Managing Your Professional Liability Risk

The litigation explosion that began in the mid-1980’s and continues today has focused the attention of the design profession upon the task of managing the risks inherent in professional practice. This emphasis has been healthy because it has resulted in improvements in the quality of professional service while reducing exposure to allegations of professional negligence.

Unfortunately, all too often a firm’s risk management procedures are neglected or overlooked in the effort to meet day-to-day client demands and deadlines. In view of this, it pays to periodically step back and evaluate the effectiveness of your risk management program (or the lack thereof). The purpose of this newsletter is to outline the basics of a risk management program for the design profession.

What is risk management?

Risk management is not simply purchasing insurance (although insurance is one risk management tool). Risk management involves identifying, measuring, and treating exposures to loss that result from the performance of your services. An exposure is basically something that could cause financial harm.

A comprehensive risk management program involves four basic steps. Exposures need to be:

- Identified
- Quantified
- Treated
- Monitored

This simple process relies heavily upon subjective evaluation, yet it can prove effective in reducing your firm’s overall exposure to financial loss.

1. Risk Identification

Risk identification is the critical first step in your risk management program. Without identifying risk, you have no framework on which to build the balance of your program.

The process of identifying risk (Continued on page 2)
involves evaluating your practice, areas of specialization, and your client base. Getting the help of an insurance professional or an attorney familiar with issues facing the design profession can help avoid overlooking an important exposure.

2. Quantifying Risk

Once risks have been identified, they need to be quantified so that they can be ranked in order of importance.

For most firms, simply ranking risk-producing activities by their potential cause is sufficient. Risk exposures tend to fall into one of three categories. First, they may occur frequently but cause relatively small financial losses. These types of risks are typically retained by the firm. Secondly, they may occur infrequently but have the potential to cause a financial catastrophe. These risks are typically insured. Finally, they may occur both frequently and with catastrophic potential. These risks are typically eliminated.

When ranking your risk exposures, give the highest priority to risks with both frequency and severity. Second priority should go to infrequent but possible catastrophic risks. Lastly, don’t ignore the small, frequent losses, but consider ways to manage and/or finance them.

3. Treating professional liability risk

The third step in the risk management process is the most involved (it is also the one in which your insurance broker can give you the most help). Treating professional liability risk requires you to determine which risk management tool (or combination of tools) can be used to either reduce the risk to an acceptable level, or transfer the risk to a third party.

While we will focus on professional liability exposures in this newsletter, ideally you should identify all elements of risk and treat each element separately. Your effectiveness in implementing the chosen tool(s) will determine your ultimate success. You have the option of:

- Eliminating the risk-producing activity so the risk no longer exists. This might involve foregoing certain types of projects; a skateboard park or a condominium might be an example of the type of project you choose to eliminate from your practice.

- Using loss prevention techniques to reduce risk. From a risk management perspective, loss prevention tools are those activities which reduce the risk associated with any specific exposure. Most loss prevention tools reduce risk to an acceptable level, but do not eliminate the risk completely (this is why you need insurance). An effective risk management program combines the use of risk transfer techniques with loss prevention tools so that most risk is both reduced and transferred.

Most of your loss prevention tools involve practice management and quality control. An effective risk management program not only helps you minimize and control risk, but also improves the quality of the professional services you provide your clients.

- Practicing management techniques that can be used as effective risk management tools, including the following:
  - Continuing professional education
  - Staff training, education and supervision
  - Quality control and quality review
  - Pre-project evaluation checklists
  - Contract review procedures
  - Sub-consultant qualification procedures
  - Post-project evaluation checklists
  - Documentation

- Transferring the risk. Risk transfer can occur through the purchase of insurance, or through a variety of contractual provisions in your contracts.
  - Insurance
    Insurance remains the most effective and popular risk management tool for transferring risk. Your professional liability insurance is simply a contract whereby the insurer agrees to assume the liability arising
out of your practice in exchange for your payment of a specified premium. The parameters of this transfer are defined by the terms contained in your policy.

A careful review of your policy’s terms and conditions is important, because exclusions and conditions may limit or eliminate the transfer of risk in areas that are of prime importance to you. In addition, many of the restrictive provisions can be eliminated by negotiating with your insurer.

The cost and availability of professional liability insurance vary due to influences in the general financial markets. In addition to claim costs, insurance premiums are affected by interest rates, stock market performance, bond prices, and the availability of capital (competition).

Design firms and other types of businesses tend to purchase more insurance when rates are low, and retain more risks during periods of high rate levels. Presently, insurance rates are as low as they have ever been. Now is the time to review the terms of your insurance program and negotiate higher limits, lower deductibles, and broader policy terms.

Contractual

The most common non-insurance transfer technique is by way of a contract. Contractual provisions such as indemnity and limitation of liability clauses, disclaimers, and other such verbiage are examples of non-insurance transfer techniques. Allocating and transferring risk by a contract is a time-tested business principle that is generally upheld by our courts.

Your contract with your client is your primary tool to establish, allocate and transfer risk. A well-written professional services agreement will go a long way toward protecting your firm. You should formalize and standardize your contract procedures. Require a partner or officer’s approval for any deviations to your standard terms. In addition, any client-form agreements should be reviewed carefully by not only your contract manager, but also your insurance broker and, if appropriate, your attorney.

You should review your standard form agreements periodically to make certain they are “state of the art.” Once again, the services of a knowledgeable contract attorney and an experienced insurance professional will be helpful.

Retaining the risk (acknowledging the risk and retaining it)

One of your risk management options is to simply acknowledge the risk and proceed with the project. This recognizes that not all risks can be avoided or minimized. Some degree of risk will always remain as long as you choose to practice.

The key to retaining risk is to be certain you are adequately compensated. Don’t take a large risk for a small financial reward. Make certain your fee and the profit margin within your fee create an adequate reward for the risks you take.

4. Monitoring professional liability risk

The final step recognizes the never-ending nature of the risk management process. As your practice evolves, new risks are created which require treatment. In addition, you must remain vigilant about the risks you’ve previously identified and treated.

Clients and their demand for your services change over time. In addition, the risks associated with your clients’ business change, and these changes directly influence your professional liability exposure. Your risk management program must be monitored on a periodic basis to remain effective.

Final comments

Much of today’s business literature focuses on activities that are good for both the business and its customers.

Author Steven R. Covey in his best-selling book, The Seven Habits of Highly Effective People, coined the phrase “win-win” for these mu-
tually-beneficial business relationships. We believe that establishing and implementing an effective risk management program within your firm is truly “win-win” because it protects your financial assets and improves the quality of service your clients receive.

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**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.

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**Test your professional liability loss prevention**

Do you know as much about professional liability loss prevention as you should? Following are five true/false statements about loss prevention and related concerns. Take your best shot at determining the correct response to each, and then review our answers to see if you’re on target.

<table>
<thead>
<tr>
<th>Questions</th>
<th>True / False</th>
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<tbody>
<tr>
<td>1. A design professional arrives on site and sees an obvious safety problem or likely OSHA infraction, the design professional would be well advised to look the other way and continue on.</td>
<td>True / False</td>
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<tr>
<td>2. Although full-time construction observation is a service some firms offer, its principal impact is income enhancement, not loss prevention.</td>
<td>True / False</td>
</tr>
<tr>
<td>3. A “merited claims” clause (i.e., a contract requirement that a client must obtain a professional’s opinion that negligence occurred) may be applied only in states with a merited claims law.</td>
<td>True / False</td>
</tr>
<tr>
<td>4. In most states, limitation of liability automatically applies to breach of contract.</td>
<td>True / False</td>
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<tr>
<td>5. As a general rule, a design professional should keep every scrap of paper associated with a project, just in case a problem occurs in the future.</td>
<td>True / False</td>
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**Answers**

1. True. Looking the other way when a safety violation is seen would violate licensing requirements. It would do little to prevent liability exposure in most instances, and could create serious repercussions.

2. False. Full-time construction observation is one of the most important services a design professional can offer, helping to reduce all parties’ exposure to problems. Many consider construction observation to be a critical element to the services offered by a competent design professional.

3. False. Merited claims protection can be obtained by contract in virtually any state or territory of the United States and in Canadian provinces.

4. False. Limitation of liability applies to breach of contract when the limitation specifically so states. In some states, limitation of liability may apply to breach of contract without such being specified, but only to the extent that negligence also is considered a breach of contract.

5. False. Keeping too much paper on hand can create problems should discovery occur. When opposition attorneys have the ability to examine several drafts of the same document, they usually will gain the ability to confuse the issue and the trier of fact. As a general rule, only final versions of documents should be kept.