

**CONSTRUCTION PROJECTS IN DEFAULT:
PROTECTING THE DESIGN PROFESSIONAL FROM
CONSTRUCTION PROJECT DEFAULTS¹**

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The construction project in trouble nearly always results in significant losses. How those losses are allocated among project participants – owner, lender, contractor, subcontractor, and design professional – will be determined most always not by the events immediately leading to the failure of the project, but instead by applicable law, the agreement by which the design professional was engaged and actions taken by the design professional early in the process to protect its position.

The design professional has two principal concerns when a project fails – getting paid and avoiding liability.

When negotiating a design services agreement, the design professional should consider first how it will charge for its services. Common methods include a percentage of the construction cost and fee for services, based upon an hourly rate structure. In addition, the design professional should consider in what intervals payment will be required. To the extent that fees can be “front-end loaded,” the design professional will have less at risk if the project does not ultimately succeed. And, if the design professional’s work is to be carried out in phases, such as the traditional five phases of architectural design – schematic drawings, design development, construction drawings, bidding and negotiating, and project administration, the design professional can reduce its exposure by being sure that it is being paid in full for each of its tasks when that task has been completed. Hence in the case of a project failure while

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construction is underway, the design professional would only have fees due it for project administration at risk. Unfortunately, many design professionals defer payment of their fees, leaving the fees at risk.

The careful design professional will also consider the source of the owner's financing for the project. What is the likelihood of construction lending being available? May loan proceeds be used for "soft costs," such as architectural fees? And, does the project owner, standing alone, have the financial wherewithal to bear the costs of its design professional. Many projects are developed via single asset entities. Clearly, such entities may not have the financial strength to ensure payment of design fees.

In some cases, the design professional should consider requiring a security deposit to assure it is fully compensated or being named as an obligee on the owner's payment bond.

When the project fails and the design professional is unpaid, recourse will almost always be indirect. Does the mechanics' or construction lien statute in place in the state whose law governs the project permit a design professional to assert a lien? Are the design professional's lien rights limited in any way, such as to services provided at the job site in connection with actual construction activities. Project administration would probably be covered under such a statute; design work probably would not be.

Can the design professional recover the plans and specifications from the local building authority and, hence, effectively pull the project's building permit? As someone will no doubt want to finish the project, and a building permit will be required, this can be a powerful weapon in the hands of an unpaid design professional.

Who owns the drawings and specifications? Who has the right to use them? A design services agreement that is well drafted from the standpoint of the design professional will

provide that the drawings and specifications are instruments of service owned by the design professional and will grant the project owner a limited license to use the drawings and specifications only in connection with the initial construction of the project and then only so long as the design professional is being paid for its services on a current basis. It and the drawings and specifications themselves should clearly protect the design by identifying it as the copyright protected work of the design professional.

Many construction lenders require an assignment of the drawings and specifications for the project from the design professional as a prerequisite to approving a construction loan. Avoiding such an assignment altogether may enhance the design professional's rights in the case of a project failure. On the other hand, a lender's requiring such an assignment can provide the design professional with an opportunity to negotiate with the lender for a provision in the document of assignment that requires, as a prerequisite to utilizing the drawings and specifications, the lender to cure all payment defaults by the owner and assume the forward obligations of the owner under the agreement for design services. A simple blanket assignment, on the other hand, will leave the design professional out in the cold.

Design professional liability typically arises in connection with the failed project for one of three reasons – allocations of defects in the drawings and specifications themselves, charges that the design professional certified faulty or unfinished work for payment or that the design professional erred in its estimate of the cost of the project.

Projects typically fail either because of cost overruns or because unexpected difficulties were encountered. Each of these circumstances can lead to an assertion that the design professional provided faulty drawings and specifications. In fact, it is fairly typical for

contractors to blame the design professional when something goes wrong with the project. They may assert that the construction drawings did not present a buildable project, or that they were ambiguous or unclear or lacked sufficient detail. Any of these assertions, if true, will result in liability for the design professional. Obviously, the best way to avoid such liability is to produce plans and specifications that are wholly adequate. However, that answer begs the question. To avoid the issue altogether, it is wise to insist that the contractor review the drawings and specifications prior to implementing construction utilizing them. Requiring the contractor to verify that the drawings and specifications are complete, unambiguous, sufficiently detailed and buildable can help avoid a charge to the contrary later on.

It is the rare project, however, that fails because of a total lack of buildability or other fatal defect in the drawings and specifications. Instead, whatever flaws may exist in the drawings and specifications lead to delays and cost overruns. Once again, early builder review will provide the design professional with significant protection. Design professionals will also be on the lookout during the course of construction for indications that design problems exist or may be claimed by persons working on the project or unusual or excessive requests for information and tradesmen who do not seem capable of properly performing their responsibility are two signs that claims may be made based upon the design professional's drawings and specifications. The design professional should alert the owner at once to the existence of such symptoms and see that they are dealt with promptly.

The design professional should also be protected in its agreement with the project owner for excessive fees that may be incurred as a result of "claimsmanship" by the general contractor or trade people.

Design professionals are often called upon to estimate the cost of constructing the project they design or, to design a project that meets an owner's budget, or both. Some case law supports the proposition that a requirement may be implied in a design services agreement that the project be designed so that it can be constructed within either certain cost parameters or a stated variance from the estimate. However, a careful design professional can avoid the risks inherent in cost estimating or designing to a budget by providing in a design services agreement that the designer does not guarantee the accuracy of any statement or estimates of probable construction cost and that they are just that – an estimate. In the absence of such exculpatory language, the law of some states burdens the design professional with responsibility for cost estimates.

As part of its construction administration responsibilities, the design professional will be called upon to certify applications for payment. This process involves, to a greater or lesser degree, an attestation from the design professional that the work for which payment is sought has been satisfactorily completed. Design professionals should be careful that the design services agreement establishes a clear and reasonable standard of care applicable to such certifications and verify the accuracy of each certification they are giving, or they may find themselves liable for damages suffered in the event of its inaccuracy. Because typical construction loan agreements require the design professional to certify pay applications to both the owner and the construction lender, the liability risk is significant.

Design professionals, particularly engineers, are more and more seeking to incorporate clauses into their design services agreements limiting their liability in the case of project problems. Typical language might limit claims against the design professional to a stated

amount or the fee received for the project. The courts have generally, though not uniformly, enforced such clauses.

The foregoing represents a generalized statement of the prevailing law and industry practices in the United States. The law of the several states, and local industry practices, vary considerably, however. Hence the careful practitioner will always check the rules applicable to the matter at hand. Citations of authority for the propositions set forth in this paper may be found in Chapters 5, 6, and 7 of *A practitioner's Guide To Construction Law*, by John G. Cameron, Jr., published by ALI-ABA.

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