

A/E RISK REVIEW

A PUBLICATION OF THE PROFESSIONAL LIABILITY INSURANCE NETWORK



FINANCE INSURANCE, LTD.
Quality Service For Your Insurance Needs

VOLUME 62, 2006

For More Information Contact:

Karen Hong

Tel: 522-2095

Fax: 522-2082

email: khong@financeinsurance.com

Steering Clear of Fiduciary Liability

The following material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with a qualified professional who can provide guidance that considers your own unique circumstances.

Most design firms are aware of the concept of negligence liability. Under common law, you are obligated to perform your professional services to the prevailing standard of care. That is, you must apply the degree of care and skill ordinarily exercised by your peers working on similar projects in the same design professional community at the same time. If a judge or jury can be convinced that you failed to abide by the standard of care, and this failure caused damages, then you would incur negligence liability, typically on a proportionate basis. For example, if your negligent act, error or omission caused 50% of a \$100,000 loss, you would be liable for \$50,000 of overall damages.

What many design firms are not aware of is that you may also be subject to fiduciary liability. Such liability far exceeds the confines of negligence. You could perform to the prevailing standard of care and still be found liable for the total amount of damages – a liability that may not be insured. Fortunately, there are steps you can take to significantly reduce your fiduciary liability.

An Important Court Case

The concept that a design professional may owe a fiduciary responsibility to a client is illustrated in a 1997 court case that took place in Alameda County, California. In this case, a major architectural firm used an AIA model contract stating that the firm agreed to

provide construction observation services for a 27-story office tower.

Not long after construction was completed, the building's curtain wall began to leak. The cost of repair was estimated at \$7 million. The building owner settled with the general contractor and its subcontractors for \$700,000 in damages and then began its pursuit of the architect.

The architectural firm claimed that it reported a variety of construction problems to the owner over the life of the project in accordance with its construction observation services. It claimed it had performed to the prevailing standard of care and that the general contractor and curtain wall contractor were solely liable for the damages.

The owner, however, claimed the architect did an inadequate job of reviewing shop drawings and observing the contractors' performance. Thus, the architect had failed to prevent construction of improperly sized and sealed building joints.

In an interesting twist, the owner's attorney argued that language in the AIA contract made the architect a fiduciary to the building owner and, as such, legally obligated to preserve the owner's assets. Thus, the attorney argued, the architect was required not only to report problems, but to ensure that the problems were corrected. This argument was significant because of the vast difference between negligence liability and fiduciary liability.

Fiduciary liability imposes a much higher standard of performance, because a fiduciary is a party to whom another party entrusts property for safekeeping. The failure to fulfill fiduciary responsibilities is determined not so much by the fiduciary's actions as it is by results.

If the property with which the fiduciary is entrusted is damaged and loses value, by definition the fiduciary failed to meet its obligations to the property owner. As such, fiduciary liability is a form of strict liability -- negligence does not have to be proved in order for the fiduciary to be liable.

In this landmark case, the owner probably would have found it difficult to prove professional negligence on the architect's part. What's more, even if the jury concluded that the architect had committed a negligent act, error or omission, it is doubtful that the architect would have been held totally liable for the loss. Clearly, the contractor and subcontractors bore a portion, if not the majority, of fault.

As it turned out, the owner did not have to prove professional negligence. The state court judge accepted the fiduciary responsibility argument and directed the jury to abide by it in determining liability and assessing damages that may be owed. After deliberation, the jury found that the defendant failed to fulfill its fiduciary responsibility and under the theory of strict liability awarded \$7 million to the plaintiff.

Amazingly, this precedent-setting decision was not appealed. Instead, it was settled out of court after trial. As such, other clients may be emboldened to seek recovery for breach of fiduciary responsibility, and not just in California. Plaintiff's counsel throughout the nation may regard this as an opportunity to seek damages without having to show negligence. Whether or not they prevail, any such claims will have to be defended. Furthermore, insuring such claims may be difficult if the firm lacks proper fiduciary liability insurance.

Professional liability insurance covers you for negligent acts, errors or omissions. It does not protect insureds from breach of contract claims, unless the insured would be otherwise liable for negligence without the contractual obligation. Assuming that a contract creates a fiduciary responsibility, a breach of that responsibility would imply a breach of contract, possibly without a negligent act or omission. Coverage could be denied under a professional liability policy.

Contractual Protection

Just as your contract with your client can create fiduciary liability, a properly worded client contract can

help eliminate such liability as well. As a prime consultant, one of your best defenses is to include a fiduciary responsibility provision in your contract with the owner. Here is sample language to discuss with your attorney:

Fiduciary Responsibility

The Client confirms that neither the Consultant nor any of the Consultant's subconsultants or subcontractors has offered any fiduciary service to the Client and no fiduciary responsibility shall be owed to the Client by the Consultant or any of the Consultant's subconsultants or subcontractors, as a consequence of the Consultant's entering into this Agreement with the Client.

Rather than including a separate fiduciary responsibility contract clause like the above, some design firms have simply added fiduciary language to their "no warranty" clause. While such a "coupling" of warranty and fiduciary-responsibility clauses seems simpler, it could be argued by a plaintiff's attorney that you attempted to unilaterally rid yourself of liability that rightfully was yours by "hiding" the fiduciary language in the warranty provision. Consult with your attorney.

Protection for Subconsultants

If you are acting as a subconsultant to another design professional, one of your best protections would be to ensure that your client's agreement with the owner includes a fiduciary responsibility provision that achieves the intent of the foregoing sample. Further, make sure that the agreement has been signed by the owner. You and your attorney should look for language similar to the following sample:

Fiduciary Responsibility

The Client confirms that neither the Consultant nor any of Consultant's subconsultants or subcontractors owes a fiduciary responsibility to the Client or Owner. The Client shall, as a material element of the consideration the Consultant requires for performance of the services enumerated herein, require Owner to formally recognize this provision in Client's agreement with Owner.

Remember, of course, that you should not implement any new contract wording unless and until it has been reviewed and approved by an attorney who is familiar with your practice, your risk management preferences,

and the laws, precedents and judicial attitudes in the jurisdictions where your contract is likely to be enforced.

The results of the 1997 California court case show that fiduciary liability presents a clear and present danger to any design firm. It is highly recommended that you discuss this issue with your attorney before entering into your next client contact.

Can We Be of Assistance?

We may be able to help you by providing referrals to consultants, and by providing guidance relative to insurance issues, and even to certain preventives, from construction observation through the development and application of sound human resources management policies and procedures. Please call on us for assistance. We're a member of the Professional Liability Agents Network (PLAN). We're here to help.

Sidebar

Avoid Extended Performance Standards

To our knowledge, there have yet to be subsequent court cases where design firms have been found to have fiduciary liability to the owner during the construction process. However, the 1997 California case highlights the need to ensure you do not take on *any* type of extended performance standards in your contract language that could increase your liability beyond your normal standard of care. Contractual terms you should watch out for include “certify,” “warrant” and “guarantee.”

By definition, words like certify, warrant or guarantee mean to assure the total accuracy of something or to confirm absolute compliance with a standard. Legally, these words and their derivatives are virtually synonymous. Therefore, if you certify or warrant something, you are guaranteeing that something is unequivocally true, correct or perfect.

By certifying or warranting something, you are assuming a level of liability well beyond the standard of care required by law. And these added liabilities are not likely insured. Your professional liability insurance is not intended to cover breach of contract or breach of warranty, the assumption of someone else's liability or a promise to perform to a higher standard of care than

required by law.

If your client has drafted a contract that requires you to certify, guarantee or warranty anything, or has absolute declarations or statements, your first line of defense is to delete those provisions. Explain why you cannot and should not be expected to expand your liability and jeopardize your insurance coverage. If your client or a lender thrusts a certification form in front of you for signature, you have the right (and should maintain it) to modify the form sufficiently to be insurable.