

Legal Direction of Defect Warranty Liability in the Korean Construction Industry

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Abstract

The defects that are bound to arise in most construction projects cause disputes among the contracting parties regarding the defect warranty liability (DWL) guaranteed by the retention of the contractor's performance security at the end of the performance period of the contract. Most current projects involve a multiple-tier contractual relationship, causing the liability for some defects to overlap. In addition, many construction projects are made up of multiple detailed work types which an expert hired by the owner inspects the part completed by the contractor and pays an interim payment. However, after the completion of work, the contractor will still hold the defect warranty liability. In a scenario in which the work is delayed due to reasons for which the owner is responsible, the defect warranty liability period is also increased, imposing an additional burden on the contractor. In this study, basic research was carried out with the goal of reducing problems related to defect warranty liability. Problems related to defect warranty liability cases and the nature of the defect warranty liability period were investigated. Possible solutions to the problems caused by the DWL that were suggested include the separation of the negligence liability period and the strict liability period, as well as the introduction of a retention money system.

Keywords : defect warranty liability, statute of limitations, retention money, negligence liability, strict liability

1. Introduction

1.1 Background and Objectives

It has been recognized that defects are inevitable in the contract execution of construction projects. When a defect occurs, conflicts among the various contracting parties are bound to arise. The main issues that arise in relation to the defects are the basis of defect judgment, the time of the effect and the contents of the defect warranty liability (DWL) of the contractor. In addition, projects often involve multi-tier contract relationships, so dealing with

liabilities for the defects is one of the most sensitive areas. These conflicts are not caused by contradictions in the current legal system, but rather by the manner in which projects have changed in various ways.

For some defects that occur after the completion of a construction project, complex legal disputes can arise. One of the controversies in disputes arising from these defects is the legal nature of the DWL period. The legal nature of the current DWL period has consistently been regarded as a period for the exercise of judicial or non-judicial rights, and is not seen as a filing period for trial claims.

Despite the court's decisions on this question, the occurrence of a dispute related to defects means that the causes of defects and the liability relationship are indeed complicated. To fundamentally solve the problems arising from the DWL period, it is necessary

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to systematically identify the legal nature of the DWL.

As such, the purpose of this study is to identify the problems incurred in construction projects caused by the DWL period, and to suggest a direction for the DWL.

1.2 Scope and Method

This study was limited to precedent cases related to the DWL that occurred from 1990 to 2015, and related laws. The methodology of this study is to examine these documents and precedent cases, to analyze the legal nature of the DWL, and to suggest a direction for the DWL period.

2. Review of Related Literature

This section presents a summary of the precedent research, related laws, and cases relating to the DWL of the contractor.

2.1 Precedent Research Studies

Although studies related to DWL have been continuously carried out, some relevant studies that deal particularly with the nature of the DWL period are reviewed, as follows.

Lee proposed the concepts of short-term defects and long-term defects as ways to clarify the liability for defect repair[1]. Choi suggested the legality of the DWL period and the rationalization direction of the responsible party[2]. Doo proposed that the parties should be able to reach an agreement within the limits of the DWL period covered by the law[3]. Cho suggested that professional liability insurance should be introduced into Construction Management (CM) contracts to enable CM professionals to bear liability for service defects[4]. Lee proposed that the law and system should be changed so that a performance guarantee can be provided instead of the DWL system[5]. Although the direction of the

DWL is very important for clarifying responsibility for defects, and several studies have been carried out on this topic, there has still been no study focusing on the direction of the DWL for contractors.

2.2 Laws Related to the DWL

The DWL of the contractor is based on the Civil Act. Construction contracts can be complex in nature, and can include contracts for sale, contracts for work, and so on, while the DWL of the contractor can vary depending on the type of contract.

Construction contracts are based on the Framework Act on the Construction Industry (FACI), a special law of the Civil Act. Contracts for public works are based on the Act on Contracts to which the State is a Party (ACSP), while the laws that form the basis of the DWL are the Act on Ownership and Management of Condominium Buildings (AOMCB) and the Act on Housing Management (AHM). There is also the Commercial Act, which governs the DWL period of the seller and the supplier.

In a sale between merchants, the buyer shall, upon receipt of the good, inspect it without delay and immediately give notice thereof to the seller if any defect or deficiency in number is found therein. Otherwise, he/she has no right to rescind the contract, to demand price cuts, or to claim damages thereby. The same shall apply in cases where, within six months, the buyer discovers in the good that was sold a defect that was not immediately discoverable. These provisions shall not apply to a seller who has been acting in bad faith pursuant to Article 69 of the Commercial Act.

The buyer may terminate the contract when the object of the sale cannot achieve the purpose of the contract, and in other cases, only a claim for damages may be made. This right may be exercised by the buyer within one year from the time he becomes aware of the fact, according to Article 575 of the Civil Act.

Article 28 of the FACI stipulates the DWL of the contractor and the subcontractor. The subcontractor's DWL applies mutatis mutandis to the DWL of the contractor. Here, the completion date of the construction work has been changed to the completion date of the construction work performed by the subcontractor. In accordance with Article 9–2 of the AOMCB, the period of liability for the main structural part of the building and ground construction shall be 10 years, and in the event of any defects in the other work, the DWL shall be determined within the range of 5 years considering the seriousness, durability, and possibility of replacement. Article 37 of the AHM distinguishes between defects related to structure and defects related to facility construction. Defects related to structure refer to defects such as cracking or settlement which may cause some or all of the structure of the apartment house to collapse, or cause danger in the structural safety of the apartment.

As mentioned above, there are many laws and ordinances stipulating the content and period of the DWL of the contractor. The Civil Act describes the defects of parts that have been finished before a project's completion, but issues may arise concerning the concept of parts finished before completion and at completion.

2.3 Cases Related to the DWL

There are some Supreme Court decisions relating to the period of the DWL based on the laws examined above. In the period from 1990 to 2015, the contractor's DWL was defined as the period of exercise of rights, not the filing period for trial claims, which was ten years after delivery.

On the other hand, for apartment housing, the DWL is applied differently based on the period of time according to the AOMCB and AHM.

3. Analysis of Problems during the DWL Period

As mentioned above, the law on which the DWL is based is the Civil Act. In reality, when defects in facilities occur, the court has consistently ruled on the nature of the DWL period based on the FACI and the AOMCB based on the Civil Act. However, considering the fact that the construction industry has changed and that technical capacities have advanced, these laws and regulations have some parts that do not properly reflect the characteristics of construction projects, and these are discussed in the following sections.

3.1 Duplication of DWL for the Same Defects

When construction work is not that complicated, the contractor can take charge of the entire construction project. In this case, because the owner is not an expert on construction, it is often difficult for him or her to understand the project, even if he or she is involved in the construction process. If a defect occurs in the object after delivery to the owner, the contractor must immediately repair the defect, in accordance with the request of the owner.

The contractor shall, upon completion of the contract, pay the final payment when the whole object is completed, and deliver the object at the same time as the payment of the contractor is received in accordance with the claim of simultaneous execution called *exceptio non adimpleti contractus*. Upon delivery of the object, the contractor shall be liable for any defects. This is reflected in the Civil Act and is the basis for judging the DWL of the contractor. Figure 1 illustrates the general DWL of the Contractor.

However, if the construction project becomes large and complex, the contractor may complete the work via subcontracting. If a multi-tier subcontract is allowed, the contract amount of the final

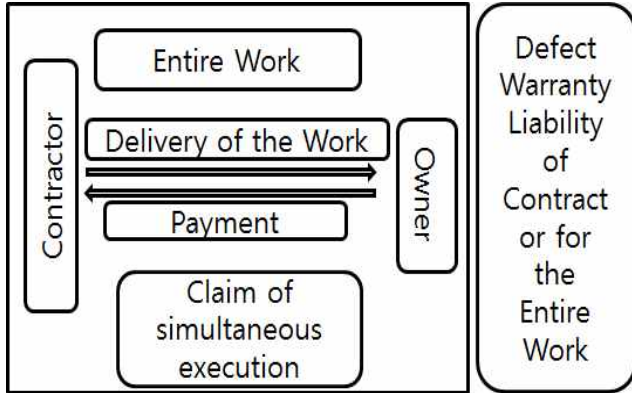


Figure 1. General DWL of the contractor

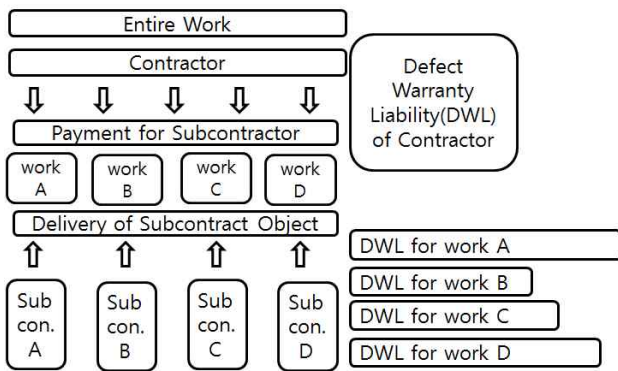


Figure 2. Duplication of liability for the same defects

subcontractor may not reach the amount to be charged in the actual construction cost. As a result, the quality of the object may deteriorate and defects may occur. Therefore, the first subcontract is allowed according to Article 28 of the FACI.

Under the subcontract, the subcontractor should be liable for any defects from the day the project is first commenced until the date of completion of the construction work performed by the subcontractor, and the day on which the object is permitted to be used. Normally, the date of commencement of permission to use the object will come before the completion date of construction work performed by the subcontractor.

Nevertheless, in practice, even if the subcontractor delivers the object of the contract to the contractor, the subcontractor must be held liable for the object

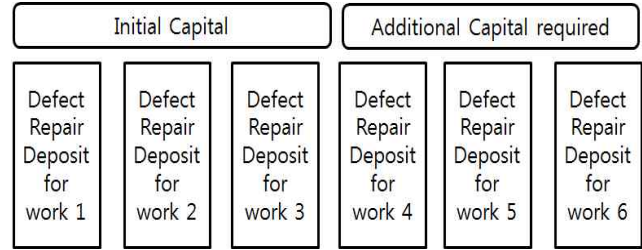


Figure 3. Request for additional capital of a sincere subcontractor for excessive repair warranty

even after delivery. If defects occur after the delivery of the whole object to the owner, the contractor shall immediately inform the subcontractor of the defect. Upon receiving the notification, the subcontractor takes on the burden of the DWL, Figure 2 illustrates this duplication of liability for the same defects.

3.2 Expansion of Capital Due to the DWL

The Acts or Cases discussed above consistently require the contractor to bear the DWL during or after the completion of construction work. Due to the overprotection granted to the owner against defects by the Act, the contractor may incur excessive expenses in guaranteeing the repair of defects.

It is difficult to identify problems caused by excessive defective repair deposits if the contractor's capital stock is enough to ensure the DWL arising from the contractor's other work.

However, a poorly-funded subcontractor has to expend additional capital for the repairs required for a large number of his/her construction projects. If the subcontractor has to purchase a bond that may not be necessary and capital needs to be increased, the subcontractor will incur a separate financial burden, as shown in Figure 3.

As a result, the system of overburdening the DWL to overprotect the owner may violate the rights of a subcontractor who faithfully fulfills the contract.

3.3 Transfer of Liabilities

In the AOMCB, the DWL of the exclusively

possessed area shall begin on the date of delivery to the Class Holder, and the DWL of the common parts shall commence on the date of use inspection or upon use approval.

In accordance with the ACSP, the contractor's liability for the defect shall commence on the date of receipt of the whole object or end on the day of completion of the final inspection. More specifically, the subcontractor's liability for the defect shall start on the day of completion of the subcontractor's part, or end on the day of permission to use the object..

In the context of the DWL, it is not clear whether the construction work completed by the subcontractor is limited to the part of the subcontract, or the whole construction work. However, the whole object must be completed before the object can be managed or used. This means that the DWL of the subcontractor is substantially started when the whole object is delivered to the owner.

For example, a contractor may perform the first work type A and the last work type D, and each work type may be performed by a subcontractor. At this time, if there is some defect in work type A and the defect is found by the time of work type A's completion, then the subcontractor who completed it has an obligation to repair the defect.

In this case, the subcontractor who completed work type A must bear the liability for the defect due to imperfect performance before the completion of the whole construction, and therefore bear the DWL after the completion of the whole construction. Thus, the contractual liability of the subcontractor is practically from the end of construction of the subcontract work type A to the period of the DWL of the work type A during the whole construction. Figure 4 shows the extension of the defect liability period of a subcontractor.

If work type A is further divided into detailed work types and the DWL is classified according to these detailed work types, it may cause problems in terms

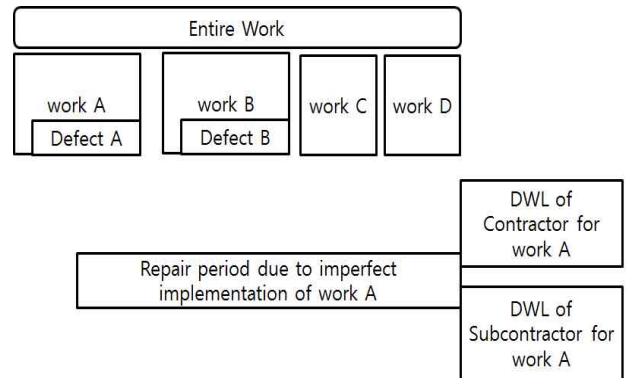


Figure 4. Extension of defect liability period

of the extent to which the subcontractor should bear the DWL.

In addition, if the contract is performed in the form of long-term continuous construction, the contractor's liability may be increased, even though the period varies depending on the liability of the owner. In other words, due to the liabilities of the owner, the liability period of the contractor or the subcontractor is increased, such that a transfer of liabilities occurs.

3.4 Damage to the Owner Due to Subsequent Defects

As mentioned above, the court has consistently ruled that the period of the DWL is the period of the exercise of rights, not the filing period for trial claims. The period for the exercising of rights is a statutory legal duration, and there is no suspension or interruption of that period. However, the statute of limitations is different from the period of exercise of rights. Since the court has ruled that the period of the DWL is the period for the exercise of rights, the owner can exercise his or her rights during the period of the DWL stipulated in the law or contract. For example, in a construction consisting of three specific phases, if defect B caused by defect A occurs after the DWL period of defect B, then the contractor is not liable for defect B. Figure 5 illustrates damage to the owner due to subsequent defects.

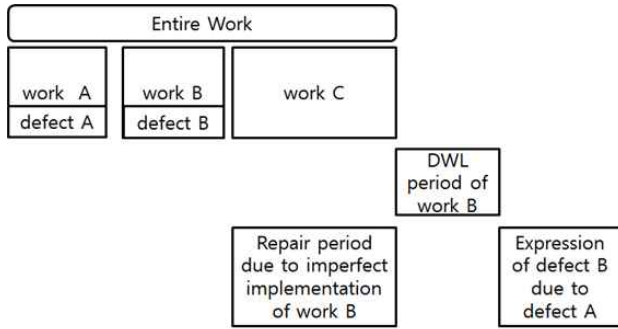


Figure 5. Damage to the owner due to subsequent defects

At this time, if the subcontractor who completed construction type A and the subcontractor who completed construction type B are different, the DWL of the subcontractor is different. The subcontractor shall be liable for the DWL from the end of the whole construction to the end of the DWL period in both contract types A and B.

However, even if defect B manifests after the period of the DWL of contract type B, the period of the owner's right to request for contractor to repair a subsequent defect has passed without suspension and interruption. As a result, the period for the exercise of rights does not substantially protect the owner in the event of a defect that is complex in nature.

4. Direction of the DWL of Contractor and Subcontractor

The DWL of the contractor and the subcontractor shall be established in the following direction.

4.1 Subcontractor's Liability for the Defect

As discussed above, there is no need to distinguish between the public and private sectors, with regard to duplication of the DWL, request of a sincere subcontractor for excessive repair warranty, and transfer of liability.

From the Owner's point of view, only the contractor needs to be held responsible for the DWL. However,

from the perspective of a contractor, a large number of other subcontractors are involved at different times, and for this reason, the DWL is needed for each sub-contractor. In most sites, when the contractor is instructed to repair defects, the contractor again orders the subcontractor to repair defects. In this process, a duplication of the relationship formed by the DWL is formed for the same defect.

Therefore, when a subcontract is concluded, the contractor shall submit a guarantee for the DWL in the sub-contractor part to resolve the problem of a duplication of the DWL. The DWL of sub-contractors is a liability based on the law, and thus is duplicated with the DWL of contracts. However, if the sub-contractor has to repair the defect during the contract period, and he/she has to have the DWL, the duplication problem can be resolved.

The fact that a subcontractor shall assume contractual liability means that the sub-contract is not terminated until the contract is terminated.

4.2 Separation of Negligence Liability and Strict Liability Period

As discussed above, construction work takes a considerable amount of time to complete, and several inspections for interim payment and final inspection for final payment are carried out by the construction manager. However, as a project involves many materials, personnel, and construction methods, it is very difficult to make facilities without any defects. It is unreasonable for a sincere subcontractor to impose a long-term DWL, assuming that the contractor has caused defects. On the other hand, if the contractor's DWL is minimized by assuming that the contractor will provide the object without defects, damages may instead be incurred by the owner.

Therefore, in order to protect both the owner and the sincere contractor, it is necessary to minimize the strict liability period, after the liability period has

been divided into a negligence liability period and a strict liability period.

Most problems that are unknown or that appear during construction are problems that relate to changes in temperature, humidity, or the behavior of the facilities, and tend to appear within one year after completion of the facility.

These problems can possibly cause injury to facility users, and it can be difficult to determine the cause of these injuries once construction has been concluded. Therefore, the contractor can fix defects by defining these as part of the strict liability period. Meanwhile, a period other than the strict liability period should be set as the negligence liability period. During the strict liability period, the owner does not have the burden of having to present proof, so conflicts with extinctive limitation may arise. As in the court ruling, the burden of presenting proof for the extinctive limitation is placed on the person claiming the statutory profit.

Therefore, the contractor should hold strict liability for defects occurring through the first year in the total liability period, and repair any defects that arise.

4.3. Introduction of a Retention Money System

As discussed above, if the contractor's liability for defects is to be subject to extinctive limitation and separated into negligence liability and strict liability, the contractor shall bear liability for defects after the interim payment or at the end of the subcontracting work. The object of the DWL is the defect of the whole object, while the object of the retention money is that of the completed part.

Thus, to ensure a warranty for completed parts, a retention money system must be introduced, and the retention money ratio needs to be determined in accordance with international practices. If a retention money system is introduced, the contractor will be more likely to provide non-defective objects

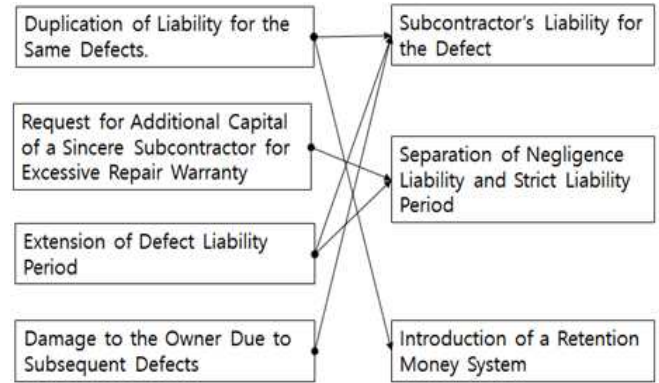


Figure 6. Summary of relation between problems and suggestions

to the owner during construction. The contractor shall not be liable for defects arising after the owner releases the retention money to the contractor. Rather, if the owner claims the benefit of the statute and proves the defects, the contractor should be liable for negligence liability. Of course, due to the nature of the construction industry, there is a possibility that the contractor will be insolvent and cannot bear the liability for defects before the expiration of the liability of the defect.

Figure 6 shows a summary of the relations between the problems and the suggestions made here.

5. Conclusions and Recommendations

In Korea, disputes and conflicts regarding defects of construction work still occur frequently. When such disputes or conflicts arise, all contracting parties suffer a great deal of stress. The root cause of disputes and conflicts related to such defects is the fact that the laws of Korea do not properly reflect the characteristics of construction projects and international practices. In this study, the Civil Act, AOMCB, FACI, ACSP, AHM and several Supreme Court cases were investigated with the goal of minimizing the problems related to construction defects. Some of the problems related to defects,

such as duplication of liability for the same defects, extension of the defect liability period, and damage to the owner due to subsequent defects, were analyzed, and the following defect liability directions were suggested.

First, the sub-contractor has to repair the defect during the contract period, and he/she has to have the DWL. Second, to guarantee against such defects, a retention money system should be introduced to replace the defect repair deposit. Lastly, the negligence liability period and the strict liability period for defects should be separated.

It is expected that the implementation of the recommendations presented in this study will reduce disputes or conflicts related to the nature of the DWL period, because the contractor's defect liability will have been clarified. In addition, the liability for the defects of the contracting parties can be alleviated by eliminating the overburdened liability for defects. After the strict liability period is discharged, the contractor can effectively manage the funds by releasing the retention money to the owner.

To apply the suggestions in this study, it is necessary to study the characteristics of construction work and the construction contract in further detail. Before replacing the repair deposit with a retention money system, it is recommended to conduct separate studies in order to examine the work and contents of the guarantee institution. On the other hand, the problem of separating the negligence liability period and the strict liability period depends on the Civil Act, so further research to establish a legal basis is needed.

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