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Building the Right Structure

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Property Development and Investment

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What's the big deal about?

Understanding the structure of the transaction

It cannot be stressed enough how important it is to make sure the construction documents are selected to fit the property investment transaction being carried out, rather than using a set of construction contracts because “these are the ones we used last time”.

Quite often problems occur when lawyers are preparing the legal documents for the main transaction, but the construction documents are prepared by other consultants.

Identifying what the parties want to get out of the transaction

From the adviser's perspective, this should be straightforward – it is the process known as “taking instructions”. However, it is surprising just how often clients are not asked for their detailed instructions and problems only come to light when you are trying to close the deal. This is easily identified by use of phrases such “it's not acceptable to the Bank”.

Lining up expectations

A simple example of this is where a property developer agrees to provide a collateral warranty to its funder from its building contractor which is quite stringent (let's call that a “gold medal warranty”) but the building contract only obliges the contractor to provide an industry standard form of collateral warranty (let's call that a “silver medal warranty”). This sounds incredibly obvious, but it's surprising how often we have to sort out issues like this when we are called into transactions late in the day.

Risky business?

By its very nature, construction is an industry where risk is a key issue. On one-off deals, there is a tendency to operate a risk transfer (or “risk dumping”) policy. On more sophisticated deals, a risk management approach will be used, ideally by use of a risk register. Careful consideration should be given to allocating risk to the party who is in the best position to deal with it.

Successful and timely completion of the original construction

Some parties view this to be the only benchmark for the construction works carried out – the building is completed on time, at the right price and to the right quality. However, this does not recognise the appearance of defects and the continued operation of the building and identifying who bears the risk for them.

Repair, renewal and reinstatement obligations for the building in use

This is important in the context of leasehold properties, where it is important to establish who has these obligations – do they remain with the landlord or are they passed to the tenant? Once this is identified, you need to establish how the relevant party is in a position to meet those obligations.

Responsibility for facilities management

This will be a consideration the property investment is structured within a property outsourcing or PFI/PPP model.

Latent defects insurance

Other than in relation to housebuilding (e.g. NHBC) or large scale development, latent defects insurance is not often used.

Suits you?

Traditional procurement

If not dying out altogether, this tradition is on the wane. It is best suited to those circumstances where the client/end user has very fixed ideas about how the development should be carried out and is not working to the tightest of timetables. More suitable for bespoke developments.

Design and build

The market leader for most development in the UK, allows the contractor to bring its expertise in the construction process to the fore. Requires the preparation of a set of employer's requirements that are responded to by the contractor's proposals. Some clients will use it as (in their eyes) a way of imposing exactly the design they want but passing all responsibility to the contractor ("design and dump"). Will be used on the majority of retail and commercial developments.

Construction management

Often viewed with scepticism, usually unnecessarily so – often advisers will point to a lack of single point responsibility (as compared to design and build). Regularly used by large developers such as Stanhope and Canary Wharf. Landmark schemes built using construction management include Paternoster Square.

Partnering

Its proponents consider it the best thing since sliced bread, while its critics consider it a foolhardy notion of motherhood and apple pie. Clichés apart, it is being used on an increasing number of projects – particularly in the social housing sector – and should be considered where there is a pattern of repeat business.

The runners & riders?

The interested parties

Often have wide powers in terms of visiting site, attending meetings, making representations and the all-important right to step-in. Despite all this power, it is amazing how little it is ever used.

The professional team

Often involved for months when a project is still speculative, long before the small matter of contract arrangements is raised. Unsurprisingly, professionals would prefer to work on the terms of their own professional bodies – so it is important to establish what contractual terms are to apply from the outset. Many inadequately advised developers find themselves with a mismatch of expectations by not addressing this early enough.

The contractor

Contractors now approach the matter of construction contracts in a more considered way – they tend to carry out their own risk assessments if the client does not provide a risk register and are not reluctant to look for parent company and other guarantees from their clients.

Sub-contractors

Furthest removed from the property investment deal in the contractual chain, the sub-contractors will carry out the vast majority of the works. The key point to consider is the context of the sub-contractor's involvement – what is the financial strength of the sub-contractor compared to the contractor? Is their involvement material (either in terms of design or quantity)?

Insurers

The insurers do not enter into any of the construction agreements but they do sit behind most of the construction contracts that are placed, usually in the context of professional indemnity insurance. One of the key difficulties is where there is an unrealistic expectation of what a contractor or professional consultant will be prepared to sign. This one is easy to spot when, at an advanced stage of negotiations, the negotiating tool of “that clause isn't covered by my PI insurance” is used.

Are we there yet?

When the contracts are placed, it might be tempting to put them in the drawer, never to see the light of day again. This is not usually possible.

Variations

Variations arise on the vast majority of construction projects, whatever anyone might say to you. The contracts should deal with them fluidly and effectively. Parties should watch out for the time bar clauses.

Fitting out

Many development schemes will require fitting out works to be concurrent with the main contract and sometimes this will involve a separate contractor. As well as statutory issues arising (such as the issue of who is to be the principal contractor) contracts will need to deal adequately with co-ordination and co-operation that ensues.

Monitoring

Interested parties should have the power to monitor the works being carried out and make representations relating to them. You should use the powers at your disposal but care should be taken with regard to unintended consequences.

Practical completion

Often a source of contention – how many contracts are left with the elephant test (you can't describe it, but you know what it is when you see it). In many cases, particularly when the completed building has a specialised use, you should consider setting parameters for practical completion.

The defects period

Contracts will have a defects liability period and care should be taken to line this up with other requirements. Something that is typically overlooked is the gap between the end of the defects liability period and the start of cover under the latent defects policy.

Is that it?

The construction process is often fraught and usually leaves those involved with it with a great deal of experience. At one end of the scale, this experience draws the words “don’t ask me to get involved with that again”. The opposite end provokes those involved to see what lessons can be learnt for next time.

Better asset management

The larger the portfolio, the more impact the slightest change can have. For those investing in property as the core part of their business, it’s madness not to evolve their construction procurement to allow better asset management.

Strategic decisions

Increasingly, business is considering its next steps in terms of strategic decisions, such as – is it time to outsource the property portfolio?

Benchmarking against industry best practice

It is possible to benchmark what is and has been achieved under construction contracts and compare those to industry best practice. To make this a dynamic process,

KPIs

If a set of key performance indicators can be agreed, it is possible to review the performance of the parties to the contract. Although the concept is well settled, agreeing the KPIs themselves can often be the stumbling block. Currently not used on a wide range of developments.

Audit

The final piece in the jigsaw – if the process aspects of construction procurement are not checked, it’s unlikely that they will have a meaningful effect.

Further Information

For those who attended, we hope that you found the presentation useful and that these notes serve as a concise reminder of the topics covered. The presentation touched upon a number of key topics about which there is much more to say – please contact us if you would like to go through any of the subjects in more detail.

For those who received a copy of the presentation from a colleague or via a mailing, we hope that you find the notes to be a useful stand-alone reference for these key topics. If you are interested by what you have read, please contact us to discuss further – we would be pleased to discuss running the presentation for you in-house (complete with CPD points!).

We welcome your feedback on this presentation and your suggestions for future events.

Please forward your enquiries and comments to Kassiani Tzanou kassiani.tzanou@laytons.com.

These notes provide only a general review of the legal topics they cover and thus cannot be relied on for any particular case. The need for specific legal advice should always be considered.