

Workshop K

Wednesday, November 9, 9:00 a.m.–noon

HIGHER POLICY LIMITS FOR SPECIFIC PROJECTS

Panelist

Gregg Bundschuh
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Despite a strong initial interest, the market for project professional liability insurance has all but dried up, and the few insurers who still offer this coverage do so under strict guidelines. The reasons behind the insurance industry's reluctance to participate in this market are complex, but the bottom line for design-build participants is that their insurance coverage may not match up to their liabilities under the contract. With panelists representing the construction, design, legal, and insurance communities, this session presents a lively discussion of issues that impact the disconnect between design-build construction and project-specific professional liability insurance.



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Gregg Bundschuh
Partner
Ames & Gough

Mr. Bundschuh is one of the panelists for Workshop K, "Design-Build Risks and Professional Liability Insurance: A Disconnect," on Wednesday morning. He is a partner in Ames & Gough, a leading insurance firm specializing in design and construction risk. Mr. Bundschuh counsels and serves clients involved in the construction industry and provides special expertise in large, complex construction projects. Prior to joining Ames & Gough, he was Managing Director, Global Construction Leader, and Environmental Practice Leader at Marsh, Inc. He was General Counsel to a national architecture and engineering firm and practiced construction law with an Atlanta firm.

Mr. Bundschuh is a Fellow of the American College of Construction Lawyers, an elective organization formed for the purpose of enhancing the skill, expertise, and the standard of the practice of construction law. He is also the former Chairman of the Corporate Counsel Division of the American Bar Association, Forum on the Construction Industry. Additionally, he has served as an arbitrator for the American Arbitration Association. He received his bachelor of arts degree from Wake Forest University and his *juris doctorate* from the University of Georgia.

In addition to IRMI, Mr. Bundschuh has written and spoken on behalf of the following organizations and publications: American Bar Association Forum on Construction, International Bar Association, American Corporate Counsel Association, American Institute of Architects, Associated General Contractors, Associated Owners & Developers, American Council of Engineering Companies, Atlanta Bar Association, *Construction Business Review*, Construction Financial Management Association, *Construction Lawyer*, Construction Super Conference, Design Professionals Coalition, *Engineering News Record*, Federal Publications—*Construction Briefings*, *Georgia Journal of International & Comparative Law*, Georgia State Bar Association, Illuminating Engineers Society of America, Institute of Continuing Legal Education, Mealey's Seminars, Mechanical Contractors Association of America, National Council for Public/Private Partnerships, National Electrical Contractors Association, *Business Insurance*, *National Underwriter*, Public Risk Managers Association, Real Estate Law Institute, and Risk & Insurance Managers Society, Inc.

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HIGHER POLICY LIMITS FOR SPECIFIC PROJECTS

Gregg Bundschuh, JD*
Ames & Gough

There are any number of reasons why an architect or engineer (A/E), contractor, or owner may need higher professional liability insurance (PLI) policy limits than those which they normally maintain. One example is a fast-track design-build project with unusual or complex design elements. Another example is a school district's insurance requirements. In some parts of the country, school district contracts require that the architect's PLI policy limits be equal to 20 percent of construction costs. With some new public high schools exceeding \$50 million in construction costs, the PLI limits required exceed what most firms purchase.

Another driver of higher limits is project size. While PLI policy limit requirements vary widely by project, the table below reflects limits owners might require.

Typical PLI Limit Requirements By Private Owners	
Construction Project Cost	PLI Limit Requirement
Under \$5 million	\$1 million
\$5 million to \$25 million	\$2 million
\$25 million to \$50 million	\$3 million to \$5 million
Over \$50 million	\$5 million or higher

Other factors to consider when determining PLI policy limits include project complexity, project delivery method, environmental exposures, geographic location, and potential contractual risk.

Fortunately, A/Es and contractors providing design-build services do not need to avoid projects that require higher insurance limits. In this paper, four insurance options will be reviewed:

- ▲ Increase practice program PLI limits;
- ▲ Increase PLI practice limits for a single project;
- ▲ Procure project-specific PLI; and
- ▲ Procure owner's protective professional indemnity (OPPI) coverage.

* This article is coauthored by David Collings, also a partner at Ames & Gough.

While the focus of this paper is on options available to insure the design professional's exposure, several of these options apply to a contractor as well, although contractor's professional liability insurance coverage is beyond the scope of our discussion here.

Increase Practice Program PLI Policy Limits

The first and most obvious question to consider when an owner requests higher limits is whether the PLI limits purchased by your firm are appropriate for the size of your firm and/or the type of projects you pursue. Excellent benchmark information is available from the ACEC and from leading insurers and brokers. Data from Schinnerer, the underwriting manager for CNA, is *periodically published*. The ACEC data can be found on their website at <http://www.acec.org/publications/mar-apr04/survey.pdf>. The most recent survey is the 2003 edition, published in April of 2004. A new survey will be released soon.

If an A/E's PLI practice policy limits compare well to peer firms, but additional limits are needed for a specific project, the following options should be considered.

Increase PLI Policy Limits for a Single Project

Some insurers offer additional limits for a specific project by endorsement (known as a SPX endorsement by some insurers and as a SALE—Specific Additional Limit Endorsement—by others). As the name suggests, a SPX endorsement or a SALE is an "add-on" to an A/E's PLI practice policy and it provides a dedicated additional policy limit for a specified project. The term of the limit is the same as an A/E's practice program; typically one year.

With most insurers, the additional limit provided by a SPX endorsement or a SALE applies in excess of the A/E's practice program limit. The exception is CNA's SALE which provides the additional limit on a primary basis, an approach preferred by most A/Es.

The SPX endorsement or SALE can be used for projects of any size, but these endorsements tend to be more common on projects under \$10 million in construction cost. As explained later, the uncertainty of the future cost of this approach makes it difficult to use a SPX endorsement or a SALE on larger projects. In addition, some insurers will only allow the endorsement to remain in effect for five years, making it unsuitable for larger projects with multi-year design and construction periods.

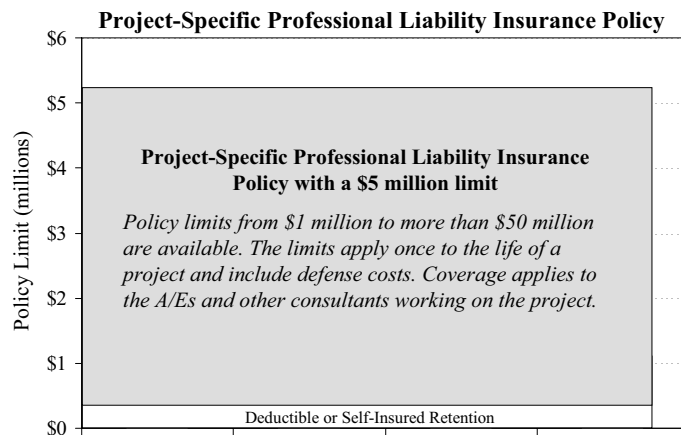
Since PLI policies respond only to "claims-made" during the policy year, we recommend that the additional limits provided by a SPX endorsement or a SALE be kept in place throughout design and construction and for at least five years after the project is completed. There may also be contractual requirements for maintaining higher limits for a specified number of years after completion.

The need to maintain a SPX endorsement or a SALE for multiple years creates a degree of uncertainty. There is no guarantee that an insurer will offer the endorsement in the future at a reasonable price or that it will be offered at all. If there are problems or losses on a project, it is likely that the cost of a SPX endorsement or a SALE will rise dramatically in the future.

Even if an owner agrees to reimburse an A/E for the cost of purchasing additional limits, the reimbursement amount will be an estimate based upon the additional premium for this year's endorsement. The risk of higher than projected costs for adding the endorsement to future policies or the endorsement not being offered at all is difficult to pass on to an owner.

Project-Specific PLI

Another option for A/Es that need higher PLI limits for a specific project is through the purchase of project-specific professional liability insurance. As shown in Figure 1, project-specific PLI policies provide dedicated multi-year limits over a per claim deductible. The policy term is from the beginning of design, through construction, and up to five years after substantial completion.



Project policies cover from the beginning of design, through construction, and up to five years after substantial completion.

Figure 1

The primary advantages to a project-specific PLI policy are dedicated limits, consistent coverage, and a single point of dispute resolution and recovery on a claim.

When to Consider Project-Specific PLI

Project-specific PLI can be used for projects of any size and type, but should be considered for projects with increased design risk because of their size, complexity, speed of schedule, delivery method, or other unusual risk factors. Project-specific policies are more common on large projects with construction values over \$25 million.

Another factor to consider is the owner's willingness to pay for a project-specific PLI policy. From the owner's point of view, there are a number of benefits to purchasing a project-specific policy, but cost reduction (see discussion on Premium Credits on next page), is not one of them. Owners that appreciate the additional protection and potential single point of recovery on a claim are most likely to support funding a project-specific policy.

Issues to Address

If a project-specific PLI program is designed properly, it can be an effective risk management tool for A/Es and owners. There are, however, important and frequently overlooked issues to be addressed.

- ▲ **Primary Coverage** – Project-specific PLI policies are primary to all other policies and they replace A/Es' PLI practice policies for the covered project.

This is an important distinction since the PLI practice policies for most A/Es have what is known as a project-specific exclusion. The exclusion normally states that if a project is insured by a project-specific policy, then the insured's practice policy will not apply—even if the project-specific policy is uncollectible because the limits are exhausted due to claims or if the project-specific insurer is out of business. There are a limited number of insurers that do not have the project-specific exclusion or will delete the exclusion from the policy.

- ▲ **Allocation of Deductible Payments** – Project-specific PLI policies cover multiple A/Es and most claims involve multiple firms. The methodology for allocation of deductible payments needs to be equitable and spelled out in writing in advance.

- ▲ **Insurer Solvency** – If an insurer providing a project-specific PLI policy goes out of business, then most A/Es covered on that policy will have no project-specific coverage and no practice coverage. If the project-specific policy is procured by the owner, A/Es should require the owner to maintain coverage with a financially viable insurer and to endeavor to replace coverage if the project-specific PLI insurer's financial rating falls below certain minimum criteria at any time during the policy period.

- ▲ **Premium** – In the past five years, losses for project-specific policies have soared. One insurer even had to add a decimal point to its loss runs to be able to show an underwriting ratio in excess of 1000 percent. As a result, the number of insurers providing the coverage is limited and the premiums can be prohibitive.

Unless an owner is willing to pay for a project policy, it is difficult to be competitive with the cost of a project-specific PLI policy included in a proposal.

- ▲ **Insured vs. Insured Exclusion** – If one A/E on a project suffers a loss because of the actions of another A/E, project-specific PLI insurers will no longer provide coverage. In addition, there may be no PLI practice policies to respond because of the project policy exclusion in PLI practice policies.

- ▲ **Joint Defense** – One project-specific insurer requires that A/Es agree to joint defense. The goal of joint defense is laudable—to minimize disputes on a project and efficiently develop resolutions for problems without protracted litigation. If A/Es find themselves being insured on this type of policy, they need to get a clear explanation of what is expected of them and how joint defense will affect their ability to defend themselves and to select counsel.
- ▲ **Policy Review** – If the owner procures the project-specific PLI policy, the A/E should ask to have their own insurance agent or broker independently review the policy.

Finding Out After the Fact

When owners procure project-specific PLI policies, it is normally one of many tasks they are handling in connection with a large project. As a result, the purchase of a project-specific policy may never be communicated to the A/Es on a project. If there is a large deductible or restrictive coverage, A/Es insured on the project-specific policy could be in for a nasty surprise years later in the event of a claim.

To avoid this type of problem, we encourage A/Es to include wording in their contract on any project where a project-specific PLI policy might be purchased.

Sample Contract Language

[The owner] agrees that it will not purchase any type of project-specific professional liability insurance for [project name] that might affect [the A/E firm's] annual professional liability insurance without first disclosing such purchase to [the A/E firm] in writing. [The A/E firm] reserves the right to review all relevant information on the proposed coverage and to reject such coverage or pursue alternative options.

If [the owner] purchases project-specific professional liability insurance for [project name] and [the A/E firm] agrees in writing to be insured by such coverage, then the owner agrees to provide [the A/E firm] with a full copy of the policy.

If [the owner] purchases project-specific professional liability insurance covering [the A/E firm] for losses arising from [project name] and does not disclose it to [the A/E firm], then [the A/E firm] reserves the right to reject or accept such project-specific professional liability coverage at the time [the A/E firm] becomes aware of it. If [the A/E firm] rejects the project-specific professional liability insurance, then the owner will have [the A/E firm] removed from the policy.

Premium Credits

When an owner purchases a project-specific PLI policy, the A/Es on the project are normally asked for a premium credit from their PLI practice programs as an offset. A/Es should ask their insurer for such a credit, but the amount will either be very small or nil. The reason is that PLI policies provide coverage on a "claims-made" basis. Today's PLI practice policy covers claims made during the policy term, even if the events giving rise to the claim happened years ago (as long as the events giving rise to the claim happened after the policy retroactive or knowledge date).

The risk to an A/E's current PLI practice policy is not reduced when a specified project just getting started is excluded. Policies in future years that exclude the specified project will benefit, but it is not possible to give a credit for a policy that does not yet exist.

Notwithstanding the above, some insurers will give modest credits, which an A/E should pursue in good faith on behalf of an owner.

Owner's Protective Professional Indemnity Policy

An owner's protective professional indemnity policy (OPPI) is similar to a project-specific PLI policy in that it can be purchased on a project-specific basis, but the similarities end there. As shown in Figure 2, the limits of an OPPI policy apply in excess of the available PLI practice policy limits of the A/Es working on the project.

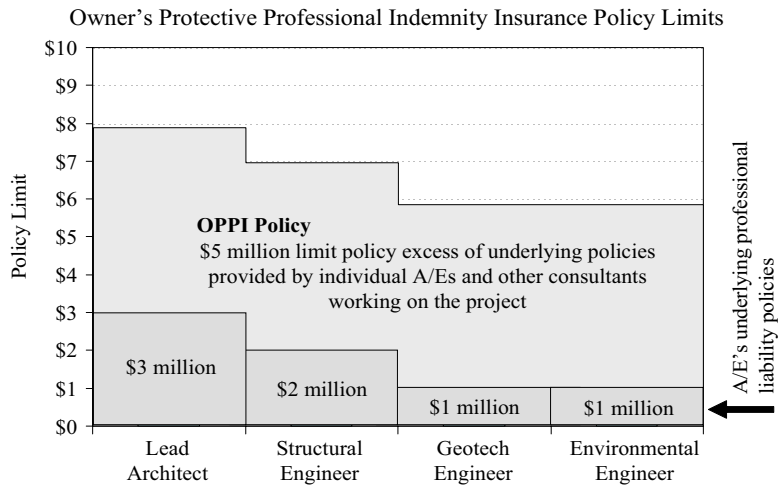


Figure 2

Because the policy limits apply excess of available coverage, an OPPI policy costs much less than a project-specific PLI policy which applies on a primary basis. The OPPI policy limits normally apply to the design and construction phases of a project plus five years. The underlying limits from A/Es working on a project will normally renew annually.

An OPPI policy provides no direct benefit to an A/E since coverage only applies to losses incurred by the owner. A/Es do benefit, however, since an owner that purchases an OPPI policy is not likely to request additional PLI practice policy limits from A/Es and because the owner is less likely to suffer an uninsured loss for which it may attempt to hold the A/E responsible.

The table below illustrates how the OPPI and primary policies in Figure 2 will respond in the event of a \$7 million covered loss caused by the lead architect with a PLI practice policy with a \$3 million limit:

1.	The project owner files a claim against the lead architect firm.
2.	At the same time, the owner notifies the OPPI insurer about the potential for a loss that exceeds underlying insurance.
3.	The owner settles the loss with the lead architect's professional liability insurer for the full policy limit of \$3 million.
4.	The owner is then indemnified by the OPPI insurer for \$4 million which is the balance of the loss.

If the lead architect's policy does not cover the loss because the limits were reduced due to a loss on a different project or coverage that is too narrow, then the OPPI policy will drop down and cover the loss, subject to the OPPI policy limit, in excess of the OPPI self-insured retention.

How an OPPI Policy Affects Contract Terms

When an OPPI policy is purchased, coverage can be severely restricted if a limitation of liability is in place and the OPPI policy is not amended properly. Consider the following example:

- ▲ An OPPI policy is purchased for a \$20 million project. Prior to starting work, the owner signs the A/E's contract which includes a \$1 million limitation of liability. Work is started on the project and a \$5 million loss, caused by design error, occurs. The owner collects \$1 million from the A/E's PLI practice insurer and then attempts to collect the balance from an OPPI policy with a \$5 million policy limit. The OPPI policy will not cover the loss because the policy only covers the amount the owner is "legally entitled to recover" and in this case that amount is limited to \$1 million which has already been paid to the owner by the A/E's practice insurer.

The solution to this problem is to amend the OPPI policy so it will respond to a loss regardless of whether or not a limitation of liability clause exists.

It is also worth pointing out that the OPPI policy provides no coverage beyond what is typically found in an A/E's professional liability policy. For example, liability assumed under contract is only covered to the extent the liability would exist in the absence of a contract. Express warranties and guaranties are not insured.

Other issues to consider regarding an OPPI policy include:

- ▲ **Third Party Claims** – The OPPI policy insures the owner for claims by third parties, to the extent coverage is provided under the OPPI policy (i.e., loss arising from design error caused by A/Es).
- ▲ **Settling a Claim** – The owner must keep in mind that claims cannot be settled without the involvement and consent of the OPPI insurer.
- ▲ **Other Policy Terms and Conditions** – As with any insurance policy, the OPPI policy includes insuring agreements, definitions, exclusions, conditions and other terms that need to be carefully reviewed.

Similar to project-specific PLI, OPPI programs are more common on large projects with construction values over \$25 million.

The information provided in this *Information Alert* is intended to be only an overview of some of the issues and solutions needed for specific projects that generate a need for additional PLI limits. Because the facts and circumstances of each project are different, including, of course, the impact to professional liability, your attorneys and insurance professionals must be involved in such a way as to be able to offer timely advice and judgment in an effort to structure a program that meets both your short- and long-term objectives. Accordingly, we encourage you to contact us as soon as possible whenever your firm is involved in a project that requires the placement of additional PLI policy limits.