



Addressing Project Defects

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Defects in the design and construction of a project can arise at any time during the project's lifespan, threatening an owner's return on investment. A defect may be immediately noticeable during commissioning or remain undetected until years after acceptance. The contractor's response and an owner's available remedies will vary depending on when the defect is discovered.

Most construction contracts provide owners with express warranties for design and construction defects that are limited in time. This article will explore how an owner can maximize the remedies from warranty provisions, as well as the rest of the terms of the contract with the contractor.

Before acceptance

An owner is in the strongest position both from a contractual and technical standpoint if a defect is discovered *before* accepting the overall project. The contractor is clearly obligated to deliver a fully functional project free of defects and must do whatever it takes to rectify the situation. Moreover, it should be relatively easy to determine the underlying cause of the defect in the early stages of startup and commissioning. After all, one of the essential purposes of commissioning is to fine-tune the project and get the "kinks" out.

To take full advantage of its contractual position, an owner with knowledge of a defect before accepting the contractor's work should notify the contractor and demand that the defect be corrected before acceptance. This is usually provided by the owner in

the form of "substantial completion." If the condition is not remedied to the owner's satisfaction, the best option for the owner is to withhold acceptance until it is properly corrected.

Another option might be for the owner to grant some form of conditional or qualified acceptance in order to move into the operation phase, but this approach is only viable if the defect does not prevent actual operation. A qualified acceptance should make clear that the aspect of the project impacted by the defect is carved out from acceptance and must be fully addressed before final acceptance can be granted. Elevating the issue to an express condition of acceptance will clarify that correcting the defective condition is not merely a punchlist item, and that the owner is not accepting the project "as is" with the defective condition.

After acceptance/during warranty phase

If a defect is discovered after acceptance, an owner must make a claim under the applicable, contractually provided warranty provision. Under an engineering, procurement, and construction (EPC) or design-build contract, the owner will be able to make a single claim to its sole contractor and force the contractor to determine whether a design or construction defect is afoot. In a more traditional design-bid-build scenario, however, the owner will be forced to make warranty claims against both its design professional and its general contractor under separate agreements.

The owner may then be required to act as a referee between the designer and contractor if there is a dispute as to the underlying cause of the defect. If that happens, the owner should assert its rights under both contracts until the situation is adequately resolved.

Even if the owner has an EPC contract with a single contractor, it should still insist on being an integral part of the remedial process because the contractor is likely to have been paid in full and therefore incentivized to find the cheapest and quickest solution, which may not be sufficient to properly remedy the defect. One point of leverage an owner may have during this phase is a letter of credit or other form of security tied to performance guarantees. The prospect of a draw on the letter of credit will provide an economic incentive for the contractor to take a defect seriously and pursue a satisfactory remedy.

In the event the cause of the defect is not clear, or is disputed, the owner should insist that a proper "root cause analysis" be performed. This engineering-driven analysis will consider any and all possible causes and will settle on the true root cause only after all the other possible causes have been eliminated with a reasonable degree of certainty. By pushing the contractor to provide a robust response to the problem, the owner can attempt to avoid a "Band-Aid" fix that might allow the defect to rear its head after the warranty period has expired.

After expiration of the warranty period

If a latent defect is discovered for the first time after the expiration of the warranty period, or if a defect addressed during the warranty period resurfaces after the period expires because the contractor's fix was not adequate, the owner must rely on a different set of remedies. In the event the contractor addressed the issue during the warranty period, but the fix did not hold, the owner can assert a claim for breach of warranty.

In contrast, if the defect claim was never raised or addressed during the warranty period because it was not discovered until afterwards, the owner may argue that the defect amounts to a material breach of the underlying contract. In most jurisdictions, the statute of limitations for breach of contract actions is longer than a typical one or two-year warranty period. For example, under New York law, which applies to many domestic and international projects, a six-year statute of limitations applies to breach of contract actions.

Establishing that the defect amounts to a material breach of the contract is an essential element of the owner's case and one that the contractor may contest by claiming the defect is merely an operation and maintenance issue that the owner should have foreseen. For example, a defective condition may still allow a project to operate as intended, but may require the owner to undertake additional maintenance. This could cause extended outage periods and ultimately impact the owner's ability to generate revenue.

Determining whether the defect is an incidental and acceptable aspect of the contractor's scope of work or whether it amounts to a material breach of that scope of work will likely turn on whether the contractor satisfied acceptable industry standards. This standard of care is typically memorialized in construction contracts and is imposed by law on engineers and design professionals.¹ The owner may also have to establish that as a result of the defect, it must perform maintenance beyond what it reasonably had expected to perform based on similarly situated projects. These showings are made by the opinions of expert witnesses and may ultimately have to be resolved through a formal dispute resolution process.²

Defective conditions, whether they are due to faulty design or construction, can threaten the economic viability of a project through either a slow bleed of inefficient operations or a sudden and abrupt collapse of availability. Understanding and implementing a strategic approach to remedying these conditions is essential for an owner to protect its investment.

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References

1. *C.H. Guernsey & Co. v. United States*, 65 Fed. Cl. 582, 595 (Cl. Ct. 2005) ("An architect must exercise such care, skill, and diligence as others who are engaged in the profession would ordinarily exercise under similar circumstances, and statutory provisions regulating the profession of architecture may expressly so provide.") (internal citation and quotation marks omitted).
2. *E.g., Wausau Business Ins. Co. v. Turner Const. Co.*, 151 F. Supp. 2d 488, 493 (S.D.N.Y. 2001) ("In an action pertaining to professional misconduct ... the plaintiff must introduce evidence, most typically through expert testimony, regarding the standard of care and the professional's variance from that standard.").