Ashurst Australia
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Construction Update

Pre-contractual correspondence and letters of intent: as you intended?

WHAT YOU NEED TO KNOW

- In *Factory 5 Pty Ltd (In Liq) v State of Victoria (No 2)* [2012] FCAFD 150, the Federal Court of Australia held that a letter of intent ("LOI") will be interpreted based on its proper construction.
- Stating that an LOI is "subject to contract" does not prevent a binding contractual relationship being formed.

WHAT YOU NEED TO DO

- Carefully draft and ensure that any LOI is regularly reviewed to ensure that it is not being used as the construction contract for the works.
- Ensure LOIs are used as a temporary measure in the absence of the formal construction contract being agreed.
- Limit an LOI in terms of the scope of work to which it applies, its duration and value. Subject to the comments below, a firm expiry date for the LOI should focus the parties' minds towards agreeing the contract documents.

Purpose of a letter of intent

In circumstances where contract negotiations become protracted, a principal on a construction project may not want or be ready to enter into a contract with its preferred contractor, but may need to commence preliminary works or design development to avoid any future delay.

An LOI allowing early works to begin to try and maintain the overall programme whilst the parties finalise the contract documents is potentially a useful tool in such circumstances. However, issuing an LOI is inherently risky and should not be a substitute for a formal contract, and should not be used where the contract can be put in place before works start.

Factory 5 Pty Ltd (In Liq) v State of Victoria (No 2) [2012] FCAFD 15 is the latest case to consider pre-contractual correspondence and whether a letter formed a legally binding contract or a mere agreement to agree at some future time.

Facts

The 2006 Commonwealth Games ("the Games") were held in Melbourne. A statutory corporation, M2006, was formed by the Victorian Government to conduct and manage the Games.

M2006 sought terms from proposed tenderers to provide services for the sale of Games related merchandise. Two companies ("the promoters") created a joint venture vehicle, Factory 5 Pty Ltd ("F5").

The promoters entered into negotiations with M2006 in relation to the proposed tender and provided M2006 with their standard terms and conditions of trade. M2006 indicated to the promoters that Playcorp Limited would likely be appointed as licensee to sell Games merchandise to the official concessionaire.

In early December 2004, M2006 decided that it would seek to negotiate the concessionaire agreement with the promoters in preference to any other

tenderer. The parties exchanged correspondence with a view to finalising this agreement.

On 23 December 2004, M2006 wrote to F5 stating that it was to be appointed on the commercial terms set out in a number of attached emails and letters "*subject to reaching agreement on a legally binding Long Form Concessionaire Agreement to be provided by M2006 and subject to M2006 Board Approval*" and requested that F5 sign the letter to acknowledge its terms, which was signed by M2006 later that day.

Negotiations for the long form agreement subsequently reached an impasse and were terminated by M2006 in June 2005. F5 issued proceedings to recover damages suffered as a result of M2006's termination of the contract it asserted was comprised by the 23 December 2004 correspondence.

The State of Victoria ("State") argued that, on its proper construction, the letter simply recorded an agreement to continue negotiations with a view to entering into a binding agreement based on the provisions of that letter.

Decision

The primary judge found that F5 and M2006 had made a binding contract on 23 December 2004; being a signed letter headed "Concessionaire Agreement", appointing F5 as the official concessionaire for the Games. That letter provided that it was subject to the parties reaching agreement on the terms of a long form contract.

Whilst the primary judge found that M2006 had repudiated the agreement by denying the existence of a contract in its letter dated 24 June 2005, he held that F5 had later abandoned that contract and, accordingly, was not entitled to damages.

F5 appealed the primary judge's decision. During the appeal hearing, the State amended its notice of contention and argued that, either the parties had not reached a concluded agreement on 23 December 2004 that was legally binding, or that any such "agreement" was void for uncertainty.

In deciding whether the letter of 23 December 2004 formed a contract or not, the Appeal Court considered *Masters v Cameron* (1954) 91 CLR 353 in which the Court identified three different instances where parties reach agreement upon terms of a contractual nature and also agree that the matter of their negotiation will be dealt with by a formal contract:

1. The parties have reached finality in arranging all the terms of their bargain and intend to be immediately bound to the performance of those terms, but at the same time propose to have the terms restated in a form which will be fuller or more precise but not different in effect. In such a situation, *Masters v Cameron* found that there will be a binding contract to perform the agreed terms whether the contemplated formal document comes into existence or not;
2. The parties have completely agreed upon all the terms of their bargain and intend no departure from or addition to that which their agreed terms express or imply, but nevertheless have made performance of one or more of the terms conditional upon the execution of a formal document. *Masters v Cameron* held that in this situation the parties would be bound to bring the formal contract into existence and then to carry it into execution;
3. The intention of the parties is not to make a concluded bargain at all, unless and until they execute a formal contract.

F5 argued that the parties intended the letter to fall within a fourth class described in *Baulkham Hills Private Hospital Pty Ltd v GR Securities Pty Ltd* (1986) 40 NSWLR 622, pursuant to which the parties agreed to be bound immediately and exclusively by the terms which they have agreed, whilst expecting to make a new contract replacing the first containing additional terms to be agreed during negotiations.

The Appeal Court dismissed F5's appeal for reasons including:

- Price was a critical and outstanding issue that had not been agreed;
- M2006 and the promoters had not been able to agree on the parameters for deciding whether or not Playcorp's prices were reasonable. The Court noted that *"an objective bystander, knowing the background of the evolvement of the 23 December 2004 letter would have appreciated that this was an issue that would need to be further discussed and resolved in preparing a binding long form agreement*";
- The letter expressly made the appointment of F5 subject to the following conditions:
    1. agreement on a legally binding long form agreement;
    2. that agreement being drafted by M2006; and

3. the board of M2006 approving the actual terms of the document.

- The letter indicated by the words *"is to be appointed as Concessionaire subject to"* indicated that the appointment would only occur in the future after satisfaction of the specified conditions, that is the 23 December 2004 letter fell within the third category identified by the Court in *Masters v Cameron*.

F5 argued on appeal that "*an agreement is not void for uncertainty because it leaves one party or group of parties a latitude of choice as to the manner in which agreed stipulations shall be carried into effect, nor does it for that reason fall short of being a concluded contract*."

The Court rejected that argument stating that: "*[t]he courts will not lend their aid to the enforcement of an incomplete agreement because it is no more than an agreement of the parties to agree at some time in the future*", acknowledging that an LOI may in some circumstances deal only with major matters in contemplation that the other aspects will be negotiated at a later stage, or to reserve the right to withdraw at any time prior to a formal contract being signed.

Implications of decision

The F5 case highlights the need for clarity in an LOI. To minimise the risk of an LOI intended as a temporary measure governing the whole of the works, an LOI should relate only to a discrete scope of works and include limitations both in terms of time and expenditure to incentivise completion of the final contract.

Principals should also be aware that this route is not without risk and, in the event of a maximum value and/or cut-off date being exceeded without an extension to the LOI, there is a possibility that there will be no contract governing the relationship with the following implications (amongst others):

1. the contractor could be entitled to payment on the basis of reasonable costs for works performed in excess of the maximum value included in the LOI resulting in it being entitled to more than the principal originally budgeted for;
2. the principal's remedies in the event of there being defects in the works could be limited as there will be no express terms governing the contractor's obligations in this respect; and
3. there will not be a set completion date and no right to levy liquidated damages in the event of delay.

To avoid these risks, principals must ensure renewal dates are diarised and that authorised expenditure is reviewed regularly to ensure that neither are exceeded.

Some LOIs include the words "subject to contract" as a means of clarifying the parties' intentions. The English Supreme Court decision in *RTS Flexible Systems Ltd v Molkerei Alois Müller GmbH & Co KG (UK Production)* [2010] 1 W.L.R. 753 ("RTS") considers this issue.

In the RTS case, the claimant sent the defendant a letter of intent setting out a draft contract and incorporating standard terms and conditions, which provided that the contract would not be binding unless signed and executed by the parties. The parties proceeded with the project, but did not sign or execute the agreement.

The Court stated that the question of whether there was a binding contract between parties, and, if so, upon what terms, required consideration of the communication and conduct between the parties. This would include whether, objectively, a conclusion could be reached that the parties' intention was to enter into a contractual relationship, had agreed all the essential terms, and that, even where certain significant terms had not been finalised, it could objectively be concluded that they had not intended agreement of such terms to be a precondition to conclusion of a binding contractual relationship.

The RTS case demonstrates that, notwithstanding the existence of a "subject to contract" clause, where work begins prior to a construction contract being executed, a binding contract could be found to have been formed in circumstances where the parties are deemed to have waived the "subject to contract" term.

In order to manage this risk, the form of final contract with the terms agreed at the date of the LOI should be appended to the LOI to demonstrate what the parties had agreed in the event of there being a dispute in the future.

Conclusion

The F5 and RTS cases highlight the risks inherent in LOIs for both principals and contractors. Parties involved in a construction project are perhaps better advised to continue negotiating the contract documents rather than attempt to short cut the process with an LOI.

In this regard, it is also important to consider what impact issuing an LOI might have on the negotiation process. Whilst both parties might think that a defined term or value might focus the parties' minds on concluding contract documents, in reality it might have the opposite effect with all attention focused on the works being performed.

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