Practical Guidance

Risk Allocation Strategies for Design Professionals

A Practical Guidance® Practice Note by
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Design professionals, including architects, engineers, design consultants, professionals who engage directly with the design-builder or contractor and provide services to the construction project design, need to be aware of the wide-ranging, multitude of risk allocations and varying levels of exposure and potential liabilities embedded in the contracts and other legally binding documents they sign. This practice note identifies and explains key risk allocation strategies for design professionals.

For a full set of construction resources, see Construction Resource Kit.

Preliminary Considerations

Construction contracts, well, any contract for that matter, should be well-written, comprehensive, and clearly define the roles and responsibilities of all parties. When disputes arise, courts first look to see if there are contractual provisions governing the subject matter of the dispute.

The first question design professionals should ask themselves is "how do I protect my interests and my work when multiple parties, stakeholders, and interests are at play?"

First and foremost, design professionals must be aware of the risks involved in the project. This includes understanding the site conditions, scope(s) of work, potential for changes, and their roles and responsibilities, as well as the roles and responsibilities of all other contract parties.

Ideally, contract terms should be negotiated and subsequently structured to allocate the risks of a project in a way that is fair and equitable to all parties. This should involve specifying the responsibilities and expectations of each party and their assumed risks. Design professionals should include protective contract provisions and limit their liability where possible.

Before diving into the ins and outs of risk allocation, it is important to understand the structure of a standard construction project, the parties typically involved, and the dynamics of those parties.

Construction Project Structure and Players

Construction projects, depending on the size, typically include numerous contracts and parties, each of which plays a specific role.

Here are the basics. The "owner" of a project is usually the person/entity who will own the building or thing constructed. There are two primary project delivery methods, Design-Bid-Build and Design-Build, each of which have their own advantages and disadvantages.

In a Design-Bid-Build scenario, the most traditional delivery method, the owner contracts separately with a contractor for the construction and a design professional for the design services related to the construction project.

In a Design-Build scenario, the owner contracts with one entity who is responsible for both design and construction—it

can be one firm that handles both, or if the owner engages a contractor, the contractor will be tasked with engaging design professional, with whom the contractor will work hand-in-hand to provide design, engineering, and implementation/construction services.

Similar to the Design-Build method, is an Integrated Project Delivery method, in which the owner, architect, and general contractor are usually parties to a single agreement.

Also, somewhat similar to a Design-Build from a contractual standpoint is the Construction Manager at Risk, or CMAR, delivery method, in which the owner engages a construction manager to oversee the project from design to construction close out.

During the design and planning stage, the construction manager works closely with the architect/design professionals and the general/prime contractor who is sometimes also the construction manager. However, with a CMAR the design professional contracts directly with the owner, not the construction manager.

For a full discussion of project delivery methods, see Advantages and Disadvantages of the Primary Construction Project Delivery Methods.

Standard Risk Allocations and Flow-Down Provisions

Allocations of risk can take many forms. Generally speaking, changes in the scope of work and delays caused by the owner are typically allocated to the owner. Risks typically allocated to the contractor include errors in the contractor's work, delays caused by the contractor, and faulty materials.

Risks generally allocated to design professionals include errors and omissions in design documents and delays in providing the same. Design professionals are also typically responsible for investigating the site conditions of a project and providing the owner with an accurate representation of the site.

The owner is typically responsible for any unknown or concealed site conditions that may be discovered during construction. However, depending on the nature of the work, the owner may seek to shift the risk of unforeseen site conditions to the contractor and unforeseen site conditions can be very costly. Because design professionals may encounter unforeseen conditions during construction that were not disclosed by the owner, they should carefully assess these conditions and immediately communicate them to the owner.

While "flow-down" provisions are more common between general/prime contractors and subcontractors, such provisions may also be included in design professional's contracts when hired as a subcontractor or contracting with a subcontractor. Flow-down provisions legally obligate a subcontractor to provide everything to the prime contractor that they in turn must provide to the owner. It is more common for contractors and subcontractors as subcontractor's obligations mirror those of the prime contractor—in essence, the same goals, specifications, terms, and deadlines—to protect owner from liability if subcontractor fails to meet certain obligations within a project duration.

Flow-down provisions can cover anything from scope of work to project timeline to payment terms to change orders to dispute resolution, among other specific areas of a project. If faced with flow-down provisions, it is important for design professionals to be aware of their specific obligations and how they mirror that of the prime party. Design professionals should not agree to open-ended, vague, and ambiguous flow-down provisions.

Common Risk-Related Disputes

The contractual relationship of all relevant parties, may dictate who may sue who, or in other words, who has a right of action against a certain party.

Lawsuits against design professionals typically arise out of deficient/flawed design documents, breaches of duties owed to the owner or contractor, failure to observe or note a specific condition during a site inspection, and delays caused by a design professional which lead to a postponement in the contractor's work or an economic loss felt by the contractor or owner.

If a design professional makes an error or omission that results in damage to the contractor or owner, the design professional may be liable for those damages. To mitigate this risk, design professionals should carefully review their work and make sure that it is accurate and complete. They should also have a system in place for checking their work for errors.

It comes as no surprise that shifting project scopes and work order changes are the biggest culprits of contention and litigation.

For example, in *Rabin v. Anthony Allega Cement Contractor, Inc.*, the Tenth District Court of Appeals held: "Where the parties to a construction contract agree to a change order which they intend to provide complete compensation for a given change in the project, the party being compensated by the change order will be contractually foreclosed from seeking additional compensation related to that same project change." 2001 Ohio App. LEXIS 4921, at *25–26.

While it is important for all parties to constantly communicate on a project, especially if plans change or work needs to be altered, communications should be in writing, or later memorialized in writing, and change orders should always be in writing. Generally, courts adhere to written and recorded changes to work orders most often than not, so it is extremely important for design professionals to have EVERYTHING in writing. Failure to do so is a common mistake in the construction industry.

In addition, it is important to be familiar with the laws governing relevant project jurisdictions, as well as recent case law within those jurisdictions that may impact the outcome of any litigation you may be involved in.

For example, in Indiana, courts have long recognized that contracts represent the freely bargained agreements of the parties. Haegert v. University of Evansville, 977 N.E.2d 924, 937 (Ind. 2012), citing Fresh Cut, Inc. v. Fazli, 650 N.E.2d 1126, 1129 (Ind.1995); Trimble v. Ameritech Publishing, Inc., 700 N.E.2d 1128, 1129 (Ind.1998). ("It is in the best interest of the public not to restrict unnecessarily persons' freedom of contract. . . . This is our baseline.")

In SAMS Hotel Group, LLC v. Environs, Inc., 716 F.3d 432 (7th Cir. 2013), SAMS Hotel Group, LLC contracted with an architectural firm Environs pursuant to which Environs would provide architectural services for a hotel and Environs would receive $70,000 (flat fee) for the services.

The contract between the two parties contained the following limitation of liability clause: "The Owner [SAMS] agrees that to the fullest extent permitted by law, Environs Architects/ Planners, Inc. total liability to the Owner shall not exceed the amount of the total lump sum fee due to negligence, errors, omissions, strict liability, breach of contract or breach of warranty." In other words, the limitation of liability of provision language within the contract capped any liability at $70,000 for Environs.

More than a year after the contact was signed, and right before the hotel was complete, it was discovered that there were serious structural defects, and the hotel was condemned by the county. Remedy attempts to resolve the structural flaws failed, and the hotel was demolished. SAMS sued Environs for $4.2 million, the estimated loss of the project.

The appellate court, applying Indiana law and state precedent, reaffirmed that parties have freedom of contract and that "includes the freedom to make a bad bargain." SAMS Hotel Group, LLC, 716 F.3d at 438. "The undisputed facts show that the negotiating parties were two sophisticated business entities of equal bargaining power who were aware of the risks involved in designing and building a hotel." SAMS Hotel Group, LLC, 716 F.3d at 435. Therefore, the architect's liability was limited to $70,000 in the face of a $4.2 million claim for damages.

In Louisiana, courts recognize "the existence of a duty of care owed by design professionals to persons with whom the design professional does not have privity [of contact]." Williams v. Wood, 2017-1049 (La. App. 4 Cir. 10/31/18), 258 So. 3d 834, 841, writ denied, 2018-1946 (La. 1/28/19), 262 So. 3d 902. While no claim for breach of contract can be asserted in the absence of privity of contract, claims for damages based on the wrongdoer's tort are not precluded. Id.

Interestingly, it is not always the design professional who is held liable for faulty plans. In 1907, the Texas Supreme Court, in Lonergan v. San Antonio Loan & Trust Co., 104 S.W. 1061, 1067 (Tex.1907), created the *Lonergan* doctrine, which provides that the contractor bears the risk of loss due to defective plans and specifications in the absence of language to the contrary. The court dismissed the contention that owners impliedly guarantee plans and specifications. The court reasoned:

> There is no more reason why the [owner] should be held responsible for the alleged defects in the specifications that it did not discover for want of skill and knowledge of the business of an architect, than there is for holding [the contractor] to be bound by their acceptance of the defective plans which they understood as well as the [owner] did, and in all probability much better. The fact that [the contractor] contracted to construct the building according to the specifications furnished implied that they understood the plans.

104 S.W. at 1065–66.

More recent opinions have reaffirmed *Lonergan* including Great Am. Ins. Co. v. North Austin Mun. Util. Dist. No. 1, 902 S.W.2d 488 (Tex. App. — Austin 1993), rev'd in part and aff'd in part, 908 S.W.2d 415 (Tex. 1995) and Interstate Contracting Corp. v. City of Dallas Texas, 407 F.3d 708, 720 (5th Cir. 2005).

Under *Lonergan*, in order for an owner to be liable to a contractor for a breach of contract based on faulty plans, the contract must contain express or implied language that justifies finding the owner liable. Interstate Contracting Corp. v. City of Dallas Texas, 407 F.3d 708, 717 (5th Cir. 2005).

Insurance, Insurance, Insurance

In the context of construction litigation, insurance carriers are generally the ones paying for the cost of defense and potentially any judgment obtained by the plaintiff. Accordingly, the importance of insurance cannot be overstated. Design professionals should carry professional liability insurance, and while owners/contractors will require

the production of certificates of insurance to ensure the policy limits meet those required by the relevant project documents, it's a good idea to review policy terms and coverage limits regularly.

Further, contracts should clearly specify which entities are to be named as additional insureds under which policies and design professionals may request to be added as additional insureds on the contractor's and/or owner's policies. This way, the parties can avoid unnecessary disputes over an uninsured loss.

Finally, design professionals should verify the credentials, licensure, and insurance coverage for any party with whom they contract.

For more on using insurance to address construction risks, see Insuring Construction Risks through Commercial General Liability Policies and Builders Risk Insurance and Its Use in Construction Projects. For a sample insurance clause for inclusion in an owner-architect agreement, see Insurance Requirements Clause (Owner-Architect Agreement).

Top 10 Tips for Design Professionals

Contracts typically contain several provisions designed to allocate risks, but unfortunately, the contracting parties may not fully understand the meaning of the provisions or the risks associated with them.

Here are some tips to consider when negotiating contract terms and helpful hints to avoid costly, litigious disputes.

1. **Know and understand all risks.** The specific risks that are allocated to the design professional will vary depending on the project and other the contract terms. It is important for design professionals to understand the risks that they are assuming when they enter into a construction contract. By understanding the risks, design professionals can take steps to mitigate those risks and insulate themselves from potential liability.
2. **Hire a professional for contracts.** Throughout drafting, review, negotiation, and/or finalizing any contract, it is important to consult with a legal professional experienced in both contract and construction law. Contract review can be exhausting and time-consuming, and the assistance of someone well versed in the subject matter can help prevent potential disputes and/or litigation. Legal counsel will also be able to advise on any other contract provisions and/or protections which may have been either intentionally or inadvertently admitted by the other party.
3. **Define scope of services/work.** Ambiguous or poorly written contracts can expose design professionals to unintended risks. Design professionals need to ensure that the contract clearly defines the scope of their services, specific deliverables, timelines, and all parties' roles and responsibilities. Within the defined scope of work, design professionals should also address any intellectual property rights of the design professional's work, specify how the designs and documents can be used or modified, and clearly state whether the design professional retains ownership of their work in the event of termination.
4. **Uphold professional standard of care / not perfection.** Design professionals are expected to perform services in accordance with the professional standard of care addressed within their industry and trade, but design professionals may also want to consider incorporating language to this effect in their contracts. This helps establish expectations for a design professional's scope of work under a contract.
5. **Document ALL communication, including change orders.** It is important to document and keep records of all communications, meetings, text messages, emails, and the like., to avoid disputes and prove compliance with contract terms and obligations. Professionals are typically responsible for preparing the initial plans and specifications for a project, but it is not uncommon for the owner to request changes during construction. The risk of these changes is typically allocated to the party that initiates the change. However, design professionals should carefully review all changes to the work and to ensure such changes are feasible and do not increase the risk of claims of errors or omissions. Accordingly, design professionals should establish a clear process for documenting and approving changes to the project scope, confirming that additional services or modifications are properly compensated and documented.
6. **Maintain/acquire necessary insurance.** Design professionals should carry professional liability insurance to protect themselves from the financial consequences of claims arising out of allegations of errors, omissions, or negligence. It is also important to review policy terms and coverage limits regularly with broker or legal counsel to ensure they align with the project requirements and allocated risks. When feasible, design professionals may consider requesting the owner to carry insurance, which would help protect the design professional in the event of a claim by a third party.
7. **Limit liability.** Negotiate for reasonable limitations on liability, such as monetary caps or exclusions for consequential damages. All parties should understand where liability resides, and how to effectively shift and mitigate risk. Including a limitation of liability provision,

prohibiting recovery in excess of a design professional's insurance coverage, is also good idea.

8. **Understand indemnification and its benefits.** Consider mutual indemnification clauses that allocate responsibility for losses and liabilities appropriately. Limitation of liability is generally considered when allocating risk between the contracting parties, where indemnification primarily deals with risk involving third parties. In many cases, design professionals are required to indemnify and hold harmless their clients against claims, damages, and losses resulting from the professional services provided, except for those caused by the client's negligence or misconduct. In construction contracts, indemnification clauses are often used to protect one party from the liability of another party. Indemnification clauses can help to protect both parties from financial losses. However, it is important to review the indemnification clause before signing a construction contract to make sure that you understand the terms and conditions. Protect your interests by familiarizing yourself and negotiating favorable terms related to liability, indemnification, and limitation of liability.

   For a sample indemnification clause, see Indemnification Clause (Owner-Architect Agreement). For information on state laws affecting the permissible scope of indemnification clauses, see Anti-Indemnity Statute State Law Survey.

9. **Outline payment terms/schedules.** In any contract, clearly outline all payment schedules and terms, including the design professional's fee structure, billing schedule, and any payment conditions. This ensures prompt, efficient, and fair compensation for services rendered. Insert "pay when paid" or "paid if paid" clauses as necessary to protect cash flow and avoid any disputes. "Pay when paid" provisions are governed by state laws and mandate the amount of time a higher tier contractor has to pay its subcontractors. State laws typically set financial penalties for the owner's failure to pay on time.

   For information on state laws limiting the availability of these clauses, see Contingent Payment Clauses in Construction Subcontracts State Laws Survey. For sample pay if paid clauses, see Pay if Paid Clauses (Construction Subcontract).

10. **Provide for mediation/arbitration and/or termination.** Disputes may arise, and if they do, a mandatory alternate dispute resolution (mediation or arbitration) provision can help to resolve disputes quickly and efficiently by a third-party mediator or arbitrator, and may prove to be substantially less costly than litigation. Design professionals should also be on the lookout for termination clauses that define the conditions under which parties can terminate the contract, the rights and responsibilities of parties in the event of contract termination, and these provisions can help protect parties' interests in alternate dispute resolution.

    For ADR resources, see Construction Dispute Resolution Resource Kit.

AIA and EJCDC Contracts

In addition to the foregoing tips and tricks, The American Institute of Architects and The Engineers Joint Contract Documents Committee offer very helpful resources for design professionals. The American Institute of Architects has a contract document website that offers nearly 250 standard sample contracts, which can be sorted by project role, project type, document type, and specialty. These contracts are recognized as industry standard documents for architects, contractors, engineers, attorneys, owners, and all other parties involved in a construction project. However, all contracts must be tailored to the specific project and risks.

Earlier this year, the Engineers Joint Contract Documents Committee released its 2023 Construction Manager at Risk (CMAR) Series—27 documents, including contracts, bonds, contractor-procurement documents, and administrative forms—for use on public and private projects in which the owner retains a CMAR to provide preconstruction services and then construct the project. The EJCDC is a joint venture of American Council of Engineering Companies, National Society of Professional Engineers, and American Society of Civil Engineers – Construction Institute.

While both the AIA and EJCDC are important resources to purchase and download standard contracts that are well respected by the industry, these documents are editable upon purchase. So, parties can change risk allocations or edit other verbiage to benefit themselves. Therefore, design professionals should consider seeking legal counsel to review and advise on general terms and risk allocations.

The specific risks that are allocated to the design professional will vary depending on the specific project and the terms of the contract. Design professionals should carefully consider the risks allocated to it and to negotiate the contract terms to minimize their potential liability.

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