PROFESSIONAL LIABILITY UPDATE

A Loss Prevention Newsletter for the Design Profession

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Risk Considerations for Design-Build Projects

Design-build is quickly becoming the project delivery method of choice for owners who seek a single point of responsibility for directing the design and construction of their new project. For design firms new to the design-build delivery method, an awareness of the unique financial and liability risks associated with design-build can help avoid unpleasant, even devastating, surprises.

When it comes to design-build, some types of projects are riskier than others. Projects that are repetitive in nature – such as fast food restaurants, chain stores and tract housing – are often good low-risk candidates. And, at the other end of the spectrum, highly complex projects – like thermal energy storage systems or wastewater treatment plants, in which the project owner relies heavily on guidance from specialized design professionals – can also be successful design-build projects. Conversely, one-of-a-kind projects that are dependent on an owner's unique needs or tastes – where changes during design or construction are likely – are ***not*** good candidates for design-build, given the "fixed price" aspect of most such projects.

Financial Risks

Design professionals face differing financial risks and liabilities depending on the role they play in the design-build project. The greatest risks occur when the design firm takes the lead as the prime design-builder.

Serving as the prime in a design-build project typically means taking an equity participation in its completion as opposed to collecting payment of a fee. Thus, the construction risks normally borne by the owner and contractor fall on the design professional as well. Aside from retaining liability for the traditional design errors, the prime design profes-

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sional can now be held responsible for specification errors, material failures, construction errors and delays – and the potentially severe financial losses – that result.

Other unique financial risks can occur when serving as prime on a design-build project. Owners often ask the design-builder to submit designs that are up to 30% or 35% complete before committing to building the project. This can lead to significant financial expense and limited recourse if the project is not built.

In one Florida case, a design professional entered into a design-build agreement and prepared preliminary designs for the owner. The project was subsequently cancelled and the design firm was not paid for the substantial design work. The design professional filed a lien, which the owner challenged in court.

The Florida Court of Appeals noted that the Florida lien statute applied only to architects and engineers, and that the design firm, as the lead in a design-build project, was acting as a construction contractor. Thus, the lien was denied.

Another significant financial risk emerges from the early establishment of contract price. With a design-build project, the full contract price is typically established at the beginning stages of design. This presents the potential for additional design and construction costs arising after the fixed contract price has been established. It can also lead to cutting corners in construction, creating defects that become apparent several years later when, often, only the design professional is an available target of a lawsuit.

Even the wording of a design-build contract can pose financial risks. For example, problems arise when the lead design-builder contracts to "perform" services for which it is not licensed. In one case, a contractor accepted the lead in a design-build project, agreeing to "perform design and construction services." After problems arose on the project, the owner sued the contractor to rescind the agreement on the basis of its illegality. The court held for the owner declaring that the contract was void since it called for the practice of engineering and the contractor did not hold an engineering license. As a result, the design professionals and subcontractors who had worked on the project were left without recourse; they had agreed to a Pay-When-Paid contract clause from the prime contractor.

Liability Risks

When acting as the prime design-builder or participating in a joint venture, design firms become responsible for all aspects of a design-build project. Concurrently, liability expands from professional liability to strict liability. This difference is profound.

Under **professional liability**, design professionals are negligent only when it can be shown that they have breached the standard of care. That is, negligence occurs when the design professional fails to exercise the degree of care ordinarily exercised by peers performing the same type of work and, as a consequence, someone experiences injury or damage.

When **strict liability** applies, it is not necessary to show that an individual or entity is negligent. Rather, one merely has to show that a service warranty or guarantee was breached, or that the product involved – in this case, a structure – did not perform as it was supposed to.

Generally, an architect or engineer serving as a subconsultant faces considerably less risk than the design-builder directly responsible to the owner. This situation can change, however, when the subconsultant manages or simply observes construction. That observation might be considered construction supervision under the design-build umbrella. In that case, the architect or engineer could be liable for both work quality and workplace injuries.

In one court case, an architect in a design-build project was charged with liabilities for injuries to two workers. The architect had agreed to serve as construction manager on a limited basis and to develop and implement a project safety plan. For protection, the architect excluded responsibility for the means of construction or control over other parties'

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workers through exculpatory clauses in the design contract.

The court held that the exculpatory clauses would have relieved the architect from responsibility for site safety under traditional project circumstances. However, in design-build projects, where the contract conflicts with those clauses, the more restrictive interpretation applies.

Another inherent problem arises when the design professional acts as a subcontractor to the construction contractor. Under the traditional method, if the construction contractor is not following design specifications, the design professional reports the situation to the owner. In design-build, the construction contractor is the client and, consequently, there is no recourse to the owner to report construction problems. As a result, these problems are far more likely to go uncorrected and materialize later, often years after construction is complete. Whether or not the contractor is still in business, the design professional is likely to be named as one of the parties to a claim.

Another potential problem is that existing insurance may not cover the added exposures. As noted, when acting as prime contractor, the design professional assumes liabilities for construction defects and workplace safety. Professional liability insurance does not cover these exposures.

As such, the design professional will need additional coverage, and it may be essential that multiple insurance policies dovetail with one another to avoid gaps. Likewise, the policies of other project participants must dovetail to help assure that all insurable exposures are covered. A qualified insurance agent or broker can provide invaluable assistance in this respect.

Bonding requirements are also typically associated with design-build projects. Design firms are often surprised when surety bonds and the personal indemnity or guarantee a surety bond company demands are requirements of taking the lead on a design-build project.

Limiting the Risks

Despite the pitfalls, certain corporate, contracting and insurance options are available to the design professional in order to limit some of these risks.

1. Corporate Structure

Whether acting as the prime or subcontractor, in order to guard against liability claims resulting from increased risks, design firms can establish new corporate legal entities – separate from their normal business structures – for each design-build project. These new entities would then become the legally responsible parties for the projects.

While this does not insulate design professionals from liability for their individual professional acts, it does protect assets used only for traditional design projects from claims on subcontracts, equipment rental and other project-specific agreements. The design professional should also consider these added risks when determining profit margins and contract prices.

2. Contractual Considerations

Because of the increased potential liabilities, the contracts between the design professional, owner, contractor and other parties gain extra importance. Careful attention should be paid to each party's work scope, indemnification clauses, limitation of liability provisions, construction observation requirements, and dispute resolution methods. The Design-Build Institute of America (www.dbia.org) in Washington, D.C. has done substantial work in drafting appropriate design-build contract documents.

Begin contract negotiations by making sure the agreement under which you operate is legal. Take steps to avoid licensing problems with state regulatory agencies or the courts. For example, where appropriate, include provisions which state that the responsible party will "engage licensed professionals" rather than "perform services."

To maximize the benefits of design-build, it is essential that each party's responsibilities and obligations be clearly defined under the contract. This not only will avoid misunderstandings as to who is

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responsible for what; it can also prevent duplication of efforts for which there is no compensation. Likewise, a "teaming agreement" is helpful in making sure that all parties to the project work together to ensure project success and minimize potential disputes.

Close attention to the work scope is essential to help obtain indemnification from other project participants for claims arising from their errors or negligence. Under the traditional system, obtaining indemnification from parties other than the client is extremely difficult because the design professional and the contractor have no contractual relationship. However, in design-build, there is typically a contractual relationship with the contractor, subcontractors and suppliers. These relationships are conducive to including indemnification clauses as a condition of service.

If work stops due to conflicts, it is the prime professional who suffers most. For this reason, a method for clarifying questions and resolving disputes becomes more important than ever. Rather than relying on litigation or traditional arbitration, specify use of mediation or some other dispute resolution technique.

Finally, firms involved in design-build should consider project insurance for liability coverage. Project insurance can cover all design firms on a specified project only, preventing attachment or depletion by claims from other projects. This can help allay the fears of the owner that insufficient coverage will be available in the event of a claim, and help get the claim resolved quickly without a lot of finger-pointing. In addition, since the premium can be attributed directly to a single design-build project, the cost can be included in the project price.

Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

Professional Liability Premiums for Design Professionals:

A Brief History

By Jeffrey W. Cavignac, CPCU, RPLU

The insurance industry is currently suffering through a hard market cycle. A hard market is characterized by decreased availability of insurance, higher prices, and more restrictive coverage. In some cases, professional liability insurance premiums for design professionals are increasing by 50% or more.

In order to appreciate the magnitude of the current increases, we really need to look back over the past ten to twelve years.

A study done by a major insurance company on its larger clients (those with average revenues of $15 million) revealed that in 1988, typical architect/engineer clients were paying 1.32% of their fees for professional liability insurance. By the year 2000, that rate had dropped to 0.50%, which equates to an approximate 62% decrease in pricing. During that same time, claim frequency was nearly cut in half, but claim severity increased dramatically. If you balance frequency against severity, actual losses decreased by about 5%. In other words, rates went down by 62%, but losses decreased by only 5%.

What did this do to the insurance companies' profits? In 1988, the industry's combined ratio (losses and expenses divided by premiums) was approximately 72.2%. This is considered excellent. By the year 2000, the combined ratio had doubled to 140%. In other words, for every dollar professional liability insurance companies took in, they spent $1.40. Needless to say, companies cannot remain in business very long with this kind of combined ratio.

We are currently seeing average rate increases of approximately 20-30%. Let's assume that your firm receives a 25% rate increase on its next re-

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newal, and also assume that you've paid rates similar to those discussed in this article. In other words, you are coming off a rate of 0.50, and your 25% increase will take you to a rate of 0.625. Recognize, however, that this is still less that half of what you were paying in 1988 (1.32%).

The bottom line is that rates will probably continue to climb. Will they go back to the 1988 level? I don't think so. They will, however, have to reach a point at which the industry again becomes profitable. In the absence of profits, insurance coverage for design professionals will disappear.

The Seventh Commandment:

After Making a Contract, Adhere to Its Terms and Modify It Only by Written Amendment

Excerpted from "Ten Commandments of Loss Prevention" by Gunther O. Carrle, Esq.

The contract should not be ignored after the project starts. If your "agreed upon" performance is substantially inconsistent with the terms of the agreement, you may not have an agreement to rely upon later.

Don't fall victim to the famous last words—"Our lawyer made us put in the agreement, but we can work something out" or, "Our lawyer said we can't agree to do it in the contract, but don't worry, it's something we always do."

Review all documents that you are requested to execute, Architect's Consent to Assignment of Contract, Architect's Consent to Assignment of Contract as Collateral, Waiver of Liens, to ensure that they do not alter, expand or modify the terms and conditions of your contract.

- Avoid agreements that require you to protect someone else's interests or to notify them of changes in the project or other events relating to your relationship with the client.

California State Agency Agrees to New Indemnity Language

Recently, after months of intense negotiation between representatives of the Consulting Engineers and Land Surveyors of California (CELSOC), the American Institute of Architects California Council (AIACC), the California Department of General Services (DGS) and DPIC, the DGS agreed to new, more A/B-friendly language in the indemnification and insurance clauses in DGS's standard contracts for design services. While these clauses can still be improved, the new indemnity language is negligence-based and insurable:

The Consultant agrees to indemnify and hold harmless the State, its officers, agents and employees from any and all claims, demands, costs or liability arising from, or connected with, the services provided hereunder due to negligent acts, errors, or omissions of the Consultant and its agents. The Consultant will reimburse the State for any expenditures, including reasonable attorney fees, incurred by the State in defending against claims ultimately determined to be due to negligent acts, errors or omissions of the Consultant.

"Frankly, it took tremendous persistence and literally years of meetings and communications to resolve this matter," said CELSOC's Executive Director Paul Meyer, who added "a special thank you to Richard Crowell at DPIC for his assistance."

This is the second major California agency to adopt improved contract language for design services; at CELSOC's urging, CalTrans previously agreed to adopt similar language.

Your Professional Services Agreement: How Good Is It?

By Jeffrey W. Cavignac, CPCU, RPLU

In a perfect world, you would use your own, well-written professional services agreement for each project. Unfortunately, this is not always the case. Oftentimes owners require the use of their own contracts.

Regardless, if you are going to use your professional services agreement, you should make certain that it is complete, and that it adequately protects your interests.

Outlined below are a number of provisions that you might consider incorporating into your professional services agreement if they are not already there.

1. Site Safety
2. Americans with Disabilities Act
3. Ownership of Documents
4. Defects in Service
5. Corporate Protection
6. Confidential Communications
7. Unauthorized Changes
8. Requests for Clarification
9. Contractual Statute of Repose
10. Limitation of Liability
11. Indemnification
12. Attorneys Fees Clause
13. Contractual Certificate of Merit

If you would like additional information about any of these items, please contact us.