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Not All Design-Build Projects Are Created Equal

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As the need for faster and more efficient construction increases, design-build agreements are growing in popularity. Design-build projects may account for 44% of nonresidential building in the United States this year. However, contractors who venture into a "design builder" role may unexpectedly become liable for design errors/omissions that are not covered by their insurance policies. In turn, they may expose themselves to liability and insurance risks that are neither insured nor managed.

In this article, we'll discuss how the contractor who becomes a design-builder, or performs design-related work through subcontractors, faces potentially unmanaged risk. We will also explore indemnity, warranty, and insurance traps by paying attention to contract language in both traditional design-build and design-assist scenarios.

Contractors Acting As Design-Builders Face Design Liability From Inherent "Holes" in Insurance Coverage

Under the design-build arrangements most commonly used in the United States, the contractor is obligated to provide design services for the project. The inevitable question that follows is "how are design builders managing that risk?" Often the answer lies in the two most common risk management approaches contractors employ – subcontracting and insuring. But are those risk management tools working as expected?

Contractors may have licensed design or engineering professionals in-house or contractors may subcontract design services through a licensed design-professional. In both situations insurance for the risk is central, either to protect the contractor from errors by its in-house designers or to ensure that funds are available in the event of design errors when subcontracting design services. There may, however, be significant gaps when relying on such insurance in these situations beyond the limitations commonly known about such insurance policies, such as "claims made" limitations, coverage amounts, and deductibles.

Although Professional Liability policies are at times called "E&O", or errors and omissions, policies, often professional liability policies do not insure against all defects or deficiencies in the designer's work. Instead, the policies are drafted to insure against a finding of liability on the part of the designer, and that liability is based on the failure to meet an applicable standard of care.

Implicit in this critical distinction is the potential for errors to have occurred, but if those errors were not within the designer's standard of care, there would be no liability. And since the insurance covers "professional liability," not merely an error, there could be no insurance coverage.

Architects often assert that their standard of care is not one of perfection, specifically stating that errors are permissible to a "reasonable" degree. Where courts embrace that standard, there could be an error, but no liability for that error and therefore no insurance coverage.

A design build contractor, however, may be fully liable nonetheless if it accepts a different standard. When that occurs, the two most common mechanisms of risk management anticipated by design-builders, assuming that the risk was shifted to the designer or through insurance, may not function as expected. In turn the design-builder may face an unmanaged risk.

Design-Build Insurance Solution

Contractors in design-build agreements may encounter difficulty negotiating contract language to address this problem. What, then, is a contractor to do?

In those situations, contractors in design-build projects are encouraged to consider Contractors Protector Professional Insurance ("CPPI"). In general, CPPI coverage is intended to directly insure the design builder from design risks, including some described here, however such policies need to be carefully analyzed since holes can exist in CPPI coverage was well.

A well-developed CPPI policy can offer various avenues of coverage. First, CPPI provides standard professional liability coverage. Depending on the wording of the policy, the gaps described in this article can be mitigated.

Second, CPPI provides mitigation, or rectification, coverage. With mitigation coverage, if the contractor/design-builder learns of a design error during construction, it can proactively correct that error or omission prior to the assertion of any claim by the owner. Contractors should be aware that many carriers require immediate notification and may require carrier approval before any money can be spent to mitigate the design errors or omissions.

Lastly, CPPI provides protective coverage. Protective coverage supplements the design professional's professional liability insurance coverage by providing direct benefits to the contractor/design-builder for any downstream claims for costs above what will be paid by the design professional's liability insurance.

Contract Wording Can Create Problems For Contractors Acting as Design-Builders

When contractors assume design-build obligations, careful attention to contract language is needed to see where exposure for design liability may exist. For example, two widely used design-build forms include either "design" or "design services" in the definition of the design-builder's "Work." Design-build forms created by large institutional or public owners often include similar language. In such cases, warranty and indemnity provisions may be the culprit in creating unmanageable liability for the contractor.

Warranty Problem

If a contractor's "Work" in a design-build agreement includes design services, and if the design-build contractor agrees to warrantee that the "Work" will be free from any defects or deficiencies," a trap could be created. Another equally dangerous way that such a provision might be phrased is for the design-build contractor to guarantee that it will correct "Defective Work." Either one of these provisions could be interpreted to impose the warrantee or guarantee on all defects in the design, and, as discussed above, insurance policies may not cover all defects or errors. Instead, they may only cover the defective work or design errors/omissions if the error was outside of the standard of care for the architect hired by the contractor. In turn, the contractor may face exposure to uninsured liability.

Warranty Solution

During contract negotiations in a design-build agreement, a best practice is for the contractor to insist that its warranty of the "Work" be defined to include construction labor and materials but not design services. The contractor can also provide the owner with a separate and insurable standard of care for design services performed by its architect, which would be separate from the warranty. Experienced construction counsel could be of help in making certain that contract language, which protects the contractor, is included prior to execution of a design-build agreement.

Indemnity Problem

Indemnity clauses are common in construction contracts, typically to trigger insurance coverage for bodily injury and property damage claims, but too often they are drafted more broadly than is necessary for that purpose. For example, when a contractor must indemnify an owner against claims "that may arise from the performance of the "Work," and "Work" includes design services, the contractor can be seen as effectively providing the owner with complete protection against design errors and omissions by its architect. As described above, the architect or design-builder may not be insured under its professional liability coverage to the same extent required by such a broadly drafted indemnity clause. In fact, this is exactly why designers often refuse to accept such broadly drafted indemnity clauses.

Indemnity Solution

A solution to the indemnity trap is to address it during contract negotiations. By removing design services from the definition of "Work," and creating a separate indemnity of the Owner against design errors and omissions by the architect, the contractor optimizes the chances that there is parity between liability for a design error or omission and coverage under the architect's professional liability insurance. As with the warranty trap, experienced construction counsel in the negotiation process can be helpful.

Design-Assist vs Design-Build

Unlike design-build agreements where the contractor takes the reigns and leads the design and build process—and may carry the lion's share of responsibility and liability—design-assist agreements can involve a more collaborative framework and do not carry the same level of potentially uninsurable liability. Design assist is a collaborative model, in which the role of the contractor is one of assisting in the development of the design, but not assuming responsibility for the design. However, a word of caution is advisable in regard to "design-assist," because while the term is used with some frequency, it is often used inadvisably or without clear definition.

As a result of the potential cloud regarding the proper use of "design-assist," contractors need to be wary of the risks posed by unfavorable contract language. Loose or sloppy language from design-build agreements can find its way into design-assist agreements and create the same assumption of liability and gap in insurance coverage contained in the design-build agreement. For example, if the owner's architect for a design-assist project is not required to fully coordinate the work of the design-assist contractors, liability for coordination of design-assist services could arguably fall upon the contractor.

To protect against unexpected and possibly uninsured liability, contractors must strive for contract documents that are carefully drafted to outline and delineate the design liability for design defects/failures of

each party involved in the design-assist process. The contract documents must be clear that the contractor will not take on additional liability for their advisory involvement in the design process and that the risk of liability for design errors and omissions remains with the owner or its designer.

More specifically, in design-assist agreements, special care must be taken to ensure that the contractor: 1) does not inadvertently waive the owner's implied warranty of the plans and specifications; and 2) requires that the owner's architect assume responsibility for and coordinate the design services of all design-assist subcontractors.

Surety Solution

Increasingly, subcontractor trades or crafts may assume design-build responsibility as part of their work. Although designers do not often provide Performance Bonds, subcontractors commonly do. A risk management technique for contractors facing potentially uninsured design risk is to mitigate that risk through the combination of imposing similar terms on a design-build subcontractor and requiring that the subcontractor provide a performance bond standing behind that obligation.

In other words, include similar warranty and indemnity obligations in the subcontract, coupled with a bond that would honor the subcontractor's obligation. Of course, the amount of the bond, duration and relevant terms should also be considered.

Conclusion

While both design-build and design-assist agreements present liability challenges, there are ways that savvy contractors can protect themselves from unexpected liability for design errors or omissions. Most importantly, design-build contractors must be aware of the traps that may exist in relevant agreements, as well as the weaknesses that may exist in risk management strategies previously thought to be sufficient.