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PROJECT INSURANCE: OWNER'S PROFESSIONAL LIABILITY EXPOSURES AND SOLUTIONS

Owners of construction projects face many risk management challenges – whether building new, adding on to existing facilities, or performing rehabilitations. For a project owner, managing construction risk is significantly different from managing the risks inherent in their daily operations. One difference of particular concern is professional liability risk associated with execution of design and other professional services.

Construction-related professional liability insurance is rapidly changing and has often been underinsured relative to the exposures created when commencing a new project. Even on a modestly sized project, an owner can have significant exposure to cost overruns, time delays, and re-work from faulty design, negligent construction management, or errors from other disciplines performing professional services on the project. Losses suffered by project owners can prove to be very costly, confusing to litigate, and difficult to calculate. The following example illustrates the complex nature of these exposures.

EXPANSION PROJECT SHRINKS HOSPITAL'S BOTTOM LINE

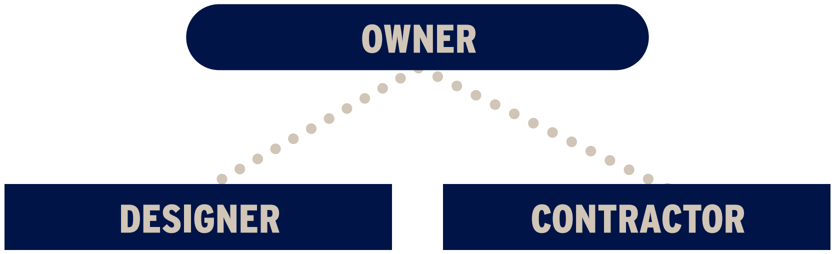
A city medical center and its board of trustees issued separate contracts for the design and construction of a two-year, $150 million expansion to its children's hospital wing. The architect was responsible for procuring all design services and was required by the owner to evidence $5 million in professional liability insurance limits from their annual practice professional liability insurance program. The project took three months longer than anticipated and went over budget by $10 million. Along with the delay and cost overruns, numerous other problems were discovered in the HVAC and electrical systems – all attributable to the design team.

The total damages alleged by the owner were $17.5 million. During discovery it was found that the prime architect only had $4 million remaining in its practice professional liability program because of defense and claim payments from the firm's engagement on other projects during the policy period. The other liable members of the design team (the mechanical and electrical engineers) each had their full professional liability limits of $1 million available. However, after defense costs eroded the remaining limits during litigation, only $5 million in combined policy limits were available from the architect's and the design firm's insurance policies. Furthermore, the firms had little or no assets to collect beyond their professional liability policies. The medical center settled immediately for the $5 million in remaining policy limits and incurred a $12.5 million loss to its bottom line.

This not uncommon scenario raises some questions: Are insurance solutions available that offer construction owners better control over the cost, scope and security of professional liability coverage? Could the medical facility have financed this exposure with an insurance product and collected its own insurance proceeds rather than incur this loss? The answer is 'yes,' and Willis has dedicated staff with the expertise and market prowess to deliver optimal solutions to its owner clients.

TRADITIONAL SOLUTIONS

Most projects constructed in the U.S. use some form of the design-bid-build delivery system. In that type of scenario, the owner assumes a central role by virtue of contracting separately with design entities and contractors. The owner first hires a designer to provide the design and later the general contractor is hired to build the project. The illustration below depicts this standard relationship.



Since the design-bid-build delivery system separates the design contract from the construction contract, the owner serves as an intermediary between the design and construction entities and takes on significant risk by contracting directly with the architect. Other delivery systems, such as design-build (D/B) or engineer-procure-construct (EPC) and emerging methods such as integrated project delivery (IPD), public private partnerships (P3) and LEAN construction, also pose professional liability challenges and exposures. These delivery systems and related exposures will be addressed in future articles.

The most common and simplest mechanism for an owner to mitigate the professional liability risk associated with its project is to contractually require the primary design professionals to maintain **annual practice policies** at prescribed limits. These policies provide professional liability coverage with limits that the owner deems adequate to cover claims that might arise from the design team's work on the project. However, coverage under the design professional's policy is in the name of the design professional and does not provide any protection directly to the owner, which cannot be named as an additional insured. Renewal of the annual practice policy by the design professional is not guaranteed and could be terminated prior to a contractually agreed post-completion insurance requirement. Claims made on projects unrelated to the owner's project (as shown in the hospital project claim scenario) may erode or exhaust the limits of liability available under the design professional's practice policy. This could leave the owner with an uninsured design professional and no source of recovery.

A second approach is for the owner to purchase a **project-specific professional liability policy** (PSPL) that covers the prime architect and its sub-consultants for the specific job. This option provides dedicated limits to the project, includes an extended reporting period for post-project completion, and replaces the design professional's annual practice policies, although the annual policies possibly could be excess of the PSPL for the designer's interests. While a viable risk management solution, there are drawbacks in this approach.

The cost of PSPL programs is significant due to the insurance industry's experience, which has historically been unprofitable. The cost can often be 1-1.25% of the construction value of a project. The policy does cover the design professionals for the specific job; however, it does not typically extend to construction management. The policy is purchased for the design team and therefore is defended by the insurance carrier for the design team and not the owner. Defense costs can often erode the limits of these policies rather quickly allowing for smaller-than-anticipated recoverable indemnification amounts for the owner.

THE OWNER'S PROTECTIVE ALTERNATIVE

A third option to mitigate project professional liability exposures is for the owner to purchase an **owner's protective policy.** The policy appeals to owners that directly subcontract the design separately from the construction under the design-bid-build delivery system, as discussed earlier. The owner's protective policy addresses financial risks associated with the performance of professional services through dedicated project-specific limits similar to the PSPL. However, this solution provides the project owner with protection when a subcontracted design professional or other project consultant's professional liability coverage is insufficient or not available. The owner still requires the primary design firm to evidence its annual practice professional liability policy at minimum limits via the contract as outlined in the first option above, but the owner then purchases a protective policy for the project to sit excess over the design firm's annual policy. The named insured on the policy is the project owner allowing control over the insurance acquisition and claim process.

The protective policy is a first-party indemnification policy and third-party professional liability policy intended to indemnify the owner for economic damages, bodily injury, and/or property damage due to the negligent performance of its subcontracted design professionals and provide coverage for the owner from third-party claims.

In a first-party loss scenario, the owner notifies its protective policy carrier at the same time that it brings a claim against its subcontracted design professional. The protective policy is then triggered when the design professional's limits are exhausted.

The owner's protective policy is often purchased for projects greater than $50M in hard construction costs. It can be put in place for a variety of projects, including commercial, institutional, schools and colleges, hospitals, airport expansions or renovations, rail, roads/highway transportation or other civil projects, correctional facilities, casinos, hotels and resorts, residential/commercial-grade construction, water, waste water and sewage, and municipal facilities.

For a third-party claim, the owner notifies the carrier when it receives notice of a claim from a third party which triggers coverage under the protective policy. As stated above for first-party losses, the policy sits in an excess position above the subcontracted design professional's annual practice policy, and if there is no underlying insurance available at the time of a claim or the limits have been exhausted from claims on other projects (again, as seen in our previous example), the protective policy will drop down and pay on a first-dollar basis or excess of any self-insured retention specified on the policy. For third-party claims, the protective policy responds in excess of a self-insured retention.

The policy covers retroactively the design phase, runs through the construction period, and includes an extended reporting period (ERP) in which to report claims. The ERP is for work that was undertaken during the active policy period for any design or work performed to put the project to its intended use.

Owners also benefit by broadening the field of acceptable design firms as they can lower the required limits of insurance of their subcontractors/consultants knowing they have the protective coverage in place. At the same time the owner can have confidence that the subcontractors/consultants are delivering the appropriate standard of care because their annual practice policies remain in place and are subject to first-dollar exposure.

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This insurance approach, while dedicating broader limits to a specific project, is typically much more cost-effective than buying PSPL coverage due to the first-dollar nature of the PSPL vs. the excess approach used with an owner's protective policy. The unique first-party and third-party coverages put the owner in a very favorable recovery position in the event of a loss and provides enhanced control over the claim process. With the current state of economic uncertainty and expense management protocols, the owner's protective policy has quickly become the coverage of choice for managing owners' professional liability exposures on construction projects.

A SUMMARY OF PROFESSIONAL LIABILITY RISK MANAGEMENT OPTIONS FOR A CONSTRUCTION PROJECT OWNER

TOPIC	OWNER'S PROTECTIVE PROFESSIONAL INDEMNITY	A/E ANNUAL PRACTICE PROFESSIONAL LIABILITY	PROJECT-SPECIFIC PROFESSIONAL LIABILITY
INSURED	Project owner – Owner controls placement, provides certainty of coverage, carrier, pricing, limits retentions, etc.	Individual A&E firms – Lacks certainty of coverage, limits	Project A&Es and sub-consultants – A&E firms typically control placement
COVERAGE	Project-specific – Term of construction plus an extended reporting period for reporting claims (typically 3-5 years) Limits dedicated to project Claim-made coverage – Can retroactively apply to completed work subject to no known claims letter Third-party coverage to owner Non-cancelable except for specified reasons Self-Insured Retentions (SIR) – Responsibility of owner but are eroded by available A&E's insurance	Annual policies – Claims made covering all work performed by A&Es Limit shared by all projects of A&E firm and retroactively all of their prior work Policies must be renewed through construction term and extended reporting period May be cancelled without notifying certificate holders (owners) Deductible/SIR – Responsibility of insured (A&E)	Project-specific policy term of design through construction plus an extended reporting period for reporting claims (typically 3-5 years) Limits dedicated to project Claims-made coverage – Typically cannot secure coverage for projects that have started construction Non-cancelable except for specified reasons Deductibles/SIR – A&E's responsibility, but many owners may share in these costs if retentions are higher than typically carried by A&Es
CLAIMS	Owner controls management of the claim process and is not reliant on A&Es to negotiate with their insurers. Owner must make demand against A&E and then file a claim directly with the protective carrier	Owner must make demand against A&E, and A&E is responsible for providing notice of claim to their own insurer A&E insurer owes a defense to A&E; limits can be eroded by defense leaving little for payment of claim Owner reliant on A&E to negotiate with their insurer related to the claim	Owner or Third Party must make demand against A&E who is responsible for providing notice of claim to the project policy insurer Insurer owes defense to insured (A&E); many projects have resulted in protracted litigation where full policy limits were spent on defense of the A&E, and the owner received no indemnity payments

TOPIC	OWNER'S PROTECTIVE PROFESSIONAL INDEMNITY	A/E ANNUAL PRACTICE PROFESSIONAL LIABILITY	PROJECT-SPECIFIC PROFESSIONAL LIABILITY
COSTS	Fixed price for term of project subject to audit if applicable Typically 25%-50% less than other project-specific coverage depending on project type, size, underlying A&E insurance and other factors	A&E's cost of professional liability insurance varies by firm, typically built into bids and is an annual charge which can vary year to year	Fixed cost for term of project subject to audit/material variation Cost is based on size, type and complexity of project, typically viewed as expensive with limited number of insurance carrier options
BENEFITS	A&Es maintain existing carrier/broker relationships Fewer disputes to insurance-related contractual provisions (limits, terms, etc.) Adequate, dedicated limits for project Certainty of coverage throughout project and post substantial completion Competitive project pricing; third-party coverage to project owner	Potentially lowest cost option, due to uncertainty of coverage and term	Fewer disputes to insurance-related contractual provisions (limits, terms, etc.) Adequate, dedicated limits for project Certainty of coverage throughout project and post substantial completion

While risk management challenges for the owner of a construction project can be significantly different from those encountered in daily operations, multiple solutions exist to manage professional liability exposures. Losses from the negligent performance of professional services are extremely costly, complex and can destroy the success of a construction project. Purchasing an owner's protective policy or another risk transfer mechanism to protect your project – and your bottom line – is a viable solution that should be considered well in advance of contract development.

CONTACTS

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