



General

21 Key issues for defects

Investing in Energy Transition Projects
March 2023



pwc

Introduction

A **Defect** is an aspect of the construction works that does not comply with the Contract.

In design and construct contracts, Defects can relate to design as well as construction.

The non-compliance can be in relation to the specific requirements of the drawings or specification or the more general requirements of the general conditions.

The complexity of the design and construction process are such that few projects are ever Defect free.

This paper deals with:

- design Defects
- latent defects
- systemic/fleetwide Defects
- the obligation to rectify Defects
- the interaction between Defects and Completion
- the Defects Liability Period
- remedies in relation to Defects
- long term Defect issues.

Design Defects

While Defects are usually thought of in the context of construction, Defects can also relate to design in circumstances where the Contract contains relevant design obligations.

Therefore the Contractor will be required to continuously rectify design errors, including as part of the design review process.

It is critical to ensure that the design review clauses reflect the fact that an error in design is a Defect before the relevant Works are constructed. Contractors should also be mindful of such provisions when considering the flow down consultancy agreements.

Latent defects

Latent defects are Defects which are not reasonably capable of being detected at the time that a release is given in connection with the Works, such that, in the absence of a provision to the contrary, the Contractor would be relieved of liability in relation to them.

The issue of latent defects is somewhat unusual because, subject to statutory time limitations, the Principal remains able to sue the Contractor in relation to defective Works after the expiration of the Defects Liability Period and the release of the relevant security.

The issue usually arises where either:

- there is a release of liability prior to the expiration of the statutory period, or

- as between Contractors, where one Contractor takes responsibility for the work of the other as part of a hand over process.

In such situations the release should exclude latent defects.

Of course, whether the Defect is latent will be an issue of both factual and expert evidence, however, the Contract should set up the exclusion.

Systemic/fleetwide Defects

Some projects involve the use of the products, such as turbines, that are used throughout the relevant industry and tend not to be bespoke.

In such cases, if the product contains an inherent flaw in design or manufacture, so that it is defective across projects, the manifestation of the Defect in one project should give rise to an obligation on the manufacturer to advise all purchasers of the issue irrespective of whether it has yet manifested itself on all of the projects.

The obligation should extend to:

- notification of the Defect
- advice as to the root cause of the Defect
- progressive reports as to rectification measures
- safety and operating instructions to mitigate the effects of the Defect.

The obligation to rectify

The fundamental obligation accepted by the Contractor is to design (where appropriate) and construct the Works in accordance with the Contract.

The obligation to rectify Defects should be set out in the Contract in the following ways:

- as a general obligation to design and construct the Works in a manner that is Defect free
- to continuously rectify Defects, irrespective of whether the Contractor is instructed by the Principal to do so
- to rectify Defects that are residual after the achievement of Completion as noted in the punch list of Defects issued at Completion and as instructed by the Principal during the Defects Liability Period.

All such obligations should:

- be expressed to be without prejudice to the Principal's other rights, especially the right to claim damages
- up to the expiration of the Defects Liability Period, permit the Principal to rectify the Defect if:
 - it is urgent
 - the Contractor fails to do so within a reasonable time after being notified of the existence of the Defect.

Defects and Completion

Most construction contracts reach a stage of Completion that has important contractual consequences prior to the Works being fully complete. This is usually known as Practical Completion in building contracts and Mechanical Completion in other contexts.

The contractual consequences include:

- the delay liquidated damages trigger
- the partial return of security
- the possession of the site reverts to the Principal
- insurance obligations are largely switched to the Principal.

Usually, the key requirement for the achievement of this stage of Completion is that the Works are complete with the exception of minor Defects that do not prevent the Works from being conveniently used for their intended purpose.

That determination is vested in the superintendent or similar person.

The extent to which Defects are permitted depends on the nature of the Works. For example, a prestige apartment building will have different requirements to a hospital, a process facility or a solar farm.

It is important to carefully consider this issue rather than rely on generic definitions.

The residual Defects will be the subject of a punch list or be listed in the certificate of Completion and the Contractor will be obliged to rectify them as soon as possible or within such time as instructed by the Principal.

Defects Liability Period

The Defects Liability Period is a period of time measured from the initial Completion of the Works during which the Principal must allow the Contractor the opportunity to rectify Defects. Correspondingly, the Contractor must rectify such Defects.

Accordingly, the Defects Liability Period is intended to be for the benefit of both parties: the Principal can have Defects rectified by the Contractor and its subcontractors; and the Contractor has the opportunity to rectify the Defects itself, rather than being sued by the Principal.

Only when all such Defects have been rectified by the Contractor will Final Completion be achieved.

The duration of the Defects Liability Period will be a matter of negotiation. Usually, the period is one to two years. The longer the period, the higher the Contract Sum will be. Those parts of the Works that are rectified might also be the subject of a separate extended period for Defect rectification, although the total period will usually be capped.

In most Contracts, the Principal will retain either a proportion of the Contract Sum (cash) or a reduced performance bond as surety for performance of the Contractor's obligations during the Defects Liability Period.

Remedies

The remedies available to the Principal where the Contractor fails to rectify Defects are a combination of self-help and damages.

The self-help remedy is comprised of the right to have the Defect rectified by another Contractor and thereafter to sue for the cost and, possibly, deduct the cost from the security. This remedy is usually set out in the Contract.

It is important to note that the remedy is not subject to reasonableness: the Principal is entitled to have the Works that it has contracted for and it is no defence to assert that the Defect is minor.

Where there are no express Defects provisions, which is rare, the remedy is damages.

As a starting point, the Principal is entitled to be put in the position it would have been had the Contract been fulfilled. In the case of a construction contract, the Principal is entitled to have the Works it contracted to receive. The measure of damages will be the cost to do what is required to achieve that outcome. The only exception to this rule is where such an outcome would be unreasonable, in which case the remedy will be the difference in value between what has been built and what was contracted to be built. However, such an outcome is rare.



Defects clauses should not be exclusive remedies

Common law rights

Unless express words are used, a Defects liability clause will generally not affect the parties' remedies under common law. For example, a Principal can sue the Contractor for damages for Defects which appear during or after the Defects Liability Period, though its damages may be limited – if the Principal has acted unreasonably – to the cost of the Contractor performing the remedial Works.

It should be noted however, that the courts require strict compliance with the procedural steps and notice provisions in the Contract relating to Defects before and Principal can claim damages for Defects. The court held that a 'wider common law right' to engage others and then to claim the costs incurred as damages for breach of Contract should not fly in the face of those obligations.¹

In particular, the Principal should ensure that the issue of a final certificate does not release the Contractor from any liability or exclude the Principal's common law rights. Nonetheless, the Principal should make this position clear by adopting the following wording:

The rights of the Principal under this clause [] are in addition to and do not limit any other rights which the Principal has under this contract or under any law.

Some elements of contracting are subject to limitations imposed by legislation. For example:

- where there is an O&M contract, the parties must expressly deal with responsibility for construction defects, especially where the Contractors are related entities
- Defects that are manifested after a considerable period, such as design life warranties, might become time barred by the applicable statute of limitations.

Long term issues

The Contract should consider and the parties should be mindful of a number of long term issues in relation to Defects, including:

- not excluding common law remedies
- limiting legislation
- the interaction with operation and maintenance
- statute of limitation issues.

Conclusion

This paper is intended to provide a brief overview of the Defects Liability Period and examples of typical clauses. Subsequent updates will deal more closely with specific issues or problems which may arise, particularly where Defects liability clauses are poorly drafted.



¹ *Turner Corporation Ltd (Receiver and Manager Appointed) v Austotel Pty Ltd (1994) 13 BCL 378.*

How to contact us



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