



Construction Industry Update

MSP Construction Update 09/2004: "Contractors Professional Liability Insurance"

September 2004

Contractors Professional Liability Insurance

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No one questions the fact that design-build contractors have a significant professional liability exposure. They are directly responsible to the owner for the design of a project, and whether they do this in house or sub it out, they remain responsible.

Over the years, however, the line of distinction between "*means and methods of construction*" and "*professional services*" has blurred. In addition, even when general contractors are not working under a design build project delivery method, they may actually sub out design to certain subcontractors (mechanical, electrical, etc.) Furthermore, standard construction contracts have changed how they allocate design responsibilities and risk. As a result many "ordinary" contractors may have a professional liability exposure.

To understand why you need professional liability insurance, you really need to understand what your commercial general liability policy does not cover. The basic commercial general liability policy, published by the insurance services office (CG0001) does not contain a professional liability exclusion, although most insurance companies do add an exclusion by endorsement.

Even if a professional liability exclusion is not added, a commercial general liability insurance policy responds only to liability arising out of either bodily injury or tangible property damage; economic damages are not covered. Unfortunately, more than 50% of the claims against design profes-

sionals are for economic damages. If a claim were made for economic damages, there would be no coverage under a commercial general liability policy, even if there were no professional liability exclusion.

Since nearly all, if not all, insurance companies providing coverage for construction contractors will specifically exclude liability arising out of the professional services typically performed by architects and engineers, this creates the need for a contractors professional liability policy.

"But I sub out the design," you might say, "and my design professional carries professional liability insurance and has agreed to indemnify me for any liability arising out of his negligent acts, errors or omissions. Why do I need professional liability?"

(Continued on page 2)

Published by

Cavignac & Associates
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(Continued from page 1)

Here are a few of the numerous reasons:

1. Hold harmless provisions can be declared unenforceable.
2. The design firm may be out of business and/or may have dropped its professional liability insurance when the claim is made. (Professional liability insurance policies are written on a claims-made basis, and coverage must be in force at the time a claim is made to trigger coverage.)
3. The design professional's insurance policy only extends to contractual assumptions of liability that the design professional would have had in the absence of a contract. In laymen's terms, this means the design professional can only indemnify you for his/her negligent acts errors or omissions, and cannot assume your concurrent tort liability.
4. The design professional's policy limits may be inadequate or may have been exhausted by other claims.

In addition, some contractors have direct professional liability exposures. They may have in-house design professionals, or they may provide construction management advisory type services that are consultative in nature (as opposed to construction related).

To address a contractor's direct professional liability exposure, the insurance industry developed contractors professional liability policies. This coverage is offered by several different insurance companies, and typically provides direct and contingent liability coverage. Any contractor that has either a direct or indirect exposure should evaluate this type of policy.

What Does Contractors Professional Liability (CPL) Insurance Cover?

To be brief, a CPL policy provides coverage for claims alleging an act, error or omission arising out of the performance of professional services. The key here is defining "*professional services*," and this can be done in two ways. One is to include a standard list of covered activities in the policy, and the second is to tailor the definition for each insured contractor, based on the types of services

they actually provide. Whichever approach is taken, it is critical that the definition of professional services encompass all the services that the contractor might provide.

Claims-Made Form

As previously mentioned, most if not all professional liability policies for contractors are written on a claims-made basis. This means that in order for coverage to apply, the policy must be in force when the claim is made. In other words, if you decide to carry contractors professional liability insurance, it should be a long-term decision.

Recognize as well that every policy has a retroactive date. The retroactive date is usually the inception date of the first professional liability policy. Any claims arising out of work done prior to the retroactive date are specifically excluded.

What Constitutes a Claim?

A claim is generally defined as "*a demand for money or services*." In other words, if someone claims that you did something wrong and demands that you either pay them money or perform additional services, this would be considered a claim.

There may also be *circumstances*, which you are aware of which might give rise to a claim, but has not been the subject of a demand. A well-written contractors professional liability policy will allow you to report this under the policy, and the insurer will recognize it as a claim if there is a subsequent demand made for money or services.

Extended Reporting Periods

Sometimes, when the decision is made to discontinue a professional liability policy, you will have the option of purchasing an Extended Reporting Period (ERP) endorsement. This extends the period of time within which a claim can be made for services arising prior to the date that the endorsement was purchased (this is commonly done at retirement).

Recognize that extended reporting period endorsements tend to be expensive due to what is known as "*adverse selection*." Those who think they need it tend to buy it, and hence the claims experience for this is not good.

(Continued on page 3)

(Continued from page 2)

What Isn't Covered Under a CPL Policy?

Contractors professional liability policies are all manuscripted policy forms created by the insurance companies providing the coverage. Before selecting a specific policy, the coverage form should be reviewed by your insurance broker (assuming he is a specialist in this area and is capable of providing such an analysis for you).

Like most open peril or “all risk” types of insurance policies, everything is generally covered except what is specifically excluded. Some common exclusions are listed in the side bar that accompanies this article. Some exclusions are more critical than others, and these should be specifically addressed.

Express Warrantees Are Guarantees

The law does not require design professionals to be perfect. It merely requires them to perform to a standard of care, typically defined as *“that degree of care and skill ordinarily exercised by members of the same profession currently practicing under similar circumstances.”*

Most design professionals avoid agreeing to express warranties or guarantees. Contractors, however, commonly provide express performance warranties to project owners that exceed a design professional’s “standard of care,” and this becomes a problem.

If the contractor agrees to warrant not only its construction services but also its design services, it has agreed to a standard of care that is not covered by its professional liability policy. Candidly, this is one of the most significant benefits to an owner of the design-build delivery process. It transfers this gap (alternatively known as the “liability gap” or the “Spearin Gap”) from the owner to the contractor. With this in mind, the contractor needs to avoid, if at all possible, guaranteeing or warranting the design aspects of the work.

Contractual Liability

Contractors have become accustomed to agreeing to sign intermediate form indemnification agreements. Such an agreement requires the con-

Common CPL Exclusions

- Express warranties or guarantees
- Assistance provided with respect to project financing
- Obligation to obtain insurance or bonds
- Product manufactured or supplied by the insured
- Auto, aircraft, watercraft or mobile equipment
- Employers liability
- Workers compensation claims
- Employment-related practices
- Nuclear energy liability
- Insured versus insured claims
- Claims brought by a related entity
- Claims based on events the insured knew about prior to policy inception
- Claims that have been reported under prior policies
- Failure to perform professional services on time
- Failure to complete a project on time
- Bankruptcy or insolvency of the named entity
- Pollution
- Specification, use, or removal of materials containing asbestos
- Losses to which project-specific insurance applies
- Return or reduction of professional fees
- Punitive damages
- Personal injury
- Cost estimates exceeded
- Fiduciary liability/securities violations
- War (and other hostile acts)
- Deliberate noncompliance with a statute or regulation
- Bodily injury or property damage resulting from means and methods of construction

(Continued on page 4)

(Continued from page 3)

tractor to hold harmless and indemnify the owner not only from the contractors negligence but also the concurrent or joint negligence of the owner. This is legal in most states and is usually covered by the contractors general liability policy. This is because the general liability policy typically provides broad form contractual liability, which allows the contractor to assume the tort liability of a third party.

Unfortunately, professional liability policies provide narrow contractual coverage. It only extends to such liability that would have attached by law in the absence of such agreement because of a negligent act, error or omission of the design professional. Because of this, it is imperative that you carefully review the indemnity agreements you are asked to sign to make certain that you are not assuming uninsurable obligations from a design standpoint.

Pollution Liability

Most commercial general liability policies specifically exclude pollution, and usually mold as well. Most contractors professional liability policies are written without a pollution exclusion. Note, however, that this does not close the gap created by the exclusion in the general liability policy. It merely extends pollution coverage to damages arising out of professional services.

In order to correctly close the gap in the general liability policy, you would need to buy a separate contractors pollution liability policy. (These are occasionally written in conjunction with a contractors professional policy.)

Means and Methods of Construction

For obvious reasons, the professional liability policy usually contains a "means and methods of construction" exclusion. The purpose of this is to avoid overlap with the commercial general liability policy.

What Does It Cost?

In order to determine the premium for a contractors professional liability policy, a rather exhaustive application is required. In addition to the application itself, a number of other supplements are usually requested. The premium is based on

what the underwriter perceives the risk exposure to be.

Because the nature of professional services differs so greatly between contractors, one is hard pressed to provide a ballpark figure of cost. Typically, however, it is a fraction of what the commercial general liability policy costs.

Conclusion

If you feel you may have a contractors professional liability exposure, it is recommended that you discuss your exposure with an knowledgeable broker and also submit an application to obtain quotations. This will not only require you to evaluate your firm's exposure, but it will give you the input of a third party expert (the underwriter) as well as an idea of what it would cost to transfer this risk to an underwriter. Even if the decision is made not to purchase contractors professional liability insurance, you will be aware of your exposures so that you can actively manage them. ✎

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