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# *Letters of Intent: Overcoming the Pitfalls*

## Introduction

No matter how forcefully lawyers may counsel against them, letters of intent (otherwise known as letters of authority or letters of instruction) have an established position in the commercial and administrative landscape of the construction industry in the United Kingdom. There is, to a certain extent, good reason for their use. In the real world where deals are struck and offices, schools, hospitals and homes, etc. are built, factors such as materials shortages, stakeholder expectations and aggressive programmes can trigger a need to "get on with the job" long before contract negotiations have come to an end and the lawyers have finished playing with words.

Authorising activities under a Letter of Intent ("LOI") has practical advantages for employers and contractors alike. An LOI can, as previously suggested, alleviate programme constraints by enabling certain activities to be progressed pre-contract, such as:

- off-site pre-construction activities;
- the instruction of subcontractors/suppliers e.g. for prefabricated items, steelwork, etc.; and/or
- the instruction of site remediation (in advance of full planning permission), enabling works and other (limited) on-site activities.

Open-ended commitments are, however, extremely unwise, both legally and commercially. Work should not be allowed to continue in perpetuity under an LOI as it is no substitute for formal contract terms, and will not (unless carefully drafted and administered) afford the parties a satisfactory degree of protection. This paper highlights many of the common problems with the drafting and general use of LOIs with reference to some of the more recent judicial decisions on the subject and offers some practical advice to those using LOIs on a regular basis.

## Overriding objective: certainty

There are no significant standard forms in use other than the RIBA model form[1] to give users the comfort of adopting a truly tried and tested formula. Whilst the majority of LOIs prepared by lawyers and surveyors contain familiar expressions and "standard" concepts, much of the detail is bespoke, drafted to suit specific commercial requirements. The starting point is generally the employer's view of what needs to be achieved under the particular LOI. This is then considered and often modified by the contractor or consultant to whom the instruction is to be issued to reflect its own expectations. Eventually an agreement will be reached, but whatever the terms, the LOI needs to be a clear and unambiguous record and an accurate reflection of the parties' intentions. This is easier said than done when LOIs are often prepared, considered and executed in haste with insufficient regard to future requirements.

The short entry on LOIs in Keating in the section on Offer and Acceptance illustrates the basic difficulty with such letters: *"It is a question upon the facts*

1. Figure J.01 of the *Architect's Job Book* 6th Edition 1995: "specimen letter to contractor notifying early start to main contract works".

*of each case whether the sending of a letter of intent can give rise to any, and if any, what, liability".*[2] Over the years, the courts have applied a variety of interpretations to LOIs, not all of them contractual:

- suppliers of steel castings were held entitled to "a reasonable sum" in restitution or quasi contract (*British Steel v Cleveland Bridge*);
- an LOI has been construed as an "agreement of indemnity in respect of reasonable expenditure incurred" (*Drake & Scull v Higgs and Hill*); and
- receipt and acceptance of an LOI has been considered as contractually binding on both parties (*Wilson Smithett v Bangladesh Sugar*).[3]

Some commentators have concluded that no contract will be formed under an LOI in the absence of other circumstances which themselves amount to a contract, such as the subsequent conduct of the parties. Therefore in order to address parties' intentions more adequately, an intermediate concept[4] is needed, and any such concept should place greater emphasis on the attitudes and expectations of the business community. However, where does this leave us until the law catches up with industry practice?

Coulson J in his judgment in *Cunningham and Others v Collett and Farmer*[5] cites the same passage in Keating when describing the two main types of LOI. Firstly, those such as the RIBA form which are drafted to avoid liability on the part of the employer, and secondly, those which give rise to specific and limited liabilities. In considering whether the use of an LOI amounted to negligence in the context of the claim, Coulson J said that whilst LOIs were in his opinion used far too often in the construction industry, there are circumstances where they may be appropriate, such as:

- where the scope and price are agreed or there is a clear mechanism for agreement;
- where the contract terms are (or very likely) to be agreed;
- where the programme, start and finish dates are broadly agreed; and
- there are good reasons for starting work in advance of finalising the contract documents.

Coulson J concluded in Cunningham that use of the LOI was not of itself negligent because the outstanding matters had been properly assessed by the defendants, who reasonably considered the matters in question to be straightforward and "could properly be resolved without too much difficulty".

So if an LOI must be issued, there are several ways in which the parties can ensure that the document is legally binding. A binding LOI has essentially three fundamental elements: (a) intention to enter into a binding agreement; (b) certainty of terms and of dealings; and (c) consideration. These are examined in greater detail below.

## Key elements

Identity and intention of the parties: it would seem self-evident that the parties must be known to each other and have reached a consensus as to the purpose of the correspondence between them. Yet even these basic principles appear to present a challenge for certain parties engaged in activities pre-contract. Care should always be taken to ensure that each party understands the purpose of the proposed LOI and that each party intends it to be binding until superseded by a formal contract (subject to agreement of satisfactory terms).

2. *Keating on Construction Contracts*, 8th Edition 2006, p.21
3. [1984] 1 All Er 504; [1995] 11 Const L. J. 214; [1986] 1 Lloyds Rep. 378
4. "between the black of restitution and the white of traditional contracts" SN Ball (Work carried out in pursuance of letters of intent – contract or restitution?) LQR Oct. 1983
5. *Cunningham and others v Collett and Farmer* [2006] EWHC 1771 (TCC) Judge Peter Coulson

LOIs are frequently issued by surveyors and project managers on behalf of their clients for expediency; however, this practice is best avoided whenever practicable. A contractor would not accept a JCT contract executed by any party other than the contractor's ultimate employer; therefore the same discipline should apply to the signature and issue of a LOI.

Certainty of terms: Much of Field J's judgment in *Hackwood v Areen Design Services*[6] considers the validity of arbitration as a process for dispute resolution when it has been argued that no formal contract was entered into. However, the judgment also includes an interesting commentary on the incorporation by reference of JCT standard terms where aspects of the contract have yet to be negotiated or are otherwise incomplete.

The case concerned the refurbishment of a grade 2 listed building in Hampshire known as Hackwood House. Final contract terms were never agreed, therefore work proceeded under an LOI between June 2001 and July 2003. If outstanding matters had been agreed the parties expected to execute a formal JCT Contract with Contractor's Design (1998 Edition). Practical completion was eventually certified in September 2003. Areen Design Services ("ADS") applied for certain extensions of time and for additional payments for claimed variations. ADS took its claims to adjudication when Hackwood rejected their applications and lost. Therefore in January 2005 ADS gave notice of a referral of the dispute to arbitration.

As part of the referral to arbitration ADS pleaded that the LOI incorporated the terms of the JCT contract which included an agreement to arbitrate contained in Article 6A and clause 39B. During the course of negotiations ADS had submitted Contractor's Proposals on the basis of the JCT standard terms; however, when Hackwood finally presented its Employer's Requirements and a copy of the JCT Contract, it also proposed some amendments to the standard form. The amendments were still being debated when ADS agreed to commence works under an LOI. The instruction from Hackwood confirmed the price for the works, the programme for on-site activities and the form of contract *without making reference to any bespoke amendments*.

Counsel for Hackwood argued that the parties could not have intended to incorporate the terms of the JCT when they were still negotiating the terms of the final contract. This submission was however rejected by Field J who concluded that the object of the LOI was to establish the terms of an interim contract that the parties appreciated might govern the whole project. The parties had not agreed which of the options set out in the Appendix to the JCT were to apply, but the Judge considered that where the JCT Appendix specifies a choice, and where none of the options is selected, the choice will still apply. Failure to agree certain terms did not mean that the JCT Contract was void for uncertainty.

In reaching his decision the Judge rejected the decision in *Amec Capital Projects Ltd v White Friars City Estate Ltd*[7] where LLoyd J was of the view that:

> Unless the options are selected and the Appendix is completed the form is incomplete and unusable and lacks the certainty required for the contract and envisaged by it.

The robust interpretation which Field J applied to the letter may not necessarily find judicial support in future, therefore it is important to refer to standard terms and any amendments under negotiation when referring to the form of contract in any instruction.

Scope and duration of instruction: The instruction should clearly identify the activities authorised under the LOI either by reference to a schedule of

6. *Hackwood Ltd v Areen Design Services Ltd* [2005] EWHC 2322 (TCC) Mr Justice Field
7. [2003] EWH23 (TCC)

activities or by incorporating specific activities in the main body of the letter. Where a Programme has been agreed, appending a copy may also assist in defining the scope and duration of the authorised activities. A clear start date, and preferably an expiry date or specific event triggering expiry, is also recommended. An express expiry date imposes a certain amount of discipline on the parties to finalise their contract negotiations in a timely manner following signature of the LOI.

Monitoring expiry dates is perhaps an administrative burden, however we are of the view that it is better to invest time in doing so, and in issuing supplemental agreements extending the instruction, than to permit the letter to operate on an indefinite basis. The risk of the terms being varied by conduct and maximum financial commitments being exceeded without such changes being addressed contractually is much greater in LOIs unlimited in scope and/or duration.

From an employer's perspective, express termination and suspension provisions are recommended, particularly in the context of LOIs authorising on-site activities. As an interim contract, employers are advised to seek to ensure that an LOI is always capable of termination at any time at the employer's discretion and that loss of profit/loss of contract claims are excluded. Contractors will understandably hope for a more balanced approach to termination and/or suspension, and are advised to seek terms permitting recovery of cancellation costs and any costs associated with demobilisation and remobilisation.

Price and payment: Price can be one of the most contentious aspects of a contract negotiation, so it may not be possible to confirm even the estimated contract sum in an LOI at the time of issue. The parties should nevertheless be in a position to price specific activities or to refer to an appropriate schedule of rates. The employer will be reassured by any measure of cost control that can be introduced into the LOI, whereas the contractor may prefer to leave prices undefined.

Where activities authorised under an LOI are for 45 days or more, a payment mechanism compliant with the Housing Grants, Construction and Regeneration Act 1996 ("the Act") will be implied if no express reference is made to payment terms. The parties may alternatively elect to apply the payment terms of the proposed contract.

Whilst the payment mechanism was not central to the discussion in *Allen Wilson and Buckingham*,[8] the judgment did touch on the complications that can arise over payment when an LOI has been allowed to lapse.

The claimant contractor seemed unsure how to claim its "perceived financial entitlement" for the valuations falling outside the only signed LOI for the works. Previously AWS had applied the payment mechanism of the proposed form of contract, but during the adjudication sought to rely on the Scheme for Construction Contracts in the Act. The adjudicator relied on the terms of the contract referred to in the LOI and the court was persuaded that (on the particular facts) this reasoning was sound. The defendant had sacked his surveyor but was, by his own admissions, administering the contract himself, therefore the payment mechanism remained in place and was unaffected by the change of administration.

Limitations on liability: Well-advised employers generally cap their financial and legal liabilities to a contractor or consultant under an LOI to a specific amount. This is usually equivalent to the value of the activities to be instructed, however if the scope of the instruction is uncertain when an LOI is issued, the parties may agree a cap on a more general basis. The cap should be

8. *Allen Wilson Shopfitters v Mr Anthony Buckingham* [2005] EWHC 1165 (TCC) Judge Peter Coulson

substantial enough not to stifle activity under the letter, but ought not to be so generous as to obviate the need for the parties, more particularly the contractor, to settle the formal contract terms. Financial caps, like expiry dates, can always be revisited if at any stage an LOI needs to be renewed.

Some contractors are now paying closer attention to their own liabilities under an LOI, for example in the context of LOIs used to instruct pre-construction phase activities in two-stage procurement. Unless an employer is prepared to concede similar limitations in the proposed contract, concessions to the contractor in the LOI are best avoided unless the limitation can be ring-fenced to apply to professional and/or off-site activities only.

## Common pitfalls

In addition to failing to accurately reflect the intentions of the parties, poor drafting can lead to a variety of other problems:

Scope/duration unclear: As lawyers we are frequently asked to review LOIs expressed to authorise the contractor or consultant to proceed with the whole of the works or services for an indefinite period and either for full value or an unconfirmed sum. On such terms, there is very little incentive for the contractor or consultant concerned to cooperate with the employer so as to conclude a formal contract.

Uncertain status of adjudication: The questionable status of LOIs as creatures of contract can also cause procedural problems when disputes arise during the course of authorised works. *Bennett v Inviron*[9] was an application to enforce an adjudicator's award. The dispute involved work undertaken by Bennett under an LOI with Inviron during the course of electrical installations at a project in Wimbledon. Bennett referred the matter to adjudication in 2005. Inviron asserted that the adjudicator had no jurisdiction as there was no binding contract between the parties necessary to comply with s.107 of the Act.[10]

The adjudicator agreed and declined to make any determination, therefore Bennett referred the matter to a second adjudicator. That adjudicator concluded that he did in fact have jurisdiction and found in favour of Bennett, but Inviron refused to pay. Inviron raised several jurisdictional challenges, including the submission that as there was no contract (simply an LOI), any remedy that Bennett might have was restitutionary and so outside the scope of s.107 of the Act.

In considering the adjudicator's award, the court had regard to various matters of fact: whilst the terms of Inviron's own contract and the proposed form of subcontract with Bennett were mentioned, the LOI was clearly identified as an LOI and headed "subject to contract"; the letter also referred to a meeting between the parties but did not elaborate as to the significance of the meeting or the terms agreed at it; and although a price for Bennett's work was confirmed, subsequent valuations well exceeded that price and the scope of work was varied.

Wilcox J concluded that the parties did not intend that the LOI should have contractual effect, as express and material terms were not specifically recorded in it or incorporated by reference in a manner satisfying s.107. Therefore even if the LOI had not been subject to contract the agreement between the parties as evidenced by the letter had to comply with the Act. The adjudicator had no jurisdiction and Bennett's application for summary judgment was dismissed.

Contractual uncertainty was again an impediment to proper interpretation and thus a bar to adjudication. In other cases, however, the courts have found

9. Bennett (Electrical) Services Limited v Inviron Limited [2007] EWHC 49 (TCC) Judge David Wilcox
10. Section 107 states:
1. The provisions of this Part apply only where the construction contract is in writing, and any other agreement between the parties as to any matter is effective for the purposes of this Part only if in writing.
The expression 'agreement', 'agree', and 'agreed' shall be construed accordingly.
2. Where there is an agreement in writing -
a. If the agreement is made in writing (whether or not it is signed by the parties)
b. If the agreement was made in exchange of communications in writing; or
c. If the agreement is evidenced in writing.
3. Where the parties agree otherwise than in writing by reference to terms which are in writing, they make an agreement in writing.
4. An agreement is evident in writing, if an agreement made otherwise than in writing is recorded by one of the parties, or by a third party, with the authority of the parties to the agreement.
5. An exchange of written submissions in adjudication proceedings, or in arbitrary or legal proceedings in which the existence of an agreement otherwise than in writing, is alleged by one party against another party and not denied by the other party in his response constitute, as between those parties, an agreement in writing to the effect alleged.
6. References in this Part to anything being written, or in writing, include its being recorded by any means.

enough in the terms of agreement and in the conduct of the parties to conclude that the adjudicator did have the necessary jurisdiction to reach a decision on an LOI, therefore the factual background to a dispute under an LOI assumes greater importance for the party wishing to rely on adjudication as a means of dispute resolution.

Instruction not renewed following expiry or renewal letter not accepted: In *ERDC v Brunel*,[11] the ERDC was engaged to construct new sports facilities for Brunel's Uxbridge campus. ERDC had submitted a tender based on a JCT Standard Form of Contract with Contractor's Design (1998 Edition). It was decided that the parties would defer formal contract execution until full planning permission for the project was obtained, and that pending the planning decision, ERDC would progress the works under an LOI.

Requests for payment were issued as if the JCT terms applied, using the rates and prices in the original tender. Several LOIs were issued during the course of the works but the contract was still not executed when the last renewal letter expired. ERDC nevertheless continued to work without the benefit of a supplemental letter for a further six months. When the contract documents were finally presented for execution ERDC refused to sign them. The contractor indicated that it would only continue to work for Brunel on the basis that a *quantum meruit* valuation would apply.

When the case came before the court, LLoyd J had no difficulty in finding that there was a clear intention to create legal relations, and the work and programme requirements were sufficiently described to avoid uncertainty. Lloyd J therefore concluded that all work carried out pursuant to the LOIs had been carried out under the contract contemplated by the last letter and so was to be treated as valued in accordance with its terms and not on a *quantum meruit* basis.

ERDC was, however, entitled to be paid on a *quantum meruit* basis for the work carried our after the date of expiry of the last letter. Nevertheless, since the conditions under which the later work was carried out did not differ materially from the conditions under which the rest of the work was carried out, the later work would be valued on the basis of ERDC's contract rates and not on a cost plus profit basis.

Monetary limits exceeded: Financial thresholds may be exceeded in a number of ways. Most commonly, authorised expenditure is exceeded and goes unchecked when a limited LOI expires and is not renewed, or agreement as to renewal cannot be reached. Similarly, an employer's maximum aggregate liability cap, which was in all probability hard won in negotiations, may be waived by conduct if the employer continues to pay out sums in excess of the cap, whether or not the general authority conferred by the LOI has expired.

In the *Buckingham case*, much of the work carried out by AWS was not included within the two lump sum items referred to in the letter of intent and certainly not the work carried out in the two contested valuations. The court nevertheless found that, as it was work that the supervising officer had authorised on behalf of the defendant, AWS was entitled to be paid in accordance with the terms of the proposed contract. Employers should, accordingly, always have an eye to the budget and be wary of issuing or permitting the issue of instruction to a party under an LOI which pushes the boundaries of the sums authorised under it.

Terms insufficient for on-site activities: A common pitfall for many employers is the use of LOIs intended only for off-site activities in a physical works context. The complexity of on-site activities from a liability perspective means that the parties are best advised to confine activities under an LOI to off-site works

11. *ERDC Group Limited v Brunel University* [2006] EWHC 687 (TCC) Judge Humphrey LLoyd

and/or services wherever possible. It can be helpful to use express terms to prohibit on-site activities so that the parties are compelled to vary the scope of the instruction formally before on-site works can commence.

LOIs authorising on-site activities are very different documents from those serving a more limited purpose. A limited letter will therefore be deficient in a number of fundamental ways if relevant terms of the proposed contract are not incorporated by reference and the LOI is silent on matters such as:

- works insurance and insurance for public/third-party property liability;
- indemnities for personal injury and/or death;
- site establishment and health and safety requirements such as CDM Regulations compliance;
- nuisance trespass in relation to adjoining owners and occupiers;
- (where appropriate) a duty of reasonable skill and care of a competent designer and professional indemnity insurance requirements;
- subcontracting arrangements (including a right for the employer to take over a subcontract or supply contract in the event of termination of the instruction).

## Conclusions

The practical issues surrounding and the judicial opinion flowing from disputes generated or exacerbated by the use of LOIs clearly demonstrate that LOIs are documents requiring serious consideration and, as such, should not be entered into lightly. Parties are best advised to put formal contract negotiations first so that the contract is not treated as an afterthought and, where possible, to seek other means of managing their commercial arrangements, such as placing smaller more limited contracts for early works if there are particular pressures to begin work in advance of agreeing the main contract. Where the parties have no alternative but to proceed on the basis of an LOI, its terms demand equivalent time and attention as formal contract terms (particularly where on-site activities are being authorised).

Avoid ambiguity, as neither party may benefit from it in the long term if the LOI is tested in an adjudication or in court proceedings. Have a positive eye to the future and to the successful conclusion of contract negotiations by including a clear statement in the LOI that the terms of the contract will take precedence and have retrospective effect. Finally, make sure that you do your housekeeping a well-drafted LOI is only as good as those who manage it. Ensure that renewal dates are documented, reviewed and met, and that authorised expenditure is not exceeded, if there is really no alternative but to issue a supplemental LOI. The terms of any supplemental letter should be discussed well in advance of the expiry of the earlier LOI so neither party is facing a “showdown” over the drafting which might lead to a legal vacuum where an instruction has expired and there is no contract in its place.

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