

Investing in Infrastructure | International Best Legal Practice in Project and Construction Agreements | January 2016

Damian McNair | Partner, Legal | M: +61 421 899 231 | E: damian.mcnair@au.pwc.com

Letters of intent



Letters of intent

Introduction

Ideally, construction work should not proceed on a project until a full and complete contract has been entered into by the parties. The benefits of entering into a formal contract are significant and include:

- certainty of rights and obligations
- certainty of price
- clear allocation of risk between the parties
- detailed description of the scope of works
- provision for the resolution of disputes between the parties
- provision for the termination of the agreement in clearly defined circumstances.

However, sometimes it is not practicable or commercially desirable to delay the commencement of construction until a contract has been signed. In these circumstances, the parties may wish to proceed on the basis of a letter of intent, sometimes referred to as a letter of agreement or letter of acceptance (LOI). This alert raises and comments on the critical issues for an Owner or Developer to consider if it is contemplating proceeding with construction before executing a contract with its Contractor (or design with its consultant).

The primary disadvantages for an Owner in relation to many LOIs are as follows:

- there is often uncertainty as to whether an LOI creates a binding agreement. As a result, the parties' rights and obligations in relation to carrying out the work and the payment for that work are not certain
- often there is little incentive for the Contractor to complete negotiations and execute a final contract, since the uncertainty referred to above will generally benefit the Contractor.

Nonetheless, a properly worded LOI is generally better than proceeding without any documentation, but it is no substitute for a complete contract.

Binding or non-binding?

The main issue to consider is whether the Owner wants to merely express an intent to enter into a contract or actually enter a contract for the commencement of certain works whilst the contract is finalised and executed.

If the Owner wants to express intent but not be bound by the LOI, then the LOI needs to clearly state that position. Specific legal advice should be sought on the content of any LOI before it is issued to a Contractor or consultant.

Although it is not strictly necessary if the LOI is clearly drafted, the following paragraph can be added to the LOI for certainty:

This non-binding letter of intent is simply a statement of the parties' present intentions with respect to its contents. Each party represents to the other that no reliance will be placed on this letter. This letter does not and is not intended to constitute a binding obligation.

In most circumstances the Owner's purpose with a LOI is to authorise certain works to commence before the contract is signed. In this case, the LOI is in fact a contract and therefore the usual pre-requisites for a contract must be present.

It is crucial that the LOI does accept the Contractor's or consultant's proposal or submission (usually as part of a tender process). This is important regardless of whether the letter is merely expressing intent to enter a contract or is a binding contract itself. By accepting a Contractor's proposal certain qualifications, exclusions or contractual terms that conflict with the Owner's requirements may be incorporated into the deal inadvertently.

Essential terms for a LOI

Payment and scope of the works

The critical portion of the LOI is that dealing with payment, the scope of the Contractor's works and the standard of performance required of the Contractor. In this regard, the LOI should cover the following.

- the basis upon which the Contractor is to be paid for work under the letter (eg cost plus margin, lump sum etc)
- timing and processes for the submission of invoices for payment (it may be appropriate for no payments to be made until the contract is signed – This can be a useful incentive for the Contractor to sign the contract)
- a cap on the amount payable to the Contractor under the letter, which can be extended at the discretion of the Owner (this is to avoid the risk of the Contractor incurring significant costs and then claiming for these costs)
- identify as precisely as possible the scope of the works to be carried out
- provision for the Owner's right to vary the scope of the works
- where appropriate, a completion date for the works
- a statement of the Contractor's standard of care to be adopted in performing the works
- a right of set-off for the Owner.

Termination

It is critical that the letter clearly sets out the circumstances under which the agreement contained in the LOI comes to an end. There are three ways for the agreement to end.

- The parties sign the formal contract.
- The parties do not sign a contract by an agreed date.
- The Owner elects to terminate the agreement.

Following termination under the second and third dot points above, the LOI should prescribe a procedure for the Contractor to stop work, make the site safe, vacate the site and return any equipment or documents provided to it by the Owner.

The LOI should state that the Contractor's entitlement to further payment following termination is limited to any amounts outstanding for work performed up to the date of termination. And in all cases payments under or in connection with the LOI should be subject to the overall cap.

Draft contract

If, at the time of entry into the LOI, a draft detailed contract is in existence, it is suggested that one of the following approaches is adopted.

- Attach the whole of the draft terms, and specify that even though they have not yet been agreed by the parties as forming the final contract, the full terms will be binding with respect to the whole of the works until the LOI is replaced by the final contract.

- Simply identify the relevant terms of the draft contract which have been finalised to date, for example, contractual conditions in relation to insurance, and intellectual property rights.

Intention to enter into a contract

Given the purpose of the LOI is to bridge the time between commencement of construction and execution of a final contract it should state that the intention of the parties is to enter into a formal contract and that the parties will use their best endeavours to execute the contract as soon as reasonably possible.

Whilst such a provision is unlikely to be legally enforceable, it provides an important indication of the parties' commercial intent for a more detailed discussion about agreements to enter into a formal contract. The LOI can be drafted such that it creates incentives for the Contractor to execute the final contract, for example, there should be no limitation of liability for the Contractor (also see the termination regime referred to below).

Retrospective effect of a contract

The LOI should also provide for the retrospective effect of the final contract. For example, by providing that:

If and when the contract is signed, the terms and conditions of the contract will retrospectively govern the work carried out by you pursuant to this letter. Any monies paid to you in respect of works performed pursuant to this letter shall form part of the contract sum under the contract.

It is also essential that a similar provision is included in the final contract.

Failure to enter into a contract

The LOI should provide that, if no contract is entered into, the LOI covers the whole of the works.

Other Terms

There are a number of other terms that should be included in the LOI. Ideally these terms should be the same as those contained in the draft contract attached to the LOI. These should cover the following topics:

- insurance (including a clear statement of what insurance the Contractor is required to effect and maintain)
- approvals (which party is to obtain)
- intellectual property
- sub contracting
- confidentiality
- governing law and language of the agreement
- dispute resolution.

Conclusion

Although a LOI should never replace a complete contract, a LOI covering the issues discussed above can significantly reduce the risks inherent in commencing construction in the absence of a full and complete contract between the parties.

© 2016 PricewaterhouseCoopers. All rights reserved.

PwC refers to the Australian member firm, and may sometimes refer to the PwC network.

Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

At PwC Australia our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.au

Liability limited by a scheme approved under Professional Standards Legislation.