

# Communiqué

A Practice Management Newsletter



Insurance  
Design  
Professional

**XL CATLIN**

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# Fee Claims: A Cautionary Tale

*The following article was written by a new member of the Loss Prevention & Client Education group within XL Catlin's Design Professional team: Brett Stewart, J.D., Risk Manager in our San Francisco office.*

It's a phone call David Sofaer never looks forward to receiving: the news that a design professional policyholder has not been paid by a client and intends to start collection proceedings. From his years as a Claims Consultant with XL Catlin's Design Professional team, Sofaer knows such a move will likely result in a counterclaim from the client.

The cases that really trouble Sofaer are those that involve relatively low dollar amounts. He tells of a civil engineer who was owed \$6,000 at the end of a project. The engineer felt strongly that the few change orders on the project were owner-driven, and not the result of any error or omission on the engineer's part. He pressed the owner for payment several times; the owner responded that he didn't feel he owed the balance because of the change orders.

## A Matter of Principle

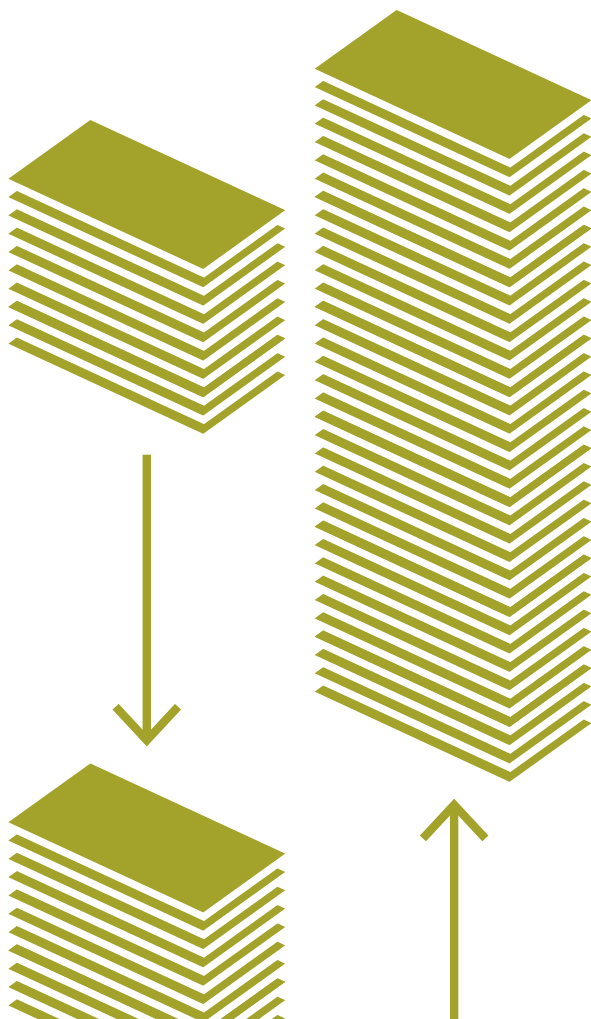
Sofaer asked the engineer to reconsider his fee claim, explaining that the engineer would have to retain counsel at his own expense to press for fees and that the action would almost certainly result in a claim by the owner against the engineer. "Often, when we're in litigation, we have to defend the case," Sofaer says. "That means we're forced to retain defense counsel, which will trigger the A/E's deductible. It will mean retaining an expert and incurring additional defense costs. Plus, no insured firm likes to have a claim on its loss record."

Sofaer says he asked the engineer to "take a deep breath" and weigh what he was owed against his deductible (\$25,000), the average defense costs (at least \$25,000), and what his time was worth.

But to the engineer, it was a matter of principle: a person should pay his or her debts. He had never had a claim—or been involved in litigation of any kind—and was perhaps naive about the hard reality of construction claims. He had earned his fee, and he was going to collect.

The engineer proceeded with his fee claim, and as predicted, the client turned around and sued the engineer, claiming negligence. The client claimed that the engineer's design was so inadequate that it not only justified withholding the remainder of the engineer's fee, but that the engineer actually owed the client over \$150,000 in additional costs to correct the alleged errors.

After a year of motions, countermotions, expert witnesses, depositions and lawyers, the case was finally settled in mediation. In the end, the civil engineer waived his fee claim and his carrier paid more than \$16,000 to get him out of the case—and he was lucky. The final tally included \$15,000 in legal fees for the initial fee claim, which the engineer paid out of pocket, and the \$25,000 deductible that was applied to \$80,000 in legal fees accumulated while defending against the negligence claim. In other words, the engineer spent \$40,000 of his own money to pursue a \$6,000 fee he never recovered.



(He was able to recover \$12,500 as part of his mediation credit under his professional liability insurance policy.)

The engineer also spent nearly 200 hours, time he'll never recover, talking to his lawyers and engineering expert, digging through files to find documents and sitting in depositions. And the claim became part of his loss record.

Given the average after-tax profit that design firms make and this engineer's hourly rate, he would have to gross \$560,000 to recover the \$27,500 he lost. For a small firm, this can be a real deal breaker.

Is this fair? Of course not. But there was something the engineer could have done differently.

"I hate saying this," Sofaer says, "but sometimes it's smarter to write off the unpaid fee if it's not very large. The reality is that even if the design professional prevails, the cost of pursuing the fee could equal or exceed the fee itself, and this doesn't even include the A/E's time and effort trying to collect." This also assumes the design professional doesn't draw a counterclaim in the process.

## Out-Of-Control Accounts Receivable

There's another scenario Sofaer finds equally frustrating and can also result in a counterclaim from the client: the architect or engineer who lets his or her accounts receivable pile up until they total hundreds of thousands of dollars.

"Some design professionals just are not very good business managers," Sofaer explains. "They feel uncomfortable asking for money, and they would rather be designing buildings than preparing or pursuing invoices," he explains. As a result, they do nothing, accumulate huge accounts receivable and wait until it is too late to exercise their contractual right to suspend or even terminate the project because of non-payment.

In the end, they're forced to send the client a huge bill. The client often balks, citing an item in dispute. Once again, if the design professional initiates a fee claim, he or she will likely get an answer in the form of a lawsuit. In addition, even if the design professional's jurisdiction provides for recovery under the mechanic's lien statute, the timelines will have usually passed and the design professional cannot take advantage of the statutory mechanism designed to protect him or her.

"It's just so unnecessary and doesn't take much effort to prevent," Sofaer says.

## What You Can Do

There are no perfect solutions for either scenario, according to Sofaer, but he does offer these suggestions:

- Do your due diligence when it comes to client selection. If the client has a history of litigation or of refusing to pay its bills, walk away. If you know ahead of time that you cannot

bring yourself to do that, consider obtaining a retainer, especially if you don't have an existing relationship with the client. Explain that you'll be incurring costs to initiate the project and marshal required resources. Failing to obtain a retainer is tantamount to giving your client an interest-free loan.

- Your contract should address payment terms and include any remedies (e.g., late fees and interest, collection costs, the right to withhold your plans and specifications until payment has been made, suspension of services, and termination provisions). Set up and stick to a collection routine. Bill regularly and often, follow up immediately if payment is delayed and don't let your receivables mount up.
- Make sure you have a clearly defined scope of services in your contract. Spend time drafting and revising your scope so it clearly and unambiguously states what you will do, what you will not do, and what you will do for additional money. The clearer your scope is, the easier it will be to manage your client's expectations. Later, if your client wants you to perform additional services, consider offering to do so for an additional fee by amending your contract. If your client says "no," then don't provide the services. However, if you feel compelled to provide and write off the services, you should let your client know you're doing this—in writing. Consider it a marketing opportunity.
- Project documents and models can be your leverage to receiving payment. Stipulate in your agreement that payment is to be made within a specified number of days after you release the documents or models and that you will proceed to the next phase of the design effort once you have been paid. Think about it: how many of your firm's service providers or vendors will continue to work with you without being paid?
- Be prepared to write off unpaid fees if the amount is not too large, especially if your client is already signaling that it will file a claim if you pursue the fees. It's a hard pill to swallow, but it may save you the pain of ultimately writing off your fee, paying your deductible, and having the counterclaim added to your loss record.

Sofaer says another key to helping avoid these kinds of situations is to maintain communication and a close relationship with the client throughout the project, including explaining what you're doing each step along the way. Help the client understand there may be changes in any project and that it will need to pay for any changes it causes. Most importantly, face up to and resolve any problems the moment they arise, and be sure to let your broker and your insurance company know if you think there's trouble on the horizon. After all, we are here to help.

# How Do You Measure Success?

It might be time to change the way you measure your firm's profitability.

"How much money do you make in design?" is a seemingly simple question that potential clients often ask design firms. Yet they're mystified when design firm owners respond by rattling off statistics such as utilization and average net multiplier. In the business owner's larger commercial world, the most common statistic used is simply profit margin, expressed as a percent of net revenue. Profit margin is easily calculated:

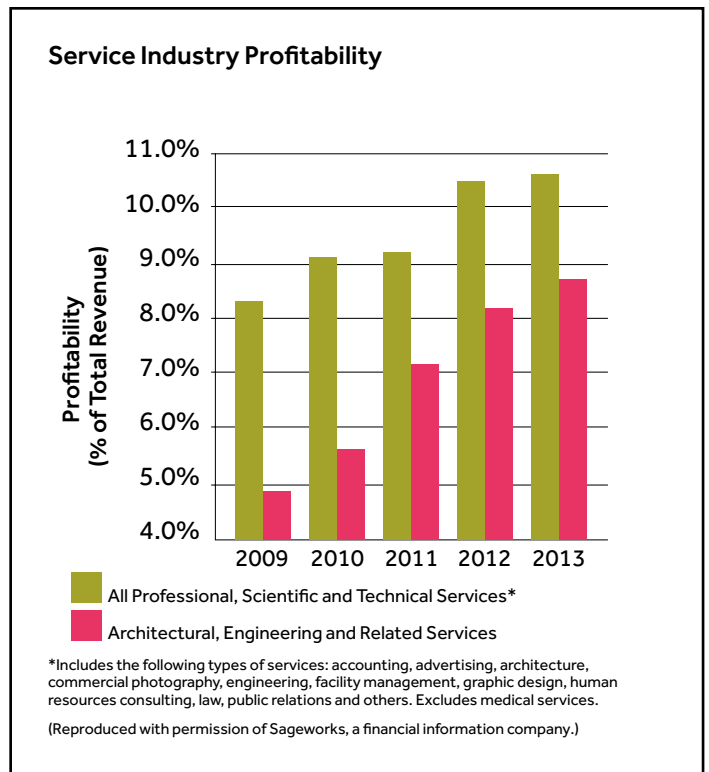
$$\text{Profit Margin} = (\text{Net Revenue} - \text{Expense}) \div \text{Net Revenue}$$

Measuring success by net revenue alone means relatively nothing to an investor or buyer of services. As an experiment, look back at almost any 10-year-old copy of *Engineering News-Record (ENR)* that lists the "top ten" design firms by net revenue in any category, and see how many of them are still with us today. Likewise, your utilization rate or effective multiplier only provides an indirect measure of your profitability. Most design firm owners operate on the hopeful calculus that, "If we stay 80 percent utilized at a 2.7 multiplier, we'll be profitable."

The problem, as insureds of XL Catlin's Design Professional unit have learned in many workshops, is that design firm inefficiencies rob the firm of profits. A 2006 study we conducted found that design firms were writing off five to seven percent of their fees due to the design firm's rework and scope creep. This loss of fees isn't measured in utilization or effective multiplier, at least not until the project is completed. That's when an estimated multiplier falls to a realized multiplier while the utilization may remain constant or increase, resulting in a project's large write-off or write-down.

In the "Service Industry Profitability" chart at right, you can see that, when compared with the entire professional services sector, profitability for architecture, engineering and related services firms is consistently lower.

Design firms can begin to address this problem by using a metric used in other sectors to measure year-to-year profit margin: "change in profit margin" or "Δ percent margin." Instead of an increase in utilization or multipliers, the goal for each quarter, project, division or studio should then become an increase in profit margin.



Improving your profit margin can be accomplished without raising your prices and without getting more work. In fact, many firms have realized they can make higher margins by getting rid of some project or client types that bring their overall margins down. Higher margins don't come free, though; they require your firm to analyze and eliminate the inefficiencies that create the basic loss of margin in the first place.

Analyzing the annual change in your firm's profit margin can put your firm on a path toward increased overall profitability. As your firm becomes more profitable, it becomes easier to hire new employees, easier to find new shareholders willing to invest in the firm and potentially easier to sell if and when the time comes.

**Firms should consider measuring "change in profit margin."**

## Design Professional



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