Letters of Intent

Contract Formation, Letters of Intent, Recent Case Law and Practical Considerations

Presented to ICES

Date: 12 March 2008

By David Moss, Gregory Buckley and Claire Rawlinson of Hammonds
1 CONTRACT FORMATION

1.1 4 basic requirements to form a binding contract

(a) Offer and Acceptance.

An Offer is an expression of a willingness to contract made with the intention that it is to become binding on the person making it as soon as it is accepted.

Whether an Offer has been made is decided objectively – an offeror will be bound where his words or conduct induce a reasonable person to believe he intends to be bound.

An Offer needs to be distinguished from an Invitation to Treat. These can arise during pre-contract negotiations when preliminary communications pass between the parties before the making of a definite offer. At this juncture there is, normally, no expression of the willingness to contract on certain terms.

(i) Gibson -v- Manchester City Council

A Local Authority wrote a letter which stated that it “may be prepared to sell” the house in which Mr Gibson lived at a specified rate. The court held that was not an offer to sell the house – its purpose was to invite the making of a formal offer from the tenant.

Perhaps most common example of an Invitation to Treat is in a shop or supermarket – where items are on display and priced. Here, the Offer does not come from supermarket owner, but from the customer at the till when he or she offers to pay the advertised price for the goods.

An Acceptance is perhaps best defined by what it is not. A mere acknowledgement of an Offer does not amount to an acceptance. There should be an expression of willingness similar to that required for an Offer. An Acceptance must also be unambiguous.

(ii) Peter Lind -v- Mersey Docks and Harbour

In this case an offer to build a freight terminal was made by a tender quoting in the alternative a fixed, and a “cost plus” price. The offeree purported to accept the tender but did not state which set of terms it was accepting. The Court held there was no contract due to lack of certainty.

When considering the concept of Acceptance, one also has to be aware of the potential for Counter Offers. These arise where a purported acceptance materially alters the terms proposed in the Offer. The legal effect of a Counter Offer is that it brings the original Offer to an end.

This is perhaps most relevant when the issuance of standard Terms and Conditions is considered. Typically, an Employer or Contractor may send out an Invitation to Tender, with a Tender being received in response. The contracting parties may then negotiate and exchange correspondence. In doing so, the parties may make of a series of counter offers until an agreement is actually reached.
Obviously, if each of these makes reference to a different set of Terms and Conditions, problems will arise. To combat this situation, the Courts have adopted the "last shot principle". The conflict in Terms and Conditions is generally resolved in favour of the party who puts forward the latest set of terms – if they are not objected to by the other party, he is taken to have agreed to be bound by them.

Conduct is also an important element to be aware of when considering Offer and Acceptance. Acceptance can occur where, for example, one party has commenced work. The commencement of work almost raises a presumption of acceptance in that where work has commenced, the courts will look for clear words (such as subject to contract) to establish that the parties did not intend to, and did not actually enter into, a binding legal relationship.

(b) Consideration

The law requires that a party suing on the basis of Offer and Acceptance must show that he has given consideration, unless the offer and acceptance is made by way of deed.

Consideration is a simple concept, particularly in the construction industry – the consideration given by the Employer is the price paid or the promise to pay, and by the Contractor is the carrying out of the works or the promise to carry them out.

(c) Intention to create legal relations

(d) Certainty

Intention to create legal relations and certainty are worthy of a training session on their own.

Construction contracts are often the product of lengthy negotiations on a wide range of issues and this makes it all the more difficult when trying to determine the exact point in the negotiations where the parties reached a concluded agreement.

A court will look at the negotiations as a whole and will look for an intention of both parties to make a contract. Parties should be of one mind as to the essential terms required for the contract to come into existence. Also, the parties must not omit any term which, even though they did not realise it, was in fact essential to be agreed to make the contract commercially workable.

(i) A "commercially workable" Contract?

As to what makes a contract commercially workable, the agreement as to the Parties, Price, Time and Description of Works is normally the minimum necessary to make a contract commercially workable.

Although these may sound straightforward, it is not unheard of for problems to arise in relation to each. For example, parties – there may be a lack of agreement as to parties where companies have common directors and there is confusion as to which company is intended to be the contracting party. Confusions can also arise when there is an issue as to whether a contract is with an Agent or Principal.
As to Price, and Time, silence on either does not prevent a contract coming into existence – if all other essential terms are agreed a reasonable charge and reasonable period of time for completion will be implied by the Supply of Goods and Services Act 1982.

(ii) "Boilerplate" clauses

Boilerplate clauses deal with those generic contractual provisions which are generally found in commercial contracts, whatever the nature of the transaction. They have to be considered as they include matters such as the choice of governing law, the mechanism for serving notices and the requirements in relation to variations and amendments etc.

These all have significant practical implications for the parties and should therefore be properly tailored to meet the parties’ requirements in the context of the agreement.

2 LETTERS OF INTENT

2.1 Introduction

The traditional concept is that a Letter of Intent is a document that affirms a present intention to enter into a future contract. In construction terms, they are used where preparatory works are required to be carried out either before the resolution of all issues to decide whether a Project is viable or during the negotiation of the final terms of the Building Contract.

Nowadays, there is no longer any accepted definition of what a Letter of Intent is – principally because they come in all sorts of forms. They range from mere expressions of hope to what are, in reality, a contract in all but name. How each is construed depends upon the facts and the intention of the parties.

2.2 Case Law

(a) Traditional Approach

Traditionally, a Letter of Intent was regarded as of no contractual effect in most situations.

(i) Turriff Construction Ltd -v- Regalia Knitting Mills

In this case the letter of Intent was worded as follows:

"Dear Sirs,

As agreed at our meeting of 2nd June, it is the intention of Regalia to award a contract to Turriff to build a factory including production, stores, offices and canteen facilities to be built in four continuous phases.... all to be subject to obtaining agreement on the land and leases with the Development Corporation, full building and bye-law consent and the site investigation.... the whole to be subject to agreement on an acceptable contract."

Judge Fay Q.C held that a Letter of Intent is “no more than an expression in writing of a party’s present intention to enter into a contract at a future date. Save in exceptional circumstances it can have no binding effect....A letter of intent would ordinarily have two characteristics, one, that it will express an
intention to enter into a contract in future and two, it will itself create no liability in regard to that future contract”.

(b) Cases supporting contractual obligations

There was then an emergence of decisions supporting contractual or extra contractual obligations under Letters of Intent. For example:

(i) Monk Construction Ltd v Norwich Union Life Assurance Society

In this case the Letter of Intent was worded as follows:

“This letter is to be taken as authority for you to proceed with mobilisation and ordering of materials up to a maximum expenditure of £100,000. In the event that our client should not conclude a contract with you, your entitlement will be limited to the proven costs incurred by you in accordance with the authority given by this letter.”

Neill LJ made a general statement that as a matter of analysis a contract may come into existence following a Letter of Intent. A Letter of Intent can give rise to three possible situations:

“There may be an ordinary executory contract, under which each party assumes reciprocal obligations to the other….There may be what is sometimes called an ‘if’ contract, i.e. a contract under which A requests B to carry out a certain performance and promises B that if he does so, he will receive a certain performance in return, usually remuneration for his performance. If no contract was entered into, then the performance of the work is not referable to any contract, the terms of which can be ascertained and the law simply imposes an obligation on the party who made the request to pay a reasonable sum for such work as had been done pursuant to that request.”

(c) Recent developments

(i) ERDC Group Ltd v Brunel University

This concerned the construction of an athletics track in Uxbridge, west London. ERDC won the bid for the work but planning permission was not given at that time.

A Letter of Intent was therefore issued. ERDC was authorised to start the work and Brunel agreed to pay for any work that was done, valued on the JCT normal valuation rules. The letter was strictly limited in value and time. If the proper contract had not been signed by 1 April, the authority to proceed was to terminate.

The contract was not signed by 1 April, but Brunel then issued another similar letter. It subsequently issued 4 further Letters of Intent, the last one being issued on 1 September.
Nevertheless ERDC carried on working and finished most of the works in November. Brunel eventually sent the JCT contract for signature in December. ERDC declined to sign and argued that as it had been working without a contract (the last Letter of Intent having expired) it was entitled to be paid on a quantum meruit basis. Practically, its entitlement under quantum meruit was much more than the valuation in its tender.

The Court held that the work done prior to September had all been on the authority as set out in the series of Letters of Intent. The judge thought that the usual requirements for a contract were all there (intention to create a legal relationship, certainty, etc) and had all been there until 1 September. He therefore found that there had been a contract until then. Accordingly, ERDC was to be paid on the basis specified in the letters – the JCT rules.

After 1 September it was a different matter. As the last letter had expired ERDC was not working on the basis of a contract, and so was entitled to be paid on quantum meruit. In this regard, ERDC had argued they were entitled to be paid on a cost-plus basis. However, the Court held that as ERDC had been prepared to do the work for the tendered rates a few months before, these did not become unfair because the letters had lapsed. There had to be some marginal additions but essentially the JCT valuation rules and ERDC tendered rates also applied.

(ii) Cunningham & Good -v- Collett & Farmer

In this case it was alleged that an Architect had been negligent in allowing his client to issue a Letter of Intent when it was inappropriate or premature to do so. The Judge endorsed the view that the widespread use of Letters of Intent in the UK construction industry can cause more problems than they solve. He noted that their greatest problem was that once sent, everyone's focus becomes upon construction work and progressing the project, meaning that the need to conclude the contract documentation is not given the appropriate priority. The consequence of this is that should problems start to arise on site, the absence of a proper contract means that the parties do not have the benefit of its provisions to resolve those difficulties.

Despite these concerns, the judge recognised that the use of Letters of Intent could be a useful tool in circumstances where:

(A) the contract workscope and price are either agreed or there is a clear mechanism in place for such workscope and price to be agreed;

(B) the contract terms are (or are very likely to be) agreed;

(C) the start and finish dates and the contract programme are broadly agreed;

(D) there are good reasons to start work in advance of the finalisation of all the contract documents.

If these preconditions were satisfied, and provided both the Contactor and the Client were keen to start work on site promptly, a Letter of Intent could be
appropriate provided that it was carefully drafted to minimise the risk to both parties should a formal contract not eventuate.

In this particular case, the court found that all of these features were present, and that as a consequence, the architect was not negligent in allowing his client to proceed in this way.

(iii) AC Controls -v- BBC

The Claimant signed a letter of intent from the Defendant. The letter provided that the Claimant should carry out certain preliminary work and the Claimant was authorised to proceed with the works up to £250,000. The Claimant was later authorised to commence works by subsequent letters, which were expressed to be subject to the Letter of Intent. These were all subject to a cap of £1m.

The project was not successful and the parties’ relationship broke down. The Claimant sought to recover the balance that it claimed it was owed for the work and services it had performed. Issues arose, inter alia, as to the basis upon which the parties had contracted and whether the Claimant carried out its work subject to a cap on the amount it was entitled to be paid.

The Court held that the cap on the contractor’s expenditure did not limit the Defendant’s financial obligation as intended. Rather, it only provided the Defendant with a right to terminate when the cap was reached. As the Defendant did not terminate, the Claimant was entitled to continue with the works in excess of the cap and to be paid on a reasonable basis.

(iv) Hackwood Ltd -v- Areen Design Services Ltd

On 4 June 2001, the Claimant proposed that the Defendant should begin refurbishment works on the terms of a Letter of Intent of the same date. The parties negotiated the terms of a JCT contract but failed to conclude the various options to be inserted into an appendix. The question to be decided was whether the parties could incorporate the JCT form of contract into a Letter of Intent whilst still negotiating the final terms.

The Judge held that the fact that parties were still in negotiations did not preclude their intention to incorporate a JCT form into a Letter of Intent. The effect of the 4 June letter was to incorporate the terms of the JCT contract into the interim contract save to the extent that those terms were inconsistent with the terms of the letter.

The object of the 4 June letter had been to establish the terms of an interim contract that the parties appreciated could govern the whole of the project. In the circumstances of the case, the fact that the parties had been negotiating a contract intended to replace the interim contract was not inconsistent with an intention that the JCT contract’s standard terms should be incorporated into the interim contract.
3 PRACTICAL CONSIDERATIONS WHEN USING LETTERS OF INTENT

3.1 Drafting points

(a) Draft a letter of intent expressed to be “open” as it may be required as evidence in the event of a dispute; if a letter of intent is expressed to be “without prejudice” it may not form the basis of an action for payment for work carried out pursuant to that letter of intent;

(b) Clearly define the scope and its “constraints” i.e. cap on costs, time which the Letter of Intent is valid, the basis of payment and authority;

(c) Make clear what remains outstanding; If standard forms/terms are referred to, be clear as to whether they are intended to be incorporated or whether a formal contract is to be entered into later on;

(d) Indicate that neither party intends to be bound until the letter is executed by each of them and confirm the instruction to proceed;

(e) Exclude basis for any other payment;

(f) Include the requirements in relation to dispute resolution. This should mirror any connected contracts or provide for adjudication if desired.

3.2 Legislation

There are two pieces of legislation which need to be considered when using Letters of Intent.

(a) Construction Act 1996

Even if a binding contract exists this does not mean that the letter will be a ‘construction contract’. It must incorporate all requirements of the Act. For example s.104 requires that there be an instruction or authorisation to carry out construction works.

In particular it is necessary to consider that if the Letter of Intent does not comply with the payment or adjudication provisions, then the Scheme for Construction Contracts will apply.

(b) Late Payment of Commercial Debts (Interest) Act 1998

All businesses have a statutory right to claim interest. If the letter fails to deal with interest or provides a remedy which is not substantial, the Act imposes a right of interest at the current base rate plus 8%.

3.3 Quantum Meruit

Quantum meruit, meaning “what he has deserved” can arise in two forms, contractual and restitutionary.

A contractual quantum meruit claim will arise where although a price is not agreed, work has been instructed and carried out. An obligation to pay a reasonable price will be implied.
A quantum meruit claim which arises under the law of restitution is based on the notion of unjust enrichment. Thus, where a party would otherwise be unjustly enriched the law will impose an obligation to pay on a quantum meruit basis. This may arise where work is carried out under a Letter of Intent which does not give rise to a contract.

(a) What is the Measure of Reimbursement for Quantum Meruit?

The practical issue is usually whether the measure of reimbursement is on the basis of cost incurred with a contribution for profit and overheads, or whether it is to be based on market value. Where there is an unconcluded contract with prices this may be taken into account in considering the reimbursement. In some cases there will be little difference in the measure between cost and market value. It might be thought that a measure based on rates would always be higher than one based on costs. This may not always be the case where the rates are based on an unconcluded contract, since there are many commercial reasons for a contractor to bid low for a contract.

In the case of an express contract to do work at an unquantified price, the measure is the reasonable remuneration of the contractor. In the case of a benefit which it is unjust to retain, the measure is the value to the Employer - normally the market value (ie a sum that would have been agreed, including profit).

In the measure of a fair remuneration and allowance for profit, consideration has to be given to the relationship of the parties.

(b) What is the practical effect of delay and defects where recovery is based on Quantum Meruit?

Some allowance must be made for work which is defective or carried out inefficiently. The issue then is the standard to be adopted to establish the defect or inefficiency and the duty owed by the contractor for performance (if any in the absence of a contract). Since restitution is not based on an implied contract theory there is generally no scope for reducing the measure by something like a set-off or cross-claim equal to the costs of putting the work right.

(i) Sanjay Lachhani -v- Destination Canada (UK) Ltd

The judge recognised that a ‘fair value’ should include a reasonable or normal profit margin over and above the costs reasonably and necessarily incurred in properly carrying out the works and likely to have been incurred by a reasonably efficient contractor. He stated that there must be adjustment for inefficiency and defective work at completion:

“If the building contractor works inefficiently and/or if the building contractor leaves defective work then, quite obviously, the actual costs incurred by the building contract must be appropriately adjusted and/or abated to ensure that the owner will not be required to pay more than the goods and services provided are truly (objectively) worth.”

(ii) Serck Controls Ltd -v- Drake & Scull Engineering Ltd

The judge considered that the performance of the contractor in terms of inefficiency and defects at completion was a factor to be considered in the measure of quantum meruit.
“The site conditions and other circumstances in which the work was carried out, including the conduct of the other party, are relevant to the assessment of reasonable remuneration. The conduct of the party carrying out the work may be relevant. If the value is being assessed on a ‘costs plus’ basis then deduction should be made for time spent in repairing or repeating defective work or for inefficient working. If the value is being assessed by reference to quantities, such matters are irrelevant to the basic valuation. A deduction should be made on either basis for defects remaining at completion because the work handed over at completion is thereby worth less.”

(iii) ERDC Group Limited -v- Brunel University (see above)

The judge held that whether the assessment is made by reference to cost or to rates and prices, the party paying for the benefit was not to be required to pay for delay or inefficiency.

(c) Is there an Entitlement to Payment for Work Carried Out Beyond the Financial Limit of the Letter of Intent?

If work is carried out beyond the financial limit of the Letter of Intent, then there will only be an entitlement if the financial limit was not intended to prevent further payment (see AC Controls Ltd -v- British Broadcasting Corporation above).

However, apart from the above, a contractor exceeding the financial limit will have great difficulty in establishing an entitlement to payment absent a clear instruction and acceptance that additional payment would be made.

(i) Mowlem plc -v- Stena Line Ports Limited

Stena was the owner and operator of the port of Holyhead in Anglesey and required the construction of a new ferry terminal called Terminal 5. Mowlem carried out the marine and offshore works under several Letters of Intent.

The first letter was issued on 17 October 2002. Stena committed to pay Mowlem a maximum of £400,000 so that they could get on with the work. As work progressed further letters of intent were required in order to increase the limit set by Stena, each superseding the previous letter. The last letter was issued on 4 July 2004 and set the maximum at £10 million. Each letter after the first stated that it superseded its immediate predecessor. Stena stated in the last letter that the commitment would allow Mowlem to proceed with the Works in accordance with the programme until 18 July 2003. That date was significant because it was the date shown on the programme for completion.

Mowlem did not complete by 18 July 2003. Stena was pressing Mowlem to complete the work because of a mistaken assumption that somehow there was a contract which required Mowlem to do just that. Mowlem continued working and indeed received instructions from Stena’s consultants in the usual way. The work was eventually completed.

Mowlem considered that the cost of the work had exceeded the limit of £10 million although Stena contested this. Mowlem submitted that the letter of intent
only applied to work up to 18 July 2003, so they were entitled to payment for work done after that date irrespective of the limit. Mowlem also submitted that since it had carried out work in excess of the limit it was in any event entitled to be paid for it. The limit only applied until the limit was reached they said.

The Judge held that from 4 July 2003 the relationship between Mowlem and Stena was governed by the letter of 4 July 2003 and the obligation to make payment continued until the letter was rescinded or a contract was executed. It made no commercial sense, he held, to have a financial limit on Stena’s obligation to make payment which could be avoided by simply carrying on to work after the date of 18 July 2003. The Letter of Intent was not limited to work before 18 July 2003. It was bizarre commercially if the limit could be avoided by simply exceeding it.
David Moss
Partner
Telephone No: 0870 839 5052
Fax No: 0870 460 3506
E-Mail: david.moss@Hammonds.com

Gregory Buckley
Associate
Telephone No: 0870 839 5025
Fax No: 0870 443 4158
E-Mail: gregory.buckley@Hammonds.com

Claire Rawlinson
Solicitor
Telephone No: 0870 839 5168
Fax No: 0870 460 3029
E-Mail: claire.rawlinson@Hammonds.com