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Good intentions, but unintended consequences?

by Laura Bowler

Letters of intent are commonly used within the Construction Industry as a way of starting work (such as procuring materials, preparing site and, in some cases, commencing work) before a formal construction contract has been entered into. Also known as 'comfort letters', their purpose is fairly constant – to enable a contractor or subcontractor to commence an aspect of the works with some assurance that they will get paid and be in line for the 'formal' contract, while preserving the ability of the main contractor or employer to limit its commitments early on. Despite their frequency of use, because letters of intent do not have any standard format, their precise effect can vary widely from a letter which merely expresses a party's intention to enter into a contract, but which creates *"no liability in regard to that future contract"*[1], to a binding contract that ends up governing the whole of the works.

Lawyers would always advise parties to enter into a formal contract rather than commence work under a letter of intent, but this is not always practical. If you must use a letter of intent, try to keep in mind some of the following tips.

Saying it is 'subject to contract' won't stop a contract coming into existence

It is not uncommon to find *'subject to contract'* (or similar wording) at the top of a letter of intent. This is because – for whatever reason – the parties cannot yet agree the 'formal' contract and do not want the letter of intent to govern their entire relationship. However, this conditional wording is not a magic bullet; where significant work has been done and paid for, the courts will be reluctant to find that there was no contract.

In *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co. KG*[2], the employer had sent a letter of intent containing a draft contract and a clause which set out that the terms would not be binding until signed by both parties. Whilst the formal contract was never signed, the court decided that, following the letter of intent, the actions of the parties (such as carrying out works and varying the delivery programme) created a binding contract. This was despite the fact that the letter of intent did not contain many of the detailed provisions that would be expected of a contract.

Be clear which letter of intent applies

By their nature, letters of intent can be informal and arise through correspondence between the parties. Where proposals have been sent back and forth, it is vital that the parties are clear, before work starts, as to which letter is 'the' letter of intent. The case of *Arcadis Consulting (UK) Limited v AMEC (BCS) Limited*[3] shows the pitfalls of getting

1. *Turriff Construction Ltd v Refalia Knitting Mills (1971) 9.B.L.R. 20*
2. *RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co. KG [2010] UKSC 14.*
3. *[2018] EWCA Civ 2222*

this wrong. In that case, the court had to choose from three competing sets of terms. One of the biggest differences between the various terms was a liability cap which, if incorporated, limited the subcontractor's liability to £610,000 (in a claim for over £40 million).

Have a clear scope, a start date, an end date and a termination option

Many people do not fully consider the terms of a letter of intent because it is only intended to get things moving and they expect it to be replaced with the formal contract. It is vital, however, to be clear about the scope of work to be performed, when the letter of intent starts and expires (and what is going to happen when the expiry date is reached), and what limit of expenditure is authorised.

It is just as important to stick to the agreed limitations (or formally record any changes) because it is easy for lines to become blurred once work has commenced. Once lines blur, disputes can often begin. One of the dangers of letters of intent is that work continues outside the authorised scope or expiry date in order to keep things moving while the formal contract is negotiated. This can be problematic because, if the formal contract is never agreed or signed, arguments arise – often about the applicable terms[4] and most frequently about extra payment. In those circumstances, contractors and subcontractors cannot be sure of additional payment where the expenditure cap has been exceeded <u>even if they have done extra work</u>[5].

Insurance

It is easy to overlook the insurance position when agreeing a letter of intent, but it is very important that this is considered and dealt with. Who will be liable if, for example, there is a flood or a fire caused by the works under the letter of intent? Who is going to insure the works during this period? An employer's insurer might not cover the works, or any damage caused, which could leave the contractor or subcontractor exposed to a liability that they might not be able to meet. Make sure the letter of intent says which party will be responsible for taking out insurance for which risks, and then double check that the insurance is in place.

<u>Conclusion</u>

The Supreme Court says that parties should *"agree first and to start work later"*[6]. As we know, that is not always realistic. Letters of intent can be useful, but risky if not properly used.

4. *See Spartafield v Penten Group [2016]EWHC 2295 (TCC) for more details.*
5. *See Diamond Build v Clapham Park Homes [2008] EWHC 1439 (TCC)*
6. *Lord Clarke in RTS Flexible Systems Ltd v Molkerei Alois Muller GmbH & Co. KG [2010] UKSC 14.*