

## LETTERS OF INTENT

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The old adage 'look before you leap' has particular significance in relation to contracting and especially in relation to letters of intent.

The use of letters of intent in contracting is ingrained within the construction industry and can often provide a fast solution to finalising contractual arrangements and ensuring the timely commencement of a project.

However, beware the fast solution and the quick fix. There are a number of important considerations that must be taken into account before issuing or responding to a letter of intent.

### WHAT ARE LETTERS OF INTENT AND WHAT ARE THEY USED FOR?

A letter of intent is a statement of intention that outlines an intended agreement between two or more parties. Letters of intent can be used for a number of purposes, including:

- As a comfort letter, that without more will not form any type of contract.
- As a preliminary contract between the parties.
- To direct a contractor to start works.

### WHEN ARE LETTERS OF INTENT BINDING?

To ensure that a letter of intent is contractually binding, it should:

- Clearly state that it is a contractually binding document.

- Ensure that all essential terms of the agreement are described with certainty (including the scope of works, payment, completion date, insurance and termination).

- Provide something of value to pass from one party to the other, such as a monetary sum in exchange for work done.

Whether a letter of intent will give rise to a binding contract depends on the circumstances of each case.

### PRACTICAL TIPS FOR PRINCIPALS

Principals are generally in a stronger position when a binding contract exists. A contractual letter of intent may carry with it the following advantages for a principal over a non-binding letter of intent:

- An agreement clearly spells out essential terms.
- When a contract is formed a number of implied terms arise as a matter of law, such as under a supply agreement, where the goods are to be fit for the intended purpose.
- It may be easier to claim against a contractor for defective or substandard work.
- As an incentive to ensure contractors finish the job.

Principals therefore need to act with caution in issuing letters of intent, and should consider whether they wish a letter of intent to form a contractually binding arrangement. There are a number of steps that a principal may take to help manage and minimise risk when dealing with letters of intent:

#### Timing is essential

Sending a letter of intent to a contractor too early during the course of contractual negotiations can undermine a principal's bargaining position. If a contractor is granted access and permitted

to start work, then the contractor may have good reason to believe it has been successful in winning the contract. A principal who then resiles from this position may experience delays to the project as well as other disruptions. It will also diminish leverage in negotiating a final price.

#### Ensure that you retain control of what is occurring

We recommend including a clause in the letter of intent to ensure the contractor must cease work on the principal's written instruction. The inclusion of this clause requires the contractor to vacate the site on request, and makes it clear that the contractor may not claim for overheads or loss of profit regarding outstanding work if the principal issues a notice to cease work.

#### Make your intentions clear

Include a statement in the letter of intent that there is no intention to enter into a binding contractual relationship with the contractor, other than on the terms set out in the letter of intent. This precaution will help you to avoid any claim by the contractor for loss of profit based on the value of the whole works if the works are abandoned.

#### Be precise

The basis, method and frequency of payment for the work being executed under the letter of intent should be clearly determined to avoid problems associated with having to later value the work.

#### Limit your liability to make payments

A principal should consider imposing a financial ceiling on its liability for payment. A monetary cap may be included on the amount of work or commitments which the contractor is allowed to take, or, alternatively a provision that all work or commitments must be approved by the superintendent in advance.

### **Make provision for subcontractors**

A clause should be included providing that any subcontract entered into by the contractor should be assignable to the principal.

### **A formal agreement is important**

To entice a contractor to enter a formal contract as soon as possible, a clause should be included stating that the contractor is not entitled to any payment for profit or overheads under the letter of intent. Further, a term providing that the formal contract is to have retrospective effect and that any payments made under the letter of intent are deemed to have been made under the formal contract.

### **Use insurance to manage your risk**

Insurance of the works should be addressed. Although there is no formal contract in place, this does not reduce the risk associated with carrying out construction works. The provision of insurance is necessary to manage this risk.

### **PRACTICAL TIPS FOR CONTRACTORS**

It is often true that non-binding letters of intent benefit contractors. This is because in the absence of a contractual arrangement there are very few obligations imposed upon a contractor. The advantages of non-binding letters of intent to contractors include the following:

- A contractor may have no obligation to complete the work.
- A contractor may start and stop work as it pleases.
- A contractor may change its mind as to the terms of the agreement, leaving the principal with the only real option of directing the contractor to leave the site. Where this occurs, a contractor will be entitled to the

reasonable value of the work done.

- Limited liability in respect of defects, as these will only factor in a calculation of the reasonable work done.

However, in large commercial dealings certainty and risk allocation is important to principals and contractors alike and we therefore recommend formal contracts to manage and allocate this risk. There are a number of precautions that a contractor may take to help manage and minimise risk when dealing with letters of intent:

#### **Get it in writing**

Ideally a signed contract should be executed prior to commencement of work on site. If this is not possible, a contractor should not commence works until a clear written agreement is obtained.

#### **Make your intentions clear**

A contractor should be extremely cautious in its preliminary dealings with a principal to avoid entering into unintentional obligations. Care should be taken to ensure terms of any agreement are clear to avoid future confusion.

#### **Getting advice up front will save you money**

Letters of intent should only be used after obtaining legal advice, as they have the capacity to form legally binding contracts at law.

#### **Deal with payment now**

Although a contractor may be able to claim on a quantum meruit basis, it is preferable that the issue of payment is addressed in the letter of intent. This should take the form of an express undertaking given by the principal that all costs, together with a reasonable allowance for overheads and profits will be reimbursed should the contract not proceed.

### **Determine whether the letter of intent is binding**

If the letter of intent does not create contractual obligations, a contractor is under no obligation to either continue with or to complete the work. This may be beneficial to a contractor if there is a delay in the execution of the formal contract.

### **FORMALISE YOUR AGREEMENTS**

Although letters of intent are useful as they enable work to commence on site prior to a formal contract being entered into, they should never be regarded as a permanent substitute for a formal contract. This is because a formal contract allows the parties to set out with particularity exactly what they are agreeing to do and what obligations they are agreeing to adopt. This is particularly important in substantial contracts where significant risk allocation is necessary.