

Professional Liability Insurance^{for} Construction Projects:

Now You See It Now You Don't

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Corporate, governmental, and institutional owners and their counsel, routinely assume that architects, engineers, and other design professionals (referred to herein as "design professionals") provide insurance that automatically affords coverage for their errors and omissions and other professional negligence that may occur on a construction project. In fact, the blind acceptance of this assumption can lead to unintended consequences for corporate and outside counsel charged with the preparation of the project documents for their clients. This article discusses certain pitfalls of placing such reliance on the belief that design professional malpractice policies will provide appropriate protection in the event of design professional liability.

Most states, including New York, do not require design professionals to maintain professional liability insurance. As a consequence, it is the responsibility of each owner/builder to ensure that its architects, engineers, and other design consultants have current insurance in place to balance the risk associated with the potential for professional liability problems. When retaining design professionals on a construction project, prudent owners and their counsel will ask to review these as to the aggregate limits of liability afforded by the insurer at the outset of the policy term, the available limits of liability for the annual policy to be secured in the event a pending claim on another project has reduced the original limits of liability, as well as the amount of the deductible which is the self-insured retention before the insurer's obligation is triggered in the event of a claim.

Owners, however, are usually not sufficiently protected by simply requiring their design professionals to show evidence that they carry traditional types and amounts of insurance. What is little known, and extremely important for owners and their counsel to recognize, is that what they may see in terms of insurance protection is usually not what they ultimately get.



Steel frame construction in the shadow of The Empire State Building. Photo taken at the construction site of 5 Times Square. See Firm News, page 4.

A design professional's professional liability policy, generally referred to as errors and omissions (E&O) or malpractice insurance, affords coverage for claims made arising out of negligent acts, errors, or omissions in the performance of professional services.

Owner reliance on professional liability insurance for design professionals may, in many instances, be illusory. The policy wording contains numerous exclusions which preclude coverage for many types of claims that ordinarily will be asserted by an owner against a design professional, e.g., claims involving the design professional's warranties, cost estimates for the project budget, or representations as to design features, and claims for the recovery of fees. Additionally, there is usually no coverage for failure

of the design professional to meet a particular contractual requirement unless the claim arises from a negligent act, error, or omission. As such, claims arising out of warranties, project delays, cost estimates, and liquidated damages are often not covered by professional liability insurance.

Perhaps the most substantial peril facing owners is that, even if a claim does fall within the protections afforded under the policy, the limits of liability will be diminished by the legal and expert fees and costs attendant to defending against the claim.

Unlike most other types of insurance coverage, Part 71 of the New York State Insurance Regulations permits insurance companies to sell E&O policies containing a provision "that reduces the limits of liability stated in the policy by the costs of legal defense." Not surprisingly, such a provision is contained in virtually all design professional liability policies offered in New York. Although Part 71 attempts to limit defense costs charged against the stated limits of liability to fifty percent, a broad exception effectively militates against the fifty percent limitation where the policy provides that the insured has the option to:

- (1) select the defense attorney or consent to the insurer's choice of defense attorney, which consent shall not be unreasonably withheld;
- (2) participate in, and assist in the direction of, the defense of any claim; and
- (3) consent to a settlement, which consent shall not be unreasonably withheld.

Since the standard professional liability policy provides these options to the insured, the above exceptions essentially moot the efficacy of the fifty percent limitation rule. Owners must, therefore, approach each claim against a design professional with the knowledge that a protracted defense by the professional risks the recovery of the available policy limits

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Selecting the Right Construction Manager



By Gary Berman

The word on the street is that clients still seem to be selecting construction management firms based more on price than on reputation and/or quality of service. If the Federal Government has learned that "best value" is achieved through a qualifications based selection process (Brooke's Act), why haven't most of the organizations and businesses in our industry caught up?

CM firms, in their brochures, statements of qualifications, proposals, and at interviews, emphasize their firm's and staff's expertise, experience and reputation. In all the paper a firm produces to win a job, maybe one page will be dedicated to the price of services. In calculating their price, consultants never have enough information, especially when it comes to scope. Therefore, assumptions have to be made and most consultants adopt different assumptions. These variances bring about different cost strategies, which translate into the client receiving a wide spectrum of pricing.

Recently we had a client verbally request a proposal from five different CM firms. Each firm was to define the scope of service based on what they thought the client needed and wanted. Then the client would review the proposals and determine which two firms should be short-listed for the interview. Subsequently a winner would be crowned. This scenario is troubling for a few reasons.

First, the client will receive five different prices based on five different scopes of service. Second, if the client is not sophisticated enough to perform the services themselves, what qualifications do they have to interpret and analyze

the scope of services proposed? They might need to hire another consultant just to study the alternatives. Lastly, the language of construction is difficult to understand. For example, value engineering means one thing to one consultant and something else to another and the client might even have a third idea of what it means. So where is all this leading?

Competition is healthy and welcome -- but it is paramount to have an even playing field for all firms. Clients should define the scope of services, the duration of the services, and the work to be performed. Clients should not ask consultants who will vie for the work to develop the request for proposal -- this is clearly advantageous to that firm for they can tailor the RFP to their firm to increase the likelihood it will be selected. There is also a danger in asking the client's attorney to write the RFP. Frequently, they do not have the technical experience to correctly represent what needs to be provided.

Clients have a few options. Borrow and customize an RFP written by a client in a similar business. Pay a firm that will not compete for the contract to prepare the RFP -- maybe a firm from an adjoining state. Contact different associations in the business. For example, if you want to hire a construction management firm, contact the Construction Management Association of America (www.cmaanet.org). They have RFP guides and detailed documents describing the various services that can be provided by a construction manager.

So it is important for clients to define the exact scope of services they require and know what

is to be built. It is also important to define the format of the price proposal. The client should describe whether it wants a lump-sum or guaranteed maximum price. The client should determine whether it wants a single total price or fees broken down into the pre-construction and construction phases. The client needs to determine whether they want the price as a percentage of the construction value ¹, a rate schedule or a blended rate for labor. The best idea for the client is to devise a form for the CM to complete. This lends itself to an "apples to apples" comparison.

Price is important but expertise, experience and reputation are just as important. How many clients have been burned by the "low bidder"? In the end, hiring the lower priced firm could cost more than hiring the "best" firm. In the final analysis, a client must weigh the balance between the confidence they have in the firm performing as required, against how much this firm will charge and what is the likelihood the firm will seek change orders. The path is not easy, but the journey is well worth the effort. If anyone has any questions about qualifications-based selection or the Brooke's Act, please contact me and I will point you in the right direction for more information. ■

¹ GREYHAWK strongly discourages hiring CMs on a percentage of construction cost basis, as this format discourages the advocacy inherent in the agency CM relationship with the client.

GREYHAWK North America L.L.C. is a national construction consulting organization founded to provide a broad range of consulting services to clients involved with the construction and engineering industries.

insurance matters

Professional Liability Insurance

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upon settlement or adjudication by arbitration or litigation.

Pursuant to Part 71, therefore, the total costs of defending an action will be deducted from the entire policy limits in determining funds available to pay damages. The reality is that serious claims, let alone catastrophic claims of consequential damages, are almost always assured of producing damages which exceed policy limits. If suit eventuates, astute counsel for an owner must carefully evaluate the strategic options of how best to proceed to a resolution of the claim with the expectation that a vigorous defense on behalf of the design professional can deplete the limits of liability leaving only a fraction of the original insurance available to pay damages owing to the professional's negligence.

As a result of the Part 71 exception to the prohibition against the reduction of liability for legal defense costs, owners inevitably find themselves in the precarious situation of deciding whether or not to accept far less than the value of their claim just to avoid the consequence of being left with little or no insurance available at the end of a lengthy and expensive litigation or arbitration. Rather than taking the risk that an architect has the assets necessary to pay an ensuing judgment, during the course of an ongoing proceeding against the design professional, the owner all too often is faced with the business decision of having to accept the remaining policy limits; which is often insufficient to remedy the problems associated with their design professional's malpractice.

A recent case in our firm posed these precise perils but, even the development of a set of strategies designed to protect against such outcome, our client could not be fully protected from an unwarranted assault upon the architect's limits of liability. The case involved our representation of a restaurateur who described to us a series of design deficiencies by his architect totaling in excess of one

million dollars. Assured by the fact that the architect he hired to design his new high-end restaurant had a liability policy of one million dollars, we chose to initiate a strategy in which a mediation would be held after the initiation of a lawsuit when negotiations were unfruitful.

The initial settlement meetings and a subsequent mediation, however, were unsuccessful in producing any offer in response to the client's reasonable settlement demands of less than the policy limits. We were buoyed by the fact that after oral argument, a panel of three experienced arbitrators issued a decision limiting discovery to little more than a document exchange.

Following three days of arbitration, and before the close of claimant's case, the architect's counsel finally acceded to our repeated demand to meet before an experienced mediator in an attempt to facilitate a settlement before additional costs were spent arbitrating the matter. After studying the case, the mediator recommended settlement of no less than eight hundred thousand dollars only to discover, to the shock of all, including the claims representative for the insurer who was present at the mediation, that the one million dollar policy limits under the architect's policy had been reduced by legal and expert fees for the brief arbitration and mediation sessions to less than four hundred thousand dollars. Thus, after roughly eighteen months since the client put the architect's insurance carrier on notice of his claims, the architect's policy had been diminished by legal and expert fees of over six hundred thousand dollars.

The claimant now faced two troublesome alternatives: accept the proffered amount of the remaining policy limits of approximately four hundred thousand dollars; or, proceed with the arbitration, at substantial cost and with the prospect of exhausting the remaining policy limits, in an effort to secure a likely judgment against the architect with minimal business and personal assets to pay a judgment.

For projects of substantial scope, owners can avoid these disturbing experiences by putting into place a comprehensive project insurance program covering all design and construction team members before the commencement of construction. Often known as an Owners Controlled Insurance Program or "OCIP," such programs are designed to obviate the protracted nature and extensive risks of reliance on the basic professional liability insurance maintained by the project's design professionals.

Increasingly, corporate and in-house counsel have begun to recognize the need and the value of securing specialized expertise to review project risks and tailor an insurance program to meet the owner's goals. The role of owner's counsel is critical and enormously important in this area of the law as the placement of a successful insurance program can give the owner more control over the quality of coverage, limits of insurance, and management of claims. This change has occurred because owners have begun to recognize that the availability of insurance covering the modern, increasingly complex construction project becomes as important, or in some cases more important, than either the bricks or mortar that constitute the physical structure being built.

At the outset of each project, construction counsel must interview the executives or senior officials of the client and survey their business goals for project success. A complete investigation calls upon the owner to review its business and legal objectives attendant to all construction related matters. By identifying all risks and other issues relating to the project, counsel ensures that the owner will be properly and fully protected should design errors and omissions or other losses arise on the project.

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In order to avoid the fate of the restaurateur, several specific steps should be taken at the commencement of the project to ensure that quality insurance and adequate liability limits are in place to cover claims arising out of the design and construction of a project. First, depending on the business objectives of the client and the risks inherent in the particular project, construction counsel should consider implementing an insurance program which specifically covers the client's project. OCIP coverage, i.e. the placement of a single insurance program covering various project risks including, builder's risk, employer's liability, and general/excess liability, is but one form of project policy available today. The greatest advantage of an OCIP is that the owner has greater control over project risk management and allocation.

As with OCIP coverage, a project professional liability policy which provides liability coverage designated for a particular project will allow for better control over the quality, quantity, and continuity of E&O insurance carried by design firms. A project professional policy protects the owner's particular project while ensuring sufficient financial resources are available to correct problems and pay damages should problems arise out of their design professionals' negligence. A single stand-alone policy covering all design professionals on the project can be secured which will allow for more consistent coverage and better control over claims involving design professionals' error and omissions.

Depending on the construction project, other insurance programs such as project management professional liability, contractor's design liability, owner/contractor protective liability, and other specialty coverage can be secured to provide even greater protection for project exigencies.

Second, a proper dispute resolution framework specially crafted to the owner's specific project can often facilitate a favorable resolution of the owner's claims. However, owing to the unique nature of issues that surround design and construction disputes, recommendation of the most appropriate forum and procedure for dispute resolution should be made only upon careful consideration of the client's business and legal goals, project team structure, and conceivable damages likely to flow from each

project team members' negligence. For example, while time and cost can be saved by employing a streamlined arbitration process before an experienced arbitration panel, counsel must ensure by contract that all team members are required to participate in the arbitration. Likewise, the time and/or discovery constraints imposed by arbitration, as well as the limited discovery arbitration permits, may preclude the opportunity to secure a complete analysis of all project documentation in order to fully develop the owner's case. Faced with the complicated decisions that must be made in these critical areas of advising the owner, formulating a framework for the best alternative on a project must be carefully developed prior to the retention of the design professional team.

Finally, if claims do eventuate on a policy which can be diminished by defense costs, a litigation strategy should be crafted only after weighing the risks of the possibility that the policy could be depleted by a full fledged defense brought by the defendant's attorney and experts. A strategy that quickly gets all the information to the carrier will usually increase the likelihood of reaching a pragmatic early settlement which will not substantially diminish liability limits by exorbitant defense costs.

Owners and their counsel must recognize that building technology, as well as the law surrounding ways in which construction projects are designed and built today, have become increasingly more complex, substantially increasing the need to manage the risks of owners in committing capital costs to their projects. Even seemingly modest losses on small projects can result in substantial damages caused by project delays, budget overruns, and lost profits. With the design and construction environment of the new millennium becoming increasingly more complex, the implementation by owners and their counsel of the appropriate insurance program for a project must be specially considered and tailored to reflect the many exigencies of this new world. ■



BBL&A's professionals (top from L to R) Robert M. Boder, Esq., C. Bradley Cronk, RA, Danielle M. Regan, Esq., Jeffrey K. Goldsmith, Esq. and Roy R. Pachecano, AIA, atop 5 Times Square designed by Kohn Pedersen Fox Associates, PC ("KPF"). The construction site tour was led by Chris Lamy and Michael Green of KPF (lower from L to R).

Attorneys in New York are invited to hear **Barry LePatner** speak on the perils and pitfalls of today's construction projects on June 11, 2001 at the **Yale Club**. The fully accredited CLE course is sponsored by David Berdon & Company LLP and geared toward attorneys who work with building and construction professionals. The course is designed to identify design/construction-related problems such as claims, delays, errors and omissions. Related topics such as framing the construction contract and the navigation of projects to successful completion will be discussed. Interested parties please call (212) 832-0400.

F I R M N E W S

BBL&A associate David J. Pfeffer was featured in the New York Times Real Estate Question and Answer section where he lent valuable legal advice concerning development related issues. Look for David in future NY Times' Q & A columns.

Join us at **Harvard's Graduate School of Design** for the 11th annual Marketing Strategies and Presentation Skills seminar with A. Eugene Kohn, FAIA. **Barry LePatner** will share valuable insights into the client's perspective from July 30 - August 1, 2001. For all interested in attending, please contact the Professional Development Department at 1-866-473-3933 or register online at www.gsd.harvard.edu/prodev.

BBL&A recently was retained as litigation counsel by a major Washington D.C. law firm to represent a conglomerate owner of a two million dollar claim made by a contractor for land-fill preparation and environmental clean-up. The claim was based upon alleged engineering errors and omissions.

BBL&A was recently retained to represent an owner of a residential project development in connection with a multi-million dollar claim asserted by a general contractor for delay damages.

BBL&A If you wish to order copies of "LePatner's Quotes on the Business of Life" issued in conjunction with BBL&A's 20th anniversary, you may do so by writing to Roy Pachecano, AIA or emailing us at mail@lepatner.com.

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Quote of the Quarter

"A man is a success if he gets up in the morning and does what he wants to do."

-- Bob Dylan