

**Design  
Professional's  
Handbook  
of  
Business and Law**

**ROBERT F. CUSHMAN  
JAMES C. DOBBS**

## CHAPTER 24

# DESIGN PROFESSIONAL'S RIGHTS AND REMEDIES WHEN OWNER BREACHES CONTRACT

Mark C. Friedlander



Mark C. Friedlander is a partner in the law firm of Schiff Hardin & Waite in Chicago. He received his B.A. from the University of Michigan in 1978 and his J.D. from Harvard Law School in 1981. He has been an adjunct professor at the University of Illinois at Chicago School of Architecture and a lecturer at the Illinois Institute of Technology School of Civil Engineering and the Engineering School of the University of Wisconsin. Mr. Friedlander is the author of numerous publications on various topics of architecture, engineering, and construction law. He concentrates his law practice in construction and litigation consulting and representation of design professionals.

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### § 24.1 Owner's Obligations under Typical Contract

In a typical contract for architectural or engineering services, the client has very few obligations. (For purposes of this chapter, it is assumed that the design professional is working directly for the owner, but most of the discussion remains valid regardless of the identity of the client.) Obviously, the client's primary obligation is to pay the design professional for his services. Most of this chapter examines what the architect or engineer can do when a client refuses to pay fully for design professional services.

An owner is generally responsible for providing information regarding the property and the project. During the programming phase of the project, information regarding the owner's criteria and intended uses ordinarily comes from the owner, and the architect or engineer cannot proceed with the design without this information. Similarly, owners are frequently responsible for providing reports of investigations performed by other consultants, including surveys, geotechnical reports, environmental reports, and construction cost analyses, as well as legal, accounting, and insurance information.

An owner frequently has additional obligations in the contract with the design professional. The owner may be obligated to purchase and maintain various insurance policies and to name the design professional as an additional insured on those policies; is usually responsible for the coordination of multiple prime contractors; and may be obligated to provide the design professional with access to the finished project for promotional purposes and/or to give the architect or engineer appropriate credit on publicly released materials or the construction sign. The owner/architect agreement also may be worded in such a way as to require the owner to include certain language and provisions in the construction contract. For example, the owner may have agreed to put clauses in the construction contract concerning indemnification or insurance requirements.

Sections 24.2 through 24.5 describe the rules of law governing performance and breach of contracts in the context of an owner's failure to make

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payment. However, the same principles apply to the owner's breach of any contract provision.

§ 24.2 Basic Contract Law

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The law of contracts is part of the common law that America inherited from England in colonial times. Although the law of contracts can be traced back to medieval England (and beyond) and is recognized in virtually every American jurisdiction, it is not a federal law. Except when the federal government is a party, contract law is a part of and depends on the law of each state. The laws and rules that the courts of each state follow are generally uniform, but certain states may have developed specific doctrines or interpretations that differ in subtle ways from those of other states. Accordingly, the contract law principles discussed in this chapter are the common, uniform principles that virtually every jurisdiction follows. However, if specific contract-related issues arise, it is advisable to consult with counsel to determine precisely how a particular jurisdiction interprets and implements the rules and laws described.

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§ 24.3 —Types of Contracts

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The common concept of a contract is a detailed, written agreement with signature lines at the end. This is one type of contract, but there are three other types which, although not in writing, are equally enforceable if their existence and validity can be established.

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One is an *oral contract*, in which the design professional verbally agrees to perform services and the owner verbally agrees to pay for them. Another kind of contract is an *implied contract*, which may be inferred from the circumstances and relationship of the parties, even without any express communications regarding payment or the professional services to be performed. For example, a patient treated in a doctor's office is required to pay the doctor for his services, despite the fact that a contract was never discussed.

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The final way of expressing a contract does not really involve a contract at all. Called *quantum meruit*, this legal theory allows a design professional to recover the reasonable value of services performed on another's behalf even without any kind of agreement or understanding with that person.

It is commonly thought that a written contract is ineffective unless both parties have signed it. However, there are other ways to accept and be bound by a written contract without signing it. For example, a written contract can be accepted and agreed to orally, if the party who is sent a

contract with one signature says to the other party, "I accept the contract," or words to that effect.

More commonly, a written contract may be accepted by action or performance in accordance with its terms. For example, if the owner, after receiving the contract, authorizes the design professional to proceed and begins making payments under the terms of the contract, the owner ordinarily will be held to have accepted the contract and all of its terms. In one case, a court upheld an arbitration award against a developer pursuant to the arbitration clause in the contract despite the fact that the developer had not signed the contract, because he had authorized the architect to proceed to render services and provided information and made payments to the architect according to the terms of the contract.<sup>1</sup>

In general, oral contracts and implied contracts are just as enforceable as written contracts. The difficulty is ascertaining the precise terms of the contract. The terms that would be set forth in black and white in a written contract may be the subject of disputed or contradictory testimony at trial when the contract is not in writing. This leads to greater uncertainty as to what the judge, jury, or arbitrator will rule.

There are certain specific instances in which a contract will not be enforceable unless it is in writing. These circumstances are set forth in the legal rule called the *statute of frauds*. The statute of frauds requires a contract to be in (or evidenced in) writing if it is for the purchase of goods (not services) valued at more than \$500, if it cannot by its terms be performed in less than a year's time, or if the contract calls for one person to guarantee the debt of another. Very few contracts for professional architectural or engineering services fall within these categories.

Even if there is no valid contract between a client and a design professional, the latter is still entitled to be paid the reasonable value of any professional services rendered. The law discourages unjust enrichment, and a client would be unjustly enriched if the benefit and value of services were received without having to pay for them merely because no valid contract existed. Under the doctrine of quantum meruit, the owner is obligated to pay the "reasonable value" of one's services, which may be measured by a regular hourly rate or the economic value of the services to the owner.

Of course, there is bound to be a disagreement about the "reasonable value" of professional services. The client is likely to claim that the services were of little or no value to him for one reason or another, while the design professional values them at usual hourly rates. Therefore, it is preferable to have a clear and detailed written contract for professional services.

What is the reasonable value of professional services if, for example, the owner never goes ahead with the project? The owner will claim that

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<sup>1</sup> Landmark Properties, Inc. v. Architects Int'l, 172 Ill. App. 3d 379, 526 N.E.2d 603 (1988).

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the services were worthless because they did not improve the value of the property, whereas the design professional put time and effort into preparing the plans and specifications. In this situation, the law ordinarily allows a design professional to recover a reasonable hourly rate for the services provided. The usual reasoning is that the property has been made more valuable; it can be improved without having to prepare a new set of plans and specifications. An architect or engineer, as a professional, is paid for the time and effort invested in a project regardless of the ultimate outcome, just as a doctor is paid even though the patient is not cured.

§ 24.4 —Damages When Contract Is Breached

The law does not automatically award a remedy to the innocent party when the other party breaches the contract, even if the breach is deliberate. The law of contracts is not punitive; no one is fined or otherwise punished for breaking a contract. The nonbreaching party is only entitled to compensation if he was harmed or injured in some way by the breach of contract.

This is why the law will recognize a *liquidated damages* clause in a construction contract but will refuse to enforce a virtually identical *penalty clause*. A proper liquidated damages clause recites that breach of the contract (frequently by delay) would almost certainly result in economic loss but that the amount of the loss would be difficult to quantify, and therefore the liquidated damages clause contains a reasonable estimate of the damages to which the parties agree to be bound. In contrast, a penalty clause seeks to create a financial incentive to avoid a breach of the contract (usu-ally late completion) by assessing a fine for the breach, which may or may not have any relationship to actual damages suffered. Most courts will enforce a liquidated damages clause as being a reasonable approximation of actual damages while refusing to enforce a penalty clause on the grounds that penalties unrelated to actual damages are inappropriate in the context of contract law.

The legal theory that virtually every court will try to apply when a contract has been breached is to place the innocent party in the same position that he would have been in had the contract not been breached. Usually this involves an award of money damages. However, in certain circumstances, such as when unique commodities are involved, the court will enter a formal order requiring the breaching party to perform the conditions of the contract. This kind of remedy is called *specific performance*.

Generally, when the owner breaches a contract with an architect or engineer, the breach is a failure to make payment. Thus, an award of money damages ordinarily should compensate a design professional adequately for the owner's breach. A design professional will virtually never be able to

obtain a court order forcing the owner to continue to perform the contract, such as by rehiring an architectural or engineering firm that the owner wrongfully terminated.

However, some of the client's duties are unique, possibly justifying a court order of compliance. For example, if an owner refuses to allow the design professional to photograph the completed project for promotional purposes, despite agreeing to allow such photographs in the contract, a court might consider such photographs sufficiently unique to justify an award of specific performance. It is difficult to predict what the financial impact of the promotional photographs would be, so the only adequate remedy may be a court order permitting the photographs to be taken.

The obvious question is: How large an award of monetary damages would the design professional be entitled to? For example, if an owner wrongly terminated an architectural/engineering (A/E) firm exactly in the middle of a \$50,000 contract after paying the firm \$25,000, to what damages, if any, would the firm be entitled? This is a more difficult question than it might at first seem.

When a court awards money damages for a breach of contract, there are three theories it can use for calculating the damages. By far the most common and preferred theory is *expectation damages*. The goal of this theory is to place the innocent party in the same position it would have been in but for the breach of contract. However, sometimes it is difficult to determine what would have happened in the absence of the breach of contract. In such cases, a court may award the innocent party a sum equal to its costs or losses incurred because of the contract (known as the *reliance theory* of damages) or the benefits that accrued to the breaching party as a result of the contract (known as the *restitution theory* of damages).

Damage awards for breach of contract sometimes contain components intended to compensate the innocent party for the time and cost involved in prosecuting a lawsuit to recover the damages. One frequent component of damage awards is interest on unpaid sums. If the contract stipulates a rate and method of calculating interest, the courts ordinarily will enforce the provision and add interest to any award of damages. Usually, however, the rate of interest must be somewhat reasonably related to the actual time value of the money and not be so high as to be considered penal or usurious. Even if the contract is silent about interest, many jurisdictions have statutes for calculating interest in the absence of a contractual provision both before and after the court renders judgment, at least when there has been a wrongful refusal to pay. Nevertheless, it is wise to make sure the contract contains an interest provision in the case of nonpayment which specifies a rate equal to or higher than that at which money is actually borrowed, because the statutory rates in most jurisdictions are unrealistically low.

Most jurisdictions will award the successful litigant the costs incurred in prosecuting the lawsuit, including filing fees and costs of transcripts. However, the largest component of the cost of prosecuting a lawsuit, the attorneys' fees, are rarely awarded. There are only three instances in which a court can award the prevailing party reimbursement for attorneys' fees: (1) when an applicable statute provides for recovery of attorneys' fees; (2) when the contract provides for reimbursement of attorneys' fees; or (3) when the court finds that the unsuccessful party or its attorney has conducted the lawsuit in such bad faith that the court awards attorneys' fees as a sanction. Therefore, it is prudent to provide in the contract that in a suit to collect unpaid fees, the design professional is entitled to be reimbursed for attorneys' fees.

In the example of the owner who terminated an A/E firm exactly in the middle of a \$50,000 contract after paying the firm \$25,000, assume that the owner did not have the contractual right to terminate the firm and therefore breached the contract. The court will try to place the A/E firm in the same position it would have been in if it had not been terminated. This does *not* mean that the firm would be entitled to the remaining \$25,000; otherwise, it would be unjustly enriched by earning the remainder of the fee without performing the work. The proper award of damages is the remaining \$25,000 fee, less the cost to the firm of completing the work. Translated, this would be equivalent to any lost profit, plus unabsorbed overhead, less any savings that accrued to the firm as a result of not having to perform the work. If appropriate, the court would add interest at the contractual or statutory rate on any unpaid sums, plus court costs.

If a client breaches a contract by failing to make timely payments, the second party is entitled to cease or suspend performing its obligations under the contract as well unless or until the breach is cured. The design professional who suspends performance would refuse to continue the design process, send plans or specifications to the client, make additional site visits, sign the lender's certificate, or approve the contractor's applications for payments.

If a client stops making payments, the choice of whether or not to cease performance is the design professional's. One may choose for business or other reasons to continue performing services under the contract, and the right to past or future payments is not lost by doing so. In fact, before deciding to cease performance, one should make certain that the client's nonpayment is wrongful and unjustified under the terms of the contract. If the nonpayment was permissible under the contract and the design professional ceases performance, then it is the A/E who has breached the contract and will be liable to the client for any adverse consequences resulting from delayed performance.



In most jurisdictions, architects and engineers have a special remedy available to make sure they get paid. This remedy is the mechanic's lien. Although many design professionals regularly review contractors' waivers of lien, they are frequently unaware that the same remedy is available to them.

A *mechanic's lien* is a right against a certain piece of property to use that property to secure payment. It is like a mortgage lien. If the client does not make payment, the architect ultimately can have the land sold and use the proceeds to satisfy his fees. The rules governing mechanic's liens vary from state to state, and they are discussed in detail in **Chapter 25**.

It is important not to confuse contract termination with a breach of the contract. Most contracts have *termination clauses* that describe how and under what circumstances either or both of the parties can terminate the contract before its completion. If a client uses the termination clause to terminate a contract before completion, he is merely exercising a bargained-for right and has not breached the contract. The details of compensation in the event of termination should be spelled out in the termination clause.

### § 24.5 — Defenses to Claims for Breach of Contract

When a design professional makes a claim against a client for failure to pay, the client may have certain legal defenses available in addition to simply denying the design professional's version of the facts. These defenses ordinarily go to the enforceability of the underlying contract, and if a defense is successful, then the contract, or the relevant part of the contract, would not be enforceable.

One such defense is the *statute of limitations*, that the claim is barred by the passage of time. Statutes of limitation often consist of two different statutes: a statute of repose (the number of years after a breach of contract in which the claim must be brought) and the statute of limitations (the number of years after discovering the claim during which it must be brought). Statutes of limitation vary from state to state, but many states have adopted a special statute of limitations applicable to construction projects. Some states have held the special statutes to be unconstitutional, but most have not. The design professional should become familiar with the law in the appropriate states to be aware of the extent of the client's and the A/E's legal rights.

Another defense to a claim for breach of contract is that the contract itself is illegal. Specific terms in the contract may violate statutory requirements. For instance, a 25 percent annual rate of interest would be considered usurious and illegal in many jurisdictions. Many well-drafted contracts contain a *severability clause*, which states that if certain provisions are declared illegal, the other provisions would remain unaffected.

Another way in which a contract for architectural or engineering services could be illegal is if the architect or engineer is not properly licensed. Every state licenses architects and engineers and deems it illegal for someone not properly licensed to contract to perform professional services. In some states, corporations are not permitted to practice architecture or engineering or else must meet certain additional requirements before they can be licensed. In theory, a client may be able to avoid payment by claiming that the contract is illegal because the firm has breached some technical requirement of the applicable licensing act. Other states, however, do not recognize this to be a defense to payment, holding that only the state government has the authority to enforce the licensing laws.

Another legal defense to a claim for breach of contract is that the contract was founded upon a mutual mistake of fact. The courts will not recognize the validity of a contract if both parties entered into it on the same mistaken assumption of fact. For example, if an A/E firm and an owner innocently sign an architectural contract on the mistaken assumption that the soil of the property is suitable for building, either party can seek to have the contract declared void on the grounds of mutual mistake of fact. Courts ordinarily will not use this doctrine to sanctify unjust results; if the A/E firm had partially performed the contract, the court would ordinarily award it proportional fees but declare the contract void for any future work.

Another defense to a design professional's claim for payment is a counterclaim for professional malpractice. This is an affirmative claim against the A/E alleging negligent performance of professional services, entitling the owner to offset the payment owed to the A/E by the amount of damages allegedly suffered from the malpractice. The rules governing claims of malpractice against a design professional are covered in **Chapter 7**. However, sophisticated judges and arbitrators know that a sizable counterclaim for malpractice is usually less credible when the owner does not bother to assert the claim until after the design professional has filed a claim for his fees.

### § 24.6 Filing a Claim

When a design professional has a claim for unpaid fees or anything else, the most difficult decision is usually whether or not to pursue it. There are a large number of factors that go into such a decision, some of which are quantifiable and tangible, others of which are intangible personal or emotional factors.

One should consider a claim to be nothing more or less than an asset, and one should determine whether to pursue the claim in the same manner one would determine whether to invest in any asset. If the likely gain outweighs the likely loss, then the investment in the claim is economically worthwhile.

An attorney should be consulted to calculate the likely gains and losses. On the positive side of the equation is the amount the A/E is likely to win multiplied by the likelihood of winning and collecting. On the negative side is the cost of prosecuting the lawsuit, consisting primarily of attorneys' fees and interruption of one's business. If the positive side of the equation is greater than the negative side, then the claim should be pursued.

For example, suppose a client owes \$20,000 for services performed. After discussions with an attorney, the design professional concludes that he is two-thirds likely to prevail but that the average cost to prosecute this type of claim would be \$10,000 to \$15,000. Two-thirds of \$20,000 is \$13,333, which is approximately the cost of litigating the case. That means pursuing this claim is close to an even proposition economically.

This formula is a guideline only. It can be made considerably more sophisticated by multiplying other possible results by their coefficients of likeliness, by including the effect of any counterclaims the client may have, and by various fee arrangements that can be made with an attorney.

Once the design professional decides to file a claim, the next decision is where to file it. It is ordinarily an advantage to file a claim in the location where one works. Not only is it more economical to litigate on "home turf," but fact finders are sometimes biased in favor of local firms and people.

The decision of whether to file a lawsuit in state or federal court is governed in part by rules of jurisdiction. With rare exceptions, a party can litigate in federal court only if the party being sued is a federal entity or is from a different state and more than \$50,000 is at stake. The advantages and disadvantages of federal and state court depend on certain factors unique to the courts. Following are some general considerations:

Federal courts usually have a smaller ratio of cases per judge than state courts in the same district.

Some state court judges are elected or serve fixed terms, making them vulnerable to political pressure.

Federal court is often more formal and scholarly than state court.

It is easier for a case filed in federal court to be transferred to another state than for a case filed in state court.

One may be able to choose the state in which to file the lawsuit. Typically, a lawsuit is filed in the state where the project is located. However, it may be possible and advantageous to file the lawsuit somewhere else, such as in one's home state.

After deciding in which state to file the lawsuit, one may have to choose a particular court system within the state. Especially in states with distinct urban and rural areas, the court systems and the procedures they follow may be quite different. For example, in Illinois, the Chicago (Cook

County) those in extremely large metropolitan areas and rural areas.

Even if one chooses to file in a state (AAA), with the protection of Arbitration clause, the absence of a procedure, however, the fact determiner.

The local courts and the parties.

The local law firm which legally apply. This state is located, but the law will apply to the performance.

A lawsuit is a document submitted in on behalf of the party of the server, or client.

Most jurisdictions require a complaint. The respondent is required to respond in a timely manner that even if the claim is not valid; he may be liable for damages and equivalent costs of filing third-party claims of the same.

County) court system is very different from the “downstate” courts or those in surrounding counties. The Cook County Circuit Court is extremely large and unusually structured so that different judges hear different aspects of a single case. The demographic characteristics of the population and, therefore, of potential jurors are different from courts in more rural areas. The caseload per judge is heavier than in the other court systems of the state.

Even if a claim must be decided in arbitration, one still may be able to choose where to file the claim. The American Arbitration Association (AAA), whose procedures are incorporated in the standard American Institute of Architects (AIA) forms, has offices in most major cities. The arbitration clause in a contract can specify the place of the hearing. Typically, in the absence of an agreement specifying a particular location, the arbitration proceeding takes place in the major city nearest to the project. However, the first party to file a demand for arbitration plays the major role in determining the venue of the claim.

The locale for resolving any claims can be specified in the contract. Both courts and arbitrators ordinarily defer to any choice of location specified in the parties’ contract.

The location in which the claim is litigated does not necessarily determine which state’s law will govern the dispute. A court in one state can legally apply the law of another state to the resolution of a dispute before it. This state law normally will be that of the state in which the project is located, but the parties to the contract may specify that a different state’s law will apply provided that the state has some reasonable interest in the performance of the contract.

## § 24.7 Litigation Process

A lawsuit is initiated with a summons and complaint. The complaint is the document stating one’s legal claim and requesting the courts to enter judgment in one’s favor. The summons is the document that notifies the other party of the lawsuit being filed and is usually served by a sheriff, a process server, or certified mail.

Most jurisdictions give the defendant 20 to 30 days to respond to the complaint. Extensions of time are routinely allowed. The defendant may respond in several ways. He may move to dismiss the complaint, claiming that even if the allegations are accurate, the law does not recognize such a claim; he may file an answer to the complaint, admitting some factual allegations and denying others; or he may file a counterclaim, which is the equivalent of his own lawsuit against the plaintiff. He also has the option of filing third-party claims, which are lawsuits against other parties arising out of the same circumstances as the plaintiff’s lawsuit.

The most expensive part of a lawsuit is usually *pretrial discovery*. Discovery involves the production and review of documents, the posing and answering of written questions called *interrogatories*, and the giving and taking of *depositions*, or oral testimony under oath outside the presence of the judge or jury. Most jurisdictions allow relatively free reign in the discovery process, which can therefore be extensive, time consuming, and an invasion of privacy. Before trial, the court ordinarily will hold status hearings, pre-trial conferences, and hearings on various motions that the parties may bring to resolve procedural disputes and issues. Some judges view these pretrial conferences as purely administrative, while other courts use them as bargaining sessions to try to reach settlement. The procedures frequently vary from judge to judge, and the only way to know what to expect is to consult with an experienced local attorney.

One especially important kind of pretrial motion is the *motion for summary judgment*, which seeks to have a judge decide the case without a trial on the grounds that there are no disputed issues of fact to resolve. Summary judgment is a powerful tool for resolving disputes quickly and relatively inexpensively. However, it is not available if each side's position is that the other is factually wrong.

Current statistics indicate that less than 1 in every 100 lawsuits is decided by a trial. Most cases are settled before trial, and most of the rest are either dismissed or have judgment entered before trial. Trials are a complicated and sometimes unsatisfactory method of resolving disputes, relying on formal procedures and rules of evidence that often complicate the fact-finding procedure.

One important decision that must be made is whether or not to ask for a jury. When a judge sits without a jury, he finds both the facts and the law. When a jury is present, the jury decides what the facts are and the judge instructs the jury in the applicable law.

In most lawsuits to collect fees, the plaintiff does not request a jury. These are called *bench trials*. Bench trials are faster and therefore usually less expensive than jury trials. A judge is a professional fact finder, whereas a juror hears one case only. Judges are typically better educated than jurors and have more experience in distilling the actual facts from the testimony.

There are, however, some advantages to jury trials. At least in theory, a jury of 12 people is less likely to be biased or arbitrary than a single judge. A jury is more likely than a judge to decide based on "what is fair" rather than based strictly on what the law requires. A jury may treat the case as more important and give it more consideration than a judge who hears hundreds of trials. If there is damaging but inadmissible evidence against a party, a jury will not be allowed to hear it, whereas a judge must hear it first to determine whether it is admissible.

The author prefers a bench trial for a winning case and a jury trial otherwise. Jury trials seem to produce less easily predictable results than trials in

front of judges, and it is easier for a lawyer to confuse or obfuscate an issue in front of a jury than in front of a judge.

After a judgment is rendered, either after trial or upon a motion, the lawsuit is not automatically terminated. The losing party always has a right of appeal. Depending on the jurisdiction, the parties must file their notice of appeal within 20 to 30 days of the entry of judgment, after which briefs are filed and an oral argument is made to the appellate court.

The appellate court then issues a written opinion. However, it will only review issues of law and will not reweigh the evidence or substitute its judgment for that of the finder of fact. An appeal is just an opportunity to correct a legal mistake the trial court may have made; it is not an opportunity to retry the case.

An alternative court for small claims is available in many jurisdictions. The rules vary from state to state. A plaintiff ordinarily represents himself without a lawyer and the courts only have jurisdiction to hear claims for relatively small amounts, usually \$5,000 or less. The procedural rules are simplified and shortened. Small claims court may be the only means of cost-effectively litigating small claims.

An alternative to the court system is binding arbitration.<sup>2</sup> A dispute is arbitrable only if the parties agree to arbitrate it. This agreement is usually written into the contract for professional services. However, the parties could agree to arbitrate a dispute after it arises even though there is no arbitration clause in the contract.

Furthermore, the dispute must be within the scope of the arbitration agreement. Standard form contracts contain a broad arbitration clause which essentially states that any dispute between the parties pertaining to the contract or project must be resolved in arbitration. However, the arbitration clause may be drafted more narrowly to provide that only certain kinds of claims are arbitrable.

Arbitration is a simplified and streamlined version of courtroom litigation. It is initiated by a demand for arbitration, which is similar to a complaint. There are preliminary and evidentiary hearings, after which the fact finder(s) renders a binding award. However, the parties select the fact finder(s) according to the arbitration rules they have agreed upon.

Opinions are mixed on whether arbitration is a superior alternative to litigation. Although arbitration is gaining support, many lawyers are not familiar with its rules and procedures and therefore tend to avoid it. Following are the major differences between arbitration and litigation:

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<sup>2</sup> For an excellent discussion of various types of alternative dispute resolution, see I. P. Lurie, *Alternative Dispute Resolution for Design Professionals* (1988). See also *Arbitration of Construction Disputes* (M. Callahan, B. Bramble, & P. Lurie, eds., John Wiley & Sons, Inc. 1990).

Arbitrations are generally resolved more quickly and cheaply than litigation, particularly litigation in congested urban court systems.

Unlike a jury of laypersons, the arbitrators are generally professionals and business people in the construction industry or lawyers with construction law experience.

The courts allow extensive discovery procedures that are ordinarily unavailable in arbitration.

It is more difficult to gather multiple parties in a single arbitration hearing than in court.

Courts follow formal rules of procedure and rules of evidence, whereas arbitration dispenses with most of these formalities.

An error of law made by the trial court can be appealed, but an arbitrator's error generally cannot be appealed.

Many of these advantages and disadvantages cut both ways. The absence of an appeal and of extensive discovery works to the advantage of a party who desires a quick and inexpensive result, but it works to the disadvantage of a party whose case is factually or legally complex. Arbitration is generally the superior method of resolving design professionals' fee disputes because of arbitration's quickness, lesser costs, and fact finders experienced in the construction industry.

There are alternatives to both litigation and arbitration. Frequently called *alternative dispute resolution*, these are nonbinding processes usually facilitated by a third-party neutral.

The weakness of alternative dispute resolution is that it is nonbinding. The party holding the money may choose to view it as just another stalling tactic. Alternative dispute resolution is likely to be more useful when both parties in good faith believe their positions are correct or when the parties have or desire a long-term relationship with each other.

The litigation process is not over after a judgment is obtained. Collecting the money may involve foreclosing on a mechanic's lien or going through another courtroom process to learn what and where a client's assets are. A number of things may happen to make the judgment difficult or impossible to collect. A client may go bankrupt or be a judgment-proof individual or a "shell" corporation with few assets, or there may be a default with the lender taking over the project, which may restrict remedies.

### § 24.8 Hiring a Lawyer to Collect Fees

It is important for a design professional to hire an experienced lawyer in a fee dispute. Collecting an A/E's fee is a specialized kind of legal practice, requiring special skills and experience a business or real estate lawyer may lack.

The biggest decision is usually the fee arrangement. There are two possibilities. The lawyer may bill according to his (and his staff's) hourly rates, with payment due regardless of the result of the lawsuit. Alternatively, the lawyer may charge a contingent fee, usually one-third of whatever is collected (plus expenses off the top), paid only if the case is successful. Some lawyers refuse to work on one basis or the other. If there is a choice, one should consider the likelihood of prevailing with a comparison of likely hourly and contingent fees.

If a lawyer is working on an hourly fee, the A/E should ask about:

1. The lawyer's rates
2. The rates of other lawyers in the office who may work on the case
3. Other office personnel (paralegals, secretaries, word processors, docket clerks): their hourly fees, whether the client is charged for them or if they are overhead, and whether the client can save money by performing some or all of their work with the A/E's own employees
4. Whether the lawyer charges higher "in court" rates
5. Frequency of billing, payment terms, and extension of credit.

When a lawyer works for a contingent fee, it is important to determine the percentage fee and whether the percentage changes depending on the length of the case. For example, if the lawyer succeeds in collecting the fee by writing a letter without ever filing the lawsuit, does he charge the same percentage for his fee? Is there a difference in percentage when the fee is collected after the complaint is filed but before trial, or when the fee is not collected until after an appeal has been resolved?

The rules governing the practice of law ordinarily require the client to pay the expenses (such as filing fees and costs of transcripts) incurred by a lawyer even on an unsuccessful lawsuit taken on a contingent fee. The A/E may want to ask the lawyer what his normal practice is and obtain the names of other clients as references.

In addition to fee structure, the lawyer's background and experience are important. Lawyers familiar with design and construction are more easily able to spot and understand the important issues. It saves time and money when the lawyer does not have to educate himself about procedural matters or construction issues. This is particularly important when the lawyer is charging an hourly fee, but it is also important on contingent fee cases. Most lawyers who charge contingent fees for collection work do not concentrate their practices in architectural or engineering claims and typically litigate a very large number of cases, many of which are uncontested. They frequently do not have the time or background to respond to complex assertions made or positions taken by the defendant against a claim.

Occasionally a dispute may arise between a lawyer and a client regarding legal fees or some other aspect of the litigation. In such cases, the state or



local bar association may be able to recommend a special committee that can investigate and resolve the matter.

### § 24.9 Collection Tactics

The best time to avoid a dispute that may result in the withholding of the A/E's fee is before the dispute has arisen. Sections 24.10 through 24.14 recommend measures the design professional can take in day-to-day practice to minimize the possibility that a fee dispute will develop.

### § 24.10 —Recommended Contractual Clauses

One of the most important contractual clauses to help ensure collection of fees is one that provides for reimbursement of attorneys' fees. The presence of such a clause in the contract will discourage the client from attempting to withhold fees, and if a claim is filed, an attorneys' fees clause is very important in rendering the litigation cost effective.

An attorneys' fees clause favorable to the design professional would be:

Client shall reimburse Design Professional for any costs and expenses, including attorneys' fees, incurred by Design Professional in any effort to enforce payment.

A more even-handed clause that would have the same effect if the A/E were to successfully sue for fees would be:

In any lawsuit, claim or other action between the parties arising out of or relating to the contract, the other party shall reimburse prevailing party for all costs and expenses, including attorneys' fees, incurred by the prevailing party in the lawsuit, claim or other action.

An interest clause, with high but realistic rates, helps to ensure that the A/E will truly be "made whole" if a fee dispute is won and will ensure superior bargaining leverage after the dispute arises. One example of such a clause would be:

Interest shall accrue on all sums due and unpaid at the rate of 1-1/2% per month simple interest from the date on which payment was due.

As discussed in § 24.6, it may be helpful to specify in the contract the venue for any dispute resolution process that may arise. In conjunction with an arbitration clause, the words "in City, State" can be inserted after the words "shall be . . . decided by arbitration." If there is no arbitration agreement in the contract, the following venue provision can be inserted:

The parties stipulate that any litigation or other dispute resolution process arising out of or relating to this contract shall be venued in City, State, and the parties hereby waive any objections to jurisdiction or venue which they may otherwise have.

A broad arbitration clause such as found in the standard AIA and Engineers Joint Contract Documents Committee (EJCDC) documents, can help collect unpaid fees. Under these clauses, any and all disputes arising out of or relating to the contract must be resolved in arbitration.

It is also possible to draft a much more limited arbitration clause. For example, the following clause is designed to have fee disputes heard in arbitration while major malpractice claims would be litigated through the court system:

All claims, disputes or other matters for which the sum sought to be recovered is less than \$50,000 shall be decided by arbitration in accordance with . . . . All claims, disputes or other matters for which the amount sought equals or exceeds \$50,000 shall not be subject to arbitration and shall be litigated, if at all, in a court of competent jurisdiction.

Arbitration clauses are very flexible. They can be joined with agreements for other alternative dispute resolution mechanisms. For example, the following clause requires the parties to mediate any dispute and, if unsuccessful, to subsequently arbitrate it:

Any and all claims, disputes or other matters in question between the parties ("controversies") arising out of or relating to this Agreement shall initially be submitted to mediation in accordance with the Construction Mediation Rules of the American Arbitration Association or Endispute, Inc. If the mediation process has not resulted in an agreed settlement within 30 days of submission of the matter to mediation, then the controversy shall be decided by arbitration in accordance with . . . .

It is not necessary to adopt wholesale any published set of arbitration rules. The rules may be modified to provide for the arbitrator to make findings of fact in a written opinion or to allow discovery and prehearing procedures. One frequent modification to standard arbitration clauses is the following:

Any arbitration conducted under this contract shall permit discovery in accordance with the Federal Rules of Civil Procedure. In the event of a discovery dispute, the parties shall submit the dispute to the arbitrator(s), whose decision shall be final and binding.

As discussed in § 24.4, it is important for the design professional to be able to suspend services under a contract when a client ceases making

payments. Although the law permits the design professional to suspend services when payment is wrongfully withheld, the A/E runs the risk that the payment would be found to be properly withheld, in which case the A/E would be liable for any resulting delays. The following clause can minimize that risk:

In the event that the Owner fails to make a payment when it is due, or if the Owner and Design Professional disagree as to whether the Owner has improperly failed to make a payment, the Design Professional shall be entitled to suspend performing services under the contract until either the dispute has been resolved or else the owner places a sum equal to [150% of] the amount in dispute in an escrow account, reasonably satisfactory to both parties, which specifies that the escrow agent shall distribute the escrow sum between the parties in accordance with any arbitration award or court judgment entered resolving the dispute.

Clients are far less likely to withhold payments if they know in advance that they cannot use the money elsewhere and will instead be required to deposit the money in an escrow account.

A problem frequently encountered by design professionals is a client who, near the end of the project, questions billings from long ago to try to negotiate down the overall fee. The following clause can prevent this from happening:

Within twenty-one days of receipt of Design Professional's invoice, Owner shall examine the invoice in detail to satisfy himself as to its accuracy and completeness and shall raise any questions or objections which he may have regarding the invoice within this twenty-one-day period. After twenty-one days from receipt of Design Professional's invoice, Owner waives any question or objection to the invoice not previously raised.

### § 24.11 —Managing Communications

The major source of claims by owners against design professionals is poor communication resulting in unrealistic owner expectations. One or both parties may be at fault.

One of the most common misunderstandings occurs when the design professional fails to inform the owner of the financial consequences of the owner's decisions. Some unsophisticated owners do not understand normal architectural and engineering practice and expect unreasonable things to be included in basic services. At a minimum, the design professional should carefully explain to the owner at the outset of the project where the line is drawn between basic and additional services. Particularly with an unsophisticated owner, the design professional should obtain the

owner's signature on an additional services authorization before performing any such work.

This problem often surfaces when the architect or engineer is designing with a fixed limit of construction costs. It is imperative for the A/E to make the owner aware of the impact of certain design choices on the construction budget. Examples are rampant of design professionals who have been required to value engineer a project at their own expense because they were too accommodating in incorporating the owner's expensive preferences into the design.

Another common mistake design professionals make is to postpone a confrontation on an unpleasant issue. It is always easier to discuss the positive aspects of a project or working relationship than the negative ones. However, it is these negative aspects that are likely to lead a client to withhold payment.

It is natural for an A/E to want to maintain a good working relationship with a client. This is especially true for project managers. Project managers tend to be younger executives, responsible for the project but not the source of the original relationship with the client. Their performance tends to be judged by the outcome of the project, not by success in collecting fees. Rather than confront and resolve an issue when it first arises, project managers often postpone discussing the issue with the client so as not to anger the client or invite closer scrutiny into other decisions previously made. One solution that is gaining popularity among design firms is to link the project manager's compensation in some way with successful collection of fees for the project. In theory, this would give project managers an incentive to pay attention to the business relationship as well as the aesthetic and technical aspects of the project.

A good rule of thumb is never to postpone resolution of a complaint or problem. The earlier in the project that a problem is confronted, the greater number of options for resolving it generally exist. Furthermore, the design professional has greater leverage earlier in the project to negotiate a satisfactory solution.

One common complaint that owners have about design professionals is that they fail to understand the owner's needs and desires. The problem is rarely that architects and engineers do not carefully listen to their clients. Rather, the clients themselves frequently either do not know what they want or have inconsistent desires about the project. The actual source of the misunderstanding is not as important as the fact that the owner perceives that the A/E did not properly perform his duties and withholds part of the fee.

Often the design professional fails to understand the conflicts and limits of authority within an institutional owner. For example, governmental entities, with their high rate of turnover and complex hierarchy, are a major source of conflicting and inconsistent instructions. Large corporations, to a

lesser extent, may be subject to similar problems. Condominium associations are famous for inconsistency and deviating from the positions originally taken by the developer or the prior year's condominium association members.

The two-step solution to prevent the development of unrealistic expectations is to communicate and document. It is sometimes difficult for architects and engineers to understand that their clients frequently do not have any real understanding of what design professionals do. A layperson typically and erroneously sees an architect's function as "making sure that the building gets built right." In particular, clients frequently do not understand the differences between a design professional's and a contractor's roles. Following are some suggestions design professionals can follow to improve communications with their clients:

1. Teach the client about the construction process, particularly about the limits and extent of the A/E's duties.
2. Carefully explain which services are considered basic services and which are additional services, illustrating the difference with examples likely to be relevant to the project in question.
3. When a client must make a decision, fully advise him of the various consequences of his options, even if he does not want to hear all of them.
4. If the client is dissatisfied, discuss the reasons for his dissatisfaction as soon as possible, and try to resolve the problem quickly.
5. Take the time to learn an institutional client's command structure, especially who does and does not have the authority to issue instructions or make decisions.

An important rule in performing design services is to document all important communications. If the communications have taken place before the signing of the contract, consider incorporating them into the contract, as described in § 24.12. If the communications take place after the contract has been signed, there are a number of different ways to document them, described in § 24.13.

#### § 24.12 —Contractual Communications

The best and most reliable source of the rules governing an A/E's relationship with a client is the contract. Most jurisdictions legally define an A/E's duties as those stated or implied in the contract. A letter documenting a conversation is evidence, but not conclusive proof, of what was said; if the same communication or instruction is recited in the contract, it is generally legally conclusive and binding.

Contracts are generally composed of two sections. The second section contains the promises, covenants, warranties, and other provisions that constitute the agreement. The first section often contains recitals of fact that are important in understanding the nature of the relationship between the parties. Any communication, whether it is a simple statement of fact or a complicated set of promises and conditions, can appropriately be included in one of the two sections of the contract.

Even if it is in writing, a client's promise may not be enforceable unless it is included in the contract. For example, suppose a client writes an A/E a letter promising a bonus calculated as a percentage of the amount by which the construction budget exceeds the lowest bid. In reliance on this promise, the A/E agrees to design the project, and the A/E and the owner enter into a standard form contract for architectural services. The owner's promise to pay the bonus probably would *not* be enforceable. Under the legal doctrine of parol evidence, a court would not consider any promises made, even in writing, before entering into the contract on the grounds that the contract supersedes all prior negotiations.

A simple solution is to incorporate such a bonus letter into the contract as an exhibit. Alternatively, a provision could be added to the contract that mirrors the terms of the letter. The point is to make sure the contract accurately reflects all of the important communications and promises made.

The contract also can be used as an educational tool. With the client, the A/E can go through the list of basic services and additional services to make sure the client clearly understands what will be provided and what will be extra. The identity of the client's representative and the extent of his authority should be discussed and included in the contract. If there are any special timing requirements or design features, these should be clearly spelled out as well.

A word of caution: drafting contracts can be a tricky business, and even plain English does not always suffice. For example, a deadline in the contract will have very little effect unless it is accompanied by the legal phrase, "Time is of the essence." When preparing a contract, it is a good idea to consult an attorney, especially when the contract deviates in any important respect from standard form contracts.

### § 24.13 —Post-Contractual Communications

Often it is important to document communications that occur after the contract has been signed. The best way is to put the communication in writing and have it signed or otherwise acknowledged in writing by the other party. An example of this kind of documentation is an additional services authorization form. If the client asks the A/E to perform an additional service, the A/E should send the client a written description of his request, reciting that the work will be billed as an additional service and

asking him to initial and return it. This procedure will effectively prevent the client from being able to claim that the A/E is not entitled to additional compensation for the work.

The second best method of documenting a communication is to send a written summary of the communication to the other party, accompanied by a request for that party to notify the first party if he believes the summary is incorrect or incomplete. Probably the best example of this kind of documentation is a confirming letter. Another example would be the minutes of meetings. The advantage of this documentation method is that it creates a clear record of the communication in a less formal and confrontational manner than requiring signature or initialing as acknowledgement. The disadvantage is that there still may be an adversarial element to the documentation. The other party is alerted to the fact that a written record of the communication is being made for some reason, and the other party may be able to claim that he never received or paid attention to the document circulated.

The least effective form of documentation is to take notes or make a record of the communication but to keep the record without circulating it to the other party. Its major disadvantage is that because the written record was never shared with the other party, that party may deny its accuracy when confronted. This method of documentation is most effective if there is a regularly established procedure (such as a telephone log) for taking notes and filing them. A further advantage of this method is that one can keep a written record of communications without the other party's knowledge.

Making an audio or tape recording of oral communications is not always effective and has several drawbacks. In some states, it is illegal to surreptitiously record a conversation without the other party's consent. If it is known that a tape is being made, people sometimes speak "for the record," distorting what would otherwise be said. Tape-recording a meeting or conversation is frequently interpreted as adversarial and confrontational. Finally, unless the tape is routinely transcribed, which is time consuming, it is difficult to organize or index tape-recorded conversations. A tape recording is most effective when one knows in advance that the communication in question will be very important and likely the source of future disputes.

#### § 24.14 — Financial Considerations

Another way the design professional can help ensure payment is to check the client's financial situation. Because of the realities of the marketplace, virtually no design professionals are paid in advance or work against a retainer. The industry standard is to bill at the end of the month for services performed earlier that month. Accordingly, design professionals routinely advance credit to their clients.

Very few architects or engineers adequately investigate their client's creditworthiness, feeling they are fortunate to have been awarded the project and fearing they would insult the owner by seeking financial assurances.

There are numerous means of verifying a client's creditworthiness. There are companies that issue credit reports on businesses and individuals. The design professional also can solicit information from the client's bank, review the client's financial statements, or ask the client for references to other design professionals, contractors, or other business people. A credit check is probably unnecessary if the client is a major corporation such as General Motors or IBM.

However, government agencies can pose a trap for the unwary. Just because the client is a municipal or public agency does not mean that it has the money to pay the A/E's fees. Many agencies have statutory limits on their expenditures, and money may not have been properly appropriated for design fees. With private clients, a mechanic's lien can usually secure one's right to payment; however, most jurisdictions do not permit mechanic's liens to be filed against real property owned by governmental agencies.

It is also important to pay attention to the precise legal entity with which one is contracting. Considerable development is performed by corporations or land trusts established specifically for the project and which may not possess any uncommitted assets with which to pay design fees. Just because the owners or others affiliated with the corporation or trust have substantial money does not mean that the corporation or trust will have access to that money. In the eyes of the law, with very few exceptions, a corporation or trust is considered a distinct legal entity, just like an individual person, and the owners of the corporation and beneficial owners of trusts are not personally liable for the corporation's or trust's debts.

This does not mean that one should never enter into a contract with a *shell* entity (one with few or no assets of its own). However, before advancing credit to the shell entity by performing services against future billings, one should make sure that the right to payment is secure from some source. For example, if the services the A/E is performing give him mechanic's lien rights, the lien against the real estate may be sufficient security. Otherwise, the client may be able to give the design professional a security interest in the real estate (that is, mortgage) or in some other real or personal property to secure payment. The structuring of secured transactions of this kind can be quite complicated and should not be attempted without a lawyer's advice.

Perhaps the simplest way of securing fee payments owed by a shell entity is to have another responsible person or entity guarantee the payments. The client would require a similar guarantee of any tenant that is a shell entity in a building he is developing; he would ordinarily require the entity's owner(s) to guarantee the entity's obligations under the lease. The same thing



can be done in the contract for professional services by a signature at the end and the following language immediately preceding it: "The undersigned hereby guarantees all of the obligations of Shell Entity under this Agreement."

A related concern involves contracts with partnerships. The law of partnerships is more favorable to the design professional than the law of corporations because it renders each partner personally responsible for the partnership debts. However, there are two different kinds of partnerships. The typical one is a *general partnership* in which all general partners are individually liable for the partnership's debts. Some partnerships are called *limited partnerships* and consist of both general and limited partners. Limited partners are essentially investors, and they are *not* liable for partnership debts beyond the amount of their financial contribution to the partnership. Every limited partnership must have at least one general partner who is individually responsible for partnership obligations. With the responsibility comes authority: ordinarily, only a general partner, not a limited partner, has the authority to bind the partnership to a contract or to hire a design professional to perform services. However, caution is advisable when the only general partners of a partnership are shell entities.

When entering into a contract with a government agency or public body, it is necessary to make sure that the agency or public body is acting within its authority. The statutes and regulations governing these entities are published, and the law holds the design professional responsible for being familiar with them. The A/E should verify that the agency is acting within the scope of its authority, that the individual who will be signing the contract has the authority to do so, that the necessary funds have been appropriated, and that the agency has followed the proper rules and procedures in entering into the contract. When in doubt, consult with an attorney.

Especially in private development, the source of the money to pay design fees frequently will be a construction loan from a bank or other financial institution. When possible, one should verify the terms of the loan agreement to make sure the client has met or can meet all conditions required to draw on the loan. The size, duration, and other aspects of the loan should be realistic and sufficient and provision should be made for payment of design fees. The A/E frequently will be asked to sign a document consenting to a collateral assignment of the contract to the lender if the developer defaults. It is reasonable to sign such a document, but one should make sure that its provisions require the lender to make payment on a current basis plus all past due invoices if the lender takes over the project after the developer's default and requires the A/E's services.

One more word of caution: beware of the private developer with the bad reputation. Ask for references and check them out. Smaller, private developers who frequently operate "on a shoestring" are the kind of client most

likely to wrongfully withhold professional fees. Especially as profit margins shrink, some private developers are unscrupulous and unethical and try to make additional money at the design professional's expense. They believe it is acceptable to slow down or withhold the last payment(s) in order to negotiate the fee down after the work has been done. They fabricate claims against the design professional to offset sums owed, and they make disingenuous and unreasonable demands for supporting documentation solely for the purpose of delaying payment.

Even honest and ethical private developers frequently believe they have a right to withhold fees for reasons not the A/E's fault. They frequently refuse to make overdue payments they acknowledge are owed merely because they have not yet themselves received the money (such as a draw on a construction loan) to pay the A/E. Unless a specific provision in the contract allows the developer to delay payment for this reason, it is not proper to do so. However, developers usually get away with the delay because the design professional does not want to alienate the client and because the collection process, even at its fastest, is usually too slow to expedite the payment. It is wise to make sure the contract contains a strong "interest on late payments" clause, and the design professional should do what contractors do: formally calculate and make a claim for the interest owed on account of the late payments.

Some developers feel entitled to withhold sufficient money to cover any dispute, even if the design professional did nothing wrong. The client may blame the A/E for failing to catch construction mistakes, or the entire draw on a construction loan may be held up because of disputes involving parties having nothing to do with the design professional. If there is a question or dispute concerning a small portion of the A/E's invoice, developers frequently refuse to pay even the undisputed sums until the question or dispute has been resolved.

One partial solution to this problem is to require that sums withheld because of a dispute be placed in escrow. If there is a legitimate, good faith dispute, the client is probably justified in withholding the disputed amount, at least until the dispute is resolved. However, the A/E wants to eliminate any incentive for the client to artificially exaggerate the amounts in dispute and to use the withheld sums to finance the project. See § 24.10 for a sample contract clause that effectuates this solution.

Working for developers who practice these "sharp" tactics is shortsighted. The job is unlikely to be profitable because the developer's decision on how much to wrongfully withhold without spurring the A/E to legal action will take that profit into account. The administrative time and expense the A/E will expend trying to collect fees may be a major drain on the firm and is virtually certain to offset any profit. Even if business is slow, the A/E's time usually would be better spent marketing to clients who will pay fully.

### § 24.15 —Quality Control

A further way to maximize the likelihood of being fully paid is to emphasize quality control and claims avoidance. Quality control is not only a professional obligation, but a good financial investment as well. It pays off in greater and faster collections and improves internal efficiency. Although there is no way to guarantee perfect work, the best way to minimize client dissatisfaction is to anticipate problems and avoid mistakes.

Following are some time-tested methods for improving quality control:

Make sure the firm's principals stay highly involved in the work.

Perform honest self-evaluations.

Encourage frank and full discussion among employees.

When problems occur, keep records of them and look for patterns in the types of problems and the people involved.

Participate actively in professional societies' peer review processes.<sup>3</sup>

Originally developed by the American Consulting Engineers Council, many professional societies now conduct formal peer review programs in which similarly situated design professionals conduct in-house analyses of other firms and their procedures.

### § 24.16 —Statement of Completion

One final recommendation is to create and obtain the client's signature on a statement of completion. The statement of completion is a certificate signed by the client reciting that services have been satisfactorily completed. It is analogous to a contractor's certificate of substantial or final completion. The statement of completion might use the following language:

Design Professional has performed all of its contractual services in accordance with its contract with the undersigned in a manner acceptable to the undersigned [except as may be noted below].

Ideally, a sample form should be attached to and incorporated in the design professional's contract, along with a provision stating that the client shall sign and deliver it to the design professional with final payment.

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<sup>3</sup> American Consulting Engineers Council, Professional Liability Risk Management (1990).

### § 24.17 Resolving a Dispute

Despite the design professional's best efforts to avoid a dispute, a problem may develop that causes the owner to withhold payment. The A/E's approach will depend to a great extent on how confrontational he is willing to be.

The first stage of resolving such a dispute is the talking stage. The A/E asks the client why he is withholding payment, and he gives his reasons. Presumably, the A/E disagrees with those reasons and tries to persuade the client they are improper. If neither party changes his position, the dispute escalates to the next stage.

The design professional usually threatens the client with some form of protective or retaliatory action including:

- Stopping work or otherwise withholding services
- Informing the lender or other interested parties of the nonpayment
- Informing the code authority of the cessation of the design professional's participation
- Informing the code authority of existing code violations
- Filing a law suit or going to arbitration.

In most jurisdictions, the law does not permit one to threaten to report a violation of the law to achieve an objective like enforcing payment. In many states, making such a threat is a crime called *intimidation* or *blackmail*. One may have an independent legal or moral obligation to report a violation of the law, but one cannot offer to forego making the report in exchange for payment.

The design professional may threaten to take civil action to enforce payment, such as filing suit or a demand for arbitration. Similarly, there is nothing improper about threatening to inform other interested parties, such as the lender or surety, if payment is not received. It is likely to be in the A/E's interest to inform the client's lender of nonpayment because the lender may insist that the A/E be paid or else declare the loan agreement in default. In fact, if the A/E has signed a lender's consent to collateral assignment form, he may be contractually obligated to report nonpayment to the lender. Also, depending on the law in that jurisdiction, the A/E may be obligated to report the cessation of his firm's involvement in the project to the applicable authorities.

The law also allows the design professional to threaten to stop work or withhold other services. Wrongful nonpayment is a material breach of the contract, and when one party materially breaches a contract, the other party is no longer obligated to continue performing. It is not usually necessary to formally terminate the contract in accordance with the termination

clause; however, the contract itself can limit or modify one's right to suspend performance for nonpayment.

Common examples of withholding services include:

- Stopping work during the design phase
- Refusing to transmit the plans and specifications to the client
- Refusing to sign a lender's certificate
- Refusing to sign or evaluate a change order
- Refusing to visit the construction site

The design professional should consult with an attorney to make sure his position is correct before deciding to withhold services. If the client can ultimately prove that withholding payment is justified, the A/E is the one who breached the contract and will be liable for the delays and extra cost caused by withheld services. The decision to withhold services is similar to "raising the stakes" in a poker game. Although the A/E increases the pressure on the client to pay him, the A/E also increases his own liability if the client's decision to withhold payment is ultimately proved to be justified.

### § 24.18 —Negotiation

The major alternative to a confrontational course of action is negotiation. Negotiation has a good chance of succeeding if both parties are proceeding in good faith. Beware of the client who professes to be willing to negotiate but takes unreasonable positions. The client may be using negotiation as a stalling tactic.

Three important considerations are common to all negotiations. First, be aware of what the alternative to negotiation is and what its consequences would be. Frequently, the only alternatives to negotiation are capitulating or filing a lawsuit (or demand for arbitration). In any negotiation, when deciding whether or not to accept an offered settlement, keep in mind the transaction costs and other consequences of the alternatives to negotiation. Both parties are likely to incur substantial attorneys' fees and related costs if the negotiation is ultimately unsuccessful and a lawsuit ensues. The ultimate goal of the negotiation should be to duplicate the result that would be reached if the claims were submitted to the appropriate dispute resolution process, with the resulting savings in attorneys' fees and other transaction costs.

The second consideration is for the design professional to put himself in the client's shoes to understand his interests from his perspective. The client may be operating from a totally different set of facts or assumptions, focusing on different goals. Talking with the client may help correct misunderstandings.

For example, a developer may try to withhold a portion of the architect's fee equal to the change order he was forced to grant the contractor because of a design omission. From the developer's point of view, he may only be aware that the design omission resulted in him paying the contractor for an extra, so it may seem logical to withhold that sum from the architect. The architect should educate the developer that this was a "betterment" situation in which the developer would have had to pay the same amount as part of a higher original contract price if the omission had not occurred in the first place. The developer would be "getting something for nothing" if allowed to withhold the cost of the extra. The developer who is acting in good faith may then pay the architect or agree to a much more satisfactory compromise.

The third consideration is the importance of devising a solution other than *zero-sum*. A zero-sum solution is one in which an improvement in the result for one party is directly counterbalanced by an equivalent worsening of the other party's result. A good example is the distribution of a fixed sum of money; the more one party receives, the less the other gets.

Creative solutions may be necessary. For example, if an owner is withholding design fees because of a consultant's error, the A/E might offer the owner something that does not cost any money. The A/E might offer to assign his claim against the consultant to the owner and to assist in prosecuting the claim in exchange for payment of all but the fees owed to the consultant. Or, if an owner is withholding money because he claims the A/E specified a poor quality or inappropriate product, the A/E may try to secure a manufacturer's warranty or the A/E or his insurer might warrant the product to avoid having to defend against a claim.

The secret to devising creative non-zero-sum solutions is in understanding the client's real interest. The A/E should learn what the client's true concerns are and search for ways to satisfy them without having to pay as much (or any) money as the client has been withholding. The successful negotiator is the one who gives in on the non-zero-sum issues to obtain concessions on the zero-sum issues like payment of fees.

There are two major types of negotiations. The first is *unstructured bargaining*, in which both parties exaggerate their positions in order to meet somewhere in the middle. The other kind of negotiation is *principled negotiation*, which involves agreeing on the legal/equitable principles governing the dispute and applying the facts to those principles to suggest a solution.

The most common example of "random number bargaining" is "splitting the difference." For no particular reason, the two parties agree to "meet in the middle" so they are each compromising to an equal extent. The major advantages of this kind of negotiation are that it is quick and simple, requiring a minimum of time or effort, and thus useful for small disputes. It tends to favor the party with the superior leverage, regardless of the relative merits of the parties' positions.

This style of negotiating has several disadvantages. The result does not reflect the merits of each party's position, it provides an unfair advantage to the party with the greater leverage, it encourages the parties initially to take unrealistic positions in order to have more room to compromise, and it provides no guidelines for determining what offers to make or accept.

Principled negotiation is a very different process. It requires more thought and creativity, but it ultimately leads to a more logical and satisfactory result. The procedure varies depending on the circumstances, but four steps ordinarily are involved:

1. Determining what the applicable rules of law or custom in the industry are
2. Applying the facts to the rules and determining whether and the extent to which the parties' positions and/or conduct comply with or violate those rules
3. Assigning responsibility/liability in accordance with deviations from the rules
4. Calculating the consequences of responsibility/liability and settling the dispute accordingly.

For example, an owner may withhold money equivalent to the cost of repairing a construction defect, claiming that the architect should have detected the defect. The first step is to determine the applicable legal rules and principles. In this case, the rule is that an architect is not responsible for contractors' mistakes unless he knew or reasonably should have known of the mistake. However, in this example, the architect was only hired to be on the jobsite two days per month and could only have prevented the mistake had it occurred when he was at the site. There are two conclusions to be drawn in assigning responsibility: the architect had only a 2/30 chance of spotting the defect, and even if the architect were on site on the day in question, the owner's and architect's positions that the architect should/would not have been able to spot the defect have equal merit at this stage in the negotiation. The negotiation results in the compromise that the architect is held responsible for 1/30 (half of 2/30) of the cost of repairs.

Another example of principled negotiation occurs when an owner withholds part of a civil engineer's fee because he omitted a water line required by code. The applicable principle might be that the owner should be restored to the same financial position that he would have been in had there not been any omission. The contractor's labor and materials cost \$10,000, including \$1,000 for having to remobilize the excavator who had otherwise completed his work. The liability conclusions are fairly clear: the owner would have had to pay for the actual cost of the pipe and installation, even without the omission, because the cost would have been included in the contractor's original price, but the owner would not have had to pay for remobilization of the excavator. The calculation follows logically: the

owner should absorb \$9,000 of the cost, and the engineer is responsible for \$1,000.

Principled negotiation has several advantages. Its resolutions are based on the merits of the parties' positions, and it is the fairest approximation of what the results of the dispute resolution process would have been. It provides strong guidance as to appropriate settlements and leaves the parties feeling as satisfied as possible with the results.<sup>4</sup>

Alternative dispute resolution, as discussed earlier, is a very useful supplement to negotiation. Most of the various types of alternative dispute resolution are designed to facilitate one or more aspects of negotiation. For example, mediation is little more than negotiation assisted by a neutral third party. Minutials are a tactic for compelling the other party to understand the strength and details of one's position (and vice versa). A professional alternative dispute resolution organization can make the initial contacts and organize the alternative dispute resolution process without revealing which party asked the organization to get involved.<sup>5</sup>

### § 24.19 —Negotiated Forbearance

It is quite common for a client to ask for some additional time to pay the design professional's fees. The reason may be that the developer's cash flow does not permit immediate payment or that the source of the payment will be the opening of or the next draw on a construction loan. Architects and engineers routinely assent to the delayed payment, particularly when the developer has been forthcoming about the reasons. However, very few design professionals protect themselves properly in this kind of situation by taking steps to increase the likelihood that the payment will be made.

When a client asks for additional time to pay design fees, it is prudent to condition approval on the client's providing satisfactory (or at least additional) security for the payment. In effect, the design professional is financing the client's operations. If the client were to go to a bank or other financial institution and ask for a similar extension of time to make payment, some kind of collateral or additional security likely would be required.

If the client is requesting the extension of time in good faith, then he is unlikely to object to a request for additional security, particularly as long as it does not cost him anything. Following are examples of additional security the A/E may want to request:

1. A personal guarantee by the principal(s) of the client
2. A collateral pledge of specific property, such as a certificate of deposit

<sup>4</sup> For an excellent and more detailed description of principled negotiations, see R. Fisher & W. Ury, *Getting to Yes* (1981).

<sup>5</sup> See I. P. Lurie, *Alternative Dispute Resolution for Design Professionals* (1988).



3. A letter of credit from a financial institution or surety company
4. Signature on a formal note or confession of judgment form, which includes recovery of attorneys' fees and collections costs
5. A stipulation as to the adequacy of design services.

The purpose of a certificate stipulating that the design professional performed services adequately is to make it difficult for the client to fabricate a claim to offset the payments owed. It is probably not fair to ask for a complete release, because a legitimate claim may yet be undiscovered, but the client can be asked to stipulate that he is not aware of any inadequacies in the performance of design services. A simple version of such a certificate might read as follows:

In exchange for Design Professional's forbearance in collection of his fees, the undersigned hereby bindingly stipulates that as of the date shown below, he is not aware of any facts, incidents or other problems which might tend to indicate that Design Professional's services were not performed in accordance with the highest standards of professional care.

### § 24.20 Consultants' Pass-Through Claims

A common problem caused by an owner's withholding of fees is a design professional's liability to consultants. Typically, this problem occurs when a developer refuses to pay the architect's invoice, which includes the invoices rendered to the architect by the engineering consultants. It is particularly vexing for a consultant whose work has nothing whatsoever to do with the dispute between the owner and architect to have his fee withheld until unrelated design issues are resolved.

Philosophically, in the absence of contractual language to the contrary, the architect should pay the consultant regardless of whether the owner has paid the architect, unless the reason for the owner withholding the money pertains to the consultant's work. The reason is that the architect, rather than his consultants, is responsible for checking and ensuring the owner's creditworthiness, because there is no direct contractual relationship between the consultants and the owner. However, as a practical matter, most architects' cash flow does not enable them to pay consultants before being paid themselves.

The best way to resolve this problem is to include a provision in the architect-consultant agreement that states how this problem will be handled if it arises. The following are by no means exhaustive, but they represent the three most popular contractual resolutions of this problem:

1. *Pay-when-paid clause*: "Architect shall promptly submit consultant's invoices to Owner and shall make payment to Consultant within

\_\_\_\_\_ business days after receiving payment from owner for Consultant's services; provided, however, that Architect shall not be liable for making payments to Consultant unless and until Architect has received payment from Owner on account of Consultant's services."

2. *Absolute obligation clause:* "Architect shall pay Consultant within \_\_\_\_\_ business days of Consultant's invoice, regardless of whether or not Architect has received payment from Owner for Consultant's services."
3. *Hybrid clause:* "Architect shall pay Consultant's invoices within \_\_\_\_\_ business days of receipt of the invoice, except that if Owner withholds any sums from Architect allegedly on account of Consultant's work, Architect shall not be obligated to pay that sum to Consultant unless or until Owner pays said sum to Architect."

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