



## CLIENT ADVISORY

### INSURING CONSTRUCTION MANAGERS

Katie Casey was delighted – she had just closed the deal on behalf of her company, C&J Construction Services, Inc., to provide construction management services for the future owner of the new Mudville<sup>1</sup> baseball park. Not only is this the biggest project undertaken by C&J in its history, Katie, who has recently been elected CEO of C&J, is a baseball fanatic.<sup>2</sup> Unfortunately, her euphoria with the new project is short-lived. After sharing the good news with her team, her assistant hands her a rather disturbing message from her insurance broker – C&J's insurance costs will be three times greater than expected for the new project. This is indeed alarming news! But Katie will not be discouraged - she is determined to find out what is behind this unwelcome surprise!

#### C&J's History

Katie is very familiar with the history of C&J - it is a well known and established construction company that has provided traditional general contracting services for over forty years. It is only within the last few years that C&J has built a construction management team and has begun to offer construction management services (thanks largely to Katie) in addition to its general contracting. While revenue from general contracting has been declining and revenue from construction management has been increasing, C&J still performs a substantial amount of building. However, Katie suspects the shocking increase in insurance costs is rooted in how C&J is perceived – solely as a general contractor, even though it advertises itself as providing construction management services.

#### Development of Construction Management

Katie is also very much aware of the history of construction management – it evolved as a professional practice *distinct* from *design* and *distinct* from *construction* in the early 1960s in response to the complexities in the construction industry.<sup>3</sup> This trend is precisely why Katie has been pushing C&J for the last several years to offer construction management services. However, it is Katie's experience that construction management has not been readily accepted as a *separate professional practice*. In fact, she has found that the relative newness of construction management has too often resulted in the failure of many to fully understand the profession. On smaller projects in the past, Katie has had to fight the all too common perception that a construction manager is *always* the equivalent of a general contractor. Because C&J will perform services *only* as an Agency CM or agency construction manager for the new \$150 million ballpark project, such a view is clearly mistaken here.

#### Meeting Her Insurance Broker

**Classification** Katie's insurance broker, Nelly Kelly<sup>4</sup>, has substantial expertise in construction risk and insurance. When Katie and Nelly meet to review the appalling premium quotes for the ballpark project, they uncover what they both suspected – the entire \$150 million ball park project has been classified on C&J's

liability policy as if C&J was the general contractor! Numerous discussions with all involved yield no changes – apparently the underwriter is adamant this is how it has always *been done*. It seems to make no difference that this \$150 million project is an Agency CM project *only*!

Finally, Nelly finds what she was looking for – a reference in the ISO Commercial Lines Manual specifically for construction managers. She locates a classification that is listed as Construction or Project Manager with the code 41620. And here is the clincher – the notes in the manual describe exactly what C&J is doing as an Agency CM, “an independent contractor who is hired by an owner to *manage* a construction project. The construction manager does not engage in *actual construction* or *hire subcontractors*.” Nelly recognizes there may be a downside to all of this, however. Any errors or omissions that involve CM work are excluded as this classification requires the liability policy be changed to exclude construction managers' errors and omissions – Nelly makes a note to discuss this with Katie later.

**Premium Base** Nelly knows that the premium basis for an Agency CM should, according to the insurance manual, be C&J's “gross sales” for the ballpark project, which the ISO Commercial Lines Manual describes as “construction or project manager *fees for services rendered*.” As a fee for services is the customary compensation of an Agency CM, this all starts to make sense to Katie. Once the liability policy is correctly classified and the correct premium basis is used (C&J's Agency CM fee for the \$150 million project is about \$2 million), the liability premium for the ballpark project is drastically reduced and now falls into line.

**Nelly Explains** While Katie is now happy with the cost of the liability insurance of the ballpark project, she wants to know why this solution was not available in some past Agency CM projects. After some research, Nelly explains that prior to December 1, 2004, the ISO Commercial Lines insurance manual mandated a *different* construction manager classification – while the description was the same – Construction or Project Manager – the code was different - 91600. More importantly, the older CM

classification used payroll as its premium base instead of fee for services typically charged by an Agency CM. Further, the older classification required the liability policy be amended to exclude *engineering, architecture or surveying professional services*.

As Katie knows, construction management professional services *are distinct from design services* – thus, this older exclusion may have only confused the issues. Finally, Nelly points out, and Katie agrees, the insurance industry is continuing to evolve, albeit belatedly, to recognize the realities of the construction management profession.

**C&J – CM at Risk** Once the issues have been worked out on the ballpark project, Katie asks Nelly to make sure the liability classifications for C&J for *all of its projects* are correct.

First, Nelly looks into a project in which C&J is acting *solely as a CM at Risk*. As a CM at Risk is the equivalent of a general contractor, Nelly finds that it has been appropriately classified as a general contractor using Contractors – Executive Supervisors or Executive Superintendents – code 91580 and is based on the payroll of the CM team responsible to the owner for delivering the project at the guaranteed price.

Additionally, those subcontractors engaged by C&J to build the project are properly classified according to the appropriate subcontractor codes. For example, as this C&J project is a small highway project, the proper code is 91588 – Contractors – subcontracted work – in connection with bridge, tunnel, elevated street or highway construction reconstruction. The premium base for the subcontractor classifications is total cost, which is the amount paid by C&J as a CM at Risk to the subcontractors for the labor, materials and equipment furnished in execution of the work done by the subcontractors.

**C&J – Combined Agency CM and CM At Risk** As C&J develops its CM services, it will continue to provide Agency CM services to its clients. However, Katie also knows that C&J may, on the same project, convert to a CM at Risk at the time of construction. To avoid the dreaded premium surprises, Katie asks Nelly how this type of project should be classified. It is Nelly's opinion, that when the CM is providing professional services for a fee and construction services for which the owner is paying construction costs to the C&J, both the Agency CM classification (code 41629 – total cost) and the CM At Risk classifications (91580 – payroll) and (Contractor – subcontracted work – total cost) should apply to charge C&J for its services and construction work.

### Some Practical Issues for C&J Construction

It is obvious to Katie that C&J, as a large construction services firm, will be simultaneously engaged in numerous projects in different roles. Project A might be in the role of an Agency CM, Project B might be in the role of a general contractor, Project C might be in the role of a CM at Risk, etc. At Nelly's urging, Katie now knows that it is critical for Katie to understand C&J's *role in each project*, including payroll, costs, etc by project.

In many instances, this means Katie must obtain the copies of the construction contracts (including change orders and subcontracts), which describe C&J's services, and provide all of this to Nelly for the documentation necessary for the insurers to determine C&J's exact role in each project.

Katie is now convinced that it is not adequate for C&J to describe its operations simply as "construction management." Rather, Katie has resolved that she will prepare a detailed description of all of C&J's operations, in the form of a narrative, and will provide the narrative annually to Nelly.

Further, Katie has instructed personnel at C&J to keep clear financial records of fees, payroll and costs *by project* in order to provide Nelly and the insurers with the information each needs to properly handle C&J's insurance and risk program.

### CM Errors & Omissions Exclusion

As Katie and Nelly are both aware, construction management is generally considered a *professional practice*. Nelly and Katie discuss this and the fact that C&J's liability insurer does exclude construction management errors and omissions liability. But what does this really mean to Katie and C&J?

**Implications of the CM Errors & Omissions Exclusion** The CM E&O exclusion eliminates *all liability* coverage for many of the services that construction managers routinely provide – approving shop drawings, reports, change orders or specifications prepared by an architect, engineer or surveyor as well as inspections, supervision or quality control performed by a CM.

While the CM E&O exclusion may not apply to *construction* done by C&J or its subcontractors, the CM E&O exclusion may remove coverage for the services that are at the heart of construction management – and thus leave C&J with a gap in its liability insurance program. Further, even if the liability policy did not exclude CM services, many of the services provided by C&J may result in claims that may not be covered by C&J's standard liability policy. For example, claims that do not involve bodily injury or property damage, such as for purely economic losses, or claims that would not meet the definition of "occurrence," would not be covered. Thus, separate professional liability insurance for those engaged in construction management is strongly recommended by Nelly.

### CM – Professional Liability

Katie is told that insurers that offer professional liability for design professionals (architects, engineers, surveyors, etc.) often provide similar professional liability coverage for construction managers. In some cases, the definition of "professional services" is expanded to include construction management. However, as each insurer's professional liability policy is different, Nelly advises Katie that it is important to examine the limitations and exclusions that apply, including the description of professional services and how that definition matches up to C&J's CM's services.

After due consideration, Katie takes Nelly's recommendation and purchases a professional liability policy for C&J, which includes in its description of professional services CM services, including for the ballpark project.

But Katie begins to wonder – if her Agency CM services for the ballpark project do not involve any construction and she has purchased professional liability coverage, why does she need standard liability coverage at all?

Nelly's response is that C&J's professional liability policy provides coverage only for C&J's *professional* activities. While certainly most of C&J's services are professional in nature, Nelly points out that not *every activity* of C&J at the ballpark site may be considered professional services. To support her view, Nelly points to court cases in which some courts have stated "it is the actual substance of the conduct under scrutiny, not the formal title or position of those involved that provides the crucial framework for determining the scope of professional services... this court viewed the allegedly actionable activities as a 'management task' of a non-professional nature..."<sup>5</sup> Her summary to Katie is simple – it's often not clear where professional services end and non-professional services begin – and thus the need for both a general liability policy and a professional liability policy. Despite some reluctance to purchase insurance that might overlap, Katie is satisfied with Nelly's explanation as ultimately Katie does not want to leave C&J without liability insurance.

## Conclusion

After their travails, Katie and Nelly both agree that an improved understanding of construction management, including the roles of construction managers and how a CM may be different from a traditional general contractor, should sharpen the ability of construction firms to obtain more appropriate classifications and better handle its risk and insurance programs. Katie and Nelly have prepared a list of issues to keep in mind for those handling the risk and insurance for construction firms:

1. It is critical to understand if and when the firm has acted as a traditional general contractor, Agency CM or CM at Risk. This information can be developed by insurance brokers from various sources, including websites, discussions with the appropriate personnel at the construction firm and a review of construction contracts.
2. From the information obtained in step one, prepare a comprehensive narrative that describes the role(s) of the firm,

making clear when the firm will be acting as an Agency CM, CM at Risk or as a general contractor. Discussion of the narrative with the personnel at the construction firm by its insurance broker is highly recommended.

3. The insurance broker should complete ACORD applications using the appropriate classifications (Construction Manager, Executive Supervisor and/or Contractors - Subcontracted Work) with proper allocation of projected sales, payroll and costs consistent with the narrative.
4. In addition to the ACORD applications, the insurance broker should provide the insurer with the narrative as well as copies of construction contracts to substantiate whether the firm is acting as a general contractor, CM at Risk, Agency CM or some combination of these services.
5. All construction firms should recognize the importance of maintaining distinct financial records for *all* projects, including breaking out costs, payroll and fees from that portion of a project in which the firm may have acted as an Agency CM, general contractor or CM at Risk. This is to ensure proper assignment of such costs, payroll and fees when the insurer performs its premium audit.

<sup>1</sup> Ernest Lawrence Thayer ©, "Casey at the Bat" San Francisco Examiner, (1888)

<sup>2</sup> Jack Norworth ©, "Take Me Out to the Ball Game" York Music Company (1908)

<sup>3</sup> An Owner's Guide to Construction Management – Assuring Project Success Under Any Delivery System, The Construction Management Association of America, Inc. © 2002

<sup>4</sup> Jack Norworth ©, "Take Me Out to the Ball Game" York Music Company (1927)

<sup>5</sup> Camp, Dresser & McKee, Inc. v. Home Ins. Co. 30 Mass. App. 318 Ct 568 N.E. 2nd 631 (1991)

## About the Author

Craig F. Stanovich is co-founder and principal of Austin & Stanovich Risk Managers, LLC, a risk management and insurance advisory consulting firm specializing in all aspects of commercial insurance and risk management, providing risk management and insurance solutions, not insurance sales. Services include fee based risk management, expert witness and litigation support and technical/educational support to insurance companies, agents and brokers. Email at [cstanovich@austinstanovich.com](mailto:cstanovich@austinstanovich.com). Website [www.austinstanovich.com](http://www.austinstanovich.com)