



*Focus on risk management...*

## **Internal Risk Management**

*by Drew Seaman and Tom Waggoner, Straub, Seaman & Allen*

Whether you like it or not, the practice of Architecture or Professional Engineering is a business. Profit is the goal. Unfortunately, in the current business environment the Architect or Professional Engineer is confronted with increasing competition for fewer and fewer profitable projects. The claims-to-revenue ratio is already high and will likely become higher due to a weakening economy, which has caused many owners and contractors to experience financial difficulties. When project finances get tight, eyes increasingly turn toward the design professional as a potential source of monies to alleviate financial strains. In this unfriendly business atmosphere, it is particularly important for design professionals to actively engage in internal risk management. As we have suggested to the design firms we represent—you need to work to make your contract documents and internal risk management a profit center.

Consider the impact on the firm's bottom line if a design firm is compelled to compromise an issue with an owner or contractor. The result is that its profits are reduced or eliminated. This is true regardless of whether the payment takes the form of paying an insurance deductible or waiving part of the fee at the end of a project. If your firm averages a 10 percent profit and you pay or give up \$20,000, your firm will need to generate \$200,000 in fees to cover that loss. That is also \$20,000 that is not available to pay as profits to the members of the firm.

Internal risk management helps to prevent these claims. Risk management takes many forms, but a good risk management program provides increased productivity and reduced errors, both of which increase profits. Every firm should develop a firm-wide, proactive risk management program. This article provides a few risk management tips to assist you in developing your own program.

Each risk management program must be tailored to the culture of the particular firm. The goal is to be claim free. To achieve this, thought should be given to including the following minimum areas in your internal risk management program:

- Client/Project Selection
- Contracts
- Communication
- Contract Documents
- Surveys
- Construction Administration

## Client/Project Selection

When determining whether to accept a particular client you must determine if the client and the project is appropriate for your firm. A procedure must be in place to properly evaluate the project and the client. Creating a checklist of issues to consider is a helpful tool. The evaluation procedure should be tailored to your particular firm, but should, at a minimum, query such things as:

1. Suitability of client — have you worked with this client before? Does the client have reputation for being difficult or litigious? Is the client sophisticated? Have initial contacts with the client been strained? Is the client realistic in his or her expectations?
2. Suitability of project — certain projects, such as condominium developments and fast-track projects, are riskier than others.
3. Suitability of staff — does the firm have the staff with the time *and* expertise to devote to the project? Is your firm's experience compatible with the complexity of the design and construction? Is there something unique about the design or construction?
4. Financing — does the owner have adequate financing? Is the funding consistent with the client's expectations for the project? Is there a contingency fund? Does the client understand the purpose of a contingency fund? Is the client an L.L.C., if so, who is backing the project; do you need a personal guarantee?
5. Materials — Does the client want to use new or unique materials or technologies in the project? Have the materials and technologies been properly evaluated? Does the owner understand the risk involved? Are assurances of sustainability and cost savings required?

## Contracts

Contract review is a necessary evil in today's business environment. The firm should appoint one or more *knowledgeable* individuals to negotiate, review and execute contracts on its behalf. This will foster consistent review practices by experienced personnel and help avoid common pitfalls. A well drafted contract that is fair to both parties can minimize risk. The firm should develop checklists to assist in identifying specific contract issues. Common pitfalls include:

1. Terms that alter the customary relationship and responsibilities of the parties. For example, if an owners tries to assign an "inspection and approval" obligation of the contractor's Work to the design professional, this should be deleted. A carefully limited and delineated *observation* obligation can be an appropriate substitute. The contractor should remain solely responsible for the quality and performance of his Work. The new AIA 2007 seems to meet this requirement.
2. Indemnification clauses should be carefully parsed. Unless the firm wants to pay for certain losses out of its own funds, any agreement to indemnify and hold harmless the owner or any other party must parallel the coverage provided to the firm in its professional liability policy.
3. Warranties and guarantees must be stricken. Design professionals should never provide a warranty or guarantee. As the provider of a service, the law in many states does not impose such an obligation on the architect or engineer. Moreover, typical

professional liability policies do not provide coverage for warranties or guarantees made by a design professional.

4. Limitation of liability clauses make sense if the clauses are properly drafted and protect both sides to the agreement. Often owners and consultants put one-sided limitation clauses in their agreements. Remember you remain responsible to the owner for the services provided by your consultant. You cannot allow the consultant to escape liability through a limitation on liability clause while you remain liable to the owner for those services. Moreover, it is unfair to allow an owner to limit its liability for any claims brought by you, but to deny the same limitation to you.
5. Waiver of Subrogation/Insurance clauses are common. If properly drafted and incorporated into the Contract Documents, they can allocate the risk of certain (but not all) losses to a project under construction and will be covered by a policy of insurance purchased by the Owner or Contractor. This may be a way to manage risk, but it will be of little value unless the correct policy is actually obtained. Follow-up is needed. All insurance clauses and certificates of insurance should be discussed with your insurance agent to ensure that the proper insurance in the proper amount has been obtained.
6. Scope of Service clauses, if *clear*, help eliminate misunderstandings. Design firms should develop a standard Scope of Services clause and then tailor it to each project. Each person involved in the project *must* understand the firm's Scope of Services sufficient to know if they are ever asked to provide services beyond the terms of the contract. Too often firms provide what they view as an extra service, but never have the contract amended. This often leads to misunderstandings, litigation and at a minimum, loss of fees.
7. Compensation - make sure the fees are sufficient to allow the firm to provide quality service. Negotiate the compensation in combination with the Scope of Services so the Owner has a menu of options, and knows what he or she is to receive.
8. Clauses requiring the design firm to comply with all laws, statutes, codes, rules, regulations and ordinances should be stricken. These clauses are routinely construed by owners to impose upon the designer a duty to insure that the structure as built complies with all laws, statutes, codes, rules and regulations. Plans and specifications are not intended to address every building code provision. It is the contractor's responsibility to comply with the applicable codes. Do not take on the burden of this added responsibility.
9. Standard Form Documents are acceptable but they *must* be tailored to each project. Moreover, there are many provisions in standard documents which must be modified to ensure that the contract is fair to both parties and are coordinated with the Contract Documents. Every internal risk management program should include a regular review and revision of the contracts and other documents the firm typically uses. Purchase Orders should be avoided. Purchase Orders are typically drafted for those providing materials or in subcontractor situations. They are not appropriate for design professionals.
10. Do not alter the standard of care applicable to design professionals. Decades of case law has created a standard which is fair and reasonable. Do not agree to the "highest standard of care."

11. Dispute Resolution clauses. Seriously consider whether you should agree to binding arbitration. Your rights may be severely impaired. Non-binding mediation is acceptable.
12. Opinions on construction cost should never be guaranteed. They are educated guesses. Leave them that way.

## **Communication**

Open lines of communication should be maintained throughout the course of the project. Misperceptions, misunderstandings and mistakes can often be avoided or minimized if the parties communicate early and often. All communications, including oral conversations, should be documented in some fashion. A key component of a risk management program is proper file documentation of all communications. This documentation includes letters, notes, memos, e-mails, plans and specifications, etc. When an issue or problem arises, the firm needs to be in position to show that the issue was discussed with the owner, construction manager and/or contractor *and* a particular decision was agreed to by the parties.

Design professionals are typically good at documenting meetings, conversations and telephone calls, but few have become proficient with e-mails. In the past, communications with owners, contractors and suppliers, were documented with a written note, memo or fax. More and more often these communications are now memorialized only by an e-mail. A protocol for handling, responding to and saving e-mails needs to be established.

This protocol should include a retention policy as well as instructions on the proper use of e-mails. Remember unless you take action to save the e-mail it will be deleted after a set period of time. This means that two months from now you will have nothing to document what occurred.

Such things as chain e-mails should be avoided. E-mails from legal counsel should never be sent to others outside the firm. Your employees must never express their emotions in e-mails. Profanity or vulgarity should never be used. Remember, if a problem develops, the opposing side will likely have access to the e-mails.

Retention of the various versions of plans must be preserved. Two years after the project is complete you may not remember why a critical elevation was changed. You must be able to identify why the changes were made and what changes were made. Documentation of the file is the only way this can be accomplished.

Establishment of firm wide protocols with redundant procedures will help make certain that adequate documentation of the design and construction process exists.

How long should you retain your records. In a perfect world you should never throw anything away. However, the reality is that this is not practical. A record retention policy should be developed and implemented. You should retain your records one year longer than your state's statute of repose. The new AIA documents attempt to establish a maximum claim period of ten years. Whether this will be upheld is unknown. If your firm does work in multiple states the retention policy needs to be tailored to each state's specific period of limitations, if any.

## **Contract Documents**

Peer review is often sacrificed because of time limitations, cost or other factors. Independent peer review is the best way to avoid errors or omissions in design drawings and specifications. By "independent" we do not mean an outside firm. Rather we mean a review by an engineer not

involved in the project. If someone that has worked on the project also reviews the drawings, that person brings assumptions and understandings which prevent them from being able to “proof” the drawings without any bias or pre-conceptions. By having someone who has not been involved in the development of the project review the assumptions, calculations and layout, the probability of catching mistakes is greatly increased. The review should include not only the drawings, but the general conditions, special conditions and specifications. Each document should be proofread for clarity of language, accuracy and content.

The review should also focus on removing provisions and sections in the Contract Documents which are not applicable to the project. We recommend that the standard front end documents, general conditions, special conditions and specifications be reviewed, in detail, annually with your attorney to minimize errors and omissions.

## **Surveys**

Surveys are often an ignored part of risk management. However, care should be taken internally to make certain that out of date site plans or topographic surveys are removed from the active file so that they are not picked up and used by mistake. Similarly, a written protocol/checklist should be established for ALTA/ASCM surveys, easement identification, flood plain identification, drainage boundaries and building staking. Each of these services has specific requirements which need to be followed to reduce errors and omissions. For example, ALTA/ASCM has established minimum standards for land title surveys. These standards can be found on their websites. Failure to comply with these standards will almost certainly be considered a breach of the standard of care.

## **Contract Administration**

Protocols for the submission and review of submittals (including shop drawings and samples), RFIs, Change Orders, substitutes, etc., need to be established. These should parallel the protocols set forth in the Contract Documents. The firm’s internal protocol should set forth the firm’s procedures for reviewing and/or responding to submittals. Standardized forms should be developed, logs should be maintained, a date/time stamp used, and a checklist of reviewer responsibilities developed. The reviewer is looking for different things depending on the document submitted. Consequently, the reviewer should be instructed on the purpose of his or her review. Appropriate stamps should be used. Improper submissions should be returned.

Contract Administration and in particular field services need to have established protocols. The protocol must be consistent with the contract between the Owner and the Design Professional. The protocol needs to identify what services will be provided, by whom, how often and include limitations on the authority of the resident project representative or field architect.

Often inexperienced EITs are used to conduct site visits. Care should also be taken to make certain that experienced personnel are used to make the site visits. EJCDC C-700 General Conditions state in §9.02 that:

Engineer will make visits to the Site at intervals appropriate to the various stages of construction as Engineer deems necessary in order to observe *as an experienced and qualified design professional* the progress that has been made and the quality of the various aspects of Contractor's executed Work.

Given this requirement careful selection of the Project Engineer for Construction Administration needs to be a priority.

The new AIA documents have modified the previous project observation requirements to provide:

The Architect will visit the site at intervals appropriate to the stage of construction, or as otherwise agreed with the Owner, to become generally familiar with the progress and quality of the portion of the Work completed, and to determine in general if the Work observed is being performed in a manner indicating that the Work, when fully completed, will be in accordance with the Contract Documents. (AIA A201 - 2007 General Conditions)

The firm's risk management program should include a formal mentor program. Performing the firm's Construction Administration obligations is an excellent opportunity for an experienced design professional to impart his or her years of experience in addressing design issues as well as communicating with others onto the next generation.

### **Conclusion**

These are but a few of the steps that can be taken by your firm to help prevent claims by Owners and Contractors. By developing an internal risk management program, you can reduce your risk of claims; increase your overall productivity and your bottom line.

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*This article is intended for general discussion of the subject, and should not be mistaken for legal advice. Readers are cautioned to consult appropriate advisors for advice applicable to their individual circumstances.*

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