



## GUEST ESSAYS

### **Insuring Design-Build Risks**

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Like many industries, the design and construction industry is in a period of great transformation. As design-build grows in popularity, construction and design firms are realigning, changing their services, forming new partnerships and repositioning themselves in response to changing market conditions. While these changes present new and exciting opportunities for contractors, they must understand that in taking on responsibility for design, in addition to construction, they also take on new risks. Failing to realize the extent of their responsibilities and liabilities as a design-builder can be a devastating oversight.

Agents and brokers need to understand the risks their design and construction clients face when performing as design-builders, or participating in design-build joint ventures, in order to advise them on their additional coverage needs. The commercial general liability (CGL) policy is not adequate to cover the expanded liabilities design-build contractors assume. Contractors professional liability is needed for that exposure. This article will identify some of the professional liability coverage issues contractors must consider in devising a comprehensive risk and insurance program.

### **Risk Transfer Not Enough**

Typically, a construction contractor venturing into design-build will do so with the intention of subcontracting the design of the project to a separate entity. Often, these contractors (and their agents) mistakenly assume that by hiring a licensed design professional they have shifted the design risk away. Unfortunately, that is not the case. Even where the contract with the design professional contains all the right risk transfer provisions (indemnity agreements, waivers of subrogation, and insurance requirements), the design-build contractor still bears a significant degree of risk.

Contractors should not rely exclusively on hold harmless or other contract provisions to protect them from design liability for the following reasons.

- The hold harmless provision could be held to be unenforceable. Many states have strict rules regarding the shifting of liability for one's own negligence to another party, and failure to conform to these rules may invalidate the provision.
- The design firm may not be in business when the claim is filed. Since professional liability insurance is written on a claims-made basis, it is likely that no coverage would exist at that time.
- Architects and engineers' errors and omissions insurance typically does not cover contractual liability, such as that assumed in a hold harmless provision, unless such liability would have attached in the absence of a contract or agreement. Rather, coverage under these policies is limited to damages that are the result of "professional negligence", which is a much different standard of care than the design-builder typically provides to the project owner. Even if the policy will respond, most design firms carry relatively low limits of insurance, and have limited tangible assets that could be used to satisfy indemnity obligations if the insurance is inadequate.

Because the design-builder's obligation to the project owner is not relieved by the inability to collect for design damages from the design subconsultant, design-build contractors should purchase their own professional liability coverage for their design-build liabilities.



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### **Contractors Professional Liability Insurance**

Contractors professional liability insurance was introduced in the late 1990s as a specialized coverage to address contractors' vicarious and/or direct liability for design errors or omissions. Contractors professional liability (CPL) insurance can be written on an annual basis to cover all of a contractor's operations, or on a project-specific basis.

Many of the first generation CPL policies were little more than an architects and engineer's errors and omissions policy with a different name, and did not always match up to contractors' coverage needs. For example, most of the original forms covered only contingent liability, and did not cover a contractor's direct liability for professional services. The second generation of forms, most of which bear a post 2000 edition date, are more tailored to contractors' professional liability needs, but they still do not cover all of the incremental design-build exposures. By learning more about this specialized coverage, agents and brokers can help their contractor clients assess their professional liability exposure, and obtain appropriate coverage. This article addresses a few of the key coverage issues contractors should consider in buying professional liability coverage.

#### **Definition of "Professional Services"**

The policy's definition of "professional services" is a key determinant of the scope of coverage. Some forms specifically define the services that are covered, while others allow the insured to participate in defining it. In the former case, the definition may omit certain services provided by many contractors, especially those involved in complicated design-build construction. For example, facility management, program management, providing of construction computer software, and leasing of personnel to others for their expertise are not covered by most standard definitions.

Defining professional services on a case by case basis (by reference to an endorsement, the application or the declarations page) allows each insured contractor to shape the coverage to meet its activities. However, contractors also run the risk of failing to include some activity, which creates an unintended coverage gap. It is imperative that the contractor provide an exhaustive list of all services it performs that could even remotely be considered professional in nature. Some insurers will agree to a broader scope of services than others, depending on their comfort with the contractor's qualifications to provide certain services.

Many policies use a combination of these two methods, including a standard definition of professional services (i.e., architectural, engineering, landscaping, surveying, and sometimes construction management) and extending that definition to also include any other services listed on a policy endorsement.

#### **Direct v. Contingent Liability**

Another important consideration in the definition of covered services is whether the policy covers the insured's own provision of professional services (direct liability), those provided on its behalf (contingent, or vicarious liability), or both. Most of the major markets' forms (including Zurich, AIG, CNA, and ECS) provide coverage for both direct and contingent liability, but contractors should confirm this point before purchasing a professional liability policy. Even where all design work is contracted to others, design-build contractors could be sued directly for damages arising out of a design subcontractor's work (failure to

properly supervise, negligence in hiring an incompetent design professional, etc), therefore they need coverage for both exposures.

### **Joint Venture Coverage**

Joint ventures between contractors and design professionals are a common approach to providing full design-build services with respect to a project, therefore contractors should pay close attention to the scope of coverage a policy provides for joint ventures. Some CPL policies automatically include the named insured's joint ventures as insureds, but most cover only those joint ventures that are specifically listed on the policy. (Where joint venture coverage is provided, it is typically limited to the named insured's liability arising out of its participation in the joint venture. Joint venture partners are not covered for their liability arising out of the project.)

Where joint ventures must be listed on the policy to be covered, contractors should be careful to add such them before any services are performed. Further, due to the claims-made coverage trigger, past joint ventures must be carried over as insureds on renewal policies for coverage to remain in force with respect to these ventures. Some insurance professionals recommend changing "joint ventures" to "co-ventures" to cover a wider array of business relationships in construction projects. However, to avoid exposing their limits to unintended persons or entities, this term should be clearly defined in the policy.

### **Exclusions**

CPL policy exclusions vary widely in number and scope from one form to the next. However, some exclusions present greater coverage concerns than others. Some of the more troublesome exclusions can sometimes be modified or deleted by endorsement. Where they cannot, contractors need to understand the limitations of the coverage and have contingency plans for how these risks will be funded.

### ***Performance guarantees***

Virtually every CPL policy contains an exclusion for "express warranties or guarantees." Consequently, contractors who provide guarantees regarding their work in excess of what is required by law (i.e., the legal standard of care, typically a "negligence" standard) have no coverage for costs associated with the failure to fulfill such promises. Unfortunately, many owners have come to expect these types of guarantees in design-build contracts. In fact, the ability to obtain such guarantees, and transfer the risk of non-performance to the design-builder, is one reason for the growth in this form of construction.

In the soft market of the 1990s, a few insurers would occasionally delete this exclusion, but that possibility seems to have evaporated in the current market. Nevertheless, contractors should request that the exclusion be modified to provide coverage for liability it would have had in the absence of such warranties or guarantees. This prevents the insurer from applying the exclusion when negligence can be established.

### ***Faulty Workmanship***

Most CPL policies exclude damage arising out of faulty workmanship. For the most part, faulty work is considered an uninsurable business risk that contractors must retain. Further, the quality of the work is considered a construction risk, versus a design risk. Nevertheless, some CPL policies preserve coverage

for faulty workmanship that is the result of a negligent act, error or omission in the performance of professional services. That is, the fact that a design error produces faulty work does not eliminate coverage.

### ***Damage to Owned Property Exclusion***

The wording of the exclusion for damage to real and/or personal property can present problems for design-build contractors. The intent of the exclusion is to preclude what is more of a "first party" property coverage from the policy. However, language such as "property occupied by, or in the care, custody or control of the insured," should raise a red flag for design-build contractors. Unlike a typical design professional, design-build contractors often perform work at the construction site. Insurers could attempt to deny coverage for damage to the facility under construction, or other property on site, on the grounds that it was "occupied" by the insured, or in the insured's "care, custody or control."

Most second generation CPL forms have addressed this problem by either removing the exclusion altogether, or removing the phrase "occupied by or in the care, custody or control" of the insured contractor. Alternatively, some policies may merely provide an exception to the exclusion for a "construction site occupied by the insured." Contractors should closely examine these provisions and request the appropriate modifications to clarify that coverage applies in such situations. Insurers should be willing to accommodate this request.

### ***Contractual Liability***

Like their architect and engineers professional liability counterparts, some contractors professional liability policies exclude all contractually-assumed liabilities. While this generally works for design professionals, contractors commonly agree to indemnify owners for damages arising out of their work under the contract, including the providing of professional services. Because A/E policies typically do not cover contractual liabilities, attempts to shift this risk to a design-subconsultant may be unreliable.

Some CPL insurers policies preserve coverage for liability assumed in "insured contracts." The definition of insured contracts varies from one policy to another, but in no instance is it as broad as its CGL counterpart. A sample definition of "insured contract" is provided in Figure 1. Note that, unlike the CGL policy, this definition does not allow for the indemnification of another for that party's sole negligence. However, unless the contractor agrees to a broad form indemnification agreement, this limitation does not represent a big problem.

### Figure 1

INSURED CONTRACT means that part of any contract or agreement under which the NAMED INSURED assumes tort liability of the INSURED's client to pay for compensatory damages to persons other than an INSURED, because of BODILY INJURY or PROPERTY DAMAGE resulting from an act, error, or omission (...). However, INSURED CONTRACT does not include any tortious conduct that otherwise would not be covered under this Policy, nor if the tortious conduct was solely that of the person or persons for whom such liability under the INSURED CONTRACT was assumed. For the purposes of this definition, INSURED shall exclude any employee of the NAMED INSURED, solely while acting in their professional capacity on the behalf of the NAMED INSURED.

Source: *Professional and Pollution Liability Policy - General Contractors*, Form GIC-PPLGCCP (5/01), Greenwich Insurance Company (marketed by ECS Underwriting, Inc.).

Some CPL insurers may be willing to provide expanded contractual liability coverage by endorsement on either a case by case or blanket basis. At a minimum, the exclusion should clarify that it does not apply to liability that would have existed in the absence of a contact. This prevents the insurer from denying coverage for liability based on the insured's negligence on the grounds that the insured had agreed to be responsible for its own negligence.

### Waiver of Subrogation

Unlike most professional liability policies, most CPL policies allow the named insured to waive its rights of recovery (and thus the insurer's right to subrogation) to some extent. A few contain blanket waiver of subrogation provisions that merely prohibit the insured from doing anything after a loss (or claim) to prejudice the insurer's rights of subrogation. By implication (and successfully tested in the courts), this type of provision does allow the insured to waive its right of recovery prior to a loss. More common, however, is a limited waiver of subrogation provision in which the insurer agrees not to pursue its rights of subrogation against specific parties - typically, the named insured's clients and/or subcontractors - if the named insured has agreed to waive such rights prior to loss. (Although the term "client" is not defined in the policy, this would presumably mean anyone with whom the insured contracted to provide covered services.) A sample waiver of subrogation provision is presented in Figure 2. Note that this provision does not allow the insured contractor to waive subrogation rights against a design professional, whether the design professional is a client or a subcontractor without the insurer's written consent.

**Figure 2**  
**Pre-loss Waivers Against Clients or Subcontractors Allowed**

The Company agrees to waive this right of subrogation against a client or subcontractor of the Insured to the extent that the Insured had, prior to a Claim, a written agreement to waive such rights; however, with respect to Coverage A [Professional Liability], no waiver of subrogation may be granted without the written consent of the Company where the client or subcontractor is a design professional.

Source: *Contractor's Professional and Pollution Liability Insurance*, Form # 77355 (12/00), CI1256, American International Specialty Lines Insurance Company.

Although the waiver of subrogation provisions found in CPL policies is broader than those included in most other types of professional liability policies, they are more restrictive than what contractors are used to under other types of policies. Contractors who are unaware of the more restrictive provisions in the professional liability policy may unknowingly execute waivers that jeopardize their professional liability insurance coverage. To avoid forfeiting their rights to coverage, contractors should either attempt to negotiate a waiver of subrogation provision that conforms to the requirements of their contracts or adapt their contracts to conform to the requirements of the policy.

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*NOTE: This article is intended for general discussion of the subject, and should not be mistaken for legal advice. Readers are cautioned to consult appropriate advisors for advice applicable to their individual circumstances.*