

**Risk Transfer in Construction Contracts:
The Architects' and Engineers' Perspective**

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Risk Transfer Provisions in Architects' and Engineers' Contracts

I Introduction

All business contracts involve elements of risk: risk of profit or loss (business risk) and risk of accidental loss (catastrophic risk). The three basic approaches to risk management are avoidance, control or finance. The primary subject of this paper is the various contractual methods by which an architect or engineer can finance construction project risks. Also addressed are some basic approaches to risk avoidance and risk control.

A. Financing the Risk

Risk allocation in the design and construction business focuses on the risk of accidental or negligent loss. Risk is financed either by retention of the risk and covering it out of business reserves or by transferring the risk to another party either by insurance or by contract. Generally, parties to a contract want to only accept risks which they can reasonably absorb or insure and to transfer the balance of the risk to another party.

B. Risk Transfer Considerations

There are a variety of factors which an A/E should consider when deciding who will bear a particular project risk. These factors include:

1. Who has the greatest amount of control over the risk?
2. Does anyone have specialized knowledge relevant to management of the risk?
3. Who can best absorb the risk or spread it over the largest pool of transferees?
4. Who will receive the greatest financial benefit from proper management of the risk?
5. What are the statutory and common law limitations of risk transfer in the

projects legal jurisdiction?

6. What is the custom in the industry and does that custom make sense in this particular situation?
7. What are the relative bargaining positions of the parties, including such factors as size, market conditions and the parties' reputations for flexibility in contracting?

The relative weight given to any one factor will vary depending on the parties, the project and the particulars of the risk.

C. Disadvantages of Risk Transfer

There are certain disadvantages to contractual risk transfer. For instance, it is not uncommon for an A/E to transfer risks to another party, usually a sub-consultant, which the A/E also insures against. This can result in the A/E paying for the insurance coverage twice in the form of increased costs of goods or services. There is also the very real possibility of incomplete risk transfer. Depleted insurance or insolvency of the transferee or an unfavorable interpretation by a court can leave the A/E liable for a risk which it expected to be covered by someone else. An issue which is of particular importance in the construction industry is that once a risk is transferred to someone else, the transferor has little or no control over the transferee's risk avoidance or prevention activities. The problem with this situation is evident in common construction activities such as trenching and scaffolding. If the A/E does the right thing and exercise control to try to prevent an accident, it may find that it has inadvertently stepped in and assumed a risk which it meant to transfer. For these reasons, an A/E cannot rely on contractual risk transfer alone to protect it from liability. It must maintain coverage for those cases where a risk transfer fails or it is not possible to effect.

II Shifting the Risk

The fees generated by the design team historically have been wholly inadequate to defray the potential risks of liability inherent in the construction process. Consequently, the designer's contract can and should contain provisions to attempt to shift this risk to others whose financial stakes in the project is sufficient to bear the risks. This section discusses some of the methods by which this can sometimes be achieved.

A. Limiting Liability

1 Dollar Limits

Probably the most efficient way to shift the risk is simply by limiting the designer's liability for it. The limitation can be to a specific dollar amount, to the designer's fee, to exclude consequential damages, or indeed to any other limitation that the parties can agree upon. The limitation probably should be "reasonable and not so drastic as to remove the incentive to perform with due care." See *Valhal Corp. v. Sullivan Associates, Inc.*, 44 F.3d 195 (3d Civ. 1995). A sample clause might be:

12.1. LIMITATION OF LIABILITY. In recognition of the relative risks and benefits of the Project to both the Owner and the Architect, the risks have been allocated such that the Client agrees, to the fullest extent permitted by law, to limit the liability of the Architect and his or her subconsultants to the Owner and to all construction contractors and subcontractors on the Project for any and all claims, losses, costs, damages of any nature whatsoever, or claims expenses from any cause or causes, so that the total aggregate liability of the Architect and his or her subconsultants to all those named shall not exceed \$ _____, or the Architect's total fee for services rendered on this Project, whichever is greater. Such claims and causes include, but are not limited to negligence, professional errors or omissions, strict liability, breach of contract or warranty. The Owner agrees to include a clause similar to this in its contract with the General Contractor, and require the Contractor to do the same in his contracts with subcontractors or materialmen.

2 Proportionate Fault for Breach of Contract

In Texas, the Plaintiff need not show the proportionate fault of each

wrongdoer in a breach of contract action, *City of Austin v. Houston Lighting and Power Company*, 844 S.W.2d 773, 796 (Tex.App.--Dallas, 1992, writ denied), and there is no statutory provision to limit damages for breach of contract through a scheme of comparative fault or causation, *Hunt v. Ellisor and Tanner, Inc.*, *supra* at 938; *White, Budd Van Ness Partnership v. Major-Gladys Drive Joint Venture*, 798 S.W.2d 805, 820 (Tex.App.--Beaumont 1990, writ dismissed). A proposed clause which might limit liability for breach of contract in a multi-defendant situation would be the following:

12.2. PROPORTIONATE LIABILITY. Any liability of the of the Architect for breach of this agreement, or for any other cause of action arising out of the breach of this agreement, shall be limited to those damages actually caused by the Architect's breach and shall not include any liability for damages caused by the Contractor, the Owner, or other members of the construction team.

A. Insurance

The most obvious risk-shift measure is through insurance, but the enormous cost of architects' and engineers' liability insurance -- and the huge deductibles that typically apply to them -- make them a very unsatisfactory method of shifting the risk from themselves. A much better method is to shift the risk from the Architect and his insurance carrier to other members of the construction team's insurance carriers, which can be done through the use of an "additional insured" clause in the Owner/Architect Agreement and, through it, in the Owner/Contractor Agreement. A typical clause might read as follows:

12.3. ADDITIONAL INSURED. To the extent possible, the Owner will include the Architect as an additional insured on all policies of insurance on this

Project, and will require, in its contract with the Contractor, that the Contractor and its subcontractors include the Architect as an additional insured on all of the policies of insurance which they are required to maintain in effect on the Project.

Although the Supreme Court has refused to extend the express negligence doctrine to additional insured provisions, *see, Getty Oil Company v. Insurance Co. of North America*, 845 S.W.2d 794 (Tex. 1992), prudence would dictate that, in light of the opinion in *Dresser Industries v. Page Petroleum*, 853 S.W.2d 505 (Tex. 1993), the clause be conspicuous.

A. Indemnification

A much-attempted, but [at least in this author's experience] seldom successful attempt at risk shifting in Owner/Architect contracts is the use of contractual indemnification clauses. These generally take one of two forms: (1) Indemnification from the consequences of the negligent acts of others; and (2) indemnification from the consequences of one's own negligence. The statutory and common law limitations upon the use of the latter are considerable, although the former can and is frequently is used by some of the members of the construction team to shift risks.

1 Indemnification from the Architect's Own Negligence

a Statutory Limitations

Some jurisdictions have statutory limitations which affect the designer's attempt to require the Contractor to indemnify the Architect. *See, e.g., Tex.Civ.Prac. & Rem.Code Ann. Section 130.002 (Vernon Supp. 1996)* which states that:

A covenant or promise in, . . . a construction contract is void and unenforceable if the covenant or promise provides for a contractor . . .to indemnify or hold harmless a registered architect, registered engineer or . . . from liability for damage that:

- (1) is caused by or results from:

(A) defects in plans, designs, or specifications prepared, approved, or used by the architect or engineer; or

(B) negligence of the architect or engineer in the rendition or conduct of professional duties called for or arising out of the construction contract and the plans, designs, or specifications that are a part of the construction contract; and

(2) arises from:

(A) personal injury or death;

(B) property injury; or

(C) any other expense that arises from personal injury, death, or property injury.

This prohibition applies only to “personal injury” and “property injury”, which may mean that the Contractor can indemnify the Architect for economic losses arising from the Architect’s own negligence. Nevertheless, none of the AIA forms attempt to require the contractor to indemnify the Architect from his own negligence. *See, e.g.*, AIA Document A 201 (*General Conditions for the Contract of Construction*), ¶3.18.

b Common Law Limitations

There is no statutory prohibition against an Owner indemnifying an Architect from his own negligence, but if it were to do so, the clause would have to meet both the “express negligence” test from *Ethyl Corp. v. Daniel Construction Company*, 725 S.W.2d 705 (Tex. 1987) and the requirement that such a clause be conspicuous. *Dresser Industries v. Page Petroleum*, 853 S.W.2d 505 (Tex. 1993); *Ensearch v. Parker*, 794 S.W.2d 2, 8 (Tex. 1990).

2 Indemnification from Others’ Negligence

Tex.Rem.Code Section 130.005 (Vernon's Supp. 1996) specifically allows contractors and others to indemnify the Architect from their [the contractor's] negligence, and the AIA *General Conditions* ¶3.18 attempt to do precisely that. The clause, however, is unenforceable in some jurisdiction which have adopted the "express negligence" standard. *See, e.g., Fisk Electric Company v. Constructor's & Associates, Inc.*, 888 S.W.2d 813 (Tex. 1994).

3 Indemnification of Others from Their Own Negligence

Owners routinely attempt to have their Architects indemnify them from the consequences of their own negligence. The clauses are of course subject to the express negligence rule, discussed above. The conspicuousness requirement may, however, be subject to actual notice. *Cf. Cate v. Dover Corp.*, 790 S.W.2d 559 (Tex.1990). Since this clause always is the subject of negotiation, however, the Architect generally will have a difficult time arguing that it was unaware of its inclusion.

Note: Many local governments historically have coerced their architects and engineers to sign express negligence clauses. Last year, the Texas Legislature ended this pernicious practice by declaring the provisions void, at least in cases involving personal injury or property damage. *See, Tex.Loc.Gov.Code* §271.904 (Vernon's Supp. 1996).

III Risk Avoidance

In addition to limiting liability, careful draftsmanship may be successful in eliminating it.

A. **Disclaimers of Express and Implied Warranties.**

Some jurisdictions imply professional warranties, and almost all jurisdictions allow express warranties. The prudent draftsman of an architect-oriented contract will attempt to

disclaim them. A proposed clause might read as follows:

12.4. DISCLAIMER OF WARRANTIES. Architect does not warrant or guarantee any particular result from its services and specifically disclaims any warranties, express or implied, which may arise by statute, common law, or equity. The excluded warranties include, but are not limited to, any implied warranty that work or professional services will be performed in a good and workmanlike manner, or any express warranty, written or oral, regarding either its services or the suitability of any of the Contract Documents.

A. Eliminating Claimants

1 Third-Party Beneficiaries

Paragraph 9.7 of the AIA B141 contains a clause eliminating third-party beneficiaries, and the AIA *General Conditions* ¶1.1.2 repeats it. These are intended primarily to avoid the existence of any contractual relationship between the contractor and the Architect, without which the contractor has no contractual claim against the Architect. *See, Bernard Johnson, Inc. v. Continental Constructors, Inc.*, 630 S.W.2d 365 (Tex.App.--Austin, 1982, no writ).

2 Subrogated Insurers

A common form of troublesome claims arising out of a construction process are those of subrogated insurers, whose decision to sue is made by a person completely remote from the construction process, much less the construction team. The Architect should attempt to eliminate these claims by obtaining the agreement of the Owner -- and, through the Owner, the contractor -- to waive the subrogation rights of their insurers. ¶11.3.7 of the *General Conditions* is a successful attempt to do this, *see Temple Eastex, Inc. v. Old Orchard Creek Partners, Ltd.*, 848 S.W.2d 724, 729 (Tex.App.--Dallas, 1992, writ denied). The AIA Owner/Architect Agreement, ¶9.4 does so, as well, but in a clause which is not conspicuous, and

which does not require the agreement of the insurance companies to the waiver. (Whether the insurance companies' agreement is required may be an open question under Texas law. *See, Seamless Floors v. Value Line Homes, Inc.*, 438 S.W.2d 598, 601-02 (Tex.App.--Ft. Worth, 1969, writ ref'd n.r.e.)). In order to remedy these potential problems, the Owner/Architect Agreement should contain a clause similar to the following:

9.4. WAIVER OF SUBROGATION. The Owner and Architect waive all rights against each other and against the contractors, consultants, agents and employees of the other for damages, but only to the extent covered by property insurance during construction, except such rights as they may have to the proceeds of such insurance as set forth in the edition of AIA Document A201, *General Conditions* of the Contract for Construction, current as of the date of this Agreement. The Owner and Architect each shall require similar waivers from their contractors, consultants and agents, and will require them to provide their insurance policies, which shall include such waivers of subrogation by endorsement or otherwise.

3 Assignees

As in any professional relationship, it behooves the professional to insure that his performance is gauged by the person with whom he has a personal relationship, rather than unidentified and possibly hostile successors to that person. Consequently, assignment of the Owner's rights against the Architect should be subject to the Architect's consent. ¶9.5 of the AIA Owner/Architect Agreement requires it.

IV Risk Control

A. Limitations

Each jurisdiction has a different statute of limitations for breach of contract actions, but in some states this period may be shortened, by contract. *See, e.g., Tex.Civ.Prac. & Rem.Code Ann. §16.070* (Vernon Supp. 1996). A clause taking advantage of this statutory authorization might be as follows:

9.3.1. LIMITATION OF ACTION. Causes of action between the parties to this agreement, including any claims for breach of contract, must be brought within two years from the day following the act or omission giving rising to the claim for breach of contract.

A. Certificate of Merit

California and some other jurisdictions have adopted statutes requiring a certificate of merit as a prerequisite to instituting malpractice litigation against architects. While Texas has not yet adopted this salutary procedure, there does not appear to be any reason why the parties cannot, in their contractual undertaking, agree to make it a prerequisite to any dispute resolution. A sample clause might appear as follows:

7.1. CERTIFICATE OF MERIT. The Owner shall make no claim for professional malpractice, either directly or in a third party claim, against the Architect unless the Owner has first provided the Architect with a written certification executed by an independent design professional currently practicing in the same discipline as the Architect and licensed in the State of Texas. The certification shall: (a) contain the name and license number of the certifier; (b) specify the acts or omissions that the certifier contends is a violation of the standard of care expected of an Architect performing professional services under similar circumstances; and (c) state the basis for the certifier's opinion that each such act or omission constitutes a violation of the standard of care. The certificate shall be provided to the Architect prior to the presentation of any claim or the institution of any arbitration or judicial proceeding against the Architect.

V. Conclusion

Construction projects are complex transactions which routinely include contractual allocation of various risks inherent in the project. To follow a successful risk allocation process, the A/E must identify the risks inherent in the project and negotiate them from the outset. The negotiations must lead to retention of risks by the A/E which are appropriate and affordable and to transfer of risks through indemnification and insurance provisions which are reasonable. It serves no purpose to force transfer provisions on another party which are so onerous that a court

will not enforce them or which the transferee cannot reasonably be expected absorb. The insurance requirements must be clear and consistent throughout the project and, finally, there must be measures in place which assure that the risks will be financed when the loss occurs.

To be efficient, useful and enforceable, contractual allocations of risk must be conspicuous in the contract, reasonable in light of the parties' resources and control and clearly integrated with all contractual aspects of the project.