
A/E RISK REVIEW

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Tight Budgets, Limited Credit Lead to Underfunded Projects

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The following material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with a qualified professional who can provide guidance that considers your own unique circumstances.

Today's stagnant economy and the resulting credit crunch have put a double whammy on design firms. Not only are new projects scarce, but project owners may not have the access to capital to which they are accustomed. That may mean projects are not sufficiently funded to ensure a high quality outcome or to withstand surprises that result in added costs and slimmer margins.

In times like today, underfunded projects can be a major cause of professional liability claims and losses for architects and engineers. When clients are strapped for capital, they look for ways to reduce costs. They may ask their designers and contractors to take shortcuts and skimp on details and quality control. In such cases, errors and omissions become more prevalent, leading to an increase in disputes and legal wrangling.

Capital-strapped projects can also result in slow payment for design and construction services. Desperate clients may even file trumped-up negligence claims as a ploy to avoid paying their designers and contractors altogether. Should the funding problem reach crisis stage, project completion comes into jeopardy. Delays, work stoppages and project termination can add to the legal quagmire for everyone involved.

Fortunately, there are preventive steps you can take to avoid or at least minimize the headaches and heartbreaks of an underfunded project.

Conduct a Financial Check of Your Client

Because inadequate funding can play a significant role in professional liability losses, design professionals should take appropriate steps to determine the financial wherewithal of a client, particularly a new client. But architects and engineers are often reluctant to perform financial background checks on their clients for fear of losing the project. They feel such an inquiry will insult, embarrass or otherwise alienate a current or potential client.

Yet the fact of the matter is most clients have already provided their financial and credit information to a number of other parties in order to obtain credit and project approval. In most cases, they are not reluctant to provide the same information to their prospective design firms or contractors. And if a prospective client is reluctant to share its financial records, maybe that's just the type of client you might choose to avoid.

Assume your background check shows that a potential client has a less than perfect credit history. Does that mean you should automatically reject this project? Of course not. The financial check is simply one of many important pieces of information to consider. If the firm or individual has an otherwise clean record as a reasonable, non-litigious client, you can move forward with the project while taking necessary precautions in the form of solid contractual language. But combine that spotty credit record with a trail of litigation and you might make the best business decision of your life by avoiding this firm.

Secure an Adequate Scope of Services

Should your investigation reveal the potential for project underfunding, an adequate scope of services becomes critical. Your services should include pre- and post-design activity designed to enhance quality control and lower your risk

exposures. Services you should attempt to negotiate in your scope of services include:

- **Pre-qualification of contractors.** Help your client assure that all contractors invited to bid are reputable, experienced, bondable and otherwise qualified to perform the work.
- **Pre-selection conference.** Encourage your client to co-host a conference where pre-qualified contractors are invited to address any questions they may have about the project and to learn the project ground rules from you and the client's representatives.
- **Plan and specification review.** As part of the selection process, have pre-qualified contractors review the constructability of plans and identify potential errors, omissions, ambiguities or inconsistencies.
- **Pre-construction meeting.** Meet with the selected contractor and client representative to review schedules, establish lines of communication and otherwise solidify understandings regarding key project components.
- **Full construction observation services.** The lack of construction observation services may be a deal-breaker for any financially questionable project that must be completed on a tight budget.

Getting a cash-strapped client to agree to have you perform these services for a fee may be difficult. Nonetheless, the need to perform them should be addressed. If the client summarily dismisses your proposed services and demonstrates a desire to proceed with the project in the least expensive way possible, you will be given a clear insight into the client's priorities. The question you then must ask

yourself is: Do I really want to work for this client under these conditions?

Should you decide to accept an assignment from a financially-challenged client, it is prudent for you and your attorney to draft contract language that provides you an “out” should the project turn sour. This includes language that gives you the right to temporarily suspend services or permanently terminate the agreement if the client reneges on its contractual obligations and financial commitments. Discuss the following clauses with your attorney.

Suspension of Services

Failure by a client to adhere to the terms of your contract, including payment terms, may be considered a cause for termination of the agreement. However, you may not want to use the ultimate hammer of termination as your first action in the event of a breach of contractual terms. Rather, you may want to use a “Suspension of Services” contract clause that gives you the right to temporarily withhold your services in hopes of forcing the client to fix the breach while keeping the contract in force. Granted, if the contractual breach continues for a sufficient time, you may ultimately wish to terminate the agreement. But in the meantime, you at least want to avoid increasing your receivables while you seek payment for services you have already rendered.

Specifically, seek the right to suspend your services without liability in the event of nonpayment of your fees (or for any other breach of contract terms you consider critical to the progress of your services). Stipulate that if the breach of contract is corrected within a short period of time (e.g., up to 30 days) you will resume services without financial penalty to either party. For a longer suspension (e.g., 30-60 days), stipulate that you will be compensated for the expenses of interrupting and resuming your services. And, for an excessive period of suspension (e.g., 90 days

or more), you need to retain the option to terminate the agreement.

The Suspension of Services clause should similarly outline your rights in the event the client suspends your services. For example, stipulate that if your services are suspended by the client, you will be immediately compensated for all services performed to date as well as any reimbursable expenses you have incurred. In addition, should you be compensated for the past amounts due and your services are resumed, the contract should require your client to compensate you for any expenses incurred as a result of the suspension and resumption of your services. The clause should also state that your schedule and fees will be equitably adjusted to reflect the current status of the project.

The Suspension of Services clause should further specify that in the event the project or your services are suspended for a long period (for example, more than 90 days), or if the client has materially breached payment terms or other conditions of the contract, you have the right to terminate the agreement without penalty upon giving five days’ written notice to the client. The clause should state that the client agrees to make no claim against you for any delay or damage as a result of you suspending or terminating services due to any client breach of your agreement. The contract may also specify that upon receipt of payment in full of all outstanding sums due from the client, or upon correcting the contract breach that caused you to suspend your services, you will resume services with an equitable adjustment made to the remaining project schedule and fees as a result of the suspension.

Be sure to coordinate your Suspension of Services clause with your Billing and Payment, Retainers, Changed Conditions and Termination provisions in your agreement.

Termination Clause

Unfortunately, a client in serious financial trouble may have no option but to terminate

your services or even put a halt to the entire project. Obviously, you cannot contractually require a client not to terminate a project. However, through a "Termination" clause you can hold the client responsible for any costs you incur associated with stopping your work on the project. What's more, a Termination clause can provide you the right to put an end to your agreement with your client for specified causes and offer you protection should you quit for justifiable cause.

A typical Termination clause states that in the event either party terminates the client-designer contract, the client has a certain number of days (typically 15 – 30) to pay the designer for all services rendered and all reimbursable costs incurred up to the date of termination, in accordance with the payment provisions of the contract.

Most termination clauses state that the client may terminate the agreement for the client's convenience and without cause upon giving the design consultant not less than seven to ten days' written notice. They also typically state that either party may terminate the agreement for cause upon giving the other party the same amount of written notice for a list of specified reasons. These reasons may include:

- Substantial failure by the other party to perform in accordance with the terms of contract through no fault of the terminating party
- Assignment of the contract or transfer of the project to any other entity without prior written consent
- Suspension of the project or consulting services for a given period of time (e.g., 90 consecutive or aggregate days)
- Material changes in the conditions under which the contract was entered into, the scope of design services or the nature of the project, and the failure to reach agreement on the compensation and schedule adjustments necessitated by such changes.

If possible, have the Termination clause state that in the event of any termination that is not the fault of the design consultant, the client agrees to also pay the consultant for all expenses reasonably incurred in connection with the orderly termination of this agreement. These termination expenses may include the cost of demobilization, reassignment of personnel and associated overhead costs.

Finally you may want to include strict contract provisions concerning ownership of instruments of service in the event of project termination. This can help prevent clients from taking ownership of your complete or near-complete construction documents while cancelling your agreed-to scope of construction administration services.

Discuss these issues with your attorney. We can help you analyze the insurance and risk management issues involved.

Can We Be of Assistance?

We may be able to help you by providing referrals to consultants, and by providing guidance relative to insurance issues, and even to certain preventives, from construction observation through the development and application of sound human resources management policies and procedures. Please call on us for assistance. We're a member of the Professional Liability Agents Network (PLAN). We're here to help.