Changes in the Professional Liability Market

January 2020

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Background

Over the past twelve months the insurance market for professional liability has solidified for the first time in fifteen years. The extent and duration of the hardening market are unknown, but all current indications are that 2020 will bring no financial relief to those seeking to renew their corporate annual programs or those seeking coverage for professional liability coverage on a project specific basis.

The insurer's change in professional liability appetite and pricing for US risks began in late 2018 with the Architects and Engineers (Designers) markets. Then in mid-2019 other classes of professional liability began showing signs of stress — primarily the Lawyers and Consultants markets. As one would expect, the stiffening market began by the insureds being asked to take on more risk themselves by means of increased Self-Insured Retentions (SIR's). Quickly thereafter, the markets began applying significant rate increases, particularly to those clients with a poor loss history. And finally, several markets began to reduce the capacity they were willing to commit on any professional liability risk.

Designers in the construction field have indeed experienced all the ill effects associated with a hardening market over the past 18 months. And we anticipate the ability to maintain current limits of coverage, retention levels, and pricing to remain very challenging for most Designers. The Contractors journey through the hardening professional liability market however, has thus far been much less severe. While several Contractors performing work in North America have been asked to take modest increases in their SIR's, pricing for professional liability has increased only 5-8% and capacity has remained relatively consistent for both annual programs and project specific opportunities (though we are starting to see some carriers evaluate capacity outlay for a single risk). While a poor claims history will indeed negatively affect a Contractors renewal, the increased costs are not proportionate to uptick experienced by other classes of professional liability risk. Will this trend continue for Contractors? Unlikely, at best, would be our opinion.

The change in the professional liability market is, like most things in life, a combination of factors. Most prevalent however, is the significant increase of claims activity and losses paid by the construction professional liability market. And some of the contributing aspects to the increase of claims include Designers and Contractors underbidding work, bidding on work outside of their firm's core competency, submission of GMP bids based upon minimal completed designs, a lack of suitably qualified/experienced professionals to work on projects, and the number of mega projects where even the smallest of errors often translates into a significant dollar loss. But the single largest contributing factor to claims is the rapid development and use of Design-Build in the US construction industry. To be sure, the insurance market has experienced frequent and severe losses associated with the Design-Build delivery model since its use began in earnest over the past decade. The root cause of these losses ranges from a basic underappreciation for the unique risks associated with the delivery model, to a lack of coordination and communication between Contractors and Designers.

Broader and more general market forces can also be blamed for the recent challenges in transferring risks by means of insurance. Over the past decade, professional liability insurers within the construction area simply failed to maintain rates and SIRs commiserate with the increased exposure. Projects continued to increase in size and complexity, yet the competition between carriers resulted in unreasonable and unsustainable rates and SIR's being continually offered to the entire construction industry. The inevitable claims are now maturing, and the collected past premiums are far short of what many insurers believe to be necessary to sustain an ongoing market. Professional liability rates are also likely rising due to peer pressure within insurance carriers. As many of the other classes of insurance (e.g. Property, Auto, Excess Casualty) have suffered significant rate and SIR increases, the probability that the professional liability lines would be left alone by a multi-line insurance carrier is unlikely.

What can we learn from previous changes in market conditions?

Although it has been some time since the construction professional liability market experienced a hardening market, it is not unprecedented. Approximately 15 years ago the market hardened briefly, and in the early 1980's the insurance market for these types of risks became nearly non-existent. Valuable lessons can be gleaned from an examination of what occurred during the past downturns.

Designers

In the mid-1980s many large United Kingdom based Architectural firms felt that they were not being well served by traditional market insurers, and that the high premiums they were paying bared little relationship to the amount of loss they were creating by way of claims. After conducting an actuarial analysis, the disaffected architects determined in was financially prudent for them to form their own non-profit insurance company.

Also, during the last true hard market, the paucity of capacity resulted in larger risks forming captive insurance companies or joining risk retention groups. One of the most significant risk retention groups in the designer's market was the Wren Insurance Association formed in the United Kingdom in 1987. Wren began by underwriting professional liability lines for large UK-based designer practices on a mutual basis.

An increased emphasis was simultaneously placed on risk management and the development of mentorship programs to train younger professionals by designers to reduce claims and stem the tide of a prolonged hard market. Finally, a more appropriate balancing of risks was negotiated within the insuring agreement between the carriers and the insureds.

Contractors

Design-Build construction is a relatively new procurement method in North America. Not so in the United Kingdom and Australia where Design-Build has been a prominent form of contract since the early 1980's. And during the past hard markets, London professional liability markets have reacted more severely within the Contractors space as opposed to rate and capacity issues for Designers. The prevalence of Design-Build likely led to this result and is a warning flag to Contractors here in North America.

Prior to 1986, the European professional liability cover for Design-Build contractors provided broad first-party coverage, including a robust Rectification extension - very similar to the broad coverage now enjoyed by Contractors in North America under a standard CPPI (Contractors Protective Professional Indemnity) liability policy. Ultimately a series of severe errors and omissions resulted in several contentious and expense claims being paid by the insurance industry. And because of the breadth of the European Contractors policy, combined with the limits of liability negotiated by the Designers, and/or lack of adequate insurance coverage held by Designers, the vast majority of the claims were paid out under the Contractors professional policies. Sound familiar?

Today in the US market one could argue we are beginning to experience a similar set of circumstances. Contractors currently enjoy broad professional liability coverage including robust Rectification and Protective coverage — which is primarily to cover losses caused by their designers under the Design-Build procurement model. Designers have simultaneously now begun negotiating strict Limits of Liability clauses within their Design-Build contracts and many downstream designers continue to carry very little professional coverage. Thus, the financial losses suffered due to errors under the Design-Build model will ultimately be borne by the Contractors professional policy — very similar to the scenario experienced by the European and Australian markets years ago.

If history does repeat itself, the types of coverage restrictions and underwriting processes that could be seen in North America for contractors include:

- Greater scrutiny by underwriters as to allocation of risk between contractor and designer within the Design-Build contract and proportionate rate assessment between the parties;
- Strict definition of professional activities and duties excluding faulty (non-professional) workmanship;
- Strict definition of “professional services” to be covered under the policy and detailed underwriting of personnel who is anticipated to perform the professional activities;
- Narrowing of the Rectification coverage to apply only to direct costs of mitigating a potential Professional Liability error, and only where insurers have given their prior consent to the mitigation measures;
- An unwillingness to provide vicarious liability of a sub-contractor if their duties are not specifically defined within the Design-Build contract;
- The introduction of an exclusion for claims arising from a Designer’s costs estimates;
- Enhanced obligations on the part of the insured to cooperate in subrogation matters against the subcontracted Designers;
- Sub-limits and significantly higher SIR being applied to Rectification and Protective claims.

Some of these concepts are already imbedded within the Contractors professional policy and may mitigate against more drastic market changes. But if history is any guide, further scope erosion of the contractor’s professional policy should be anticipated.

Best Practices to Allay a Shrinking Professional Liability Market

Preparation for the annual renewal process cannot begin early enough. More communications with the markets, not less, will produce a more palatable result. Evidencing to the markets that the Insured is actively engaged in professional liability Risk Management training throughout the company is also essential. And an ability to demonstrate rigorous adherence to good contractual protocol will serve the Insured well. But what does best contractual practice really mean for both the Insured and the perceived risk from the insurers viewpoint?

We believe the issues which must be analysed, and in turn demonstrated to the insurance market, include:

- The number and type of GMP contracts;
- How joint venture partners are selected;
- Specific contractual language when a joint venture partner includes a Designer;
- How design oversight is being conducted (in-house design team, third party design review, communication protocols with the designer and sub-designers...);
- Use of Integrated Project Delivery;
- Structure of project specific insurance programs;
- Response teams responsibility when a design error is identified.

It is our intent over the next few months to perform an analysis of what truly reflects best practices of each of these topics and share those with our clients.

Considering the structure of a Designer's and Contractor's professional liability program may also be useful in minimizing the effects of a hardening market. Bundling other lines of coverage with a single carrier allows the insurance partner more premium and thus make the risk more attractive. Spreading the risk between several carries by means of quota sharing may also be a wise alternative as such would spread the risk of loss to a number of carriers and thus minimize the response from the market to an adverse claim.

Overall professional liability will continue to contract in 2020. But thoughtful preparation when approaching the market and recognizing historical trends will assist in minimizing the effects of the growing hard market.

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