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For More Information Contact:
Karen Hong
Tel: 522-2095
Fax: 522-2082
email: khong@financeinsurance.com

Court Decision Increases Design Duty to Third Parties

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On July 3, 2014, the California Supreme Court issued its highly anticipated decision in the matter of *Beacon Residential Community Association v. Skidmore, Owings, & Merrill, LLP* (Opinion No. S208173). The underlying claim involved a 595-unit condominium project in San Francisco. The developer treated the project as for-rent apartments for two years before selling units to the public. After the units were sold, the condo owner's association complained of water infiltration, cracked drywall, inadequate firewall separation and -- most importantly -- solar heat gain, which made some units periodically uninhabitable. The solar heat gain was allegedly due to a combination of value engineering decisions, some by the owner without design team objection and some by the design team itself. A claim was filed against the designers.

The San Francisco Trial Court held that absent property damage or a direct contractual relationship, the architects owed no direct duty to the condominium owners for the claimed damages. Unfortunately, the victory was short lived. First the California Court of Appeals and then the California Supreme Court disagreed. The California Supreme Court held:

[A] n architect owes a duty of care to future homeowners in the design of a residential building where . . . the architect is the principal architect on the project - that is, the architect, in providing professional design services, is not subordinate to other professionals.

By this holding, the California Supreme Court has opened the door for design professional liability to third parties for purely economic damages even where there is no contractual relationship and no property damage or bodily injuries. The Court did so even though Skidmore's agreement expressly disclaimed the existence of any "third-party beneficiary of the obligations contained in the Agreement."

How Could This Happen?

Prior to this decision, the prevailing law in California under the economic loss rule held that design professionals had no duty (and therefore no liability) to third parties in the absence of a contractual relationship and/or actual property damage or bodily injuries. The architects in the Beacon Residential project even sought to establish those boundaries by expressly disclaiming and disavowing the existence of any third- party rights or benefits from the obligations contained in the agreement. The Supreme Court observed that despite this clause, the architects provided services "knowing that the finished product would be sold as condominiums." Drawing principally on the history of products liability cases, the Court stated,

Although liability for the supply of goods and services historically required privity of contract between the supplier and the injured party, the significance of privity has greatly eroded over the past century. . . The declining significance of privity has found its way into construction law.

In the end, the *Beacon Residential* decision addresses only a single issue -- a design professional's duty to third parties, particularly those who are the ultimate

"consumers" of the end-product of their services. However, this is incredibly significant in that duty is the first and most limiting of the four elements of a claim of professional negligence. A professional negligence claim generally requires a showing of duty, breach of the standard of care, causation, and damages. Duty has historically been the key point of containment and control. As the *Beacon Residential* decision even observed, "Courts . . . have invoked the concept of duty to limit generally 'the potentially infinite liability which would follow from every negligent act." (Quoting *Bily v. Arthur Young.)*

Six Factors Create Third Party Duty
In evaluating whether such a third-party duty exists, California Courts weigh and balance six factors as previously set forth by the Court in *Biakanja v. Irving* (1958). Those six factors are:

1. Extent intended to affect claimant;
2. Foreseeability of harm to claimant;
3. Certainty that injury was suffered;
4. Closeness of connection between conduct and injury;
5. Moral blame; and
6. Policy of preventing future harm.

Not all six factors need to be present for a duty to exist. They simply need to establish enough weight to tip the Court's judgment to find a duty.

The alleged facts are therefore critical. As alleged by the condominium owners and noted by the Supreme Court, the architects allegedly agreed to provide "full architecture and engineering", "construction administration", and "construction contract management", and in doing so actually attended weekly jobsite meetings and provided complete design oversight and inspections for compliance throughout construction. As the Supreme Court noted several times, the architects were well compensated for doing so with a fee of $5M.

The architects argued they had no duty to the owners' association on the grounds that they made only recommendations, and all final decisions were by the owner/developer. The Supreme Court concluded that based on the allegations:

[The architects] applied their specialized skill and professional judgment throughout the construction process to ensure that it would proceed according to approved designs. The work [the architects] performed does not resemble 'a broadly phrased professional opinion based on a necessarily confined examination' of client-provided information, nor did [the architects] act merely as 'suppliers of information for the use and benefit of others.'

Consistent with the Court's references to historic products liability cases, the status and comparative power and sophistication of the unit purchasers was a major factor in the Court's decision. As it said:

The average homebuyer is more akin to the 'presumptively powerless consumer ... The usual buyer of a home is ill-equipped with experience or financial means to discern structural defects ...

A Six Step Strategy
True, the *Beacon* decision only had direct and immediate consequences in California. But it's no secret that what starts in California doesn't always stay in California. Therefore, it is wise for all design firms to take steps to prevent assuming a design duty to third parties. Here is a six-step strategy:

Continue Using the Intended Beneficiary Clause. The architects in *Beacon* expressly excluded third-party beneficiaries as a part of their agreement with the developer. Nevertheless, the Supreme Court disregarded that disclaimer for these claims. The easy response would be to simply abandon the use of an intended beneficiary clause. Don't! Disclaimers of third-party beneficiary clauses will still be enforceable in many situations and jurisdictions. Accordingly, you should double down with a clause to be mirrored in both the contract and in the design documents, such as:

Consultant's services and work product are intended for the sole use and benefit of Client and are not intended to create any third-party rights or benefits or for any use by any other person or entity or for any other purpose.

Draft a Closed and Limited Scope of Services. In *Beacon*, the Supreme Court was heavily influenced by the architects' allegedly comprehensive scope of services. Design and construction professionals should

employ a detailed scope of work that avoids open-ended or ambiguous obligations or result-oriented duties that are more akin to the delivery of a product than a service. With that detailed scope of work in place, "close it" by expressly disclaiming extra-contractual services with a clause such as:

Consultant's Services shall be limited to those expressly set forth in this Agreement. Consultant shall have no other obligations or responsibilities for the Project except as agreed to in writing.

Assume Limited & Allocated Construction Roles. The Supreme Court in *Beacon* did not or chose not to recognize the distinction between design and construction responsibilities. The Court essentially cast them as an undifferentiated collection of services and thereby made the architects co-responsible for the construction outcomes. To avoid this, the design agreement should clearly differentiate the construction role from design services:

Owner recognizes that the Contractor and Subcontractors will be solely in control of the Project site and exclusively responsible for construction means, methods, scheduling, sequencing, jobsite safety and compliance with all construction documents and directions from Owner or building officials. Consultant shall not be responsible for construction related damages, losses, costs, or claims, except only to the extent caused by Consultant's sole negligence.

Warn Client of Value Engineering Modifications. In *Beacon*, the single issue that seemed to have the greatest impact with the Supreme Court was the heat gain. At its core, this issue arose from multiple programming and "value engineering" modifications that ultimately created a problematic condition in some units. At best, most design professionals regard value engineering as an inevitable evil which leads to a downgrade in the project and a modification out of sequence with the preferred design evolution. Design professional service agreements and scopes of work should prepare the client for the realities of this process. Such an "educational" provision might read:

Upon the written request or direction of Client, Consultant shall evaluate and advise Client with respect to proposed or requested changes in materials, products, or equipment. Consultant shall be entitled to rely on the accuracy and completeness of the information provided in conjunction with the requested substitution. Client acknowledges that such changes may result in a reduction in the quality and performance of the project and accepts that risk in recognition of the objectives of the change. Accordingly, Consultant shall not be responsible for errors, omissions, or inconsistencies in information by others or in any way resulting from incorporating such substitution into the Project.

Seek Contractual Separation. The *Beacon* Court placed significant emphasis on the "principal" role of the architects. How this will ultimately apply to subconsultants within discrete disciplines remains to be seen. However, for the moment, the more contractually removed from the ultimate claimant, the better. Obviously, that approach will not work for those traditionally placed in the role of a prime consultant. In that capacity, the best solution may be to expressly differentiate the role of subconsultants and to establish direct allocations of responsibility to such subconsultants for such disciplines. Such a provision may read:

Owner and Consultant have jointly selected subconsultants to Consultant with appropriate qualifications for their designated scope of work, and have required such subconsultants to indemnify Owner and Consultant and to carry appropriate insurance for the Project. Accordingly, Owner agrees that it shall not seek to hold Consultant responsible for errors, omissions, or other wrongful acts of such subconsultants except to the extent of Consultant's proportionate responsibility for such claims, damages, or losses, or to the extent subconsultants' insurance and other resources are inadequate to respond to the claim.

Recommend Outside Review. The motivation and rationales for the *Beacon* decision sound almost exclusively in themes of product liability and consumer protection. Essentially, the position is that such private purchasers lack the wherewithal and sophistication to evaluate the project. If so, there clearly are third-party services that can do so. As a means of overcoming this sympathy and disparity, consider working with the selling developer to recommend and advise the

purchaser to seek outside advice. Such a recommendation may provide:

The purchase of any improved real estate is a significant decision. Construction and equipment standards can and do change over time and the condition of improved property can be impacted by post-construction, operation, maintenance, and repairs. Accordingly, prior to purchase, Purchaser is encouraged to seek a qualified, third-party review of the present condition of the property.

Can We Be of Assistance?

We may be able to help you by providing referrals to consultants, and by providing guidance relative to insurance issues, and even to certain preventives, from construction observation through the development and application of sound human resources management policies and procedures. Please call on us for assistance. We're a member of the Professional Liability Agents Network (PLAN). We're here to help.