

Letters of intent – pitfalls for the unwary

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It is fairly standard practice for construction or engineering projects to commence before a contract has formally been concluded. As such, it is common in the construction industry for parties to use letters of intent to cover this pre-contract commencement of works.

From an employer's perspective, a letter of intent should enable the contractor to be persuaded to start works before the contract is finalised and signed. Other clear advantages from the employer's point of view include the fact that a letter of intent can bring certainty in respect of issues as to cost and time. In short, the employer can issue a letter of intent that squarely reflects what it wants to achieve. In drafting the letter of intent the employer can set limits, for example, in respect of the scope of works to be undertaken or by adding a cap to the amount to be paid to the contractor. From a contractor's perspective, a letter of intent provides some comfort that it will be paid for the pre-contract work it carries out.

However, letters of intent have been the subject of numerous disputes and have generated a significant amount of case law. How effective a letter of intent is for the employer or the contractor will very much depend on the drafting. However, two considerations worth bearing in mind at all times, which have been considered by the court, are:

- firstly, whether or not the letter of intent is binding on the parties to it and, if so, on what terms; and
- secondly, where the letter of intent expires, what will be the contractual position between the parties, particularly if the contract has still not been finalised and/or signed.

If the letter of intent expires, the parties can face uncertainty as to what their respective positions are, in particular, whether there is a contract and, if so, what the terms of that contract are. Should it become apparent that there is dispute between the employer and the contractor, it is well worth seeking legal advice at an early stage.

The perils of parties agreeing that work should proceed before a formal written contract is executed was illustrated in the recent judgment of the Supreme Court in *RTS Flexible Systems Ltd v Molkerei Alois Müller GmbH & Co KG*.

In this case, RTS was awarded a contract by Müller to update Müller's packaging equipment. The award of the contract was contained in a letter of intent which was to have effect for a stated period. The letter of intent incorporated Müller's MF/1 standard terms, placing limits on liability and a "subject to contract" clause providing that the contract was not effective until signed.

The judge at first instance held that after the expiry of the letter of intent, the parties had reached a full agreement on the work that was to be done, for the price already agreed between the parties. It was held that there was a contract that RTS would carry out the agreed work for the agreed price, but that the contract did not include the MF/1 terms. The decision was appealed by RTS on the basis that it would not have the benefit of the limitations of liability contained within the MF/1 terms.



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On appeal, the Court of Appeal took a different view and held that there had been no contract after the expiry of the letter of intent. It was held that the parties had clearly intended that following expiry of the letter of intent there was no intention to create binding legal relations, unless and until a written contract was executed by both parties. This was appealed by Müller as it would have faced a claim for payment by RTS's on a reasonable (or quantum meruit) basis.

On appeal from the Court of Appeal, the Supreme Court (formerly known as the House of Lords) decided that Müller and RTS did reach a legally binding agreement. The parties had negotiated and agreed all the essential terms including all the essential MF/1 terms. On this basis, the MF/1 terms were incorporated in their entirety. Further, the Supreme Court held that the binding agreement was not subject to contract as, by the parties' conduct and negotiations they had waived the requirement for a formal written contract and therefore the subject to contract condition. Müller were therefore unsuccessful in attempting to pick and choose sections of terms that were under negotiation.

Whether there was a binding contract between the parties (and the terms of that contract) depended on a number of factors. It needed to be determined whether the words and/or conduct of the parties would lead objectively to the conclusion that the parties had intended to create legal relations. Further, it had to be decided whether the parties agreed upon all the terms which they regarded (or the law required), as essential for the formulation of legally binding relations.

In this case there had been unequivocal conduct on the part of both parties showing that it was agreed that the project would be carried out by RTS for the agreed price on the terms agreed. This included the MF/1 terms. RTS had agreed to be bound by those terms without the necessity of a formal written contract.

Whilst this decision is to be welcomed as it resists the unattractive "no contract" approach adopted by the Court of Appeal, it highlights the risk of proceeding with works before a contract is agreed and signed. Lord Clarke giving judgment gave these words of caution:- "The moral of the story is to agree first and to start work later...".

If you would like to discuss any of the issues raised in this update, please contact:



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