Letters of Intent in Construction

In a perfect world, principals and contractors (and contractors and subcontractors) would finalise all aspects of their deal and record it fully in a written, signed contract before any work was performed or expenditure incurred. In reality, however, the parties are often under commercial pressure to commence preliminary works as soon as possible and turn to a "letter of intent" (LOI) while they continue to negotiate the main contract.

The use of a LOI can be beneficial as it can allow the parties to get a head start on the construction program in a number of useful ways, allowing them to let the subcontracts, begin the design process or order long lead-time items. There are, however, significant risks attached to this approach and so it is important that great care is taken to properly record the parties’ true intentions (and even then there is a risk of difficulties and disputes arising).

Potential risks with using a LOI

One of the risks when dealing with LOIs will be whether the LOI has been replaced by a full contract, especially if the LOI is expressed as expiring on a set date or the payment limit for the project has been exceeded and the parties ignore the expiry or payment cap and continue to perform the contract. Furthermore, LOIs will not usually record the key terms dealt with under a full contract such as variations, extensions of time and defects.

Drafting tips for LOIs

When preparing a LOI, it is important to:

- expressly state whether or not it is intended to be legally binding;
- identify the key terms of the contemplated agreement, so far as they can be agreed, including:
  - parties to the LOI;
  - scope of works;
  - maximum price for the works which are to be carried out under the LOI;
  - construction program, with a definite completion date;
  - payment mechanism, showing how payments are to be made and assessed under the LOI; and
  - termination rights.
- set out any outstanding commercial matters to be resolved (or conditions precedent to be satisfied) before the main contract can be entered into;
- make it clear, if this is the intention of the parties, that the LOI is intended to give rise only to an interim agreement pending the negotiation of the main contract, and that neither party intends to be bound by the main contract until the written document is executed by each of them. However, if the parties’ behaviour contradicts this (by acting outside of the scope of the LOI), it is possible for the parties to inadvertently waive such provisions;
- set out insurance provisions required to be taken out by the parties in relation to the works;
- make mention of GST, as failure to do so can lead to a dispute on whether the sum is inclusive or exclusive of GST;
Conclusion

It is always preferable to negotiate and enter into a full contract which deals with all issues, rather than diverting resources to the preparation of a LOI (or any other interim/preliminary contract for that matter). However, in the face of pressing commercial realities (such as tight timeframes for the completion of a project), there will continue to be a use for LOIs in order to document (albeit on an interim basis) the parties’ intentions for a particular project and allow for an early start on a project.

Despite the clear benefit of being able to get the ball rolling earlier under a LOI (as compared to finalising a full contract), there are significant risks attached to commencing a project under such an arrangement. If the parties seek to take this approach, it is critical in the process that the client’s intentions are achieved in preparing the LOI. From a legal perspective, this is primarily achieved through the use of clear language which covers all critical and necessary issues, as set out above.

- include a method of dispute resolution within the LOI;
- make it clear who is to be the instruction-giver in relation to the work to be carried out; and
- make it clear that once the intended contract is concluded it will apply retrospectively, and that any payments under the LOI will be treated as payments against obligations under the main contract once this comes into force.