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Strategies, Tactics, and Ethics of Allocating Responsibility in Construction Claims

I. Project Types

Introduction

Construction defect litigation (CDL) claims now come in all possible project types, sizes, and ownership structures. Although it does happen that some construction defect claims are exclusively related to a single party, it is rare. There are usually multiple parties who share responsibility, and sometimes there are dozens. Therefore, the mechanism for allocating responsibility needs to be flexible from a single issue on a small project; to more than a hundred defects, occurring at many hundreds of locations, allocated to dozens of parties.

Condominiums

The construction defect litigation industry was born into the world of condominium construction in Southern California, beginning in the 1980s, and matured close to its current form in the 1990s. Those early cases were mostly multi-family, two-three-story (low-rise) construction of both attached townhomes and stacked units. They were often configured in buildings with 2-20 units each, in communities from 20-200 units or more. Defect allegations for these projects tended to be consistent and extrapolated to all possible units and areas.

Single-Family Tract Homes

The transition from condos to single-family tract homes was easy and natural, considering the similarity of homeowners associations, the same wood frame construction, the consistency of the unit types, and the same building expert qualifications. The projects ranged from small entry-level homes to large, expensive "McMansion" communities. As with condos, the defect allegations from building to building are consistent, inspections are sometimes not universal, and testing is virtually always extrapolated as far as logic and reason would allow (and sometimes farther).

Custom Single-Family Residences

SFRs are a natural extension of the "CDL model". In many cases, they were even better because the homeowners were paying the plaintiff attorneys and experts, rather than the attorneys taking the cases on contingency. The homes range in size and cost from small and modest to gigantic and are worth far more than \$10 million. In fact, the bigger and more expensive, the more likely the litigation will be nasty and protracted. So much so that we have delivered seminars, written case studies, and published magazine articles with titles like "I was trying to build a monument to myself, and you ruined it!" These cases are commonly fraught with high emotion and drama. Because they are so personal, there can be a disconnect from economic realities. Some owners want revenge and are willing to pay their attorneys and experts to make

the contractors suffer. Sometimes there is very little insurance coverage for the issues because there is little to no property damage. Another difficulty is the relationships that contractors and subs have with one another are often very close. Contractors are frequently small owner-operators who have worked together for decades and are personal friends. These projects are often performed without the formality of written contracts, scopes of work, change orders, or even detailed invoices. Definitely figuring out who did what work can be near impossible until the time of deposition testimony.

Condominium Conversions

In the early 2000s, we began seeing condominium conversion projects as the subject of CDL; the buildings had been constructed decades earlier as apartments. Many were poorly constructed originally and suffered from years of neglect (AKA "differed maintenance") by absentee landlords. Some "conversion developers" are unscrupulous, shoddily updating the apartments with little more than a coat of paint and new carpet. The units are commonly sold to the lowest end of the market, to people who are the least prepared for the complexity of dealing with these issues. It is common for HOAs to be undercapitalized and underprepared for the maintenance and repair burden they will face. To properly allocate responsibility, we must first analyze and decide what the owners "deserved" at the time of their purchase; then estimate the costs to bring the project into conformance with that standard. Only then can we sort out the roles and responsibilities of the parties involved.

Commercial / Industrial / Institutional

As CDL matured, the CDL "industry" became more and more project-type agnostic. The building sizes range from modest to hundreds of thousands of square feet, in configurations including low-rise, mid-rise, and high-rise. All construction types are seen in CDL: Concrete structures including mid-rise, high-rise, and tilt-up; structural steel; masonry; wood or steel-frame, etc. Uses include retail, office, manufacturing, warehouse, schools, hospitals, and government buildings of all types.

Multi-Family Mid-Rise (4-12 stories) and High-Rise (more than 10-12 stories)

The CDL model cut its teeth on low-rise, wood-frame condominiums but has moved on to all building types, especially mid- and high-rise. These might be condominiums or apartments. They are commonly wood or steel framing over concrete podiums for parking or all concrete. The complexity of the issues and increasingly sophisticated specialty experts due to special building envelope / enclosure, plumbing, mechanical, elevator, and common area issues that are unique to these larger projects make them expensive to litigate, settle, and repair.

Mixed-Use Developments (Low-Rise, Mid-Rise, and High-Rise)

Mixed-use projects of all sizes (low-, mid-, and high-rise) create the kind of different ownership and therefore, factions with significantly different interests and levels of business sophistication. These different groups are sometimes at odds with one another: one area of these projects is sometimes causing damage or interruption to the other, like when a common residential area is leaking into a retail space, or a restaurant's equipment is making noise or creating odors.

Ownership

As with all aspects of CDL today, the industry sees all possible ownership structures. The original, most common structure was homeowners associations in condos, then single-family tracts. Private single ownership by individual homeowners as well as for-profit businesses became

common in the 1990s, and associations of commercial unit owners soon followed. We now commonly see not-for-profit organizations involved in CDL, including developers of low-income housing, community organizations, and private schools. The most recent entrants to CDL have been the public sector: schools but also local and federal government agencies.

II. The Mechanics

Introduction

The process for allocating responsibility of construction defect allegations is mostly a science, but some critical parts include the “art” of applying professional judgment. The mechanics or "science" part of an Allocation of Responsibility should be mostly inarguable and include: (1.) making a sensible list of defects that can be allocated, (2.) assigning values to each defect issue or category, (3.) making a list of all possibly involved parties, and (4.) understanding each of their roles in the project. The "art" includes an Expert or Experts: (1.) deciding what issues need to be repaired, (2.) how they should be repaired, and (3.) assigning justified portions of responsibility for each issue.

Analyze the Issues

Like the Allocation itself, analysis of the issues is mostly a science, but some critical parts include the “art” of applying professional judgment. Make a "sensible list" of what the problems are (or are alleged to be). Identify where each (alleged) defect occurs. Consider and contrast all locations where they COULD occur. That is - total population vs. the defective population. Decide if alleged defects will be repaired. Answer how defective conditions will be repaired and what other parties say about the method of repair. Answer how much will the repairs cost and what other parties say about the repair costs.

The Matrix (Issues & Players)

Make a complete list of all the project players, in some sensible order, like alphabetical. In a spreadsheet, begin with the defect list (down) and apply the players across the top (see graphics at the end of this document). Each party will have at least two columns: "% Responsible" and "\$ Amount." An Allocation Matrix will require fancy formulas to do all the math for us, including math checks, to make sure there are no errors. The formulas are beyond the scope of this presentation. This can get Complex when there are lots of issues (left column of the matrix), lots of parties (across the top of the matrix,) and is then complicated when multiple parties work on the same trade in various phases or physical areas. This matrix can be formatted to output with the 100% estimate and the allocated percentage and amounts for each party, usually 1-4 pages. The creator of this Allocation Matrix can create an Allocation Summary sheet with a simple list of all the parties and their project cost total allocated amount linked to the more complex matrix worksheet.

Who - What – Where?

For each issue, begin figuring out definitively who did what and where. For example, if the first issue is roof leaks, and there were two phases of construction, do we know who installed the roofs on both phases? For more complex issues like waterproof decks, you might need to dig into the project documentation to figure out the cause of problems and who might be responsible including the architect, engineer, framer, sheet metal fabricator/installer, door installer, waterproofing applicator, tile installer, siding contractor, handrail installer, and the general contractor who was supposed to coordinate all these parties. The supporting / backup documentation for this will probably be: (1.) in a detailed Issue-By-Issue Report, arranged by issue

number; and (2.) in a separate Player File for each party that has original project documents like contracts, Scope of Work, RFIs, change orders, etc. Plus, each party may (probably will) need a summary and analysis of the file documents, where Expert conclusions are memorialized. In many circumstances, there will be more than one party that performs work on the same trade, but in different locations. If there are two project phases, one with 2 buildings and the second with 3, all the same size, then phase 1 is 40% and phase 2 is 60% of the roofing on the project. The organization of this information is important and complex. If the supporting / backup information is only saved in the brain of the Expert, this is a terrible system.

Allocate Costs Across the Issues

Structure the repair estimates and all other project and litigation costs such that each defect has a "total burdened" cost that will be allocated across the responsible parties. That is, the allocation amounts need to include direct costs, indirect costs like general conditions, overhead, profit, and other project costs including design, permits, third-party management and inspection, alternative living expenses, etc. Attorney fees and other litigation costs need to be handled somewhere. We prefer them as separate line items outside total repair project costs.

Associate Issues & Parties

Associate each of the issues with costs across all the applicable parties in the Allocation Matrix. Our roof example above might be simple: 100% responsibility to the "roofer". If the issues are the same across two phases, and there were different roofers on phases 1 and 2, then Roofer 1 would get 40% of the project costs and Roofer 2 would get 60%. We would call this the "science" part. The "art" or professional judgment part of allocating is when we have assemblies like the waterproof deck described previously.

Joint & Several Allocation

Joint & several liability, to me (a simple construction guy) means that if you are in for a penny, then you are in for a pound. This is a consumer protection aspect of law that means if there are two responsible parties but only one has the means to make the consumer whole, then the one could end up paying a larger percentage of cost than their percentage of responsibility. We know each state has different laws on this but that's beyond the scope here. For our roof example, the two roofers would never get more than 100% of the portion of the project they worked on: so, 40% and 60% of the total roofing costs, respectively. In our deck example, we identified 10 parties that could have shared responsibility. If any one of those were the only one with the means to make the consumer whole, then they could end up paying 100%. With this in mind, we would populate the Allocation Matrix with 100% for each of the 10 parties. So yes, this means we have allocated 10 times the project cost total for that line item. Depending on the complexity of the issues in any given case, the grand total of a Joint & Several Allocation will generally fall between 1.5 and 2.5 times the total project cost. And yes, that means small players get a horribly out-sized allocation. Other than the percentage allocation (100% to each) this output should not get much argument. It's a supportable analysis of who, what, where, and how much for the entire collection of defect allegations.

A Real, Professional Allocation (to be proud of)

Now, we move into the realm of "art" or professional judgment. To create a sensible document that fairly allocates 100% of the total project costs (not 99%, not 101%) to all the potential players, we need to apply professional judgment and decide who is more and who is less responsible for each issue. We perform what we call a "Contracting 101 Analysis" of the roles and responsibilities of each party, on each issue by looking at both the Issue Analysis (plans, specs,

inspection, testing, damages, etc.) and Player's Files (contracts, RFIs, changes, etc.). For each issue, the Expert must decide on a supportable percentage of responsibility for each party. From our deck example: architect 5%, engineer 0%, framer 10%, sheet metal fabricator/installer 5%, door installer 10%, waterproofing applicator 25%, tile installer 20%, siding contractor 5%, handrail installer 5%, and the general contractor 15% (Total 100%). When presented to the parties, this is where the wailing and gnashing of teeth gets loud. In mediation, when a party argues that their responsibility on any issue is less than my analysis, I invite them to go discuss it with the other parties allocated on those issues. If they can work out the percentages amongst themselves to redistribute my 100%, then I will consider it ;-)

Allocation (Claim) Packages

To make big, supportable claims, we need to collect our analysis into packages that can be evaluated by the parties we are expecting to pay. These packages typically include a memo summarizing all the contents including the applicable contract terms, RFIs, changes, investigation, testing, evidence of damage, and applicable pages of the Allocation Matrix. The more graphic intensive this package the better. A spoonful of sugar helps the medicine go down. This should support and resemble the amount of the settlement demand made to each party.

Conclusion

Connecting all the moving parts of a complex construction defect matter requires tremendous organizational skill, technical expertise related to building defects and construction contracting roles and responsibilities, and the willingness to apply professional judgment that people from opposing parties will argue with. It's not for the faint of heart. Go get 'me, tiger!

III. The Professional Judgment

Real, Professional Allocation

The allocation of damages in a construction defect case challenges the parties to determine a reasonable basis for dividing up the defects and costs among the multiple parties in any matter. A vital part of the allocation is the understanding of the various design professional and contractor scopes of work. These often overlap and intertwine, so a detailed understanding of what entity may have a role in any issue is crucial.

Once the scopes are understood, the spectrum of costs must be fully explored. In most cases, there will be at least two repair cost estimates. In many cases, the defense will also have an alternative cost for a repair protocol that is less extensive than one Plaintiffs propose. Generally, this information will produce a range of repair cost, which can then be allocated amongst the various parties based on scopes of work and responsibilities.

While the parties can and will disagree on values or percentage of responsibility either as a whole or based on individual issues, developing the issues, cost of repair estimates, and which scopes of work are potentially implicated by the issues provides the framework or playing field from which to pursue resolution.

Allocation Matrix

Outlining the issues, the costs, the basis for the claimed defect, and the potentially responsible parties in a chart format is essential for allowing the analysis and evaluation of the potential exposure for any party. Often, Plaintiff's expert will provide a matrix, from which defense counsel and the claims professional can extract information pertinent to the insured or group of insureds.

This matrix will be used throughout the case to analyze exposure, compare pricing, and repair protocols, and develop a resolution strategy expeditiously and effectively. Taking Plaintiff's matrix and adding columns to address issues such as defenses, alternative repair, or alternative costs, greatly assists the defense team in evaluating the potential risks and exposure, and can allow a clear view of possible risk transfer opportunities.

Exposure Analysis/Settlement Ranges

The analysis of possible exposure/settlement range should include a range of possible costs of repair (including overhead/profit, general conditions, and other burden elements), and a real, reasonable determination of the percentage of liability based on the issues and any multiple or overlapping areas of potential responsibility.

This analysis should also include additional damage items such as attorney's fees, expert costs, relocation costs, and other items that will vary case-by-case. As noted, the parties will disagree on values and percentages, but putting these items together will provide a full, balanced, realistic picture of possible exposure and allow an in-depth evaluation of exposure to determine the ultimate resolution strategy.

Contracting 101

The contractual relationships on a project play an important role in the ultimate determination of allocation. On Most projects, the relationships are as follows:

- Owner
- Owner/Architect
- Architect/Subconsultants
- Owner/General Contractor
- GC/Subcontractors

Responsibility and liability can flow among and between the various entities, so an understanding of those relationships is a necessary element of any allocation analysis.

Plans, Specifications, Codes & Standards

Any Allocation analysis must include a review of the contract documents, including plans, specifications, manufacturer's documentation, change orders, and communication throughout the project. Often, an issue that is originally allocated to one subcontractor eventually is determined to be the responsibility of another subcontractor. Reference to the initial scope of work documentation must be coupled with this review of the other contract documents as scopes change and evolve over the course of a project.

Reference to these documents and information is essential to a full understanding of the project, the allegedly defective issues, and, ultimately, a proper allocation of potential liability and exposure.

Allocation Packages

If representing the General Contractor, the defense team must walk the line between defending the claims but working with potentially liable subcontractors and design professionals to develop a settlement strategy that can fairly and equitably allocate potential damages to the responsible parties. Outlining issues, money, the timeline, and potential exposure by trade is an effective way to develop an overall view of what a possible resolution will look like.

While Plaintiff generally retains the burden of proof of allocation, the design team and contractors can make great strides in pushing a case to finality by taking a sensible cooperative approach to allocating liability and responsibility apart from what Plaintiff provides. Having these discussions early and sorting out differences of opinions can be the difference between an early resolution and drawn-out litigation.

IV. The Ethics

Double Speak – The Developer “Whose Side Are You On?”

As is the case in most construction defect matters, the Developer’s counsel must play a dual role in allocations and overall defense. On the one hand, the Developer counsel must take an active role in defending the claims made by the Plaintiff. Most Developer’s counsel pursues a strong defense position against the claims by hiring experts and creating “defense” reports that will likely be used at the time of trial.

However, because most Developer’s attorneys have strong indemnity provisions which allow for a clear “downstream” recovery, they are often incentivized to work closely with Plaintiff, especially on allocations, and maximize the exposure of the subcontractors and collect more money. For instance, many Developers’ counsel will operate with two costs to repair: one that they plan to use in trial for “defense” purposes; and one that is the “defense cost to the Plaintiff’s scope of repair.” The latter provides an advantage to upstream indemnitee to collect as much as possible from the indemnitor.

The above scenario does create some obvious conflict issues and can be somewhat uncomfortable, especially in a mediation setting. In other words, as often said by the other defense lawyers: “who side are you on?” Allocated demands to subcontractors typically reflect a simple pass-through model which is the Plaintiff’s cost to repair, plus fees. Thus, creating a tricky situation when Developer’s counsel wants to zealously advocate for their client and argue the efficacy of the allocations from the Plaintiff.

Even though there is the potential for intrinsic conflict, most attorneys operating in the construction defect community for the last 10+ years understand how this game is played. They understand that allocations are a pass through of Plaintiff’s wish-list. And most understand that Developer’s counsel is walking the proverbial tightrope and are advocating for both sides.

Is Developer’s counsel truly advocating for both sides or just for their client? There are various hurdles and obstacles (e.g.: coverage exclusions, sub-limits, uninsured subcontractors, etc.) that may and often do arise after allocations are made to subcontractors. If the allocations made to the subcontractors are “too low”, the Developer and/or its insurance company may be left paying for damages that are owed by the downstream entities. The “pass through” allocations based on plaintiff’s cost of repair allows for a cushion in addressing potentially non-covered damages and eventually achieving settlement. Developer’s counsel’s job is to limit the direct exposure to their client, which essentially involves the “pass through” allocation. When the matter goes to trial, it is no longer a matter of finding common ground, it’s putting up the best defense possible for the Developer and asserting the defense cost of repair, as discussed above.

Assigning Percentages – “Show Me The Money”

The tier approach, often used in construction claims, allocates defense and indemnity based on the extent to which a particular trade has contributed to the loss. However, below are some other common considerations based upon the policy restrictions that can be used solely or in conjunction:

- **Joint and Several (Also Known as All Sums):** An insurer's obligation is joint and several if its policy is triggered. The original "all sums" language in the insuring agreement obligates the insurer to respond in full. This language has since been replaced by "those sums."
- **Pro Rata:** This approach recognizes that the insurer should only be responsible for the PD occurring during its policy period.
- **Methodology:** Generally, the approach (i.e., pro rata or joint and several) will determine which calculation method is used and whether the insured will participate in bare years.
- **Equal Shares:** The joint and several approaches are conducive to an equal share allocation among policies triggered, without any contribution from the insured in bare years. Some practitioners interpret equal shares to mean that each insurer must share equally regardless of the number of policies in play. For example, Insurer A has nine policies, and Insurer B has one. Each insurer shares on a 50 percent basis (i.e., two insurers, two shares). An alternate interpretation is that each policy participates equally.
- **Time on Risk:** In a pro-rata approach, the specific policy period is compared to the total triggered period, and the loss is then shared based on the proportion of the specified period compared to the total period. The insured is responsible for bare years depending on the reason for lack of insurance (i.e., voluntary, or involuntary) and whether the jurisdiction permits it. Furthermore, defense and indemnity may be treated differently.
- **Time-on-Risk Times Limits:** Limits of liability are factored in; the premise is that there is a greater assumption of liability by the policy with higher limits. While justifiable in a concurrent loss situation (provided for in the other insurance condition), in a continuous loss case, such an approach fails to recognize the fundamental premise that it is PD, and the amount of such PD, occurring during the policy period that is covered for which the insurer should pay. The limits are relevant only to the extent that the amount of covered PD is finite. To include limits in a pro-rata calculation creates the inequitable result of one insurer paying more than another when their time on risk is the same, and the PD is assumed to have occurred equally over a specified period.
- **Other Methods:** Among other methods, "flexible" or "weighted" pro-rata allocation recognizes that other factors may require a nonlinear approach to when PD occurs. Facts may indicate that PD occurred in different amounts at different times.

Coverage Issues

Allocation in continuous damage claims would be unnecessary if only one policy was activated. In construction defect claims, the defects and damage are initially latent and characterized by a continuous and progressive process. In addition, distinct defects could contribute to the same damage. Various trigger theories address such claims, including manifestation or discovery, exposure, continuous, and injury-in-fact. In a continuing/progressive damage dynamic, when does the triggered period begin? When does it

end—when the defect and/or damage manifests or is discovered, when the first complaints are documented, or when a suit is filed?

The California Supreme Court in Montrose Chemical Corp. v. Admiral Ins. Co., 10 Cal. 4th 645 (Cal. 1995), provided while the underlying case involved environmental contamination, the ruling also specifically impacted construction claims. The court determined, in addition to nullifying the manifestation trigger, that a loss is insurable until legal liability is established (i.e., when a verdict is rendered).

Tri-Partite Considerations

In addition, as is often the case in construction defect and other insurance defense litigation, a claim for relief typically includes both covered and uncovered damages. Obviously, it is in the everyone's best interests to have as many damages covered by insurance as possible. From the insurer's perspective and against the backdrop of owing duty of good faith and fair dealing to its insureds, however, it is generally better to have an allocation of covered vs. non-covered damages. This places the insurer, insured, and insurance retained defense counsel in a difficult position as the duty to defend is broader than the duty to indemnify. If there is a reasonable potential for coverage, there is a duty to defend a suit. The duty to indemnify, on the other hand, requires more than just a potential for coverage. It must be demonstrated that the loss is covered. Therefore, allocation of defense and indemnity may be treated differently.

Policy Limits

In construction defect cases, insurance policies commonly define an occurrence as "an accident, including continuous or repeated exposure to the same or similar harmful conditions" which results in property damage. Safeco Ins. Co. of America v. Fireman's Fund Ins. Co., 148 Cal.App.4th 620, 631 (Cal. App. 2007). Parties should also be aware that courts generally determine the number of occurrences under an insurance policy, policy limits, based on the causes of damage, not the type or amount. For example, water intrusion, has multiple causes, there have been multiple occurrences under an insurance policy. However, widespread water intrusion had been caused by only the failure to apply sealant, which could likely have constituted a single occurrence.

Accordingly, parties involved in a construction defect case should pay close attention to the cause of the alleged damages. If all damage arises from a single source or process, that may constitute a single occurrence for purposes of determining policy limits. Conversely, if there is a single type of damage caused by multiple failings, that may constitute more than one occurrence and trigger higher policy limits.