SIGN ON THE DOTTED LINE

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Every time an organisation enters into a contract it is inevitably facing commercial risks. Consequently, risk – which can be defined as "the effect of uncertainty on objectives" 1 - is at the heart of commerce. Part of the management team's responsibility, on behalf of the corporation, is to mitigate this risk. Commercial risk can be managed in many ways including the establishment of policies & procedure, management of change, peer review, planning, insurance and the contractual transfer of risk.

Unexpected and unwelcome events do occur, but these are the exception and, when they do occur, a corporation may need to rely on the safety net provided by the legal liability framework. The most successful approach to contracting is to draft the contract in such a way as to be clear in terms of what has to be done and then do what the contracts says should be done.

One of the most-likely-worst-case-scenarios is that a company will go to work without a clear written contract. One situation which will result in this is that a contractor makes an offer to a potential client and, subsequent to the offer, there is a flurry of communication (some written, some not), and the client gives an instruction to start the job before the contract is reduced to a single document and executed (signed). This is often predicated on the issuing of a Letter of Intent (LOI)

It has become common in the international offshore oil and gas industry to start work before a contract is formed on the basis of an LOI. An LOI is a pre-contractual written document that details a preliminary understanding between the parties involved. As such, an LOI allows a contractor to start work and, if necessary, to order long-lead items and/or commence engineering and fabrication before a final contract has been agreed. Furthermore, as they are designed to expedite work, LOIs typically refer to and incorporate previous communications between the parties. They may also incorporate provisions from previous agreements as an interim arrangement until a final contract is agreed. However, despite all the above, an LOI does not necessarily mean that the final contract has been secured. As such, it is vital to understand whether an LOI is simply one more item of communication or the final step in the conclusion of a contract.

The fact that an LOI is not, in itself, the same as a contract was clarified in ERDC Group v Brunel University [2006], 2 where the court commented that LOIs come in many forms: some are simple expressions of intent; some make it clear that they do not create any legal obligations between the parties involved; and some are close to full-blown contracts. Consequently, the term 'letter of intent' does not offer any legal clarity. Nevertheless, although the term has no legal significance, courts often treat LOIs as legally binding. 3 As such, the wording of an LOI should be considered. Additionally, as well as the wording of an LOI, courts will look at the facts surrounding its writing to establish whether there is a contract between two parties. 4

To see how important, it is to understand when an LOI counts as a contract, we can first look to British Steel v Cleveland Bridge [1984]. 5 In this case, Cleveland Bridge, the client, issued an LOI to British Steel, the contractor, before the terms of a full contract were agreed. As part of this, Cleveland Bridge requested that British Steel expedite the work. British Steel then went on to fabricate nodes for Cleveland Bridge, as per the LOI. After the receipt of the LOI, while the work was being carried out, the parties continued to negotiate over the terms of the final contract. British Steel never agreed to certain terms proposed by Cleveland Bridge but, nonetheless, completed the work and delivered the nodes. After delivery, Cleveland Bridge refused to pay the full amount because of the timing of the delivery and the order in which the nodes were delivered. This led to a conflict in which British Steel raised an action against Cleveland Bridge to recover the shortfall and additional monies for storage. The court, however, held that no contract existed, despite British Steel beginning the work as requested, because the parties were still negotiating material terms at that time.

In the judgment, the court commented that both parties were confident a formal contract would be agreed when Cleveland Bridge asked British Steel to commence the work. The court added that if a contract had been agreed, the parties would have been bound by its terms. However, no contract was agreed, so there were no terms to refer to. In this situation, the law provided that Cleveland Bridge pay British Steel a reasonable sum for the work and, because the parties had not concluded their negotiations, it was not possible to establish the extent of their respective liabilities. This shows that working on an LOI alone, without clearly setting out whether this will count as a contract in the event of a dispute, can give rise to harmful uncertainty.

We can see another case of uncertainty caused by relying upon an LOI in RTS Flexible Systems Limited v Molkerei Alois Muller [2010]. 6 In this case, three courts - the court of first instance, the appeal court and the Supreme Court - reached three different conclusions after reviewing the same facts. To summarise, RTS, the contractor,

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1 ISO 31000
2 ERDC Group Ltd v Brunel University [2006] BLR 255 at 256
3 In Turrif Construction Ltd v Regalia Knitting Mills Ltd. [1971] 9 BLR 20, contractural obligations were held to exist
4 AC Controls v British Broadcasting Corporation [2002] 89 Con LR 52
5 British Steel Corporation v Cleveland Bridge and Engineering Co ltd [1984] 62 BLR 107

was asked to provide an automated system for packing yoghurt pots by Muller, the client. During negotiations, RTS provided several different offers, the last of which included a fixed price of £1,682,000 and a description of the work. The work was to be completed by September 2005. To meet this deadline, in February 2005, RTS agreed to commence work based on an LOI in which Muller expressed their wish to proceed with the project as set out in the last offer, with a final contract set to be agreed and signed within four weeks. The LOI went on to state that the contract would be based on a model form contract provided by the Institute of Electrical Engineers. The model form, meanwhile, provided that the contract would not take effect until it was executed. This LOI was enough for RTS to commence the work. But when the LOI expired in May 2005 without a final contract being signed, RTS continued to work on the project and delivered the machines in September the same year.

This proved problematic when a dispute developed regarding whether the machines RTS delivered met Muller's performance requirements. By this point the parties had agreed on the majority of the model contract, but it was never formalised. Muller then only paid RTS 70% of the contract price, so RTS raised an action to recover the full amount.

The judge in the court of first instance held that RTS and Mueller had concluded a contract for RTS to carry out the work set out in the LOI, but not under the terms of the draft contract. This judgment relied on Percey Trentham v Archital Luxfer [1993], 7 which held that it was unrealistic to suppose that the parties did not intend to create legal relations when substantial performance had already occurred. The court of appeal, however, came to a different view, holding that there was no contract at all between the parties and citing British Steel v Cleveland Bridge [1984] as authority for this. The Supreme Court reached yet another opinion, stating that the parties had entered into a contract on the terms of the draft contract and, by their conduct, had waived the provision that the terms of the contract would not take effect until signed. This judgment reiterated that the existence of a binding contract depends on whether, 'objectively' (i.e. by the standards of a reasonable person as opposed to what the parties thought), the parties had agreed to create legal relations and whether they had agreed on the major terms of the contract. Overall, however, this case shows that different courts may interpret the same facts in different ways, partly because there is a vast amount of case law to draw upon as a precedent. Since it is virtually impossible to predict a judgement, the key to success is ensuring clarity.

More generally, the cases above show how, while working on the basis of an LOI is common, uncertainty can arise when it is not clear whether or when a contract has been agreed. The only way to avoid this uncertainty – and the associated risk – is to have a clearly drafted contract before starting work. Or, as Lord Clarke noted in RTS v Muller, the moral of such cases for contracting parties is always 'to agree first and to start work later'.

Of course, commercial pressures will sometimes result in contractors commencing the work on the basis of an LOI. But when this does happen, the contractor should always ensure that the wording and obligations of the LOI, if any, are clearly understood by both parties. The contractual allocation of risk is a skill that should be practiced by every management team. Good contracting starts with taking an interest in the contract and ensuring that the contract is clear and unambiguous Finally, and, arguably, most importantly, the management team should also endeavour to have the LOI reduced to a comprehensive contract as soon as possible; preferably, before the work starts in earnest.

6 RTS Flexible Systems Limited v Molkerei Alois Muller Gmbh [2010] UKSC 14
7 Percey Trentham v Archital Luxfer [1993] 1 Lloyds LR 25