

Resolving construction disputes through mediation

A primer for construction-defect law and mediating a construction dispute

By Robert Jacobs

Disputes about construction projects can be costly and time-consuming. Early resolution of such disputes saves months or years of construction delay and substantial sums in avoidable damages and attorneys' fees. Informal resolution between the parties is often the first step in addressing construction disputes, but when informal resolution does not work, mediation can be a highly effective next step. Successful resolution of a construction dispute at mediation almost always requires that the dispute be adequately worked up before mediation.

Knowledge of the construction project

The kind of workup necessary for settlement at mediation depends on the sort of construction project involved. Following is a brief description of types of construction commonly encountered by counsel, along with a description of the sort of workup necessary to effectively position the dispute for resolution at mediation.

- **Private commercial.** These projects include gas stations, convenience stores, car washes, and office buildings. They can either be a small project (such as construction of tenant improvements in an existing building), a moderate project (such as construction of a new restaurant), a large project (such as construction of a large shopping mall), or an industrial project (such as construction of a factory).
- **Private residential.** These projects include remodeling or expansion of an existing residential property or new construction of a custom-designed single-family home.
- **Private common-interest development residential projects.** These disputes frequently involve claims that construction was defectively performed; such claims often arise after the project is completed.

A Homeowners Association (HOA) at a condominium project may become aware of defects in roofs, windows, decks, or other components of such projects (often because of visible water intrusion during rainstorms). When this happens, the HOA engages a construction professional to assess the scope and nature of the problems. If the problems appear throughout the project, the HOA may engage legal counsel to sue the general contractor, who, in turn, sues their subcontractors. The defendant contractors and subcontractors often have insurance policies covering these claims.

These lawsuits tend to be significant, and a court will usually appoint a special master to coordinate discovery and settlement activities. Handling such claims can be a niche practice.

- **Public improvement projects.** These projects include construction of roads, dams, bridges, buildings and other works of improvement constructed by public entities.

Settlement of construction defect claims on new residential construction

Due in part to the high levels of construction-defect litigation involving

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new residential construction, the California Legislature has adopted a construction Right to Repair Act. (Civ. Code, §§ 896, 938.) The act requires homeowners to allow builders to fix certain construction defects before commencing litigation against them. It only applies to original construction intended to be sold as an individual dwelling. The act does not cover personal-injury claims, fraud-based claims, claims to enforce a contract or specific other claims. If the act does not apply, the construction dispute is generally governed by construction-dispute statutes and case law.

An owner and contractor can often informally resolve a "Right to Repair" dispute without the assistance of a mediator. But if they cannot agree on whether or not an item is defective or on the scope of repair, then a voluntary mediation is a way to resolve the dispute without litigation.

Construction contracts

In some situations, the approach to settlement is partly driven by the kind of contract the parties used on the project because construction contracts often contain specific terms concerning dispute resolution. However, the terms of a construction contract dispute resolution can vary. In the event of a dispute, the construction contract will be a crucial document in determining the rights and obligations of the parties and the procedures to be followed.

Construction contracts come from several different sources; such contracts may vary in the provisions they include for dispute resolution. Examples are contracts to:

- Construct a new custom-built home may be drafted by the attorney for the owner or the homebuilder using a form of contract supplied by the American Institute of Architects (AIA). An AIA contract may require that a construction dispute be referred to the architect for resolution before any other dispute resolution steps are taken.
- Remodel a home may be drafted by the contractor or their attorney.
- Construct a small commercial building may be drafted by the attorney for the contractor using a form of contract supplied by the Associated General Contractors of America (AGC).
- Construct tenant improvements in a commercial building drafted by the attorney for either the contractor or the building owner.
- Construct a large project such as a shopping mall or a large commercial building may be drafted by the attorney for the owner (with input by the attorney from the contractor).
- Complete only a portion of the work of improvement (i.e., a subcontract) may be prepared either by the attorney for the contractor or the subcontractor.

No one size fits all. Most construction contracts will contain several common terms, including:

- The cost to construct the work of improvement;
- Allocation of responsibility for developing plans and specifications;
- Obtaining permits; and
- Time for completion.

Common construction disputes

Defective construction

These disputes generally take one of two different forms: Pre-completion or post-completion.

Pre-completion (claims arising during construction). If during construction the owner discovers the contractor is doing improper work, the owner may demand that the contractor remove and replace the defective work or that they change their construction procedures.

If the owner and contractor cannot come to agreement on how the work is to be done, then the contractor may discontinue working on the project, thereby delaying completion. Interest and penalties under the construction contract may begin accruing.

The contractor may record a mechanic's lien, thereby clouding title to the property. The contractor may issue a Stop Payment Notice, which can interfere with the owner's financing of the construction project.

Early settlement of such disputes can forestall damages that may otherwise make settlement difficult if not impossible after further delay. A determination whether construction is in fact defective may require involvement of third parties such as the architect, expert consultants or other third parties.

Post-construction

If the owner discovers defective construction after the project is completed, then the owner and contractor may have a payment dispute. However, the escalating delay damages commonly encountered with disputes occurring during construction may not be present. In these situations, the owner's damages may consist of the cost of repair along with damages for loss of use plus attorney's fees.

Many residential construction projects (such as condominium or other projects with common areas) have a homeowner association (HOA). Sometimes residential projects are built with construction defects. Where HOAs exist, they may engage legal counsel to address construction defects post-completion of the project. A lawsuit for construction defects is often filed only against the general contractor, who in turn sues the subcontractors who worked on the project. Coordinating the various claims and discovery in such cases is a logistical challenge. Often, a court will appoint a special master to oversee discovery, coordinate investigations, and conduct settlement discussions. These are highly specialized proceedings and a more in-depth discussion of them is outside the scope of this article.

Nonperformance

Sometimes a contractor or subcontractor runs out of funds, loses construction workers, or encounters other reasons they cannot complete the work. When this happens, the owner is left with an uncompleted project, sometimes with

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disputed outstanding claims by the contractor for payment.

If the contractor has not paid their subcontractors or materials suppliers then those subcontractors or suppliers, may record their own mechanic's liens against the project. If the owner is financing the project through a construction loan, then the lender may stop advancing further funds until construction resumes. In these situations, it is in the best interests of all parties to get these claims resolved as soon as possible.

Delay

Construction projects should run on a tight schedule – but they often fail to do so. Delay can occur for all kinds of reasons. Subcontractors may breach their subcontract agreement so that the general contractor must get a new subcontractor. Contractors may be conflicted with other projects which may compete for their time and attention. Delivery of materials may be delayed. Governmental authorities may limit the work or stop it all together.

Delay is expensive. Materials costs and wages can increase; construction-loan interest will continue to accrue; and the owner may not be able to lease out the project. Whenever possible, it is best to resume construction as soon as possible and thereby limit the damages that may be caused by further delay.

Change orders and unforeseen problems

Sometimes a contractor will bid a project on the assumption that the soil can be readily worked but instead find that rock must be excavated before foundations can be constructed. Other times hazardous materials are discovered during the course of excavation. And occasionally designs and plans are imperfect and the project cannot be built as designed.

An owner's directive to the contractor that the construction project be changed is commonly referred to as a "change order." The owner and contractor may disagree about the necessity of a change order or the appropriate cost of such change orders. When such disagreements arise, it is in the parties' best interests to resolve such disputes as quickly as possible in order to avoid potentially significant delay damages.

Nonpayment

Sometimes owners run out of money. Sometimes general contractors either can't or won't pay their subcontractors. Many construction contracts contain certain "milestones" that specify when certain payments (commonly referred to as "progress payments") are to be made. Sometimes there is disagreement between the owner and the contractor as to whether the milestone has been reached such that payment is due.

Regardless of the reason, nonpayment claims are common with construction projects. If the contractor is unable or unwilling to complete construction until the dispute is resolved, then it is in the parties' best interests to quickly resolve the dispute in order to avoid significant delay damages.

Mediation as a condition precedent

Because delay damages can quickly become significant, it often makes sense to get a construction dispute into mediation as soon as the claims have been fully identified, documented and worked up. However, there are additional reasons mediation may be a critical first step toward resolution before filing a complaint or instituting arbitration.

Some construction contracts provide that mediation is a "condition precedent" to further legal action. For example, the Standard Form of Agreement (or Construction Contract) drafted by the American Institute of Architects (AIA) provides that "Claims, disputes and other matters in question" concerning the AIA construction contract must be submitted to mediation as a "condition precedent" to "binding dispute resolution." (See AIA Document A110-2021 Standard Form of Agreement Between Owner and Contractor for a Custom Residential Project.)

Why is this important? If counsel files a lawsuit or institutes binding arbitration proceedings without having first mediated their claims, then opposing counsel can later argue that the lawsuit or arbitration is premature. If a judge or arbitrator agrees, the proceeding could be dismissed. Not only would such a dismissal be potentially expensive, but it could also create even more delay on the project. The claim may even be time-barred if a statute of limitations has run during the proceedings.

Some contracts provide that if a party fails to mediate before commencing an action (or if, before suit is filed a party refuses to mediate after being asked to do so), then that party waives any right to recover attorney fees even if that party prevails at trial and would otherwise be entitled to an award of attorney fees. (See the form prepared by the California Association of Realtors (C.A.R.), California Residential Purchase Agreement and Joint Escrow Instructions, C.A.R. form RPA, revised 12/22.) California courts will enforce an attorney fee waiver. (See *Frei v. Davey* (2004) 124 Cal.App.4th 1506.)

Preparing for mediation

Often, a contractor or subcontractor will be insured under an insurance policy that will cover damages arising from defective construction. It may be advisable to ensure that counsel for the contractor or subcontractor has tendered defense and indemnity to any insurer that may provide a defense. In many construction-defect suits the insurer – not the contractor – funds the settlement. (For further information about the role of insurance in settling construction defect claims, see the treatise published by Continuing Education of the Bar, 2 Pierce and Sullivan, California Construction Contracts, Defects, and Litigation (2023) (Cal CEB), § 12.1, Construction Defects: Insurance and Express Indemnity.)

Many construction defects and damages are not readily apparent to untrained persons. Parties to construction disputes frequently engage consultants to

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identify the defects, develop a scope of repair and testify regarding the repair costs. An owner who is experiencing significant damages due to construction defects or delay damages may need a consultant to testify about such damages. In appropriate cases, the expense of having an expert prepare a report for use at mediation may be justified. An expert opinion or report prepared by such a consultant can be essential to meaningful settlement discussions.

Mediation briefs

If a construction dispute is scheduled for mediation, adequate preparation must be stressed. A thorough mediation brief is the key to settling many construction disputes. If the dispute centers on claims of construction defects, the claimant must clearly demonstrate the nature of the defects. This may require clear photographs of the construction defects or the damage caused by the defects. Briefs that include photos of the defective components with contrasting photographs of undamaged components can be very helpful in settlement discussions. In some situations, a sample of the damaged or defective component can be persuasive.

If a construction dispute is based on delay, then it may be essential for the claimant to provide documentation as to the cause of the delay and the damages caused by the delay. If a construction dispute is based on a contractor's abandonment of the project, or if for any reason the project must be completed by a different contractor, the claimant may need to obtain new bids to complete the project. Such new bids should be included with the mediation brief so that these "cost to complete" damages are clearly and persuasively communicated to the mediator and the opposing party.

If a construction dispute is based on new, different, or unexpected conditions, it may be necessary to engage an expert consultant. The consultant should be able to describe the proper approach to remediating the condition and the projected additional costs.

Regardless of the nature of the construction dispute, resolution can often be facilitated if the party claiming damage provides clear proof of liability, along with clear documentation as to damages incurred or to be incurred.

The best way to position a construction issue for settlement is for the claimant to provide the opposition with all documentation that it may need to fully understand the scope and nature of the defects, costs of repair, and all attendant damages.

Pre-mediation conferences

A pre-mediation conference is an ideal way to address any gap in information or documentation that the mediator may raise at the mediation. The effectiveness of the pre-mediation conference is enhanced if it is held after the mediator reads submitted briefs. If the mediator needs additional information or documentation, then there may still be time to assemble and provide it without rescheduling the mediation.

The mediation

It may not be necessary to have construction or damages experts attend the mediation, but when technical questions arise, such consultants' "live" input can be invaluable. Having experts available on standby for a phone or Zoom call on the day of the mediation can significantly enhance the effectiveness of a mediation. Settlement of some cases at mediation may only be possible if construction experts actively participate in the mediation. Counsel's evaluation as to whether such consultant input will be necessary should be done well in advance of the mediation so that the experts can be available on-call.

Settlement

Some construction disputes are highly complex and may require opposing counsel to work together. If resolution of the construction dispute involves any degree of complexity, then preparing a proposed settlement agreement before the mediation may prove very useful. By preparing a draft form of a settlement agreement in advance, counsel can carefully consider the sequencing and procedures of any future remedial construction work.

Mediator selection

A key factor for mediation success may depend on selecting a mediator who understands the dynamics of the construction dispute and who can skillfully discuss the issues. An ideal candidate for more complex mediation is a mediator who has the interpersonal skills to bring the parties together and can bring creative solutions to complex construction problems that may not otherwise be apparent.

Conclusion

The key steps for positioning most construction disputes for settlement at mediation are: Fully document the nature and scope of the problem; fully document the necessary fix or repairs; fully document all related damages (such as delay damages); provide such documentation to the other side and the mediator; have experts available as appropriate; and select an experienced mediator who will understand the issues and can bring the parties to consensus.


Jacobs

Robert Jacobs is a mediator and arbitrator with 30+ years of litigation experience. He is affiliated with Judicate West. *Before becoming a neutral, he had more than 25 years of experience representing builders, developers, general contractors, and owners in many construction disputes. He presently mediates and arbitrates real estate, construction, business, personal injury, employment and trust litigation cases. Reach him at Bob@attorney-mediator.law.*

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