

# **PERPLEXING ISSUES IN DESIGN BUILD PROJECTS©**

**Joint Fall CLE Meeting  
Section of Taxation and the Section of  
Real Property, Probate and Trust Law  
American Bar Association  
October 1, 2004**

**©Susan Linden McGreevy  
Husch & Eppenberger LLC  
1200 Main Street, 17<sup>th</sup> Floor  
Kansas City, Missouri 64105  
(816) 421-4800**

**©A. Elizabeth Patrick  
Jessica D. McKinney  
Kilpatrick Stockton LLP  
1100 Peachtree Street, Suite 2800  
Atlanta, Georgia 30309  
(404) 815-6573**

**©Norman M. Arnell  
Stinson Morrison Hecker LLP  
1201 Walnut Street, 29<sup>th</sup> Floor  
Kansas City, Missouri 64106  
(816) 691-2701**

## **INTRODUCTION**

The increasing popularity of Design-Build projects is attributable to a number of factors, including an excellent sales presentation by the parties offering such services.

Prior to the more recent popularity of design-build, the most frequently (and perhaps still the most frequently) used system of construction was that of design-bid-build. In this format, the owner engaged the designer and together they arranged for bidding based upon the plans and specifications developed by the designer and a separate contractor was then engaged by the owner to perform construction services.

In a nutshell, design-build offers to the owner what could be referred to as one-stop shopping. Whether the designer is the lead (sometimes called the "front end") or the contractor is the front end, the promise to the owner is that the owner need deal only with one party that will provide for the owner all of the services needed for construction.

The attractiveness of dealing with one source does, however, mask the fact that there are problems and pitfalls that can be obscured by the offered concept of saving time and money. Design-build is not suitable for all projects, including those that require special use and design services, where an architectural statement is desired, or for renovating or remodeling existing construction.

Under design-build, the owner is not involved in the game of finger pointing if something goes wrong whereby the contractor claims it was the designer at fault and the designer claims it was the contractor that was at fault. The owner can look to the design-build team and any disagreements between members of the team can remain between them.

This series of papers addresses some of these risks and pitfalls in outline form and each paper essentially covers three issues. As in all things, certain aspects of issues may spill over into one or more generalized headings.

A recommended compilation of state-by-state laws and regulations is contained in The Design/Build Deskbook, Third Edition, published by the ABA Forum on the Construction Industry. As with all compilations, it pertains to a point in time and further research for a state is required.

# **PERPLEXING ISSUES IN DESIGN BUILD PROJECTS**

**Joint Fall CLE Meeting  
Section of Taxation and the Section of  
Real Property, Probate and Trust Law  
American Bar Association  
October 1, 2004**

**©A. Elizabeth Patrick  
Jessica D. McKinney  
Kilpatrick Stockton LLP  
1100 Peachtree Street, Suite 2800  
Atlanta, Georgia 30309  
(404) 815-6573**

**PERPLEXING ISSUES IN DESIGN BUILD PROJECTS  
OUTLINES PREPARE BY A. ELIZABETH PATRICK  
AND JESSICA D. MCKINNEY©**

- 1. STRUCTURING THE DEAL**
- 2. PREPARING AND NEGOTIATING THE RIGHT CONTRACT**
- 3. MANAGEMENT OF THE PROJECT**

## **PERSPECTIVES AND PERILS OF DESIGN/BUILD DELIVERY: STRUCTURING THE DEAL AND CONTRACT RISK**

In spite of the fact that there is growing popularity for the Design-Build method of project delivery because it offers several advantages to the Owner, this method of project delivery nonetheless presents risks and a number of pitfalls for the unsuspecting property Owner. However, it can be extremely successful if done correctly. Thus, in order to ensure success, at least as close as humanly possible, an Owner should pay close attention to three major issues, which if addressed correctly in the beginning stages of the project will maximize the success of the project. Those issues are: 1) structuring the Design-Build project relationship; 2) preparing and negotiating the right contract; and 3) managing the project for success. Each numbered item will be briefly discussed below.

### **Structuring the Deal**

Initially when deciding to utilize the Design-Build project delivery system, an Owner has to figure out with whom, or with which "entity", it is going to contract. In the typical design-bid-build system the Owner contracts with an architect/designer *and* a construction company. However, in the Design-Build scenario there is one entity, but how do you get one entity? Although there are some Design-Build teams that only do Design-Build work and therefore they are already "one", this is typically not the case. So, does the architect go out and find a willing construction company? Does the construction company find the designer? Or, does the Owner find a willing designer and a willing contractor and put them together? Once together, what type of "union" do the designer and the contractor enter into to accomplish the project goals under the Design-Build delivery method. This very important issue can either ease or complicate the Owners' interest in the contract documents and the project.

There are several forms the "entity" can take. Each one has pros and cons that an Owner must be sensitive to for her own protection. Sometimes the designer and the contractor will form a joint venture. A joint venture is an association of two or more persons, partnerships, corporations or any combination of them, established to carry on a single business activity, which is limited in scope and duration. The entities comprising a joint venture usually share the economic interest in the venture and have proportionate control over management of the project. On the other hand, the designer and the contractor may decide to form a limited liability partnership (LLP). A limited liability partnership usually has no assets and the liability of the partners is limited to the amount of capital invested in the LLP. Thus, an Owner should be careful in contracting with an entity that is essentially shielded from liability.

It is a daunting task to ask an Owner to look into and be cognizant of the type of entity with whom it is contracting, but this crucial step could mean the difference between being able to recover, or not. If unsure, it is incumbent on the Owner to seek professional, legal advice. As

the above two examples show, the difference between a joint venture, or a LLP is great and will, if the project takes a bad turn, impact the Owners' bottom line.

### **Preparing and Negotiating the Right Contract**

The second major issue that impacts the success of a project under the Design-Build delivery system is contract negotiation. Contract negotiation is essential for the Owner, mainly because the American Institute of Architects (“AIA”) and the Associated General Contractors of America (AGC) standard contract forms were designed to protect the Design-Build entity and not the Owner. The key contract provisions that an Owner should be ready to negotiate include, but are not limited to, a) insurance; b) indemnification; c) performance and payment bonds; d) liquidated damages; and e) environmental conditions.

#### **A. Insurance**

Insurance, and its companion topics of indemnification and performance and payment bonds are meant to provide insulation to the Owner for the negligent and intentional acts and omissions of the Design-Build entity, its subcontractors, etc. Insurance coverage is not only necessary to protect the Owner from exposure because of the Design-Build entities acts and/or omissions, but it is also many times a hot issue for lenders and other third parties that have an interest in the project and project financing.

The AIA and ACG standard contract forms lack “umph” in giving the Owner her due protection as far as insurance requirements are concerned. In fact, although the contract forms may include some language requiring insurance for the construction of the project, the standard forms are void of any requirement that the Design-Build entity carry insurance capable of providing coverage for design errors. Insurance coverage for design errors is contained in professional liability and errors and omissions liability policies, however, unless the Owner specifically requests the inclusion of these types of insurance, this protection is non-existent and exposes the Owner to serious risk for any design errors and omissions. Moreover, an Owner should consider, after consultation with appropriate insurance representatives, if business interruption insurance is a necessity to protect against any claims that the Owner may have if the project is not completed in a timely fashion.<sup>1</sup>

Finally, an Owner should pay close attention to the limits of coverage and ensure that the coverage amounts are sufficient based on the size and scope of the project. In a nutshell, an Owner should insist that all claims arising out of any type of service provided by the Design-Build team, including design errors, be properly insured, giving special attention to exclusionary language, coverage amounts and the requirements of being “additional insureds” per lending and tenant requirements. A mistake in carefully reviewing the contract’s insurance language could end up being a very costly mistake for an Owner in the Design-Build project delivery system.

---

<sup>1</sup> See also the discussion below regarding Liquidated Damages.

## B. Indemnity

Indemnity, or the ability to shift the impact of loss, like insurance, is crucial in protecting an Owners' interest in the project. The AIA contract documents contain, in Part II, a limited indemnity provision. However, from the language used in the AIA indemnity provision, it is arguable that indemnity only exists for personal injury and property damage that occurs during the construction of the project. Again, this leaves the Owner wide open to substantial exposure for liability incurred as a result of design acts and omissions, or as a result of liability imposed for something other than personal injury or property damage. Modification of the indemnity provisions, and coordination of indemnity provisions in project agreements is essential to minimize liability gaps and eliminate duplicative coverage.

## C. Performance and Payment Bonds

Neither the AIA or the ACG contract documents require the Design-Build entity to provide performance or payment bonds to the Owner. Quite simply put, from an Owner's perspective, this is unacceptable.

Performance bonds protect the Owner against loss if the Design-Build entity fails, or refuses, to perform its obligations under the contract. This type of bond is especially important to have if the Design-Build entity, for whatever reason, becomes insolvent and cannot perform. Payment bonds protect the Owner from claims to pay for the labor, materials and equipment furnished for use in the performance of the contract obligations. This type of bond is material to protect the Owner against claims by subcontractors that they were not paid for work done on the project. Because both of these types of bonds are solely for the Owner's benefit, it is no wonder that they are not included in either the AIA or the ACG contracts.

An important note to make, is that just as insurance *does not* provide coverage for the Design-Build entity's failure to complete the project, or pay for services, labor, or equipment utilized during the project, performance and payment bonds *do not* cover defective design, personal injury, property damage, or late completion claims. Therefore, both insurance (professional liability, errors and omissions, and business interruption coverage included) *and* performance and payment bonds are imperative for an Owner to have in its contract documents.

## D. Liquidated Damages (Delay Damages)

Project completion, more specifically, timely project completion is essential in most projects, whether completed under the Design-Build delivery system, or not. If late, the financial consequences could be great, including, but not limited to, increased financing and lost profits. So, how does an Owner protect herself in case the project is not completed in a timely manner?

First, there is a Contract. The contract mandates that the Design-Builder will complete the project within a time certain. If not, the Owner always has the option to sue the Design-Builder for breach of contract. To sue means to institute litigation. Litigation is time consuming, expensive and there is no guarantee that the Owner will recover "delay damages." Additionally, with clauses in the standard contracts favoring extended time and increased costs for any delay that is not caused by the Design-Builder, the Design Builder may in fact have a better chance of being successful in litigating a breach of contract claim. One of the most

abhorrent contract provisions for the Owner is the *ACG Mutual Waiver of Consequential Damages*. The Mutual Waiver of Damages is a contractual agreement whereby the Owner and the Design-Builder forever relinquish any claim they have against each other for consequential damages. In litigation, this waiver would in fact preclude recovery of damages incurred for loss of business, loss of financing, lost profits, extra overhead, and/or loss of reputation. Because most damages associated with a delay of the project are made up of indirect or consequential damages, the Owner would, in effect, not be entitled to any damages for the late delivery of the project.

In order to alleviate the financial impact of litigation, and the uncertainties that litigation has, the Owner should strike, or at least attempt to "soften" the waiver of consequential damages language. In the event that the Design-Build entity does not agree to a modification of the waiver language, the Owner should insist that a specific rate, or daily sum certain, be included in the contract agreement for liquidated "uncertain" damages. Although the Design-Build entity may agree to including a liquidated damages provision in the contract, the Owner should be wary of an attempt by the Design-Builder to limit or cap the liquidated damages. This limit can come in the form of only being responsible for liquidated damages if it is determined that the delay came from defective work, or only being responsible up to the amount of the contract price or some percentage over the contract price.

#### E. Environmental Conditions

In many projects, particularly those involving underground construction, the impact of environmental issues on the project can be staggering. Usually, at the outset of the design-build process an Owner is responsible for providing the Design-Build entity with information regarding the site conditions. If the Owner is not careful and the contract documents are not clear on the issue of ability to rely on the information, the Owner may create liability for herself if the information provided to the Design-Build entity is incorrect and the Design-Builder's reliance on the erroneous information results in defective design or untimely project completion.

In spite of the fact that the Design-Builder is responsible for the design and the construction, courts and arbitration panels have nonetheless awarded Design-Builders cost adjustments, time extensions, and found no liability for defective design where the information relied on to create the design was supplied by the Owner. Thus, it is important for the Owner to not only have geotechnical, environmental and other applicable surveys completed prior to the project being started, but the Owner should also negotiate contract terms that specifically address, in detail, which party is responsible for differing site conditions. In fact, if the Owner has the bargaining power, she should stipulate in the contract that she is providing no warranty that the information provided in the evaluations is correct, that the Design-Builder is not entitled to rely on the representations contained in the evaluations, and place an affirmative duty on the Design-Build entity to conduct its own tests to verify the Owner's information. Although this type of contractual language addressing differing site conditions may be a hard sell, it should be broached early on in the Design-Build negotiating process.

Notwithstanding, if negotiation of the differing site provision language is not received positively by the Design-Builder, which it most assuredly will not be, the Owner may still be able to somewhat limit her exposure for differing site conditions by specifically addressing same

in an “Equitable Adjustment” provision. For example, the Owner should try to limit recovery for equitable adjustment for differing site conditions to only time extensions, and not increased price.

Nonetheless, the Owner has to remember that shifting the responsibility on the Design-Build entity for differing site conditions will most likely cause an increase in the contract price. At that point, it is up to the Owner to weigh the pros and cons with spending more money up front, or spending more money if the project is not completely accurately, timely, or both.

## **Management of the Project**

The best way for an Owner to ensure that her interests are properly protected is to understand and appreciate the scope of the project and the manner for implementing same. The Design-Build entity has the incentive of giving the Owner the smallest bang for the biggest buck, therefore, it is up to the Owner to know her project. Because the Design-Build entity is working in its best interest and there is no one actively watching out for the Owners' interest, the owner must put in place some form of checks and balances. In that vein, an Owner should either a) use its in-house personnel to oversee the entity's actions, or b) hire an independent person, firm or consultant to act as its eyes and ears while the entity is working on the project.

Additionally, the Owner, or its hired watchdog, should pay particular attention to defining the building's performance criteria. How the parties will demonstrate that the performance criteria will be met (e.g., performance testing requirements) may be the most important aspect of managing the project. Having a shiny new building is important, but having a shiny new building that does not work is useless. Moreover, based on the complexity of the project, other aspects of the scope of services can take on many different forms. Thus, the Owner should negotiate for the retained ability to make modifications and/or changes to the scope, without incurring additional costs, or being required to grant extensions of time to the Design-Build entity.

# **PERPLEXING ISSUES IN DESIGN BUILD PROJECTS**

**Joint Fall CLE Meeting  
Section of Taxation and the Section of  
Real Property, Probate and Trust Law  
American Bar Association  
October 1, 2004**

**©Susan Linden McGreevy  
Husch & Eppenberger LLC  
1200 Main Street, 17<sup>th</sup> Floor  
Kansas City, Missouri 64105  
(816) 421-4800**

**PERPLEXING ISSUES IN DESIGN BUILD PROJECTS  
OUTLINES PREPARED BY SUSAN L. MCGREEVY©**

- 1. BARRIERS TO COMPETITION RESULT IN FEWER CHOICES IN DESIGN-BUILD**
- 2. COST OF PARTICIPATION IN DESIGN-BUILD COMPETITIONS REDUCE OWNER CHOICES**
- 3. MANAGING THE CULTURE CLASS OF DESIGN-BUILD**

## **BARRIERS TO COMPETITION RESULT IN FEWER CHOICES IN DESIGN-BUILD**

In choosing Design-Build, owners should consider what they are giving up as well as what they are getting.

1. *Less flexibility in choice of team members.* Under traditional Design-Bid/Negotiate-Build, the owner has the ability to choose its designer from a wide array of firms, whom it could interview, winnow down to a short list, and perhaps solicit proposals and conduct interviews. Having selected the designer, the Owner could then, typically, solicit offers (hard bid or negotiated) from an array of contractors.

By using design-build, the owner can find itself far more limited in who it has to choose from, and what the “team” looks like. Builders and designers usually team up, so that an owner who prefers builder A may not have the opportunity to pair him with designer B. While in some situations, owners have pre-selected team members and required them to work together, this shotgun-marriage approach is not always successful. It also probably violates the rules under which design-build is conducted by public owners.

There are some contractors and designers who have worked together enough that they present themselves as an ongoing entity and would have difficulty extricating themselves from the relationship in order to join up with a different partner. (There are potential confidentiality issues, or the need to obtain work for a joint entity that has staff specifically paid by it, among other issues, that can lead to such difficulties). And, of course, there are many “design-build firms” who purport to have on staff all the expertise to do design-build so that it would be truly uneconomical for them to join with an outside firm instead and waste their own resources.

All of these situations act to reduce the amount of choices, and the amount of competition, available to an owner seeking to develop a project.

2. *Loss of less sophisticated firms as participants* – many small firms who haven’t done design-build work in the past won’t have the staff or knowledge of how to take it on. This could particularly affect emerging firms and minority firms, lessening their ability to compete in this arena. Not only can this go against announced inclusion policies of the owner, it can also result in valuable talent being excluded from potential consideration.

3. *Loss of firms that lack the ability to attract partners.* Unlike hard bid work where sometimes all it takes to get a job is a low price and a bond, design-build is much more subjective in selection criteria. This can make it hard for a firm that doesn’t have a track record (perhaps because it comes from out of town), to find “the right” partner. Many times, it is the threat of these firms swooping down that keeps competition lively on competitive bid projects. Similarly, a good but contentious general contractor that

has had an adverse experience with some design firms in the past might find itself unable to partner with one of the more desirable designers and thus get cut out of the competition. The less competition, the fewer options the owner has, and frequently the higher the ultimate cost.

4. *Loss of firms that lack the ability to obtain bonds.* A decision has to be made as to who will be the design-builder: the builder, the designer, or a combination of the two. If surety bonds are to be required, this requirement can significantly restrict the pool of otherwise eligible candidates for being the design-builder.

Obtaining surety bonds generally requires a lengthy underwriting process in which the contractor develops a relationship with a surety bond agent who assembles a package of information about the contractor and finds the right surety to which to pitch the business. One of the major factors in extending surety credit is the net worth of the contractor. Contractors learn this. Many of them have substantial hard assets, such as excavation or paving equipment and others keep retained earnings or working capital at significant levels to satisfy a surety who wants to make sure that the contractor has the cash flow to pay its bills.

Design firms are seldom set up financially in a manner that is attractive to surety companies. They do not have reason to keep significant retained earnings in the company, frequently being sub-S corporations or partnerships or LLCs. They also do not generally have a track record of doing actual construction work. For these reasons, only a few large design firms have the ability to obtain surety bonds. This would mean that the design firm would probably be precluded from being the design-builder, unless it could convince the surety of its teaming contractor to issue a surety bond in the design firm's name.

5. *No appreciable improvement in fragmented bonds/insurance coverage.* Firms – both design and construction – also run into problems with sureties who will not agree to write bonds for them on design-build projects. In traditional design-bid-build, the integrity of the construction work is assured by a performance bond, but the integrity of the design is backed by professional liability insurance. Due to concerns that they will find themselves held responsible for risks they did not intend to undertake, some sureties and insurers have a limited appetite for design-build. Given that there are fewer sureties in business anymore, and fewer professional liability carriers, and tighter standards for the remaining participants in the market, this all can result in fewer options for the owner to choose from.

## **COST OF PARTICIPATION IN DESIGN-BUILD COMPETITIONS REDUCE OWNER CHOICES**

Contractors are used to preparing bids and negotiating proposals “on the come,” meaning that they know that they will not recoup their expenses for preparing the bid if they don’t get the job. The financial blow is somewhat softened by the fact that much of the work is spread among subcontractors and suppliers who do “take-offs” from the plans of their own scope of work and submit prices to the general contractor for inclusion in the bid. Because bidding is such an ingrained part of the construction process, contractors historically build the cost of bid preparation into their overhead and cost structure.

Designers, almost totally to the contrary, are selected based on general discussions about their backgrounds, expertise, prior projects, etc. Because there has not yet been any design, the amount of data created by the firm before it is selected is generally not significant.

When design-build competitions are held, the nature and extent of what each side has to do is changed. The team members have to spend a significant amount of time working out the basis of their relationship (unless they already have an LLC, JV or other format in place) and getting background information before they even start to come up with a proposal. Only then does the real work start.

If the owner wants any competition or varying ideas at all, it will want to solicit proposals from more than one firm or group of firms. To encourage competition and control expenses, typically design-build competitions are done in at least two-phases. The first phase is generally a paper submission of basic information, such as

- Identity of the team members, and the particular people on their staffs who will be primarily involved in the project
- Background information about each firm – how long in business, where located, where licensed, size, organization, etc.
- Illustrations and examples of prior design-build work, the closer to the anticipated project the better
- Broad ideas about the upcoming project to illustrate that the proposer has a good grasp on what the owner wants

If significant response it received by the owner to the request for proposals, it will typically narrow down the field for Phase II to five or fewer entities. If only a few proposals were received, all will likely be asked to participate in Phase II. And if only a few were solicited in the first place, the owner may skip the preliminaries and just ask for all the information at once.

Phase II will consist of meeting with the owner to get as much information as possible about the proposed site, budget, program, design preference, etc. Then the team members have to do a lot of work. They have to

- identify a design concept
- flesh out the design in terms of schematic drawings, so that cost estimates and a constructability analysis can be performed
- retain sub-consultants and identify subcontractors for all problematic aspects of the work, negotiating terms for their participation (either just on the development portion for or the project as a whole)
- compile cost estimates based on material selections and very rough drawings
- prepare sketches, drawings, models and other presentation materials
- participate in presentation meetings which may be out of town for some or all of the participants.

All of this takes staff time and resources, consultant time and resources, which can run into tens of thousands of dollars easily. Some owners attempt to increase participation by offering a stipend to those design-builders who make the cut to Phase II. This does nothing to defray the expense of participating in Phase I, and seldom covers more than a fraction of the actual expenses of Phase II.

The net result of what is involved in this process is that many firms – particularly design firms – cannot afford to participate. This leads to less competition for the owner, fewer ideas for consideration, and possible exclusion of one of the participants of a permanent design-build team if the other can't devote the time or resources to the competition.

## MANAGING THE CULTURE CLASH OF DESIGN-BUILD

Designers think it's their role to "protect" the owner from contractors who would cut corners and overprice changes if they could

Designers think it's their role to protect the integrity of their design, not to solve the contractor's cost issues

Contractors think that designers over-design everything.

Contractors think that designers don't appreciate the impact on construction of delays in getting submittals approved or answers to RFIs

Contractors think that designers expect contractors to cover up their mistakes

Now contractors and designers are going to team up as partners.

Any chance that there will be a culture clash? *Absolutely.* All people come to new experiences with the baggage of their prior experiences. The longer the people involved have been in their roles, and the stronger their personalities and the more vivid their memories of past experiences, the harder it will be to overcome past prejudices. Yet, the success of the entire project – for the owner as well as for the designer and builder – hinges on their ability to do just that.

An attorney advising parties who are going to be on the design-build team should have serious conversations with the clients about setting up *internal* disputes-resolution procedures – something not generally thought about in a hierarchical contractor-subcontractor structure. The last thing that anyone wants is the existence of disputes that can affect the timing of work or quality of the end product. Some places where differences in outlook could affect the project are:

- *Quick response time.* Designers have often been thought to not be terribly concerned about contractors' demands for immediate answers to questions. Part of the perceived advantage of design-build is that it produces a useable, income-producing property in less time. If the design firm is merely hired by the design-builder, it may not have any particular incentive to change the way it does business just to accommodate the design-builder. Consideration might be given to specifically addressing turn-around time in the JV agreement or LLC, perhaps building bonus participation into the equation.
- *How much is enough?* Contractors don't always welcome designers nosing around their work-in-progress, thinking that the designers will tell them to "rip it out and do it again," because the designer traditionally feels

that this is his/her role, to protect the owner. If the designer is subservient to the contractor (in a legal sense anyway), the owner may lose the valuable check-and-balance of the independent review. Counsel for the parties setting up the design-build entity should discuss how these two roles will be reconciled in the field, and address in the documents who gets the final say on some of these issues.

- “*Value Engineering*” pressure. As contractors control more of the design process, they could have an incentive to influence designers to reduce standards, quality, safety factors, etc., in the interest of getting the cost down. To the extent that the designer’s compensation is dependent on making the contractor happy (i.e., if it is a contractor-led design-builder), or reducing costs, an owner would have to be on the look-out for such pressure on the designer.

Clearly, design-build changes the internal dynamics on a design-build team. Depending on whether the team is designer-led or contractor-led, the other discipline is now working for the leader and has to do things his way. An owner probably should look out for more signs of internal struggles within a design-builder that has different firms involved than one that has all the disciplines in house. The goal is to not allow internal politics to affect a project.

This is not to imply that either designers or contractors as a group are unethical, underhanded or looking for anything other than the best value and best job for their customers. It is to reflect the fact that there are “dynamic tensions” build into the traditional design and construction process that provide checks and balances for owners. People who have thought and reacted the same way for decades should not be expected to change their attitudes just because a few pieces of paper have been signed. If those people are owners of their firms, and stand to make money out of cooperating with The Enemy, they may be able to overcome their prejudices – or maybe not. If they are merely employees of a large firm, they have even less incentive to change the paradigm.

Clearly, this also changes the internal dynamics on a design-build team. Depending on whether the team is designer-led or contractor-led, the other discipline is now working for the leader and has to do things his way. Where the design-builder has all the expertise in-house, this was always a problem.

# **PERPLEXING ISSUES IN DESIGN BUILD PROJECTS**

**Joint Fall CLE Meeting  
Section of Taxation and the Section of  
Real Property, Probate and Trust Law  
American Bar Association  
October 1, 2004**

**©Norman M. Arnell  
Stinson Morrison Hecker LLP  
1201 Walnut Street, 29<sup>th</sup> Floor  
Kansas City, Missouri 64106  
(816) 691-2701**

**PERPLEXING ISSUES IN DESIGN BUILD PROJECTS  
OUTLINES PREPARED BY NORMAN M. ARNELL©**

- 1. RISK MANAGEMENT PROBLEMS FOR THE DESIGN-BUILDER**
- 2. THE OWNER'S RISK MANAGEMENT CONCERNS**
- 3. SPEED**

## **RISK MANAGEMENT PROBLEMS FOR THE DESIGN-BUILDER**

From a competitive standpoint, a number of firms have gotten into the field advertising themselves as being capable of doing design-build projects.

The number of firms advertising that they are capable of doing such work in fact probably far exceeds the number of firms that have carefully thought through the problems that could be incurred in presenting a firm as a "design-builder."

### **Issues From Traditional Contractor Standpoint**

An experienced contractor generally will know that it has an insurance package that covers most risks, other than those relating to credit and the ability to complete the project in a timely manner and in accordance with plans and specifications.

Many contractors think that the risks of the addition of the design function (if the contractor becomes the front end of a design-build project) is taken care of by a provision that they insert in their contracts indicating that they are not licensed or authorized to perform design services (in those states where contractors are forbidden from providing such services) and indicating they will have no liability to the owner for any problems inherent in or arising out of design issues.

This particular fix might not work for a contractor because the contractor is the party that has an agreement with the owner by which the contractor has agreed to design and complete a project. Whether or not a court is going to uphold this contractual negation of the essence of the bargain between the parties will be subject to question in a lot of states.

Furthermore, most contractors have not considered the fact that they do not have the professional liability insurance against the effect of a defective design and their policies may in fact exclude any such liability from their coverage. Presumably they might have difficulty obtaining insurance to fill the gap when they hold themselves out as not being responsible for providing design services, or where to do so would violate state laws.

Additionally, even were a state to hold the contractor absolved from responsibility for design where it has provided in its contract with the owner that it is not responsible for design but that its subcontractor designer is so liable, courts might well say that since it did contract to provide adequate design services whether directly or through a subcontractor, that it has in fact breached a vital portion of the contract, even though it cannot be directly held responsible for the design, it is responsible for the entire project. The issue is open to doubt and question and is not one that should be dismissed lightly.

Furthermore, we understand that there is a trend by a number of bonding companies to limit their responsibility on bonds for design-build projects by putting in an exception in the performance bond for matters relating to the design element. This may not yet be widespread but as litigation tends to go through the courts, contractors may find this to be an increasing problem.

A contractor may try and protect itself from the standpoint of design responsibility by taking an indemnification agreement from its subcontractor/designer. There are benefits to that, particularly if you have a well funded and well insured designer. However, most design firms are not highly capitalized and even the highly capitalized ones do not carry professional liability insurance of a size that would cover the potential claims relating to a significant project. Thus, even such indemnification might not be of help, particularly when the dispute gets down to the area that often arises, whether it was a design defect or a defect in execution of the design.

### **Issues From the Standpoint of the Design Firm**

If the design firm is on the front end of the contracting relationship, generally, unless the design firm is a very large and experienced firm that in fact does construction as well as design, it is unfamiliar with the insurance and bonding issues and requirements of a construction contractor. Furthermore, it is taking on an unfamiliar field, the obligation for the execution of the design as well as for the design. Should the design firm attempt to limit its responsibility for the execution of its design by indicating that it would be the contractor's responsibility and not its responsibility to the owner, it runs the risk not only of offending the owner and perhaps losing the project, but also the risk, similar to that of the contractor that tries to limit its design responsibility that a court might find it responsible for breach of the obligation to provide a completed, satisfactory project.

Furthermore, one theory that could be utilized in both situations (that of the contractor as the front end and that of the designer as the front end) is the theory, and the court might determine, that the front end party was negligent in selection of the party providing either the design or contracting services that were not in the general area of expertise of the front end party.

The same issues with regard to distinguishing where the fault lies lays also with the designer as with the contractor on the front end.

Furthermore, because, as stated, since most design firms are not as well capitalized as contractors, the design firm might find it very difficult to obtain adequate or appropriate bonds or insurance for the project.

### **Issues Arising Out of the Relationship of the Parties**

The foregoing comments relate to those situations where the parties have an arrangement whereby one is a principal and the other is a subcontractor to it.

Another way of handling this would be for there to be a joint venture between the parties.

The joint venture does not solve the issues set forth above, except, perhaps, for the financial capability issue with respect to obtaining a bond. It does not resolve the issue, as between the contractor and the design firm, of the responsibility for claims of an owner.

### **THE OWNER'S RISK MANAGEMENT CONCERNS**

The owner has a problem, except in the joint venture situation, if either the contractor or the designer is front end, in reaching the liability insurance of a responsible party not in

contractual privity with it, whether it be the design responsibility or the contractual services responsibility of those parties.

In reaching the designer's responsibility should the contractor be front end, one solution that has often been proposed and utilized is to provide in the prime contract that there is a third party beneficiary or a cut-through clause which specifically provides that the owner can reach the designer's responsibility directly and requiring that the contractor have a third party beneficiary provision for the owner in its agreement with the designer. Similar provisions are adopted where the designer is the front end party.

Although this sounds good, one of the problems that you encounter in a design-build situation is that the owner generally cannot pick one or the other of the necessary parties, either the contractor, if the designer is front end, or the designer, if the contractor is front end.

Accordingly, the owner is running the risk of an unsatisfactory performance by the designer or the contractor because they are not the parties that the owner would have selected for the project. Even though there may be liability insurance that can be reached, which may not always be the case, and such insurance is adequate, an owner would rather have a project built to its desires, rather than a lawsuit or a lengthy claims proceeding.

Where there is such a third party beneficiary or cut through clause, it is generally in jurisdictions where the contractor is not by law authorized to engage in providing design services.

In such situations, the owner may not be able to hold the contractor responsible for design defects, even in the absence of an agreement that it will not look to the contractor for such purposes, on the theory that the owner knowingly engaged the contractor to perform services contrary to law, under the general equitable concept that where parties agree that one party will perform an act contrary to law, such may not be an enforceable agreement.

## **SPEED**

Too much speed can get you more than a speeding ticket, it can also let you acquire headaches of a size you would have difficulty conceiving of in advance.

Although one of the purposes of design-build is stated to allow a speedier process from start to finish (similar in that regard to what used to be called "fast-track" where you had separately engaged designers and contractors), many of the same problems that were encountered in the fast-track method of contracting will exist also in the design-build process.

Fast-track projects came to the fore in the 1970s and 1980s when inflation in the costs of construction was rampant, and up to 10% of a project cost could be saved by shortening the construction period by several months.

For instance, equivalent to the fast-track where a building permit was obtained for ground and foundation work before one was obtained for the structure, the working of the ground and the foundation could well have been structured in a fashion contemplating a particular kind and nature of improvements. Such contemplation would have been based upon the laws and codes in

existence at the time the project was initiated or when the first permit was issued. But since no permit was issued for the structure itself, there would seem to be no basis to object to changes made in the general building codes that would affect the nature of construction of the structure, which might well affect the foundation and the ground work. This is a risk that the owner takes because of either fast-track or because of design-build.

The owner would start with a contract and would have a price agreed upon, but because a change in the operative law would lay a proper basis for a change order, the owner would not know the ultimate size of its financial commitment until the affect could be ascertained. Thus, instead of having a project in which the owner would know in advance the general parameters of its financial commitment (subject to the usual problems of changed conditions, etc.), the financial commitment could significantly change so that the owner could be in position where the owner's financing might be in peril.

The age-old problem of whether a design is usable and practical from the standpoint of the owner's long-term maintenance and other expenses, may be exacerbated by a design-build project because you have no counterweight of independent designers and contractors who can comment on each other's proposed design and method and proposed construction method. There is much less reason for parties who are in a joint contractual relationship (whether it be a front-end designer, a front-end contractor or a joint venture of both) to review and test out the other's assumptions, conclusions and cost estimates.

One possible solution is, of course, to have an independent party reviewing the design before the owner accepts it. This will work, but the owner will be paying for an extra party and might as well have contracted directly with a designer and directly with a contractor so that each would have direct liability to it and full responsibility, and not just potential third-party liability to the owner.

Design-build and its faster construction will work if either the project is a "cookie-cutter" building similar to many the design-build team have already done or based on an owner-supplied basic design (such as a "big-box" store) or if the owner has personnel that have the training and experience to review and understand design and the construction process.