

The Tangled Web

of Hybrid Construction Contract/Defect Claims

Article by Pete Fowler

At first, things were going swimmingly.

The new apartment building was well-received by politicians and neighbors. It would add 60 desperately needed apartments to the city's housing stock, with amenities locals wanted and rents they could actually afford.

Financing was secured fairly easily. The developer, a legend in his own mind and well-known for his bareknuckled business tactics, chose an up-and-coming, woman-owned general contractor to lead construction. The developer selected her, in part, for publicity purposes—and it worked. The many articles about the project referred to the general contractor being woman-owned, which, of course, made the developer look good.

The general contractor, in turn, hired a diverse group of subcontractors, most of which were minority owned or woman-owned. Given these subcontractors and their stories, media interest in the construction project was high.

Construction started on time—after, of course, the well-attended “breaking ground” ceremony—and was going according to plan, at least at first. Sure, the construction timeline was aggressive, but it wasn't the kind of timeline the general contractor and subcontractors hadn't seen before or couldn't tackle.

As the project approached completion, the tone of communications from the developer became less friendly, and response time to RFIs (Requests for Information) and Change Order approvals slowed noticeably. This was a problem because everyone knew from the beginning that the plans had been rushed and required continuous clarification. This was all despite nothing but glowing reviews from the developer and his team early in the project as to the quality of the general contractor's and subcontractors' craftsmanship.



Pete Fowler
CONSTRUCTION
Consultants

The subcontractors—many of whom were “mom and pop” operations—complained to the general contractor about the slowed payments and having to perform work out of sequence due to the lack of information from the developer and his designers. The general contractor’s team did all they could to keep the project moving forward toward completion.

Finally, the general contractor began considering options. She carefully read the language of her contract with the developer and it appeared she had a cut-and-dry breach of contract claim; it was clear about the payment application process and requirements for all parties and the contractor had been careful to comply. But still, the payments, as well as needed information and change approvals, were delayed further and further.

With subcontractors slowing their work and threatening to quit for nonpayment, and her colleagues concerned about their company’s cash flow, the general contractor hoped to resolve these issues promptly—and without filing a mechanic’s lien or hiring expensive lawyers. She got advice from a longtime friend and personal lawyer, who had also helped with her divorce, to compose a short but politely stern email to the developer.

The developer’s response a day later shocked her. “I’m not paying a cent until you and your subs fix the many defects my team has identified around the building, including issues with the foundation, windows, and decks,” the developer said. The contractor sighed and

shook her head. Little did she know, she had just been sucked into a recently evolved type of construction dispute: the hybrid construction contract/defect case.

Hybrid construction contract/defect cases are complex construction disputes because of the cast of players involved.

If you’ve been in the construction industry for longer than five minutes, you or a client have likely been involved in a legal dispute over a general contractor or subcontractors not getting paid by a property owner/developer. Nonpayment claims of this nature are common in the construction industry—from the small artisan level to high-end sophisticated residential and commercial projects. These types of cases, while contentious, are fairly straightforward and predictable breach of contract cases.

Same thing goes for construction defect cases. While slightly more complex than breach of contract cases, most defect cases follow well-worn paths toward resolution.

But when these two kinds of cases intersect in the course of a single legal dispute—typically when a property owner/developer claims there are construction defects and tries to use those defects as leverage against a general contractor’s or subcontractors’ claims of nonpayment against them—they morph into a combined complex case with no clear paths to a fully favorable resolution for any of the parties involved.



You can chalk up the complexity of these hybrid construction contract/defect cases to the parties themselves and the third parties that get pulled into these disputes, such as insurers and surety companies. Not only do these players have divergent interests that occasionally align, but there can be an emotional component to these cases. Owners/developers, general contractors, and subcontractors tend to get worked up when they're not getting what they want and are convinced the other parties are to blame.

Here are the cast of players involved in these hybrid cases, and how they add to the complexity of resolving the underlying claims.

Owners/Developers

Often, when faced with an accusation of nonpayment, an owner/developer will claim they did not pay the general contractor because the contractor and subcontractors were not hitting construction milestones on time. Their position will be that they would have had no trouble paying the general contractor promptly if they were running on schedule.

But by alleging a construction defect claim, an owner/developer can reposition their nonpayment as justified by defects, and attempt to offset the general contractor's or subcontractor's nonpayment claims. And as if their defect claim didn't shake things up enough, an owner/developer is likely to get emotionally worked up over the fact that, allegedly, the general contractor is ruining their "vision" for what they're building.

Their emotions will also run high if an unpaid general contractor or subcontractor files mechanic's liens against them. A surety bond might provide some temporary relief from the threat of foreclosure brought about by the liens, but it is still an obligation an owner/developer will be responsible for—and it will not cool off their heated emotions. The owner/developer's emotions will probably spell trouble for attempts to resolve these claims promptly and reasonably.



General Contractors

General contractors are often stuck between a rock and a hard place with these hybrid claims. On one hand, they must stay in the good graces of the owner/developer. On the other hand, they will want to stay in the good graces of their subcontractors.

This is a delicate balancing act. For example, their contracts with their subcontractors may provide bases for not paying them, such as when there are potential defects, or the contracts may require the subcontractors to indemnify the general contractors from mechanic's liens. General contractors have to decide whether it is in their best interests—in both the short term and the long term—to hold their subcontractors' feet to the fire when it comes to these contract terms or an owner/developer's questionable defect claims. The general contractor will want to think twice about continuing to not pay their subcontractors or blaming them for the alleged defects. That's because treating their subcontractors poorly could lead to big problems down the road with future bids.

But at the same time, general contractors will be feeling the heat from an owner/developer who refuses to budge, both about not paying the general contractor and their defect claim. Continued nonpayment will cause serious business problems. And if a mechanic's lien is filed against them, they may need to secure a surety bond guaranteed by their commercial property or personal residence. At the same time, they could still be on the hook for a defect claim given the particular facts of the dispute.

Subcontractors

Interestingly, in these hybrid cases subcontractors can wield a lot of power. But they also stand to lose big.

In some states, like California, subcontractors have a constitutional right to be paid for their work, and to be paid promptly. In some states, again California being one of them, subcontractors may have a right to payment for their work even when the general contractor who hired them has not been paid. If you combine these legal rights with a subcontractor's ability to place a mechanic's lien on the property of an owner/developer or general contractor, it would appear a subcontractor is in a strong bargaining position in these cases.





But upon further review, that position isn't as strong as it seems. For one, not all states have laws as favorable to subcontractors as California's are. Second, depending on the nature of a subcontractor's contract with a general contractor, the subcontractor may not have a legal basis for demanding payment before the general contractor receives payment.

Third, many subcontractors are small operations with tight margins and without much money in the bank. They may be forced to represent themselves in these disputes, or hire an attorney whose fees could eat up any payments the attorney secures. Finally, if the alleged defect pertains to their work, they could lose any favorable bargaining position regarding the nonpayment claim. For these reasons, many subcontractors will have to resign themselves to the fact that they may only receive pennies on the dollar in these cases for the work they've performed.

Attorneys for the Parties

In construction litigation, there are two types of attorneys: those who practice construction law full time, or at least some of the time, and those who do not. The latter type adds complexity to these hybrid construction contract/defect claims.

It is not unusual for parties to these hybrid claims to be represented by their personal attorneys or their business attorneys. That's a good thing if those attorneys are well-versed in construction law. But it's a bad thing if they're not—and most of the time they're not.

If attorneys for the parties have litigated construction contract or defect claims before, they'll be familiar with the construction business, the mindsets and motivations of the players involved, the general fact patterns that

give rise to these claims, settlement values, and the reasonable concessions the parties should expect to make in order to resolve these claims.

If they haven't litigated these claims frequently, or ever, not only won't they be familiar with how these claims are litigated, they'll likely attempt to pursue common business litigation strategies—such as a drawn-out discovery phase where every email ever sent by any party is meticulously reviewed—that will delay the resolution of the dispute and drive the cost of litigating it through the roof.



Insurers

Like the other players, these hybrid cases put insurers in a tough spot. Normally, insurers would not be involved in construction contract claims. But in these hybrid cases, the insurers and their counsel are pulled into the dispute thanks to the allegations of property damage. Because an insurer's duty to defend is broader than its duty to indemnify, it will likely be a participant in resolving the dispute no matter how questionable the owner/developer's defect claims might be.

Knowing that insurers will be involved in settlement discussions, owners/developers may try to play up the alleged property damage knowing that is the only way insurers will contribute to the settlement fund. Insurers and their counsel, wise to this game, will likely focus on the economics of any resolution and make sure they aren't left holding the bag for what is primarily a breach of contract claim.

Surety Companies

Finally, a surety company and its attorney will be in the background, doing everything it can to avoid exposure to loss and, if it cannot avoid loss, trying to minimize it. The surety will be monitoring the dispute because it will be indemnified by the owner or the general contractor if it has to pay the mechanic's liens placed on either's property.

That said, sureties typically aren't heavily involved in the resolution process of these cases. Even so, their mere presence puts pressure on the owner or general contractor because they know they're on the hook for indemnifying their surety if they cannot come to an agreement about resolving the nonpayment and defect claims.



Easy to initiate, but hard to resolve

In these hybrid cases, an owner/developer could use even the smallest possible construction defect to turn a basic construction contract dispute into a complex hybrid contract/defect dispute. When they do so, they're transforming a relatively straightforward legal dispute into a more complex one because of the number of players in these cases and their competing and complementary interests.

Unfortunately for the owners/developers, contractors, and subcontractors involved in these hybrid cases, rarely are there any true winners. The nature of these claims often result in the parties taking a bath in one way or another. The owner/developer will need to pay some amount to their general contractor, the general contractor will need to pay some amount to their subcontractors, and the amount the subcontractors receive will likely not be close to 100% of what they're owed.

But as anyone involved in construction litigation knows, often the most fair settlements are those that none of the parties are thrilled with. And with these hybrid cases, rarely are the parties thrilled with the settlements that end the dispute and resolve the underlying claims.

Robert C. Carlson is a founding partner of Koeller Nebeker Carlson Haluck, LLP.

carlson@knchlaw.com

Pete Fowler is the founder of Pete Fowler Construction Consultants.

pf@petefowler.com

Barbara Laskaris-Lorigan is Vice President – Head of Claims at Golden State Claims Adjusters.

barbara@gstateca.com

David C. Veis is a partner at Robins Kaplan LLP.

dveis@RobinsKaplan.com



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CONSTRUCTION
Consultants

