Defects Liability In Construction Projects: Understanding The Contractor’s Liability

It is an implied contractual term under English law that construction contractors are required to deliver works that meet the description and standard under the construction contract. Failure to do so, for example by using lower quality materials, constitutes defective work which is a breach of contract.

Under English law, the employer’s legal remedy against the contractor for defective work is to claim damages. Only in exceptional circumstances can the aggrieved party be granted ‘equitable remedies’ – such as specific performance, which requires the breaching party to perform its obligations as promised, rather than pay damages. For this reason, construction contracts often provide some powers for the employer, during a limited time period, to recall the contractor to site after practical completion has been certified to rectify any defects in the work. The term for this period differs depending on the form of contract used, but is often referred to as the defects liability period ("DLP").

Under typical construction contracts, at completion of the work by the contractor it is customary for a certificate of practical completion to be issued, following which the DLP starts to run. At the expiry of the DLP, it is customary for a certificate to be issued stating that all defects have been rectified, following which the works are certified as completed in accordance with the contract and a final certificate is issued, which discharges the contractor from its obligations and signifies completion of the contract.

The legal position following the issue of the final certificate is often misunderstood: this article considers the position under English law and provides an overview of the forms of security commonly used to protect the employer against defects.

The meaning of the final certificate

The issuance of the final certificate has far-reaching contractual and legal implications. It is therefore important in each case to review the provisions in the construction contract concerning the DLP and final completion certificate carefully in the context of the applicable governing law.

A common misconception is that issuance of the final certificate discharges the contractor in full from liability for all defects in the work. The final certificate customarily:

- signifies that the works have been accepted as completed in accordance with the contract;
- discharges the contractor from further liability for defects which would have been apparent from an inspection of the works;
- triggers the return to the contractor of all security held by the employer;
- precedes the drawing up of final statements of account and settlement of the contractor's final account; and
- signifies completion of the contract.

However, the final certificate does not fully discharge the contractor from liability for defective works that only become apparent after the issuance of the final certificate. While the employer no longer has the right to recall the contractor to site (and the contractor no longer has the right of access to site to remedy defects), as is customarily the case during the DLP, the contractor remains liable to the employer in respect of any defects arising.

Post-completion claims by the employer

After issuance of the completion certificate, the extent to which the contractor is liable to the employer will depend on the governing law of the contract and, in some cases, local laws in the project jurisdiction which apply regardless of the contract’s governing law.
Under English law, since the employer no longer has a contractual right to recall the contractor to site, the employer will itself have to remedy any defects in the works which arise or become apparent after the DLP, and then make a claim for damages from the contractor.

It may be that other governing laws will afford greater rights to the employer to force the contractor to return to the site and remedy any defects, even after the issuance of the final certificate. It is therefore worth clarifying this point at the contract drafting stage, so that the rights and obligations of the parties can be clearly stated in the contract to avoid any confusion at a later stage.

Under English law, the employer's right to claim damages for defective work is subject to time limitations under the Limitation Act 1980. In relation to claims arising out of ordinary contracts and tort claims, the Act imposes a six-year limitation period, which runs from the time the cause of action arose; in relation to claims arising out of contracts executed as deeds, the Act imposes a twelve-year limitation period within which any claim must be brought. Similar limitation periods will be imposed in other jurisdictions, and again it is worth confirming the position at the drafting stage, in case the parties wish to deal with the issue by an express term in order to avoid any unusual national limitation provisions that might otherwise apply.

The scope of the contractor's continuing liability for defects and the limitation periods applicable under the relevant governing law, as well as the overall duration of the DLP and insurance issues, are therefore important factors to consider when evaluating counterparty credit risk at the contract drafting stage.

Security

The employer naturally wishes to be protected against the cost of repairing any defects that may arise during the DLP. The most common approach is to require the contractor to supply a bank guarantee, usually in the form of a stand-by letter of credit, of up to ten percent of the contract price. This may take the form of a specific guarantee covering the DLP, or it may consist of a modification to an existing bank guarantee covering earlier stages of the works, which has been reduced in value.

Where the works consist of a number of parts which are subject to individual DLPs, it is common practice to reduce the value of the security bond as each DLP expires (although from the contractor's perspective it is important to ensure that express provision is made in the contract for such reduction).

While the use of bank guarantees is the most common form of DLP security, cash retention funds are also seen (whereby the employer withholds some of the final payment due), either on their own or in conjunction with other forms of security, such as a bond or letter of credit.

These mechanisms provide the employer with some protection during the DLP, but the employer will not enjoy such protection after the final certificate has been issued and all security returned to the contractor. Contractors are naturally reluctant to provide further security after the issuance of the final certificate but depending on the particular circumstances of each project, this may be open to negotiation.

It is important to bear in mind that in major construction projects, the contractor party may be a shell company formed by a consortium for the purposes of the project, and may therefore not have any significant assets of its own against which the employer could enforce an arbitration award or court order. In such circumstances, the employer should seek parent company guarantees or similar assurances from the parent companies, shareholders or other affiliated companies, to cover the full duration of the contractor's liability to the employer.

Conclusion

Contrary to popular belief, the issuance of a final certificate does not necessarily discharge the contractor's liability for defects in full. As a matter of English law (and under most standard forms of construction contract) the contractor will continue to be liable for latent defects until the expiry of the relevant limitation period. It is important to take this into account when assessing project risk, credit and insurance issues, and, from the employer's perspective, to ensure that any security package provides reasonable protection against the possibility of latent defects.