

Understanding And Developing A Risk Management Policy For Condominium Projects

I am currently watching a 10-part Discovery Channel series called “The Deadliest Catch”. It chronicles the fishermen involved in the Alaskan King Crab trade out of Alaska, where each year 250 boats converge on Dutch Harbor, awaiting the official King Crab harvesting season. The injury rate is a staggering 100%, with at least one fisherman per year guaranteed to die. The reward is up to \$140,000 for five days of work. Although I hesitate to make an analogy between “The Deadliest Catch” and Architects venturing into the risky waters of condominium projects, I must admit that, during the first episode, the analogy crossed my mind. Maybe I work too much, or maybe it is the fact that every single day I receive telephone calls from design professionals asking me to assist them in navigating the risks of condominium projects. The rewards can be great, but the risks are extremely high, often outweighing the potential rewards.

The purpose of this article is to address the risks (and remind some of you who may have forgotten the risks); provide you with an understanding of the types of things you need to be aware of before entering into such projects, including whether you are actually “covered” by Owner Controlled Insurance Program policies (“OCIP,” also commonly known as “Wrap-up” policies and hereinafter referred to as “Wrap” policies), and assist you in developing your own Risk Management Policy to be followed when considering condominium projects. I promise not to take the fishing analogy any further (after all, I am just a hook-and-worm gal myself, but infinitely fascinated by the Discovery Channel.)

The Risks

Condominium developments are among the riskiest areas of practice for design professionals, yet the amount of condominium projects currently in various stages of development across the country has dramatically increased in the past 1 ½ years. What has changed to make reputable Architects want to consider taking on condominium projects? Have Homeowner’s Associations stopped suing? Have Developers misled you into believing that their Wrap policy covers your professional errors and omissions, thus creating a false sense of security? Has the civil justice system finally agreed that Architects should be held in a special light – one where their exercise of judgment is respected, the uniqueness of their design services acknowledged, and the Architect who practices in a reasonable and prudent manner is protected? Or are the Architectural fees for such projects simply too good to pass up?

Unfortunately, very little has changed with respect to how the legal and insurance industries view condominium projects. A condominium project is still ten times more likely to give rise to a claim than a commercial project. One 2004 statistic indicated that the loss ratios on condominium projects is anywhere from 228% to more than 900%, depending on the discipline. Homeowners still have expectations of high quality and low maintenance requirements. Problems occurring in condominiums usually occur in multiples – if a window is improperly detailed and constructed for one unit, it is likely improperly detailed and constructed for every unit. If a roof drainage system is

improperly detailed and constructed and the roof leaks, then the roof will typically leak into more than one unit, etc. etc.

Additionally, many Developers and/or their legal counsel, have a loose understanding of exactly who and what services are covered by the Wrap policies, often claiming that “the Architect is covered.” Such statements are not only misleading, but dangerous as the Architect is then led to believe that, because they are “covered” by the Wrap policy, they do not need to concentrate on negotiating the terms and conditions of their contracts.

What Is A Wrap Policy, And Who And What Are Covered?

Wrap policies are purchased by the Developer and are similar to a Project Policy (discussed below) in that the policy provides coverage for the General Contractor and all the subcontractors who are enrolled in the policy. However, this is General Liability coverage, not Professional Liability coverage. *Under the Wrap policy, professional liability coverage is excluded.* In other words, if the Homeowner’s Association or individual homeowners claim that damages arose out of, among other things, the negligent errors and omissions of the Architect, then the Architect would not be covered by the Wrap policy.

Apparently, a couple of insurance companies are willing to delete the professional liability exclusion, for a price, but deletion of the professional liability exclusion merely results in the coverage of Bodily Injury and Property Damage claims only, and not coverage for the typical allegations of design deficiencies which are the most important exposures for a design professional. In other words, the Architect’s inclusion in the typical construction defect claim would not be covered by the Wrap Policy if the claims merely related to the Architect’s alleged negligence, yet there was no property damage or bodily injury claims included.

Although these Wrap policies really do not benefit the Architect from an errors and omissions coverage standpoint, the advent of such policies has, at the very least, forced the Developers into being more proactive. The Wrap policy has evolved rapidly over the past few years to fill the void in General Liability coverage available for multi-family residential projects. Due to Construction Defect litigation, most commercial insurers ceased offering general liability coverage to contractors who worked on these projects. In order for the Developer to hire qualified contractors, it became necessary to develop a new paradigm of coverage. The insurance industry has done a fairly good job of making coverage available, although it is very expensive.

Many steps of underwriting are now included in the process before a Wrap policy can be placed, and the steps are designed to help prevent or at least mitigate litigation. For example, Developers must submit soils reports; they can use only certain types and applications of the popular EIFS; they must have an acceptable quality assurance program in place; they must use an on-going site inspector who identifies potential problems during construction and corrects them; have a home warranty program and must include certain maintenance requirements in the CC&Rs of the homeowners

association, just to list a few. Clearly, the insurance carriers now dictate the rules of the game for Developers when they are seeking Wrap policies and hopefully the result will be an improved quality of construction, thus reducing the likelihood of litigation.

What Is A Project Specific Policy, And Is It Available For Condominium Projects?

The Project Specific Policy (“Project Policy”) is a Professional Liability policy and is traditionally written for one project, covers the entire design team (usually excludes soils and geotechnical engineers), has one set of limits dedicated to the one project and has a pre-determined or pre-negotiated length of time. *These policies are a wonderful solution to a myriad of problems, but unfortunately, they are very expensive for condominium projects and project owners oftentimes will not pay the price.* With that said, there are policies available, and it is worth discussing the options with your professional liability insurance broker, if at least to be able to direct the Developer to that broker to explore the options. For those current condominium projects with project policies in play (very few) professional liability insurance brokers are seeing terms such as three years design/construct plus an additional 3-5 years of discovery. These insurance brokers would like to see 10 years of discovery, but it is difficult to find. Remember, this is a “claims made” type policy, which means a policy must be in force or the discovery period must be valid at the time the claim is presented, or there is no coverage.

These policies are usually funded by the project owner, but the prime architect is the named insured and is responsible for the deductible (which is pre-negotiated and must be included in contracts with subconsultants) and the premium as well as any audit amounts that may be due.

The main benefit of the project specific policy is to insulate the design professional's practice policies from the claims that we know will more than likely result from providing services on condominium projects. Some design professionals may have condominium exclusions on their practice policies which would preclude them from even working on condominium projects. Thus, a Project policy would be a necessity if the Developer was to have that particular Architect involved in the project.

Again, it is very important to discuss the state of your insurance with your professional liability broker. You must determine not only whether your own practice policy prevents you from providing services for condominium projects, has a sub-limit of liability coverage, or has a “cap” on the percentage of fees which you can generate from condominium projects. Further, you should determine the current availability and reasonableness of project policies for condominium projects. Unfortunately, we are finding that insurers are very reluctant to offer project policy coverage on a condominium project, but the inquiry should nevertheless be made.

What Do I Do If The Developer Tells Me That My Professional Errors And Omissions Are Covered By The Wrap Policy Or That There Is A Project Policy In Place Covering The Design Team?

This issue comes up on a weekly basis. The bottom line is that, as explained above, the Wrap policies do not cover professional liability, period, unless the exclusion has been deleted, and then, *still*, only bodily injury and property damage are covered. ***Always ask the Developer for an actual copy of the Wrap policy and then provide it to your professional liability insurance broker and your attorney to review and confirm the coverage.***

With respect to the Project policies, if the Developer says there is one in place, then great. However, you must again ask to see a copy of the actual policy and then provide it to your professional liability insurance broker for confirmation of coverage. ***My partner, Jean Weil, and I, are in the process of negotiating contracts on behalf of Architects for many of the high-profile condominium projects in Las Vegas and California. We have yet to see an actual copy of a Wrap policy that covers the Architect's errors and omissions, despite numerous requests. Further, we have only one instance where a project policy was purchased by the Developer covering the design team.*** In other words, you should not be relying on such policies to cover or eliminate your exposure on condominium projects.

In light of the fact that Wrap policies really do not cover the Architect from and errors and omissions standpoint, and Project Policies are very difficult for Developers to find for the price they want to pay, the Developers are left to rely on the Architect's practice policy. That is, you end up providing services for one of the riskiest types of projects in existence, with no better insurance coverage than for any other type of project. This means that if you are going to provide services for a condominium project, **you must have a great client, a great project and a great contract.**

Risk Management Policy For Condominium Projects

After numerous meetings and discussions regarding condominium projects over the past year, Jean and I developed a Risk Management Policy for Condominium Projects. The Policy is based upon numerous articles, contract guides by the various professional liability insurance companies, and an understanding of how the courts in our respective jurisdictions are treating various contract provisions, not to mention construction defect litigation in general. Of course, the courts and juries can be as consistent with contract interpretation and standard of care issues as contractors are in interpreting the Uniform Building Code. Thus, unfortunately, there is no "bullet proof" contract, let alone a Risk Management Policy that will *prevent* lawsuits.

The following are tools to, at the very least, assist in managing and hopefully minimizing your exposure when litigation eventually ensues on these types of projects.

1. Carefully screen the DEVELOPER:

- a. Do you know the Developer?
- b. Is the Developer an LLC?
- c. Does the Developer have a history of litigation?
- d. Does the Developer have a good reputation?
- e. Is there adequate financing?
- f. Is there commitment to quality?
- g. Has the developer done other multi-family projects, and specifically condominiums, and were they successful?
- h. Does the developer have a long track record and is it likely to be around in the future?
- i. Will the developer build the project with its own forces or act as a “paper developer”?
- j. What are the contractor selection criteria?
- k. What is your overall gut feeling about the developer?

IF you have no history with this Developer, and your research reveals questionable results, then we recommend that you reject the project. I am representing a client who accepted a job three years ago without performing a simple check on the Developer’s litigation history. After the Developer refused to pay my client the remaining amounts due on the contract, and after the Developer sued my client for errors and omissions, we discovered that the Developer was a plaintiff in 35 lawsuits over the past ten years, and a defendant in just about as many lawsuits. If such a search had been performed *before* the project, my client most certainly would never have taken the job. Contact a lawyer in your jurisdiction whose legal practice focuses on the representation of design professionals. He or she will be able to discuss with you the process for conducting such a search or simply conduct the search for you. (And no, the client referenced above was not my client at the time he took on the project, and thus I did not have the opportunity to advise him regarding such a search!)

2. Carefully screen the PROJECT:

- a. What type of project is it? (wood-framed, high-rise, low-end)
Conventional wisdom says that luxury high-rise condominium and hotel-condominiums might not be as likely to end up in litigation. Low-rise or wood-framed buildings are the greatest risk.

IF you have a good relationship with the Developer and your research yields favorable results, and IF the project is “lower risk”, then proceed into contract negotiations and see how badly this Developer wants to use you for this condominium project. IF the Developer is willing to sign a good contract, then the benefits may outweigh the risks of taking on the condominium project.

3. Ensure that the CONTRACT properly addresses the allocation of risks associated with the project. What type of contract is the proposed Developer willing to sign?

This is KEY. Even if they are a great Developer, if they are unwilling to sign a contract with the key items discussed below, then you should consider rejecting the project. Most Developers are unwilling to sign the Architect's own standard agreement (be it a modified AIA document or some other form), but we are finding that many of the more prestigious Developers are willing to accept modifications to *their* own standard agreements, and are willing to listen to the reasons why the Architect needs different terms and conditions for condominium projects. Additionally, most Developers, especially those who have initially promised to include you in a Project Policy or Wrap policy, are willing to negotiate more favorable terms once they discover that the Wrap or Project policies are not an option for the Architect for the project at issue.

Our argument is as follows: "Listen Mr. Developer, you originally intended that the Architect be "protected" by your insurance plan, yet now that plan is not an option. We assume that you still intend to "protect" the Architect, and now we are just going to have to do it via the contract. If your intention is to not protect the Architect, then the Architect will consider whether this is the right project in which to be involved."

The following sample clauses must be explored in contract negotiations:

- a. **Complete Indemnification for Condominium Projects.** Start out your contract negotiations asking for the following:

"The Developer acknowledges the risks to the Architect inherent in condominium projects and the disparity between the Architect's fee and the Architect's potential liability for problems or alleged problems with such condominium projects. Therefore, the Developer agrees, to the fullest extent permitted by law, to defend, indemnify and hold harmless the Architect, its officers, directors, employees and subconsultants (collectively, "Architect") against all claims, damages, liabilities or costs, including reasonable attorneys' fees and defense costs, regardless of the nature of the claim or damage, and including but not limited to claims and damages arising out of or in any way connected with the services performed under this Agreement. The Developer shall not be obligated to defend, indemnify or hold Architect harmless in any manner whatsoever for the Architect's sole negligence or willful misconduct."

If the Developer rejects the above, then you need to consider whether to accept the job. A mutual indemnity would be the next option.

- b. **Waiver.** The below waiver should accompany the above indemnity language. Again, if the Developer really wants you, then they will consider such a clause.

“In consideration of the substantial risks to the Architect in rendering professional services in connection with this Project, the Developer agrees to make no claim and hereby waives, to the fullest extent permitted by law, any claim or cause of action of any nature against the Architect, its officers, directors, employees and subconsultants (collectively, Architect), which may arise out of or in connection with this Project or the performance, by any of the parties above named, of the services under this Agreement, except for claims or causes of action arising out of the Architect’s sole negligence or willful misconduct.”

- c. Indemnity for First \$75,000 of Any Action .** IF the Developer will not agree to the indemnification and waiver identified above, then this section is highly recommended. This section is your second choice and should not be used if the Developer will accept the indemnification and waiver noted in a and b, above.

“The Developer acknowledges the risks to the Architect inherent in condominium projects and the disparity between the Architect’s fee and the Architect’s potential liability for problems or alleged problems with such condominium projects. Therefore, the Developer agrees, to the fullest extent permitted by law, to defend, indemnify and hold harmless the Architect, its officers, directors, employees and subconsultants (collectively, “Architect”) against all claims, damages, liabilities or costs, including reasonable attorneys’ fees and defense costs, regardless of the nature of the claim or damage, and including but not limited to claims and damages arising out of or in any way connected with the services performed under this Agreement, for an amount not to exceed the first \$75,000 of any claim, demand, liability or cost, or any attorneys fees or costs related to such claim, demand, liability or cost.”

- d. Limitation of Liability.** The below Limitation of Liability language, or some variation thereof, must be included in condominium contracts, even if only to limit your liability to the amount of available professional liability insurance.

“In consideration of the substantial risks to the Architect in rendering professional services in connection with this Project, the Developer agrees, to the fullest extent permitted by law, to limit the liability of the Architect, to the amount of Architect’s fee, or available professional liability insurance, whichever is less.”

- e. Separate Project Policy.** Have the Developer explore the availability of a Project Policy and also discuss this with your professional liability insurance broker each time a project is presented for consideration. The market is constantly changing, and although the Project Policies today are very expensive, a company next week could present a product that is more reasonable.

- f. **Construction Observation.** The idea is that the Architect's presence at the site may help to recognize potential problems. If the Developer does not want to retain you to provide Construction Administration services or at least limited observation services, then consider the risks of not being involved in the construction process and make sure that your decision is well-documented.
- g. **Require Confirmation of Your Consultants' Insurance Coverage.** Require your consultants to submit to you a certificate of insurance to verify that they are adequately insured. Preferably, have all subconsultants on condominium projects enter into contracts directly with the Developer. The Architect may still coordinate the work of the consultants, but you do not want the added legal liability of entering into contracts with said consultants (also known as "vicarious liability".)
- h. **Maintenance Manual.** Encourage the Developer to be pro-active by inserting Developer responsibilities such as the following into your contract with the Developer:

"The Developer agrees that the bylaws of the Homeowners' Association established for this Project will require that the Association will perform, as recommended in the Maintenance Manual, all necessary routine maintenance, maintenance inspections and any other necessary repairs and maintenance called for as a result of these maintenance inspections. The bylaws shall also contain an appropriate waiver and indemnity in favor of the Client, the Architect and all Consultants and the Contractor if the maintenance recommendations contained in the Maintenance Manual are not performed."

Have a similar clause applying to the individual homeowners.

- i. **Third Party Quality Control Company.** Insert language requiring the Developer to retain a third party construction inspection service to perform a technical review or peer review of the plans and specifications and to monitor construction:

"The Developer shall retain and utilize an independent third party construction inspection service to perform a technical review of the approved plans and specifications and to monitor construction of the project and report any defects, disparities, errors or omissions to the Developer. The Developer will insure that all recommendations for repairs, corrections or changes are accomplished."
4. Carefully document all meetings, observations and conversations pertaining to the project. In particular, note any recommendations you make that are not followed.

5. Your standard contract format is preferred and should be used whenever possible. Client-generated contracts are not preferred and must incorporate all of the key elements noted above and no provisions that are objectionable. Questions regarding specific contract language and terms should be submitted to a specified Architectural representative, who should then consult with your professional liability broker and request a legal opinion from your attorney.
6. Do not accept any condominium project regardless of how large or how small without first performing the above checks and then running it past a principal for final review and approval.

In conclusion, although Architects cannot expect that they will not be sued in the future, Architects can, through implementation of the above measures, reduce their exposure. You should consult with an experienced attorney familiar with professional liability and an experienced professional liability insurance broker regarding the above and for further assistance in identifying and reducing your exposure to loss. This article and each of the clauses herein are designed to provide useful information. It is not to be regarded as providing opinion or legal advice for or about any individual project, case, party or contract.

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