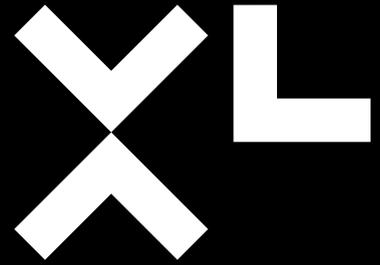


April 2015

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## Design Professional

# The High Risk of Residential Claims

What factors drive the many claims that plague residential design projects? In this article, we look at the data and offer suggestions on how to manage your risk.



A principal of an architectural firm that specializes in corporate projects called XL Group's Design Professional team recently. He was thinking about getting into the residential market, and wanted to talk about the risks.

It's easy to understand the temptation. The residential market—single-family subdivisions, single-family residences, condominiums, apartments and condominium conversions—is making a big comeback in many areas. In fact, housing starts nationally exceeded a million units in 2014 for the first time since 2007, with most of the growth stemming from multi-family construction.

### What the Numbers Say

While residential projects accounted for less than eight percent of the fees earned by our insureds in 2014, they represented 28 percent of the claims and 32 percent of the claim payments we settled in 2014. The disparity between the fees on one hand, and the exposure and claim frequency on the other, gives you an idea of the high degree of risk in residential design services.

Although the risks vary depending on a project's type, discipline and location, the overall numbers have remained fairly consistent for years. Residential claims strike all design and technical disciplines.

Residential claims can be very expensive. For example, of the large loss claims (those over \$250,000) settled by XL Group's Design Professional team in 2014, nearly 25 percent came from residential projects. Residential claims also take longer to settle. In the U.S., 31 percent of our open claims five years and older are residential claims. Even more striking, 44 percent of open Canadian claims five years and older are residential.

## Diving Deeper

There are a number of reasons why these projects see so many claims. First, many residential developers/builders are highly leveraged. For them, the key driver is often speed, not quality, which translates into shoddy construction and increased defects.

This sort of developer rarely gives the design team the opportunity to provide construction phase services; construction observation may be “on call” at the developer’s discretion or eliminated altogether to save money.

This increases the design team’s risk tremendously. Of the 2014 large loss claims, nearly 75 percent of the design teams—three out of every four—had limited or no construction phase services.

The shortage of skilled tradespeople also contributes to construction defects. As the pool of workers declined during the downturn, they moved to other industries or dropped out of the labor force. A 2014 survey by the Associated General Contractors of America (AGC) found that over 80 percent of construction firms were having difficulty filling positions for on-site workers.

Additionally, in order to lower costs, builders often substitute new, less-expensive materials. Many of these may not work well with other components or last as long as traditional ones. And some new materials simply don’t perform as promised.

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For homeowners, the projects are—ultimately—highly personal. Their home may be the single biggest purchase of their lives, and they want it to be right. Many have little or no experience with the building process and the design professional’s role in it. Often, they don’t understand how “minor” changes by them (or the contractor) will affect cost and schedule. What’s more, many buyers, especially in condo projects, may not realize that they bear the ultimate responsibility for upkeep and maintenance.

## Duplicative Danger

On condos, apartments and residential subdivisions, duplicative construction and design means that a single construction defect or design error in a multi-unit project can be reproduced many times, resulting in huge damages. A \$5,000 construction error repeated in each of 300 units adds up to a mighty big claim.

Condominiums deserve their own special circle in the residential claim inferno. While less than one percent of the fees generated by our policyholders come from condo projects, nearly eight percent of claims dollars paid are attributed to condo projects. What causes such a gap? In addition to all the reasons discussed, condominium boards are often approached by aggressive law firms that warn the boards of their fiduciary duty to the homeowners associations (HOAs) if they don’t act on any construction defects. The condo boards then sue either the developer, who brings in the contractor and designers by third party action or cross-complaints, or all the parties directly. Either way, the designers are almost invariably drawn into the suit.

Apartment conversion is another area of concern. If an apartment building you design is converted to a condominium, you inherit the liability almost as if you had designed the project as a condominium in the first place. But where you once owed a duty of care to a single client, you may now owe that same duty to hundreds of owners if an apartment complex you designed has been converted—except that you have no contractual protection of any kind. What’s more, condo owners tend to have much greater expectations than renters.

## Single-Family Residential Projects

Single-family residential projects can be risky, too, especially for a smaller design practice, where a single large claim can be its undoing.

We often see claims arise from high-end custom home projects. These involve wealthy clients who have unreasonable expectations, and who make excessive changes and demands. Such issues often translate into scope creep for the designer, which in turn leads to unpaid fees, fee claims by the A/E, and counterclaims by the owner.

## Proceed with Caution

XL Group's Design Professional team has found that design firms that are very experienced in residential projects, that are aware of the pitfalls and that institute steel-plated risk management measures may have fewer claims. But if you're new to the residential arena, we recommend extra diligence in managing your risk. Here are a few recommendations:

- **Make client selection a priority.** Your choice of client may be the single most important factor in a successful and trouble-free project. Select clients that are sufficiently financed, have experience in residential projects, have ties to the community and care about quality. You want a client that shares your concerns about the high-risk nature of residential projects.
- **Learn as much as you can about the project.** Where will it be built? Is it in a jurisdiction where construction defect claims are especially prevalent? Are there any unusual requirements? Is the project controversial or is there opposition to the project? Does the site present any unique challenges? Are the budget (including a healthy contingency) and schedule realistic? Is the fee worth the risk?
- **Find out about the contractor.** What is the selection process? Using low-bid contractors can significantly increase the chances of litigation on the project. Will the owner share with you a copy of the proposed construction contract? If not, what business relationship with the contractor or construction manager is the owner hiding from you? Consider making your involvement with the project contingent on your acceptance of the contractor and seeing a copy of the proposed construction contract.
- **Consider your own firm's experience in residential design.** Do you have enough qualified staff? Is your firm knowledgeable about the project locale? Make sure your subconsultants are qualified, too, and carry adequate professional liability insurance.
- **Develop an equitable agreement.** Your agreement should properly address the allocation of risks associated with the project, and should provide for mediation as the first line of dispute resolution. (For more information and a list of suggested important contract clauses for condominium projects, see the "Condominiums" chapter in XL Group's *Contract eGuide*.)
- **Insist on providing full construction observation services.** Site observation allows you to see if the work is progressing in general conformance with the contract documents and according to the design concept, and to answer questions or clarify and interpret documents for the contractor on the spot. It may also enable you to

## If you're new to the residential arena, we recommend extra diligence in managing your risk.

identify problem areas early on—far less costly than fixing problems after the project is completed.

- **Watch for any substitutions requested by the developer or contractor.** Clearly document any objections you have.
- **Be sure to err on the side of over-communicating with all parties, including owners/developers, contractors and homebuyers.** Hold change-order prevention meetings and owner/design professional/contractor team meetings biweekly during design and construction.
- **Document all meetings and conversations pertaining to the project.** In particular, note any recommendations you make that are not followed by the owner/developer or contractor.
- **Make sure the construction documents are as complete as possible,** fully coordinated, consistent, easy to follow and error-free.
- **Stress maintenance issues, especially on condo projects.** Offer to prepare a maintenance manual as part of your services. Have your client write into the homeowners association by-laws that all required maintenance will be the responsibility of the homeowners. Consider meeting with the owner or homeowners association shortly after occupancy to discuss the importance of maintenance.

As XL Group's Design Professional team explained to that architect who wanted to get into the residential market, the numbers tell a not-very-pretty story. Unless his firm is resolute about choosing its clients and projects selectively, gets adequate contractual protection and institutes rigorous loss prevention measures in every residential project it considers, a wiser choice might be to stay in the market it knows.

# Human Resources, Risk Management and the Future of Design Firms

Your firm's HR function can act as an effective loss prevention tool.

Human resources (HR) is a field to which many design firms pay little attention. Smaller firms have no HR department to speak of. The owner or his or her administrative assistant collects the necessary forms and paperwork, hiring is done ad hoc, layoffs are painful and certainly unplanned, and training and education are likewise dependent on the vagaries of the economy and the workload.

In firms that have grown just large enough to have a dedicated HR person, that person is tasked with everything from handling health insurance and filing social security forms to placing recruitment ads and conducting interviews. Rarely, if ever, do firms consider HR as a strategic tool. More often, they view it as an overhead function that's necessary but outside the stream of ongoing projects.

As our insureds know from our Risk Drivers research, our second leading risk driver is project team capabilities. Its involvement in the claims we see has stayed at roughly 25 percent since we did the first Risk Drivers analysis in 2001.

In the "Project Team Capabilities" chart, note how often the words "inexperienced," "unqualified," and "insufficient" are listed. These proximate causes for claims continue to occur at the same rate as they have for over 14 years now, despite the eight-to-10-year period necessary in most states and provinces for designers to become professionally licensed.

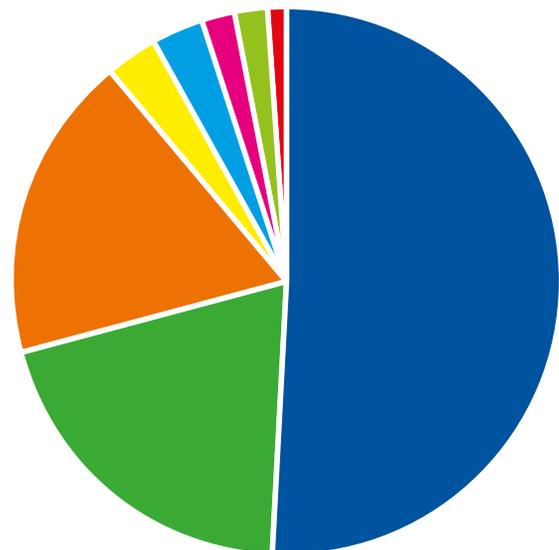
Why do these claims occur? Who's responsible for all this "inexperience," for putting "unqualified" staff on projects and for having "insufficient" numbers of staff to complete a project? Unfortunately, it's not always right-out-of-school junior staff who are involved in these claims—in many cases licensed designers are involved. Often these designers are new hires whom the firm has immediately put to work on a project that has overloaded the current staff. This is because most design firms only hire new staff when they land a project too large for their current staff to handle. With the current dearth of qualified designers, a firm that advertises open positions is lucky to find a good applicant within six months. Meanwhile, the firm has already started working on the project.

If a new employee is hired while the firm is in such a situation, he or she is immediately assigned to begin chargeable work on the project, with little or no planned integration into the firm. The result, especially when the individual is a project manager or senior designer, is an employee who doesn't know the symbol library, doesn't know where to turn for answers, may not know local codes and officials, and is also cautious about asking for help. The end result might very well be a claim and yet another statistic for our Risk Drivers research.

The above scenario is fairly typical of the design profession's hiring pattern over the last 20 years. Firms staff up for projects, grow organically and occasionally buy or sell one another. In bad economic times, when the project pipeline slows, firms make the painful decision to lay off staff.

However, this ebb-and-flow in hiring has been radically disrupted over the last five years. According to the Pew

Project Team Capabilities



- 51% - Inexperienced design staff
- 20% - Experienced on-site design staff
- 18% - Inexperienced project manager
- 3% - Other
- 3% - Firm inexperienced in project type
- 2% - Unqualified back-up staff
- 2% - Outside firm's normal territory
- 1% - Insufficient number of staff

Research Center, the first “baby boomer” officially reached retirement age five years ago and since then, baby boomers in the U.S. have been retiring at the rate of 10,000 per day! Of course, not all retiring baby boomers are designers, but designers are proportionally represented. Design firms are now faced with the prospect of an internally shrinking workforce and an insufficient flow of new entrants to replace them.

Which bring us back to HR. This new hiring environment elevates the HR function to a more strategic position in design firms than it has occupied. Since design work is by definition knowledge work, firms’ very lifeblood is a supply of knowledge workers equal to the work at hand.

Insufficient supplies of new designers mean firms will struggle to maintain revenue, and will be forced to decline larger projects or new levels of projects when busy. It also means that firms face increased risk exposure with those new employees they’re able to find.

On the other side, there may be increased risk exposure stemming from current employees who use this competitive environment to find better-paying jobs at other firms. They may either leave a project mid-way through, or effectively “check out” prior to giving notice.

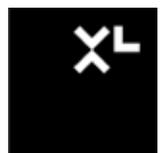
There are no quick fixes for this change in the hiring environment, but firms should be alerted to the increased level of risk this new future holds. In essence, firms should be in a constant state of hiring and integrating new hires while at the same time talking to soon-to-be-retired employees about their goals. In a worst case scenario, a seasoned employee announces his or her retirement in two weeks’ time on the same day the firm lands a major project. Savvy design firms will be talking to their boomer employees now about their intended retirement dates and hiring new employees well in advance of anticipated major projects.

## Where Are All Ontario's Engineers?

Wondering why it can be so difficult to hire a qualified engineer for your firm? On a recent CBC broadcast, the CEO of the Ontario Society of Professional Engineers stated that over 33 percent of Ontario engineering graduates are working in fields that don't require an engineering degree. Further, among those engineering graduates who are working in engineering, many do not work in the consulting engineering sector.

You can download a podcast of the show, “Ontario Today,” broadcast on March 3, 2015, here:

[Download Podcast HERE](#)



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