DESIGNER LIABILITY

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A. The "Economic Loss" Rule

One of the legal constraints imposed on an architect or engineer's liability for alleged damage suffered due to the architect or engineer's design is the "Economic Loss Rule." The Economic Loss Rule provides that where the loss allegedly suffered due to a design professional's design is "economic loss to the subject matter of the contract," the action is limited to one for breach of contract. *Bank One, Texas N.A. v. Steward*, 967 S.W.2d 419, 440 (1998); *and Bernard Johnson, Inc. v. Continental Constructors, Inc.*, 630 S.W.2d 365 (Tex.App.–Austin 1982). Where a party is complaining of a failure to receive what it bargained for under its contract with a design professional, the loss the party suffered is considered an "economic loss" and the party is limited to a cause of action for breach of contract. In other words, negligence claims are precluded. Further, in order to sue a design professional for breach of contract, the complaining party must be one that had the contract with the design professional or an intended third-party beneficiary. *See e.g. Bernard Johnson, Inc., supra; MCI Telecommunications Corporation v. Texas*, 993 S.W.2d 663 (Tex.App.--Fort Worth 1996); *and City of Corpus Christi v. Acme Mechanical Contractors*, 736 S.W.2d 894 (Tex. App.--Corpus Christi 1987).

In summary, except in cases of loss due to physical property damage or personal injury, which is considered non-economic loss, a design professional generally cannot successfully be sued for negligence. In cases of loss not involving physical property damage or personal injury, a design professional is generally liable only for breach of contract and then only to parties with which it had a contractual relationship.

The discussion below addresses the significant legal aspects of a design professional's contractual undertakings and liability.

B. Contract Issues

1. Contract formation–Capacity & Consideration

The first thing that a court or arbitration panel will do when presented with a dispute between two parties, whether a design professional and his or her client, or anyone else for that matter, is to ascertain whether a valid contract exists that governs the items in dispute. In order for a contract entered into between two parties to be valid, the parties must have had the capacity to contract. Parties generally have the capacity to contract unless they suffer from some legal impediment such as, in the case of individuals, failure to obtain the age of majority or mental incapacity. These types of issues typically do not arise in the context of commercial construction projects.[1]

Further, to be valid, a contract must be supported by what the courts call "consideration." "Consideration" is typically defined as "a benefit to the promisor or a loss or detriment to the promisee." *See Northern Natural Gas Co. v. Conoco, Inc.*, 986 S.W.2d 603, 607 (Tex. 1998). In the typical contract entered into by a design professional, the primary consideration provided by the design professional is the rendition of professional services by the design professional and the primary consideration provided by the owner is payment for the design professional's services.

2. Intent of The Parties and Rules of Construction

The next issue that a court or arbitration panel will address after determining whether there is a valid and binding contract between the parties is whether the contract applies to the items in dispute and, if so, what the contract says as to those items. A court's primary objective in construing

[1]However, similar concerns might arise. For example, in the case of a public works project, issues might arise concerning the authority of the municipality to enter into a contract for the type of project and the amount involved, and, where a design professional is dealing with a representative of the other party, whether that representative has authority to act.

the parties' contract is to determine the intent of the parties from their agreement as a whole. *See e.g. National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex. 1995). Whenever possible, courts will attempt to read the parties' agreement so as to avoid a conflict or ambiguity. *See e.g. Balandran v. Safeco Ins. Co. of America*, 972 S.W.2d 738, 740-41 (Tex. 1998).

Where a court is not able to read the parties' agreement so as to avoid a conflict or ambiguity, the court will resort to one or more of various rules of construction in order to "construe" the parties' agreement. These rules of construction include construing the contract against the party that drafted it, *see e.g. Republic Nat'l Bank v. Northwest Nat'l Bank*, 578 S.W.2d 109, 115 (Tex. 1979), relying on specifically negotiated provisions over conflicting boiler-plate provisions, *see e.g. Pilarcik v. Emmons*, 966 S.W.2d 474 (Tex. 1998), giving terms having a specialized meaning within the industry the same meaning for purposes of contract interpretation, *Mescalero Energy, Inc. v. Underwriters Indem. General Agency, Inc.,* 56 S.W.3d 313 (Tex.Civ.App.–Houston [1st Dist] 2001), interpreting contracts so as to find mutuality of obligations, *see e.g. Portland Gasoline Co. v. Superior Mktg. Co.*, 243 S.W.2d 823, 824 (Tex. 1951), overruled on other grounds, *Northern Natural Gas Co. v. Conoco, Inc.*, 986 S.W.2d 603 (Tex. 1998), and interpreting the contract so as to avoid finding illusory promises, *see e.g. Light v. Centel Cellular Co.*, 883 S.W.2d 642, 645 (Tex.1994).

3. The Parol Evidence Rule

The court's duty to interpret the contract between the parties by examining their agreement as a whole does not give a court or arbitration panel license to consider oral discussions and extraneous written documents between the parties dated prior to, and that are inconsistent with, their written agreement. This is known as the "Parol Evidence Rule" and has been described by the

Supreme Court of Texas as follows. "When parties have concluded a valid integrated agreement with respect to a particular subject matter, the rule precludes the enforcement of inconsistent prior or contemporaneous agreements." *Hubacek v. Ennis State Bank*, 159 Tex. 166, 317 S.W.2d 30, 32 (Tex. 1958). *See also Brannon v. Gulf States Energy Corp.*, 562 S.W.2d 219, 222 (Tex. 1977); *and Hunt v. Bankers Trust Co.*, 689 F.Supp. 666, 674 (N.D.Tex. 1987). The Parol Evidence Rule does not bar evidence of discussions and writings undertaken before the parties entered into their written agreement that are *consistent* with the agreement and such discussions and writings can be considered to "explain" the parties' written agreement. Further, the Parol Evidence Rule does not bar evidence of fraudulent statements and writings intended to induce another party to enter into a contract. In addition, the Parol Evidence Rule does not bar parol evidence of *subsequent* modifications to a written contract.

4. Contract Forms

It has often been stated in jest that an oral contract is not worth the paper it is printed on and this statement is generally true, at least figuratively, if not literally. Not only is a written contract invaluable if a dispute should arise, a written contract will go a long way toward preventing unnecessary disputes by helping to ensure that the parties' understandings of their respective rights and obligations are consistent.

Where a design professional is not forced into using a particular contract form mandated by an owner, the easiest, fastest, and often most favorable starting point for a design professional is a standardized contract form promulgated by the American Institute of Architects, the Engineers Joint Contract Documents Committee, or a similar organization representing the interests of design professionals. These contracts have several advantages over non-standardized contracts. First, they

are the product of many years of input, use, and revision by design professionals. Second, they have been tested against the many different types of disputes that can arise on a construction project. Third, they are typically harmonized with other standardized contracts from the same organization often used by the other contracting parties on a construction project. Fourth, they are often the subject of many interpreting court opinions, which provides the parties a better ability to predict the outcome of a dispute.

Although standardized forms are a good starting point for drafting a contract, modifications are typically needed. Any additional agreements should be memorialized in writing and made a part of the contract. A failure to do so may render the additional agreements unenforceable parol agreements (see "The Parol Evidence Rule" above).

5. Key Provisions

Some of the key provisions included in contracts involving design professionals, which often must be specifically negotiated or tailored, are the following.

Scope of Work

One of the most important substantive provisions in a contract involving a design professional is the scope of work provision because it defines the design professional's duties for the project. Great care should be taken with respect to the scope of work provision to ensure that the design professional's undertaking is described specifically and without any unnecessary ambiguity. Among other things, the design professional should ensure that his or her scope of work does not overlap with other design professionals for the same project and that the design professional's duties with regard to additional items such as project administration and oversight are clearly set forth or excluded.

Schedule for Performing Design Services

Under most standardized construction contracts, the design professional will be required to provide a schedule for performing design services to be approved by the owner. Once approved, the circumstances under which the design professional will be allowed to deviate from the schedule are limited and thus the schedule must be carefully considered in advance. Delays caused by an owner or by circumstances outside of the design professional's control will generally be excused. However, where the design professional subcontracts a portion of its scope of work to one or more subconsultant design professionals, a delay by the subconsultant typically will not justify a delay in the schedule with the owner. Accordingly, the design professional should consider possible delays by subconsultants when proposing a schedule and should ensure that the contracts with subconsultants contain at least as restrictive a schedule as the contract with the owner.

Pay-When-Paid and Pay-If-Paid Clauses

Where a design professional either utilizes, or is, a subconsultant, consideration should be given to the fact that the source of funds used to pay the subconsultant will generally be the funds paid by the owner to the primary design professional under the contract between the owner and the primary design professional. Parties typically incorporate provisions in their contracts in an attempt to harmonize the obligation to pay the subconsultant with the receipt of funds from the owner. These clauses are typically known as "pay-when-paid" and "pay-if-paid" clauses. A "pay-when-paid" clause has the legal effect of delaying payment to a subconsultant only for a reasonable period of time, after which time payment must be made to the subconsultant *regardless* of whether the primary design professional has received payment from the owner. A properly worded "pay-if-paid" clause will *condition* payment to the subconsultant on payment by the owner to the prime design professional. In order to be effective as a "pay-if-paid" clause, the contract provision must state that

payment by the owner is an express condition precedent to the obligation to pay the subconsultant and that the subconsultant assumes the risk of non-payment by the owner. *See e.g. Aesco Steel, Inc. v. J.A. Jones Const. Co.,* 621 F.Supp. 1576 (E.D. La. 1985).

Indemnification

Indemnification refers to a situation where, generally speaking, one party is required to pay an obligation of another. Indemnification provisions are often included in construction contracts. For example, a general contractor is often required to indemnify an owner and the owner's design professional against claims brought by injured third parties, such as subcontractor employees. Similarly, a subconsultant will often be required to indemnify the prime design professional against claims relating to the subconsultant's work.

In Texas, indemnification provisions are limited in their enforcability. In order to be indemnified against one's own negligence, the indemnification provision must satisfy what is known as the "Express Negligence Rule." The "Express Negligence Rule" requires that a party seeking indemnity from the consequences of that party's own negligence express such intent in specific terms within the four corners of the contract. *See Ethyl Corp. v. Daniel Const. Co.*, 725 S.W.2d 705, 707-08 (Tex.1987). In addition, the indemnification provision must be sufficiently conspicuous. An indemnification provision is considered sufficiently conspicuous if a reasonable person against whom a clause is to operate "ought to have noticed the clause." *Dresser Ind., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 511 (Tex. 1993).

The Texas Civil Practice & Remedies Code provides that, in the case of contracts relating to construction projects, a provision purporting to indemnify an architect or engineer from claims of personal injury or property damage arising from the design professional's negligent design or project administration are unenforceable. Texas Civil Practice & Remedies Code § 130.002. As a suit

against a design professional for personal injury or property damage will almost always allege negligent design or administration, this statue has broad applicability.

Notice Requirements

Most contracts relating to a construction project, whether the parties are design professionals, the owner, or contractors, will contain notice requirements requiring that a party give notice within a certain limited period of time in order to seek redress for the events or conditions giving rise to a claim. These provisions often require a particular method of notice, usually in writing, among other things. For example, AIA B141 requires the architect to give prompt written notice of circumstances beyond the architect's control requiring a change in the architect's scope of services. Similarly, for example, AIA201 and applicable general conditions, used between an owner and a general contractor, provides stringent notice requirements for claims by the general contractor for additional compensation allegedly arising from defects in the design professional's plans and specifications for the project.

Attorneys' Fees

Standardized contract forms typically used on construction projects may or may not include attorneys' fees provisions allowing the recovery of the attorneys' fees incurred by a "prevailing party" in litigation. As lawsuits will often involve competing claims and counterclaims, some of which might be successful by both parties, a "prevailing party" is typically considered to be the party receiving the net affirmative recovery in its favor. For contracts entered into in Texas and contracts governed by Texas law, attorneys' fees are recoverable by statute where the claim is one based on a contract or is based on "rendered services." Texas Civil Practice & Remedies Code § 38.001. This is the case even if there is no attorneys' fee provision in the contract.

Alternative Dispute Resolution

Alternative dispute resolution is a term that refers to a means of resolving disputes between two or more parties other than in court through litigation. The primary methods of alternative dispute resolution are mediation and arbitration. Mediation is a process through which two or more parties embroiled in a dispute are brought together, typically in a single session, in an effort to arrive at a compromise and settlement of their dispute with the assistance of a mediator. Mediators' techniques, tactics, and styles differ, but typically involve extracting from and carrying between the participants, offers and counter offers, in an attempt to get each of the parties to compromise to the point where a mutually agreeable settlement is reached. Mediation can be required by the parties' contract either before or after a lawsuit or arbitration is commenced. In the absence of such a contractual agreement to mediate, mediation is available only where the parties agree or where ordered by the court during a lawsuit.

Arbitration is a private "litigation" conducted between two or more parties before one or more arbitrators. Arbitrators are essentially "private" judges. There are typically one or three arbitrators. Where three arbitrators are used, each party will usually select one arbitrator and the two selected arbitrators will then choose a third. Arbitrators are typically attorneys, but may also be industry professionals, including design professionals in appropriate cases. Arbitration is similar to litigation in that the parties will generally be allowed to take discovery, though it is usually more limited than that conducted in a litigation. After discovery and other preliminary matters are concluded, an arbitration will be conducted before the arbitrator(s). An arbitration is similar to a trial in that evidence, including witness testimony, documents, and other allowable evidence, will be presented in support of each parties' claims and defenses. Most arbitrations conducted before the American Arbitration Association that involve construction contracts will be governed by the Construction Industry Arbitration rules of the American Arbitration Association. These rules can

be viewed online at the American Arbitration Association's website at www.adr.org.

Arbitration is often selected as a means of alternative dispute resolution because it is generally thought to be faster and less expensive than litigation, though this is not necessarily the case, especially where three arbitrators are used as each is paid for their services. Arbitration is typically available only where the parties have agreed to arbitrate. Third parties against which the parties to the arbitration have claims can generally only be joined where they also have agreed to arbitrate.

The bases of appeal from the arbitrators' award are much more limited than those available to an unhappy litigant in the civil courts. In Texas, an arbitration award can be set aside only where:

> (1) the rights of a party were prejudiced by:
> (A) evident partiality by an arbitrator appointed as a neutral arbitrator;
> (B) corruption in an arbitrator; or
> (C) misconduct or willful misbehavior of an arbitrator;
> (2) the arbitrators:
> (A) exceeded their powers;
> (B) refused to postpone the hearing after a showing of sufficient cause for the postponement;
> (C) refused to hear evidence material to the controversy; or
> (D) conducted the hearing . . in a manner that substantially prejudiced the rights of a party; or
> (3) there was no agreement to arbitrate . . . and the party did not participate in the arbitration hearing without raising the objection.

Texas Civil Practice & Remedies Code § 171.088. An arbitration award can be modified or corrected where:

> (1) the award contains:
> (A) an evident miscalculation of numbers; or
> (B) an evident mistake in the description of a person, thing, or property referred to in the award;
> (2) the arbitrators have made an award with respect to a matter not submitted to them and the award may be corrected without affecting the merits of the decision made with respect to the

issues that were submitted; or
(3) the form of the award is imperfect in a manner not affecting the merits of the controversy.

Texas Civil Practice & Remedies Code § 171.091.

C. Design-Build Contracts

Owners are increasingly turning to contracts where both the design and the build functions are wrapped up into a single contract. This is intended to avoid situations where a design professional points to defective performance by a contractor or a contractor points to defective design by the design professional as the cause of some loss, delay, or damage experienced on the project. The entity contracting with an owner to perform a design-build contract may be an entity licensed as both a design professional and a contractor. Alternatively, a design professional might enter into a design-build contract and hire a contractor to perform the build function or a contractor might enter into a design-build contract and hire a design professional to perform the design function.

As a design professional entering into a design-build contract with an owner loses the ability to point to the contractor for defects and omissions in the construction portion of the project, the key contract provisions discussed above take on particular importance. For example, a design professional's contract with a contractor on a design-build project should include a validly worded indemnification provision meeting the requirements of the "Express Negligence Rule" requiring the contractor to indemnify the design professional for any claims by the owner relating to defective and deficient construction. Similarly, a design professional's contract with a contractor on a design-build project should include a validly-worded "Pay-If-Paid" clause relieving the design professional of the obligation to pay the contractor should the owner refuse payment to the design professional.