

DESIGN PROFESSIONAL
LEGAL UPDATE

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CLAIM NOTICE AND DISPUTE
PROCEDURES IN WASHINGTON –
WHAT DESIGN PROFESSIONALS SHOULD KNOW

Since 1995, Washington courts have consistently ruled that claim notice and dispute procedures in construction contracts will be strictly enforced. These claim procedures often include:

- Short time requirements for providing the owner or client with notice of a claim for compensation or a schedule extension
- Specific requirements as to data that must be included with any claim
- A rigorous structure as to whom the claim must be presented, often consisting of multiple levels of project administration
- Strict alternate dispute resolution requirements, including informal negotiations, mediation, presentation to dispute review boards, and/or arbitration

- Short contractual deadlines for commencing litigation

The Washington Supreme Court recently affirmed these principles in *Am. Safety Ins. v. City of Olympia*, 162 Wn. 2d 762 (December 27, 2007). The *City of Olympia* case follows the court's decision in *Mike M. Johnson v. Spokane County*, 150 Wn. 2d 375 (October 23, 2003), a case on which we reported in an earlier newsletter.

In *City of Olympia*, Kapstan, the general contractor was obligated to follow a clear and specific timeline for presenting its claims. The contract also contained an administrative claim review process. If the contractor aggrieved by the City's decision, it was obligated to file a law suit within 180 days of the administrative determi-

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RESPONSIBLE BIDDERS FOR PUBLIC PROJECTS –
AN IMPORTANT LEGISLATIVE DEVELOPMENT

Project owners and design professionals have long understood the value of having a responsible contractor build their projects. Owners and designers want to achieve a finished project of the highest possible quality and at a reasonable price. Also, projects that are constructed by responsible contractors suffer less from construction defects, change order surprises and demands for extra compensation.

On **private procurements**, savvy project owners and their design professionals often collaborate on the careful selection of construction contractors and utilize extensive negotiations to arrive at acceptable contract terms that meaningfully allocate risk.

However, on **public procurements**, there has historically been much less flexibility in selecting construction contractors based on criteria that emphasize contractor "responsibility." There is a dizzying array of public procurement statutes in Washington. Most emphasize awarding the construction contract to the lowest bidder, and until now, and only with a few exceptions, efforts at using contractor "responsibility" in the procurement as a way of weeding out unacceptable contractors have not met with much success. Indeed, when public bodies have tried to interject concepts of "responsibility" into their procurements, either by pre-qualifying contrac-

tors who would be allowed to bid or by interjecting concepts of "responsibility" in deciding to whom the contract would be awarded, the consequence has often been the filing of bid protests. Bid protests can and do result in substantial project delay and an increase in the cost of the final procurement.

In an effort to improve bidder responsibility, the Washington Legislature recently amended RCW 39.04.350 (Public Contracts and Indebtedness, Chapter 39.04. Public Works) to allow the State or municipality to adopt

relevant supplemental criteria for determining bidder responsibility applicable to a particular project which the bidder must meet. (RCW 39.04-350(2))

This simple sentence accomplishes a fundamental change in Washington public procurement law: it provides more discretion to the contracting entity to evaluate bidder responsibility.

This statute further provides that the supplemental criteria for determining

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CLAIM NOTICE AND DISPUTE PROCEDURES (cont'd)

nation on a claim. The contractor's surety took over the claim after the contractor experienced financial difficulty. Ultimately, the surety attempted to present a claim to the City, albeit and untimely and lacking in sufficient detail to satisfy the City. The City pressed the surety for details, while reserving its rights under the contract regarding the claim procedures and time limits. The City also agreed to consider negotiations to attempt to resolve the dispute, although negotiations never actually took place. At all times, the City continued to reserve its rights to enforce the claim notice and claim submittal requirements. Ultimately, the surety sued the City to recover on the claim.

The Supreme Court determined that the law suit was properly dismissed, because the surety did not comply with the claim provisions in the contract and because the City did not unequivocally waive its rights to demand compliance with these procedures and time limits.

The *Spokane County* and *City of Olympia* cases strictly limit the ability of the party seeking extra compensation or an extension of contract time to argue that the owner waived the claim notice procedures by negotiating with the party seeking change order relief. Even protracted claim negotiations between the owner and the party seeking more time or money will not result in a waiver of the contractual claim procedures. The courts are unwilling to imply a waiver of claim procedures. If an owner articulates a willingness to waive the claim notice procedures, the waiver should be in writing and be clear, specific and formally accepted by the owner.

There are important public policy concerns that seem to motivate these recent court decisions. Among these are: 1) a recognition that parties should be able to bargain for any claim procedure they want and, once agreed upon, to strictly enforce it. 2) a recognition to allow parties to argue that claim procedures were waived by an owner through the act of negotiation could interfere with the laudatory goal of fostering settlements of disputes. As stated by the Washington Supreme Court in the *City of Olympia* decision:

The law favors amicable settlement of disputes... If we found that by agreeing to enter into negotiations the City waived its rights under the contract, we would deter future parties from attempting settlement before resort to the use of the courts. Such a result would be directly contrary to established public policy and thus we find that entering into settlement negotiations, without anything more, does not constitute and implied waiver of contractual defenses.

What Will Happen Now?

The contractor community generally views owner claim procedures as draconian measures intended to defeat any legitimate claim for additional time or compensation. The recent decisions from the Washington Supreme Court have fanned the flames of this discontent and there is a drum-beat of activity for a legislative "fix." It is too early to tell if this effort for a legislative remedy will get much traction.

What is the Relevance of this Issue for Design Professionals?

If a design professional's agreement with its client contains specific claim notice or filing procedures or deadlines, these provisions are likely to be strictly enforced by Washington courts. Furthermore, design professionals are increasingly working in contractual relationships far different from the traditional design-bid-build model. In delivery systems such as the design-build model, design professionals may be subjected to the same claim notice or filing procedures or deadlines as construction contractors when seeking additional compensation and time extensions.

Design professionals who draft owner specifications may also be involved in preparing language relating to contractor claim notice or filing procedures. The inclusion of overly onerous claim procedures in owner specifications can actually generate unnecessary disputes between the owner and contractor. Any dispute between a contractor and owner can breed a claim by the owner against the design professional.

Recommendations

Understand and follow your contractual claim procedures. Be sure to understand and follow the claim procedures that control your ability to get paid. If you are working as a subconsultant to another design professional, or as a subcontractor to contractor, ask to see a copy of the contract with the owner. Claim procedures that may govern the relationship between the owner and a prime design professional or design-build contract can be buried in your subconsulting contract or incorporated into your contractor by reference through a flow-down or cram-down provision. It is critical that you understand what claim procedures you have agreed to follow. It is also critical that you educate your project managers on the claim procedures that need to be followed if a dispute arises. We find that all too often, the staff administering the contract does not know what those who negotiated the contract have agreed to do.

Advocate for reasonable claim procedures. If your scope of service includes preparing procurement documents or advising the owner on procurement documents, we recommend that you advocate for the use of reasonable and sensible claim procedures. Draconian claim procedures only lead to intractable disputes, and intractable disputes that result in litigation are an invitation for claims against design professionals. Claim procedures should be reasonably related to the nature and scope of the project and designed to facilitate the early and reasonable resolution of disputes. They should not be used as a barrier to the meaningful resolution of legitimate claims for extra contract time or compensation.

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RESPONSIBLE BIDDERS FOR PUBLIC PROJECTS (cont'd)

bidder responsibility, including the basis for bid evaluation and the deadline for appealing the determination must be included in the invitation to bid or bidding documents. *Id.*, at (2)(a).

This legislative change is accompanied by some additional protections for contractors. Any potential bidder is allowed to ask the state or municipality to modify the supplemental criteria based on specific concerns of the prospective bidder. If the state or municipality then modifies its criteria, it is required to issue an addendum to the bidding documents. *Id.* at (2)(b).

If the bidder does not provide the requested information regarding the responsibility criteria, the state or municipality can either base its determination on the information available or reject the bid on the grounds that the bidder is not responsible. *Id.*, at (2)(c).

If the state or municipality determines to reject the bid on the grounds that the contractor is not responsible, the reasons for the determination must be provided in writing, and the rejected bidder is given the right to appeal this decision. *Id.*, at (2)(d).

Finally, the Capital Projects Advisory Review Board is required to develop suggested guidelines to assist the state and municipalities in developing supplemental bidder criteria. *Id.*, at (3).

As of this writing, the Capital Projects Advisory Review Board, which is made up of several representatives from various constituencies in the construction industry, has the issue of recommended supplemental bidder responsibility criteria under advisement.

Some suggestions for design professionals assisting the state or municipalities on public projects are as follows:

- Be sure all public clients are aware of this new legislation and encourage public clients to consider including meaningful supplemental criteria for determining bidder responsibility in procurement documents.
- Responsibility criteria should be objective, reasonable and appropriately suited to the needs of the particular project.
- Counsel against the use of unreasonable, subjective and irrelevant supplemental criteria; the use of such criteria will only lead to bidding delays and appeals.
- Be wary of supplemental criteria that seek to evaluate prior construction claims history.
- Pay careful attention to the recommended supplemental criteria that may be released by the Capital Projects Advisory Board and also to any legal precedent, as public bodies and the courts begin to consider the imposition of bidder responsibility criteria in public procurements.

On balance, we believe this legislative change is of great importance for Washington design professionals providing services to public bodies. The judicious use of sensible bidder responsibility criteria should cut down on construction defect issues, cost over-runs, excessive change order requests and the other issues that can plague public projects. Since owners often deflect these issues back on their design professionals, minimizing these issues can only help to reduce claims.

William J. Bender

LIEN RIGHTS FOR WASHINGTON DESIGN PROFESSIONALS - WHAT YOU ALWAYS WANTED TO KNOW, BUT MAY HAVE BEEN RELUCTANT TO ASK

Design professionals working on projects located in Washington have important lien rights for help in getting paid.

We have found that design professionals, unlike many construction contractors, subcontractors and suppliers, are reluctant to take the steps necessary to protect and enforce their lien rights. Some of this reluctance is due to avoidance of an adversarial stance with clients. Liening a client's property is perceived as unseemly. Additional reluctance exists because a legal proceeding to collect fees is all too often an invitation for a counterclaim for professional negligence.

The best practice remains to ensure payment for your work in a timely manner as the work is being performed. That said, the perfection and enforcement of lien rights can sometimes be of significant assistance in leveraging payment for design work.

What is a lien?

Many design professionals do not know the meaning and context and lien rights. Lien rights are created by the legislature to implement an important principle. Those who provide goods or perform labor or services to improve real estate should be able to tap into the added value of the improve-

ments to get paid. A lien is nothing more than a security interest in the real property upon which the project will be constructed or other improvements made. Once properly perfected, a lien can be foreclosed upon, just like a mortgage on a home can be foreclosed upon by a lender who is not being paid. A properly recorded lien is a security interest in real property, just like a mortgage is a security interest in real property. If the lien is foreclosed, the property is sold and the design professional can then be paid out of the proceeds of the sale of the property. *If only the application of the lien law was so simple!*

Lien rights are complex and perfecting and enforcing liens requires adherence to many technical requirements

There are many ways that a lien claim can be unsuccessful. In many situations, the right to lien is contingent upon giving proper notice of lien rights to the property owner, other project participants and the project lender. The actual lien must be timely and properly recorded, and proper service of the lien made on all those entitled to service. Foreclosing on a lien is a technical process and all steps must be followed.

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LIEN RIGHTS FOR WASHINGTON DESIGN PROFESSIONALS (cont'd)

RCW 60.04.021 gives any architect, engineer or surveyor furnishing **labor or professional services, materials, services or equipment** for the improvement of real property the right to file a lien for the value of the services provided.

Notice requirements

It is beyond the scope of this short article to set out all of the notice requirements applicable to various contractual relationships and for various kinds of liens. As a general proposition, **any design professional firm that is not contracting directly with the project owner must provide a "pre-claim" notice.**

The concept behind the pre-claim notice is to let the owner know that there are entities with lien rights, who have the right to file a lien if they are not paid for their work. The project owner should know who is working on its project and should not be surprised if an unpaid entity files a lien against the project's real estate.

There are also "Notice to Customer" requirements for parties who contract directly with owners on projects of a certain size or where the owner's project is a personal residence.

These notice requirements take on special significance as design professionals begin to work in more varied contractual relationships. For example, a design professional working as a subcontractor to a construction contractor on a design-build project is probably required to provide a "pre-claim" notice to protect lien rights. If the design professional was contracting directly with the owner, the pre-claim notice would not be required. Also, if the design firm was a second tier subcontractor to a lead design firm, then the pre-claim notice would be required. These are just examples of the many variations on this theme.

Identify possible lien rights and lien procedures when starting the project.

When beginning a project, we suggest that possible lien rights be evaluated and any necessary notice requirements identified and implemented. For example, a "pre-claim" notice must be provided within 60 days of first providing work on a commercial project. If the "pre-claim" notice is missed, the lien rights can be abandoned.

Again, it is beyond the scope of this article to spell out all of the notice requirements and where they apply. Design professionals will be well served to incorporate these requirements into their internal procedures and to follow those procedures, once they have been adopted.

The Special Case of Dealing with Lenders Notice to lenders

In order to provide notice of lien rights to possible lenders or subsequent buyers, design professionals must record a separate notice in the real property records of the county in which the property is located when providing "preconstruction activities." The reason for this requirement is that pre-construction services are not visible to the public. Once construction has started, however, the fact that design work has been or continues to be

done is self evident. Such preconstruction activities include preparing plans, specifications, surveys or other engineering services. This notice is recorded prior to the commencement of the actual construction.

The underlying reason for this requirement is to allow lenders or subsequent purchasers to know that the property can be encumbered by a lien if the design professional is not paid for professional services.

Lender's subordination agreements

In this very tight lending environment, some lenders are beginning to take steps to insure that construction loans are paid before any other indebtedness, including the owner's obligations to pay the design team. We are increasingly being asked to review lenders' proposed subordination agreements that attempt to guarantee the lender that any claim for payment will be given a priority only after the lender is paid in full. These agreements also often allow the lender to step into the owner's shoes to finish the project, if the owner defaults on loan payment obligations. We suggest that these agreements be reviewed by design firms on a project-by-project basis. The terms can be onerous and unacceptable.

The lender as leverage for getting paid

Most loan agreements contain covenants that require the owner not to allow liens to be filed. Liens are an indication that an owner may be in trouble and the loan security may be in jeopardy. Lenders will often step in and require that the liens be discharged. Lenders, for example, can insist that loan disbursements be paid directly to design firms, either by the lender directly, or, by two party checks to the owner and design firm. In some circumstances, the lender can be your friend to help leverage payment.

The stop payment notice to lender

A design professional with valid lien rights can also serve the lender with a "stop payment" notice. This notice does not provide the design professional with payment, but it does create a priority for the security interest that is claimed by the lien over the security interest that protects the lender's underlying debt. Since no lender wants to have its security interest diminished, a proper stop payment notice can serve as added leverage on the lender to see to it that the owner pays for services rendered.

Lien priorities

Washington lien law establishes the order for getting paid, if a lien is foreclosed. These "priorities" are generally as follows:

- i) Liens for performance of labor;
- ii) Liens for contributions owed to employee benefit plans;
- iii) Liens for furnishing material, supplies or equipment;
- iv) Liens of subcontractors, including, but not limited to, liens for their labor and materials; and
- v) Liens for prime contractors or for professional services.

As you can see, design professionals are generally last in line for the

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LIEN RIGHTS FOR WASHINGTON DESIGN PROFESSIONALS (cont'd)

payment of secured creditors. This lack of priority has serious consequences for projects “under water.”

Projects under water

Unfortunately, if the design professional is not being paid, it is a safe bet that others are not being paid as well, and “others” may well be in a higher priority class for payment if liens go to foreclosure. This means that if the property is sold to satisfy a lien foreclosure, those who are last in line may be out of luck. Design work, however, often leads the project. This is all the more reason to perfect ones’ lien rights and to insist on timely payment. Design firms who make a practice of financing cash-strapped developers often experience payment problems that cannot be solved, even by the best lien practices available.

Lien foreclosure procedures

Assuming proper and timely notice, there are also a host of requirements for actually recording the lien and, if the recording of the lien does not leverage payment, then moving to foreclose on the lien.

For lien rights to be practical and cost-effective, we recommend that firms be equipped to handle lien notice requirements as part of the regular contracting and documentation process for initiating any professional engagement. However, if it becomes necessary to actually record a lien or to start foreclosure of the lien, this is the time to call your attorney. The failure to follow the exact steps set out in the statute can lead to the loss of lien rights and even to a claim that the property was damaged by the recording of an invalid lien.

Bonding “around” a lien

Design professionals need to be especially careful when owners record a lien bond, often to allow re-financing of the property. The bond simply serves to replace the property as security for the debt.

In a 2007 Washington State Court of Appeals decision, *DBM Consulting Engineers, Inc. v. United States Fidelity & Guarantee Co.* (142 Wm App. 35), the Court addressed the issue of whether a design professional could recover monies on a lien bond for a judgment relating to breach of contract action. The underlying facts in this case were fairly straightforward and not at all unfamiliar to any design firm: the property owner had retained the design firm to perform engineering services on a prospective residential development site. It was uncontested that the design firm properly recorded a lien on the property to secure payment for its services. The owner fell \$63,000 in arrears in payment and subsequently sought to sell the property, notwithstanding the debt owed to the engineer, which was secured by the engineer’s lien. In order to facilitate the sale, the owner obtained a lien bond to secure the debt and free the property for sale.

The design firm brought a claim against the owner for breach of contract. A jury returned a verdict in favor of the engineer. Damages of \$38,000 were awarded, as well as contractually mandated attorneys’ fees of \$85,000 and pre-judgment interest of \$11,000. The owner defaulted on payment of the judgment. Subsequently, the engineer brought a claim against the surety, seeking to recover the bonded amount in partial satis-

faction of the jury verdict against the property owner.

The Court of Appeals reversed the trial court and held that the surety was not obligated to pay according to the judgment against the owner. In arriving at this decision, the Court reasoned that any action to recover on a lien bond must necessarily be based on a claim that directly implicates the lien itself. Accordingly, the Court held that the engineer’s fatal flaw was to pursue a breach of contract claim against the owner without also seeking foreclosure on the lien itself.

This case should serve as a cautionary tale for design professionals who find themselves in the position of having an owner bond around the design professional’s lien. The lesson to take from this case is that the nature of the security (property or bond) determines the process of foreclosure, and any change in the nature of security from property to bond does not obviate the requirement to properly foreclose on the lien.

Assessing the chances before foreclosing

It makes little sense to foreclose on a lien if the secured debt with a priority ahead of your lien is greater than the market value of the property. This is a common problem. The first priority lien may be the lender’s mortgage. However, the property may have a market value of less than this first priority debt. It would make little sense to foreclose on the lien, in this case, since the mortgage holder would need to be paid first from the proceeds of sale and there would be no remaining value in the property to satisfy the design professional’s lien.

Before moving to foreclose a lien, it is important to consider the overall value of the property and the amount of secured debt ahead of your lien.

Workouts

Many project debt problems are solved in negotiated work-outs. Either the developer finds new financing, brings in new partners, or the lender patches up the problems in the project so that the lender can recover at least some of the funds advanced. Perfecting a lien can give your firm a place at the table when a work-out is arrived at. You may not get 100 cents on the dollar, but you may get at least a substantial part of your fees paid. You also may be a key player in allowing the project to go forward, since your instruments of service are necessary for completion and your lien rights give you added leverage to work out a payment scheme.

Public projects

These comments apply only to private works contracting. There is a whole different set of requirements for perfecting lien rights against either the payment bond or the retention on a public works job. We will address these requirements in a subsequent newsletter.

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