



Expert Commentary

## Project-Specific Professional Liability: Who Really Pays for Design Errors?

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An important issue that needs to be addressed at the beginning of any construction project is the professional liability arising out of project design and construction management services. There are many examples of losses arising out of professional services, including costly delays, bodily injury, sick building syndrome, and environmental losses. Design firms do carry professional liability insurance, but it has significant limitations from the owner's perspective, including the following:



- Owners share the design firm's professional policy limit with many other firms. Professional liability policies have a single aggregate policy limit that applies to all liabilities and defense costs arising from current and past work of the insured. If there is a claim, the owner has to hope it is near the front of the line to be sure of adequate protection.
- Protection is here today and gone tomorrow. Many professional liability claims arise well after project completion. An owner has to depend on a design firm to stay in business and continuously renew its insurance in order to have a policy against which to claim in the future.
- Owner cannot be added as an additional insured. Most professional liability underwriters for design firms will not name the owner as an additional insured. If the owner is sued for a professional loss caused by the design firm, the indemnification clause in the owner/design firm contract may provide protection but the

professional policy will not defend the owner.

- Low limits. Most design firms are small and carry professional liability limits of \$1 million or less.
- Limitation of liability. Many design firms will not work without a limitation of liability equal to their fees and a waiver of consequential damages.

When facing the limitations of design firm professional liability insurance combined with typical contractual allocation of professional risk, an owner has two choices.

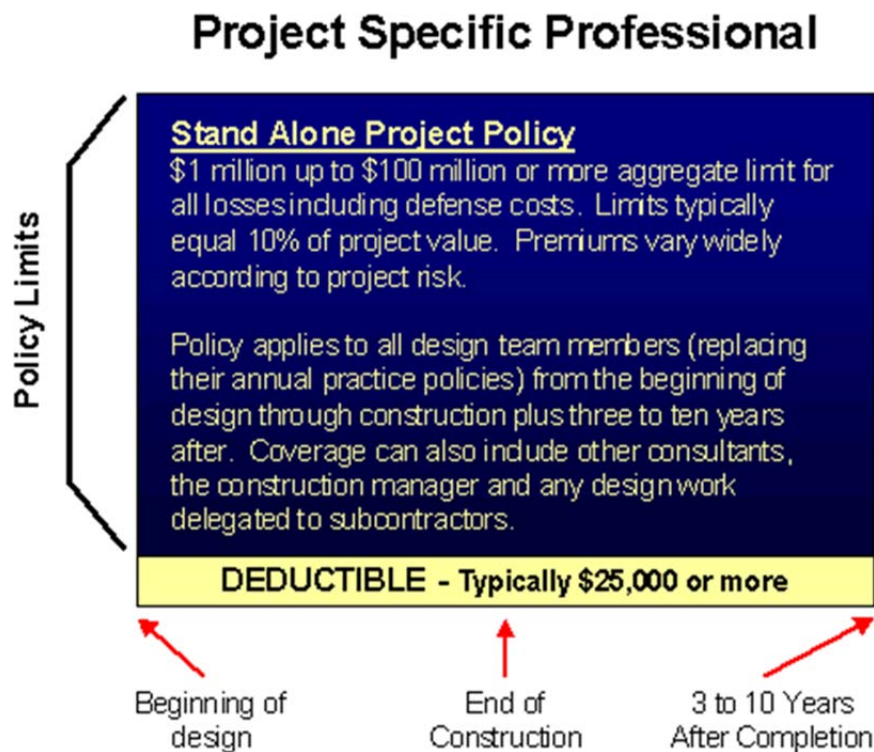
Assume the professional risk that exceeds available insurance or existing contract terms. Purchase a professional policy dedicated to the owner's project.

In most cases, owners decide to assume the professional risk that exceeds the design firm's insurance or contract terms. For projects with a higher degree of risk, however, many owners are deciding to purchase project specific coverage.

## Program Design and Coverage

There are two options for structuring project specific professional liability policies: stand-alone project-specific policy and the owner's protective policy, which is described later in this article.

## Stand-Alone Project-Specific Professional Liability Policies



Project-specific professional liability policies are negotiated as dedicated limits over a deductible and the policy term is from the beginning of design, through construction plus 3 to 10 years afterward. The project policy automatically replaces the practice policy of each design team member because the professional policy purchased by almost every design firm excludes all projects insured by a project policy. A project policy may be procured by either the owner or the lead design firm, although the premium is normally paid entirely by the owner. A project policy may be placed by itself or in combination with a general liability and workers compensation wrap-up.

Coverage can be placed up until the start of construction. Almost every underwriter will backdate coverage to the beginning of design. Of course for a design-build project, coverage should start at the beginning of the design firm/contractor relationship-normally the bid preparation phase.

The advantages of a project specific professional liability policy include the following.

- Noncancelable coverage, premium, and limits are dedicated to the project
- Single source of responsibility for claims
- The ability to sponsor a projectwide professional liability risk management program
- Coverage for all professional consultants including design work delegated to contractors
- Owner can be named as an additional insured

Of course no approach is without its disadvantages. Some concerns include the cost (combined with limited or no premium credits available from the design firms' professional liability underwriters) and concerns by design firms about the quality of the project policy coverage and deductible size.

Also, owners need to understand that a project policy is being purchased for the design team. Sometime owners are surprised when years later a claim occurs and the project policy underwriter assists, sometimes aggressively, the design team with its defense.

## Owner's Protective Approach

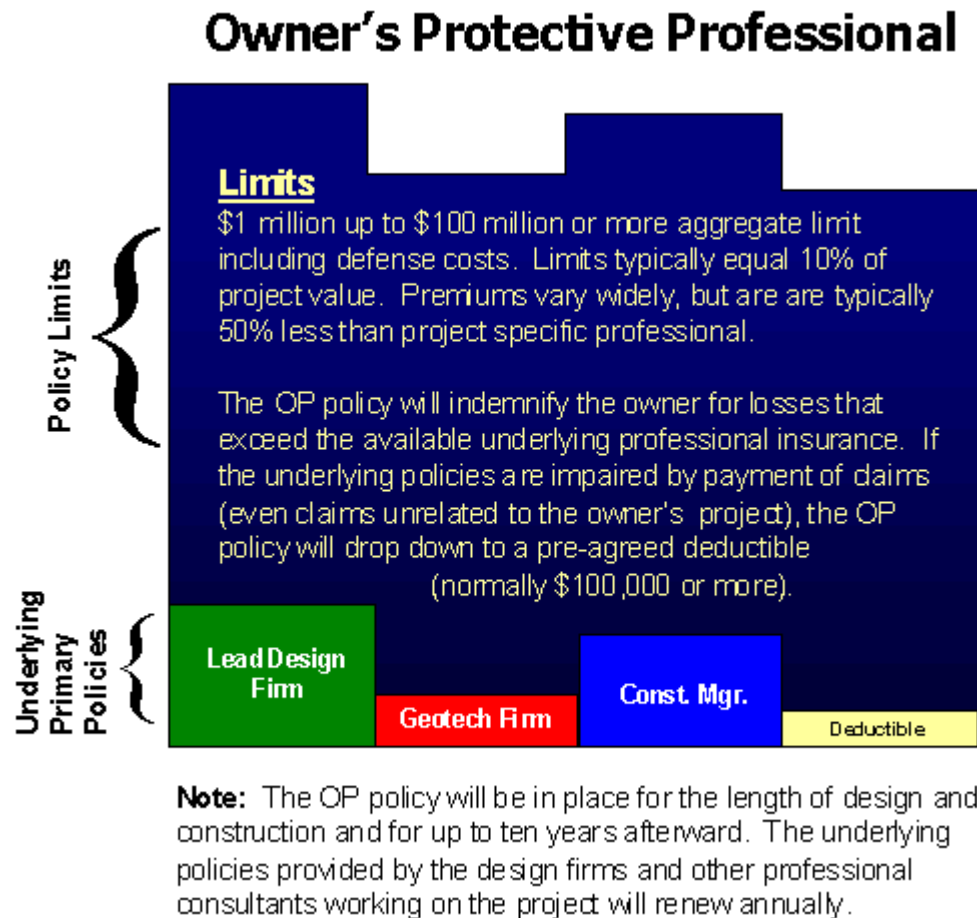
When an owner considers a project specific policy, the following question is frequently asked.

***Can a project specific policy be designed to provide excess coverage over the insurance maintained by the design firms working on the project?***

It seems such an approach has the potential to be simpler and cheaper, but the excess approach doesn't work well. Almost every design firm in the United States has an exclusion in its annual professional liability policy similar to the following wording.

***If you, the insured, work on a project where there is a project specific policy, then any claims arising from such project will be excluded by this policy. This exclusion will apply regardless of whether you are able to collect from the project-specific policy for any reason (i.e., even if the project policy applies on an excess basis).***

In theory, an owner could ask every member of the design team to amend its annual policy to state that the project policy exclusion will not apply to the owner's project. The problem with this approach is that to be assured of continuing protection after project completion, the owner would have to get evidence of the proper endorsement from every design firm that worked on the project every year for the next 5 to 10 years. This may prove to be quite an administrative burden.



In addition, project-specific professional liability underwriters have proven to be reluctant to consider the excess approach and typically offer a limited credit for providing excess versus primary coverage.

However, there is a way around this problem known as the owners protective (OP) policy. Unlike a project-specific policy, which covers the design team with dedicated limits, the OP policy directly covers the owner (and not the design team) and therefore does not trigger the onerous project specific exclusions (described above) in every design firms' professional liability policy. The OP program works as follows.

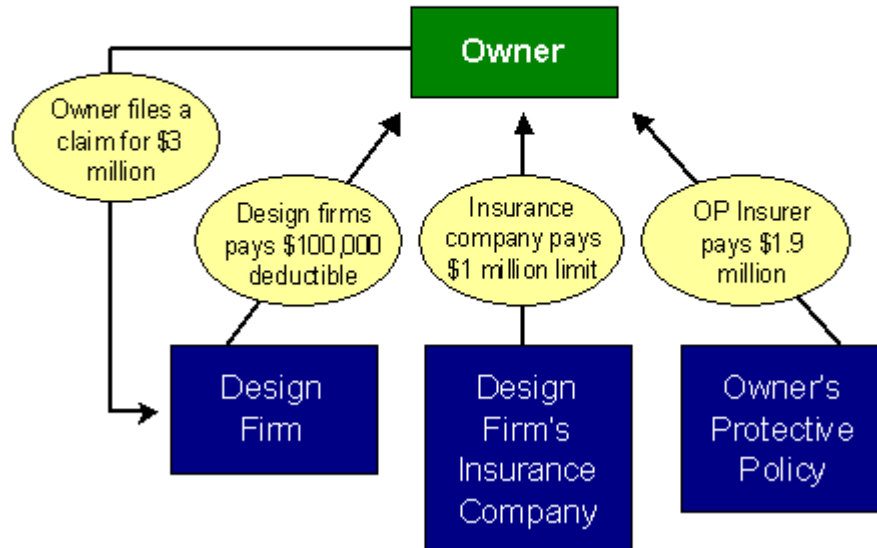
- Coverage is provided to the owner for claims in excess of the design firms' annual primary professional liability policies up to the amount of the limit provided by the OP policy.
- Coverage applies on a first-party basis. To collect on a claim, the owner needs to prove to the underwriter that a design firm working on the project committed a "negligent" act, error, or omission resulting in a loss and that the amount of the loss exceeds any available professional insurance. Frequently, this is proven by the payment of a claim by a primary underwriter.
- If the insurance of a design firm working on the owner's project is exhausted by payment of a claim—even a claim unrelated to the owner's project—the OP policy will drop down to a preagreed amount.

- If the owner is sued directly for the actions of the design firms, the owner can be covered-giving the equivalent of additional insured protection.

### Illustration of How a Claim is Paid by an Owner's Protective Policy

Example: \$3 Million Professional Liability Loss

Design Firm Has Only \$1 Million Limit



The advantages of an OP policy are as follows.

- The design team does not have a reason to know or care that coverage is in place. Coverage and claim payments are direct between the owner and the insurance company. This eliminates meetings with the design team to explain a project policy.
- The cost should be approximately 50 percent less than a standard project-specific professional policy. However, this does not always apply. There are still more underwriters for the "stand alone" approach, and the additional competition sometimes makes the cost difference minimal.

While the owners protective approach has a number of advantages, there are some disadvantages.

- With a standard project-specific policy, the owner has the benefit of one source of recovery regardless of the number of members of the design team involved in a claim. With the OP approach, this is not the case. If a claim involving several firms occurs, the owner will have to settle with several insurers to be able to determine the size of the OP claim.
- While coverage is provided on a first-party basis, the trigger for an owner's claim is the design firm's liability to the owner. This can create a significant problem in the event the design firm's contract with the owner has a limitation of liability and/or waiver of consequential damages clause. For example, if a design firm causes a
- \$20 million loss but its liability is limited to \$1 million, then the OP underwriter will only pay \$1 million. This problem should be fixed by endorsement.
- There is little experience with claims in the OP coverage format. Some underwriters are concerned that a primary coverage dispute could cause a problem in settling a claim under the OP policy.

# Program Design Should Match Project Needs

Regardless of the option chosen, the program design needs to be tailored to meet the needs of everyone involved in the project. There are many important details that cannot be addressed here. Public projects have different needs than private ones. Stadiums generate different risks than offices. And project delivery methods-design-build versus design-bid-build-should impact program design as well. Understanding these differences and designing an effective program that works requires an insurance broker with the proper experience to place project-specific and/or owners protective programs and effective cooperation and communication between all parties involved in the project.

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