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Letter of Intent

Letter of Intent: Risk and Mitigations

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Abstract

Letter of Intent (LOI) is one of the common tools used in the engineering and construction industries. This is to commence execution activities before signing the contract between the parties. It is widely used for multiple reasons. However, LOIs have embedded risks that may result in a collapse of the relationship between the parties before signing the contract which may ended up in court rooms trying to resolve disputed items. This paper will highlight why LOIs are being used, what the risks are and how to mitigate them with an overview of some real-life cases.

Keywords: Letter of Intent (LOI), Engineering and Construction Industry, Contract Management, Contractual Risks, Construction Disputes, Legal Implications, Risk Mitigation.

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INTRODUCTION

A LOI is "a statement of the parties' present intentions with respect to its contents. Each party represents to the other that no reliance will be placed on this letter. This letter does not and is not intended to constitute a binding obligation" (pwc, 2023). It is effectively used to commence the execution of the scope of a contract before signing it with the intent to sign while finalizing all open issues/conflict that prevent putting the pen on the paper. For example, a LOI can be used for schedule driven projects while finalizing the contract and its pre-requisites. The coming sections will discuss why to sign LOI agreement, how to mitigate the risk with real life cases related to LOIs.

BODY

LOIs are typically non-binding agreements. However, this need to be explicitly mentioned in the language of the LOI, with all parties agreed on this. This non-binding nature could lead later to several disputes and claims if the intent changes or if the agreement is based on different unwritten assumptions between the signing parties, considering LOI is a simple and a brief document unlike contract terms and conditions.

Why Are LOIs Being Used?

LOIs are used for many reasons including but not limited to the following:

- **Tight Schedule:** Project deadline, in some cases, is fixed and any delays could result is negative financial or reputational consequences to the Owner like damaged to the public reputation, losing revenues, paying additional interest fees, etc.
- **Early Procurement:** Some projects require early procurement of material, like Long Lead Items (LLIs) that fall within the Project Critical Path, or services, like hiring subcontractor to perform early work activities.
- **Lengthy Negotiations:** Negotiations in complex projects can be prolonged due to different reasons. If the owner has selected the Contractor, an LOI can be signed to commence the work while negotiation may continue.
- **Delays in pre-requisites:** In some cases, the prices and all other terms and conditions are agreed, however, the contracts cannot be signed because of delay in paper work related to a pre-requisite like a bank guarantee. Here, LOI can be signed and work commenced until Contractor completes the required paper work.

As can be seen, the LOI can be found a way to accelerate the execution with the absence of the binding agreement which shows good intent to enter this agreement but in the same time put the relation between the parties at risk if any unprecedent event affect this intent. (Nash, 2016) (Oualnan, 2023)

What Are the Common Risks Associated with LOI?

There many risks associated with LOIs, if not addressed in a proper way in the write up, it could lead to disputes and claims. These risks can be categorized per the following:

- **Scope Risks:** Normally, the scope of the LOI is part of the scope of the unsigned contract. However, the clarity and the limit of the scope to be executed under the LOI could be different between the signing parties which could lead to disagreements if the completed work falls under the scope of the LOI or not.
- **Schedule Risks:** Another category is the risks associated with the duration and the length of the LOI. Unclarity of the start and end dates and the requirements for extensions may end up in conflicts about the executed work and if it is falls within the LOI validity.
- **Financial Risks:** Money is key factor of any agreement. LOIs, similar to any agreement, have their own embedded risks. These risks could be associated with the Owner capability to pay for the executed work or the Contractor entitlement to be paid for the completed work.
- **Contractual Risks:** Since LOIs are simple agreements compared to the contract, it may miss to address many cases that is usually covered in full contracts. This may result in several contractual disputes related to the obligations and rights of each party.

How to Minimize these Risks?

There are internal and external risks associated with LOI and the following items can help in minimizing the risk of dispute and claims:

- **Include A Clear Scope of Work (SOW):** The first thing to be agreed between the parties is the SOW. SOW is the heart of the LOI and it is necessary that it is clearly defined. The scope has to be part of the full scope covered in the tender shared with the Contractor and shall not include any out-of-scope items. In most cases, it covers mobilization of resources, commencement of engineering and commencement of earth works, as applicable. Other scope items can be included, for example, placing Purchase Orders; however, it is not recommended unless entering the agreement is almost certain since this is a commitment to be made by the Contractor regardless the contract will or not be signed. Moreover, the parties should not forget to clarify if the scope can be changed during the LOI execution or not. If yes, the mechanism of this scope to the LOI and to the Tender has to be clarified and defined.
- **Identify Specific End/Start Dates and Extensions:** To have a common understanding between the parties of when the contract can be signed, a duration should be included in the language of the LOI which by the end of this duration the contract is supposed to be signed. Also, the write up should cover the mechanism and requirements for any extension, if it is required for any reason.
- **Identify Frequency and Entitlement of Payments:** Each LOI should include a paragraph defining the payment schedule and associated deliverables. If included, frequency and mechanism need to be detailed in addition to the relation to the agreed contract price. In some cases, all parties may agree to enter the LOI with no payment until the contract is signed, as LOI duration is normally short. Others may have progress payment based on the work completed on monthly basis or even milestone payment. This will ensure clarity about when and how the Contractor can be compensated until the contract is signed.
- **Include the Rights and Obligations of Parties in Case of Termination:** To protect the Contractor rights in case something unexpected happens e.g., pandemic, bankruptcy, etc. which prevent the contract from being signed, it is recommended to add a section covers the rights of each party. This can be through paying Contractor all costs associated with LOI with additional fees to compensate Contractor for any damage caused due the change in the intent. Fees can be a percentage of the paid amount or fixed fee e.g., termination fee. This will ensure that if anything goes wrong and triggers a change in the intent, there is a binding language protect the right of the Contractor.
- **Set A Payment Cap:** On the other hand, it is recommended for the owner to add a cap for the maximum payment within the LOI agreement. This is to protect the owner from any slippage in expenditures if Contract is not signed within the planned time frame for any reason. For example, if there is a shift in priorities in the Owner organization due to new Board of Directors, the signing date could slip and the cap will protect the company from excessive payment beyond the budget related to any progress made by Contractor.
- **Identify the Mechanisms for Claims and Disputes Resolution:** Before commencement, the parties should define a process of the LOI to govern any claim or dispute raised during the LOI. While an LOI does not cover such item due to its brief nature and relying on the write up in the unsigned contract terms and condition. Nevertheless, the contract may not be signed and some claims or disputes may raise during the LOI execution.
- **Avoid Non-Funded Projects:** It is highly recommended that project fund is secured prior signing the LOI. Funding is a major step weather the project is really critical or not and normally it is a

lengthy process requires internal approval within the Company and other Partners, if any. Then, the involvement of lenders could elongate the process. These factors may drag the planned signature dates and any conflict between the Owners, Partners and Lenders could result in the collapse of the project.

By mitigating the risks between the parties, LOI can be an efficient tool to accelerate the progress and help the owner to achieve the set targets and allow Contractor to support this and maintaining its major legal writes under this letter. (Nash, 2016) (pwc, 2023)

Documented Legal Cases Related to LOIs

Due to its non-binding nature, disputes can occur between the parties. There are several documented legal cases in courts related to work executed under LOI. The following are example of real-life cases:

- **CLS Civil Engineering vs. WJG Evans and Sons [2024]**

This is a case where the WJG Evans and Sons "Contractor" claimed a payment of £1.4 million exceeding the Payment Cap of £1.1 million stated in the signed LOI. The court reviewed the case and decided based on the fact that there is a Payment Cap stated identified clearly in the write up of the LOI, that the CLS Civil Engineering "Owner" is obligated to pay only £1.1 million, "The Payment Cap".

In this case "The Payment Cap" protected the Owner for any additional payments to be billed by Contractor. This case shows the importance of agreeing on a payment cap and how this can protect the owner form any cost slippage beyond the budget.

Alternatively, Contractor could notify the Owner before the cap is reached and request for Owner direction to stop or proceed when the bills hit £1.1 million.

- **RTS Flexible Systems Ltd. vs. Molkerei Alois Muller GmbH & Co KG [2010]**

In this case, RTS Flexible Systems Ltd. "Contractor" agreed with Molkerei Alois Muller GmbH & Co KG "Owner" to sign LOI to commence engineering, build, delivery, installation and commissioning for a total price of £1.7 million while signing the contract after the Owner finalize an amendment and technical specifications within four weeks of the LOI signature date. The Contractor continued to work after the expiration of the four-week period stated in the LOI and demand payments for the work completed that period. The Supreme Court obligated the Owner to Pay Contractor the amount of the work executed after LOI expiration date on the basis that the LOI is binding document based on the agreement to commence work until the contract is signed.

This case shows the importance of extending or terminating the LOI when it expires. Neglecting this could makes the situation more complicated and may result in further loses to one or more of the parties.

Alternatively, the Owner could issue a Stop Notice before the end of the fourth week to avoid any excessive payments and to ensure Contractor stops all billing activities.

So, the write up of the LOI and items covered do mitigate the risk and keep companies legal and financial rights even if some argue it is not a binding agreement. (Edwards, 2025/26)

CONCLUSION

In Summary, LOI can be a good tool to be utilized between the parties on the basis that signing the contract is imminent. However, it is a risky tool which may result in complicated disputes if the trust is lost between the parties and can have financial and reputational damages to the parties. Hence, it is recommended to mitigate all legal and technical risks in the write up of the LOI before it is signed and work commenced.

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