

## Professional Indemnity – Design & Construct

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### Introduction

Nowadays, construction and contracting firms invariably carry Design & Construction (D&C) Professional Indemnity Insurance (PII). For many disciplines it is compulsory, many clients insist on it, and for all it is desirable. This note explains some of the characteristics of such insurance and the issues which may arise.

### Background

Historically, contractors have avoided Professional Indemnity 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) Professional Indemnity Insurance (PII) 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 PII 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.

### Types of Contractors

The types of contractor who would be interested in this type of policy are likely to operate in the following fields:

- Air Conditioning, Heating and Ventilation
- Builders (Domestic and Commercial)
- Electrical and / or Lighting
- Engineering Contracting
- Highways and Roads
- Mechanical and / or Process Engineering
- Refrigeration
- Refurbishment and / or Shop Fitting and / or Acoustics
- Water and Sewerage

This list is not exhaustive and many other contractors may feel the need to protect themselves and/or be required to hold cover by their clients.

### Key Features of the cover

- Claims made against the Insured arising from
  - Any negligent act error or omission
  - Dishonesty of employees
  - Libel or slander
  - Unintentional breach of confidentiality
  - Unintentional infringement of intellectual property rights
  - Loss of or damage to documents
- The legal costs of prosecuting claims for infringement of intellectual property rights (usually optional with a sub-limit)
- Defence costs in dealing with certain criminal proceedings (usually a sub-limit)
- Costs of representation at certain other inquiries or proceedings (usually optional with a sub-limit)

- Collateral Warranties – claims arising from these are explicitly covered with no limit on assignments (must be disclosed and negotiated with underwriters)
- Costs and expenses taken to mitigate a loss
- Defence costs (lawyers, court costs, experts etc.) may be inclusive or exclusive of the Indemnity Limit

**Type of work** – This is the most important aspect when assessing a risk and is worth looking at in a little more detail:

- **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, on 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.

#### **What do insurers look for?**

**The size of the firm** – One of the major factors that determine insurers' rating and underwriting criteria is the size of the firm. This can be established by looking at the number of employees and directors as well as the turnover and number and size of contracts in which they are involved.

**Qualifications and experience** - There is no professional body for contractors. It is for this reason that insurers have to pay careful attention to the qualifications and experience of the principals and staff. If a contractor is offering professional services then insurers will expect to see qualified staff, such as a qualified Architect, Engineer or Surveyor. If there are no qualified staff, then insurers will want to see CV's of those involved in technical work, normally demonstrating at least five years' practical experience, and possibly more depending on the services offered.

**Contract sizes** – Clearly the size and scope of a building project is an important consideration for underwriters. Large complex works involving structural engineering are considered higher hazard than lower value 'standard' buildings such as houses, offices or shops. In short, big contract values equate(s) to big claims.

**Technology** - Is the firm using 'cutting edge' technology or standard, tried and tested processes? Tried and tested techniques are seen as lower risk.

**Overseas exposure** - Does the contractor carry out work for overseas clients? Careful consideration would be paid to such work especially in the US or Canada.

**Retroactive exposure** - Does the contractor have an exposure to claims arising from past work, whether in the current firm or a former firm?

**Environmental exposure** - Does the contractor knowingly get involved in the environmental field such as clearing brown field sites for redevelopment?

**Asbestos exposure** – Does the contractor get involved in the identification and removal or handling of asbestos? Often policies exclude or severely restrict the cover for such work.

**Cladding / glazing exposure** – Does the contractor get involved in cladding? This is a specialist area and has encountered many problems over the years and so the contractor's experience in this field is key.

**Claims experience** - The claims experience is an important determining factor in the assessment of risk. This information usually reflects the type of work carried out by a practice. It also reflects the quality of the practice's work, staff, internal risk management and experience.

#### 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 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 architect's 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.

#### Other considerations

**Level of cover** - There are no minimum levels of cover imposed on Contractors by any regulatory authority or professional body. The requirement for cover itself is often client driven; therefore, there is often an attempt by the client to influence the actual scope of cover. It may not always be possible to provide the broadest limits of

indemnity and factors such as the contractor's activity and market conditions will influence the overall cover provided. Insurers can generally offer from £250,000 to £5m Limits of Indemnity. Higher limits can be placed via excess-layer arrangements.

**Consortia** - Most proposal forms have a specific question regarding consortia. These generally occur on bigger jobs, often where a combined tender is put together by more than one design and build team covering all professional and building disciplines. Warning signs include reference to acting as lead contractor. The question is whether or not there is an agreement whereby a separate legal entity is created for one or more jobs, or whether there is a partnership created between two or more of the participating firms (in which case attention needs to be paid as to how it is insured).

**Project partnering** - There are now more and more projects that involve project partnering. In respect of this activity, there is just one contract that is signed by all involved in a project. The intention is that everybody communicates more; there is less repetition of work (and less error) and less contractual ambiguity. Experience overseas has suggested that this type of approach does indeed reduce the number of problems. But care must be taken to ensure that this kind of agreement is not drafted in such a way as to inadvertently create some form of single project partnership or to expose anybody to liabilities that rightly belong elsewhere.

**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.

#### **Is there an alternative?**

D&C PII gives a measure of protection to you the professional, but it is not an efficient or effective way of protecting clients' risks. Payment under the policy is dependent upon you being at fault, and costs will be incurred by both you and your client in establishing whether you are liable or not.

Whilst D&C PII should still be held, there are easier way of clients insuring the risks associated with design and build construction projects. We would recommend the purchase of a Latent/Structural Defect insurance (often referred to as Buildings Guarantee Insurance) which covers the client or building owner against loss arising from defects within a 10/12 year period and is transferable to new owners. This may significantly reduce the risk of you having to call on your D&C PII cover. ***It is recommended that you suggest to your clients that they investigate what is available to them to insure their risks more directly.*** Ask Rowlands & Hames for more information.

#### **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.

## 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. For example, some insurers are now excluding cover for personal injury claims in relation to asbestos, whereas they offered such cover in the past. Cover only operates from the retroactive date, usually the date of first inception of a PII policy although for additional premium this may be backdated to incorporate previous activity.

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.

## The usual cover

The operative clause of a PII D&C policy is restricted to cover only professional activities and it is important to note that the policy does not cover poor workmanship. Therefore, cover is normally limited to design or specification, feasibility study, technical information calculation, surveying undertaken only by, or under the direction and direct control of, a properly qualified Architect, Engineer or Surveyor. Supervision cover will normally be limited to situations where the insured is not supervising their own, or their sub-contractors' workmen, in their contractor capacity. Other professional activities that are intended to be covered will normally need to be endorsed separately.

The Limit of Indemnity may be 'in the aggregate' i.e. the indemnity limit is 'used-up' through the period of insurance or 'any one claim' which tends to be more expensive. Defence costs may be inclusive within the limit of indemnity or may be 'in addition' to the limit of indemnity. The excess may or may not apply to defence costs and expenses. Each insurer has their own standard offer which may be adjusted to suit.

## The usual exclusions

Design and construct policies demand careful attention to exclusions. Typically, policies will exclude:

- Employers' Liability, Public & Products Liability, Property etc.
- Loss or damage to physical property (but loss of documents are covered) unless arising from a breach of professional duty by the Insured.
- North American offices and jurisdiction
- Nuclear risks
- Claims and circumstances known at inception of the cover
- Onerous collateral warranties
- War, Terrorism & Nuclear Risks
- Pollution; Asbestos; Toxic Mould - care must be taken here if the contractor needs or wants environmental claims covered (ask for a separate quotation)
- The excess
- Valuations
- Contractual Liability assumed more onerous than any implied duty, trading losses, fines and penalties.
- Joint ventures/Consortia
- Acts prior to any retroactive date (usually the original inception date of the cover)

## How to request a quotation

Simply speak to your usual contact at Rowlands & Hames on 01253 594211.

New clients should contact: John Isles on 01253 598953 or 07974 667825 or by email to [john@rowlands-hames.co.uk](mailto:john@rowlands-hames.co.uk)

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### **General Guidance Only**

This guidance has been produced to provide a general overview of the subject and Rowlands & Hames accepts no responsibility for any errors or omissions as a result.

**Please contact Rowlands & Hames for further information.**

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