

# Residential Construction: The Importance of a Contract

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A domestic building contract does not have to be complicated but the consequences of not having a robust contract with your builder can be.

Picture a villa in a prestigious location, it is in need renovation and an extension would allow the property to keep up with the neighbours. A builder has been found, a price agreed and all involved are hopeful the works will be completed in 18 months. There is just one, seemingly small problem, the contract consists of five pages of outline design drawings and a promise to carry out the works described in the document for an agreed price.

Perhaps not surprisingly, the above project does not complete in 18 months and the price is certainly not as agreed. In fact, the project eventually completes at twice the anticipated price and over a year late using a replacement contractor. In the interim the original contractor is terminated and legal proceedings commenced in relation to the amount due for works completed (or not completed) to date and a series of unapproved variations some of which breached planning and building consents requiring significant remedial works to be undertaken.

It is tempting to say “all of this could have been avoided with a robust contract” but that may be optimistic. What would be realistic would be to say that a robust contract could have:

- clearly defined who was responsible for doing what and at what price;
- provided a clear payment structure and defined contract price;
- provided mechanisms to control changes made during the project and allow the employer to understand the consequences of changes; and
- clearly assigned risk so that, in the event of a dispute, the parties understood their own positions and could look to resolve matters rather than launch into dispute resolution without a clear picture of the parties’ respective risks.

A robust contract for residential works need not be extensive or expensive. A contract can be kept proportionate to the value and complexity of the works being undertaken. Use of selectively amended standard form contracts for minor works can keep the cost of putting in place a tried and tested contract, for example the FIDIC suite of contracts. Even where bespoke forms of contract are used, they can be based on drafting and market positions commonly seen with departures only where necessary to meet the needs of both parties.

Below we look at some of the critical issues for residential construction projects and how to avoid the pitfalls.

In any construction project three key objectives are critical:

- time;
- cost; and
- quality.

It is important to identify what the employer requires in respect of each of these categories if the contract is going to meet the needs of the project. The approach to critical areas of the contract will be determined by which of the above concerns takes priority in each case. This is particularly the case in residential

contracts where an owner is likely to have very particular priorities with real world consequences. For example, the budget may be fixed or a failure to complete on time may leave intended occupants without accommodation.

## **Form of Contract**

There are two common forms of construction contract:

- 'construct only' with the design done by a separate consultant team; and
- 'design and build' with both the design and building work under one contract.

There are pros and cons to each approach and if the wrong contract is selected this can create problems throughout the project.

A 'construct only' contract can lead to a lower and more certain price. In this model, the contractor knows exactly what it has to construct and so can offer a relatively firm price and, because they do not take responsibility for design development, it can generally offer a more competitive margin than in a 'design and build' contract where the risk is higher.

The construct only approach means that, through a separately engaged design team, the employer can retain control over the design – an important factor for bespoke projects.

However, because design must be completed in advance, the time taken to complete the design before construction begins means the overall timetable for the project will be longer than in a design and build project where design is progressed alongside early stages of construction.

By contrast a design and build project offers two main advantages over the build only approach. Firstly, the works can be commenced before the detailed design is completed. This speeds up the project but it does mean that the contractor takes greater control of the design and later design changes may impact on works already done; this has time and cost implications. Secondly, all risk for the project sits with one contractor meaning, in the event of a dispute, there is no question of who is to blame; the main contractor is responsible for issues in the design and the works.

On the basis of the above it is critical to make sure that the project is structured to meet your needs. If cost is the decisive factor, a build only approach is likely to give the greatest certainty as well as control over the design process. If time is the critical issue, then a design and build approach can reduce the programme but that is likely to have cost consequences.

## **Scope of Works**

It is vital that the scope of works includes everything that is required as part of the work. If items are not included in the scope of works then they are not within the price. In the project referenced above, a failure to ensure there was a proper scope of works led to significant cost increases far beyond the owner's anticipated budget. This is the case both in 'construct only' projects where a detailed set of drawings and specification are needed and in 'design and build' projects where a set of 'employer's requirements' define the parameters that the final design must meet.

In design and build projects it is particularly important to ensure that any particular design features or technical requirements that the owner wants are captured in the employer's requirements even if this means that some design work is done prior to awarding the design and build contract. In this type of

contract, the contractor is required to meet the employer's requirements.

Another issue is to rely on drawings and Bills of Materials to list out everything the contractor is expected to physically procure and build/install. Whilst this can create an exhaustive list of the physical construction activities, it is easy to forget to deal with issues such as co-ordination of contractors on site, co-ordination of design between the design team, main contractor and specialist sub-contractors, monitoring compliance with building regulations, planning permissions and so on. In the project above the parties each assumed the other was dealing with listed building consent leading to repeated breaches of those consents all of which had to be rectified at significant cost.

When contract and design/specification documents are being produced by multiple contractors/consultants inconsistency can appear in the documents. In those circumstances it is advisable to include drafting in the contract setting out the order of priority of the document and who decides how the conflict will be rectified. Where possible, the risk of additional cost as a result of discrepancies should sit with the contractor; this acts as an incentive to check for and remedy any inconsistency at the earliest possible stage to avoid unforeseen cost.

## **Variations**

In construction it is common for changes to be required after the contract is signed. This can be caused by any number of issues, for example a need to value engineer the project, because a statutory authority requires a change to meet permit conditions or because the client decides that they would prefer a different finish or layout as the build progresses.

Variations can lead to disputes between the parties where there is no clear agreement how much the variation will cost or how much time it will add to the programme. Simply instructing the contractor to 'get on with it' will inevitably lead to such disputes.

The contract should include a clear mechanism for instructing and pricing variations and it should always be followed. Such a mechanism should allow the employer to request a quotation for the proposed variation, receive information of the cost and time required to undertake the variation and then decide to instruct it or to abandon the proposed change. The contract should also hold the contractor to those cost and time quotations in the same way they are held to their lump sum price and time for completion. Returning to the cautionary tale above, the project is financed by an offshore holding company as part of a complex tax-efficiency structure set up by the ultimate owner. The company holds funds to meet the project budget. Unknown to the directors of the company or the ultimate owner his partner, on a number of occasions, attends the site and authorises significant changes. Because the contract included no mechanism for this the contractor commenced the works without providing any estimate of cost or time consequences and incurred significant liabilities for all concerned and, in some cases, breached listed building consents. As there was no process for the changes to be reviewed by the design team and the contractor was not expressly liable for design or planning issues these variations later had to be reversed at the owner's expense.

## **Payment**

The contract should always specify how much is to be paid and when payment is to be made.

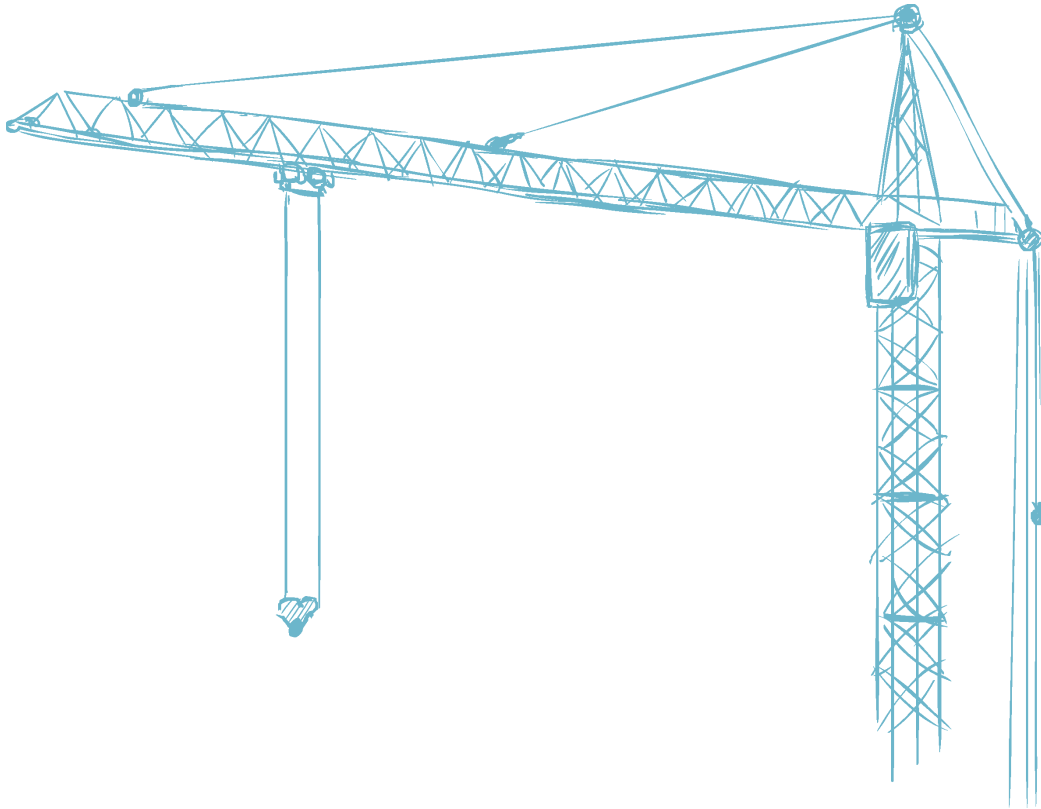
There are numerous ways of pricing the scope of works, for example the price may be a lump sum cost or it may be calculated based on measuring the quantity of work done and applying set prices per metre or

per item.

In addition, contracts can provide for payment on a monthly basis based on the amount of work done or they can specify milestones in the project, e.g. completion of foundations, completion of structure etc. at which a percentage of the price is payable.

However payment is managed it is important that the process is clearly set out. A number of key points to consider are:

- if an advance payment is being made by the employer, it should insist on security in the form of a bond or cheque for that payment to ensure the contractor does not get to keep the money without performing the services;
- the employer should ensure that it or someone on its behalf is certifying that the contractor has actually done the work it claims payment for; this may mean engaging an Engineer to oversee the project; where milestone payments are used the employer should take care not to provide the contractor with too much cash 'up front' in the event the works are not completed; this places the employer at risk;
- wherever possible the employer should ensure that where it is paying for goods those goods transfer to it, although risk of damage to goods should remain with the contractor until completion; to ensure it is getting something for its money even if the goods are not yet incorporated into the works;
- a retention, typically around 10 percent of the contract price, should be provided for. The retention is held back from each payment and forms a pot of money which the contractor will not get unless it: (a) completes; and (b) rectifies defects. The retention acts as an incentive to finish the job to the correct standard. If the contractor fails to comply with the contract the employer may retain all or part of the retention and use it to fund the completion of the works/remedial works offering some financial protection.



## Timing

Construction projects have a tendency to run late. This can be for a variety of reasons: from encountering unexpected ground conditions requiring additional work to employer led variations or adverse weather conditions.

It is important that this is considered at the outset and the risk of delayed completion split between the parties. In certain circumstances, notably where the employer fails to give access or instruct variations, the employer will be expected to accept the delay caused and give an extension of time. Conversely, where the contractor deploys insufficient resources or does not sequence the works efficiently, any failure to meet the planned completion date should be the contractor's risk.

There are also a number of issues, for example unforeseen ground conditions and statutory approvals where either party could accept the risk as part of the terms agreed. In general terms, the more risk the contractor accepts the higher the price will be to offset the risk of damages being levied by the employer in the event of delay.

Contracts should include a mechanism for granting extensions of time to the completion date in defined circumstances. We would recommend requiring the contractor to notify any claim for an extension of time within a set period of time, typically 14-28 days, or else waive its right to claim. This helps give the employer a clear picture of the risks to the project as it progresses.

Depending on the employer's priorities, the level of risk it accepts should vary. If completing on time is paramount then the employer should transfer the risk of delay to the contractor and back that up with delay damages which offer a strong incentive to complete on time however, doing so will increase the cost of the project. Conversely, if the budget is tight the employer may accept more risk in relation to delay in exchange for a lower lump sum price.

Including a mechanism for early warning in the event of delays may allow the employer to mitigate risks to the programme. Additional mechanisms such as the right to instruct the contractor to accelerate the pace

of works or to engage third parties at the contractor's cost can also be included to give the employer additional remedies as well as acting as incentives to the contractor not to fall behind.

Where the contractor does not complete on time, the contract should provide a mechanism to compensate the employer for the delay. Typically, the contract will set out a pre-agreed rate at which damages accrue, for every day the contractor is late, the employer may deduct a set sum from what is due to the contractor or recover any excess from the contractor.

## **Practical Steps**

This article has explored some of the key issues to be addressed in a construction contract as well as illustrated the pitfalls of not ensuring a proper contract has been put in place.

As stated at the beginning of this article, putting in place a robust contract need not be complex or expensive. Whatever the contract used, there are a number of practical steps that can be taken to reduce the risk in any job:

- ensure the specification properly sets out what is required and is consistent;
- consider what your priorities are at the outset of the works and ensure the contract matches those priorities;
- vet your contractor and ensure it is reputable and holds all the proper licences and appropriate levels of insurance;
- consider the use of a project manager to manage the contractual processes throughout the build and to review the design documents. Construction projects are not transactional and managing the project will need hands-on input from someone familiar with the contractual process and construction; and
- once the contract is in place refer to it in the management of the project.

Returning to the example of the troublesome villa mentioned at the start of this article, ensuring a robust contract is put in place that reflects the needs of the project can avoid problems down the line. Whilst putting in place a contract may require some negotiation up-front, in our experience taking the time to put in place a robust contract can save a great deal of time and money in disputes in the later stages of a project.

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