

The Risks of Residential Design Continue to Rise

Residential, or "habitability," projects take many forms. From hotels to single-family houses, habitability projects represent significant service opportunities for architects—and a tremendous source of claims.

During the recent economic downturn, residential construction was a bright spot. For architectural firms, the construction boom meant resorts, housing developments, and multi-family projects, including condominiums. After every construction boom comes the rush of claims. For firms that provided habitability design services, these claims can be disastrous. And now, while the new housing market has cooled considerably, the need for apartments and condos continues strong. And these multi-family projects represent significant risk management challenges to design firms.

According to statistics from Victor O. Schinnerer & Company, Inc., the administrator of the AIA's Commended Program of professional liability insurance, from 2000 through 2004 all forms of habitability projects represented tremendous risks to design firms. By way of contrast, housing and hotels represented just over 16 percent of reported income by policyholders in the AIA Commended Program but generated almost 42 percent of all claims. In addition to damaging the reputation of a firm, a claim means lost productivity, out-of-pocket expenses, and insurance defense and payment costs—which mean higher insurance rates.

Single-Family Residential Projects

Whether houses or townhouses, this project type is of great risk for small design firms. While the average paid claim was only about \$75,000, the top quartile of all claims in this category cost an average of more than \$210,000. The top ten percent of paid claims resulted in payments averaging more than \$850,000.

Small design firms often think that because of their lesser fees on "smaller" scope projects, they are immune to major claims. But of the top 20 paid claims over the five-year period, eight were made on behalf of firms in our small firm program with payments averaging nearly \$750,000. As the cost of residential projects and their financing increase, the claims related to them also increase.

Multi-Family Residential Projects

These projects are the prime example of where the risks faced by design firms greatly outweigh the fees. Claims from multi-family housing projects—while always a problem area for professional liability—now threaten to drive insurance rates skyward and more firms out of business.

Reported billings from multi-family housing projects represented less than 4.5 percent of the total reported income from policyholders in the CNA insurance program. However, claims from these projects represented almost 20 percent of all claims. The ratio of the percentage of claims to the percentage of billings—over four-to-one—is astounding.

Multi-Family Rental Properties

Many rental property claims over the last five years were brought against civil and mechanical engineers. Architects, because of their vicarious liability, also experienced high loss ratios. The average paid claim was about \$150,000. The top ten percent required more than \$800,000 per claim while the top quartile payments averaged almost \$470,000 per claim.

Although single-owner, multi-family facilities, such as apartments, do not have the same multiple claimant problems of condos, there are often repetitive design problems or construction defects that increase remedial costs. And this exposure often is expanded

because on many such projects, the design architect is not involved in the construction phase.

Condominiums

Condominium design projects represented the absolute worst project type from a claims perspective. Even firms experienced in condo design—those that worked with reputable developers on projects where construction quality was not compromised—suffered. The average paid condo claim was about \$190,000, with the top ten percent averaging more than \$820,000. The top 25 percent averaged about \$540,000 in defense and indemnity costs. And, as with single-family housing claims, small firms were hit especially hard by condo claims.

Of the top 25 paid claims, seven were on behalf of firms in our small firm program. These seven claims averaged close to \$670,000 each. And while many of these claims related to ineffective HVAC or structural systems, it often was the architect, as the prime design professional, who ended up with the financial loss. Too often this exposure resulted because the architect used an uninsured consultant who was negligent and had no ability to stand behind the services provided.

Hotels and Motels

Although temporary habitation projects do not have the same issues of constant occupation and emotional attachment of permanent residences, they are still risk-prone projects. Structural and mechanical engineers are especially at risk, with vicarious liability risks for architects. Over half of the top 25 claims were paid on behalf of engineers and these averaged more than \$615,000. While the average paid claim was only about \$220,000, the top ten percent cost more than \$850,000 each. The top quartile payment for claims was more than \$580,000.

Market Reaction

The high number and cost of claims generated by habitability design services has led to a market reaction. Some firms are changing their services to avoid such projects. Others realize that they need to charge appropriate fees to provide services and absorb the risks. And some reacted to rising insurance costs related to these high-risk projects by going without coverage and jeopardizing their personal assets as well as the viability of their firms.

The AIA Trust-sponsored CNA program administered by Schinnerer still covers firms designing habitability projects, including condos, apartments, and other multi-family housing projects. But claims drive costs, and as these projects generate increased claims, design firms need to recognize and manage their exposures to protect the viability of their practices.