GOLD SEAL Assisting Beyond Expectation

Tipsheet 9
PI Insurance – Tips & Traps for Construction Contracts (Part 2)

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More common 'pitfalls' for a construction professional's service contracts and their impact on PI insurance.

"Good faith" obligations

Most professional services contracts are between independent contractors. However, contractors performing services for or on behalf of other parties or acting in an "agency" capacity are often required to act in good faith and act in the best interests of the principal.

Example: The Consultant shall at all times exercise the utmost good faith in the best interests of the Principal and the Project and keep the Principal fully and regularly informed as to all matters affecting or relating to the Services and the Project or otherwise.

While there is an implied duty of good faith between parties to commercial contracts, courts are reluctant to apply this duty to all rights and obligations of the parties.[i]

It is better for the parties to either specify which rights and obligations must be exercised with good faith, or to not include a good faith requirement at all and leave it to the courts to imply the duty where it is appropriate.

If a good faith clause is included in the contract and a civil liability dispute arises the clause may trigger the 'contractual or assumed' liability exclusion in the contractor's PI policy.

For these reasons, contractors should resist the inclusion of a "good faith" clause in a professional services contract in case it extends the professional's duty of care.

Personnel Qualifications

Professional services are often performed by a team of employees or contractors who have been contracted to provide the services (on behalf the firm or organization).

Principals commonly ask the firm to "warrant" the expertise or skill of their personnel (including contractors).

Example: The Consultant hereby warrants that its servants, agents, Sub Consultants and employees are both competent and qualified to perform the Services in the manner contemplated by this Agreement.

As a general rule, professional firms should not give a warranty for something that does not involve an 'exercise of reasonable care and skill' – otherwise they could 'assume' a higher duty to the principal than would apply at law. Their PI policy may not respond to a claim involving an 'absolute' warranty as to their personnel's competence or skill.

When an employee is recruited, it is reasonable practice to check their references, qualifications and previous employment history. Professional firms should only warrant that they have exercised reasonable care and diligence in identifying whether the employee is competent and qualified to perform the services.

Budgets – Efficient and Economical Solutions

Keeping a handle on construction costs is vital to the commercial success of a construction

project. Principals often require professionals to supply their services in a way that is economical or which conforms to the construction budget.

Example: The Consultant warrants that any designs will conform to any Cost Plan provided by the Principal (as amended at the time the relevant design work is carried out).

Example: The Consultant represents and agrees that it shall execute and complete the Consultant's Design Obligations in accordance with the Design Documentation Program and produce the Design Documents so as to provide effective, efficient and economical solutions to satisfy the performance and other requirements of the Contractor's Project Requirements.

This sounds fairly straightforward but problems can arise: compliance with the construction budget is generally not in the construction professional's control and/or construction budgets can be underestimated if they haven't been prepared by someone with the required expertise.

A substantial economic loss claim could result if the construction budget is exceeded.

Quite often policies for architects and other professionals exclude claims relating to:

- preparation of a budget or cost plan;
- a construction budget or cost plan being exceeded; or
- a failure to design the building so it can be built economically.

Some policies will cover these claims if the construction budget or cost plan has been prepared by a qualified quantity surveyor.

Clauses in a contract that impose this obligation need to be re-drafted otherwise they can result in 'uninsured' losses for the professional.

Deeds of Novation

When a developer's role in engaging the project team and consultants to design a building is complete, developers often hand the project over to a building contractor to manage the construction phase. Developers often require construction professionals to sign a deed of novation which passes on the benefit of the consultants' contractual obligations to the building contractor.

Example: The Consultant acknowledges and accepts that upon a contractor being engaged for the Project, the Consultant, without being entitled to compensation, may be directed to promptly execute a deed of novation with the Contractor, in a form prescribed by the Principal including without limitation, any form in Schedule K. The Consultant shall comply with any such direction.

While deeds of novation are standard practice in the construction industry, care must be taken to ensure that the terms of the novation do not extend the professional's duty of care or result in the professional holding the developer harmless unless the building contractor is to legally 'stand in the shoes' of the developer as if they were the contracting party at the very beginning of the project.

Deeds of novation attached to a professional services contract often cannot be re-negotiated once the professional services contract has been signed. The deed of novation needs to contain similar terms to the services contract (including indemnities and standard of care), otherwise it could trigger the "contractual liability or assumed liability" exclusion in the professional's policy or compromise the insurer's rights of subrogation by holding the developer and/or the building contractor 'harmless'.

Liquidated damages

Most PI policies exclude claims for liquidated damages. Professional services contracts can require a professional to pay liquidated damages in a number of ways including paying the cost of:

- An insurance policy that has to be purchased because the professional did not buy it;
- Rectification work which is done because the professional has failed to deliver the required work to the standard required;

- Engaging another professional to complete work that has not been prepared to the standard required;
- Failure to deliver the work by a required time or deadline.

Example: The Consultant will be liable for loss or damage as a result of a sub-consultant suspending work and claiming a debt for failure to be paid.

Example: If the Contractor fails to –

(a) complete supply of the Goods or Services by the Completion Date; or

(b) fails to meet any specified delivery date nominated in the Schedule;

liquidated damages at the rate specified in the Schedule shall be paid by the Contractor to the Principal. The parties agree that the liquidated damages specified constitute a fair and reasonable pre-estimate of the loss that will be suffered by the Principal.

In most cases, PI policies will not cover liquidated damages or debts owed by the professional to the principal either because:

- Liquidated damages, debts or penalties are specifically excluded; or
- Even where the reason for the damages is due to professional negligence or breach of professional duties, no "civil liability"claim has been brought by the principal.

Reviews and approvals

Construction projects are often 'collaborative' in that the project manager, principal's representative or developer works closely with the construction professionals to achieve the project outcome.

Primary responsibility for the professional services should remain with the professional. However in the course of designing a building and/or specifying the finishes, fittings and other elements of the building, compromises may be made for a variety of reasons (including time and cost).

Professional services contracts don't always reflect the 'collaborative nature' of the project and often transfer full responsibility for the services to the professional regardless of any directions given by the project manager, principal's representative or developer.

Example: Any approval, review or comment, or any failure to approve, review or comment by the Principal upon any document or design produced by the Consultant will not:

(a) relieve the Consultant of its responsibility to provide the Services in accordance with this Agreement; or

(b) constitute an acceptance by the Principal of any responsibility in connection with the Services or any part of it.

Problems can arise where a professional's recommendation regarding a particular approach or specification of a particular material to address safety, efficiency, environmental, planning or other concerns is not followed.

Example: An architect specifies a certain grade of strengthened glass in the building to protect against the effect of heat. The project developer wants to save money and instructs the architect to user a lesser grade of glass.

Who is responsible if the glass cannot withstand certain temperatures and shatters injuring the occupants?

How does the professional's advice stack up if the developer made a decision to compromise the specification but there is nothing in writing because the professional simply followed the developer's directions?

Clauses that impose all responsibility on the professional even where:

- the developer acts against the recommendations of the professional; or
- the developer uses the professional's work for a purpose that was not contemplated by the professional,

should not be accepted.

These clauses attempt to contract out of the fundamental principles of 'contributory negligence' which make each party liable in accordance with their share of the responsibility for the damage. Professionals should not accept any clause that seeks to apportion liability in any other way.

Otherwise the insurer may be able to deny a claim because the professional has assumed greater legal liability than would apply at law.

A practical method, by which professionals can shift responsibility back to the principal where commercial decisions or risks are taken, can also assist to address this situation. The professional should put their opinions in writing and specifically disclaim responsibility if the developer does not follow their recommendations.

Clauses like the one stated above should be re-negotiated so that there is a 'carve out' of responsibility where the principal uses the professional's work for a purpose that was not contemplated (ie not the purpose for which it was designed) of where the principal decides to use a less appropriate material, fitting finish or specification.

It is important for you to work with your brokers and lawyers to ensure that an insurance program is placed that meets the requirements of a contract.[ii]

For more assistance, or if you would like a legal review of your contracts and insurance policies, contact your broker for a referral.

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[i] In *Esso Australia Resources Pty Ltd v Southern Pacific Petroleum N L* [2005] VSCA 228 Buchanan JA was reluctant "to conclude that commercial contracts are a class of contracts carrying an implied term of good faith as a legal incident…., so that an obligation of good faith applies indiscriminately to all the rights and power [sic] conferred by a commercial contract". Cases in NSW also support that a duty of good faith is valid but may not apply to all rights and obligations between the parties to a contract. The question has not been examined by the High Court of Australia.

[ii] A recent case in WA highlights the importance of seeking legal advice and specialist insurance broking advice during contract negotiations. The case of *Allstate Explorations NL v Blake Dawson Waldron (A Firm)* [2010] WASC 97 involved the plaintiff suing their law firm for uninsured claims of up to $7m on the grounds that the insurance clause included in a contract required the contractor to hold insurance which was not available in the insurance market.