Why a Project Owner Isn't Made an Additional Insured Under a Design Professional's Errors and Omissions Policy

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Executive Summary

Adding either a project owner or another architect/engineer as an additional insured under a professional liability policy could have such serious adverse consequences to all concerned parties that insurance carriers historically have refused to issue such endorsements.

Design professionals understand that it is contrary to their best interests to name anyone as an additional insured under their professional liability policy. For this reason, they have historically insisted both to their clients and their insurance carriers that additional insured endorsements can not be issued.

Some of the key problems with providing an additional insured endorsement include:

1) It may expand coverage to include claims against the additional insured that are not attributable to the negligent acts, errors and omissions of the named insured.

2) It may create confusion concerning responsibility for the Owner's implied warranty of specifications to the contractor, which is broader than A/E's responsibility to the Owner for negligent design. This could cause defense or asserted coverage for risks that only the owner should bear as part of enhanced owner risks.

3) It may turn routine contractor change order requests into claims against the policy.

4) It confuses the nature of the coverage in that project owners who are not licensed professionals have no legitimate need for professional liability coverage for professional services that they are not legally entitled to perform.

5) If the insured is a subconsultant to a prime A/E that is named as an additional insured, the prime A/E could tender defense of a claim against itself to the carrier

a) if the third party claim includes any allegations (regardless of how minor) against the subconsultant, or

b) if the third party claim does not include allegations against the subconsultant but the prime A/E defends itself against the claim by impleading the subconsultant in to the suit or otherwise alleging negligence on the part of the subconsultant.

6) Defending the additional insured could seriously erode or even exhaust the insured's self insured retention (SIR) if defense is included in an endorsement. But since an insurance company would not agree, in any event, to include defense as part of an additional insured endorsement, the insured would actually be paying all the additional insured's defense costs of the additional insured out of its own pocket without limit..

Only Negligence of the Insured Design Professional is to be Covered

Professional Liability Insurance for design professionals or architects/engineers (AEs) has historically, and almost universally, been unavailable to project owners as "additional insureds." There are good reasons for this, as explained in this memorandum.

If a project owner is named as an additional insured on a design professional's policy it could result in the policy responding to claims that are not within the intent of the underwriter. When underwriting a design professional, the insurance company intends to cover only those claims that arise out of the negligent acts, errors and omissions of the design professional. Not all acts, errors and omissions that cause increased project costs are covered.

Hypothetical: Omissions in Drawings

Consider a situation in which the A/E's drawings fail to show details that affect the contractor's ability to install HVAC duct work. The contractor may have fabricated its duct work off-site, and only when beginning installation at the project learns that there are interferences with structural steel members, plumbing lines and electrical conduits that will prevent the use of some of the duct that has been fabricated. In fact, this may cause a delay to the contractor and additional cost in removing duct work, fabricating new duct work, and installing it in a different configuration, manner and sequence than planned.

The contractor may be entitled to recover under a change order for its reasonable additional costs resulting from the errors in the drawings. This is because the owner has a legal obligation to the contractor known as "implied warranty of specifications." The question is whether these additional costs that must be paid by the project owner to the contractor may be recovered by the owner from the A/E. The answer is: "It depends." Specifically, it depends on whether the omissions and errors by the A/E were negligent or were merely errors that are reasonable errors within the normal standard of care.

Owner has Implied Warranty of Specifications but Architect/Engineer Makes no Warranty

Whereas the A/E makes no guarantee or warranty that its services, designs and specifications will be error free or perfect, the project owner is deemed to have given an implied warranty of specifications to the contractor. This means that regardless of whether or not the specifications or drawings were negligently drafted, the project owner is liable to the contractor for the costs of changes in the event that the contractor cannot carry out its work using those specifications and drawings.

In the hypothetical situation described above, if the project owner were to deny the contractor's change order request, the contractor might file a claim or suit against the owner to recover its damages. The project owner, under common law principles, would not be entitled to recover its costs of that contractor claim from the A/E absent proof that the costs were attributable to the A/E's negligence. In the event that the owner made such an assertion, the A/E's policy would defend the A/E against the claim. The A/E policy would not, however, defend the owner against the contractor claim, nor would it pay any of the owner's legal fees in pursuing a claim against the A/E in the event that the owner brought the A/E into the action a defendant.

Adding the Owner as additional insured may broaden damages covered under the A/E's policy – including routine contractor claims

In the example above, when the contractor sues the owner to recover its additional costs that it alleges were caused by the defective specifications, the owner might tender the defense of the claim to the A/E's insurance carrier. That could effectively give the owner access to the A/E policy to defend against any and all contractor claims since most contractor claims allege at least some minimal element of design defect.

In defending a contractor claim, the A/E's policy would be doing something that it fundamentally was not designed to do. It would be responding to routine contract administration issues and disputes rather than negligence on the part of the A/E for which the A/E would have been liable at common law. A stubborn and litigious owner that fights

with its contractors over change orders could tap into the A/E's policy to help the owner be even more litigious.

Knowing that its defense costs are being paid by the A/E's carrier would be an open invitation to a project owner to play hardball with its contractors, disallowing change orders even when they are reasonable. The project owner could arbitrarily deny a change order and force the contractor to file a claim or suit against the owner. Since the contractor claim would naturally include an allegation that the drawings were defective, the owner would tender the claim to the insurance carrier—saying that the claim is based on negligent design professional services. The A/E and its insurer could find itself defending all kinds of run of the mill change order requests that the owner effectively turns into claims.

Owners' Risk of Design Defect may be Termed "Enhanced Owner Risk" and is Different from that of the A/E

As explained by David Hatem, Esq., in an article first published in the Central Artery/Tunnel Professional Liability Reporter, Vol. 2- No.1 (9/96),

Owners on construction projects typically are exposed to various risks, including the risk of design defects, which are qualitatively and quantitatively different and beyond the risk which generally are assigned to design professionals.

By granting an owner blanket, or qualified additional insured status, the professional liability insurer would be exposing itself to coverage (defense and indemnification) for risks, liabilities and claims which potentially may substantially exceed the coverage traditionally offered to design professionals.

Assuming that the professional liability insurer has the obligation to defend the owner (as additional insured) against such 'enhanced owner risk' claims, the professional liability insurer would potentially be confronted with the frequent need to reserve its rights. This would presumably disappoint the expectation of the owner. It would also potentially deprive the insurer of the right to control the defense and settlement of such claims—depending upon the state law.

In addition, 'enhanced owner risk' claims will expose the design professional's insurance coverage (typically written on an aggregate basis) to significantly greater risk exposure and payment of claims expenses. This will generally serve to diminish coverage limits.

Moreover, a blanket grant of additional insured status to the owner may indirectly result in an expansion of the design professional's contractually negotiated indemnification obligation. This could result from the deductible, SIR payment, or insurance payment of the design professional being exposed to substantially more risk than intended under the negligence-based indemnification obligation.

Additional Claim Scenarios Where Claim is Against Owner but an Allegation of Professional Negligence is Thrown in for Good Measure

In addition to a variation of the change order claim scenario described above, Mr. Hatem presents five other hypothetical claim scenarios for the purpose of demonstrating the types of claims for which an owner named as an additional insured under the design professional liability policy might seek coverage.

In each of the claim scenarios, a claim arises against the owner by either a third party or a construction contractor. Each claim includes multiple allegations or theories of recovery, including design professional negligence. The negligence allegation may be completely unfounded and unsubstantiated. It may be included in the complaint as part of the "kitchen sink" approach so common today. Examples of claim scenarios include the following:

1. An adjacent property owner sues the project owner for property damage and consequential damages due to negligent construction operations, including alleged 'design errors and omissions' of the owner's design professional.

2. A contractor sues a project owner for its failure to make timely decisions in response to the design professional's recommendations and for arbitrarily rejecting contractor claims that the A/E recommended for approval. In the alternative, the contractor alleges owner liability for contract documents containing 'errors and omissions.'

3. A family of an employee who was killed while working for a general contractor on a construction site sues the project owner. The allegations are that the owner severely limited site access, failed to coordinate the activities of multiple contractors on the site, and issued defective contract documents which failed to sequence construction activities.

4. A contractor sues a project owner for delay damages caused by severe weather conditions, lack of owner-furnished permits, untimely owner payment, owner failure to timely issue a notice to proceed with construction, and unanticipated environmental conditions. One final allegation is that the drawings contained 'errors or omissions.'

5. Contractor sues the project owner due to differing site conditions. Contractor asserts that the owner had superior knowledge of the conditions that he did not disclose to anyone. He also asserts, as an alternative cause of action, that the contract documents were 'defective' because they did not disclose the conditions. (In this scenarios, the design professional believes the contractor has a legitimate differing site condition claim that should be paid by the owner.) [1]

In each of the claim scenarios above, the claims are brought solely against the owner, but the allegations upon which the claims are based include a combination of assertions.

Primarily, the allegations argue owner fault. But they also make assertions concerning the design professional's performance.

By virtue of the owner being named as an additional insured, the owner would likely tender to the professional liability carrier every one of these claim scenarios. The Owner would argue that the claim arose out of professional services because each scenario contains an allegation concerning the professional services. As a result, the professional liability carrier could find itself defending the owner for differing site conditions claims, site safety claims, etc. – none of which the underwriter could have anticipated when issuing the policy.

Adverse Consequence of Additional Insured Status Where Project Owner is Additional Insured

Before responding to the claims presented in these scenarios the insurer would first carefully consider the allegations to determine if there is genuine potential that the claim arises out of negligent performance of the insured design professional. If the insurer deems that the allegations do not suffice to prove negligence against the A/E but instead are based on actions of the project owner or others, it would either reject coverage outright or proceed with a reservation of rights.

Moreover, it is almost impossible to imagine an insurer granting an owner a "duty to defend" as part of any additional insured status. Consequently, the owner would obtain no defense of any of the claim scenarios. Since the coverage of the policy is intended to be triggered only by the negligent performance of professional services, the insurer may likely also refuse to settle or resolve any dispute until a court had first issued a judgment against the design professional.

The insurance company should be quite concerned if the project owner, or an insurance broker, take issue with the established principle that the E & O policy is intended only to respond to the A/E's negligence rather than to claims arising out of the Owners acts, errors and omissions.

A project owner should be made aware that if it were to be named as an additional insured under the policy, the "insured versus insured" exclusion would then be applicable to bar coverage for claims by the project owner against the named insured design consultant — quite the opposite of the intent desired by the owner.

Project owners are not performing professional services

The project owner does not have an interest in obtaining professional liability for its own actions since the owner is not a design professional. The owner will have no license to perform professional services and it must not perform professional services. For this

reason, therefore, there can be no purpose for a project owner to be named as an additional insured for liability arising out of its own actions since by definition its own actions cannot include professional services.

Design professionals have good reason not to want the project owner named as an additional insured. Naming the owner complicates and strains the relationships between the parties. It may encourage claims against the owner by contractors and others to inappropriately include unfounded allegations of professional negligence.

In potentially having to defend the owner against claims that arise because of owner acts, errors and omissions, the insurance available to the A/E could be severely eroded or even exhausted. There may be insufficient insurance remaining to cover legitimate claims against the A/E. There is also the problem for the A/E that its future ability to obtain insurance will be impaired and/or that its insurance premiums will be significantly increased.

For all the reasons discussed above, design professionals, insurers and brokers should explain to project owners that additional insured status is not necessary and appropriate to protect the legitimate interests of the owner. It also is harmful to the design professional and may have unintended consequences for all concerned.

Where another Design Professional is the Additional Insured

The Harm to the Insured. Additional problems are created if the insured design professional is providing services under a subcontract to a prime architect or engineer and that other firm requests that it be named as an additional insured.

Where the prime architect is performing professional services for the project in addition to the services being provided by the subconsultant, it is possible that a suit by a third party alleging professional liability will name both the prime architect as well as the insured subconsultant. This could also happen even if the only professional services allegedly performed by the prime A/E involve negligent selection and supervision of the subconsultant.

Defending a complex claim against the prime A/E could be extremely costly to the insured. [2] Since an additional insured endorsement would not cover defense costs, the insured would be paying out of its own pocket all the defense costs of additional insured, prime A/E. The subconsultant would be paying the A/E's legal defense costs as they are incurred rather than reimbursing them after a final determination of liability. If, however, the additional insured endorsement covered defense costs, the insured would still be gravely injured because the defending the A/E would erode or exhaust its self insured retention (SIR). For an insured that has a large SIR for each and every claim (with no aggregate SIR), this could be especially devastating.

The Harm to the Insurance Company. In virtually every claim against a prime A/E, the claim will also name the subconsultant or will include allegations concerning services performed by the subconsultant. Even if the complaint does contain allegations concerning the subconsultant, however, the prime A/E who is an additional insured will most certainly bring its own action (impleader claim) against the subconsultant so that the subconsultant becomes a co-defendant and the prime A/E reaps the benefit of coverage under the additional insured endorsement.

The insurance carrier had no opportunity to underwrite the prime A/E. It may have even been willing to provide coverage to that A/E if it had an application from that firm showing its claim history, project history, financial information, and other information needed for underwriting.

Basically, the prime A/E would be obtaining professional liability coverage for its own actions as well as those of the subconsultant, without having to go through the underwriting process and without having to pay premium for the coverage.

In addition to other problems, this could create a moral hazard in that the prime A/E would have an incentive to be creative in responding to claims so that it could shove claims under the named insured's policy and thereby avoid having to have its own carrier pay the claim. In future insurance applications, the A/E might even reap lower premiums from its own carrier for having successfully shifted the claim to the subconsultant's carrier.

For these reasons, it is not advisable for professional liability carriers to issue additional insured endorsements for the prime architects and engineers for whom their insured's serve as subconsultants.

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[1] The article written by David Hatem, Esq., for Central Artery/Tunnel Professional Liability Reporter, Vol. 2- No.1 (9/96) is as relevant today as it was when first published. He is with the law firm of Donovan Hatem, LLP in Boston. (617-406-4800).

[2] It must be noted, however, that even if a professional liability insurer, in some rare circumstance, for significantly increased premium, issued an additional insured endorsement, the endorsement would at a minimum (a) exclude any duty to defend the additional insured, and (b) expressly state that it provided indemnity to the additional insured only to the extent of liability directly attributable to the named insured's negligent acts, errors and omissions as finally determined by a court of competent jurisdiction, and only after any appeals of a final determination have been exhausted. If the contract provided for arbitration, or any form of alternative dispute resolution in place of litigation, there would be no circumstances under which I would advise issuing an additional insured endorsement since the dispute determination would not adequately issue a fact finding and legal opinion establishing the factual and legal basis for determining the insured's negligence and assessing damages directly attributable to that negligence.

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