Professional Indemnity for Design & Construction

Background

Historically, contractors have avoided P I insurance by persuading clients that they have no design liability and that design professionals e.g. architects, engineers and the like will have such cover and that this would be sufficient. In recent years though, contractors are increasingly taking on a design liability, either by employing their own in-house professionals or by assuming a liability where they sub-contract out the design element. Design alterations during construction can also expose even the most basic contractor or firm.

When you undertake contracts on a design and construct basis it is you who will be the client's first port of call in the event of a design related problem. Even if a claim is ultimately the responsibility of another party, the costs of redirecting liability can be high and success is far from guaranteed. You will be responsible regardless of your ability to enforce an action against the negligent party.
This is where a Design and Construct (D&C) PI insurance policy comes into play, protecting both your finances and your relationship with your client. When problems do occur a swift and realistic approach is needed, particularly when the problem arises during the construction period.

Today, many clients expect even the smallest of construction firms and contractors to hold D&C PI insurance cover.

What does a D&C PII policy cover?

The cover afforded by a PII policy depends on the wording of the policy itself, any endorsements etc. A typical policy will cover you against any sum (up to the limit of indemnity) which you are legally liable to pay arising from any claim made during the period of insurance by reason of negligence or breach of duty arising from the conduct of your professional business. Whether the policy only covers claims for negligence (in contract or tort) or is wider and covers breach of professional duty or civil liability depends on the wording. Fitness for purpose obligations or indemnities are often specifically excluded, as are liquidated damages. See other exclusions at the end of this guidance.

Our cover typically includes

Claims made against the Insured arising from

- Breach of professional duty
- Any negligent act error or omission
- Dishonesty of employees
- Libel or slander
- Loss of or damage to documents up to £50,000
- Prosecution defence costs - no excess applicable
- Collateral Warranties - no limit on the number of assignments
- Costs and expenses taken to mitigate a loss
- Compensation for court attendance
- Defence costs (lawyers, court costs, experts etc.) inclusive of the Indemnity Limit

- Aggregate limit of indemnity - Any one claim limits maybe available for certain risks for an additional premium

Type of work

- **Full blown design and build** - this is where the contractor does everything using its own employees i.e. all the design work, the supervision of construction and the building work. The professional exposures are the same as a consultant within the construction industry.
- **Contingent design and build** - This is where the contractor takes on the contractual responsibility for the design but sub contracts out such work to others. The design work would be carried out by firms of architects and engineers who should carry their own professional indemnity. In view of the fact that insurers should be able to recover payments from those professionals who have carried out the negligent work, (any payments made emanating from their negligence) this is regarded as lower risk. It is vital here that the contractor ensures that any consultants it employs carry, and continue to carry, PI insurance.
- **Pure contracting** - This is where the contractor purely builds from the designs and under the supervision of other professionals who have been appointed directly by the client. This is considered by insurers as low risk work but is not without its dangers. See 'Hidden Exposures' below
- **Hidden exposures** - Frequently contractors who offer no design services at all are being asked to carry professional indemnity. A question they often ask is 'what risks do I face if I offer no professional services. The answer is that there are some risks:
    1. Design alterations: any firm involved in building anything will nearly always need to 'tweak' the plans a little in order to make them work. You could call this 'buildability' and the problem is that a small alteration here could have a larger knock-on effect, thus causing a real problem later in the job. A real liability can arise if plans are altered.
    2. Design checking services: often firms, formally or informally, double check designs to ensure they work. Failure to do so can lead to a claim.
    3. Temporary works: scaffolding, access roads, perimeter fencing, storage facilities are often part and parcel of a contract but are not designed and are left to the contractor. Such works can be expensive and can go wrong leading to further expense and consequential loss.
    4. Unsuitability of materials: Contractors may erroneously utilise materials that do not meet the specifications and have not been agreed. This can be very expensive if the materials prove not to be fit for the purpose intended.
    5. Duty to warn: a duty to warn the client of any problems or errors that the contractor might become aware of is sometimes included in the contract. Failure to warn when one is aware could lead to a liability and a claim under a PI policy.
- **Fees** - Sometimes a contractor earns fees (as opposed to turnover which is the correct description for the three categories above). They might project manage for other contractors or carry out other professional functions such as design or quantity surveying. These activities would be rated the same as a professional firm carrying them out.

Claims Examples[*]

Design failure - Contractors provided the client with a design and build service in respect of construction of a quarry conveyor belt, capable of carrying tonnes of material. The design of system was subcontracted out to specialists. After catastrophic failure of the conveyor belt machinery, substantial damage was caused. Although the claim was subrogated by PI insurers against specialist designers, the claim was settled against the Contractor for £42,000.

Alleged specification failure - Major fire at Heathrow Terminal 1 emanating from a fast food restaurant caused multi-million pound damage. Insured, one of 13 defendants added as co-defendants by building insurers. One of many allegations involved the inadequate specification of extractor flue that allowed hot gasses to build. Although the contractor was involved in specification, the claim was successfully defended. Costs £50,000.

Design failure - Temperature of new cold storage room at factory consistently too high because of inadequate design. Paid £250,000 plus costs.

Inadequate design - Air extraction and temperature control at restaurant failed to work properly. Restaurant was closed pending repairs. Paid £150,000 plus costs.

Structural design defect - Incorrect structural calculations contributed to total building failure of new car park. Paid £750,000 plus costs.

Negligent project management - Contractor instructed in role of project managers on existing but uncompleted development, problem due to bankruptcy of original contractors. Project involved restarting development, i.e. putting it back on track, utilising previous designs but new professional team. Allegations of negligence concerning duplication of work carried out by original team and additional duplications between new team, Surveyors, Engineers and QS. This led to an over-run on the contract budget. Paid £26,500.

Failure to comply with written specification - A shop-fitting contractor was verbally instructed by the client's project engineer not to use galvanised steel as per the agreed specification due to the lack of time available. The client subsequently sued for negligence as they had never authorised this change in specification and there was nothing was in writing. The claim was for over £100,000 but was eventually defended, incurring significant legal costs nevertheless.

Fire Safety Audits - When it comes to fire safety system, it is always wise to rely upon fire safety audit that ensures control over diverse system of arrangements, including firefighting equipment, exit lighting, warning systems, procedure training and compartmentalization so that you enjoy better fire resistance. These audits may ensure better safety from fire accidents but what if your customers claim negligence on your part. In such circumstances, it is always beneficial to get the coverage of professional indemnity insurance and stay away from hazards of libel and slander.

Structural Design Error - Detailers prepared structural drawings for the erection of steelwork. It was subsequently alleged that the drawings contained errors and £110,000 was claimed for the cost of alteration and the resulting delays in construction.

Design Errors - Fuel economy consultants were allegedly negligent in their design of heating and lighting for a factory. Substantial remedial work was required, resulting in a claim for £600,000.

Engineering Consultants - Consulting engineers were found to be negligent in their design of waste heating boilers. A claim for £4 million was brought for the cost of extra work and the resulting delays.

Late Additions - A general builder who was completing a refurbishment of a set of domestic flats to a previously agreed specification was asked to fit some additional external balconies not included in the architects plans. The design of the balconies subsequently led to water penetration into the flats beneath. The builder's design was found to be at fault and a significant compensation claim followed.

*these are generic claims examples which have been summarised and published by various insurers

Collateral warranties - Sometimes also called Duty of Care agreements, these are contractual agreements between parties who otherwise might not be in a contractual arrangement. In the case of a contractor it is unlikely he will have a contractual relationship with the purchaser of the building or the eventual tenant. It is possible that the building is funded by a bank or some other financial institution and again the contractor is unlikely to have a contractual relationship. A Collateral Warranty creates a contractual relationship between the contractor and these parties which reflects the responsibilities that the contractor has to his client. These agreements can also be assigned meaning that their benefits can be passed on from one owner or tenant to the next. Very often they only stop when the limitation period expires and this is likely to be 12 years after the date of practical completion. So now the contractor can be pursued by parties other than his client.
PII Insurers generally take the view that they will accept claims arising from sensibly worded agreements. The British Property Federation (developers' trade association) has agreed standard templates with most construction related professional bodies (RIBA, ACE, RICS included), which most insurers will accept. Insurers regard the acceptance of contractual liability beyond that normally owed by a professional to be beyond the intention of a PII policy. Therefore, unreasonable agreements could have very damaging effects on professionals, leaving them without cover.
Most PII policies address the issue of collateral warranties by clearly setting out the limits beyond which cover will not apply. This should avoid the need to submit each and every agreement for sanction by the insurer. Some of the more restricted policies offer very little cover in connection with this type of agreement, not even covering the British Property Federation agreements described above.
Of course, the 'claims made' nature of PII policies causes a difficulty here. If a contractor signs up to a collateral warranty having reassured himself that it is within the scope of his PI cover, what if he later chooses to (or is obliged to) change insurer? Or what if the insurer changes the wording? For this reason, you should urge your contractor clients to sign up to sensible agreements only. This can be very difficult in times of recession in the construction industry when contractors could be tempted to sign up to very nearly anything to secure work, regardless of the longer term consequences.
Consideration also needs to be given in cases where a collateral warranty requires you to carry a limit of indemnity higher than you normally would, as you will be committing yourself to carry a higher level of cover for the duration of the contract (usually 12 years) this can add significant costs to your PII premiums overtime. Contractors are often able to negotiate a reduced limit of indemnity with the developer when this is a concern.

The Housing Grants, Construction and Regeneration Act 1996

The biggest issue here for PI policies is the introduction of a standardised adjudication process to speed up the resolution of construction industry claims, cutting to a matter of weeks a process that has historically taken years. It is beyond the scope of this commentary to go into detail on the Act but it has had the following major effects:

- Insurers generally require notification of adjudication claims within a day or two. Notification of claims has always been an issue under PI policies, but insurers have not normally taken issue with the Insured over the matter of a day or two unless there has been clear prejudice. With adjudication claims there is little or no room for latitude.
- Insurers will not allow the insured to compromise any right of appeal. They must not enter into any contracts that allow the adjudicator to finally determine a dispute. Most policies incorporate a number of crucial clauses relating to the handling of adjudication claims. As ever, Contractors must read their policy very carefully to ensure that they do not fall foul of any of the requirements, in particular as regards this Act.

Please refer to our D&C policy wording for full details of your responsibilities to insurers in respect of adjudication.

Claims made

PII policies (which are annually renewable) are written on a claims made basis, in contrast to many other types of insurance. This means that the insurers who pay the claim are those providing cover when the claim, or a circumstances which might give rise to a claim, is first notified to insurers, rather than when the work was undertaken or the mistake made. The significance of this can be seen: the cover might be wider when a contract is entered into than when a claim is made. Cover only operates from the retroactive date.

Indeed, you may have entered into contracts in the past which are not fully covered by your current insurance, or which you can only cover on payment of an additional premium. When negotiating with clients therefore, you will want to avoid agreeing to potential liabilities for which you might not be able to get insurance in the future. This might mean restricting the services you provide, or excluding or limiting liability. If you take on liabilities which in the event are not covered by insurance, both you and your client are likely to suffer. You will also want to check the insurance clause in any contract, and include caveats such as 'provided that such insurance is available at reasonable commercial rates'.
A further example of the effect of a claims made policy is that if a claim is made against a retired professional who is no longer covered by a current insurance policy, there will be no insurance for that claim. On retirement therefore, you need to ensure that insurance is maintained - either under your former firm's policy or your own run-off policy