

Letter of Intent

Stefan Berry

Junior Associate

E: Stefan.Berry@QuiggGolden.com

T: +44 (0)28 9032 1022

This article provides an overview of the legal implications of using letters of intent. It sets out the risks and the potential advantages using a letter of intent (“LoI”) can have for both employers and contractors.

Over the past month I have had several queries from clients regarding Lols. These queries have ranged from minor clarifications to potentially serious issues. The construction industry’s affinity, or problem, depending on your perspective, regarding Lols is very understandable. Often in projects there are items with long lead times to be ordered or preparatory work that needs to take place. Given the length of time full contract negotiations can take the use of a LoI as a stop gap can be a commercially sensible action. However, they can lead to headaches through either misuse or misunderstanding of the potential legal ramifications. All parties to construction contracts and using Lols should heed the words of Lord Clark in *RTS Flexible Systems v Molkerei Alois Muller* about the:

“Perils of beginning work without agreeing the precise basis on upon which it is to be done. The moral of the story is to agree first and start work later.”

‘Letter of intent’ as a name does not hold any legal significant and can be used to describe any pre-contractual document which indicates an intention to enter into a contract and generally asks the contractor (or sub-contractor) to begin some aspects of the works or design prior to full agreement and execution of the contract. LoI generally fall into three categories:

1. Non-binding statements of intention (category 1);
2. Interim contract containing its own terms (category 2); or
3. A final contract i.e a construction contract in its own right (category 3).

The first step in establishing what category your, or any, particular LoI falls into is to establish whether or not it is binding. This means establishing to what extent the LoI may be a contract. This will largely be determined by assessing the specific language of, and communications around, the LoI. As a result, there is no one set of rules or a conclusive checklist that can be used to determine whether a particular LoI is definitely binding. Key features however to look for in determining whether the LoI is binding are:

1. Does the LoI require the contractor or subcontractor to carry out some aspect of work e.g. preparatory work?
2. Does the LoI provide for payment of this work i.e. is the employer or contractor promising to pay for the preparatory work, or aspects of it?
3. Does the LoI expressly outline that it is not intended to create legal relations, for instance, has it been marked subject to contract?

England

Quigg Golden Solicitors
Central Court
25 Southampton Buildings
Chancery Lane
London WC2A 1AL

+44 (0)20 7022 2192
London@QuiggGolden.com

Quigg Golden Solicitors
1 Tonbridge Road
Maidstone
Kent ME16 8RL

+44 (0)1622 541 700
SouthEast@QuiggGolden.com

Ireland

Quigg Golden
31 Waterloo Road
Ballsbridge Dublin 4

+353 (0)1 676 6744
Dublin@QuiggGolden.com

Northern Ireland

Quigg Golden
18-22 Hill Street
Cathedral Quarter
Belfast BT1 2LA

+44 (0)28 9032 1022
Belfast@QuiggGolden.com

Kingdom of Saudi Arabia

Quigg Golden
P.O. Box 18623
Jeddah 21425
Saudi Arabia

+966 (0)2 651 8222
Jeddah@QuiggGolden.com

If it is not clear whether any work is required as a result of a Lol, there is no provision for payment and it is marked 'subject to contract' or it outlines that the Lol does not form a contract then it is likely a Lol will fall into category 1 and not be binding on either party. Given this type of Lol is not binding on either party it allows flexibility as the contractor may walk away at any point without notice and similarly the employer can instruct the contractor to stop work at any point. There is also an equal amount of uncertainty and risk regarding for instance the time to complete the works, site access, control over materials, relationships with third parties or liability for defects. Furthermore under this type of Lol payment is likely only due on *quantum meruit* basis i.e. fair payment for the work done. *Quantum meruit* however, requires the employer to have had the benefit of the work. If for instance, a contractor was completing an element of design under a Lol, if the employer instructs the contractor to stop working under the Lol prior to the aspect of design being completed and without the work thus far being provided to the employer it is unlikely the contractor will be due payment at all. Furthermore, given this category of Lol isn't a contract there will be no right for a dispute to be referred to adjudication.

A Lol will fall into category 2 if it appears to be binding based on the above criteria but has an expiry date for parties to have executed a final contract by or a cap on how much can become due for payment under the Lol. This is a Lol which is binding for an interim period at which point either party can legally walk away from the project if they wish, if say it is clearly not commercially viable, or agreement cannot be reached in an aspect of the contract. Employers or contractors that are sub-contracting under a Lol should ensure that any Lols falling into this category do include a cap on the amount to become due to ensure they do not become due to pay unexpected amounts. Key though is the actions of the parties following the expiry of the Lol if they continue to proceed with the works. The parties may either be deemed to have entered to any contract they have been negotiating or the work proceeds with no contract at all and therefore there will be no liability for defects or delay etc.

A category 3 Lol is a construction contract in its own right. It may be due to the content of the letter incorporate terms, such as NEC3 Option A or a JCT D&B by reference. Despite the formal execution provisions in those contracts it may be determined that the parties are taken to have set aside a need for these formal execution requirements. A contract will not however fall into category 3 where any of the following are present:

1. A lack of agreement in a manner that the parties consider necessary or might objectively consider necessary or the final contract;
2. Continuing negotiation on factors that are material such as scope of the works, contract price or date or period for completion; or
3. There is an element in the letter which is inconsistent with the incorporation of standard terms, or there is a clear pre-condition set out for conclusion of the final contract which has not yet been met.

Given however the strict formal requirements for executing documents as a deed, the Lol or referenced form of contract and as a result the period of liability under the contract will only be 6 years.

Our general recommendation is generally that there is no substitute for a properly drafted contract accurately reflecting the agreement between the parties to a project, often ambiguity breeds dispute. Where a Lol is used though it should be drafted to fit into the most appropriate category for the project, to ensure the appropriate risks can be managed.



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