

Design Liability: Professional Liability Insurance

By American Global



Design liability will remain an important topic in the construction industry for the foreseeable future, particularly with respect to design-build projects. Our first article in this design liability series, "Design Liability: The Procurement Phase," discussed the relationship between the contractor and the designer on design-build projects and the importance of addressing and agreeing on all key design subcontract issues prior to bidding a project. The second article, "Design Liability: Claims and Recovery," examined in detail claims history on certain design-build projects over the last decade—the types of claims brought by contractors against their designers and the outcome of those claims when such information was available. The focus of this third article is the impact that the design-build projects' risk allocations and claims history have had on the professional liability insurance market.¹

One of the by-products of shifting too many uncontrollable risks to the contractor has been an increase in the number and severity of claims by contractors against design firms and an overall deterioration of the relationship between contractors and designers. We provided many detailed examples of the types and magnitude of such claims in our second article and offered different ideas on how to move forward from the design-build world's troubled past.

One aspect of design-build projects that we have left to explore is that of insurance and, in particular, professional liability insurance. Professional liability insurance is the line of coverage that would be expected to respond when it comes to claims related to design work—or more generally professional services. There are several different types of professional liability insurance for both contractors and designers that will be explained in this article in addition to the current state of the professional liability market and considerations when structuring professional liability coverage for a specific project.

The main professional liability insurance available to contractors is contractors professional liability (CPrL), a third-party liability policy providing the contractor coverage for negligent acts, errors, and omissions arising out of its—or its subcontractors'—performance of professional services. As respects coverage, the marketplace is building consistency as many, if not all markets, are now providing the four basic insuring agreements or coverages under a typical CPrL policy: professional liability, protective indemnity, rectification or mitigation, and, while optional, contractors pollution liability.

¹ Thanks to Jeff Slivka, president—environmental and construction professional at RT Specialty; François Wasselin, senior vice president of American Global; and Caryn Maxfield, senior vice president at American Global, for authoring this article.

There are also some insurers adding a few additional insuring agreements to the policy, such as cyber liability or faulty work coverage.

An overview of each of the three major CPrL policy coverages and optional coverages is provided below.

- Professional liability (PL) (third party) provides protection for liability to others arising out of negligent acts, errors, or omissions in the providing of professional services performed by or on behalf of the named insured.
- Protective indemnity (PI) (first party) provides protection for damages incurred by the insured (e.g., design-builder) that the insured is legally entitled to recover from the designer for errors or omissions committed by the designer. It is an excess coverage, meaning that it pays for the difference between the total damages incurred by the design-builder and the damages paid by the professional liability limits available to the design-builder from the designer. It is important to understand the impact that contractual limitations of liability afforded the designer may have on this coverage part since it only pays for damages the insured "is legally entitled to recover." Thus, if a designer's limit of liability is less than the designer's minimum limits of professional liability as required by the PI coverage, this could impede or possibly void PI coverage altogether.
- Rectification/mitigation (first party) pays for the expenses reasonably incurred during the mitigation or rectification of a negligent act, error, or omission arising from professional services (performed by or on behalf of the insured) that, if not rectified, would likely result in a professional liability claim under the CPrL policy. Unlike protective indemnity coverage, rectification/mitigation coverage is a primary coverage subject to a self-insured retention.

Optional coverage parts that can be added to a CPrL program may include the following, depending on the insurer.

- Contractors pollution liability (CPL) insurance pays for liability arising out of pollution resulting from work performed by or on behalf of the named insured at job-sites and during transportation and disposal. There is an element of first-party coverage also included within emergency response cost coverage for costs incurred to contain or mitigate a pollution event.
- Faulty work provides coverage for the claims arising out of the workmanship of "your work" or in the use of defective materials or products used in "your work." Specifically designed to cover contractors' self-performed work and not the work of subcontractors, the faulty work coverage is triggered when a third-party claim is brought against the contractor by an owner or other third party.
- Cyber liability provides coverage for damages arising out of security breaches when the insured is performing its typical professional or construction services. Unlike a standard cyber policy, this coverage part is tied to the professional services performed by the insured and is not applicable to all operations of the organization. While it is not truly cyber coverage, it does afford some element of liability coverage to the insured.

Structuring the Professional Liability Coverage

Before getting into the details of the options available to structure professional liability coverage on design-build projects, it is important to highlight some of the key issues in accessing professional liability coverage, as it can help in the structuring of these programs. One of the biggest issues with contractors' professional liability claims is the proper and timely reporting of not only known claims but also of incidents or circumstances that could lead to claims. Regardless of the incident, circumstance, error, or claim, contractors should always err on the side of reporting to the insurer if the insurance form allows insureds to report a "circumstance" that may develop into a claim. This can

be tricky as often seemingly innocent clarifications can be the starting point of a trail of exchanges between a contractor and a designer that may eventually result in a claim.

As such, it is important that all managers involved in handling the relationship between contractors and designers be trained on the nature of professional liability coverage and policy triggers. Importantly, if a circumstance develops into an actual claim, the insurer will typically agree that the original date of the notice will become the claim's official notice date.

Securing the proper coverage will be difficult if the owner's professional liability insurance specification is structured inappropriately or not in line with commercial standards, especially on design-build projects. Some owners, especially those new to the design-build procurement method, do not understand the drawback of naming the design-builder as a named insured, in addition to the primary design professional being a named insured, on a project-specific professional liability policy.

On a design-build project, the designer is not under contractual privity with the owner but with the design-builder, and the design-builder is responsible for the design under its contract with the owner. The owner should be attuned to the fact that the design-builder is the entity that needs to be protected by insurance for design error as it is the entity obligated to provide the design services to the owner and responsible for all costs arising out of design errors.

Importantly, professional liability policies typically contain an "insured versus insured" exclusion, meaning any claim between entities insured under the same policy would not trigger the professional liability policy. In other words, the design-builder could not recover for design error under a professional liability policy that names both design-builder and designer as insureds, rendering that policy much less effective for the design-builder. Thus, the owner's insurance requirements should allow the design-builder and its designer to determine between themselves the appropriate levels and structure of the professional liability insurance coverages.

To avoid the insured versus insured limitations discussed above, the contractor and the designer should ideally each obtain separate professional liability coverage. The design firm may evidence certain limits from its corporate ("practice") program and, typically at the design-builder's discretion, may also obtain a project-specific professional liability (PSPL) policy. In addition, the design-builder may choose to obtain a project-specific contractor's protective professional indemnity (CPPI) policy that may be particularly efficient since it typically includes additional coverages such as rectification and protective coverage discussed above. Additionally, the design-builder's CPPI policy not only covers its own exposure but also comes in excess of the designer's professional liability policy(ies), providing additional limits to the project. Alternatively, the design-builder may be able to leverage its professional liability coverage from its practice program. However, be aware that coverage is not necessarily automatic, particularly where the design-builder is a joint venture (JV) (i.e., typically insurers need to approve the addition of a JV to a practice policy).

When thinking about professional liability limits (whether for a designer or for a contractor) for any particular project, the cost of the coverage is not the only element to consider. Beyond the obvious per-claim and aggregate limits, it is the type of policy that will determine whether the professional liability limit provided applies solely to the project currently being considered or whether the limit is shared across many projects and how often the limits may reinstate. Typically, practice program limits apply to all projects: past (but still only after the retroactive date specified in the policy) and present.

This means that professional liability claims paid out on other projects will erode the limits available for your project. However, practice programs are typically written with annual policy limits, meaning that the limit will reinstate with each new year's policy. A project-specific policy, on the other hand, is usually written for one project only, thereby affording its entire limit to that project for the project's entire duration (including the extended reporting period postconstruction). Typically, the aggregate limit will not reinstate but instead applies for the duration of the policy.

One final consideration is pricing, as project-specific professional liability insurance tends to be much more expensive than practice programs for the same coverage limits. In summary, when comparing the same dollar value for a limit, the practice program approach may appear to be providing more limits since the aggregate reinstates annually with each policy renewal; however, it can be eroded by claims on other unrelated projects, so in some cases, it may be preferable to have smaller but dedicated limits for your project despite the additional expense for a PSPL policy.

The type of project and its complexity, risks, and exposures—particularly considering the potential consequences of design error—along with commercial considerations and competitive tension, will help to determine whether practice or project-specific professional liability coverage, or a combination of both, is most appropriate.

Professional Liability Claims Generally

There has been an uptick in both severity and frequency over the past 2–3 years with respect to contractors' professional liability claims. In general, the increase in frequency is seen in the realm of construction management under the design-bid-build and construction manager at risk (CMAR) delivery methods. Errors in construction management refer to contractor errors in managing the overall construction process of the project rather than the delivery method itself. For instance, the marketplace is experiencing increased claims associated with errors in scheduling, sequencing, material cost, and quantity estimating, as well as the overall "mismanagement" of a project. Most of these claims are in the hundreds of thousands rather than millions; however, they have the potential to easily exceed \$1 million.

Claim severity is more often associated with the errors in traditional design and engineering, regardless of the delivery method. From surveying errors to underspecified reinforcing steel to misapplication of products or materials, these typical design claims often rise into the tens of millions.

Market Consequences from Claims Activity

The CPrL market is composed of about 40 insurers or markets, both domestic and international. It has remained somewhat steady overall in offerings and insurer desire to compete for the most common construction-related risks (i.e., commercial general contractors and trade contractors). As with many lines of business, appetite typically separates the marketplace: some insurers prefer small- or middle-market contractors, while others pursue the larger risks or contractors. Additionally, some insurers avoid design-build projects, while others understand the risk and price and cover it appropriately. The same can be said for capacity, with the majority of markets offering \$10 million or less in capacity, whereas a handful of select insurers are willing to offer \$25 million or higher. Oftentimes, the insurer(s) on a contractor's practice program will be the only market interested in writing project-specific professional liability coverage, with a few exceptions.

With respect to CPrL rates, the market is currently experiencing 2–5 percent rate increases year-over-year on practice programs, driven by claims activity primarily under the design-build delivery method and associated with rectification or mitigation coverage. Tightening of the market can readily be seen in residential and heavy civil construction design-build projects, which may carry an even greater increase in rates based on other factors relating to the insured such as loss/claims history, exposure base fluctuations, and operational changes.

Additional notes as to marketplace evolution include the following.

- Overall residential work seeing additional underwriting scrutiny; for-sale residential projects seeing higher rates or being entirely outside many insurers' appetites.

- Rectification claims are at the forefront of insurers' minds as claims under this insuring agreement are increasing. Unlike a typical liability claim, the "payout" of rectification claims occurs much earlier in the process, typically during ongoing construction. Even those newer insurers offering rectification coverage will be required to pay these claims quicker than they may have anticipated, and insurers that do not have the existing claims expertise in handling these first-party rectification claims may not understand the nuances of this coverage and incorrectly treat a claim like a liability claim, which may impede quick recovery under the policy.
- Faulty workmanship coverage remains available from three or four insurers, but an evolving reduced appetite is worth noting. As claims data is compiled, this newer coverage offering sees an unpredictable insurer appetite and, at some point, may not be commercially available.
- Insurers are now seeking more details as to the nature of services provided by design-build contractors (i.e., additional underwriting) regarding the nature and scope of design work, personnel performing such work, and relevant experience level.
- In addition to heightened underwriter scrutiny, professional liability insurance capacity for large projects remains limited and challenging to access, with few markets willing to offer terms, and tremendously high premiums (which are a function of the claims activity seen over the past few years in design-build projects).
- Multiple markets will be introducing new policy forms in 2024 or updating existing forms, so insureds' and insurance professionals' attention to all details in product offerings will only increase in importance.

Reversing the Current Professional Liability Trends

The increased frequency and severity of professional liability claims, both with respect to designer professional liability policies (practice and PSPL) and contractor CPrL and CPPI policies, especially on the large design-build projects over the last decade, has resulted in a continual significant increase in the cost of professional liability insurance over the last several years. Additionally, the number of insurers that are willing to write professional liability insurance continues to dwindle, particularly for PSPL and project-specific CPPI policies. We are at a point where many contractors and designers are considering and sometimes selecting to self-insure increasingly larger levels of exposure (i.e., assuming higher and higher deductibles), sometimes working together to establish significant contingencies that they believe are a better use of capital as opposed to paying premium dollars.

How can we not only stop this trend but reverse it to bring the availability and cost of professional liability insurance back to a reasonable place? Reduce claims. How do we reduce claims? There are many options to explore, but as we mentioned before, a large number of the issues stem from a nonoptimal risk allocation between owners and design-builders. As such, theoretically, utilizing alternative project delivery methods, such as progressive design-build (PDB), may reduce the number of claims made by the contractor against the designer since the contractor's price to the owner is not required until the design is almost complete and the "unknowns" during design development have been revealed.

In our final article in this design liability series, we will explore PDB, other alternative project delivery methods, and other tactics designed to reduce professional liability claims.

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