"CLEAR INTENTIONS – PRE-CONTRACTUAL RISKS AND LETTERS OF INTENT"

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Navigating through the pre-contractual stage of a development is a tricky task. The use of letters of intent as a tool to enable parties to act pending formal legal documentation can be beneficial. In these circumstances, however, risk management is paramount to prevent parties falling into pitfalls prior to completion of the main building contract.

In an economic climate of high and 'sticky' inflation, letters of intent are increasingly popular. Allowing a contractor to mobilise before the parties enter into the proposed final contract is, of course, often very advantageous. With costs spiralling and materials scarce, securing lower costs and placing supply chain orders in advance is a necessity for developers, particularly when faced with a strict budget and an immoveable completion date. Letters of intent play an indispensable role in this regard and will continue to be a common feature in the construction industry.

But what are the risks, and how can parties manage them?

PRE-CONTRACTUAL COMMUNICATIONS

When a dispute arises, parties often seek to rely on communications made at the pre-contractual stage as evidence of their intentions and of their interpretation of subsequent contractual provisions. However, one key difficulty arises in relation to what pre-contractual communication, if any, is admissible.

Case law provides that whilst communications in the pre-contractual stage will be admissible for the purposes of understanding a contract's commercial aims and its provenance, such communications cannot be used to aid the interpretation of specific contractual provisions. This distinction is crucial.

Whilst the rule may appear to kill pragmaticism and seem unhelpful, the reality is that, without it, parties would be faced with a prospect where every contentious provision could be fought over on its interpretation. That would be unfeasible, inevitably leading to further practical difficulty and uncertainty.

Another key difficulty arises as to whether and/or when pre-contractual negotiations, communications and documentation themselves become contractually binding. It is often assumed that pre-contract negotiations are not legally binding. However, because (with limited exceptions) contracts can come into effect without any formality or written documentation whatsoever, if not correctly managed, pre-contractual communications or documents can result in a contract being formed inadvertently or at an earlier stage than intended. Parties can, therefore, become contractually bound to terms, obligations and liabilities to which they might never otherwise agree. In ***Pretoria Energy v Blankney Estates (2022),*** one party believed that a 'heads of terms' document (tantamount, in law, to a 'letter of intent') was binding. The other did not. A £56.4 million claim ensued, the outcome of which turned solely upon which of those differing understandings was correct.

It is therefore essential for parties to know how to conduct negotiations, and how to exchange pre-contract communications and documents, without unintentionally becoming bound to unacceptable terms. The longstanding answer has been, and remains, to outline expectations in a letter of intent. However, to guard against such risks, it's vital to ensure that any such letter is properly drafted.

HOW RISKY?

When proceeding with a letter of intent, it is paramount to understand that the consequences of poor drafting can be very costly. The case of ***Arcadis Consulting (UK) Ltd v AMEC BCS Ltd (2018)*** is a prime example. It concerned a pre-contractual agreement between a specialist concrete sub-contractor and a consultant designer in respect of two large construction projects. The parties commenced works and put into place a letter of intent while they conducted negotiations on a construction contract that never materialised. Unfortunately, the letter of intent was not clearly drafted – neither as to its legal status and force, nor as to its terms.

To the intense dismay of one of the parties, the letter of intent was ultimately found, by the Court of Appeal, to constitute a contractual offer, which was then accepted by exchange of correspondence and by conduct when the works began. Not only was that party therefore inadvertently landed with a binding contract per se, but it was also bound by terms

contained within what it had thought was merely a non-binding letter of intent. One of those terms was a liability cap of just £610k. This proved disastrous for one party's damages claim when issues in the works arose and it faced a potential loss of £40m.

MANAGING THE RISKS

So, if a letter of intent is to be used, what is the best approach?

Firstly, both parties should clarify, at the outset of negotiations, the point at which they will become contractually bound. If discussions are never intended, by either party, to result in a binding oral contract, that should be recorded and all negotiations/discussions/communications should be marked 'subject to contract'. The same applies when it comes to the letter of intent. Do the parties intend the letter of intent to have contractual force pending completion of the final contract, or not? Either way, the point should be expressly confirmed, and negotiations should be conducted, and the letter itself should be drafted, accordingly.

Secondly, the purpose of a letter of intent must be understood. Letters of intent should always be viewed as an interim measure only; they are not a panacea which will engage a contractor for a project's entirety. Their function, rather, is to serve as a 'stopgap', allowing work to commence whilst the parties finalise the details of the main contract. The main contract will ultimately supersede the letter of intent.

It's also worth reviewing the contractor's proposed scope of activities, as this can determine whether a letter of intent is the right pre-contract tool. It's common practice for contractors to have much earlier engagement on a project and to advise on the design and buildability of the works as part of a 'two-stage' tendering/procurement process. A letter of intent is to allow works to commence whilst the building contract is formalised. So, if the design or scope of the works is still to be determined, a pre-construction services agreement is likely to be more suitable.

To avoid the mistake made in ***Arcadis,*** parties need to understand what is being signed up to. There is extensive case law which shows that the courts will prioritise consideration of the language used[i] and interpret accordingly. Clear drafting is therefore vital. Moreover, sometimes calling the letter a "letter of intent" is part of the problem, as the name itself can be misleading. The opening paragraph typically found in such letters will refer to future intention. This is unhelpful as it diverts attention away from the fact that the letter itself usually constitutes a contract which (subject to the drafting and the conduct of any earlier discussions!)

i i.e. as opposed to the parties' intentions, wider circumstances, commercial common sense, etc. These other factors are generally only taken into account when there's genuine ambiguity in the contractual wording.

is binding on the parties. For this reason, it may be preferrable to refer to the letter as an "early engagement letter" and to include reference, in the letter itself, to it being a "preliminary contract". These simple changes can help parties keep a fix on the key issues handled in the agreement and allow them to focus on understanding their obligations.

The nature and value of the works being procured through the letter should be considered, with appropriate clauses drafted into its terms. It's necessary to distinguish between authorising £25,000 for pre-contract design and doing the same for £250,000 of on-site work. Although both fall under the Construction Act's remit, high-value works should always include an express mechanism for valuation of the works, facilitating interim payments and the obligation to maintain relevant insurance.

Other notable key provisions which a good early engagement letter should include or take into consideration are:

- An agreed scope of the preliminary works to be carried out under the letter, with a breakdown for the costs attributed to each service/activity
- Clarification that no other works are to be carried out until the main building contract is completed (and therefore no other payments are to be made until such time)
- A maximum expenditure cap on the amount to be paid for the preliminary works
- Query whether the Construction (Design and Management) Regulations 2015 are engaged
- Termination rights for the "Employer" and what happens if the building contract isn't entered into following termination
- Query whether ownership of advanced goods or materials need to be considered
- Confirmation that the letter is to be superseded by the final contract.

IN SHORT: A USEFUL PRE-CONTRACTUAL SOLUTION, BUT USE WITH CARE

Whilst there is ultimately no substitute for progressing works pursuant to the final building contract, the reality is that parties will frequently wish to 'crack on' with the works at a much earlier stage. As such, letters of intent, are here to stay.

An understanding of how contracts can be formed, and the status and admissibility of pre-contractual communications; combined with the careful conduct of negotiations and the precise, comprehensive drafting of letters of intent, should enable developers to mitigate the risks associated with carrying out works prior to completion of the main contract.

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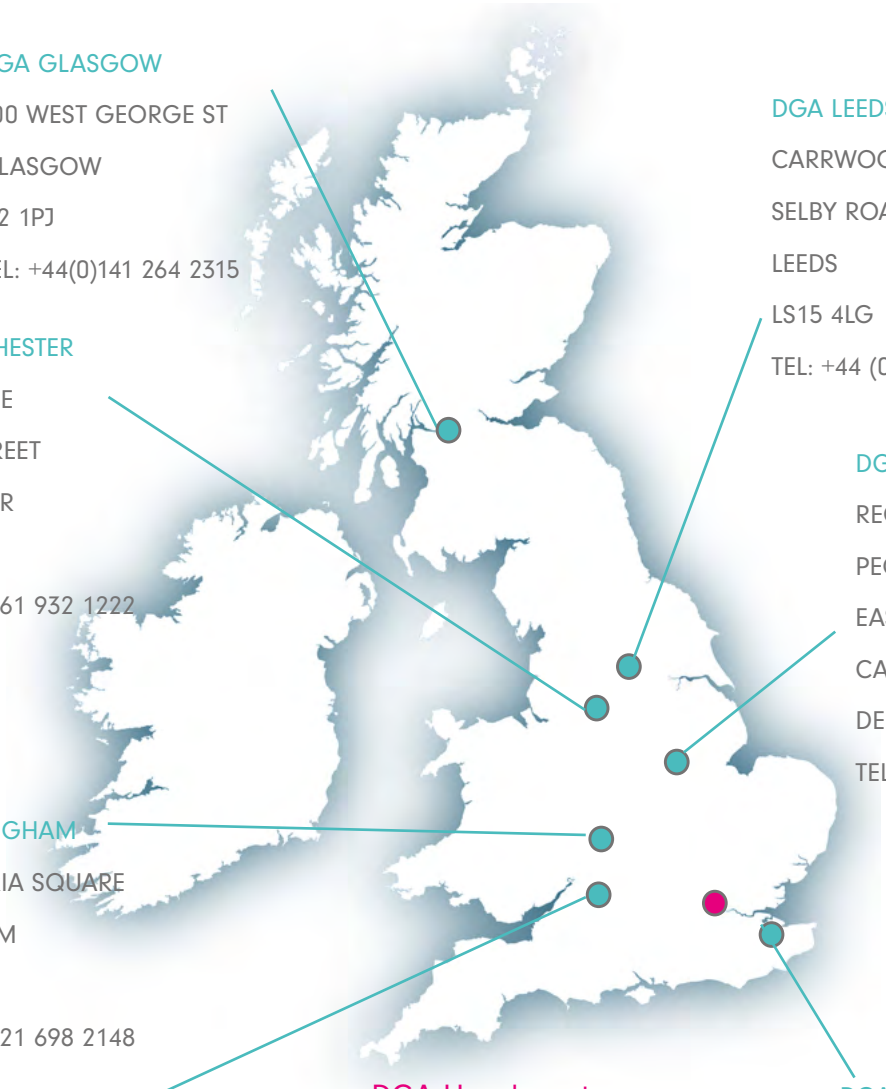

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