

CONSIDER THIS

consequences of that might be.

If the project proceeds while the contract documents are being negotiated, that affects the parties' negotiating positions.

The client may find itself with part of a project, which the contracting market would demand a substantial premium to complete (if it were willing to do so at all).

While the work that has been carried out to date will typically present a low residual risk 'tail' for the contractor, he may only be entitled to payment at cost. Even that might be uncertain (if he has burst a ceiling on time, money, or workscope). He will be reluctant for the market to perceive him as the contractor who failed to complete a project, or could not be relied upon by his client. He will have formulated his short to medium term business plan relying on the revenue from the project. His supply chain will be aligned to that.

Generally, a letter of intent will represent a greater risk to the upstream party than to the downstream party. On any view, though, the longer the letter of intent remains in place, the more difficult it will be for either party to withdraw. That means that both parties' negotiating positions weaken.

By contrast, work-start can be postponed in its entirety until the contract documents are agreed. In that way, the contractor cannot rely on being appointed, and the client cannot make progress towards his end goal. Suspension of appointment and project delivery may bring a momentum to contract negotiation, which is lost when work starts on a letter of intent. There is a question that the parties should ask themselves, which is sometimes a difficult one: is the fact that the contract documents have not been agreed when work is to start a signal that there is a real stumbling block in the negotiation?

...Letters of intent are used too often in the construction industry as a way of avoiding, or at least putting off, potentially difficult questions as to the final make-up of the contract and the contract documents. There is no doubt that, sometimes, they are issued in the hope that, once the work is underway, potentially difficult contract issues will somehow resolve themselves. They are plainly not appropriate in such circumstances.¹

Key points

The risks are therefore numerous, and can be sizeable. Most importantly, there is a clear risk that it may prove impossible to agree a full contract, in which case the letter of intent will govern all of the work done. But there

may be circumstances in which there is a compelling argument for a letter of intent. There may be a commercial imperative to make progress. A particular works package may have a disproportionate lead-in time, or a sensitive availability window.

Mr Justice Coulson set out the circumstances in which he considers that a carefully drafted letter of intent might be appropriate¹:

A letter of intent can be appropriate in circumstances where:

- i) the contract workscope and the price are either agreed or there is a clear mechanism in place for such workscope and price to be agreed;*
- ii) the contract terms are (or are very likely to be) agreed;*
- iii) the start and finish dates and the contract programme are broadly agreed;*
- iv) there are good reasons to start work in advance of the finalisation of all the contract documents.*

If a letter of intent is to be put in place, the following risk-reduction measures are recommended:

- It should be put in place for as short a time as possible. It is not a breathing space, but a limited opportunity to conclude the negotiation. Before the letter of intent is exhausted, the parties must conclude the negotiation, or be ready to put in place a further letter of intent for a similarly carefully framed workscope.
- The workscope should be described in detail, probably by reference to the tender enquiry documents (and the technical components of the tender, especially if the contractor carries design responsibility though there is then a need to guard against clashes among the documents). The financial limit and programme milestone should be clear, and generous enough to allow all of the defined work to be carried out within them (so that there is not a clash among these three types of limit on the contractor's obligations).
- The payment mechanism should be clear. Payment of the contractor's reasonable cost, perhaps plus a pre-defined profit allowance, is usually the best route to a simple and clear mechanism.
- It should be signed by both parties to signify their acceptance, and to avoid the scope for a 'battle of the forms'.

If these guidelines are adhered to, then the risks involved in letters of intent will be mitigated. Save for necessary, short-term, circumstances, however, letters of intent remain unsatisfactory platforms for construction and engineering projects.

**Head Office:**

Stapleton International
Stanhope House
113-117 Stanhope Road South
Darlington, County Durham
DL3 7SF
United Kingdom
Tel: +44 (0)1325 488048
Fax: +44 (0)1325 281245

Other principal offices:

Stapleton International
78 Cornhill
London
EC3V 3QQ
United Kingdom
Tel: +44 (0) 207 648 2800
Fax: +44 (0) 207 621 0202

Stapleton International Pte Ltd
20 Cecil Street
#21-01 Equity Plaza
Singapore 049705
Tel: +65 6222 5523
Fax: +65 6222 5521

Stapleton International
11490 Westheimer
Suite 850
Houston, TX 77077
Tel: +1 713 425 6315
Fax: +1 713 783 0067

Stapleton International is a multi-disciplinary consultancy working to provide professional services to our clients.

We assist our clients in the effective management of complex technical and commercial issues related to large engineering and construction projects, providing solutions in:

- Risk Assessment and Management**
- Planning and Scheduling**
- Cost Management**
- Dispute Resolution**
- Expert Witness Services**

**CONSIDER THIS**

A brief review of commercial issues relevant to the construction, engineering and energy industries.



Mark Dixon BSc (Hons), DipArb, FRICS, FACostE, FCI Arb, Chartered Arbitrator, Director, Stapleton International Limited

Expert Witness Agreed Joint Statements - Open or Privileged?

It is common in civil litigation and arbitration proceedings for a judge or arbitrator to make an order requiring expert witnesses of the same discipline to meet on a without prejudice basis and prepare a statement of the issues upon which they are agreed and those which they are not agreed.

While the discussions between experts remain without prejudice, the content of any agreed joint statement is not, since the primary purposes of the statement is to assist the court and the parties in refining and hopefully limiting the issues. The statement would serve no purpose if it remained protected.

Expert statements made for the purposes of a mediation, on the other hand, would ordinarily remain without prejudice, since they would be protected, as a matter of public policy, by the without prejudice cloak of the mediation process.

The rise in popularity of mediation, particularly during the course of formal proceedings, does however raise potential difficulties concerning the purpose and status of documents produced.

This difficulty arose in *Aird & Anor v Prime Meridian Limited* [2006] BLR 494.

In that case, the HHJ Thornton QC held a case conference where there was discussion about the benefits of the parties' respective architectural experts meeting to discuss certain issues. At the same conference, both parties expressed willingness to try and resolve their differences by mediation.

Following the case conference, the judge made an order, inter alia, that (i) the architectural experts should meet on a without prejudice basis and prepare a statement of the issues upon which they are agreed and those which they are not agreed and (ii) the proceedings shall be stayed to allow the parties to attempt mediation.

The experts subsequently agreed a draft joint statement which was initially marked 'without prejudice', but a final draft was soon agreed and signed with the without prejudice marking removed.

The mediation took place a couple of months later, but proved unsuccessful.

Stapleton International Limited

Stapleton is a long established firm of consultants investigating contractual, financial and management issues within the construction, engineering and energy industries.

For further information please contact Suzanne Green.

Head Office:

Tel: +44 (0) 1325 488048

Fax: +44 (0) 1325 281245

E-mail: info@stapletonint.com

Website: www.stapletonint.com

"Articles and opinions in this newsletter are the opinions of the authors and not necessarily of Stapleton International. They should not be applied to any particular set of facts without seeking appropriate professional advice."

If you have any comments on the issues raised in this edition or there are any subjects you would like to see addressed in future issues of this newsletter please contact Suzanne Green.

Email: suzanne.green@stapletonint.com

¹ Cunningham & Others -v- Collett & Farmer TCC 2006, para 89 ² As in ERDC -v- Brunel University TCC 2006
¹ Cunningham & Others -v- Farmer TCC 2006, para 90

CONSIDER THIS

Following this, the claimant sought to amend its claim in the litigation. The application was resisted by the defendant on the basis that the proposed amendments were inconsistent with the views expressed by the claimant's expert in the earlier signed joint statement. The claimant contended that the joint statement was prepared for the purposes of the mediation and so was privileged. The defendant accordingly sought a declaration that the statement was a conventional joint statement under CPR rule 35.13(3) and therefore an open document.

In order to protect HHJ Thornton from hearing any prejudicial information, the application was heard by another judge. Before the judge was a statement from HHJ Thornton setting out his understanding of the order that he made, and evidence from the parties' respective solicitors and experts. The judge decided the application without a hearing.

In refusing the defendant's application, the judge concluded:

(1) A joint statement of the kind signed by the experts would not usually be privileged. The fact that it might have subsequently been used in a mediation would make no difference.

(2) However, the present case was not a usual situation. The judge did not think he was making a conventional order,

but rather an order for the purposes of the mediation. The claimant's solicitor and expert thought it was for the purposes of mediation.

At its highest, the defendant's expert thought it had a dual purpose. As at September 2005, the primary function of the statement was to assist the mediation. Prima facie, therefore, the document was privileged.

(3) The claimant's expert did not carry out the sort of extensive background work that he would ordinarily have done before signing a conventional joint statement and it would be unfair to the claimant to conclude that the statement was an open document in circumstances where, had the expert realised it had such status, he would not have signed it at all.

The judge therefore concluded on the facts that the statement was privileged.

The defendant however obtained leave to appeal. In reversing the first instance judgment, the Court of Appeal said:

(1) The judge was wrong to qualify the terms of HHJ Thornton's order. HHJ Thornton's subsequent view, unexpressed at the time, was immaterial.

(2) A court does not in any event have the power to make an order, qualified as the judge found, in compelling the parties to produce a without prejudice statement.

(3) The words used in the order plainly required a joint statement to be agreed in the conventional sense.

(4) Contrary to the findings of the judge, the evidence supported the view that the experts both understood that it was a conventional joint statement for the court proceedings.

(5) The timing of the joint statement in relation to the relatively early stage of the proceedings was irrelevant.

Interestingly, while an appeal court would not normally open up and change findings of fact made in the first instance, the Court of Appeal in this case justified itself on the grounds that the first instance decision was made without a hearing and so the Court of Appeal was in just as good a position to decide the facts.

The lessons are clear from this case. Where mediation or other form of ADR is to take place during more formal proceedings, the expert and those instructing him must be meticulous in ensuring the purpose of any document produced is understood by all concerned and that purpose is appropriately and accurately recorded.

Mark Dixon is a Director at Stapleton International Limited and is a practising expert witness, arbitrator and adjudicator. You can e-mail him at mark.dixon@stapletonint.com

Commercial Risks

The contractor may start on a letter of intent, without completing his due diligence on the client or insisting on payment security (as he might do as part of the contract negotiation). But what begins as low risk can grow if the letter of intent is still in place when work becomes more intense: with the result that the monthly turnover could exceed the client's ability to pay.

There is a supply chain risk for the contractor. He may have a limited obligation to his client (eg to do a prescribed scope of work, up to a set financial ceiling, or to a defined milestone). It may not be very clear exactly what the contractor is to do. Or it may be clear, but susceptible to quick change. It is difficult to engineer a 'back-to-back' chain of responsibility in that context. The employer is also at risk: the long-term programme might be extended by virtue of letters of intent. If the contractor can only 'drip-feed' his supply chain, procurement and production windows may be missed.

Typically, the contractor's payment entitlement under a letter of intent is imprecise. Is he to be paid at cost (or cost plus) or in accordance with the value of the works? And if it is value-driven, how is that value to be assessed when the contract documents are not agreed? Does the value include the cost of materials on-site, but not yet constructed? Does it include the cost of materials off-site? And so on. An apparently simple mechanism may be a recipe for uncertainty for both parties.

The marketability of the project might suffer, to the client's prejudice. It is unusual for the contractor engaged on a letter of intent to have to provide collateral warranties, but the market might demand such warranties, for institutional investors, potential tenants, funders, and so on. If the client cannot provide such warranties, then the value of the development may suffer materially.

Pending agreement of the full contract, the insurance arrangements may not be settled. Problems might then arise during (or even after) design and construction, for which there is no insurance which might have responded to the issues had the contract documents been in place and had they demanded it.

A project proceeding on a letter of intent will usually afford the client poor control over programme, and no set liquidated damages. There will probably be no completion date – only an ill-defined obligation to make reasonable progress. If the original scope of work changes while

the contractor is constructing it, any lack of definition of the original scope will create room for debate. The letter of intent is unlikely to cater for variations.

A separate legal challenge could arise if the project is funded more than 50% by public funds. Public procurement rules must then be followed where the capital value of the project satisfies the financial threshold for compliance with the public procurement rules, which address the whole procurement process, from advertisement to award. Importantly, there is a 'standstill' period between decision to award and award, designed to allow any legal challenges to procurement. It is doubtful whether compliance with public procurement rules can take place lawfully, in tandem with letters of intent which – as a matter of fact – demonstrate that decisions have been made on procurement and construction.

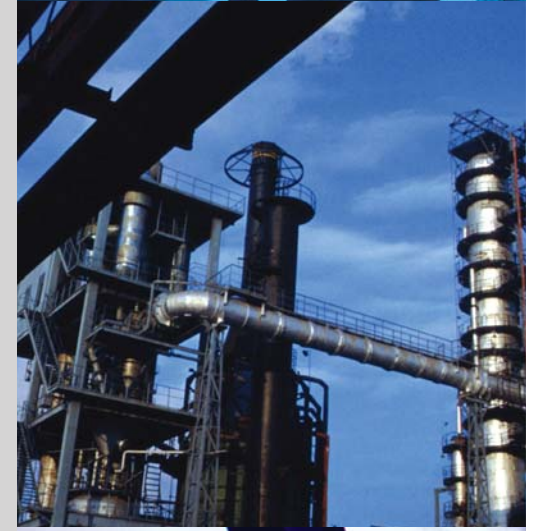
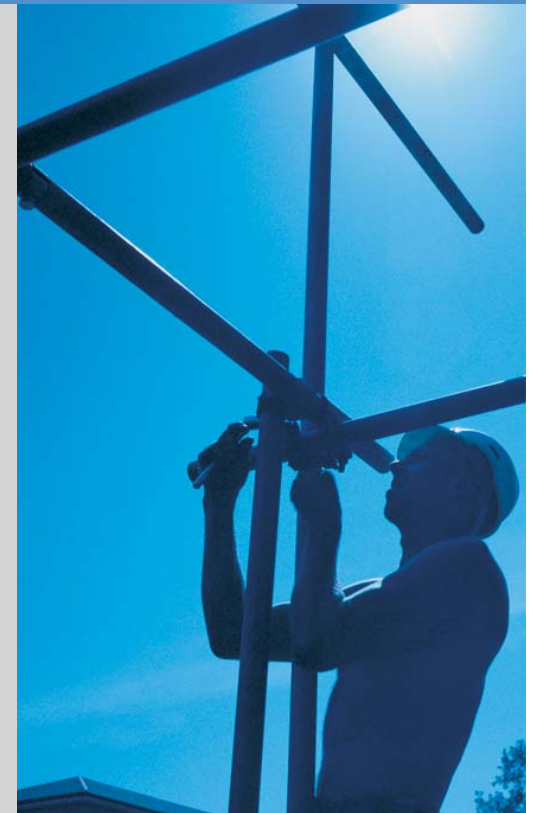
Practical Risks

This risk is best described by Mr Justice Coulson in the TCC ¹:

In my view, the principal problem with letters of intent is a practical one: once they have been sent, and the contractor has started work pursuant to that letter of intent, all those involved, including the professional team, can easily take their eye off the ball and forget about the importance of ensuring that the full contract documents are signed as quickly as possible. Everybody is then so busy dealing with the day-to-day problems being thrown up by the commencement of the works themselves that the task of signing off an often complicated set of contract documents is relegated to an item of secondary importance. Then, very often, something goes wrong on site and, in the absence of a full contract to regulate the parties' rights and obligations in such circumstances, the result is confusion and acrimony.

Tactical Risks

The principal benefit of a full formal contract is certainty. Even if one of the parties is disadvantaged by the contractual treatment of a particular issue, it at least knows what its position is. Letters of intent do not provide such certainty. And then when the letter of intent expires, the uncertainty is even more acute: do the parties continue on the letter of intent as if its limitations had been waived? Or do they shift from the letter of intent into an entitlement to be paid a reasonable value for work done ²? Uncertainty may discourage the contractor from discontinuing work, not sure what the



Letters of Intent in Construction & Engineering

by Colin J. Fraser, Partner, Construction & Engineering, McGrigors LLP Tel: +44 (0)141 567 9412 Fax: +44 (0)141 204 1351

...Letters of intent are used unthinkingly in the UK construction industry, and ...they can create many more problems than they solve.¹

There is often commercial pressure to progress a project, even though the suite of contractual documentation needs more work. A contractual platform of sorts is sometimes created, using a letter of intent to regulate the parties while the contract is negotiated.

But letters of intent are risky:

Legal Risks

As the Court made clear in ERDC –v- Brunel University, letters of intent take different

forms, with critically different consequences: *Letters of intent come in all sorts of forms. Some are merely expressions of hope; others are firmer but make it clear that no legal consequences ensue; others presage a contract and may be tantamount to an agreement "subject to contract"; others are contracts falling short of the full-blown contract that is contemplated; others are in reality that contract in all but name. There can therefore be no prior assumptions, such as looking to see if words such as "letter of intent" have or have not been used. The phrase "letter of intent" is not a term of art. Its meaning and effect depend on the circumstances of each case.*

The letter of intent might be a simple cost-

reimbursement model - a unilateral assurance by the client that it will pay the contractor for any work it carries out. Or it might be a contract in itself – either a simple or a more complex one.

A simple contract might be one to construct a prescribed scope of work, for cost plus a pre-agreed profit percentage.

A more complex contract might also incorporate the draft contract documents, in an identified revision, which will apply until the full suite is formally agreed.

The precise form of words used, and the correct interpretation of their meaning, is critical to understanding the rights and obligations - and the risk profile - undertaken by each party.

¹ Cunningham & Others -v- Collett and Farmer HHJ Coulson, TCC 2006, para 88

² Cunningham & Others -v- Collett and Farmer 2006, at para 88