


Letters of Intent



Cash flow is the lifeblood of any organisation. Companies in the private sector generally focus on increasing profits, but it is inadequate cashflows that can cause serious financial difficulties.



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LETTERS OF INTENT - THE CIPS POSITION, AND WHAT THE BUYER NEEDS TO KNOW

- 1 The CIPS Position**
- 2 What is a Letter of Intent?**
- 3 Binding or Non-Binding?**
- 4 What is the Purpose of a Letter of Intent?**
- 5 What Reasons are there for using Letters of Intent?**
- 6 What should a Letter of Intent contain?**
- 7 Is it wise to sign a Letter of Intent?**
- 8 Procedure for Issuing Letters of Intent**
- 9 Keeping Risks to a minimum**
- 10 Are there any alternatives?**
- 11 What problems can arise?**
- 12 Case Study**

Appendix – Suggested Format for a Letter of Intent

1 THE CIPS POSITION

CIPS is expressing beliefs on Letters of Intent (LOI) as unfortunately these are commonly used, especially in high value and high risk procurement projects, when in fact CIPS holds that their use should be avoided where possible. CIPS believes that P&SM professionals should be proactive in their procurement projects and should therefore be able to foresee the potential problem of having to start a project before the main contract can be let. They should therefore ask the main contractor, (or, as appropriate the sub-contractor), for a written offer covering the limited work required to get the project under way. This offer can then be accepted by the Client, rather than the Client issuing a LOI which is in fact an offer to the contractor. CIPS believes this approach represents better practice in such circumstances.

CIPS would underline its view that LOI should only ever be employed in exceptional and therefore very rare circumstances.

The key points of the CIPS position are as follows:

- CIPS believes that P&SM professionals should be sufficiently proactive and prescient in the procurement projects and activities they are engaged in to make the use of LOI unnecessary
- In view of the dangers associated with LOI the CIPS recommendation is that P&SM professionals should only resort to using such a device in extreme and exceptional circumstances
- In those cases where the contractor appears, for whatever reason, to have lost interest in progressing the project the CIPS considers that the P&SM professional should consider placing his business elsewhere
- CIPS recommends that rather than drafting and issuing a LOI the contractor should be invited to submit a proposal for the limited volume of work which would otherwise be defined in such a document
- If circumstances dictate that a LOI is unavoidable the CIPS recommendation is that the P&SM professional should develop and implement a formal and unambiguous procedure for issuing such documentation

2 WHAT IS A LETTER OF INTENT?

As LOI have no distinct legal meaning there is some confusion about them within the P&SM profession. Thus, LOI should not be confused with contract award letters or letters of comfort.

A contract award letter is simply a letter advising the successful contractor that they have won the contract; this should only be issued once the procurement process is complete; that is to say, bids have been clarified and terms and conditions negotiated to a satisfactory conclusion.

It is letters of comfort that are most commonly confused with LOI. **CIPS holds that letters of comfort should not normally be employed.** However, there are certain circumstances where they can be used as long as great care is exercised. For instance, when a contractor states in their bid that their offer is valid for 60 days, they can often state, especially during difficult

negotiations, or if they do not perceive the Client's business as especially valuable to them, that their offer is no longer valid at the 61st day. In fact under English Law at least, the contractor can withdraw their offer at any time until it is accepted by the Client. Nevertheless, it is sometimes prudent to issue a letter of comfort requesting that they confirm that the offer is still valid after the period specified in the tender.

A letter of comfort should state that the Client is:

- hoping to be in a position where they can offer a contract to the contractor
- requesting that the contractor should keep their offer valid for another specified period of time with a request that this be confirmed in writing
- offering no contractual commitment.

However, if the objective of keeping the offer valid for a longer period is really crucial, the client might offer a peppercorn sum to act as consideration for keeping the offer valid, thus creating a legally binding contract so ensuring that the offer from the contractor remains on the table.

The client should recognise that a letter of comfort can make the contractor feel so secure that their willingness to negotiate or concede on points under discussion may thereby be jeopardised.

CIPS suggests that where a contractor is being difficult or is appearing uninterested in progressing the contract, the Client should, unless there is no other alternative, stop the negotiations and place the business elsewhere.

A LOI differs from a letter of comfort in that it is in fact an offer from the client to the contractor, with the consideration stated, which the contractor can accept and as such create a legally binding contract. A more accurate term than 'Letter of Intent' is "An Instruction to Proceed".

The purpose of a LOI is to have the preferred contractor (i.e. that contractor to whom the buying organisation expects to award the contract, or their sub-contractor) to do something. For instance the client might want the contractor to:

- order some of those materials for the project or service which may have a long lead time
- reserve the capacity in their systems to deliver the project as the contractor may be lining up other clients to absorb that capacity
- start the project; however, the extent of this "start" must be clearly specified.

The client must ensure that the LOI does not inadvertently legally oblige them to award the whole contract to the contractor even if that is the intention. Rather it obliges the client to only pay for that piece of work identified in the LOI.

3 BINDING OR NON-BINDING?

One of the pitfalls in a LOI which some may regard as a casual non-binding document is that certain of its provisions may indeed have legal effect. For example:

- 1 Seller may grant intending buyer access to possible confidential information to allow

the buyer to conduct his due diligence checks. However, the Seller may not want the Buyer to make use of information obtained in this way for any purpose other than in respect of the transaction in question

2 Both parties may well have an interest in prohibiting the disclosure of the terms being discussed, or even the fact that they are negotiating at all. Many potential buyers do not want the terms disclosable for fear that the seller may use them to negotiate a better deal with someone else

3 A 'no-shop' clause, ie a clause prohibiting the seller soliciting or entertaining any competing offers from prospective third party buyers

Termination also needs to be addressed. This can either be a specific date (unless an extension is mutually agreed by the parties), or rather than an end date there can be a mutually agreed provision for a specific period of notice

It is important therefore for a distinction to be made between binding and non-binding LOI; the former is to be preferred as it will contain the key elements of a contract (offer, acceptance, and consideration). Such a letter should incorporate a sentence or clause along the following lines:

'This Letter of Intent is intended to create a legally binding contract between the parties'

Given that the purpose of a LOI is to bridge the gap between the start of the project and execution of a final contract it should state that the intention of the parties is to enter into a formal contract and that the parties will use their best endeavours to execute said contract as soon as possible. Although such a provision is unlikely to be legally enforceable it provides a useful indication of the parties' commercial intent

The LOI should also contain provision for the retrospective effect of the final contract. A suitable form of wording could be as follows:

'Once the contract is signed, its Terms and Conditions will retrospectively govern the work carried out by you pursuant to this LOI. Any monies paid to you in respect of such work shall form part of the contract sum under the contract'

4 WHAT IS THE PURPOSE OF A LETTER OF INTENT?

Generally speaking the aim is to set out the general terms of a transaction, together with the specific points that might have been agreed prior to the finalisation of a definitive agreement. This is often pushed if one or both of the parties is unwilling to spend the time and money required to negotiate an agreement until a LOI has been signed. Furthermore a seller might be unwilling to let the buyer go through the due diligence process without first obtaining a LOI.

Often the parties agree that it is important to have key terms of the transaction in writing (for example, the purchase price and how it would be paid) as early as possible, so as to avoid later confusion. Not least a LOI may be required to facilitate the financing process

5 WHAT REASONS ARE THERE FOR USING LETTERS OF INTENT?

CIPS takes the view that there should only be one reason for issuing a letter of intent – to secure the project programme. CIPS holds that P&SM professionals should be sufficiently involved in the procurement process that they can anticipate the potential of having to secure the programme whilst being unable to proceed with the contract award thereby avoiding the need to issue a LOI.

Be that as it may, Clients have reported a number of reasons for using LOI. These include the following:

- the business case not yet been approved
- the funds not yet secured
- technical approval has not been obtained
- the contract not yet signed
- some documentation is still being awaited
- negotiations not yet concluded
- short timescales due perhaps to an emergency or poor planning
- there is pressure from customers, or competition to get the product to market
- tight commercial deadlines have to be adhered to

CIPS has identified these scenarios in order to help P&SM professionals be aware of, and so avoid, minimise or manage any problems which might arise. Such situations. **CIPS suggests that P&SM professionals should think very carefully about issuing a LOI in any of the above circumstances as there is a risk that the main contract might not be awarded to the preferred contractor, or indeed to any contractor.**

A further consideration is that the Client is often pressurised by the contractor's sales team to provide a LOI due to:

- claims of long lead times (for example, project timescales under threat due to non-availability of materials)
- claims of competition for capacity from other clients
- year-end sales figures and associated discounts
- a need to source and recruit labour

6 WHAT SHOULD A LETTER OF INTENT CONTAIN?

If, after due and careful consideration the decision is made to use a LOI, it needs to be borne in mind that it should as a minimum contain the following data:

- a) Basis of payment (eg cost plus margin, lump sum etc)
- b) Timing and procedures for submission of invoices
- c) A cap on the amount payable to the contractor under the LOI (which can be extended at the owner's discretion)
- d) an accurate description of the range of works to be carried out
- e) provision for the owner's right to vary the scope of the works
- f) a completion date where possible

- g) a clear statement of the contractor's standard of care to be adopted in carrying out the works

The LOI should set out a procedure whereby the owner can instruct the contractor to cease work and vacate the site. The LOI should also state that the contractor's entitlement to further payment after such termination is limited to any amounts outstanding for work carried out up to the date of termination.

7 IS IT WISE TO SIGN A LETTER OF INTENT?

Although CIPS, as noted above, is very critical of LOI and would always advise P&SM professionals against using them, there are some circumstances (project work or large production runs for instance) where they can appear to be an attractive and justifiable solution, being a "non-legally binding" way to get the parties to set out in writing what the nature of the undertaking is between them.

All too often parties will sign such a document, feeling that they have little or nothing to lose by doing so. However, caution should always be exercised before signing. As a general rule, it is recommended that the parties go right through to the final contract document, ensuring that it is correct in all respects, rather than risk the pitfalls of a LOI.

It is not unusual for parties to believe that by signing a LOI they have reached an agreement in principle to enter into a complex legal transaction. In such circumstances the parties may believe (probably correctly) that negotiating the exact content of the final definitive contract documents will take time and that if something is not put in writing without delay the proposed deal will fall apart.

This is understandable, and it is true that in certain complex transactions a LOI can be a useful interim measure allowing the parties to set out in writing some measure of commitment. Notwithstanding this, P&SM professionals should always bear in mind the very strong reservations the CIPS has about the dangers and pitfalls of using LOIs

8 PROCEDURE FOR ISSUING LETTERS OF INTENT

If a letter of intent cannot be avoided, **CIPS advocates that the P&SM professional introduces a formal procedure for issuing them.**

This procedure should include the following:

- they must be signed off a person senior to that person who would normally sign off the contracts
- documentation should be completed to state the reasons why the organisation is issuing a letter of intent and to state the risks associated with the issuing of the letter of intent, in particular in relation to the project, and a figure should be associated with the risk wherever possible
- all forms should be signed by the person responsible for signing the contract and a record should be retained with the contract details
- that the CEO, or his or her nominated representative, is advised when letters of intent are issued

As negotiation and contract conclusion may be difficult for the Client once a LOI has been issued, the following aspects should already have been agreed beforehand:

- price, cost and payment terms (otherwise these could very easily be increased)
- issues relating to intellectual property rights
- deliverables, service levels and time-scales

These issues are minimised if the Client already has an umbrella agreement in place with the contractor since terms and conditions etc. would have been agreed prior to the particular procurement project in hand.

Draft Contract Terms

If a draft detailed contract is in existence at the time a LOI is drawn up, one of the following approaches should be adopted:

- a) attach the draft terms in their entirety, and specify that even though they have not yet been fully agreed by the parties as forming the final contract, the full terms will be binding with respect to, the whole of the works until the LOI is replaced by the final contract; or
- b) simply identify the relevant terms of the draft contract which have been finalised to date; for example contractual conditions in relation to insurance, or IPR (intellectual property rights)

9 KEEPING RISKS TO A MINIMUM

If the P&SM professional is forced by circumstances to produce a LOI, the following good practice should be adhered to:

- the wording should include “it is our intention to award the contract for” and “this letter is not intended to create a legally binding contract for anything other than the limited works stipulated in the letter” so that it is clear that the main contract is not currently being awarded
- if there are reasons for not awarding the contract these should, ideally, be stated eg. “.... subject to the successful conclusion of our negotiations on ...” or quite simply “subject to approval from our directors...”
- the amount of work the client is liable for from the letter of intent should be stated eg. “... the development work of Phase One up to and including a maximum liability to us, the client, of £60,000 excluding VAT..”
- the wording should state that “in the event of the main contract not being awarded to you, the contractor, then all design work (for example) will vest with us and that we have the right to novate the contract to an alternative contractor”.
- the terms and conditions that apply to the offer should be stated which should be as close as possible to those under discussion for the main contract
- the date at which the letter of intent expires
- words which entitle the client to cancel the letter of intent if operationally necessary
- a requirement for the contractor to confirm acceptance of the letter

It is important that the letter of intent is worded very carefully so that it, and the actions supporting it, is not taken to be legally binding for anything other than the specific piece of work stated in the letter. It should also state what is intended to happen next in the contract award process.

10 ARE THERE ANY ALTERNATIVES?

CIPS advocates that, instead of issuing a letter of intent, the client should invite the contractor to submit an offer for the limited volume of work which would normally be stipulated in the LOI. The client can then accept this offer and a separate contractual arrangement comes into force from the main contract, which may in due course be awarded to the contractor.

The separate contract, which can be created by the client submitting an order in response to the offer, should be written so that it can be novated or merged into the main contract as soon as the main contract is placed.

In construction contracts where the main contractor might sub contract the first phase of the work; the client should ask the sub-contractor to submit the offer for the first stage of work (or whatever is needed at the time) along with a novation agreement signed by the sub-contractor and the main contractor, for signature by client. It must be a condition of the contract that the contract will, at the sole option of the client, be novated to the main contractor should the contract negotiations be satisfactorily concluded. It is important that the client ensures that:

- the sub-contractor performs to the same terms and conditions as were required of the main contractor for the specific work(s)
- the main contractor cannot refuse to accept the novation of contract should there be problems with performance etc.
- a novation agreement is signed by all parties

11 WHAT PROBLEMS CAN ARISE?

CIPS policy is that P&SM professionals should actively discourage their organisations from using letters of intent as they can create many problems including:

- the contractor perceiving that they are no longer in a competitive situation i.e. that the business has been won by them already
- the client may become reliant on the contractor if the competition are advised, or hear informally, that they were unsuccessful
- the contractor will be reluctant to negotiate, for instance on terms and conditions and service levels as they are no longer trying to secure the business
- as the LOI has created a contractual commitment – a breach of contract could well result in an action for damages
- the risk that the main contract fails to be awarded to any contractor and so the work in hand as requested in the LOI is a waste of resources.

Once signed, a LOI, even if non-binding may place a seller at a negotiation disadvantage by creating expectations by third parties. The potential also exists for breaches of confidentiality.

Also, once terms are incorporated in such a document, even if non-binding, parties seeking to renegotiate may encounter difficulty. This is particularly likely to be the case where parties have been in a hurry to sign a LOI without considering the ramifications

A further consideration is that, during the due diligence process by a prospective buyer (after the execution of a LOI but before final contract), he (the buyer) may have access to a great deal of privileged information which could well be of some concern to the contractor.

12 CASE STUDY

The following example clearly demonstrates the limitations of Letters of Intent from the Client's perspective:

In the late 1980's Tesco decided to build a new store at Redditch (one of a number in the company's expansion programme at the time) and employed the construction firm Costain as its design and build contractor.

At the commencement of the project Tesco sent a LOI to Costain which said:

'We write to advise you that it is our intention to enter into a formal contract with your company in accordance with the Tesco standard documentation for use with Design and Build Contracts'

Costain signed the LOI and returned a copy to Tesco. Costain completed the construction of the store; however a formal contract was never concluded between the parties

Some years later, during some alterations, a fire broke out, causing damage which, claimed Tesco, was more extensive than it should have been as the fire containment measures installed by Costain had proved inadequate. Tesco made a claim against Costain who argued that they had never accepted contractual responsibility

It was decided in the courts that a contract had indeed been concluded between the parties; however, this did not extend to Costain having liability for the designs subsequently produced, and implemented, by Tesco's design consultants some years later.

13 CONCLUSION

Letters of Intent are a way of suppliers passing risk back to purchasers, and as such **CIPS strongly recommends that they should not be used**. CIPS has suggested an alternative to letters of intent and suggests that where letters of intent have to be employed, this should be seen as a failure on the part of the P&SM professional.

Where P&SM professionals have to use letters of intent these should be supported by robust procedures which are formally adhered to, along with a clear policy on those issues which must be agreed with the contractor, in writing, prior to the LOI being issued.

14 REFERENCES

Books

A section on Letters of Intent, together with a suggested form of wording, may be found in 'Buying Goods and Services' by Allwright and Oliver (revised edition by S Singleton and K Burnett)

Articles and Papers

The Effect of Letters of Intent
J McGuinness
SCL (Society of Construction Law) 1997

'Surprise'
T Wrzesien
Paper (18 October 2002) in the Winward Fearon construction project series

Legal Cases

The Use of Letters of Intent – Midland Veneers Ltd v Unilock HCP Ltd

Ventriloquism or Voice of Reason – Harvey Shopfitters Ltd v ADI Ltd

The Meter is Running – AC Controls v BBC

Websites

www.scl.org.uk
www.winwardfearon.co.uk
www.allbusiness.com
www.envision-sbs.com
www.rics.org

APPENDIX – SUGGESTED FORMAT FOR A LETTER OF INTENT

“I am writing to confirm that it is our company’s intention, subject to the satisfactory conclusion of negotiations between us, to place a contract with your company for(eg. the design, supply, construction and commissioning of for the sum of £.....(if already agreed).

The contract will generally be in accordance with the terms and conditions set out in your tender datedother than for the clauses set out in the attached Annex which still have to be agreed. The programme for finalising all outstanding issues between us is enclosed (if appropriate). This letter is not intended to create a legally binding contract for anything other than the limited works stipulated in this letter.

Pending the conclusion of our negotiations you are hereby authorised to proceed with up to a total value not exceeding £.....

On the placing of the contract with you, all work carried out by you under this letter of intent will be deemed to have been carried out by you under the terms and conditions of the contract.

If we are unable to reach agreement with you on the outstanding issues between us within a period of weeks from the date of this letter we shall have the right to terminate this letter of intent by notice in writing. In that event:

- we would reimburse you forcarried out by you under the terms of this letter up to the date of termination to a limit of £..... together with the cancellation costs reasonably incurred by you in respect of orders for the(eg. long lead time items). Alternatively we would have the right to take over such orders from you, and all orders placed by you shall contain such provisions.
- The property in all drawings and other documentation prepared by you under the terms of this letter and any materials manufactured would vest in us

Please acknowledge your acceptance of this letter and confirm that you will be starting work immediately”.

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