion that if you don't have a written contract, you don't have a contract at all. Not true. In virtually all states in the U.S., a contract is an abstract thing which is formed when there is a "meeting of the minds." A contract is simply an agreement between two or more people that courts will enforce. In the A/E world, a contract will likely legally exist if the design professional offered to perform work, the offer is accepted, and the work is done and paid for. A written document is simply good evidence of the agreement.

So, an oral agreement may be determined to create an enforceable contract here and the Owner can sue for breach of contract when the contract is not performed properly. Now we'll now look at what difference the lack of a written contract could mean in the resulting lawsuit. The first problem that the Engineer and his lawyer can expect is an "expansion" of the Engineer's scope of work. Now that a suit is filed, it is common for the Owner and/or Contractor to claim that they relied on the Engineer to "make sure" that construction was accomplished as designed. The Owner will hire an expert witness to opine that any engineer in the Defendant's shoes should make sure that the foundation excavation is properly done, or that the reinforcing steel is properly placed, or that the foundation drain is properly installed. Unfortunately, although this may be incorrect, that argument will be consistent with the preconceptions of many jurors.

And because there's no written contract, there is no clause stating that the Engineer is not responsible for the means, methods, etc., of construction. Of course, the defense's expert witness will contradict that view, and testify that the custom and practice in the profession does not require the Engineer to inspect or otherwise supervise the construction. However, all that gets the Engineer is a standoff, a "he said, she said" situation which still leaves a question for a judge or jury to decide. And when there is a decision to be made by a third party, there is a risk and thus pressure to settle to avoid the chance of an adverse verdict. The Engineer could be in a much better situation if there was a signed contract with standard terms and conditions that leave no doubt about construction-phase responsibility.

This illustrates a general problem the absence of a clearly written contract presents. When there is no contract, the Owner may make all sorts of allegations about the A/E's scope of work, or "assurances" he gave about the quality of his work

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or what the project would cost, just to mention a few. Once again, the issue in litigation may end up being less whether those claims are true than what the A/E's risk is if a judge or jury chooses to believe the claims.

When the Owner claims that the A/E gave oral assurances, for example, about project costs or project performance, something worse can happen. The A/E's professional liability insurance typically will only cover claims for breach of the standard of care, that is, professional negligence. So, if and when the Owner makes a claim that the A/E guaranteed a result of some kind, the insurance will not cover that claim. Then the pressure to settle short of trial, to avoid a verdict that is not covered by insurance is even greater. And when settlement costs go up, so might your insurance premium.

Another important benefit of having a clearly written contract is that the A/E will get the benefit of the parole evidence rule. When there is a lawsuit where the A/E has a written contract, this rule precludes the introduction of outside evidence to alter the terms of the contract (such as an alleged oral agreement). The only time outside evidence would be permitted is if there is ambiguity in the written agreement.

Another common scenario is this – the A/E sent a proposed contract to his client, but he was afraid to insist that it be signed before he started work. Nonetheless, he does the work and his fees are paid. Many people believe that if the proposal isn't signed, there is no contract. That is usually untrue as well. As long as the parties behaved as if the contract was in force - meaning the work scope in the proposal was performed, and the fee in the proposal was paid - courts will probably treat the contract as if it was signed. However, since the contract is unsigned, the A/E will not likely get the benefit of the parole evidence rule should questions be raised about the scope and/or quality of the professional services.

Of course, another consequence of the absence of a written contract is that all of those terms that your insurance company wants you to include in the contract were never even proposed. Important protections such as a limitation of liability, mandatory mediation, and ownership of design documents, simply don't exist. Those clauses usually put tremendous downward pressure on the settlement costs of cases, so they are very valuable.

What does this all mean? The bottom line is that it pays to send your client a proposed contract, and to always attach those standard terms and conditions you've been advised by your insurance company and your lawyer to use. Don't be afraid to ask your client to sign it and send it back before commencing work. Even if the client doesn't sign it or send it back, you will have a much better chance of resolving a future claim on a reasonable basis, but a written and signed contract will start you on the best track.

Phil Cardi is a partner with the law firm of Cardi, Schulte & Ford LLC, in Greenwood Village, Colorado, and has been representing architects, engineers, and surveyors for 30 years. If you would like more information regarding this article, please do not hesitate to contact Phil at PCardi@csf-legal.com.

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Spotlight on Navigator's Accountants Professional Liability Program

Program Highlights

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- Firms of any size excluding the Top 8.

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Contact Information:

Open Brokerage:

Rocco Malandrino – Rmalandrino@Navg.com (846)285-9093
Randy Villanueva – RVillanueva@navg.com – (212) 613-4224
Dave Westfall – DWestfall@navg.com (847)285-9086
Stacey Friedman – SFriedman@navg.com (212) 613-4279

Program Manager:

Betsy Magnuson
The Herbert H. Landy Insurance Agency, Inc.
betsy@landy.com

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Owners and developers have lawyered-up their contracts to include hundreds of provisions intended to shift risk to the design professional while minimizing reward. Five years of economic decline have put owners and developers in the driver's seat with respect to negotiating contracts. The excess supply of design professionals has created an environment where they feel they have no choice but to sign whatever contract is presented.

Design professionals have more leverage than they think. No project gets built without plans and specifications; thus, design professionals have ample negotiating power to secure a fair and balanced contract that allocates both risk and reward in a way that makes sense. They need to pay close attention to each and every contract clause, and particularly those key clauses that will affect them most acutely in the event of a problem. A good contract versus a bad contract is the difference between life and death in the event of knock-down-drag-out litigation.

The following is a brief discussion of the top ten "make or break" contract clauses that will most likely determine the design professional's fate in the event of a lawsuit.

Indemnity and Defense Clauses

Indemnity is a duty to make good any loss, damage or liability incurred by another. In short, it is an agreement to assume a specific liability in the event of a loss. Effectively, by accepting an indemnity obligation, the risk shifts from one party to another and serves as a kind of "insurance" for the party getting indemnity.

Indemnity clauses in contracts usually go hand-in-hand with defense clauses. The defense clause is a contractual provision where one party agrees to "defend" the other party from future claims or lawsuits, i.e., one party contracts to pick up the costs of defending the other against claims and lawsuits, including attorneys' fees, expert fees and other hard costs of litigation. Often, this means paying for the other party's defense, even in the absence of fault.

Indemnity and defense clauses have the most far-reaching implications for design professionals as they can dramatically shift the risks and costs of a claim to the design professional. They are the most difficult to negotiate, the most likely to be the "deal breaker", and the most hotly litigated. For example, by agreeing to indemnify and defend a client from any and all future claims or lawsuits, the design professional has essentially become the "insurer" of everything that can go wrong on a project. In a complex construction dispute, defense costs and fees can run into seven figures.

Courts strictly construe indemnity and defense clauses, applying the same rules that govern other contracts and look at the plain language of the provisions. Design professionals must expect to be held to the terms of any indemnity and defense clause.

As a rule, professional liability policies cover damages that flow from errors and omissions that constitute a violation of the standard of care. Insurers do not insure against any and all liabilities that a design professional assumes by contract

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Thus, design professionals should avoid any agreement to indemnify or defend the client. If a design professional *must* give indemnity to the client, the indemnity obligation *must* be clearly tied to a finding of negligence. Also, the contract should expressly state that indemnification does not include any duty to defend the client. Finally, the indemnity obligation must be limited to the design professional's proportionate share of negligence.

Please note, indemnity and defense clauses can be hidden in a client's lengthy standard form contract. Clients (and their lawyers) know that most design professionals are sufficiently sophisticated to pay attention to clearly identified indemnity and defense clauses. It is easy to overlook a defense and indemnity clause buried in the text of an otherwise seemingly innocuous clause. In short, there is no way to avoid reading *every* provision of *every* contract.

Waiver of Consequential Damages

Consequential damages are losses that flow *indirectly* from a breach of contract. In contract law, the goal is to return the non-breaching party to the position it would have been in, absent the breach. Consequential damages are those damages a breaching party knew or should have known (e.g., foreseeable) could result from a breach at the time of contracting. These may include delay damages, acceleration damages, lost profits, loss of use, damage to business reputation, damage to credit worthiness, etc. Thus, without a clause waiving consequential damages, the design professional could face the risk of damages far in excess of any benefit.

Luckily, these clauses are usually acceptable to owners and developers, however, they will not typically include a consequential damages waiver in their form contract. A design professional will likely need to add this clause to the contract. The design professional can usually secure a unilateral agreement whereby only the client waives the right to recover consequential damages; however, if the client objects, a mutual waiver is acceptable.

Limitation of Liability Clause

A limitation of liability clause is a contractual provision by which the parties agree on a maximum amount of damages recoverable for a future breach. To ensure that such a clause is enforceable, it should be plain, clear and conspicuous to help demonstrate that the clause was expressly negotiated as between the parties.

Typically, when design professionals are able to negotiate limitations of liability, such clauses limit liability to the greater (or lesser) of a specific sum or the design professional's fee. Other such clauses limit liability to available insurance policy limits (as professional liability policies are depleted by defense costs and fees, as well as satisfaction of other claims). Ideally, the limitation of liability clause ought to specify that the limit of liability is inclusive of fees and costs incurred in the defense of the claim.

Note, limitation of liability clauses are *only* enforceable as between the contracting parties. Thus, other parties (not parties to the contract) are not bound by any such limitation. Nevertheless, these clauses are an effective tool to calibrate risk and reward.

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Design professionals are more apt to propose a competitive fee structure if their client is willing to limit their liability in the event of a breach. The design professional can obtain maximum protection if, in addition to the limit of liability, it can secure an agreement from the client to indemnify and defend the design professional for claims and damages above and beyond the limit of liability. This will protect the design professional from claims by other parties. These types of clauses are particularly appropriate for projects with the potential for significant risk.

Sole Remedy Clause

In most states, design professionals can be held personally liable for errors and omissions in the plans that they stamp or seal. This is true even if the design professional is acting in the course and scope of employment with a firm. Thus, parties can sue the firm and the individual professional. The sole remedy clause insulates the individual design professional from being named in a lawsuit. These clauses can be unilateral, protecting only the design professionals, or they can be mutual, protecting both sides.

Waiver of Third-Party Obligations

Other parties, not parties to the contract, may claim that the design professional owes them an independent duty of care. To inoculate themselves from these claims, design professionals can include a short waiver of third-party obligations clause. That is, they can contractually agree that nothing in their contract creates a contractual relationship or cause of action in favor of a third-party.

Standard of Care Clause

The standard of care is generally defined as the degree of care and skill ordinarily exercised, under similar circumstances, by reputable professionals practicing in the same discipline, in the same locality and in the same timeframe. The standard of care is not perfection.

Sometimes clients want the design professional to agree to a "super" standard of care. For example, clients may want a design professional to agree to perform services in accordance with the "highest degree of skill and training" or the "highest standard of practice." These provisions create the potential for unlimited liability because virtually any error or omission becomes a breach of the standard of care, no matter how minor. Additionally, such modifications to the standard of care could create coverage issues as professional policies are premised on the common law standard of care.

Disclaimer of Warranties and Guarantees

In most states, the concept of "warranties" or "guarantees" stems from products liability law. For example, a manufacturer or retailer of goods may "warrant" or "guarantee" the fitness or quality of its goods. If the goods fail to meet expectations, the consumer may have a cause of action for breach of implied or express warranty.

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Some states have extended this concept to design professionals by holding that design professionals impliedly warrant the accuracy and/or constructability of the plans and specifications. Sometimes a client will ask a design professional to expressly provide a warranty and/or guarantee in a contract. However, this is essentially a backdoor way for a client to contractually demand performance above and beyond the standard of care, and perhaps even perfection.

Design professionals should avoid any and all contractual promises to warrant or guarantee performance. Design professionals provide a service, not a product, and cannot promise a particular result, particularly because they have limited control over the end product. Ideally, design professionals should incorporate a clause disclaiming all warrantees and guarantees.

Attorneys' Fees Clause

In most states, absent a specific statute or express agreement, attorneys' fees are generally not recoverable by the prevailing party. However, parties can freely contract to "award" attorneys' fees to the prevailing party. Unfortunately, attorneys' fees clauses are a double-edged sword and can drive up the stakes and often impede settlement. Further, insurers do not cover an adverse award of attorneys' fees where that obligation is assumed only by contract. Design professionals are usually better off deleting any contractual agreement where attorneys' fees are paid to the prevailing party.

Dispute Resolution Clause

Design professionals can expressly negotiate an agreement to resolve disputes. Typically, disputes can be resolved through mediation, arbitration or litigation. Frequently, parties expressly agree to mediate all disputes in advance of arbitration or litigation. In this manner, parties avail themselves of an opportunity to reach a quick settlement before expending attorneys' fees and costs. Design professionals should include mediation clauses in their contracts. However, there has been a shift in the industry away from arbitration and in favor of litigation in the event mediation fails. The consensus among most attorneys and insurers is that design professionals tend to fare better in front of juries, as opposed to arbitrators. For this reason, design professionals should seriously consider avoiding contractual agreements to arbitrate disputes, thereby losing their right to a jury trial.

The above contract clauses have proven to be the most important clauses to address in standard form contracts. However, be aware that state laws vary with respect to the enforceability of certain contract clauses. The design professional should consult with an attorney to assist in reviewing contracts and/or preparing customized standard terms and conditions. She or he can also utilize standard form contracts prepared by reputable organizations representing the design professional industry as a whole.

Jean Weil is a founding partner at Weil & Drage, APC, a law firm with offices in California, Arizona and Nevada where she concentrates her practice on the representation of design professionals. If you would like more information regarding this article, you can reach her at: jweil@weildrage.com

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