

Letters of Intent in the UAE: Handle with care!

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What is a letter of intent?

Construction projects frequently need to get started quickly, before final documents are agreed. In these situations, the industry often uses a 'letter of intent' ("LOI") as a bridging measure to allow work to proceed and to give the parties some legal protection. The LOI is then meant to be replaced by the formal contract.

An LOI should never be taken lightly, even if it is meant to be only a temporary arrangement. If the terms are not drawn properly, the parties may find themselves in dispute or forced into an arrangement that was not contemplated. After all, an LOI is still a contract.

Unfortunately, more often than not, parties are under intense time pressure to sign an LOI. This may lead to LOIs being signed with key terms missing or without understanding the repercussions of what is being signed.

Why should I use an LOI?

LOIs provide some comfort that the parties are genuinely interested in seeing a deal concluded. LOIs also set the ground rules for completing the negotiations and provide a framework for the final agreement. In addition, LOIs can enable the parties to get a head start on the construction program in a number of practical ways, including allowing them to let the subcontractors commence the design process or order long lead-time items.

LOIs are helpful when the contractor needs to obtain necessary approvals and permissions from government authorities. LOIs also cater to the employer's desire to urgently get the contractor on to the site to commence works.

If drafted correctly, LOIs can be used to flush out preliminary issues and allow them to be resolved prior to negotiating the finer points of the final agreement. For example, where an agreement may have been subject to site testing, this can be done under the LOI so that the formal contract is unconditional.

Are there any pitfalls in using an LOI?

There are many risks in using an LOI, if it is not done carefully. One of the key issues is whether the LOI will be replaced by a formal contract, especially where the LOI will expire on a specified date or upon reaching a maximum value of work. The parties need to ensure that the formal contract is concluded or that other arrangements are agreed before the LOI expires.

If the parties disregard the expiry of the LOI and continue to carry out work without putting a new LOI in place, there is uncertainty as to the terms under which that work is being done. In such a situation, disputes over work performed under the LOI, which may have been referred to arbitration, may be left to the local courts.

If work that is not contemplated by an LOI is purported to be carried out under it, there will be greater uncertainty than would be the case under a formal contract, as LOIs will not usually contain

key terms to manage variations, day works and extensions of time.

UAE law on the ‘binding v. non-binding debate’

The most common risk in using an LOI is the possibility that a dispute will arise as to whether it is legally binding. While many jurisdictions have a number of judgments as to when an LOI is binding, this issue is yet to be explored in detail by UAE courts.

Federal Law No. 5 of 1985 (“Civil Code”) gives guidance as to the essential ingredients of a binding LOI in the UAE.

Article 141 of the Civil Code provides that the parties to a contract must agree on the essential elements of the obligation, but that they can leave matters of detail to be determined at a later date.

The Ministry of Justice official commentary states that the law does not stipulate that in order for the contract to be concluded there should be an agreement over all essential matters and matters of detail. The law stipulates that it must be clear that the parties intended to reach an agreement even if they fail themselves to finalise all of the details of the contract.

The Civil Code also requires that certain formalities must be met for a contract to be concluded. These formalities include that there be an offer and acceptance and consensus ad idem i.e. the parties should agree upon the same thing in the same sense. It also states that a contract may only be made upon the agreement of the two parties to the essential elements of the obligation, and the other lawful conditions which the parties regard as essential.

While the Civil Code does not describe what is an “essential” element of the contract, in the case of LOIs, numerous elements may be regarded as essential. For example, payment terms, time for completion, warranties by the contractor, construction programme, scope of work under the LOI (and not necessarily the formal contract) are all arguably essential elements of an LOI.

Without any clear statement at law to give guidance as to what are the essential ingredients of a binding LOI, it becomes extremely important that an LOI is carefully drafted to properly record the parties’ true intentions and deliver the intended legal outcomes.

In short, the LOI should clearly reflect the agreement of the parties to enter into a binding agreement by incorporating all essential rights and obligations.

It is to be noted that the implied obligation of good faith may mean that the courts will find bad faith (and therefore a breach of contract) if the parties fail to agree in certain circumstances, such as one party deliberately trying to avoid reaching an agreement, delaying proceedings or failing to take reasonable steps to reach an agreement.

Essentials of an LOI

An ambiguous LOI is not the best foundation for the final formal contract. So what should an LOI contain?

The LOI should state clearly what it is and what it aims to achieve. For example, it could state that the employer intends to accept the contractor’s tender and enter into a contract for the carrying out of the tender works but, is not yet ready or able to do so.

The major terms of the final contract should be agreed and set out in the LOI. The key terms yet to be agreed should be set out in the LOI, as this clearly frames the remaining negotiation to take place during the LOI period.

Importantly, the LOI should also set out a clear risk allocation, confirmation of the contract price, a

detailed specification and scope of work for the LOI (attached as schedules), a distinct dispute resolution process and well-defined termination rights.

In addition, the LOI should contain clear statements regarding insurance obligations and related indemnities (no work should be done without appropriate insurance cover in place!), intellectual property licenses or rights and essential boilerplate clauses such as governing law. If the parties intend to incorporate some or all of the terms of a standard form contract (e.g. FIDIC) into the LOI, this should be stated expressly.

It is also important to ensure clarity regarding how the LOI arrangement comes to an end. This brings certainty to the agreement, which is in both parties' interests.

The parties may wish the formal contract to supersede the terms and conditions of the LOI.

The parties may also wish to agree that any works carried out or payments made under the LOI will be treated as carried out or made under the formal contract.

While these suggestions are important, they are not exhaustive. Each LOI will depend on the project to which it relates, the scope of works required under the LOI and the agreed rights and obligations.

What happens if a formal contract is not concluded?

Imagine playing a card game where you are not sure of the rules. There is a chance that you may get lucky and win the game but, the chances of you losing are way higher than you winning it. The parties to a construction project may find themselves in a similar situation, where the project might be completed without any issues based on the LOI alone. On the other hand, if a formal contract has not been finalised and things go wrong, there is a high probability that any dispute will be far more complicated than it should be and will incur substantial legal fees as a result.

Some LOIs will contain an expiry date and it is advisable that the contractor does not work past this date. When the LOI does not contain an expiry date and there is a legitimate deadlock in contractual negotiations, the parties should stop the work, commit to a written extension of the LOI or enter into a new arrangement.

Short term solution only

By its very nature, an LOI is not intended to contain all the detailed terms of the parties' agreement. Parties should not seek to just keep extending an LOI to cover more work, or even the project, simply because it seems convenient.

An ambiguous and under-detailed LOI could lend itself to uncertainty and disputes. Parties should opt to enter into a detailed formal contract shortly after the LOI and in any event before substantial works are commenced.

Conclusion

In the time-critical construction industry, LOIs will continue to be needed and used, so it is important to make sure that you get it right to avoid uncertainty and open-endedness.

The fact that LOIs pose a 'risk' is not a problem in itself. Risk is an inherent part of all construction projects. The problem arises when there is no management of this risk.

Legal advice should be sought when deciding to enter into an LOI. Parties may not think it is important because the LOI is temporary and might simply use a document that was used on the last project to serve as an LOI but, this can be a recipe for disaster. A clear and tailored legal

perspective ensures that all critical and necessary issues are fully addressed.

For further information on construction laws and business in the UAE, please contact Scott Lambert, Regional Head of Construction and Infrastructure, Al Tamimi & Company at s.lambert@tamimi.com