

# ProNetwork News

Risk Management Tools for the Design Professional



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## If You Build It, They Will Sue: Condominium Projects – Part II

by Trevor O. Resurreccion, Esq. & Peter L. Stacy, Esq., Weil & Drage, APC<sup>1</sup>

Continued from the August 2016 issue of ProNetwork News including an analysis of *Beacon Residential Community Association v. Skidmore, Owings & Merrill LLP, et al.* and its impact on future court decisions.

### IV. Important Contract Provisions

#### A. Indemnity, Indemnity, Indemnity!!!

In the real estate business the often-touted phrase is “location, location, location.” In the design and construction industry, the most important contract provision is INDEMNITY. Indemnity is an agreement to assume a specific liability in the event of a loss. It may mean a shifting of risk from one party to another. More often than not, it is the client saddling the design professional with an onerous indemnity provision. Many articles have already been written about addressing the client-drafted indemnity. Avoid an express duty to defend (and in California especially, negate this duty). Tie the indemnity obligation to a determination of negligence. However, in the context of agreeing to perform professional services on a condominium project, you must not only be wary of the indemnity provision imposing a contractual obligation on the design professional, but serious consideration should be given to obtaining express indemnity language from the client developer and/or the client developer's contractor and subcontractors. Since the design professional may be sued directly by an HOA or individual unit owners, express indemnity running in favor of the design professional is equally important.

#### B. Waiver of Consequential Damages

These damages are the “indirect damages and expenses” claimed by plaintiff(s) allegedly relating to asserted design and construction defects. Often,



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consequential damages include damages relating to delays, loss of use, lost profits, etc. It is a balancing provision in that it should recognize, much like a limitation of liability (discussed further below), that there are relative risks and rewards for each party's participation on the project. As was commonplace during the recent recession, some client developers pursued claims against design professionals and contractors for missed market opportunities to sell their individual units before the housing bubble burst. The design professional has no control over such market factors. A properly-worded, mutual waiver of consequential damages is an appropriate way to address this.

### **C. Limitation of Liability**

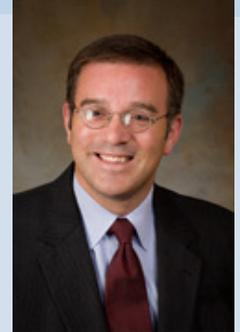
Given the increased risk of being sued on a condominium project, a limitation of liability (overall cap) of the design professional from the client developer is essential. A limitation of liability provision can be tied to the amount of available insurance, the architect's total fee, or some other amount as negotiated between the parties to the contract. The limitation of liability provision should be negotiated at arm's length such that both parties have the opportunity to accept, reject or modify the provision.

### **D. No Third-Party Beneficiaries**

It has long been a recommendation that design professionals include a "no third party beneficiaries" clause in their contracts to eliminate the possibility of third parties (i.e., parties not in privity of contract with the design professional) to avail themselves of contract rights and claims in litigation. Generally, this is still the case. However, with the Beacon decision, since the HOA and individual unit owners may be deemed third party beneficiaries as a matter of law, attempts should be made to tie them to be bound by the affirmative defense and limitation provisions of the contract that are there to protect the design professional. This necessarily requires the cooperation of the client developer through a contractual obligation.

### **E. The Certificate of Merit**

Many states have a statutory certificate of merit requirement as a condition precedent to suing a design professional. While these statutes vary in effectiveness, it is at least some minimal stumbling block that plaintiffs must navigate. Design professionals should also consider strengthening the certificate of merit requirement and conditions through their contracts. Require that anyone pursuing a claim against a design professional not only obtain a certificate of merit but also support the certificate with a detailed report by the expert upon whom the certificate is based. Expressly require a certificate of merit regardless of the forum (e.g., civil courts, arbitration, judicial reference).



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Peter has drafted and negotiated complex contracts concerning multi-million dollar public works projects and private hotels, casinos, resorts, horse racing organizations, mixed-use developments, and multi-family subdivisions. He represents a wide variety of clients, including architects and engineers, contractors, investment advisors, horse racing association, horse owners, entrepreneurs, entertainers, manufacturing and fabrication companies, property managers, and retail businesses.

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### F. Provisions Requiring the Developer and Subsequent Owners to Include Maintenance Requirements and Manuals in CC&Rs and Purchase Agreements

A lack of proper maintenance of common areas, landscaping, drainage, roofs, decks, etc. have long been at the heart of most common interest development/condominium lawsuits. Accordingly, it is important for both the design professional and the client developer to craft maintenance obligations and requirements binding upon the HOA and unit owners. Such provisions not only serve to mitigate the actual damages but work as affirmative defenses if the HOA and/or unit owners fail to abide by them. The following provisions are recommended:

- 1. General Maintenance.** The Owner agrees that the bylaws of any Homeowners' Association established for the residential portion of this Project will require that the Association will perform, as recommended in the CC&Rs, Bylaws and/or 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 Owner, the Architect, all Consultants and the Contractor if the maintenance recommendations contained in the CC&Rs, Bylaws and/or Maintenance Manual applicable to the Association are not performed.
- 2. Homeowner Maintenance Obligations for any Residential Portion of Project.** The Owner agrees that the CC&Rs established for the residential portion of this Project will require that the Homeowner will perform, as recommended in the CC&Rs, Bylaws and/or Maintenance Manual, all applicable and necessary routine maintenance, maintenance inspections and any other necessary repairs and maintenance identified. The CC&Rs shall also contain an appropriate waiver and indemnity in favor of the Owner, the Architect, all Consultants and the Contractor if the maintenance recommendations contained in the CC&Rs and Maintenance Manual applicable to the Homeowner(s) are not performed.
- 3. Maintenance Manual.** Owner shall retain and utilize an independent third party consultant to prepare a fully detailed Maintenance Manual to be provided to the Homeowner Association. Such Maintenance Manual will contain all the information necessary for the Homeowner Association to maintain the Project. The Maintenance Manual will contain specific requirements for:
  1. Why the maintenance is required
  2. What maintenance tasks are required
  3. Where (which locations) the maintenance tasks will be performed

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4. When (and how often) the maintenance tasks will be performed
5. How the maintenance tasks will be performed
6. Who is the best entity to perform the maintenance tasks
7. The estimated costs associated with each of the maintenance tasks
8. Logs documenting the status of all maintenance tasks

4. **Owner's Obligation to Retain Third Party Construction Inspection Service.** The Owner shall retain and utilize an independent third party construction inspection service to perform a technical review of the final Construction Documents and observe and document construction of the project and report any defects, disparities, errors or omissions to the Owner. The Owner will insure that all recommendations for repairs, corrections or changes are accomplished.
5. **Waterproofing Consultant.** The Owner shall retain and utilize an independent third party waterproofing consultant to provide advice, oversight, and performance evaluations to ensure that all components of a building's exterior perform. The waterproofing consultant shall be involved in the preparation of roofing, waterproofing, and exterior wall systems specifications, drawings, and construction inspection of the waterproof installation.
6. **Independent Property Inspector.** The Owner will assure that the Purchase and Sale Agreements for all units sold will require that each purchaser must retain an independent property inspector to inspect the purchased property for defects prior to closing.
7. **Indemnity with respect to claims by HOA or Homeowners.** The Owner 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 Owner agrees, to the fullest extent permitted by law, to indemnify and hold harmless the Architect, its officers, directors, employees and subconsultants (collectively, Architect) against all damages, liabilities or costs, including reasonable attorney's fees and defense costs, arising out of or in any way connected with the services performed under this Agreement, except for the Architect's sole negligence or willful misconduct. This indemnity obligation shall be binding upon Owner's successors, assigns, legal representatives and any subsequent owners of the Project and/or Property, and this indemnity obligation shall inure to the benefit of Architect, and its successors, assigns and legal representatives. Owner shall obtain the express written agreement of any subsequent owner and/or purchaser

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of the Project and/or Property to be bound by this provision, and shall provide Architect with a copy of such agreement. Should the Owner fail to obtain the express written agreement of the successor Owner(s) or Purchaser(s) or such successor Owner(s) or Purchaser(s) fail to perform the obligations herein, then Owner shall remain responsible to indemnify, defend and hold harmless as set forth above.

8. **Waiver.** In consideration of the substantial risks to the Architect in rendering professional services in connection with this Project, the Owner 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.
9. **Third Party Beneficiaries.** Nothing contained in this Agreement shall create a contractual relationship with or a cause of action in favor of a third party against either the Architect or Owner, except as otherwise imposed by law. The Architect's services under this Agreement are intended as being performed solely for the Owner's benefit, and no other party or entity shall have any claim against the Architect because of this Agreement or the performance or nonperformance of services hereunder.
10. **WRAP or OCIP (Owner Controlled Insurance Program) policy for Project.** Prior to commencement of construction, the Owner agrees to obtain or require that the Contractor obtain a WRAP (or OCIP if the WRAP is unavailable) policy of insurance for the Contractor and its subcontractors for the Project, and provide Architect with proof of such insurance prior to the commencement of construction. Architect and its consultants shall be named as Insureds with the WRAP or OCIP insurance for the Project. The WRAP or OCIP policy shall include coverage for the negligent acts, errors and omissions of Architect and Architect's consultants in the amount of \$5,000,000 per claim and aggregate, subject to \$50,000 deductible per claim. The WRAP or OCIP policy and limits (1) shall be primary to any similar insurance carried by Architect and Architect's consultants and not excess; (2) shall apply as if each Named Insured were the only Named Insured; (3) shall apply separately to each insured against whom claim is made or suit is brought ;(4) shall have a fully paid ten (10) year discovery and extended reporting period. The failure to secure and maintain the WRAP or OCIP shall be considered a material breach of this Agreement and entitle Architect to immediately terminate this Agreement.

11. **OPPI (Owner Protective Professional Indemnity) policy for the Project, Project Specific Excess.** Prior to commencement of construction, Owner agrees to obtain or cause to be obtained an OPPI policy to supplement the Architect's professional liability insurance limits in the amount of at least \$ \_\_,000,000. The policy shall be purchased and fully paid for a discovery and extended reporting period of ten (10) years following substantial completion of the Project. The Owner shall provide Architect with proof of such insurance policies. The Owner and the OPPI Insurer shall waive subrogation, and shall have no claim against the Architect, Architect's consultants and their employees, owners, officers and directors and insurers. If the Owner decides not to procure an OPPI Policy, then the Owner shall pay/reimburse the Architect the cost of securing and maintaining project specific excess insurance in the amount of \$ \_\_,000,000.00 for a period of ten (10) years following substantial completion of the Project. The project specific excess must also be secured prior to the commencement of construction. The failure to secure and maintain the OPPI or project specific excess policy shall be considered a material breach of this Agreement
  
12. **Contractor Indemnity.** The Owner shall require in its agreement with the Contractor that the Contractor shall indemnify and hold harmless the Owner, Architect, Architect's consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorneys' fees, arising out of or resulting from performance of the Work, provided that such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), arising out of or relating to the negligent acts or omissions of the Contractor, a Subcontractor, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in part by a party indemnified hereunder.
  
13. **Specific HOA Obligations.** The Owner shall include in the Project's "Declaration of Covenants, Conditions and Restrictions" the by-laws applicable to individual residential condominium units, individual residential condominium unit purchase agreements, or similar documents, provisions providing that the Project's Home Owners Association ("HOA") and individual unit owners (singly, "Unit Owner" and collectively, "Unit Owners") to the following effect:
  - a. The HOA shall be responsible for (a) proper and timely maintenance of all portions of the Condominium Portion of the Project not the

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- direct responsibility of a Unit Owner (the “Common Areas”), and the Unit Owners shall be responsible for the proper and timely maintenance of all portions of their individual units, in each case such maintenance to include, at a minimum, the routine maintenance, maintenance inspections and any other necessary repairs and maintenance called for as a result of such maintenance inspections as described in the Maintenance Manual referred to above in this Agreement, and (b) establishing reasonable requirements for adequately funding, on a continuing basis, a maintenance program to satisfy the HOA responsibilities;
- b. Neither the Architect nor its consultants nor their respective officers, directors and employees, shall be responsible to the HOA or the Unit Owners for the proper and timely maintenance of the Common Areas or the individual units;
  - c. The HOA and each affected Unit Owner shall first consult with construction experts knowledgeable and experienced in the matters concerning the HOA and such Unit Owners prior to initiating any dispute resolution proceedings involving any allegations of deficiencies in the performance of or asserting any claims against the Architect or its consultants in connection with the Condominium Portion of the Project;
  - d. The HOA, in contemplating the pursuit of any claims, must also survey Unit Owners, and send out questionnaires to individual Unit Owners concerning the actual or potential claims of any individual Unit Owners, and evaluate whether the HOA may pursue both the claims of the association as to common areas and the claims of Unit Owners as to the interiors of individual units whether any claims of Unit Owners must, in the interest of judicial economy, be brought by the Unit Owners individually concurrently with any claim brought by the HOA but joined, as required above; and
  - e. The Unit Owners and the HOA will obtain adequate insurance to protect the Unit Owners’ and HOA’s respective interests in the property. .

**14. Architect Shall Be Allowed to Review Documents.** The Owner shall afford the Architect the opportunity to comment upon draft copies of the various documents referred to in this Section prior to their finalization.

### V. Insurance Issues

No discussion regarding protecting yourself from third-party claims is complete without a discussion regarding professional liability insurance policies. The AIA Trust recently published a summary report of the 2014 professional liability

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insurance carrier interviews. According to the report, there is a trend amongst owners requesting higher limits for insurance coverage. The insurance carriers which reported on this trend noted: "These requests for higher limits are not necessarily tied to the value of the project or increased exposure from the design professional, but rather are an attempt to increase the overall insurance proceeds available to the owner to respond to claims. As a result, carriers are seeing an increased use of project specific policies to respond to these requests." Further, the total claim cost amounts have increased while the total number of claims has reduced. However, the general expectation amongst carriers is that the frequency of claims will increase over the next year based upon increased in work activity for their insureds.

With respect to claims based upon project type, the insurance carriers reported that claims involving multifamily residential, condominiums, and schools/universities were reported to be approximately 25% of total claims. As many architects are aware, many developers are making the decision to convert rental apartments to condominiums. By doing so, architects and others involved in the design and construction of multifamily residential projects are increasingly faced with the prospect of a new pool of potential third-party claimants, including individual homeowners and homeowners' associations. "Add that to the scope and quality variations caused by contractor and owner value engineering substitutions, and the fact that the ultimate third-party condo owners are not always happy with the finished product. The result has been increased claims by the condominium owners against developers, contractors and design professionals." For those architects whom regularly or are considering providing design services for condominium projects, consider the following: "Several insurers interviewed indicated that they take a more detailed look at firms that provide condominium design when they quote policy rates. Over 40% of the insurers interviewed reported that they have policy restrictions on condominium work, and almost 60% interviewed stated that condominiums may lead to higher rate increases in the coming years."

The client developer should be required to obtain WRAP or OCIP insurance to cover general liability claims of the contractor and subcontractors. Such policies should be in place from commencement of construction through completion and be "occurrence based." It is one thing to require that a WRAP or OCIP be obtained in the contract but it is vitally important to make sure one of these policies is actually obtained. The failure to obtain should be a material breach of the design professional agreement, and grounds for termination. There have been too many cases where the design professional becomes the main target in litigation due to the fact that a WRAP or OCIP – although contractually required – was not obtained and the design professional is the only party with insurance.

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You would think that there would be a specific insurance product for design professionals performing condominium projects. There currently is not. The availability of project specific professional liability insurance to cover the design team is rare if non-existent for such projects. Therefore, it is the design professional's practice policy of professional liability that remains at risk. It is important to ensure that there are no exclusions in your policy regarding condominium projects. Many policies prohibit more than a certain percentage of your annual revenue to be generated from services on such projects. You may also want to look at project specific excess insurance to cover the risks associated with specific condominium projects, and the design professional should seek the cost of the same as a reimbursable cost from the client developer.

Lastly, an OPPI policy should be discussed as offering the client developer some protection as opposed to requiring the design professional to raise its overall practice policy to higher limits at increased premium cost. The OPPI does not directly offer any insurance protection for the design team. It generally sits in an excess or secondary position to the design professional(s)' practice policies. In other words, the OPPI protects the Owner for the design professional errors and omissions once the design professional's practice policies have been exhausted.

### **VI. Conclusion and Recommendations**

The bottom line is that condominium projects remain high risk. There is no absolute protection that a design professional can negotiate with its client to avoid the very real possibility of HOA and/or individual unit owner claims and lawsuits. Some states have adopted statutory pre-litigation schemes to address residential construction and design defects and "right to repair." Unfortunately, the statutory language has created rights for HOA and/or homeowners to pursue contractors and design professionals directly, regardless of contractual privity. The Beacon decision has taken it even farther. The best defenses remain a good set of plans and specifications, used by competent general contractors and subcontractors, with appropriate third party observation and inspection (especially of the building envelope/waterproofing). Having a client that will be there at the time of a claim is no guaranty so past performance and litigation history are worth investigating. Both you and your client should explore all of the various insurance products. Consult your insurance broker. Both you and your client should be united in making sure that HOA and unit owner maintenance requirements are mandated in the project CC&Rs, declarations and manuals. Lastly, if defect and deficiency issues do arise, a well-drafted protocol to address the same may lead to a more efficient and economical resolution of the same. The money may be good and the projects plentiful but the risks are real. Thoughtfully approaching each and every project, from contract negotiation to the purchase and sale of individual units, is key to both you and your client.

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#### **Design Professionals and the Give-and-Take of Standard Contracts**



For design professionals, the word "standard" becomes tricky when applied to contracts. Project owners often want to keep things simple by requiring so-called Standard Contracts for all parties.

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