Top Ten Drop-Dead Contract Clauses Design Professionals Cannot Ignore

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In days long gone by, design professionals routinely submitted a brief proposal outlining the scope of their proposed services and the anticipated fee. Such proposals, when accepted, formed the contract. Perhaps such a proposal contained a few terms and conditions intended to balance risk and reward. The objective was to ensure that the design professional's risk in taking on the project was commensurate with the fee to be earned.

Unfortunately, with the evolution of the construction industry, the short form bare-bones contract is virtually extinct. Owners and developers have lawyered-up their contracts often including hundreds of provisions intended to shift risk to the design professional while minimizing reward. Five years of economic decline have put owners and developers in the driver's seat with respect to negotiating contracts. The supply of design professionals willing to sign *any* contract far exceeds the supply of projects. Owners and developers present "take it or leave it" contracts, rather than negotiating fair and reasonable terms. Design professionals routinely sign one-sided contracts with onerous provisions, all aimed at transferring risk to them and away from their clients. Seldom, if ever, does the fee justify the risk.

Fortunately, design professionals have more leverage than they think. They should not underestimate their contribution to the construction process. No project gets built without plans and specifications. As such, design professionals have negotiating power to secure a fair and balanced contract that allocates both risk and reward in a way that makes sense. However, they must pay close attention to each and every contract clause, and particularly those key clauses that will affect them most acutely in the event of a problem. A good contract versus a bad contract is the difference between life and death in the event of knock-down-drag-out litigation.

While certainly not a comprehensive list, the following is a brief discussion of the top ten "make or break" contract clauses that will most likely determine the design professional's fate in the event of a lawsuit.

Indemnity and Defense Clauses

Indemnity is a duty to make good any loss, damage or liability incurred by another. In short, it is an agreement to assume a specific liability in the event of a loss. Effectively, by accepting an indemnity obligation, the risk shifts from one party to another and serves as a kind of "insurance" for the party getting indemnity.

Indemnity clauses in contracts usually go hand-in-hand with defense clauses. The defense clause is a contractual provision where one party agrees to "defend" the other party from future claims or lawsuits. This means that one party contracts to pick up the costs of defending the other against claims and lawsuits, including attorneys' fees, expert fees and other hard costs of litigation. Depending on how the defense clause is written, it may mean paying for the other party's defense, even in the absence of fault.

Indemnity and defense clauses are akin to "location, location, location" in the world of real estate. These clauses have the most far-reaching implications for design professionals. They most radically shift risk and costs in the event of a lawsuit. They are the most difficult to negotiate and are most likely to be the "deal breaker." No surprise, these clauses are also the most hotly litigated once a lawsuit has been filed.

Courts construe indemnity and defense clauses applying the same rules that govern other contracts. The courts look to the intent of the parties and construe the plain language of the provisions. Design professionals cannot hope that the courts will relieve them from the consequences of negotiating a bad indemnity and defense clause. Many courts have stated, "We hold parties to their contracts." Design professionals must expect that they will be deemed to be a sophisticated party (even if they are not) and will be held to their contracts.

When a design professional agrees to indemnify and/or defend their client (regardless of fault) they take on risk grossly out of proportion to any economic reward. For example, by agreeing to indemnify and defend a client from any and all future claims or lawsuits, the design professional has essentially become the "insurer" of everything that can go wrong on a project. In a complex construction dispute, defense costs and fees can run into seven figures.

As a rule, design professionals' insurance companies cover damages that flow from errors and omissions that constitute a violation of the standard of care. Insurers do not insure against any and all liabilities that a design professional assumes by contract. Design professionals *must* consult with their insurer, broker or attorney to be sure that any indemnity and defense obligation they take on will not run afoul of their insurance coverage.

What can a design professional do to avoid the imposition of an indemnity or defense clause absent a finding of negligence? They should *not* sign a client's one-sided contract that forces the design professional to take on risk that fails to match the reward. If possible, they should avoid any agreement to indemnify or defend the client. Such express provisions in contracts also extend the time frames (statutes of limitation) wherein the design professional can be sued by the client. If a design professional *must* give indemnity to the client, the indemnity obligation *must* be clearly tied to a finding of negligence.

Ideally, the contract should expressly state that the design professional does *not* intend to defend the client, and that the indemnity obligation is limited to the design professional's proportionate share of negligence. If the design professional must also accept a defense obligation, that the intention *must* be clear that both the indemnity and defense obligation is limited to the design professional's proportionate share of negligence.

Please note, often indemnity and defense clauses can be hidden in a client's lengthy standard form contract. Clients (and their lawyers) know that most design professionals are sufficiently sophisticated to pay attention to clearly identified indemnity and defense clauses. However, given that some standard form contracts can exceed 100 pages, it is easy to overlook a defense and indemnity clause buried in the text of an otherwise seemingly innocuous clause. In short, there

no way to avoid reading *every* page and *every* provision of *every* contract.

Waiver of Consequential Damages

Consequential damages are losses that do not flow directly and immediately from a breach, but rather result *indirectly* from a breach. In contract law, the goal is to return the non-breaching party to the position it would have been in absent a breach. Thus, recoverable damages include those that are reasonably "foreseeable" at the time of the contract. The problem is that, with the benefit of 20/20 hindsight, all damages are arguably "foreseeable."

A breaching party is responsible to pay for direct damages, such as costs of repair or diminution in value, plus out-of-pocket expenses. However, a breaching party is also responsible to pay consequential damages, which are those damages a breaching party knew or should have known at the time of contracting. Thus, consequential damages include all reasonable and foreseeable damages that flow from the breach. These may include delay damages, acceleration damages, lost profits, loss of use, damage to business reputation, damage to credit worthiness, etc.

If left unaddressed by way of a contract clause waiving the client's right to recover consequential damages, the potential for such damages creates risk far in excess of any reward. As such, it is commercially reasonable to eliminate the risk of consequential damages by negotiating a consequential damages waiver.

Note, an owner or developer will not automatically include a consequential damages waiver as part and parcel of any standard form contract. A design professional will likely need to add this clause to the contract. Ideally, the design professional can secure a unilateral agreement whereby only the client waives the right to recover consequential damages. However, if the client objects, the parties can mutually agree to waive consequential damages.

Limitation of Liability Clause

Limitation of liability is a contractual provision by which the parties agree on a maximum amount of damages recoverable for a future breach. To ensure that such a clause is enforceable, it should be plain, clear and conspicuous to help demonstrate that the clause was expressly negotiated as between the parties.

Typically, when design professionals are able to negotiate limitations of liability, such clauses limit liability to the greater (or lesser) of a specific sum or the design professional's fee. Other such clauses limit liability to insurance policy limits. However, when such a limitation is included, the clause should specify that liability is limited to the *available* policy limits, since professional liability policies are depleted by defense costs and fees, as well as satisfaction of other claims. Ideally, the limitation of liability clause ought to specify that the limit of liability is inclusive of fees and costs incurred in the defense of the claim.

Note, limitation of liability clauses are *only* enforceable as between the contracting parties. Thus, other parties (not parties to the contract) are not bound by any such limitation. Nevertheless, these clauses are an effective tool to calibrate risk and reward. Design professionals are more apt to propose a competitive fee structure if their client is willing to limit their liability in the event of a breach. The design professional can obtain maximum protection if, in addition to the limit of liability, the design professional can secure an agreement from the client to indemnify and defend the design professional for claims and damages above and beyond the limit of liability. This will protect the design professional from claims by parties who are not parties to the contract. These types of clauses are even more appropriate when dealing with projects with the potential for significant risk.

Sole Remedy Clause

In most states, design professionals can be held personally liable for errors and omissions in the plans that they stamp or seal. This is true even if the design professional is acting in the course and scope of employment with a firm. Thus, parties seeking to sue are not limited to suing just the design professional's *firm*, rather they can also sue the individual. The sole remedy clause is a simple solution to insulate the individual design professional from being named in a lawsuit. Design professionals can include a sole remedy clause, which limits recovery by the client to the firm only and bars recovery against the individual officers, directors and employees. Sole remedy clauses can be unilateral, whereby only the design professionals are protected, or they can be mutual, whereby both sides agree to limit their remedies as against their respect firms.

Waiver of Third-Party Obligations

Other parties, not parties to the contract, may claim that the design professional owes them an independent duty of care. Thus, non-clients will sue the design professional if they can. There is a simple solution to this problem. Design professionals can include a short waiver of third-party obligations clause. That is, they can contractually agree that nothing in their contract creates a contractual relationship or cause of action in favor of a third-party against either the client or the design professional. In this manner, the design professional can demonstrate an express intention that it owes duties *only* to its client, and not third-parties.

Standard of Care Clause

The standard of care is generally defined as the degree of care and skill ordinarily exercised, under similar circumstances, by reputable professionals practicing in the same discipline, in the same locality and in the same timeframe. The standard of care is not perfection. However, sometimes clients want the design professional to agree to a "super" standard of care. For example, clients may want a design professional to agree to perform services in accordance with the "highest degree of skill and training" or the "highest standard of practice."

The problem with these provisions is they create the potential for unlimited liability because virtually any error or omission becomes a breach of the standard of care, no matter how minor.

Thus, design professionals should avoid any and all contractual promises to perform to the standard of care. If the client insists on a standard of care clause, be sure to avoid contractual promises to perform above and beyond the standard of care.

Disclaimer of Warranties and Guarantees

In most states, the concept of "warranties" or "guarantees" stems from products liability law. For example, a manufacturer or retailer of goods may "warrant" or "guarantee" the fitness or quality of its goods. If the goods fail to meet expectations, the consumer may have a cause of action for breach of implied or express warranty.

Some states have extended this concept to design professionals by holding that design professionals impliedly warrant the accuracy and/or constructability of the plans and specifications. Sometimes a client will ask a design professional to expressly provide a warranty and/or guarantee in a contract. However, this is essentially a backdoor way for a client to contractually demand performance above and beyond the standard of care, and perhaps even perfection.

Design professionals should avoid any and all contractual promises to warrant or guarantee performance. Design professionals provide a service, not a product, and cannot promise a particular result, particularly because they have limited control over the end product. Ideally, design professionals should incorporate a clause disclaiming all warrantees and guarantees.

Attorneys' Fees Clause

In most states, absent a specific statute or express agreement, attorneys' fees are generally not recoverable by the prevailing party. However, parties can freely contract to "award" attorneys' fees to the prevailing party. Unfortunately, attorneys' fees clauses are a double-edged sword. A design professional can never be made whole without the opportunity to recover attorneys' fees. However, such clauses drive up the stakes and often impede settlement. Further, insurers do not cover an adverse award of attorneys' fees where that obligation is assumed only by contract. Thus, design professionals are usually better off deleting any contractual agreement to pay attorneys' fees to the prevailing party.

Dispute Resolution Clause

Design professionals can expressly negotiate an agreement to resolve disputes. Typically, disputes can be resolved through mediation, arbitration or litigation. Frequently, parties expressly agree to mediate all disputes in advance of arbitration or litigation. In this manner, parties avail themselves of an opportunity to reach a quick settlement before expending attorneys' fees and costs. Design professionals should include mediation clauses in their contracts. However, there has been a shift in the industry away from arbitration and in favor of litigation in the event mediation fails. The consensus among most attorneys and insurers is that design professionals tend to fare better in front of juries, as opposed to arbitrators. For this reason, design professionals should seriously consider avoiding contractual agreements to arbitrate disputes, thereby losing their right to a jury trial.

In closing, design professionals have more negotiating leverage than they think. They can control their destinies by closely reviewing and negotiating *all* provisions of their contracts. The above ten contract clauses have proven to be the most important clauses to address in most standard form contracts. However, be aware that state laws vary with respect to the enforceability of certain contract clauses. Accordingly, a design professional should consult with an attorney to insure that all proposed contract clauses are in accordance with applicable state law. Ideally, the design professional should consult with an attorney to assist in reviewing contracts and/or preparing customized standard terms and conditions. At a minimum, the design professional can utilize standard form contracts prepared by reputable organizations representing the design professional industry as a whole.

About the Author:

Jean Weil is a founding partner at Weil & Drage, APC, a law firm with offices in California, Arizona and Nevada. She has been representing design professionals since 1987. In recent years she has secured three state Supreme Court decisions favoring design professionals: *Terracon v. Mandalay*, 206 P.3d 81 (Nev. 2009) involved the extension of the economic loss doctrine to design professionals; *Otak Nevada, LLC v. District Court*, 260 P.3d 408 (2011) involved the strict enforcement of the certificate of merit statute as applied to design professionals; and *Rolf Jensen v. District Court*, 282 P.3d 743, 128 Nev. Adv. Op. 42 (2012) involved the first high state court to rule that owners and developers cannot seek indemnity for ADA and FHA violations as against design professionals.

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