LAW OFFICES OF JONATHAN J. SWEET

15951 Los Gatos Blvd., Ste. 14
Los Gatos, CA 95032
(408) 356-0317
jonathansweetlaw@comcast.net

GETTING PAID FOR CONSULTING

Jonathan J. Sweet

INTRODUCTION

Profitability is an essential element for consultants. Increasing that profitability is a goal for nearly every business. Those in business recognize that ensuring and increasing profitability includes taking affirmative steps to operate effectively and efficiently, and avoiding mistakes which can cause your business to incur substantial liability. This paper will explain some of the ways a consultant can ensure that he or she gets paid for the work they perform for clients, and avoids incurring such liability.

Intelligent operation of your consulting business includes following these guidelines:

1. Choose Carefully With Whom You Work
2. Set Up and Operate Your Consulting Business Properly
3. Separate Your Business Assets From Your Personal Assets
4. Get the Right Insurance to Protect You
5. Understand the Contracts You Enter Into
6. Know and Understand the Laws which Apply to your Business
7. Use the Legal System Carefully
8. Seek Attorney Help When Needed
9. Understand the Bankruptcy System
10. Avoid Spending Today's Money on Past Mistakes

Using the above steps will help you to operate with maximum profit, and minimum liability.

Understanding and Reviewing Contracts

The primary focus of this paper will be on item 5, reviewing and understanding contracts.

It is critical that you review and understand the risks you are accepting

when you sign a contract. Arguing to a judge, jury or arbitrator that you signed a contract, but did not read it, or that you did not understand it is unlikely to be accepted as a valid defense.

Key Contract Clauses

Contract clauses in consulting contracts which can create major issues include:

A. Indemnity

B. Attorneys' Fees

C. Arbitration or mediation

D. Confidentiality

E. Change order/scope of work revision

F. Payment

G. Termination for cause/convenience

H. Ownership of intellectual property

I. Insurance

J. Trade Secrets

A. Indemnity clauses

Most consulting agreements contain an indemnity clause. A typical indemnity clause requires that if a client is sued by a third party, the consultant would defend the client, or cover the client's loss due to a claim by the third party.

Some indemnity clauses in consulting agreements call for mutual indemnity. You, as a consultant, would cover or defend the client for claims resulting from your actions, and the client would cover or defend you from claims against you resulting from the client's actions.

Indemnity clauses are most likely to be enforced by a court if a dispute arises, although states may impose limitations on enforcing certain types of indemnity clauses. For this reason,

you should carefully scrutinize indemnity clauses in any consulting agreement you are asked to sign, to determine the extent of risk that clause represents to you.

1. California Law Generally Requires Each Party to Pay for Losses It Causes.

Under California law, each party is generally responsible for its own actions:

> "Everyone is responsible, not only for the result of his or her willful acts, but also for an injury occasioned to another by his or her want of ordinary care in the management of his or her property or person, except so far as the latter has, willfully or by want of ordinary care, brought the injury upon himself or herself."

Civil Code Sec. 1714(a) (West, 2011)

If you are sued because of the act of another party, you may be entitled to bring that other party into the lawsuit to have the court determine that new party's obligation to contribute or indemnify you or to pay the plaintiff for part of the damages. This type of claim is called "implied indemnity." This legal right for implied indemnity exists independent of "express indemnity," which may arise because of an indemnity clause in a contract between you and a client.

2. What Triggers the Indemnity Obligation?

The trigger for the indemnity obligation varies. Some clauses state that the trigger is "negligence." Some state that the obligation exists for claims "arising from" the consulting work, or from the duties or obligations arising under the consulting agreement. Some clauses may include language stating that your obligation to defend and indemnify the client exists, even if you are not found negligent to the third party.

Indemnity clauses are complex, and difficult even for attorneys to understand. If you sign a consulting agreement which contains a broad indemnity clause, which dramatically increases your risk in doing the project, you should consider whether to increase your price to cover that additional risk, or whether to avoid taking that project, because the risk is simply too

great.

B. Attorneys' Fees

The American legal system is based primarily on the British legal system. Under the British legal system, the loser in a lawsuit is always required to pay additional damages to the winner to cover the winner's legal fees. The American founders felt that the British rule barred too many people from being able to use the court system because of the financial risk involved in suing a party and being exposed to the other side's attorneys' fees if the plaintiff lost. For this reason, our legal system does not call for the loser to automatically pay the winner's attorneys' fees.

Under California law, the right for a winning party to collect attorneys' fees as additional damages only exists in the presence of an attorneys' clause in the contract, or if provided for by a statute which governs the claim. In other words, an ordinary claim for breach of contract does not give the right to recover attorneys' fees as damages, unless there is an attorneys' fees clause in the contract.

A typical attorneys' fees clause would state:

> "In the event of any dispute, whether by litigation or arbitration, to enforce the rights or duties under this agreement, the prevailing party will be entitled to recover its attorneys' fees, experts' fees, and court costs as damages."

1. Advantages and Disadvantages of Attorneys' Fees Clause

There are both advantage and disadvantages in having an attorney's fees clause in your consulting agreement. Many attorneys believe that the paying party does not want an attorneys' fees clause, and the party performing work does. The rationale for this position is that the paying party has more money, and would prefer to be able to use that economic leverage to discourage a claimant from resorting to litigation and accepting a lesser amount in settlement. If a lawsuit occurs, the paying party will argue that the performing party should

discount its claim in settlement by the amount it would have to spend to fully pursue litigation.

Some attorneys estimate that filing a lawsuit, and taking it to conclusion with a trial costing at least $100,000 in legal fees and court costs. A typical time frame for litigation from start to finish in California is about 12 to 18 months. If you have an unpaid bill for $10,000, and no right to collect attorneys' fees as damages, it does not appear to make sense to spend $100,000 to collect $10,000. In addition, your personal time spent involved being a plaintiff or a defendant in a lawsuit has an economic cost for the parties because it diverts time and energy away from your regular work.

3. Typical Dollar Amount of Your Contracts

One factor to consider on whether you should have an attorneys' fees clause is the size of a typical consulting contract for you. If your typical job is $10,000, an attorneys' fees clause may be more desirable than if a typical contract for you is $200,000. If you are owed $10,000 from a client, and a payment dispute arises, the client is likely to tell you that it will cost you too much to litigate, and that you should accept a large discount on what you are owed to avoid spending the money for attorneys' fees to pursue the claim.

You may resent a client using its economic leverage to force you to compromise your claim. On the other hand, you are unlikely to want to spend a lot of money on legal fees purely to satisfy your resentment. Each of you has to make a personal decision about how much you value pursuing a claim with litigation, as opposed to taking economic realities into consideration. Most clients are likely to have deeper pockets to pay for legal fees, and may be willing to spend money in legal fees out of proportion to the individual claim, in order to show the business world that they will fight claims, rather than just paying settlement money to avoid legal expense.

4. An Attorneys' Fees Clause May Not Make Sense For All Your Contracts

Even if you typically use an attorneys' fees clause, you may not want one for every

contract. You should consult with your attorney to decide on any given project if he or she thinks it make sense, given all the relevant considerations.

C. Arbitration or Mediation Clauses; Alternative Dispute Resolution

Because of the high cost of litigation, and other impacts associated with lawsuits, both courts and private parties have developed alternative methods to resolve disputes. The two major types of alternative dispute resolution are "arbitration" and "mediation."

1. Arbitration

Arbitration is an alternative dispute resolution process where the parties agree to use a third party, often a retired judge or industry expert, to accept evidence in the form of testimony and documents, in an arbitration hearing, to render a decision which binds the parties, and can be entered as a court judgment for enforcement. Arbitration can be agreed to by the parties by the use of an arbitration clause before a dispute has arisen, or by stipulation by the parties to arbitration after a dispute has arisen.

2. Advantages of Arbitration

In the past, parties believed that arbitration was preferable to litigation because it would resolve disputes more quickly, at a lesser cost, and provide the parties with more control over the process than litigation. Parties could participate in arbitration without attorneys, which would avoid spending legal fees. As arbitration has become more complex and more expensive, this perception began to bear less relationship to reality.

Still, depending on the type of dispute, arbitration may allow parties to resolve the dispute more quickly, and at a lesser cost than litigation. It may allow the parties to use an industry expert, who will understand the technical issues associated with the dispute, whereas a judge may not know anything about the field or technical issues involved.

3. Disadvantages of Arbitration

The major disadvantage of arbitration in California is that the arbitrator's decision is almost unappealable. If a judge renders a verdict which is incorrect, based on the facts presented at trial, or based upon the applicable law, an appeals court can overturn the trial court's decision.

An arbitrator's decision cannot be overturned, except in very limited circumstances. The major basis for altering or overturning an arbitrator's decision is undisclosed bias of the arbitrator. Prior to appointment of an arbitrator, the arbitrator is required to disclose any potential conflicts of interest, or relationship to the parties or their attorneys. If an arbitrator fails to disclose a conflict, a court may consider changing the arbitrator's decision.

A court action in California takes approximately 12 to 18 months from filing to trial. If you wish to delay the decision, an arbitration which can occur more quickly may be a disadvantage. For a typical payment dispute between a consultant and a client, this disadvantage would be for the client, not the consultant.

Another potential disadvantage of arbitration is that parties in an arbitration do not usually have the right to conduct discovery, which is the litigation pretrial exchange of documents, testimony and information. The purpose of discovery is to allow the parties to litigation to fully understand and be aware of the facts and law which apply to the dispute. If the evidence which supports your case relies heavily on obtaining pretrial information, you may not wish for arbitration because of the lack of right to discovery.

Arbitrators also allow much more evidence at the arbitration than would be allowed in a court trial. The rules of evidence which govern a trial are not usually applied in an arbitration, which may be a disadvantage, depending on the nature of your dispute.

4. Even With An Arbitration Clause, Dispute May Go To Court

If your contract with a client contains an arbitration clause, you may still end up in court.

If one party to a dispute files a lawsuit, the other party has to file a petition to compel arbitration, if the second party desires to have an arbitration to resolve the dispute. In many cases, although there is an arbitration clause, neither of the parties wants to use arbitration, and the case ends up in court.

5. Mediation

Mediation is distinct from arbitration. Mediation involves hiring a third party neutral to help the parties negotiate a settlement. The mediator does not hear evidence, or make a ruling or decision. Mediators are usually retired judges, or persons with expertise in the subject matter of the dispute. If your dispute involves intellectual property ownership, you may hire an intellectual property attorney to be your mediator. The mediator meets initially in a joint session with the parties, and their attorneys, then breaks the parties up and meets separately with the parties to attempt to broker a deal with the parties to end the dispute.

Mediation usually involves some discussion of the merits of the dispute. However, the focus is more likely to be around the transaction costs of litigation, arbitration, or some other method of dispute resolution which prolongs the process beyond the mediation. The mediator may provide some evaluative input to parties on the merits of each party's position, but is more likely to attempt to build consensus by placing emphasis on resolution of the dispute now, with all parties compromising.

Mediation allows the parties to present their positions on a limited basis to the mediator, but the parties are more frequently asked to compromise, in the interest of putting the dispute behind them, and moving on with their affairs. If the parties have ongoing business relationships, which the parties wish to continue, mediators will tell the parties that litigation as a dispute resolution method is likely to end those relationships, rather than allowing them to continue.

Statistically, mediation is the most successful method of resolving most disputes. It can be done prior to litigation or arbitration, or after those dispute resolution processes start, but prior to a trial or arbitration. Although some parties may feel they did not get their "day in court" with mediation because they were not able to tell their whole story to the mediator, mediation is the most practical alternative to resolving disputes.

D. Confidentiality

I am sure that most of you have seen Non-Disclosure Agreements (NDA's) or confidentiality clauses in your contracts with clients. Clients are convinced that every piece of information they give you, or to which you have access as part of your consulting work is confidential, and a trade secret. California law has definitions of trade secrets, and you are supposed to keep as confidential trade secrets you learn from your clients acquired during the scope of your consulting work.

It is difficult, sometimes, however, to define what constitutes a trade secret. Common definitions include information which is not generally known to the public, such as customer information, manufacturing or marketing processes, or software code. Determining what knowledge you bring to a consulting job, or what trade industry contacts or information you had prior to your work for the client, as to what you acquired in working for the client is not easy.

The definition of what is a trade secret, and what your obligations are in regard to confidential client information may be stated very broadly in agreements you are asked to sign. This may also be contract language about which a client is sensitive, and you may have to sign NDA's or contracts with confidentiality clauses which are broad, and hope that this does not become an issue after your project is completed for the client. Knowing something about the history of the client, and whether they have pursued litigation against other consultants or others in the past for trade secret misappropriation is helpful in deciding which projects and clients to

take.

E. Clauses on Change of Scope

If your contract for consulting work is based on a fixed price, or has a ceiling or cap, if you are asked to perform additional work, you will want to be paid additional money. It is rare for the scope of work on a project not to change. An increase in scope may also affect the time for completion of your work, require that you hire sub-consultants, or work overtime on the project.

The consulting agreement should address how a change in scope of work will alter either the contract price or the time for performance. The most common way to approach the issue is to have a form, commonly called a "change order," which the consultant submits to the client which identifies:

a. The change of scope

b. The reason for the change of scope

c. The additional charges (or reduction of charges) associated with the change in scope

d. Time or materials may be broken out separately for the additional charges

e. Places for an authorized party for the consultant and client to execute the change order

f. How the change in scope may affect the contract completion date or work schedule

It is unwise to perform additional work for a client without a signed change order, prior to performing the changed work. Disputes between consultants and clients are most likely to revolve around quality and timeliness of work by the consultant, and a claim by the client that the claims for payment for additional work by the consultant were not authorized or should not cause an increase in the amount to be paid the consultant.

Although a manager at your client's location may tell you to do additional work, and

assert that you will get paperwork later, this is very risky. Having a change order form available to be filled out by an authorized party, and stating that you have to have that form filled out first, as opposed to performing additional work based on oral direction is a better business practice. Doing work on a handshake may have worked once, but times have changed, and getting it in writing is key if you wish to be paid for additional work.

1. Clauses Defining Scope of Work

Closely related to change order clauses, are contract clauses which define the scope or work. Definition of what you are providing can be broken into two broad categories: (1) a clause which describes what you are providing, such as technical advice or consulting related to a particular project or service; (2) a clause which is specification based, whereby you are promising to provide a product or service which will achieve a particular objective of the client.

Doctors do not promise to make you well, and lawyers do not promise to win your case. Similarly, as a consultant, you should be wary of promising to achieve a particular objective. If the client tells you how to do your work, and you do that work, you should be entitled to be paid, whether the client's objective was achieved or not. Nevertheless, you want to satisfy your clients, if possible. Most consultants rely on word of mouth, and on referrals for future work, so attempting to be careful to define the scope for your work so that you do not warrant a particular result should not be confused with trying to satisfy your clients.

F. Payment Clauses

Contract language should address how much, when, and conditioned upon what events payment will occur to consultants. Typical systems involve the consultant submitting periodic invoices (often monthly), and the client paying based on the invoices within 10 to 30 days. Some payment plans involve an advance payment. Some clauses may address the percentage of work completed, or have a process by which a client representative or a third party certifies

that certain milestones or progress of the consultant's work has been achieved.

If the consultant performs physical work at the client's site, the consultant may have mechanic's lien right against the client's property. This is a specific claim against property, for the consultant's work having improved the value of the client's property. This is a different legal theory than a claim based on contract, even though the claim may be for payment for the same work.

Mechanic's lien law in California is a complex area, with specific time deadlines which the lien claimant must follow in order to have a valid lien claim. If you have any questions about mechanic's lien law, and how it might apply to your work as a consultant, you can contact me at my office.

G. Termination

1. Termination For Cause

Contracts usually state that the client may terminate the consultant for non-performance. Certain other circumstances, such as the filing of bankruptcy by the consultant may trigger the client's right to terminate the consultant. Common claims by a client for non-performance by the consultant may include the consultant failing to meet the client's schedule, the consultant providing defective work, and the consultant failing to pay subcontractors or suppliers. Some contract clauses on termination for cause may set forth a procedure by which the client gives a written notice of breach by the consultant, and the consultant may have a specified period of time to cure the alleged breach.

Some contracts may also include a clause on what gives the consultant the right to terminate the client for cause. Since the client's primary obligation is to pay, it is usually non-payment which is the claim for breach by a consultant against a client. Failure to cooperate with the consultant on the project, or to timely provide the consultant with technical or other support

may also provide the consultant with the right to terminate the contract with the client. A period for the client to cure its payment default should also be set forth in the contract, and a method and timing for the consultant to provide notice to the client of the client's default.

2. Termination for Convenience

Some contracts will provide that the client may have the right to terminate the contract without any cause. This is also called "termination for convenience." Some contracts may give the consultant a similar right to terminate without cause, but this is less common. There are pros and cons to including this type of clause. Usually, it is only the client who has the right to terminate without cause. How you operate your consulting business may dictate the economic impact of being terminated without cause. If the clause exists in a consulting agreement you sign, language should be included on the timing for the notice of termination, and the client being liable for work in progress, or specially fabricated materials already ordered or delivered being the responsibility of the client.

H. Ownership of Intellectual Property Created By Consultant For Project

It is likely that the consultant will create intellectual property such as software, patentable material, trademark, or other intellectual property. The consulting contract should address who will own that intellectual property. A legal doctrine called the "work for hire" doctrine provides that intellectual property created by an employee of a company is owned by the employer, not the employee. An outside consultant is not usually subject to the "work for hire doctrine." The client usually seeks to provide by contract that intellectual property created by the consultant is owned by the client. Although the consultant can attempt to negotiate contract language to retain ownership of the intellectual property he or she creates during the project, most clients will not allow the consultant to own it. Separating out what intellectual property or knowledge you had prior to ever working for the client, as opposed to what was created for the client during

the client's project can be difficult.

Careful contract drafting may help in this area, but will not solve this problem entirely. This area of contract may also be very sensitive for clients, similar to trade secret and confidentiality, and the consultant may have little negotiating leverage in the contract language regarding intellectual property ownership.

I. Insurance Clauses

Most contracts will require that the consultant obtain or have insurance in place. A typical insurance clause will identify the amount over coverage, deductibles, and often specifies that the client is to be named an additional insured under the consultant's policy. Insurance clauses for consulting contract may require workers compensation insurance for any employees of the consultant, or may require vehicle insurance, depending on the nature of the consulting work, and the client's work location, relative to the consultant's location. Some insurance clauses actually state that the insurance company must be admitted as an insurance carrier in California, and may specify that the insurance company which issues your policy have a rating by Best or some other organization. Your insurance broker will help you determine the specifics of the insurance you need, and the rating and status of the company you select for your policies.

The two basic types of insurance which are likely to arise for consulting work are Commercial General Liability Insurance (CGL) and Errors and Omissions Insurance (E &O). Coverage under these types of insurance are different, and how these types of insurance may be triggered are different.

1. Commercial General Liability

This type of insurance generally covers tort claims, such as personal injury or death. These types of risks are considered "unforeseeable." This type of risk is different from economic losses, such as a client failing to pay your consulting bill, or you crashing the client's

server, which causes business interruption losses to the client. Another common exclusion from coverage under a CGL policy is for liability assumed under a contract. Although it sounds helpful that a party has CGL insurance, in the event of a claim, the coverage of such insurance is limited, Many types of claims may not be covered.

In other words, if you do not perform your consulting work properly, and the client suffers economic losses due to your failure, CGL insurance is not likely to cover a claim against you. If, however, you cause property damage to the client's site, coverage may exist since property damage is often covered under a CGL policy.

CGL policies are usually written on an "occurrence" basis. This means that for coverage to exist, the claim must be for an act which occurred during the policy period (time when the coverage existed). You do work for a client in 2011, and have insurance for the calendar year 2011. In 2012, the client becomes aware of a claim against you based on an act or failure to act in 2011. Under these facts, the time when the act occurred dictates whether there is coverage, and coverage is likely to exist.

The basic point to remember about CGL insurance is that it has limited coverage, and that it may provide more psychological reassurance than actual coverage. If the claim against you is based on an intentional action such as misappropriation of trade secret, or unfair competition because you hire away employees of your client, coverage under your CGL policy is not likely.

If you have a claim for which there is no insurance coverage, you may have personal liability or exposure for a loss. If you are trying to protect your assets, you need to know what losses to which you are exposed. CGL insurance may cover you for a claim that a client's customer was injured when he tripped over your power cable carelessly left at a jobsite, but is not likely to cover many economic or business losses that you may cause to a client.

Incorporation of your business to protect your personal assets is another method to protect your assets, in addition to having insurance.

2. Errors and Omissions Insurance.

E & O insurance is commonly carried by professionals such as engineers, doctors, lawyers, and accountants. As compared to CGL insurance, E & O insurance does cover negligent acts by the consultant or professional, and can cover economic losses suffered by the client. Some consulting contracts, particularly if there is a design component to your work, as well as installation of hardware, may require E & O insurance.

A typical client will require that the consultant obtain one or more of the above types of insurance, and may ask for evidence that you have obtained the insurance. The contract may specify that you are supposed to provide certificates of insurance as evidence of the policies. The contract may identify the dollar amounts of coverage for the insurance, and may even require that the insurance be obtained from a California-admitted insurance carrier, or have a particular rating in order for the insurance to be acceptable to the client.

3. Additional insured provisions

Contracts often require that the consultant add the client to the insurance carried by the consultant as what is called an “additional insured.” As an additional insured under your insurance, the client would have the same contractual rights to coverage and indemnity as you would. Clients would prefer that your insurance, rather than theirs, cover losses associated with your consulting work. As an additional insured on your insurance policy, the client has the ability to bring legal action against the insurance company if the insurance company fails to honor its contractual obligations to the client. The client as additional insured can also make a complaint to the California Department of Insurance which regulates insurance companies in California. Insurance brokers provide additional insured certificates for you to give to your

clients when required.

J. Trade Secrets

Closely related to confidentiality clauses, contract language on trade secrets may be very broad in consulting contracts. Some language should be included to protect you which excepts from trade secret coverage publicly available information, or which you learned from third party sources, rather than from the client or its representatives. Clauses on trade secret often provide for liquidated damages (specified damage amounts irrespective of actual damages suffered by the client) and for injunctive relief (non-monetary order from court that party do or not do specific act).

CONCLUSION

This paper identifies some basic steps you can use to increase the likelihood of getting paid, and to improve the profitability of your consulting business. These steps include intelligent selection and review of consulting contract language. Investigating and using care and caution with whom you decide to do business, both clients and parties or co-owners, is also critical.

I strongly advise consultants to have an attorney review and advise the consultants about the contract forms they use, or to have an attorney review and analyze contracts the consultant receives from clients for execution. If advised by your attorney that the consulting agreement you are given is slanted toward the client, you may still decide to do the work. But, having that knowledge, you can price the job accordingly. Alternatively, you may decide to pass on that project for another project where the contract is more balanced, and you can be more confident of being treated fairly in the event of a dispute.

Jonathan J. Sweet

Jonathan J. Sweet is the principal of the LAW OFFICES OF JONATHAN J. SWEET, located in Los Gatos, California. Mr. Sweet regularly represents small businesses in preparing consulting contracts, partnership agreements, incorporation, and counseling clients on legal and human resource issues. He also represents clients in litigation. Mr. Sweet serves as an expert witness in litigation. Mr. Sweet is available to act as a professional arbitrator or mediator when retained by either parties or attorneys for parties

Mr. Sweet is the author of *SWEET ON CONSTRUCTION INDUSTRY CONTRACTS/MAJOR AIA DOCUMENTS* (Wolters/Kluwer, Aspen Law & Business, 2009), and *AVOIDING OR MINIMIZING CONSTRUCTION LITIGATION* (John Wiley & Sons, Inc.,1993).

Mr. Sweet currently teaches law classes at Lincoln Law School of San Jose. He has taught law courses through San Jose State University 2002-2003, and at the University of San Francisco School of Law in the Fall of 1994, the Spring of 1997. Mr. Sweet regularly lectures on legal issues through Lorman Education Services, and other organizations.

Mr. Sweet received his B.A. Degree from the University of California, Berkeley in 1978, and his J.D. Degree from the University of San Francisco in 1985. Mr. Sweet has been a member of the IEEE CNSV since 2008, a member of the Board of Directors of the Peninsula Builders Exchange since 2002, and is currently its Treasurer. He has been a member of the California State Bar Association since 1986 and the Santa Clara County Bar Association since 1990.