

# A/E RISK REVIEW

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## A Condo Comeback? Designers Beware

*The following material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with a qualified professional who can provide guidance that considers your own unique circumstances.*

Finally, after years of decline, the housing market is beginning to show some signs of life. Slowly but surely, residential real estate is recovering in an increasing number of metropolitan markets across the country. And as inventories of existing residential properties decrease, new housing starts are beginning to emerge.

Among those new residential housing starts are condominiums projects. Some markets are finding that developers are dusting off condominium project plans that were laid idle for a number of years. They are reviving plans for condo and combined condo-commercial developments and searching for design firms to help take these projects to completion.

What better time, then, to remind architects and engineers of the substantial professional liability (PL) risks that condos can present.

### The Risks Remain

Why are condos so risky? Here's a refresher course on the inherent risks:

- Condominium projects are often highly leveraged financially. Developers typically work with thin margins and tight budgets. To control costs they may scrimp on quality of materials, hire low-bid contractors and forego important design services such as construction observation.
- Designer fees are typically low. Because the developer can replicate a single design to produce multiple units the design fee is typically miniscule

compared to the overall exposure of something going wrong. Thus, the risk-reward ratio can be out of kilter.

- Errors are easily multiplied. With the typical large condo project, a single design can be executed over and over again. Thus, a single design error or omission, or faulty construction means and methods, can be replicated over and over again. For example, one design or construction flaw that results in multiple leaky roofs, walls or windows can easily turn into a large class action suit.
- Condominium buyers are often unsophisticated when it comes to multi-unit ownership issues. Residents have no relationship with the designer and typically little or no knowledge of the construction process. They don't understand that the prevailing standard of care does not include perfection and are quick to seek remedy for the smallest problem.
- Homeowner associations may neglect upkeep and maintenance. They are often reluctant to pay for the full range of services needed to maintain shared exteriors, roofs, utilities and common grounds. And when something goes wrong with their home or shared areas, they often act emotionally rather than rationally to protect their substantial investment.
- Attorneys are well aware of the condominium-buyer and homeowner-association issues just mentioned. Some view condominiums as litigation goldmines. They actively solicit homeowner associations as potential clients and urge these associations to provide a very critical review of the condo complex in a search for defects. If the developer scrimped on quality, it probably won't take long to find a reason to file a demand.
- Once a complaint or lawsuit is filed, the developer is often nowhere to be found. It is not uncommon for a condo developer to be a shell limited liability corporation (LLC) set up solely to build and sell a single project. Once the last unit sells, the LLC dissolves. Similarly, a low-bid contractor may not have substantial assets or insurance. So the only deep pockets remaining are those of the design team and their insurance companies.

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## Insurance Still an Issue

Certainly, not all condominium developers are shady or all condo projects shabby. There are many highly reputable firms that build quality projects. But from a professional liability insurance company's standpoint, condos have a very checkered past. These insurers have long perceived condos as multi-million-dollar claims waiting to happen and most are extremely reluctant to underwrite them.

If you are considering venturing into condos, we can help you check out the availability of coverage beforehand. Some PL insurers may insure your firm but exclude your condo work from coverage. Other insurers may put a cap on the amount of condo work a design firm can have – e.g., no more than 10% - 20% of total projects. (Fortunately, some insurers realize that placing such a percentile cap results in them providing coverage only to firms that “dabble” in condos and excluding design firms who are highly experienced in condo design.) Some insurers will cover clients who do substantial condo work but require a near pristine claims record for both the designer and the developer. As a specialist insurance agency, we may be able to help you get your condo work insured at a reasonable rate.

So what should design firms do when offered the opportunity to work on a condominium project? They need to proceed cautiously, acknowledging the dangers and taking the steps necessary to minimize risk.

## Project and Client Selection

When considering a condominium project, choose your dance partners carefully. This is the most important step to avoiding potential claims. Indeed, you should walk away from any start-up developer working on their first condo project. A developer that is a single-project LLC should also be a red flag.

Look for clients with long track records of producing quality condominium projects, preferably those who retain an ownership interest or property-management role in their projects. Ask a potential client about its litigation history. Conduct Internet searches, which often reveal past claims, disputes or other legal issues. Get a list of references from designers who have worked with this client. Contact them and ask about the client's experience, reputation, commitment to quality, and history of project disputes or litigation. Learn as much as possible about any past claims. Try to gauge the developer's cooperative spirit in resolving disputes. Finally, visit some of the client's past projects noting quality of construction.

Ask to examine the client's financials. The services of firms like Dunn & Bradstreet can be invaluable in gauging a client's financial stability. There's nothing wrong with checking credit histories, asking for financial statements and the like. However, be ready to reciprocate if you receive a similar request from the client.

Determine whether a contractor and trade subcontractors have been selected for the project. If so, meet with the principals and review their condo history. Ask whether they would be willing to provide a “constructability” review of your design. If a contractor has not been selected, ask to be made part of the review process. Consider making your involvement with the project contingent on your acceptance of the contractor.

Learn as much as you can about the project itself. Are there unusual design requirements? Does the geography present unique challenges? Are there other condominiums in the area and do they have any history of disputes and litigations? Is the project a new high-rise condominium (moderate risk) or a low-rise wood-framed project (higher risk)?

Consider how your skills and experience match the project. If you've never gone solo with a condo project, you may need to retain the services of subcontractors with substantial condo experience. Those selections will be crucial. Make sure your subconsultants are well versed in the project and well covered with PL insurance of their own.

Finally, get us involved in your condo decision. Share what you've found about the client, contractor and project. We can give you an idea of what coverage is available in the current market and a ballpark as to the rates being charged. We'll help examine any “owner controlled” or “wrap” policies your client may have and see whether it offers you any protection. We'll help you determine whether project-specific insurance is available and, if so, how to sell the advantages of this owner-financed coverage to your client.

## Condo Contracts

Let's say your developer and condo project checks out and you decide to proceed further with the potential engagement. You'll want to pull out all the stops when it comes to securing protective contractual language. In fact, you may want to make some key contract clauses mandatory.

If you can't negotiate sufficient protection into your contract, it might be best to walk away. A knowledgeable client will understand your concerns and should be willing to provide reasonable liability protection. Any unwillingness to draft an equitable contract will also tell you something about your potential project partner.

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Following are specific contract clauses you and your attorney should fight for:

**Scope of Services.** Make sure your scope of services includes all of the services you deem vital to ensuring a high-quality, low-risk project. Of utmost importance, make construction observation a required service. You'll want to observe the jobsite and ensure that the contractor adheres to your design documents. This gives you the opportunity to spot potential trouble early and work with the developer and contractor to take corrective actions in a timely and cost-efficient manner -- before a claim situation develops.

**Specification of Materials.** Pay particular attention to substitution requests from the contractor or developer. Don't accept inferior or untested materials or systems.

**Ownership of Documents.** Seek contract language wherein you retain ownership of the design documents and prohibit the use of your design documents on other projects or future phases of the same project. If the client insists on owning the documents, make it contingent upon receipt of your total fee and, again, prohibit reuse without your permission and future services and fees.

**Limitation of Liability.** Negotiate for a limitation of liability clause that caps your risk to a specific dollar amount, whether your project fee or your available insurance limits. In most cases, the developer has a significant profit potential from a condominium project. It is only right that they be willing to take on a significant portion of the risk.

**Contingency Fund.** You'll want to ensure that the contract requires the client to maintain an adequate contingency fund to handle unanticipated expenses. Negotiate the right to terminate your services should the developer fail to live up to financial or contractual agreements.

**Indemnification.** Have your client acknowledge in writing the special risks inherent in condominium projects and the disparity between your fee and potential liability. If possible, have the client agree to indemnify you and hold you harmless against all damages, liabilities or costs arising out of the services you perform under the contract, except for those costs that result from your sole negligence or willful misconduct. Avoid taking on any liability for the contractor or any subs hired directly by the owner or the contractor.

**Maintenance.** Have your client agree that the bylaws of the homeowner's association will require the association to perform, as recommended in the maintenance manual, all routine maintenance, inspections and other necessary repairs and maintenance called for as a result of these inspections.

The bylaws should also contain an appropriate waiver and indemnity in favor of you, your client and the contractor if the recommended maintenance services are not performed.

Consider negotiating to have the development of the maintenance manual part of your scope of services. Then have the appropriate consultants working on the project develop written maintenance recommendations for plumbing lighting, HVAC, roofing, decking, exterior walls, sidewalks, ponds and so on.

### **Risky Business**

Even with good contractual protection, condos are a risky business. That's why it's important to ensure your fee is sufficient to offset the added liability. Call upon our services when considering a project and when you and your attorney are drafting your contract with the client. That way, we'll be knowledgeable about the project, client and contractor, understand the contractual and other protections you have obtained, and best be able to negotiate on your behalf to obtain needed coverage at an acceptable price.

### **Can We Be of Assistance?**

*We may be able to help you by providing referrals to consultants, and by providing guidance relative to insurance issues, and even to certain preventives, from construction observation through the development and application of sound human resources management policies and procedures. Please call on us for assistance. We're a member of the Professional Liability Agents Network (PLAN). We're here to help.*