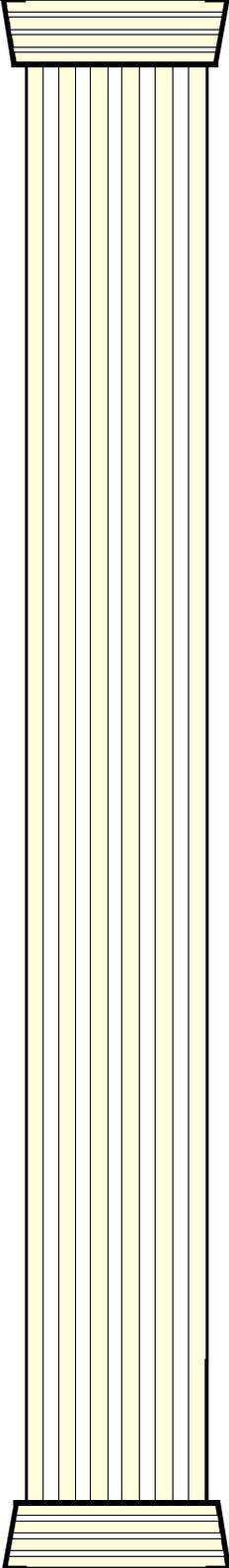

PROFESSIONAL LIABILITY UPDATE

A Loss Prevention Newsletter for the Design Profession

MSP PL 01/2004: "Combating Budget Overruns"

January, 2004



Combating Budget Overruns

Article courtesy of Professional Liability Agents Network (PLAN)

The old saying "penny wise and pound foolish" certainly applies to the field of design and construction. Case after case of professional liability claims demonstrate how taking shortcuts when it comes to project quality can quickly become expressways to disaster.

Shortcuts are most commonly taken when project managers recognize that the value of time and resources spent on a project starts outstripping the potential return on investment. More often than not, this situation occurs when a project reaches its latter stages and unanticipated expenses are eating into intended profits.

In the short term, the client might not realize that quality is being sacrificed, unless a glaring error or omission occurs. Usually, problems do not immediately become apparent, which makes the relaxation of quality control measures all the more tempting. By contrast, budget overruns are immediately apparent to a client.

The professional liability problems that can result from reducing quality control measures to avoid budget overruns – especially when services are performed hurriedly or by less-skilled or less-experienced practitioners – are self-evident. And it only takes one project

gone sour to devastate a reputation or career.

How do you eliminate the root problem of budget overruns in the first place? Almost by definition, budget overruns occur for one of two reasons: either the extent of professional services needed was underestimated or undervalued during the upfront negotiation process, or the scope of services expanded during the course of the project without appropriate changes in fees.

Importance of Scope of Services

Developing a comprehensive scope of services is an essential first step to basic project and budget management. The

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scope should identify exactly what you will do as a design consultant and, equally important, what you will **not** do. A comprehensive scope allows you to budget time for your services more effectively. As a consequence, you can quote a more accurate fee.

Document your scope of services in conjunction with your client. If the client demands extended services, documentation gives you ammunition for establishing an adequate and itemized budget. If the client chooses that you not perform specific recommended services, or that you perform such services in a limited manner, document the client-imposed limitations within your scope.

But remember: in the event of a future claim, a judge or jury is likely to believe a plaintiff's argument that you, as an experienced professional, were in a far better position to know what was and was not needed for successful project completion. Accordingly, you could be found negligent because you did not insist upon performing a critical service whose omission feasibly allowed a problem to occur. Never mind that you told the client that the service was needed. Never mind that the client expressly said the service would be unnecessary or performed by others.

Some clients are relatively naïve when it comes to negotiating a scope of services; others just appear to be so. Some use vague contract language because they don't know any better; others do so in hopes of improving their chances of making a claim stick should one problem or another materialize. For example, what does the requirement "*help the client obtain necessary permits*" really mean? Does it mean you will help complete forms, or does it mean that you will also testify if need be?

Specify what you will do in terms of services you will perform, not in terms of outcomes. No one knows for sure what services will be required to attain a desired result. You provide professional services. You do not provide guarantees, assurance or insurance.

Obtaining Changes

Consider this scenario: The project's design phase is complete and you present the client with an unanticipated, several-thousand-dollar bill for a wide array of changes you did not bother to document at the time each was performed. Some of these changes are the result of "scope creep" – add-on requests from the client once the design work began. Others are the result of your own oversights that didn't become apparent until your design work commenced.

How do you suppose the client reacts to these added charges? Does he say, "*No problem!*" and

merrily sign the invoice to authorize payment? Or does he say, "*What's this? Had I known this work involved an extra fee, I never would have authorized it!*"

Too often, the latter attitude prevails, creating the seed from which claims and lawsuits emerge. The client can refuse to pay, and you very well could wind up suing the client for payment of additional services.

To no one's surprise, the client responds by suing you for negligence. Alternatively, to keep the client happy, you could simply eat the extras and hope for a break-even project when all of your unbudgeted bills are paid.

To avoid this problem, it is critical to document every change in scope. When the client authorizes you to go beyond the original scope, prepare a written change order or memo of acknowledgement indicating what the extra comprises and how much it will cost to perform. Be sure that your form or memo references the basic contract, so all its terms and conditions apply.

Whenever possible, obtain the client's acceptance in writing. By presenting your overall change budget buttressed by individual, signed change orders, your client will be far more understanding. Better yet, submit your change-order bills on a regular basis, so you can avoid the presentation of a



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mountain of additional charges created from multiple molehills of minor changes.

Contingency Fund

Relatively few projects evolve exactly as originally planned. Educate your client about the possibility that he or she will be required to pay for a certain threshold percentage of project omissions or errors, and encourage the client to plan for the resultant extra costs by setting up a contingency fund.

A contingency fund establishes a certain percentage of the project budget to cover the normal costs of errors and omissions that a client can expect to incur despite your best efforts and adherence to the required standard of care. Your contract should include an agreement that your client will not sue you for extra costs that are within the contingency amount.

The percentage set aside for a design contingency should take into account all of the relevant factors, including the scope of services provided, limitations and other pertinent provisions of your agreement with your client, the size, complexity and duration of the project, and any innovative or other unusual features of the project design. A 5%-10% contingency fund is not unusual for a standard project.

Here is a sample contingency fund provision:

Contingency Fund

The Client and the Consultant agree that certain increased costs and changes may be required because of possible omissions, ambiguities or inconsistencies in the drawings and specifications prepared by the Consultant and, therefore, that the final design and construction cost of the project may exceed the estimated cost. The Client agrees to set aside a reserve in the amount of ___% of the project construction costs as a contingency to be used, as required, to pay for any such increased costs and changes. The Client further agrees to make no claim by way of direct or third-party action against the Consultant or its subconsultants with respect to any increased costs within the contingency because of such changes or because of any claims made by the Contractor relating to such changes.

All changes paid for by the contingency fund need to be documented, of course. To an extent, these added fees will fall into the category of “known unknowns,” and, because they will have been budgeted, they should create little cause for concern.

Beware of Unreasonable Optimism

Optimism is good. But being overly optimistic results in budgets that are too low, contingency funds (if any) that are too small, and a host of other positives that become negatives when exposed to the light of reality.

Unquestionably, clients do not want to be burdened with prospective problems and uncertainties at the outset of a project. By the same token, you do not want your client to be swept away by unfounded euphoria; nor do you want to become the problem when overly optimistic outcomes do not materialize. Proceed realistically. Advise the client of the true cost likely to be required and that a project free of problems is more fantasy than reality.

When the size of your fee is likely to be a factor in whether you are selected for a project, be wary of optimism on your own part. Be particularly careful when developing your scope of services, to create a link between the comparatively low fee you propose and the specific services you’ll provide. It needs to be underscored that fee-based procurement is not a technique well-suited to the retention of professional services.

When Necessary, Bite the Bullet

When project managers first realize that the budgeted profit will not be realized, in full or in part, they have two choices: bite the bullet or ask for more money.

Biting the bullet means providing everything the client expects or has been led to expect (via the scope of services) at the agreed-to fee. The logic for biting the bullet is basic: It is better to keep the client happy than to make the client unhappy, thereby risking loss of the client – and client referrals.

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More to the point, the dollar loss associated with performing professionally – i.e., applying the appropriate amount of quality control – is a prudent investment in risk management, especially given the damage, inflation and dispute costs associated with litigation.

Biting the bullet should not be your first choice. Many clients have been in similar situations themselves and will be sympathetic for pragmatic reasons: They understand that firms performing services at a loss are probably not going to perform

those services as well as they otherwise could, to the client's ultimate detriment.

In short, your first choice should be speaking with your client to obtain the amount to which you believe you are entitled. In many cases, design professionals report, clients are willing to pay the additional amount, in full or at least in part. In some cases, they pay nothing at all, but – even then – quality control should not be sacrificed. Professional performance should be maintained as your objective. By taking this approach, you should avoid problems, retain a client for the future, and learn an important lesson.✂

***Disclaimer:** This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

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