LIABILITY INSURANCE IN THE CONSTRUCTION INDUSTRY

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An understanding of basic risk management is essential for all construction participants. All such participants need to be able to recognize the general risks involved in a construction project, and identify the risks associated with their particular roles in that project. Construction participants then need to evaluate their options for managing those risks. At a very basic level, there are three ways to handle construction-related risks: (1) transfer the risk to other construction entities through contracts; (2) mitigate or eliminate the risk by modifying behavior; or (3) purchasing insurance. This paper focuses on issues involving this third method of managing risks - liability insurance.

I. CHOOSING A LIABILITY INSURANCE CARRIER

The first step in procuring liability insurance coverage often involves choosing a broker or specialized agent to service and provide guidance to the architect or engineer. Insurance brokers and/or agents can be an excellent source of information and education about particular insurance policies. The International Risk Management Institute ("IRMI") also is a good source of information. Their website is www.irmi.com.

When determining the carrier from which to purchase liability insurance, engineers and architects should assess the following:

COVERAGE - Which carrier offers the best and most applicable coverage? Construction professionals need to know whether the coverage is likely to be sustained, or does the company often change its offered coverages depending on the market.

LIMITS AND DEDUCTIBLES/SIRs - The liability insurer is only obligated to pay claims up to the aggregate policy limit and usually the policy imposes a per claim/occurrence limit restricting the amount of coverage available for each claim. Policies can differ as to whether claims expenses (including attorney fees) will be included in the tally towards the exhaustion of policy limits. With regard to deductibles/self-insured retentions (SIRs), is the deductible/SIR applied to each claim, does it apply to liability and defense costs, and must it be paid up front or can the insured wait to pay until after the claim is resolved?

STABILITY - How long has the insurer been in the particular business of writing professional liability policies? Has the company come in and out of the market depending on the economic climate?

SOLVENCY - Is the insurer economically viable and capable of withstanding changes in the insurance market? Rating services such as Best's, Duff & Phelps, Moody's and Standard & Poor's assist in this analysis.

PRICE - Construction professionals should analyze the premiums required from various insurers for the limits of liability and coverages provided. However, price should seldom be the primary consideration in that you usually get what you pay for.

UNDERWRITING - What are the company's underwriting procedures? Does the company accept poor or borderline risks?

REINSURANCE - Reinsurance is reapportioning the risk of loss to more than one insurance carrier. Determine whether the carrier has selected adequate reinsurance arrangements that help guarantee that the carrier will be solvent to pay large claims.

CLAIMS SERVICE - Does the carrier have a history of complaints about its claims handling? Can the insured report a claim directly to the local broker rather than to the company, and does the carrier allow the insured's input as to the selection of defense counsel?

CLAIMS PREVENTION - Some insurers offer claims prevention programs and seminars, newsletters and on-site audits to reduce potential exposure to claims.

II. GENERAL LIABILITY INSURANCE VS. PROFESSIONAL LIABILITY INSURANCE

The two main types of liability insurance available to architects and engineers are commercial general liability insurance policies and professional liability insurance policies.[1] These policies are designed to cover completely different risks so it is very important for the construction professional to understand the differences between the policies and the type of loss each policy covers.

A. Commercial General Liability Insurance

1. Insuring Agreement

A commercial general liability ("CGL") policy typically provides coverage for four types of damages: (1) "bodily injury"; (2) "property damage"; (3) "personal injury"; and (4) "advertising injury." "Advertising injury" usually relates to claims of libel, slander, invasion of privacy, misappropriation of advertisement, or copyright infringement. "Personal injury" usually is defined to include false arrest, malicious prosecution and wrongful eviction. "Bodily injury" is fairly easy to interpret – it means "bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time." In Alabama, unlike many other states, mental anguish and emotional distress, even when not arising from an actual physical injury, have been found to be "bodily injury" under the standard CGL policy. See Alta Mut. Ins. Co. v. Morrison, 613 So. 2d 381 (Ala. 1993).

In the construction context, the most litigated damage issue usually involves the definition of "property damage." Under the typical CGL policy, "property damage" is defined to mean:

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[1]Umbrella and excess liability insurance is available as well. Generally, an umbrella policy increases the limits of a general liability policy. It may also provide coverage that an underlying policy does not provide. An excess liability policy usually just extends the limits, with no additional coverages, of the underlying policy.

(a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or

(b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the "occurrence" that caused it.

Insurance carriers issuing CGL policies frequently assert the definition of "property damage" as a defense to coverage when a property owner makes construction-related or faulty workmanship claims.

Under a CGL policy, any alleged damage suffered by a claimant must be caused by an "occurrence." "Occurrence" is defined as: "an accident, including continuance or repeated exposure to substantially the same general harmful conditions." Until recently, Alabama courts defined "occurrence" broadly.

> Although an exact definition of an occurrence would be of paramount importance, the cases decided by [Alabama appellate courts] have tended to settle occurrence issues by determining if the insured expected or intended a specific bodily injury or property damage. The current rule seems to be that an insured will not be denied coverage unless he intended or expected injury no matter the character of the act. Even a cursory reading of relevant Alabama cases revealed that almost any event is an insurable accident, i.e., an "occurrence."

Alabama Liability Insurance Handbook, § 8-3 (1996).

The case of Hartford Cas. Ins. Co. v. Merchants & Farmers Bank, 928 So. 2d 1006 (Ala. 2003), seems to call this principle into question. In that case, the Alabama Supreme Court made clear that the term "accident" as used in the definition of "occurrence" is "[a]n unintended and unforseen injurious occurrence; something that does not occur in the usual course of events or that could be reasonably anticipated [and] has been variously defined as something unforeseen, unexpected, or unusual." In analyzing whether a complaint against the insured was based on an "occurrence," "it is the facts, not the legal phraseology, that determined whether an insurer has a duty to defend its insured in the action." "When a complaint supplies descriptive facts and those facts are irreconcilable with a legal theory, such as

'negligence,' asserted in the complaint, the facts, not the mere assertion of the legal theory, determine an insurer's duty to defend." In short, this case seems to pull back on Alabama's broad interpretation of "occurrence" and hold that the legal theory or cause of action asserted does not govern coverage; rather, the facts alleged in the complaint do.

2. Exclusions

The main exclusion architects and engineers should be aware of in CGL policies is the professional liability exclusion. This exclusion usually is added to CGL policies via endorsement. It typically states:

> This insurance does not apply to "bodily injury," "property damage" or "personal and advertising injury" arising out of the rendering of or failure to render any professional services by you, but only with respect to your providing engineering, architectural or surveying services in your capacity as an engineer, architect or surveyor.
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> Professional services include:
>
> (1) Preparing, approving, or failing to prepare or approve, maps, shop drawings, opinions, reports, surveys, field orders, change orders, or drawings and specifications; and
>
> (2) Supervisory or inspection activities performed as part of any related architectural or engineering activity.

The standard CGL policy also contains several other exclusions that carriers invoke for claims arising out of construction. Those include: (1) the expected or intended injury exclusion; (2) the contractual liability exclusion; (3) the care, custody and control exclusion; (4) the damage to property exclusion; (5) the "your work" exclusion; (6) the "your product" exclusion; (7) the "impaired property" exclusion; and (8) the "sistership" exclusion. These exclusions were crafted by the insurance industry to attempt to avoid the risk of insuring against faulty workmanship and to prevent courts or insureds from transforming the CGL policy into a performance bond.

B. Professional Liability Insurance Policy

Professional liability coverage for architects and engineers has been written for approximately 40 years. It provides the primary coverage for bodily injury, property damage and consequential damages caused by an architect's/engineer's negligent performance of professional services. Professional liability coverage is sometimes referred to as "errors and omissions" insurance. By definition, a professional liability policy is specialized and limited. It is designed to insure members of a particular professional group against liability arising out of a special risk inherent in the practice of the profession.

Like other professionals' malpractice coverages (e.g., doctors, pharmacists, real estate agents and lawyers), such coverage can be expensive. However, in today's litigious climate, especially in the construction context, such coverage for architects and engineers is highly recommended.

1. "Professional Services"

As the name of the policy suggests, a professional liability policy is designed to insure against liability caused by a negligent act, error or omission committed by the insured in the course of providing professional services. It is intended to cover claims related to the breach of the professional's traditional duty of care - the duty to use the degree of care and skill expected of a person in the same profession. This intent is usually conveyed by defining professional services in the policy to essentially the services the policyholder is qualified to perform as an architect or engineer. Some policies define "professional services" as "those services which [the insured is] legally qualified to perform for others in [the insured's] capacity as an: (1) architect or engineer; or (2) landscape architect, land surveyor or planner." Those services may be specifically listed in the policy, on the declarations pages or in an endorsement. If the services are indeed listed, that list controls and the liability arising from services beyond those listed usually will not be covered. Robert Mark Chemers and James A. Knox, Jr. "When Designs Don't Work: Professional Liability Coverage of Architects and Engineers," 15 Construction Lawyer 17 (January 1995). The exact interpretation of what a "professional service" is, especially when the policy is unclear or does not specifically list the insured services, has been fertile ground for litigation between insureds and insurers.

One interesting case is American Motorists Ins. Co. v. Republic Ins. Co., 830 P. 2d 785 (Alaska 1992). In that case, the underlying claim asserted that an architect's bid to design a school contained misrepresentations. The insurer argued that preparation of a bid was not a "professional service" within the meaning of its policy. The court disagreed and ruled that professional services had been rendered

and that the policy therefore applied. Specifically, the court highlighted that the bid was more than just a quote and consisted of 160 pages that could only have been prepared by an architect pursuing his profession.

A frequent area of dispute is whether supervision of construction is considered a "professional service." Service as a construction manager or supervisor often is specifically excluded by professional liability policies. However, absent an exclusion, the courts have been receptive to the argument that supervision is considered a "professional service" but each case rises or falls depending on its specific facts.

2. Claims-Made Policies

It is very important to remember that most professional policies are claims-made policies as opposed to occurrence policies. As mentioned above, CGL policies usually are occurrence policies.

The difference between an occurrence policy and a claims-made policy is the nature of the peril insured. As the name suggests, an occurrence policy provides coverage if an occurrence resulting in covered damage occurs during the policy period regardless of whether the claim against the insured is asserted within that period. Occurrence policies can, therefore, give rise to much uncertainty for insurers because the carrier's exposure for a given occurrence or damage can last for decades.

Under a claims-made policy, the claim itself is the peril insured against. Coverage attaches under the policy that was in force when the claim is made, regardless of when the occurrence/damage giving rise to that claim took place. However, if a claim is not made until after a claims-made policy expires, no coverage attaches even if the claim itself is based on an occurrence or damage that took place during the policy period.

From the insurance company's perspective, claims-made coverage allows more certainty for the prediction of losses and risks. When a claims-made policy term expires, the insurer knows exactly what its exposure is, at least in terms of the nature and number of claims made. From the policyholder's perspective, a claims-made policy allows more clarity in the determination of policy period issues. There is much litigation as to when, under a CGL policy, an "occurrence" or damage happens. A claims-made policy gives the insured more certainty as to which insurer is actually "on the risk" for a particular claim.

3. Insuring Agreement

A typical insuring agreement for a professional liability policy reads: "We will pay on behalf of the Insured all sums in excess of the deductible . . . that you are legally obligated to pay as Damages because of Claims first made against you during the policy." A fairly standard definition of "claim" is: "any demand made against you seeking Damages due to your Professional Services and alleging liability or responsibility on your part." "Damages" are defined to mean: "the monetary amounts for which you may be held legally liable, including sums paid as judgments, awards, or settlements." Based on these definitions, the type of claims, losses or damages covered are broader than a CGL policy which is restricted just to damage which could be defined as "bodily injury," "property damage" or "personal or advertising injury." As such, professional liability policies respond to a larger variety of claims for damage and consequential damage (such as lost revenues, lost use of property or delay) that are caused by the insured's professional activity.

In addition to a broader scope of damages covered (as long as they are caused by the architect's or engineer's "professional services"), the definition of "Claim" in a professional liability policy gives the insured broader coverage than the CGL policy. In a standard CGL policy, coverage is triggered once a suit is filed. In a professional liability policy, coverage is triggered when a "claim" is made. As mentioned above, "Claim" often is defined as a "demand made against you seeking damages." This can include the service of a lawsuit or the institution of an arbitration proceeding. It would also include a demand letter from the allegedly injured party. However, to be considered a demand letter, courts usually require that the letter contain a claim for damages against the insured.

4. Exclusions

Professional liability policies can contain a "prior acts" exclusion. This is very important due to the claims-made nature of such policies. Under a "prior acts" exclusion, if claims are made within the policy period but they are based on occurrences predating that period, there would be no coverage. The "prior acts" exclusion can be deleted, usually via endorsement, but frequently requires an additional premium because obviously the insurer is undertaking more uncertainty if no "prior acts" exclusion exists. In addition, applications for professional liability policies usually require disclosure of information about existing claims and potential claims. It is very important that the applicant thoroughly address those questions because, among other things, misrepresentation of material facts on an application can create a coverage defense for the insurer.

Construction professionals' liability policies often include a provision excluding coverage for high-risk design. This may include services for the construction of tunnels, bridges or dams; sewage treatment; hazardous waste treatment; asbestos; toxic chemicals; and nuclear energy.

Professional liability policies can contain contractual liability exclusions. These exclusions are placed in the policies because according to insurers, design professionals tend to voluntarily assume risks that have nothing to do with their competence as architects or engineers; and they breach contracts for reasons other than malpractice. Some of these exclusions include: providing or failing to provide accurate cost or quantity estimates; failing to complete plans or specifications on time; contractual indemnification of others; breaching express warranties or guarantees; and deliberate suspension or termination of performance.

Professional liability policies for architects and engineers also may contain construction risk exclusions. These exclusions dovetail with the purpose behind the policy, i.e., to insure the policyholder for claims arising from construction design. Execution of the design should be left to the contractor. If an architect or engineer starts building, the risk, according to insurers, increases dramatically. The usual construction exclusion states that coverage is excluded if the claim arises from "actual construction activities by the insured; or assembly, construction, erection, fabrication, installation or supply of products or materials by the insured."

Like most professional policies, construction-related professional liability policies exclude coverage for intentional tortuous activity. That exclusion often encompasses "dishonest, fraudulent, or criminal acts, errors or omissions; intentional torts including libel or slander; infringement of copyrights, trademarks or patents; industrial piracy, unfair business practices, misappropriation of trade secrets; punitive damages; and fines or penalties."

It is imperative that the architect or engineer thoroughly review any professional liability policy with his/her insurance broker or attorney. Due to certain risks encountered by the design professionals, negotiation with the insured about some of these exclusions may be necessary. Of course, the removal of a standard exclusion from a policy, if the carrier is willing to do so, would necessarily result in a higher premium.

III. ADDITIONAL INSURED ISSUES

Construction contracts often include requirements that the construction entities name others as additional insureds under their liability policies. Usually, professional liability insurers do not allow additional insureds on their policies. However, CGL policies frequently include additional insured endorsements.

Even if the project involves contractual indemnification by the contractor or others to the design professionals, there are advantages for the architect/engineer to be named as an additional insured. Being an additional insured reinforces the risk transfer accomplished by the contractual indemnity by providing the additional insured with direct rights under another insurance policy. Being an additional insured gives the design professional the right to an immediate defense (assuming a covered claim exists) by the named insured's insurer, rather than waiting to establish fault and being reimbursed for defense costs. If the design professional is an additional insured under the underlying CGL policy, it may also be an additional insured under the umbrella policy depending on that policy's wording.

It must be remembered that if you are named as an additional insured, the aggregate policy limits are shared with the other insureds. As such, it is important to know what limits remain available under any policy for which you are named as an additional insured.

The insurance industry also has crafted a variety of different endorsements. The more recent endorsements usually narrow the scope of coverage afforded to the additional insured. The most recent endorsement is geared to prohibit coverage for the additional insured's sole negligence. In other words, the relatively new endorsements trigger additional insured coverage only when the named insured contributed to the negligence that caused the damages. As such, it is recommended that construction participants specify in their construction contracts which additional insured endorsement should be used. It also is important for the architect/engineer to know whether the additional insured coverage applies as primary coverage.

The bottom line is that additional insured clauses are not substitutes for indemnification provisions in construction contracts, but they are an additional benefit to the parties named as an additional insured.

IV. CERTIFICATES OF INSURANCE ISSUES

Many insurance contracts require the party who is providing work or services to obtain an Association for Cooperative Operations Research and Development (ACORD) certificate of liability insurance for the other party. ACORD is a not-for-

profit insurance association that develops and implements standards for the insurance industry. The most common ACORD certificate is the ACORD 25 "Certificate of Liability Insurance."

Construction entities mistakenly use certificates of liability insurance to evidence that their contractual insurance requirements have been met. Certificate holders often believe that they have certain rights solely through the certificate. This is not true if the ACORD certificate includes its usual disclaimer: "This certificate is issued as a matter of information only and confers no rights upon the certificate holder. The certificate does not amend, extend or alter the coverage afforded by the policies below."

Based on this disclaimer, if the insurance policy listed on the certificate has not been amended to broaden the designated insured, the certificate holder has no rights against the insurer (but may against the construction entity issuing the certificate). Thus, it is very important that certificate holders look to the policy itself to determine coverage. Design professionals should obtain a copy of the policy and any additional insured endorsement evidencing a change to the policy in addition to obtaining a certificate of insurance.

V. INSURED'S DUTIES

The two main duties imposed on the insured in liability policies are: (1) the duty to timely notify the insurer of a claim; and (2) the duty to cooperate.

It is very important for the insured to notify any and all liability insurance carriers of a claim. Under a CGL policy, the insured is required to give timely notice of any lawsuit as well as any "occurrence" that may give rise to a lawsuit. In determining whether reporting a claim to an insurer is timely, Alabama courts usually look at two issues: (1) the length of time between the suit / "occurrence" and the notification; and (2) any excuses the insured may have in failing to provide timely notice. There is case law suggesting that the determination of those two issues is a fact issue for a jury to decide. However, there are a number of cases from Alabama state and federal courts finding that, as a matter of law, the insured failed to meet its duty to provide timely notice. In addition, in Alabama, unlike other jurisdictions, the primary insurance carrier does not need to establish prejudice to invoke this coverage defense.

With regard to claims-made professional liability policies, it is imperative that a claim is actually reported during the policy period. To accommodate reporting of

claims made toward the end of a policy period, 30 or 60 days are usually allowed to report a claim after the end of that period. Some policies even permit an extension of the claims-made period, but only for claims relating to incidents that happen prior to the end of the original policy period. A timely reporting to a professional liability carrier is particularly critical if the insured is planning to change carriers because the application for coverage with the new carrier usually requires the insured to list any such claims and the new carrier could then exclude them from coverage.

Under both CGL and professional liability policies, the insured has an ongoing duty to cooperate with the insurer. This is particularly relevant when the insurer agrees to defend the insured. In those circumstances, the insured is expected to assist in obtaining and producing witnesses and documents, to attend depositions, and to attend trial. The time an engineer or architect spends in cooperating with the insured can be very expensive but the insured bears the expense itself and cannot seek reimbursement from the insurer.