

Letters of Intent – Beware of the Risks



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Abstract

In a perfect world, work on a construction contract should not commence before a full and complete contract has been executed by the parties. It is, however, often desirable for work to commence before the formal agreement has been signed. In such circumstances, it is common practice to issue a letter of intent to enable the selected contractor to start work. Whilst this is a convenient solution to bring the contractor on board as early as possible, letters of intent are sometimes problematic and subject to dispute.

Disputes can arise over the interpretation of the obligations of the parties, such as whether the letter of intent has created a binding agreement or not. A letter of intent is fundamentally an agreement by the parties today to enter into a contract in future, with the expectation that the parties will reach agreement on the terms and conditions of that future agreement. In the case of *Turriff Construction Ltd v Regalia Knitting Mills (1971)*, the courts expressed the general rule that a letter of intent is “the expression in writing of a party’s present intention to enter into a contract at a future date” and that only in exceptional cases would it have a binding effect (Turner 2010). In the more recent case of *Diamond Build Ltd v Clapham Homes Ltd (2008)*, the courts identified three types of letters of intent. The first is a “pure” letter of intent, the second is a simple contract which is intended to be superseded by a formal contract and the third is a whole contract with no intention of a future contract.

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Introduction

The term ‘letter of intent’ is familiar to most construction professionals, yet not all practitioners are fully aware of

the true meaning and the potential risks associated with such letters.

What are letters of intent? Kelly (2007) states that ‘A letter of intent is a statement of intention that outlines an intended agreement between two or more parties’. Fairclough & Chance (2004) state that ‘A letter of intent ordinarily expresses an intention to enter into a contract in the future but creates no liability with regards to that future contract’. For this reason letters of intent are often called ‘if’ contracts.

What are the reasons for issuing letters of intent? According to McMullan (1991) the reasons for issuing letters of intent include the following;

1. Delay in reaching agreement of all contract terms or delay in preparation of the formal agreement.
2. The need for early commencement of works or for ordering of materials.
3. A declining use of letters of acceptance in favour of extensive negotiation with the successful tenderer.

Whilst a letter of intent may be issued for one or more of the above reasons and with no intention of constituting a contract between the parties, a letter of intent can, in certain circumstances, create a contract, albeit unintended by the parties.

A letter of intent is an interim arrangement before a contract is agreed and signed. Letters of intent should not be considered as substitutes for a properly drafted contract, but merely as a safeguard of legal rights whilst the contract is being finalised (Kilvington 2002). Where parties do not enter into a formal agreement but rely on a letter of intent, the consequences can be very costly.

In *Monk Construction Ltd v Norwich Union Life Assurance Society (1992)* the Court of Appeal found that the letters of intent can give rise the following three possible scenarios;

1. There may be no contract at all. i.e. pure letter of intent.
2. There may be an ordinary contract.
3. There may be an “if” contract.

Similarly, in the case of *Diamond Build Ltd v Chlapham Homes Ltd (2008)*, the courts recognised and confirmed that three types of letters of intent exist:

1. Pure “letters of intent” which do not give rise to contracts at all;
2. Simple contracts, which are capable of being binding, but are entered into with the intention that they will be superseded by subsequent finalisation and execution of the formal contract; and
3. Those that are (so far as they go) the whole contract (which may be supplemented by verbal agreements, or even need further terms implied into them), with no intention that they will be superseded by a formal contract.

In deciding whether a letter of intent falls into one of the three types mentioned above, the courts have taken into account both the wording of the letter of intent and the perceived intention of the parties at the time of its issuance.

Quantum meruit

Before exploring the various types of letters of intent, it is helpful to review the related subject of quantum meruit and claims in relation thereto. Quantum meruit generally means reasonable remuneration for work performed at the request of another.

Pickavance (1997) categorises quantum meruit as either “contractual quantum meruit” or “resitutionary quantum meruit”. Contractual quantum meruit is a claim for reasonable remuneration under a contract. Resitutionary quantum meruit will arise where there is no agreement between the parties or where the agreement between the parties has been frustrated, voided or has become unenforceable.

Where a letter of intent has failed to materialise into a contract or where no clear definition of the value of work

to be performed has been agreed by the parties, then a claim for restitutionary quantum meruit may arise. Restitutionary quantum meruit will not apply if there is a contract, in which event and the terms and conditions of the contract will prevail.

If a Letter of Intent is Non Binding

As mentioned above, a letter of intent, in principle, is not a contract. When work is carried out under this type of arrangement, and no contract is subsequently entered into, a contractor will usually be entitled to be paid on a quantum meruit basis. In such circumstances, there will be no fixed date for completion and the employer will not be able to deduct liquidated damages for delay. It was held in the case of *Murphy v Brentwood District Council (1990)* that in the absence of a contract agreement, the contractor will not be liable for negligence for defects in the building. (*Fairclough & Chance 2004, p2*).

The principles affecting the formation (or not) of contracts where an offer or acceptance is said to be “... subject to contract...” were set out extensively in *Masters v Cameron (1954)* (*McMullan 1991*). The High Court concluded that the words used by the parties are not the sole consideration for deciding if contract was formed or not. The intention of the parties, as evidenced by the circumstances in each case, is a critical matter to be discerned by the court.

In the case of *British Steel Corporation v Cleveland Bridge and Engineering Company Ltd (1984)*, Cleveland Bridge wrote to British Steel advising of its intention to enter into a supply contract and proposed a number of terms, (which were never agreed) and to proceed with the works. The parties continued to correspond each asserting their preferred terms, but never reached an agreement. British Steel subsequently completed delivery of the materials. Cleveland Bridge claimed that the delivery was late and that British Steel was liable for damages. The delivery schedule was one of the items not agreed by British Steel. The court found that;

1. No contract had been formed
2. British Steel was entitled to recover on a quantum meruit basis
3. It was possible for a contract to be created by a letter of intent although it was not the case in this particular instance.

In relation to whether a contract had been created, the trial judge re-affirmed that;
“there can be no hard and fast answer to the question whether a letter of intent will give rise to a binding agreement, everything must depend on the circumstances of the particular case”

In summary, if the letter of intent is non-binding then the following would be some of the key rights and obligations of the parties:

1. The contractor is entitled to be paid on a quantum meruit basis for work performed
2. The employer will not be able to claim damages for delay
3. The contractor will not be liable for defects
4. Limitation for action would be 6 years

If a Letter of Intent is Binding

According to Murdoch and Hughes (1997), a letter of intent itself does not usually give rise to any legal rights and obligations. There are exceptions to this general rule. In the case of *Turriff Construction Ltd v Regalia Knitting Mills Ltd* the court held that the letter of intent constituted a contract. In that case, the plaintiffs (*Turriff Construction Ltd*) were advised that their tender for designing and building a factory building for the defendants (*Regalia Knitting Mills Ltd*), was successful. The Plaintiffs asked for ‘an early letter of intent.....to cover us for the work we will now be undertaking’. The defendants issued a letter stating ‘the whole to be subject to agreement on an acceptable contract’. The Plaintiffs carried out design work necessary to seek planning permission and obtained estimates. Six months later, the defendants abandoned the project. The court held that the plaintiffs had made it sufficiently clear that they wanted an assurance of payment for their preparatory work in any event, and that the letter of intent constituted that assurance and therefore the plaintiffs were entitled to be paid.

Fairlough and Chance (2004) have quoted two other instances where the courts have held that letters of intent formed a contractual relationship. Generally, the inclusion of the words “subject to contract” would lead the courts to the conclusion that the parties did not intend to be bound by the letter of intent. However, in the case of *Harvey Shopfitters Ltd v ADI Ltd* (2003) the Court of Appeal found that the court is entitled to look behind the apparent or literal meaning of the words of a letter to determine the parties’ true intention. The

courts will analyse each letter of intent as a whole. As a consequence, even express wording, such as “we do not intend to create legal relations”, may not be sufficient to avoid the courts finding that the letter of intent is in fact a binding contract.

In another case, *Tesco Store Ltd v Costain Construction Ltd* (2003), the judge – emphasising the importance of the intention of the parties to be legally bound – found that a letter of intent issued by the developer, a copy of which had been signed and returned by the contractor, did amount to a simple contract. In addition, there were terms implied into the contract such that the contractor would perform any construction work in a good workmanlike manner, and that any design element would be reasonably fit for its intended purpose.

If there is a binding letter of intent and a full contract is subsequently entered in to by the parties, the terms of the contract will govern retrospectively the works carried out under the letter of intent. Where there is a binding letter of intent but no final contract has been entered into by the parties, the works will be based on the terms of that binding letter of intent.

Including the above information would reduce ambiguities in the letter of intent.

What are the points to be considered when drafting a letter of intent?

It is important to consider the following key points in drafting a letter of intent, so that the letter fulfils the intended purpose.

Kilvington (2002), suggests that the letters of intent should;

1. Clearly describe the scope of works.
2. Set out a mechanism for payment
3. Set a monetary cap that can be paid to the contractor
4. Include a programme
5. Describe the insurance obligations of the parties
6. Set out the matters need to be resolved for the contract to be entered into.
7. Indicate that neither party intends to be bound until the written contract is executed by each of them
8. State that the contractor is not entitled to further payment by way of quantum meruit

9. Make it clear that once the contract is concluded it will apply retrospectively

McNair, Milliner and Mazzochi (2003), suggest that a binding letter of intent (a contract) is preferable for the owner, because it creates contractual certainty with respect to those matters stipulated in the letter. Where a binding letter of intent needs to be issued, they recommend to include the wording 'This letter of intent is intended to create a legally binding contract between the parties'

Where the parties desire to use a non-binding letter of intent, McNair, Milliner and Mazzochi (2003), recommend to include the words "This non-binding letter of intent is simply a statement of the parties' present intention with respect to its contents. Each party represents to the other that no reliance will be placed on this letter and is not intended to constitute, a binding obligation"

Concluding observations

A letter of intent is not a substitute for, but is sometimes a necessary prelude to, a contract. In instances where a letter of intent needs to be issued, it is important to clarify whether the letter is intended to be binding or non-binding.

A binding letter of intent can be beneficial to the owner by creating contractual certainty. A non-binding letter of intent may allow greater bargaining power for the contractor.

In deciding whether a letter of intent created a binding contract between the parties, the courts have repeatedly considered not only the letter itself but the intentions of the parties and their conduct. Care should also be taken when drafting letters of intent to include clear intention of the parties and certain key aspects as described in the preceding sections.

Where used appropriately, letters of intent can be a useful tool for securing the early engagement of a contractor where commencement of work prior to signing of the formal contract is necessary or desirable.

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