

American Bar Association
Forum on the Construction Industry

**The Right Floatation Device: Changes in Insurance and
Surety Products to Keep Up With Innovative
Contracting Methods**

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Presented at the 2012 Fall Meeting

October 18 – 19, 2012
Sheraton Boston Hotel, Boston, MA

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Introduction

Risks associated with alternative project delivery are changing and expanding with each new delivery method. The insurance market has not always kept pace with construction industry innovations, but there have been several new coverages recently introduced. Awareness of these policies, and creativity in customizing them, can yield valuable additions to your clients' corporate or project insurance portfolio to cope with the risks of alternative project delivery.

Of equal importance is the increased risk associated with the failure of a project participant to procure proper insurance. Reliance upon the contract insurance requirements specified in industry standard form agreements is of little help because most are written in generic terms with only core coverages specified. Parties involved in a design-build project, for example, incur increased risk when a trade contractor fails to purchase adequate limits of contractor professional liability insurance. This scenario could easily happen if the trade contractor is performing design services in addition to construction, and perhaps also contributing to a BIM model.

The difficulty of creating an appropriate project insurance portfolio can be complicated by a number of factors, including risks unique to a type of project, corporate insurance program limitations, improper specification of contract insurance requirements, and lack of understanding of extensions available for core coverages. This paper examines some of the most common insurance issues encountered in new forms of alternative project delivery; Integrated Project Delivery, Public-Private Partnerships, and Design-Build. The paper will also examine two new coverage extensions for Contractor's

Professional Liability and other specialty insurance coverages that have applicability to alternative project delivery.

1. Alternative Project Delivery Insurance Issues

a. Integrated Project Delivery

Certain segments of the construction industry, like healthcare, have begun moving away from the traditionally adversarial relationship that existed among the owner, architect, and constructor of a project. Using Integrated Project Delivery, or IPD, the parties employ a collective approach in which they agree, within certain limitations, to share the risks, agreeing to forego individual liability policies in favor of deductibles or self-insured retentions to cover errors and omissions (but not willful acts) by themselves or one of the other parties. A certain change in mindset is required for this to work, a conscious switch from trying to make sure the other guy pays to collectively accepting and managing risk. The incentive is fewer mistakes and delays, and participation in a reward pool if things go well.

The intent of IPD is to encourage a team approach from the beginning and to reduce the number of situations that lead to liability claims. Under IPD, each party is implicitly encouraged to ‘have the back’ of the others, because to play selfish might result in a financial downside for all. The parties agree not to make claims against each other under most circumstances.

There are specific insurance implications of IPD, of course. For all the benefits of this new approach, it presents risks that typical insurance products do not address. One of the main hurdles is fault, or the lack thereof. Construction insurance is traditionally fault-

based, and some carriers may not be amenable to a no-fault approach. And while the parties to the project may be willing to go the no-fault route, third parties with liability claims will not. This is where the IPD concept is most at risk. Under IPD, all parties are on the hook for a valid third-party claim against any one of them. Multiple carriers have the potential to undermine the IPD team approach based on their handling of claims.

Another problem revolves around professional liability. A collaborative approach can blur the lines of design responsibility, and the insured-versus-insured exclusion limits traditional recovery in a multiparty contract. A customized approach that integrates the contract risk sharing scheme into a project-specific professional liability policy often works best as exhibited below.



Several insurance companies have developed special IPD solutions tailored to the unique needs of IPD. The solutions can include:

- Professional liability coverage tailored to the contract terms and coordinated with a Controlled Insurance Program;

- Incorporation of both first party and third party coverage for technology risks associated with the use of BIM;
- Project dispute resolution processes incorporated into the terms of the professional and pollution liability coverages;
- Some builders risk insurers will agree to waiver of subrogation against all IPD team members;
- Claims adjusting protocols feature a single point of contact for all lines, establish internal coordination features and foster collaboration with the insureds;
- The insurer assists with the evaluation and enhancement of the IPD project's QA/QC program.

Finally, subcontractor default insurance is often overlooked as an integral part of an IPD insurance program, but its terms can also be customized to meet the contract risk allocation provisions.

b. Public- Private Partnerships (P3)

Increasingly, government is teaming with the private sector in Public-Private Partnerships. These allow private capital to be invested in public construction projects in return for future income during the operational phase. In a time of scarce tax dollars, governments at all levels view P3's as a way to get more bang for the buck. Businesses entering into P3s face a number of unique risk factors, including bidding and procurement requirements, buy-American provisions, performance bonds, availability of mechanic's lien remedies, prevailing wage requirements, minority hiring and sub-contracting requirements, sovereign immunity rules, and lastly, politics and the

possibility that the public may turn against a project for any number of reasons, including cost overruns. Depending on the locale, one might even add political corruption to the list of things to watch out for when entering a P3.ⁱ

The insurance industry now offers policies to protect against these risks to developers and contractors entering P3 building projects for things such as toll roads, highways, bridges, tunnels, airports, waste water treatment plans, utility projects, rail and light rail projects, and prisons. Coverage can include general liability insurance, professional liability, builders risk during construction, and operational general liability and property after the project is complete. Insurers provide intensive risk assessment, and once coverage is purchased, continue to offer project-specific risk management advice and claims management and resolution programs.

Considering the complex relationships involved in a P3 project, the insurance coverage must contemplate protection for more parties and more risks than in a traditional design-bid-build setting. The chart below illustrates some of those coverage extensions.

| P3 Entity | Risk Exposure | Insurance Solution |
|---------------------|---|---|
| Owner | Design and Construction defects; Preliminary Engineering Services | Name Public Owner as Indemnified Party on Design Professionals' Liability Insurance and as Additional Insured on all Contractors' GL Insurance Policies |
| Owner and Lender(s) | Premises/ Operations of Construction and Completed Project | Name Public Owner and Lenders as Additional Insureds on Concessionaire's GL Policy |
| Owner | Property exposures | Builders Risk Insurance with mutual Waivers of Subrogation |
| Concessionaire | Cost, Schedule, Revenue | Miscellaneous Professional |

| | | |
|---|---|--|
| | Projections, Lawyers and Accountants Liability, and Economic Consultants Liability | Liability Insurance Policy |
| Concessionaire | Fiduciary Liability, Limited Partnership Liability and Employment Practices Liability | Fidelity/ Crime Insurance, Management Liability and Employment Practices Policy |
| Concessionaire | Funding Risk | Miscellaneous Professional Liability; Management Liability Insurance |
| Concessionaire | Legal Requirements - permits - approvals (e.g. incorrect identification, or technical errors resulting in failure to obtain or achieve approvals, etc.) | Miscellaneous Professional Liability Insurance Policy |
| Concessionaire | Environmental and site risk | Pollution Liability Insurance |
| Concessionaire | Vicarious design and construction defect risk | Indemnified Party on Design Professionals' and Additional Insureds on Contractors' General Liability Insurance Policies |
| Concessionaire | Premises and completed operations on finished Project | Annual GL Insurance Policies; Additional Insured on ALL Contractors, including Operations & Maintenance GL Policies |
| Lender's Engineer | Due Diligence review - cost, schedule, design, constructability feasibility studies on behalf of the lending institutions | Professional Liability: Lender's engineer may be an insured under separate Project-Specific Professional Liability Policy. |
| Design-Builder Contractor and all Subcontractors of all tiers | Defective design (vicarious) | Design Builder is an Indemnified Party on Sub-Consultants' Design Professionals' Professional Liability Policy. |
| Design-Builder Contractor and all Subcontractors of all tiers | Construction: Premises and Completed Operations, Safety, Faulty Workmanship: BI, PD | Construction Wrap-Up Insurance Policy. |
| Design-Builder Contractor and all Subcontractors of all tiers | Property Exposures | Builders Risk with mutual Waivers of Subrogation |
| Design-Builder Contractor and all Subcontractors of all tiers | Environmental Risk Exposure | Contractors Pollution Liability |
| Design-Builder Contractor and all Subcontractors of all tiers | Railroad liability-exposure for operations with 50' of RR tracks | Railroad Protective Liability Insurance |

| | | |
|--|---|--|
| Design-Builder Contractor and all Subcontractors of all tiers | Payment and Performance Guarantees | Surety Bonds |
| Design Professionals as Sub consultants to Design Builder and contract to Lenders or Owner | Professional Services/ Errors and Omissions/ Delay and Consequential Damages/ Misunderstanding Conceptual (RFP) Design Criteria or other project requirements | Project Specific Professional Liability Insurance Owner, Concessionaire and Lenders are Indemnified Parties |
| Operations & Maintenance Contractor | Premises Liability and Completed Operations Risk Exposures | General Liability Insurance Annual Insurance Policies. Concessionaire is an Additional Insured |
| Operations & Maintenance Contractor | Environmental Risk Exposures | Pollution Legal Liability Insurance. Concessionaire is an Additional Insured. |
| Operations & Maintenance Contractor | Property Exposures; Care Custody & Control | General Property Insurance |

Source: Chartis Insurance Company and Donovan Hatem

From the public entity’s perspective, the goal when soliciting proposals from private consortiums is twofold: to appropriately allocate risk between the public entity and the private parties; and to attempt to assure a reasonably level playing field among the proposers as they consider the cost, type, and duration of insurance required to be maintained during the project construction and operation. Interestingly, it is difficult for even the most sophisticated of P3 consortiums to develop a comprehensive insurance scheme for the project which often includes the full range of insurance products. Contract insurance requirements for a P3 project typically express the obligations of the public entity, the private entity, the periods during construction and then operation, and for those parties included within a Controlled Insurance Program (CIP) and those outside of it. It is not uncommon for there to be several rounds of discussion during proposal development between the public entity and proposers specifically related to the specificity of the contract insurance requirements.

The examples which follow are designed to provide a flavor of the types of risk issues addressed in P3 insurance discussions:

- Which party takes responsibility for a builders risk or property loss in excess of required limits? Should the public entity specify a “probable maximum loss estimate” or allow each proposer to develop their own?
- In a 20 to 50 year concession agreement, who bears the long-term risk of an increase in insurance premiums? What is the appropriate benchmark for measuring an increase in insurance cost?
- Every P3 contract contains an extensive force majeure clause. Which risks are insurable and how long is the waiting period (retention)?
- Under certain builders risk and property policies, “subsidence” risk may not be insurable but “abnormal subsidence” may be.
- What is the appropriate limit of general and umbrella liability insurance during the operation of a toll bridge; \$50 million or \$100 million?
- Should the public entity specify the use of a project-specific professional liability insurance policy or allow the proposers to use a combination of project-specific and annual practice insurance policies?
- If traffic on a toll road or bridge can be impeded by an upstream or downstream event, should the proposers be required to purchase contingent business interruption insurance?

c. **Design-Build**

Under design-build delivery, risk and insurance issues are most affected by the configuration of the design-build entity. Contractor-led design-build is the most common variation. In most cases, the design-builder will not want to solely rely on either the contractual obligations of the designer or designer's professional liability insurance policy, which often includes relatively low policy limits. Instead, the design-builder will want its own professional policy to protect against its vicarious liability arising from the acts of design professionals acting on its behalf as well as the direct claims that may be asserted against the design-builder for the negligent performance of its own professional responsibilities.

Contractors Professional Liability (CPL) coverage on a design-build project provides such coverage for the general contractor's professional services. CPL can be purchased as an annual practice policy or as a project-specific policy. Part A covers defense and indemnity related to actual or alleged negligent acts, errors or omissions in rendering professional services. Part B of CPL protects the general contractor against damages beyond the policy limits of a design professional's own coverage. A design professional's own coverage must be exhausted before Part B coverage of the general contractor kicks in.

Part B is also called Protective Coverage and is often misunderstood. Protective Coverage is a first-party coverage that indemnifies the design-builder, excess of the design professional's professional liability insurance, for costs the design-builder incurs, and is legally entitled to recover, as a result of negligent acts, errors, and omissions of design professionals with which the named insured holds a contract. In addition,

Protective Coverage also affords a difference-in-coverage (DIC) above the underlying professional liability policy and extends coverage to the design-builder in the event the underlying policy is deficient in coverage. Such deficiencies may include exclusionary language for mold or other pollution conditions, residential exclusions, cost overrun exclusions, or quantity estimating exclusions that may exist in a design professional's practice program.

Insurers also offer enhancements to the CPL product beyond the coverages afforded in Parts A and B which include:

- Expanded professional liability coverage for contractor's means and methods – closing the gaps created by exclusionary language applied in many industries –for commercial general liability;
- Expanded definition of professional services that now includes technology services, specifically addressing LEED® and BIM;
- Blanket joint venture coverage to help protect the design-builder's interest in a joint venture;
- Modification of the warranty/guarantee exclusion to make an exception for liability that would have attached in the absence of the warranty or guarantee; and
- Choice of Self Insured Retention coverage under Part B.

2. Contractors Professional Liability Insurance

a. Rectification Coverage

A new type of coverage that has come on the market from a few insurers is rectification, or mitigation of damages coverage. This insurance provides the contractor with first-party coverage for damages incurred as a result of a design error discovered during the construction process; something that if not addressed would have resulted in a professional liability claim. A typical beneficiary of a rectification policy would be a contractor who discovers during construction that the designer he hired specified the wrong size rebar. It has to be ripped out and replaced, and the cost is \$3 million.

These policies typically carry a self-insured retention starting at \$250,000. The insurer will usually subrogate against the design professional. Meanwhile, however, the contractor can repair the defect with insurance money rather than using its own funds. The disadvantage of rectification coverage is that it can expose the contractor's professional liability insurance to a greater probability of loss, and possibly affect the future insurability of the contractor, regardless of whether the insurer is successful in his subrogation action against the designer.ⁱⁱ

b. "Faulty Workmanship" Coverage

Artisan and specialty contractors—those who do one thing, such as carpentry, plumbing, or roofing--have "faulty workmanship" exposure that is not covered by general liability or traditional professional liability policies. These contractors must normally meet several tests to be allowed to purchase the policies from insurers, typically including construction values of at least \$500,000, five years of experience, an acceptable loss ratio, and less than 25 percent residential and 10 percent condominium exposure.

“Faulty Workmanship” coverage applies to such things as property damage, loss of use, or the recall of a product, say a furnace or air conditioner installed by the contractor. There is also protection for vicarious liability, meaning for the negligence of any architects, engineers or designers hired by the artisan firms as subcontractors, or for “value engineering” opinions that prove to be wrong. An example of this might be when the contractor gives the client advice on how to do a job in what he thinks would be a cheaper way that in fact turns out to cost more. “Faulty workmanship” policies can also provide coverage for damage from water intrusion, mold, asbestos, silica or respirable dust risks. Insurers can tailor these policies for the unique circumstances of individual artisan contractors.

3. Specialty Insurance Coverage

a. Intellectual Property Insurance

Construction designers and architects sometimes face the issue of intellectual property infringement. An infringer could be someone who copies a unique design feature or set of features marketed by a firm, someone who gains access to a design for an entire building and uses it without permission to construct an identical building, or someone who obtains a set of plans, changes the captions and the sets off to sell them to a third party. In establishing infringement, one must determine whether the design was provided as a work-for-hire, whether the architect licensed the plans to a client for a limited purpose and period of time, etc.

Intellectual property insurance is available to enforce copyrights, known as abatement insurance, and to defend against infringement claims. Abatement insurance

policies may require that damages beyond a certain amount, say, the first \$100,000, be devoted to paying back the money laid out by the insurance company for the case. Defense insurance contains no similar provision, but does require the policyholder to obtain a ‘favorable opinion letter’ on the case to receive benefit of the full policy limits. Multi-Peril policies reimburse the decreased value in a firm’s assets resulting from the loss of IP litigation either as a plaintiff or defendant. Covered perils are Loss of Commercial Advantage, Business Interruption and Cost of Redesign, and Remediation & Reparations.

b. Contract Litigation Insurance

Legal fees are the big stick of contractor litigation. Even companies that believe that they have a meritorious case are often reluctant to go into court due to the legal and consulting costs involved. They feel pressure to settle, knowing that not only will they have to pay their own legal fees and costs but that there is a chance that they might get saddled with an order to pay the other side’s legal fees if they lose. Depending on the size and nature of the claims, legal fees can easily be more than the damages themselves. While the U.S. civil litigation system generally requires each side to pay their own legal fees, no matter the outcome of the case, “loser pays” contractual language is becoming more prevalent and many courts have enforced these provisions. Europe has always had a “loser pays” legal system, enforcing the rule whether the litigation was contract-related or not, and companies often insured themselves against just such an outcome.

Until relatively recently, however, contract litigation insurance was not available in the United States. But at least one large insurer is now offering the coverage here,

enabling companies or individuals to pursue strong, contract-related claims that otherwise might reluctantly have been abandoned due to the risk of losing. It also enables companies to better budget for litigation expenses and may provide leverage in settlement negotiations.

c. Cyber-Liability Insurance

We hear almost daily of data breaches by hackers, virus attacks, and other reminders that businesses are vulnerable to that most modern form of crime, the cyber-attack. The construction industry is no exception. Mobile data delivered to or from iPads or other tablet computers in the field provide much convenience to the construction process but also vulnerability to cyber-attacks unless the proper steps are taken.

But what if the proper steps are not taken, or if they are taken and a clever hacker breaks in anyway? Commercial general liability and property policies have proven to provide unsatisfactory protection, especially in light of court rulings that stolen data is not considered tangible property under property insurance policies. Many businesses assume that these policies provide them coverage, until they discover, to their dismay, that they do not, or only in a limited sense. More than twenty insurers have developed special policies that do cover these risks, and the market is rapidly evolving. Policies come under different names—network risk insurance, cyber-liability insurance, and several others, but may generally be termed ‘data breach insurance.’ⁱⁱⁱ

Most of these policies cover first-party losses, such as incurred by a business in repairing the breach, and third party losses, such as damages paid to customers whose data was stolen. There may also be coverage for related issues such as intellectual

property infringement, personal injury, or advertising injury from online content. The third-party coverage typically has separate sections for privacy and network security issues. The latter may include such things as denial-of-service (DOS) attacks, malicious virus attacks, or deliberate corruption of the data stored on the system.

Businesses should have their coverage reviewed to see if there is adequate protection for cyber-liability or any protection at all. It is likely that most businesses will have policies with many gaping holes. What was once something for I.T. to worry about has now become an issue that affects the entire organization.^{iv}

4. Conclusion

The difficulty of creating an appropriate project insurance portfolio can be complicated by a number of factors, including risks unique to a type of project, corporate insurance program limitations, improper specification of contract insurance requirements, and lack of understanding of extensions available for core coverages. By working with a knowledgeable broker, lawyers and their clients can navigate these considerations and produce an effective insurance program for any project, no matter the alternative project delivery method.

ⁱ Peter C. Halls, Faegre & Benson, “PPP for the Rest of Us: Issues for Contractors and Suppliers to Public Private Partnership Projects,” American Bar Association, 2010.

ⁱⁱ Jeff Slivka, New Day Underwriting Managers, “Mitigation of Damages Coverage Helps with Design Defects,” September 2011.

ⁱⁱⁱ “Data Security Issues Escalate as Risk Management Evolves: An Advisen Special Report,” April 2010.

^{iv} Ibid, Advisen report.