



Perplexing Issues in Design- Build Projects

By Susan Linden McGreevy,
A. Elizabeth Patrick,
Jessica D. McKinney, and
Norman M. Arnell

Before design-build's upsurge, the most common (and perhaps still most common) system of construction was design-bid-build. Design-bid-build owners engage a designer and arrange for bidding based on plans and specifications developed by the designer. Then a contractor is chosen to perform construction services.

Design-build offers the owner "one-stop shopping." Whether the designer or the contractor is the lead (the "front end"), the owner deals with only one party for all construction-related services.

The attractiveness of dealing with only one entity and the savings of time and money mask problems associated with design-build. Further, design-build is not suitable for all projects, including those that require special use and design services, or that need to make a statement, or that are to renovate or remodel existing construction.

Susan Linden McGreevy is chair of the Construction Practice Group in the Kansas City, Missouri, office of Husch & Eppenberger LLC. A. Elizabeth Patrick is a partner and Jessica D. McKinney an associate in the Atlanta, Georgia, office of Kilpatrick Stockton LLP. Norman M. Arnell is a partner in the Kansas City, Missouri, office of Stinson Morrison Hecker LLP and chaired the Real Property Division Design and Construction Committee.

This article addresses potential risks of design-build projects. For a state-by-state compilation of laws and regulations relating to design-build projects, *The Design/Build Deskbook, Third Edition*, published by the ABA Forum on the Construction Industry, is an excellent resource.

Perspectives and Perils of Design-Build Delivery: Structuring the Deal and Contract Risk

Despite design-build's growing popularity, risks exist for unsuspecting owners. Owners should address three major issues during the beginning stages of the project to optimize success: (1) structuring the design-build project relationship, (2) preparing and negotiating the right contract, and (3) managing the project for success.

Structuring the Deal

On deciding to use design-build, the owner must choose with whom to contract. Design-bid-build owners contract with an architect/designer *and* a construction company. But with design-build, there is only one entity.

Although some organizations do only design-build, this is not typical. So, does the architect find a construction company? Does the construction company find the designer? Does the owner find a designer and a contractor and bring them together? Once together, what type of "union" is formed to accomplish the project?

The entity may take several forms. Sometimes the designer and contractor form a joint venture (JV), an association established to carry on a single business activity, limited in scope and duration, with participants sharing economic interests and project control. In the alternative, a limited liability partnership (LLP) may be formed. An LLP usually has no assets, and the partners' liability is limited to the amount of capital invested in the LLP. This liability shield may hamper owner recovery efforts. Owners must be cognizant, therefore, of the type of entity with which they are contracting. If unsure about the ramifications of contracting with a particular organizational form,

the owner should consult with counsel. The differences between a JV and an LLP are great and will, if the project falters, affect the owner's bottom line and its ability to recover from the design-builder.

Preparing and Negotiating the Right Contract

Contract negotiation affects project success and is essential because the American Institute of Architects (AIA) and Associated General Contractors of America (AGC) standard contracts are designed to protect design-build entities. Some provisions to negotiate are insurance, indemnification, performance and payment bonds, liquidated damages, and environmental conditions.

Because the design-build entity is protecting its best interest and not the owner's, the owner must implement a system of checks and balances.

Insurance. Insurance, indemnification, and bonding protect the owner from the negligent and intentional acts and omissions of the design-builder, subcontractors, and suppliers. Insurance coverage not only protects against the design-builder's acts and omissions but is required by lenders and other third parties interested in the project.

The AIA and AGC standard insurance provisions inadequately protect the owner. Although the forms require insurance for construction, they lack provisions regarding coverage for design errors. Instead, coverage for design errors is contained in professional liability and errors and omissions policies. Unless specifically requested, however, this protection is non-existent and the owner is exposed to serious risks from design

errors. Moreover, owners should consider business interruption insurance to protect against delays in project completion.

Finally, owners must ensure that the design-builder's coverage is adequate, by insisting that all claims arising from the design-builder's services, including design errors, be properly insured. Failing to review a contract's insurance language could prove costly.

Indemnity. Indemnity, the ability to shift the effect of loss, is also crucial. The AIA contract contains a limited indemnity provision, likely protecting only against personal injury and property damage occurring during construction. Again, the owner is exposed to liability for design errors and for occurrences other than personal injury or property damage. Modification and coordination of indemnity provisions in project agreements is essential to minimize liability gaps and eliminate duplicative coverage.

Performance and Payment Bonds. Neither the AIA nor the AGC contracts require surety bonds. For owners, this is unacceptable. Performance bonds protect the owner if the design-build entity does not perform its contract obligations. Payment bonds protect against claims to pay for labor, materials, and equipment furnished for use in the project. Because bonds benefit only the owner, they are not included in the AIA or AGC contracts.

Just as insurance *does not* provide coverage for the design-builder's failure to complete the project or pay for services, labor, or equipment, performance and payment bonds *do not* cover defective design, personal injury, property damage, or late completion claims. Therefore, the contract documents must require the appropriate insurance *and* surety bonds.

Liquidated Damages (Delay Damages). Timely project completion is essential. If late, the financial consequences could be great. To protect against delay, the contract must have a firm completion date, allowing the owner to sue for breach of contract if the completion date is not met. But litigation is time-consuming and expensive, and the owner is not guaranteed

recovery. In addition, standard contracts favor extended time and increased costs for delays not caused by the design-builder. Thus, the design-builder may stand a better chance of success in a breach of contract claim than the owner.

The AGC's "Mutual Waiver of Consequential Damages" clause disfavors the owner. The clause requires the parties to relinquish consequential damage claims against one another. Because most damages associated with project delay consist of indirect or consequential damages, the owner is, in effect, not entitled to damages for the late delivery of the project. Owners should omit or negotiate the waiver of consequential damages language. If the design-builder refuses to omit the language, a specific rate, or daily sum certain, should be included in the contract for liquidated damages. Owners should be wary of attempts by the design-builder to limit its responsibility for delays caused by defective work or to be responsible only up to the amount of, or some percentage over, the contract price.

Environmental Conditions. In many projects, particularly those involving underground construction, the effects of environmental issues can be staggering. Owners typically provide information regarding site conditions at the outset of the design-build process. If the contract documents are unclear regarding the design-builder's ability to rely on the information, the owner may be liable if the information is incorrect and the design-builder's reliance on the information results in defective design or untimely project completion. Design-builders are awarded cost adjustments and time extensions and are not held responsible for defective design when relying on owner-supplied information. See, e.g., *Marine Colloids, Inc. v. M.D. Hardy, Inc.*, 433 A.2d 402 (Me. 1981) (contractor not liable for completing project in compliance with plans provided by the client); *Krestow v. Wooster*, 360 So. 2d 32 (Fla. Dist. Ct. App. 1981) (architect not liable for nonconformance with zoning ordinance when architects had relied on erroneous legal advice from client's

lawyer concerning applicable zoning classification); *Jacka v. Ouachita Parish School Board*, 186 So. 2d 571 (La. 1966) (client liable for increased architectural costs caused by erroneous topographical map supplied by the client).

Obviously, these cases all turn on the wording of the agreements between the parties. The AIA language (particularly the new 2004 design-build document just disseminated this year, the A141) is very clear about information furnished by the owner and the design-builder's right to rely on it. This language would not immunize the designer from suit by a third party (member of the public), particularly if the state requires the designer to personally perform all the work on plans he or she stamps, as in Georgia. *Hutchinson v. Dubeau*, 289 S.E.2d 4 (Ga. Ct. App. 1982), citing Ga. Code Ann. § 84-2121 (1976). Absent such an over-

If the owner wants competition or varying ideas, the owner should solicit proposals from multiple firms.

riding statutory obligation, the designer might be entitled to indemnification if the information the designer relied on from the owner was inaccurate. See, e.g., AIA, A141 "Agreement Between Owner and Design-Builder" (2004) ex. A (terms and conditions), ¶¶ 2.2.3 (owner must provide all prior test, inspections of site, environmental information, and so on), 2.2.6 (design-builder can rely on them).

Thus, owners must complete applicable surveys before startup and negotiate detailed contract terms addressing responsibility for differing site conditions. The owner also should stipulate that it does not warrant the information provided in the evaluations, that the design-builder is not entitled to rely on the representations contained in the evaluations, and that the design-

builder must verify the information. Although this type of contractual language is a hard sell, it should be broached early in the negotiation process. Shifting responsibility for differing site conditions to the design-builder, however, will likely increase contract price. Owners also may limit exposure for differing site conditions by including an "Equitable Adjustment" provision, limiting recovery for differing site conditions to time extensions only.

Management of the Project

An owner must understand the project's scope and manner of implementation. Because the design-build entity is protecting its best interest and not the owner's, the owner must implement a system of checks and balances.

In addition, the owner should carefully define the building's performance criteria. How the parties demonstrate that the criteria are met (performance testing requirements, for example) may be the most important aspect of managing the project. Having a shiny new building is important, but a shiny new building that does not work is useless. Further, the owner should negotiate to retain the ability to modify and change project scope without incurring additional costs or granting time extensions.

Unforeseen Obstacles in the Design-Build Process

Barriers to Competition Result in Fewer Choices in Design-Build

In choosing design-build, owners should consider what they are getting *and* what they are giving up.

Less Flexibility in Choice of Team Members. With design-bid/negotiate-build, the owner may choose its designer from a number of candidates. Having selected the designer, the owner could then, typically, solicit offers from many contractors.

With design-build, the owner may be limited in the candidates that it may choose and in what the "team" looks like. Builders and designers usually team up; so, an owner who prefers builder A may not have the opportunity to pair builder A with designer B. Although some owners have pre-

selected team members and require them to work together, this shotgun-marriage approach is not always successful. Also, it probably violates design-build rules for public owners.

Some contractors and designers present themselves as an ongoing entity. Thus, joining with different partners is difficult. And, many firms have all the expertise in-house to do design-build. Therefore, joining an outside firm wastes resources.

Loss of Less Sophisticated Firms as Participants. Many small firms that have never done design-build likely lack the resources to take it on. This fact often affects emerging and minority firms, lessening their ability to compete effectively. Exclusion of these firms from consideration goes against owner inclusion policies and can result in the loss of valuable talent.

Loss of Firms That Lack the Ability to Attract Partners. Unlike hard bid work in which sometimes all it takes to get a job is a low price and a bond, design-build selection is much more subjective, making it hard for a firm not having a track record to find "the right" partner. The threat of these firms' swooping down keeps competition lively on competitive bid projects. Similarly, a good, but contentious, general contractor that has had an adverse experience with some design firms in the past might find itself unable to partner with one of the more desirable designers and thus get cut out of the competition. The less competition, the fewer options the owner has, and frequently the higher the ultimate cost.

Loss of Firms That Lack the Ability to Obtain Bonds. Who will be the design-builder: the builder, the designer, or a combination of the two? If surety bonds are required, the pool of eligible candidates may be restricted.

Obtaining surety bonds generally requires a lengthy underwriting process in which the contractor develops a relationship with a surety bond agent, who assembles a package of information about the contractor and finds the right surety to issue the bond. A major factor in extending surety credit is contractor net worth.

Many contractors have hard assets, retained earnings, or working capital at levels sufficient to satisfy a surety's requirements.

Surety companies, however, seldom find design firms financially attractive, because they rarely keep significant retained earnings. In addition, they lack a track record of doing actual construction work. Therefore, only a few design firms can bond projects. Thus, many firms are precluded from design-build, unless its teaming contractor can bond projects.

No Appreciable Improvement in Fragmented Bonds/Insurance Coverage. With design-bid-build, the integrity of the construction work is assured by a performance bond, but the integrity of the design is backed by professional liability insurance. Concerned with being responsible for risks they did not undertake, many sureties and insurers have a limited appetite for design-build. Having fewer sureties, professional liability carriers, and tighter standards for remaining market participants result in fewer options for owners.

Cost of Participation in Design-Build Competitions Reduces Owner Choices

Contractors usually prepare bids and negotiate proposals not knowing if they will recoup the associated cost. Spreading the cost of bid preparation among subcontractors and suppliers helps soften the financial blow. Because bidding is such an ingrained part of the construction process, contractors historically build the cost of bid preparation into their overhead and cost structure.

Designers, however, are selected based on general discussions about their backgrounds, expertise, and prior projects. Because there has not yet been any design, the amount of data created by the firm before selection is generally insignificant.

Design-build competitions change the nature of what each side must do. Team members spend significant amounts of time working out the basis of their relationship (unless they already have a format in place) and getting background information before

beginning to prepare a proposal.

If the owner wants competition or varying ideas, the owner should solicit proposals from multiple firms. Typical design-build competitions are done in two phases. Phase I is generally a paper submission of basic information, such as

- identity of the team participants and key staff members,
- firm background information,
- representative design-build projects, and
- broad ideas about the project that illustrate an understanding of the owner's needs.

If the request for proposals receives significant response, the field for Phase II is narrowed to five or fewer entities. If only a few proposals are received, all will likely participate in Phase II. And, if only a few were solicited in the first place, the owner may request all the information at once.

Phase II consists of meeting with the owner to get as much information as possible about the project. Then the team members go to work by

- identifying a design concept,
- fleshing out the design in terms of schematic drawings, so that cost estimates and a constructability analysis can be performed,
- retaining sub-consultants and identifying subcontractors for problematic aspects of the work and negotiating terms for their participation,
- compiling cost estimates based on material selections and rough drawings,
- preparing sketches, drawings, models, and other presentation materials, and
- participating in presentation meetings.

The amount of time and resources required is great. To increase participation, some owners offer a stipend to Phase II participants. Still, Phase I expenses are not covered, and the stipend is usually only a fraction of Phase II expenses.

The net result of the process—many firms, particularly design firms, cannot afford to participate—leads to less compe-

tion, fewer ideas, and possible exclusion of one of the participants of a permanent design-build team if the other cannot devote adequate time or resources.

Managing Design-Build's Culture Clash

Contractors and designers are going to become partners? Any chance of a culture clash? *Absolutely.*

- Designers believe they must "protect" the owner from contractors cutting corners and overpricing changes.
- Designers believe they must protect the integrity of their design, not solve the contractor's cost issues.
- Contractors believe designers overdesign everything.
- Contractors believe designers do not appreciate the effect of delays in getting submittals approved or RFIs answered.
- Contractors believe designers expect them to cover up design flaws.

Everyone comes to new experiences with baggage from past experiences. Yet, prejudices must be forgotten for a project to be successful.

Attorneys advising design-build entities should advise their clients to establish *internal* dispute-resolution procedures. If not addressed, past disputes may affect the timing and quality of the end work product. Areas where differences in outlook could affect the project are

- *Quick response time.* Designers sometimes appear unconcerned about contractor demands for immediate answers to questions. If the design firm is merely hired by the design-builder, it may lack incentives to change the way it does business just to accommodate the design-builder. Turnaround time could be addressed in the parties' agreement, perhaps building bonus participation into the equation.
- *How much is enough?* Contractors rarely welcome designers scrutinizing their work-in-progress, believing that designers will tell them to "rip it out and do it again," because of the designer's traditional role of protecting the owner. If the designer is subservient to the contractor (in a legal sense anyway), the owner may lose

the valuable check-and-balance of the independent review. Counsel for design-build team participants should discuss how these roles will be reconciled in the field and address who gets the final say on what issues.

- *"Value engineering" pressure.* If contractors control the design process, incentives exist to influence designers to employ "short-cuts" to lower cost. If designer compensation depends on pleasing the contractor, owners should be vigilant for such pressure.

Clearly, design-build changes the internal dynamics on a design-build team. Depending on whether the team is designer-led or contractor-led, the other discipline is now working for the leader and has to do things his way. Owners should be more wary of internal struggles within a design-builder that has different firms involved than one that has all the disciplines in-house. The goal is to prevent internal politics from affecting a project.

These struggles do not imply that designers or contractors are looking for anything other than the best value and best job for their customers, only that "dynamic tensions," built into traditional design and construction processes, provide checks and balances. Designer-contractor prejudices will not change because a few pieces of paper have been signed. If firm owners are involved, and money made through cooperation, the prejudices may be overcome. If only employees are involved, less incentive exists to change the paradigm.

Risk Management Problems for the Design-Builder

Although many firms advertise themselves as design-build firms, few have carefully thought about design-build's realities.

Issues from Traditional Contractor Standpoint

Contractors' insurance packages cover most risks, other than credit risks and proper project completion.

Many contractors believe the risks of adding the design function are

resolved by a contract provision indicating that they are not licensed or authorized to perform design services (in those states where contractors are forbidden from providing such services) and that they will incur no liability for design problems.

This fix may fail because the contractor's agreement with the owner is to design and complete the entire project, and, therefore, a clause immunizing the contractor from liability might be viewed as negating the essence of the bargain between the parties. Ultimately, the enforceability of such a provision might turn on the jurisdiction's laws governing enforceability of exculpatory clauses in general and on the exact language of the provision. See *Valhal Corp. v. Sullivan Associates, Inc.*, 44 F.3d 195 (3d Cir. 1995) (discussing Pennsylvania law regarding the enforceability of exculpatory, indemnity, and limitation of liability clauses); *LaSalle Nat'l Trust, N.A. v. Board of Directors of the 1100 Lakeshore Drive Condominium*, 677 N.E.2d 1378 (Ill. App. Ct. 1997) (recognizing that exculpatory clauses generally "are not favored and are strictly construed and must have clear, explicit and unequivocal language showing that it was the intent of the parties").

Furthermore, most contractors have not considered their lack of professional liability insurance coverage for design defects. Likely, their existing policies exclude such coverage. If contractors disclaim responsibility for design-related failures, or state law prevents them from providing design services, they may find it difficult to obtain the required coverage.

In addition, even if state law allows a contractor to avoid liability by inserting a disclaimer into the contract, courts may be reluctant to validate such a provision. The essence of the provision is that the design subcontractor is liable for design defects. But because the contractor agreed with the owner to complete the entire project, design included, courts may still find the contractor breached the contract if the design services fail. A definitive resolution of this issue has yet to be determined.

Contractors may protect themselves from design-related defects by negotiating an indemnification agreement with their designers. Such an agreement works well if the designer is well-funded and insured. But many design firms lack the necessary capitalization, and even those that are adequately capitalized do not carry professional liability insurance in amounts sufficient to cover potential claims. Thus, indemnification may not provide an adequate solution, particularly when the dispute is over whether a failure is a design defect or a defect in execution of the design.

Issues from the Standpoint of the Design Firm

Unless the front-end design firm performs both design and construction, it likely is unfamiliar with the insurance and bonding issues associated with construction work. A design firm, unfamiliar with construction, may alienate the owner and its contractor by attempting to limit its liability for construction failures. In addition, as discussed above, courts may be reluctant to enforce a provision allowing the designer to avoid liability because the designer contracted with the owner to provide a complete project, construction included. Moreover, courts might employ an alternative theory, finding the front end, whether contractor or designer, negligent in selecting the other team member.

The Owner's Risk Management Concerns

Assuming the absence of a joint venture, owners may encounter difficulty reaching the liability insurance of a party not in contractual privity with them. Solving the problem requires a third-party beneficiary or a cut-through clause in the prime contract with the front end and a similar provision in the contract between principal and subcontractor. This provision allows owners to reach the liability insurance of subcontractors on the project.

Practically speaking, however, third-party beneficiary provisions may be inadequate. If the owner contracts

only with the front end, the owner often has little choice in the front end's selection of subcontractors. Thus, the owner is stuck possibly with an unsatisfactory subcontractor. So, even though they may be able to reach the subcontractor's liability insurance, assuming that it provides adequate coverage, most owners would prefer a properly built project to litigation.



Third-party beneficiary or cut-through clauses are generally employed when contractors are prohibited from providing design services. In these jurisdictions the clauses are important, even if the owner has agreed not to look to the contractor for design flaws, because of the equitable principle that prevents parties from knowingly contracting to perform an act that is contrary to law. See *Am. Jur. 2d Equity* § 131 (stating that "[a] court of equity will not assist in the enforcement or abrogation of an illegal or immoral contract or transaction"). A properly drafted third-party beneficiary clause in a contract between a contractor and a designer will be for the benefit of the owner, giving the owner a direct right of action against the designer and should be effective even though the contractor cannot be held responsible for design errors. A cut-through clause would allow the owner to pursue the contractor's rights against the designer.

Speed

Not only can too much speed get you a speeding ticket, but also headaches of monumental proportions. A chief purpose of design-build is faster project completion (similar to "fast-track" projects). Unfortunately, design-build projects suffer many of the same problems.

Fast-track projects became popular in the 1970s and 1980s when, because of high inflation, owners compressed schedules to save costs.

For instance, obtaining a building permit for ground and foundation work before obtaining a permit for the structure is common in fast-track projects. The ground and foundation work contemplate the future erection of a particular structure. But if codes change between issuance of the groundwork/foundation permit and the building permit, the ground and foundation work may be unsatisfactory for the type of structure required by the new codes. Unfortunately, this is a risk for fast-track and design-build owners. Thus, although the owner started with a contract for an agreed-on price, the change in the operative law may justify a change order. Therefore, the total project cost is unknown until the effects of the change in the code—on the ground/foundation work and the structure—are ascertained. Not only could this change affect the owner's bottom line, but it also may imperil project financing.

Conclusion

The usefulness and practicality of a project's design, in terms of the owner's maintenance and other expenses, may be frustrated by design-build. Because the separate entities used in typical design-bid-build projects are part of the same team, an important counterweight for the owner—review of construction by the designer and design by the contractor—is removed. Because the parties share profitability in a design-build project, they lack the incentive to review the other's assumptions, conclusions, and cost estimates.

A possible solution is hiring an independent owner's representative or using in-house personnel to review the design before owner acceptance. But the cost of the independent representative may outweigh the benefits of choosing design-build, thus justifying choosing an independent contractor and designer—both of whom would be directly responsible and liable to the owner in the event of problems. ■