

Construction focus: A solution to a problem or a problem in itself?

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Risk allocation around the pricing of works is a key commercial point in any construction project. Although different forms of contract contain different mechanisms on how the price of the works is calculated, the vast majority of contracts that we see on a daily basis are 'lump sum' contracts whereby pricing risk is passed to the contractor by the parties agreeing a lump sum that can only be adjusted in certain circumstances under the building contract. The JCT Design and Build Contract 2016 (JCT DB) and the JCT Standard Building Contract 2016 are two such examples of lump sum contracts. Although the JCT DB and other JCT forms do include various optional fluctuations provisions which are designed to deal with the circumstances in which a contract sum can be adjusted (eg, for changes to labour and materials costs), these are typically disappplied by employer-clients, who want as much cost certainty as possible.

However, contractors are becoming more reluctant to take on cost risk due to the increasing cost of raw materials, supply chain issues, labour shortages and extended lead times - all of which are set against the backdrop of, and compounded by, increasing energy prices and the geopolitical situation in Ukraine.

The Department for Business, Energy and Industrial Strategy's '[Monthly Statistics of Building Materials and Components for August 2022](#)' showed a 24.1% rise in 'All Work' construction material prices in July 2022 when compared to July 2021 prices and a 45.2% rise when compared to July 2020 prices. There are concerns that construction prices will continue to rise in Q4 of 2022 and 2023. The Construction Leadership Council's '[Construction Product Availability Statement](#)' on 13 September 2022 noted that:

Price inflation remains the biggest issue for the entire industry and further significant increases in inflation are anticipated due to energy, raw material and labour cost rises.

The economic climate and the continuing volatility in construction prices means that contractors are reluctant to hold tender prices for long and are becoming more hesitant to agree a lump sum contract without 'pricing in' the risk as part of a higher lump sum (thereby allowing the contractor to absorb price increases) and/or securing the ability to place orders with key suppliers sufficiently early on in the project to 'lock-in' current prices.

However, construction contracts are often long and technical documents. Even where legal or commercial terms of a contract are concluded quickly, it can take time to collate the various technical documents which describe the works to be undertaken. While the building contract is negotiated and collated, it is often the case that employers and contractors want to get on site or want to start securing orders for long lead-in items, or items where they want to secure prices. This often necessitates the use of a pre-contract tool such as a letter of intent, a letter underwriting costs or some other similar arrangement.

However, as warned by Lord Clarke in *RTS Flexible Systems Ltd v Molkerei Alois Muller GbmH & Co KG* [2010], parties should be cautious of the:

... perils of beginning work without agreeing the precise basis upon which it is to be done. The moral of the story is to agree first and to start work later.

With the use of pre-contract documents on the rise, it is therefore important to consider the risks of entering into such documents as well as the perceived benefits.

What is a 'letter of intent'?

Although the term 'letter of intent' does not have a specific legal meaning, it is usually a letter given by the employer to a contractor which is seen as a 'stepping stone' to a formal contract, which allows the contractor to carry out works before the main contract is entered into.

Letters of intent generally indicate an intention to enter into a formal contract at a later date and instruct the contractor to carry out certain works in the interim period; they work on the basis that a contractor will carry out a specific scope of authorised activities with an agreed maximum expenditure typically calculated by reference to the period for which it is envisaged that the letter will be required to subsist before the building contract is placed. Authorised activities might include site set-up, commencement of design work and/or the placement of orders with suppliers, as well as physical works on site.

What are the benefits?

As alluded to above, the key benefit of a letter of intent is to allow the contractor to commence works on site before the building contract is signed. This saves precious time and helps ensure that the project commences on time.

What are the risks?

When the building contract is entered into, it typically supersedes the letter of intent and works performed under the letter of intent are deemed to have been performed under the terms of the building contract.

However, issues can arise when the building contract is not entered into as intended, with such disputes often revolving around payment. As such, there are a number of points to be aware of from an employer's perspective when entering into a letter of intent.

Clear terms

As with all contracts, the letter of intent needs to clearly set out the terms of the agreement. If a dispute arises, the normal principles of contractual construction and interpretation will apply, and the legal effect of the letter will turn on the drafting. As commented by HH Humphrey Lloyd QC in *Tesco Stores v Costain Construction* [2003]:

It is part of the folklore of the construction industry that there is exists a mythical beast, 'the Letter of Intent' ... the legal effect of a letter of intent depends on the true construction of the communications between the parties and the effect, if any, of their actions pursuant to those communications.

If a letter of intent is to be used, it should provide the parties with certainty about:

- the scope of work to be carried out by the contractor;
- the payment mechanism and the limit of expenditure that is authorised;
- when the letter of intent starts and whether it expires;
- what terms and conditions apply to the works being carried out;
- termination rights and what happens on expiry or termination; and
- the agreed procedures for dispute resolution.

If the contractor is carrying out any design, a copyright licence should also be included. If the contractor is carrying out works, it is important to confirm who is expected to obtain the relevant insurances for the works.

Agreement of the building contract

Ideally, the legal terms of the main building contract should be agreed before a letter of intent is entered into and should be clearly referred to in the letter of intent (particularly if the terms of that contract are to apply to any work undertaken pursuant to the letter). Key commercial items such as contract sum, the level of liquidated and ascertained damages (if applicable), date of possession and completion date, should also be agreed before the letter of intent is entered into and it is good practice to recite these in the letter of intent.

One of the main risks in entering into a letter of intent before the parties have agreed the contract terms is that the employer's bargaining power may be significantly reduced once the letter of intent has been entered into and the contractor has started work.

Sticking to agreed limitations

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work outside of the authorised scope or beyond the expiry date so as to keep the project on target. However, this raises problems if the final contract is never entered into and a dispute arises as to payment or such other matter.

In *RTS*, the original letter of intent (which contained a draft contract and included a clause which said that the contract would not be binding unless signed by both parties) had expired. After its expiry, the contractor continued to carry out the works, but the building contract was never signed. The Supreme Court held that the actions of the parties after the expiry date created a binding contract between the parties in the terms of the letter of intent. It is therefore important to stick to the agreed limitations (ie scope, payment and timing) and to formally record any changes if needed.

An agreement to enter into the building contract

A letter of intent is only an agreement to enter into the building contract. There is always a risk that a contractor may choose not to enter into the building contract when asked to do so, or that it may seek to renegotiate contract terms (including the previously agreed price). This is a particular risk in the current market while prices continue to increase. Although this risk can be managed by keeping the duration of any letter of intent as short as possible, our view is that a court is unlikely to require a contractor to enter into the building contract by ordering specific performance, as damages would likely be considered an adequate remedy for the employer. However, delays to the project caused by retendering works in this situation may cause the employer serious difficulties, especially if it has agreed to deliver a project for a third party in a particular timescale.

Conditional contracts as an alternative?

If 'locking in' the price is important, but the parties are not ready to proceed straight to a full building contract for some reason, it may be possible to adopt a creative solution, such as entering into a conditional building contract. Depending on the reason the parties cannot enter into a full building contract, there are various ways in which such a contract could be structured. One such structure we have used on recent projects is to introduce a 'pre-construction phase', with the full construction phase under the building contract being triggered by the employer once certain agreed events arise. During the pre-construction phase, the contractor may be authorised to undertake similar activities to those instructed under a letter of intent - the benefits being that the parties are bound into a contract with an agreed contract sum from the outset and the triggering of the construction phase is in the employer's control. However, this approach may not be an option if insufficient commercial parameters are agreed to allow a conditional contract to be concluded.

Underwriting of orders

In contrast to a letter of intent which typically authorises works, it may be that a contractor wishes to pre-order materials to lock in prices and secure production slots. In these circumstances, it may be that a letter from the employer underwriting the cost of early orders, is more appropriate. For the purposes of this article, we refer to such letters as 'letters of undertaking', but this term has no formal legal meaning and the form such a letter will take depends on whether the employer intends to make any payment to the contractor.

It may be that the letter of undertaking requires the employer to make payment to the contractor in relation to certain orders (eg, to underwrite deposit payments the contractor is required to make) but equally we draft letters where no payment passes from employer to contractor: the letter simply confirms that the contractor is authorised to place certain orders of an agreed value and the employer agrees to pay those pre-agreed costs to the contractor if the building contract is not entered into for some reason (less any refunds or discounts the contractor might be able to obtain).

What are the benefits?

The use of letters of undertaking allows contractors to order long-lead items early on in the project and before the contract is placed. They allow contractors to secure prices with its supply chain (giving them comfort to agree a lump sum price with the employer) and help to ensure that the project commences on time.

What are the risks?

Any payment and termination obligations need to be set out in clear and certain terms. If payments are being made to the contractor under a letter of undertaking, these should (where possible) be made subject to title in the materials being vested in the employer and subject to other protections (eg, appropriate contractual reliance on any design) so that the employer will not be without recourse if the building contract is not entered into or if the contractor becomes insolvent.

Concluding thoughts

Although it is always advisable to enter into a building contract rather than commence work under a letter of intent or other pre-contract tool, there may be times where this is not possible for the reasons highlighted above. It is important to be aware of the risks of entering into letters of intent and undertaking (and other forms of pre-contract tool), and to weigh these against the benefits. While such letters can often seem like a straightforward solution to the pressures arising from increasing construction prices and long lead times, they may cause unintended issues further down the line if due consideration is not given to their terms.

Cases Referenced

- *RTS Flexible Systems Ltd v Molkerei Alois Muller GbmH & Co KG* [2010] UKSC 14
- *Tesco Stores v Costain Construction* [2003] EWHC 1487 (TCC)

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