Design Liability:
The Procurement Phase

Expert Commentary

by American Global

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The woes of many mega firm-fixed price design-build projects have been at the forefront of the US infrastructure industry discussions for the past several years due to mega losses and the decision by many contractors to pull out of the market altogether. As the industry continues to discuss, and begins to implement, numerous and varied potential solutions, a comprehensive dive into many of the factors that have contributed to the abysmal design-build project losses and the resulting consequences in the market is warranted.[1]

Over the course of this and several future articles, we will explore design-build procurement best practices, the drivers behind and types of claims by contractors against their designers, the effects the design claims by contractors have had on the availability and cost of professional liability insurance, and alternative methods of procurements that may significantly reduce design error risk, design claims, and project losses.

The focus of this article is the procurement phase of a firm-fixed price design-build project[2] and the measures contractors and designers can take to reduce or mitigate risk of loss. First, when considering whether to participate in a design-build procurement, contractors should be fully aware of the allocation of risks in the owner contract, or key contract terms, which ideally are included in the request for qualifications (RFQ) or request for proposals (RFP) documents, and know whether the RFP process

[1] Thanks to Caryn Maxfield, senior vice president of American Global, for authoring this article.

[2] For purposes of this article, all references to design-build procurements or projects pertain to firm-fixed price design-build procurements wherein each contractor bidder is submitting a fixed price to the owner based on its designer's preliminary design, which is approximately 30 percent complete.

allows for negotiation of such terms. If project risks for which the contractor has little or no control over are unfairly allocated to the contractor, and contract terms are not negotiable, deciding not to bid on a particular design-build project is likely the best decision.

Additionally, contractors should look to partner with a design firm and its personnel dedicated to the project with design-build project experience who understand and accept that the risk profile for the designer differs significantly from a design-bid-build procurement where the designer completes the design under contract with the owner, and the contractors submit bid prices based on a completed design.

Typically with design-build procurements, the contractor and designer agree to team well before the RFQ, if applicable, and RFP are issued. Particularly in a procurement with an RFQ stage, it is important that the contractor and designer are aligned with respect to key terms governing their engagement since once their team is shortlisted by the owner, the contractor cannot swap in a new designer without formal owner approval, which will be based primarily on whether the new design team is as equally qualified as the initial design team.

Thus, the contractor and designer would be wise to negotiate the key terms of the design subcontract and formalize the agreed upon terms in an executed teaming agreement prior to submitting the RFQ proposal. If the parties cannot come to terms, they can part ways and potentially find new partners before entering the procurement process. This concept is even more important for procurements with only an RFP stage since, once selected as the preferred bidder, the contractor will have a very difficult time obtaining owner approval for a new design firm, especially since approval may give rise to a bid protest. Moreover, the contractor will be in a very difficult position if a bid bond or other proposal security were submitted with the RFP bid. Best practices, therefore, dictate that the contractor and designer execute the full design subcontract addressing both the RFP phase and the post-award phase—locking in the terms and conditions, design price, design deliverables schedule, and design scope prior to submitting a bid.

Following are some of the key terms of the design subcontract for which agreement should be reached before the contractor and designer are officially bound to one another in a procurement, either due to shortlisting or project award.

The Standard of Care

Tied to a designer's liability for design errors and omissions, as well as professional liability insurance coverage, the standard of care should be a defined term in the design subcontract. An often-used definition is "the care and skill ordinarily exercised by members of the same profession currently practicing in the location of the Project on projects of similar size and complexity at the time the services are performed." Utilizing this standard of care is typically acceptable to both the contractor and the designer and will not likely run afoul of professional liability insurance policy language. However, what if the standard of care for design in the owner's contract is a higher standard? For example, the owner contract may require that design be "of the highest quality" or that the "work must be free from defect" and "work" as defined includes design?

Designers are unlikely to accept such a higher standard of care, and their insurance policies may exclude any services that are warranted to be free from defect or appear to be a guarantee. Unless the contractor can negotiate with the owner to accept the more common standard of care, the contractor will be in the position of being held to a higher standard of care with respect to design than that of its designer. Unfortunately, there is no solution to this "gap" in design liability exposure for the contractor, although, in reality, owner claims regarding defects will likely materialize with respect to the construction work, and if those construction defects were caused by design errors or omissions, the designer will most likely be found to have breached even the "common" standard of care.

Payment Terms

The contractor and designer will need to determine whether the designer will be paid for the bid phase services and, if so, agree on the pre-bid rates for designer's personnel that are typically at a reduced

multiplier or at cost and possibly with a "not to exceed" cap. Success fees, if any, and the timing of such payment should be expressly stated.

The designer's price for post-award services, whether lump sum or based on specified rates with a not to exceed cap, as well as the payment terms/rates for designer's engineering services during construction (or construction administration in the vertical space) if not included in the lump sum price, should be agreed on in the executed design-subcontract pre-bid as well. The contractor will likely impose pay if/when paid terms on the designer, similar to most subcontracts for the post-award services.

Payment Withholding Rights and Disputes

The contractor typically has payment withholding rights with respect to claims or anticipated claims against the designer. During disputes between the contractor and designer, the design subcontract should require the contractor to continue to make all undisputed payments to the designer and the designer to continue diligently performing its services. The parties may choose to define certain types of disputes that require resolution on an expedited basis.

Another option that may enhance dispute resolution and avoid claim situations is the creation of a design contingency fund, which amount is included in the bid price, from which the contractor can fund its costs incurred due to design errors or omissions. If the fund is exhausted, any contractor claims against the designer would proceed in the normal course as they would have if there had been no design contingency—notice and dispute resolution with the designer and its insurers.

Responsibility for Variations in Quantities

During the bid phase in most design-build procurements, the contractor will be responsible for, and have sole discretion, in determining the materials quantities and cost estimates. However, in the process of making such determinations, often the contractor and designer will work together to create a quantities matrix listing the major project materials with various probabilities of percentage variances—increases and decreases—and calculate contingency dollars to cover the potential increased quantities.

Designers may seek to exculpate themselves in the design subcontract from any liability for quantity overruns, but this position is typically not accepted by the contractor. Designers will acknowledge that the contractor must rely on their preliminary design to adequately estimate materials quantities and costs; thus, it follows that the designer's breach of the standard of care with respect to preliminary design may result in designer's liability for the costs of quantities overruns.

Value Engineering versus Additional Services

As design is developed post-award, the parties work together to ensure that the project as designed will stay within the budget. To the extent design development reveals that the budget may be exceeded, the parties will jointly perform value engineering, and the designer will revise the design to reduce costs and keep the project within the budget.

Defining in the design subcontract the point at which changes to the design are no longer value engineering —when they become "additional services" requiring compensation in addition to designer's lump sum price—is difficult but necessary to avoid disputes. The parties may agree on certain design deliverable milestones in the owner contract as the trigger for additional services. For example, the parties may agree that once the 60 percent design development documents have been approved by the owner, contractor-directed changes to the design thereafter constitute additional services.

Professional Liability Insurance

There are several factors to consider when determining the appropriate professional liability coverages to be provided by the designer. First, the owner contract may contain professional liability insurance limit requirements. The owner contract may further specify that such limits must be carried by the lead designer, or it may state that such limits may be obtained by a professional liability policy in the name of either the contractor or the designer, or a combination of both parties. The contractor may have several options and will certainly comply with such owner requirements but may desire to require the designer to carry greater limits to adequately protect itself from potential design error project losses.

On larger projects, the parties may also consider obtaining a project-specific professional liability (PSPL) policy that would be the primary policy covering the lead designer and all subconsultants on the project, with the designer's practice policy to sit in excess of the PSPL. Maximum deductibles or self-insured retentions may be specified in the owner contract, but if not, the contractor and designer will need to agree on appropriate deductibles for any PSPL policies, taking into consideration commercial availability and cost. All policies should be retroactive to the start of the design services (pre-bid) and will likely be required by the owner or the contractor to have an extended reporting period for a number of years (e.g., 5 years) after the completion of the project or the statute of repose, whichever is greater.

Limits of Liability

Some designers insist on a limitation of their liability to the contractor, and some contractors refuse to provide any limitation on the designer's liability. Thus, this issue should be one of the first conversations before a contractor and designer decide to team.

If the contractor agrees to provide the designer with a limit of liability, additional questions will need to be determined. The contractor may want the designer to have some "skin in the game," and the designer may seek to avoid any exposure beyond its insurance. For example, the contractor's position may likely be that the limitation of liability will not include the value of any PSPL policy and perhaps will not even include the practice policy limits evidenced for the project.

In any event, a determination of the appropriate limit of liability should factor in the construction value, the designer's subcontract price, the limits of the designer's professional liability insurance policy(ies), the complexity and riskiness of the project overall, and an analysis of the potential losses the contractor might incur due to design error. Finally, note that designer's indemnity obligations for third-party claims are typically carved out of the limit of liability.

Conclusion

A primary goal shared by all parties involved in a construction project is the avoidance of claims. On a design-build project, especially since the contractor and designer are on the same team, taking measures pre-bid to reduce or eliminate claims between them will help foster a successful project.

First, contractors should choose the right design firm partner who has an understanding, and acceptance, of the heightened risks involved in a design-build project. Then, early in the procurement phase, it is imperative that the contractor and designer not only work together to optimize the design and develop a winning strategy but to also engage in deliberate negotiations and reach agreement on all issues —memorializing them in a complete and executed design subcontract prior to submitting a bid. The contractor and designer should attempt to formulate specific contractual risk mitigation provisions, such as some of those discussed above.

Entering into a clear design subcontract where both parties are aware of, and can price, the risks on their respective ledgers will help to reduce or eliminate claims between them and help ensure a successful project for all parties.