

What makes a fit out contract 'fit for purpose'?

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For this reason, substantial amounts of time, money and effort are spent on the fit out of shops, restaurants and offices so that their appearance aligns with the image that the owners wish to portray, creating an environment that is conducive to making sales and conducting business.

In a construction contract the employer is at risk of being exposed (and potentially out of pocket) if a fit out is not completed on time, on budget and at the required quality.

Notwithstanding the importance of fit outs, fit out contracts are not always given the attention they merit. Indeed, we have experience of high value and high profile fit out projects being procured on the basis of flimsy letters of intent and on the contractor's standard terms of engagement, which are invariably biased in the contractor's favour.

This can result in contracts under which the employer's contractual entitlements may be ambiguous, limited or which fail to correspond with the rights that an employer may assume that it would have, especially given the significant sums of money concerned.

Against this background, the purpose of this article is to provide a snapshot of some key issues that employers should ensure are properly addressed in any fit out contract.

Procurement

Selecting the contractor is the first step and it is usually prudent for employers to run a tender process to determine the most competitive offer for the project, taking into account issues of quality, price, and the experience of the contractor (i.e. it may be particularly valuable to have a contractor familiar with the base build of the building where the fit out is taking place).

The tender process should be completed in good time so that the contractor has sufficient opportunity to mobilise and to place orders for materials, while careful consideration should be given to identifying the party who is responsible for obtaining the necessary consents and approvals (such as a the building permit) for the project.

Design and construction

A further important issue is to decide the extent to which the contractor is required to undertake design.

As a general rule, specialist designers are likely to be engaged for intricate and complicated designs while design responsibility will probably reside with the contractor (who may have its own design team) if the design is relatively functional and straightforward. The contract period is usually quicker if the fit out is both designed and constructed by the contractor.

Regardless of the identity of the designer, it is important for the terms of engagement to include a design review process (to ensure that the design is satisfactory to the employer, including in terms of aesthetics

and as against any design requirements for franchise stores) as well as a 'fitness for purpose' warranty. All design obligations should be backstopped by the designer's professional indemnity insurance.

Once the design is sufficiently advanced, construction works can begin. The contractor should be subject to appropriately robust construction obligations. In particular, it is important that the Contractor is required to construct the works in accordance with 'best industry practice' and with good quality materials.

It is important that the employer engages a project manager to supervise the works, to report back to the employer on progress and to certify payments.

Payment

The scope and nature of fit out works is usually relatively certain and this lends itself to lump sum pricing structures which, in turn, increase certainty of price for the employer. That said, no contract price can ever be completely 'fixed' as, for example, it will inevitably increase if the employer instructs the contractor to perform additional works or changes the work to be done.

As with any other construction contract, it is important for the employer to have the express right to instruct variations (including decreasing or omitting part of the works) and the variation process must be subject to a clear pricing mechanism. For example, variations could be priced in accordance with analogous prices under the contract or in accordance with prevailing market rates (which can be determined through obtaining quotes from the market). However, it is important that the price should not be subject to any approval from contractor, otherwise the employer may find that the contractor can apply pressure by refusing to agree payment terms when the employer is keen to have the work completed.

Third parties

Fit outs often take place within close proximity to operating neighbouring businesses (such as in malls). This means that contractors must perform the fit out works in such a way that they do not cause nuisance or inconvenience to third parties and in accordance with the requirements of the landlord/building owner (i.e. regarding the times when the contractor is permitted to perform the works, noise levels and access to and from the site).

On account of the interface with third parties, it is therefore vital that the contractor carries robust public liability insurance, which names the employer as a co-insured party.

Timely completion

As the employer will almost certainly be prevented from trading (and therefore generating revenue) while the fit out works are being undertaken, fit out contracts must be subject to a definitive commencement date (which should not be subject to the date that approvals are obtained) and a fixed completion date.

If the works are not completed on time, consideration should be given as to whether delay damages should be levied against the contractor for each specified period of delay (i.e. a day or week). It is important that the rate of delay damages is sufficient to incentivise the contractor to complete the works as quickly as possible, while a further incentive can be added by providing that the employer may terminate the contract if any cap on delay damages (which is customarily 10% of the contract price) is exhausted.

In addition to imposing penalties for late completion, employers sometimes agree to pay bonuses if the works are completed before the contractual completion date, especially if it is commercially important for the works to be completed by a particular date (i.e. in time for a shopping festival).

In order to avoid any ambiguity, the contract should clearly set out the standards that the works are required to attain in order for them to be taken over.

Aesthetic appearance is important so, at the very least, the employer must be satisfied that the works have been performed in accordance with agreed designs and with the specified materials. Additionally, the contractor must have obtained all necessary consents and approvals (i.e. from Civil Defence and the relevant municipality) for the works to be occupied and used for their intended purpose while the contractor must have a good reason for not remedying any outstanding defects or completing any outstanding works.

Defects

Notwithstanding the taking over of the works, it is almost inevitable that defects will subsequently emerge. Defects are inconvenient and compromise the appearance of a fit out and therefore must be promptly remedied by the contractor when directed by the employer, bearing in mind the need to minimise disruption to the employer's business.

Incentivising performance

Dispute resolution is invariably expensive (and the cost can be disproportionate to the actual value of the fit out project) so it is prudent to include mechanisms in the contract to enable the employer to recover money from the contractor in the event of breach. This approach also serves to incentivise the contractor not to breach its obligations and to quickly make good any breaches that do occur.

In this regard, employers usually require the contractor to provide the employer with a performance security. The best option for the employer is to obtain an on-demand performance bond from a bank operating in the same jurisdiction in which the employer is located, which remains in force until the expiry of the defects liability period (provided that employer is satisfied all defects have in fact been remedied).

However, contractors sometimes resist providing performance bonds because of their cost (which may also lead to an increase in the contract price).

A pragmatic solution to this is for the contractor to furnish the employer with a signed but undated security cheque, which the employer may cash if it suffers loss on account of a breach by the contractor. To comfort the contractor, drafting can be inserted to clarify that employer will account to the contractor to the extent that the amount received by the employer from cashing the security cheque exceeds the loss suffered.

A further mechanism is for employers to seek to retain 10% from each payment and press for this amount to only be paid to the contractor with the final account (after all defects have been remedied). If this is unacceptable to the contractor, a typical compromise is for half the retention to be paid upon takeover, with the balance falling due following the remedy of all defects.

A 'back loaded' payment structure which is paid in instalments against the completion of specified milestones can also be used to enhance the employer's position, while employers should always look to include a clear right of set-off in the fit out contract.

Termination

As with any other contract, a fit out contract should be subject to clear rights of termination, including in respect of breaches that remain outstanding following the expiry of a cure period; insolvency; as well as if a cap on delay damages is exhausted. Any applicable local law formalities regarding termination should be properly addressed in the drafting.

Concluding thoughts

Fit out projects are subject to the same issues and risks that apply to any construction project and failure to properly address these concerns can seriously backfire on an employer.

For this reason, we recommend that time is invested in engaging fit out contractors upon clearly drafted and robust 'short form' construction contracts that adequately protect the interests of the employer.