



Fenwick Elliott

LETTERS OF INTENT
PRINCIPLES AND PITFALLS

Matthew Needham-Laing

31 January 2006

IMPERIAL COLLEGE, LONDON

It can take a long time for the formalities of a professional appointment, building contract or sub-contract to be concluded, and time is money for all parties involved in construction. Employers and Contractors want to get started on a project as soon as possible, consequently they frequently resort to sending letters expressing their intention to enter into a formal contract for the entirety of the Works in due course. There are a variety of reasons why such letters are resorted to, and why both parties to a contract find them acceptable for their respective purposes.

In the case of the Employer, they may wish to get the development started early to reduce the borrowing costs or bring forward the date when the development produces an income, rather than delay the design or commencement of construction until the formal contract has been signed.

In the case of the Contractor or Sub-Contractor, frequently they want some form of letter before commencing work so they have some comfort, whether it is illusory or real, that they will be paid for the work they are about to embark upon.

It therefore suits both parties to send or receive a letter expressing their intention to enter into a formal contract in due course.

Letters of intent come in a variety of forms, but generally they can be categorised into three main types:-

- 1 The most common arrangement is that where the Contractor agrees to start work without any agreement to do the whole Works. The Contractor can thus call a halt at any time to the Works. The arrangement is simple and contractual. Usually the letter is sent from the Employer, and is either countersigned or accepted by conduct by the Contractor. There is usually (but not always) a payment on a cost reimbursement basis, and sometimes Employers seek to put a limit on their liability to pay the Contractor, by expressly stating that the letter only authorises expenditure up to a certain amount. The Contractor may not be obliged to complete the work at all, and may not be required to complete it by any particular time, but there will be an implied term as to the quality of whatever work the Contractor does. This type of letter of intent is frequently described as "*an if contract*" following the case of *British Steel Corporation v. Cleveland Bridge Engineering Company Limited*¹.
- 2 Alternatively, and less frequently, the letter of intent is expressed as the Contract for the whole of the Works, frequently referring to the Terms and Conditions, and the various Contract Documents which are to be incorporated into the formal Contract once signed.
- 3 Finally, there is a "*Letter of Comfort*" which is no more than an expression of the parties' intentions, and creates no legal relationship at all. If a Contractor or Consultant carries out work pursuant to this Letter, then any entitlement to payment for what he does would be on a restitutionary, quantum meruit basis.

In the majority of cases where parties have resorted to issuing a letter of intent, they subsequently finalise their negotiations for the entire Contract, and the letter of intent arrangements are superseded by execution of the Contract, which then governs all the Works being carried out. It is only when those negotiations fail to conclude a formal Contract, that letters of intent are exposed to judicial scrutiny. The optimism with which the parties agree to carry out the Works pursuant to the letter of intent is exposed to the uncompromising law of contract formation as formulated by the Courts over a century ago.

These principles were recently restated by HHJ Seymour QC in *Co-operative Retail Services v. International Computers Limited ("ICL")*². This is a notorious case in which HHJ Seymour QC rejected in forceful terms the proposition that the Court should infer the existence of a contract from the parties' conduct in the absence of any identifiable offer or acceptance. Although HHJ Seymour's decision was spectacularly overturned in the Court of Appeal, the Appeal Court Judges did not comment on HHJ Seymour's analysis of the law on contract formation.

HHJ Seymour, in particular, referred to two cases which encapsulated the principles to be applied when addressing the critical question of whether the parties intended, objectively, to conclude a legal and binding agreement. The first of those cases was *Rossiter v. Miller*³ and in particular HHJ Seymour referred to the speech in that case of Lord Blackburn:-

¹ [1983] BLR 95

² [2003] EWHC1 (TCC); [2003] EWCA CIV [1955]

³ [1878] 3 App CAS 1124

"... it is a necessary part of the Plaintiff's case to shew that the two parties had come to a final and complete agreement, for, if not, there was no contract. So long as they are only in negotiation either party may retract; and though the parties may have agreed on all the cardinal points of the intended contract, if some particulars essential to the agreement still remain to be settled afterwards, there is no contract. The parties, in such a case are still only in negotiation. But the mere fact that the parties have expressly stipulated that there shall afterwards be a formal agreement prepared, embodying the terms, which shall be signed by the parties does not, by itself, shew that they continue merely to negotiate. It is a matter to be taken into account in construing the evidence and determining whether the parties have really come to a final agreement or not. But as soon as the fact is established of the final mutual assent of the parties so that those who draw up the formal agreement have not the power to vary the terms already settled, I think the contract is complete."

HHJ Seymour also relied on the more recent case of *Pagnan SpA v. Feed Products Limited*⁴, which identified the principles to be applied to determine if there was a concluded contract which can be summarised as follows:-

- 1 In order to determine whether a contract has been concluded in the course of correspondence, one must look at the correspondence as a whole.
- 2 Even if the parties have reached agreement on the terms of the proposed Contract, nevertheless they may intend that the Contract shall not become binding until some further condition has been fulfilled.
- 3 Alternatively, they may intend that the Contract shall not become binding until some further term(s) have been agreed.
- 4 Conversely, the parties may intend to be bound forthwith even though there are further terms still to be agreed or some further formality to be fulfilled.
- 5 If the parties fail to reach agreement on such further terms, the existing contract is not invalidated unless the failure to reach agreement on such further terms renders the contract as a whole unworkable or void for uncertainty.

It is obvious from those principles, as they are summarised, that in reviewing letters of intent cases, each decision turns on the facts of that particular case. The case law can only provide examples of circumstances where parties have either reached agreement or failed to reach agreement, and the consequences that flowed as a result.

The *Co-operative Retail Services v. ICL* case, to which I have already referred, is an example of a case where the parties had an existing contract and sought to negotiate a variation to it. However, as indicated already, frequently letters of intent are issued which will authorise the Contractor to perform Works up to a certain value. Examples of this can be seen in the cases of

⁴ [1987] 2 Lloyds Reports 601

*Emcor Drake & Scull Limited v. Robert McAlpine Limited*⁵ and *Mowlem plc v. Stena Line Ports Limited*⁶.

In the *Emcor* case, the Contractor issued a letter of intent authorising expenditure up to £2 million to its M&E Sub-Contractor. Work proceeded on this basis and negotiations continued to formalise the contract. Further letters of intent were issued to increase the value of the Works authorised in increments until the sum authorised reached £14 million against a total budget of £34 million. At each stage the Sub-Contractor agreed to the increase in authorised expenditure. The Main Contractor then sought to increase the authorised expenditure to £34 million, effectively finessing the Sub-Contractor into a contract for the entire Contract Works. The Sub-Contractor refused to carry out any further work and left site. In the subsequent litigation the Main Contractor contended that there had been a contract in place with the Sub-Contractor to carry out the Works up to the value of £34 million and the Sub-Contractor was in repudiatory breach. HHJ Havery QC rejected this argument, holding that the Sub-Contractor's obligation was to carry out works consistent with the construction contract, but limited in value to £14 million.

The situation where a Sub-Contractor is able to stop work half-way through a project leaves the Contractor in a desperate situation. The Contractor needs the Works to be completed, and yet the Sub-Contractor is able to demand a high price knowing that any delay will be costly to the Contractor. Even if an alternative sub-contractor can be found, they are unlikely to offer the Contractor a competitive price and the Contractor will have little or no ability to pass the increase of cost up to the Employer.

The *Emcor* case can be contrasted with the case of *Mowlem plc v. Stena Line Ports Limited*⁷. In this case a contractor carried out work pursuant to a series of letters of intent, and it was common ground that each of the relevant letters of intent took effect in law as an offer capable of acceptance so as to bring into existence a contract where Stena requested Mowlem to carry out work and promised that if Mowlem did so, then Mowlem would receive remuneration for its performance. The type of letter of intent was described in the *British Steel Corporation v. Cleveland Bridge & Engineering Company Limited*⁸ as "an if contract".

In this case the contract that was brought into existence by the acceptance of the offer contained in each of Stena's letters of intent superseded the previous letter of intent. The dispute between the parties therefore revolved around the content of the final letter of intent dated 4 July 2003. This final letter of intent expressly committed Stena to pay for Works carried out up to 18 July 2003 and for Works up to a value of £10 million. The letter of intent therefore had limited authorisation, both in respect of time and/or money, and this was accepted by Mowlem. Mowlem, however, argued that Stena permitted them to carry out Works beyond 18 July 2003 and/or Works that exceeded that value, and that Stena should then pay a reasonable sum for those Works. In addition, Mowlem were claiming in quantum meruit for the work that exceeded the £10 million cap. Stena conversely argued that Mowlem was not prohibited from carrying out Works after 18 July 2003, but insofar as Mowlem chose to carry out Works after 18 July 2003, those Works would be subject to the terms of the letter of intent, and in particular they would be subject to limited authorisation of £10 million. The £10 million therefore

⁵ [2004] EWHC 1017 (TCC); [2004] CILL 2132

⁶ [2004] EWHC 2060 (TCC)

⁷ [2005] EWHC 2206 (TCC)

⁸ [1983] BLR 95

represented a cap on Stena's liability. Stena also argued that Mowlem were not entitled to be paid on a quantum meruit basis as there was a contract in place.

HHJ Seymour firmly rejected Mowlem's arguments.

To date, all the examples of the letters of intent cases are where the Courts have found there is a contract in existence of some form or another. In the *Co-op* case, the Court found there was already a contract in existence between the parties and the negotiations upon which the Co-op subsequently relied to try and argue that a variation to that contract had been agreed, failed. The parties therefore reverted back to their original contract. In the *Emcor and Mowlem v. Stena Line* cases, the Courts found that the letters of intent themselves formed the basis of contracts between the parties, albeit not contracts that the parties had anticipated they were entering into.

The other situation where a dispute over letters of intent occurs is where one of the parties believe they have entered into a contract and the other party disputes the existence of the contract, with the result being that there is no contract in existence at all. An example of this situation is the case of *Gurney Consulting Engineers v. Pearson Pension Property Fund Limited*⁹. This is again a judgment of HHJ Seymour QC, in which he found himself returning to the issues of offer and acceptance which had pre-occupied him in *Co-op v. ICL*. The case arose out of a structural collapse at a building site in London. The central issue in the case was whether the contract had been concluded between a firm of Consulting Engineers and its Employer. To a large extent communication during the course of the negotiations concerning the Contract were conducted in writing, and took place over a period commencing in March 1998 and concluding in December 1998. No contract in terms of a final executed set of documents was ever concluded, but Pearson argued that a contract was in place for the following reasons:-

- 1 It was clear from the correspondence between the parties that they had agreed a contract which would be subject to the ACE Terms and Conditions;
- 2 The Consulting Engineers had sought and had obtained a payment in accordance with the Schedule of Payments agreed between the parties in negotiations;
- 3 There was evidence to suggest that the senior figures within the firm of Consulting Engineers who were concerned with the project believed that there was a contract in place.

It is interesting to note that Counsel for both parties accepted that the principles to be applied in a case such as this were those found in the judgment of Lloyd LJ in *Pagnan SpA v. Feed Products Limited*, referred to above. The judge was also referred to the case of *G. Percy Trentham Limited v. Archital Luxfer Limited*¹⁰, which sets out four matters which are of importance when approaching the issue of contract formation. These are as follows:-

"The first is the fact that English law generally adopts an objective theory of contract formation. That means that in practice our law generally ignores the subjective expectations and the unexpressed reservations of the parties. Instead the governing criterion is the reasonable expectations of honest men. And in the

⁹ [2004] EWHC 1916 (TCC)

¹⁰ [1993] 1 Lloyds REP 25

present case that means that the yardstick is the reasonable expectations of sensible business men.

Secondly, it is true that the coincidence of offer and acceptance will in the vast majority of cases represent the mechanism of contract formation. It is so in the case of a contract alleged to have been made by exchange of correspondence. But it is not necessarily so in the case of a contract alleged to have come into existence during and as a result of performance.

The third matter is the impact of the fact that the transaction is executed rather than executory. It is a consideration of the first importance on a number of levels... The fact that the transaction was performed on both sides will often make it unrealistic to argue that there was no intention to enter into legal relations. It will often make it difficult to submit that the contract is void for vagueness or uncertainty...

Fourthly, if a contract only comes into existence during and as a result of performance of the transaction, it will frequently be possible to hold that the contract impliedly and retrospectively covers the pre-contract performance."

HHJ Seymour, notwithstanding the decision in *Percy Trentham*, having reviewed the evidence, decided that no contract existed between the parties. In particular, he was influenced by certain findings, which no doubt frequently occur in the construction industry.

The Judge was struck by the fact that there were a number of blank spaces in the ACE Form and also in the British Property Federation Standard Form of Collateral Warranty, the contents of which had not been agreed by the parties. Collectively these blanks amounted to a large number of significant terms. Secondly, the Judge was struck by the evidence of the Employer (the Pension Fund) who as a matter of policy always sought to engage professionals on familiar standard forms, such as the ACE Form.

The Judge therefore concluded that it was the parties' intention only to make a contract by formal execution of a written document in the appropriate form. In this respect, it is particularly important to note that during the long exchange of correspondence between the parties, the Consultants sent to the Employer an ACE Memorandum executed by them on 5 November 1998. The Judge concluded that this amounted to an offer to enter into an agreement with the Employer on the terms of the Memorandum. The Memorandum was capable of acceptance by execution by or on behalf of the Employer. The Memorandum was never executed and therefore the offer was never accepted. In fact, the Judge found that the offer had been rejected by the Employer by letter dated 1 December 1998 when the Employer terminated the Consultant's involvement with the project. The Judge noted that the purported termination was not said to be pursuant to any term of any alleged contract or pursuant to any alleged breach of some term of the contract which would amount to a repudiation of the alleged contract. As a consequence, the Judge decided that no contract was ever concluded between them.

By way of comparison to the *Gurney* case is the Court of Appeal's decision in *Harvey Shopfitters Limited v. ADI Limited*¹¹, a letter of intent case in which the Court of Appeal had little difficulty

¹¹ [2003] EWCA CIV 1757

in rising above the traditional offer and acceptance analysis. The facts of the case were never disputed between the parties and were briefly set out in the Court of Appeal Judgment as follows:-

"The appellants were asked to carry out alterations and refurbishments to the Respondents' property. They [the Respondents] had employed architects, Salt Evans, who had produced tender documents based on the JCT Intermediate Form of Building Contract 1984 (the IFC 1984) and set out the proposed amendments to that form and the manner in which the conditions were to apply. The appellants were invited to tender in relation to those works on 6 May 1998. The final documentation provided by Salt Evans was provided to them [the Appellants] on 26 May 1998. In a series of documents in June 1998 the appellants offered to carry out works "in accordance with the conditions in the contract" by returning the form of tender, which constituted an offer to carry out the works for a lump sum of £339,895.34. The respondents informally indicated through the architects that the tender was acceptable, and the appellants commenced work on site in accordance with the tender on 6 July 1998. On 7 July 1998 the Architects wrote the letter on which both parties now rely. It reads as follows:-

Further to your tender dated 23 June 1998 and fax dated 24 June 1998, I write to confirm that it is the intention of our client, A.D.I. Limited, to enter into a contract with you on the basis of the tender sum of £339,895.34 exclusive of VAT, for the project.

The main contract documents are currently being prepared for signature. I confirm that the conditions of contract will be those of the JCT Intermediate Form of Building Contract 1994 [sic] Edition amended as stated in the tender documents and this contract is to be executed under hand.

The date for commencement is to be 06 June [sic] 1998 and the Contract Period is to be 12 weeks with completion on the 25 September 1998.

I have been instructed by our client to request that you accept this letter as authority to proceed. If, for any unforeseen reason, the contract shall fail to proceed and be formalised, then any reasonable expenditure incurred by you in connection with the above will be reimbursed on a quantum meruit basis. Any such payment would strictly form the limit of our client's commitment and our client would not be subject to any further payment of compensation for damages for breach of contract.

If you are agreeable to the foregoing, please:-

- (i) sign the enclosed copy of this letter and return it to me at the above address..."*

...the Appellants were not in a position to sign a copy of that letter until the relevant director, Mr Nolan, had returned from holiday on 28 July 1998, when he duly signed the document and returned it to the architects.

Thereafter, work continued, but no formal IFC 1984 contract was prepared, although it was common ground at the trial that there was nothing left for the parties to agree. The form simply had to be prepared in accordance with the particulars of contract fully set out in the tender documents."

The Works were completed, and subsequently there was an adjudication over upon the basis of the Final Account calculated on the basis of a lump sum tender figure. Some twelve months later the Contractor then commenced legal proceedings claiming that they were entitled to be paid on a quantum meruit basis.

The Court of Appeal had little difficulty in dismissing the Contractor's argument. In particular, the Court of Appeal said that the letter of 7 July could not be read in isolation. It formed the culmination of a process which resulted in an agreement as to price and to all material terms necessary for the commercial efficacy of the Contract on the IFC 84 Conditions. The fact that the letter giving instructions to proceed envisaged the execution of further documentation did not preclude the Court of Appeal from concluding that a binding contract was entered into. All the necessary ingredients of a contract were present.

In conclusion, therefore, parties often enter into letters of intent without fully appreciating what their rights and liabilities are. I would suggest, as a minimum, the following three points should be considered before signing a letter of intent:-

- 1 Is the letter of intent to form a binding contract? Whether it does or does not depends on the construction of the communications which have passed between the parties and the effect, if any, of their actions pursuant to such communications.

If a contract is found to exist, then it will determine the parties' obligations or, alternatively, if no contract is found to exist, the letter of intent will have no contractual effect.

In drafting letters of intent, it is therefore vital for the parties to state clearly whether or not the letter of intent is to form a binding contract. If work is done pursuant to a contract, then the Contractor will have obligations as regards the workmanship and time for completion. Conversely, if there is no comprehensive contract, then there can be no such contractual obligations, although there may be obligations for negligence as regards workmanship.

- 2 If materials are purchased or brought pursuant to the letter of intent, how are these to be paid for?

Whether or not the letter of intent is legally binding on the person carrying out work under it, they will almost certainly be entitled to be paid for their work. The letter of intent should therefore state the basis of such payments. If the letter of intent is to be contractually binding, then payment schedules should be inserted. If no provisions are inserted, then a reasonable rate will be implied.

If a letter of intent is not legally binding, the Contractor will almost certainly be entitled to payment on a quantum meruit basis, i.e. the Contractor is entitled to be paid a reasonable sum for the labour and materials supplied by him.

- 3 The letter of intent should state that if a contract is subsequently entered into between the parties, then any payments made under the letter of intent form part of the Contract Sum, thus avoiding potential overpayment problems.¹²

Of course in an ideal world there would be no letters of intent. All parties would agree the terms of their contracts, and execute formal Contract Documentation before commencing work.

31 January 2006
Matthew Needham-Laing
Fenwick Elliott LLP

¹² Boomer v. Muir [1933] 24 P.2d 570