

## the letter of intent - why employers love it and lawyers hate it

by martin müller and elize welcome

Contractors often commence with construction following instructions contained in a *letter of intent* in the mistaken belief that the *letter of intent* is equivalent to a *letter of acceptance* or *employer's award*.

The *letter of intent*, also known as the *memorandum of understanding*, is neither a *letter of acceptance* nor an *employer's award*. Should the employer later decide not to sign the contract agreement, for whatever reason, this misconception can have devastating consequences for the contractor.

In South African law a contract only comes into existence once an offer gets accepted. Prior to acceptance there is no contract.

In the construction industry an offer is typically made when the contractor *submits its tender or proposal*. It is important to note that the contractor's *submission of its tender* constitutes the offer, and not the employer's *invitation to tender*. By putting out its tender, the employer merely invites the various contractors to make their respective offers.

Acceptance typically occurs when the employer awards the *tender* or issues a *letter of acceptance*. This acceptance must, however, correspond with the terms of the offer. A so-called acceptance which alters the conditions of the offer or introduces new provisions is not an acceptance, but a counter offer, which may or may not be accepted by the contractor. A contract is only concluded once there is a meeting of the minds as to the terms according to which the offer is accepted, and not when the *letter of intent* is received.

**a letter of intent is the legal equivalent of being "almost pregnant"**

A typical *letter of intent* informs the contractor that its tender or proposal was successful and expresses an undertaking that the parties will enter into a contract agreement as soon as certain outstanding matters are settled. It is an undertaking by the employer to enter into an agreement with the contractor at a future date. It is nothing more than an agreement to agree, which is not enforceable under our law. In law, you either have a contract or you don't. A *letter of intent* is the legal equivalent of being "almost pregnant".

Notwithstanding the above, *letters of intent* are frequently being used in almost every project in the construction industry today. There are many reasons why the parties to a construction contract, in particular the employer, might find a *letter of intent* appropriate even though the employer is not yet ready to commit to the newly formed relationship.

- The employer may not be ready to accept the tender formally due to financing arrangements not having been finalised, but wants to ensure that the contractor does not withdraw its *tender or proposal* and will proceed to make arrangements to commence its work.
- After signing a *letter of intent*, the parties usually issue a joint press release announcing the event.

- It is not uncommon to provide an undertaking in a *letter of intent* to keep the transaction and the information exchanged during negotiations confidential.
- From a business perspective, signing a *letter of intent* indicates that each party has obtained the necessary approval to work towards closing the proposed deal and that the parties have moved into a stage of serious negotiations.
- In its purest form the *letter of intent* simply records a commitment to a timeline for negotiations, including a deadline for closing the deal.

Whatever the reasons for using a *letter of intent*, it merely advises the contractor of the employer's intention to accept the tender at some approximate future date.

It is not an acceptance of the *tender or proposal* and therefore cannot impose legal obligations on either party as far as the "contract to be signed in future" is concerned.

This is not to say that no legal consequences can flow from the *letter of intent*.

*Letters of intent* often also include an instruction from the employer to the contractor to proceed with the work necessary, so as to enable it to meet the agreed programme. Even though the contractor can in theory refuse to comply with this instruction, based on the fact that no contract is yet in existence, the *letter of intent* is in practice often seen as an instruction in good faith. The contractor may then proceed with the work in the mistaken belief that the terms of the standard building agreement stipulated in the tender documents will apply.

The problem is that the “agreement to agree” part of the *letter of intent* is unenforceable. When the employer later refuses to sign the very agreement it undertook to enter into in the *letter of intent*, the contractor, who has already started work in good faith, is in the worst possible position. The standard agreement upon which the contractor based its *tender* or *proposal* has not come into existence and the contractor will not be able to rely on any of its standard terms. Furthermore, neither the contractor nor the Court can force the employer to sign this agreement, even though the employer undertook to do so in the *letter of intent*.

The contractor has done work at the special instance and request of the employer as per the enforceable section of the *letter of intent* and is certainly entitled to compensation. The problem,

## beware of the letter of intent!

however, is that the agreement which came into existence is invested with ambiguity and uncertainty as the standard terms cannot be relied on. The terms according to which the parties contracted are suddenly partly oral and partly in writing, and may lack various contractual terms essential to any construction contract, including those relating to payment, variations, termination and *force majeure*. Only certain sections of the *letter of intent* will be held to be binding by the Court and it will then be up to the contractor to prove the terms of the agreement. This is certainly a position any contractor would want to avoid at all cost.

*Letters of intent* are unfortunately a reality of the business world. They should, however, be used with great caution and, whenever possible, in conjunction with advice from an attorney with specific construction law expertise.

*Letters of intent*, which often make provision for work to be done before the contract is signed, are extremely problematic as they create complex legal problems. If parties to a transaction intend to bind each other, they must conclude a binding contract and not merely rely on a letter of intent. A contractor should not, pending the finalisation of the contract, commence with any preliminary work, without an agreement on how it will be compensated should the contract for whatever reason never come into existence.

## the subcontractor’s lien

by martin müller and elize welcome

The builder’s lien is a right of retention which the contractor acquires over the building or structure which it has constructed and not received payment for.

It is no doubt the most powerful tool the contractor has to ensure payment. The lien in itself can never constitute a cause of action, as it is a form of tacit security which provides the contractor with a defence against the vindicatory action of the owner of the property. The question that comes to mind is whether the subcontractor, who has no contractual nexus with the owner, but has, at the request of the contractor, put money or money’s worth into the property, also enjoys a lien against the owner of such property.

Unlike the United Kingdom and Canada, where the builder’s lien is regulated by legislation, the builder’s lien in South Africa is regulated by common law. Unless there is an explicit waiver of the lien in the contract, the builder’s lien will always apply.

It is common practice, however, particularly when the contractor obtains a payment guarantee from the employer to waive its lien in terms of the building contract. It was held in *Sandton Square Finance (Pty) Ltd v Vigliotti 1997 (1) SA 826 (W)* that the contractor cannot insist on its lien if security is tendered by the employer. The court can therefore order that the lien be relinquished against adequate security being furnished by either the employer or the owner of the property.

## can a subcontractor acquire a lien over property without a contract with the owner?

In order for the contractor to exercise its lien against the owner of the property successfully, the following two requirements must be met:

- The owner of the property must be enriched. It was held in *FHP Management (Pty) Ltd v Theron and Another 2004 (3) SA 392 (C)* that the purported expenditure must in fact have been incurred and the improvements must have been necessary or useful, or must have maintained or enhanced the market value of the property. A lien will not be allowed where the owner would never have incurred a similar type of useful expense himself. The court will apply generally fair and equitable considerations, taking into account factors such as the owner’s financial position and the removal of the improvements by the possessor when deciding whether the contractor has acquired a lien over the property of the owner. The lien will either cover the

owner’s actual enrichment, or the lien holder’s expenditure, whichever is the lesser.

- The contractor must remain in lawful possession of the property to which its claim relates. The lien does not, however, automatically revive if the contractor relinquishes its possession and subsequently regains it. The only exception to this rule would seem to be if the contractor is deprived of its possession by force, the threat of force or as a result of fraud.

It was held in *Ploughall (Edms) Bpk v RAE 1971 (1) SA 887 (W)* that the contractor’s right to enforce its lien is a real right and does not arise from contract. In *Howes & Clover (Pty) Ltd v Ruskin and Others 1978 (1) SA 99 (W)* the court specifically found that a subcontractor who lawfully obtains possession of another’s property and enriches the owner thereof at the request of the contractor, acquires a lien over the property.

In *Wynland Construction (Pty) Ltd v Ashley-Smith and Others 1985 (1) SA 534 (C)* the court held that it would be absurd and most inequitable for the owner to be held to ransom by a subcontractor who refuses to give up possession despite the fact that the owner has paid the main contractor.

Where the owner of the property has paid the main contractor, he is no longer enriched and the subcontractor has no lien, even though the subcontractor might not yet have been paid by the main contractor.

It can therefore be concluded that it is not necessary for the contractor, or the subcontractor for that matter, to establish a contractual nexus with the owner of the property in order to enforce its lien

against the owner successfully. The common law lien is a real right, based on enrichment and possession, and not on contract.

## ens construction law unit - a problem-solving approach

The Edward Nathan Sonnenbergs Construction Unit is a multi-disciplinary unit focusing on all aspects of construction law. It draws its expertise from various departments across the firm, namely Litigation and Dispute Resolution, Insolvency, Business Rescue and Debt Recovery and Corporate Commercial. This allows the Unit to provide clients with seamless legal advice to avoid potential problems, by implementing innovative solutions.

The Litigation and Dispute Resolution team within the Construction Unit has extensive experience in High Court litigation, Arbitration, Mediation, Adjudication, Dispute resolution, Risk analysis and avoidance. The team has expertise in the Fidic Red, Yellow and Silver Book (FIDIC), the General Conditions of Contract 1999 and 2004 edition (GCC), the various editions of the Joint Building Contract Committee contracts (JBCC), as well as the New Engineering Contract (NEC 2 & 3).

The team has been involved in a large number of litigious construction matters, ranging from High Court trials to arbitrations, reviews of arbitrators' awards and interdictory relief relating to building projects on behalf of Contractors, Developers and Employers. The areas of construction practise in which the Unit specialises include: extension of time claims, challenges imposed by penalty provisions, design defects, professional liability claims, alleged malperformance and breach of contractual obligations, payment disputes including certification disputes, disputes relating to practical and final completion, contract price adjustments covering, *inter alia*, disruption claims, variations and instructions.

The team assists the Corporate Commercial team in contract negotiations and offers training courses in respect of these contracts, as well as training contracts tailored for specific projects. The Litigation and Dispute Resolution

team works seamlessly with the Insolvency, Business Rescue and Debt Recovery and the Corporate Commercial teams to ensure that every matter, where appropriate, is considered on a 360 degree basis by professionals with the relevant experience and expertise.

### passionate about construction law

The Insolvency, Business Rescue and Debt Recovery team within the Construction Unit advise clients in the building industry on the registering or taking of security to protect their investments; different types of security including builder's liens, whether enrichment liens or debtor and creditor liens, the validity and value of securities held, the perfection of securities and likely recoveries on liquidation; dealing with the client's claims to ensure maximum recoveries in a liquidation; and, where appropriate, the bringing of a liquidation or sequestration application for a relatively speedy or urgent recovery from a debtor.

The Corporate Commercial team within the Construction Unit provides a broad base of construction-related services. The team's expertise and services include advice on Standard Form Contracts (including FIDIC, NEC, JBCC and other standard forms recommended for use by the Built Environment Professions); drafting of standard form qualifications and project specific contracts; advice on applicable legislation; and advising both government institutions and private sector bidders on construction-related aspects of public private partnerships, including the relationship between public private partnership agreements and construction subcontracts, the risks relating thereto and the negotiation thereof.

The Corporate Commercial team has, *inter alia*,

- advised on the procurement and delivery of construction, conversion, enrichment, fabrication and maintenance services for a nuclear power plant from both within and outside South Africa (including all licensing and regulatory consents);
- provided ongoing legal advice and support to Bombela in respect of the Gautrain Project;
- assisted Siemens with the negotiation and drafting of the contract for the construction of the Eskom Coal Turbine Plant;
- advised on the design, construction and finance of an LNG regasification terminal and the associated importation, regasification and utilisation of LNG as well as the subsequent use thereof *inter alia* in a power station and related commercial, property law and financial transactional agreements;
- advised on the commercial and financial aspects of fossil fired, gas fired and co-generation power stations in Mozambique, Namibia and Botswana;
- provided on-going legal advice to Kumba Resources in respect of the terms of its contract for the design, detail engineering, manufacture, inspection, testing and supply of plant, equipment and materials for the two off 36 MW DC furnaces for the Smelter Project at Empangeni;
- drafted and negotiated Energy Africa's Consultancy Service Agreements (FIDIC-based) for the Pre-Front End Engineering Design Services for the proposed offshore Kudu Gas Field Development; and
- attended to review and advise on the EPC contract concluded in respect of the design, construction and procurement of a gas transmission pipeline from Mozambique to South Africa.

## ens construction contract training

### is your construction project an active volcano waiting to erupt?

Your team might have worked on JBCC, FIDIC, GCC or NEC contracts before, but are they fully equipped to deal with the following?

- Late or insufficient access
- Defective drawings or specifications
- Delays on the critical path
- Defects caused by other contractors
- Insufficient or unclear instructions
- Variation orders
- Payment issues
- Extension of time claims
- Inability to obtain a completion certificate

These everyday encounters can turn a model project into a fiasco if they are not managed effectively and in accordance with the contract. Although the construction contract is the core element of any project, parties to a project often do not fully understand the scope of their obligations and liabilities.

- ENS holds **contract training courses** at our offices in Johannesburg and Cape Town, but can also be arranged at your offices. For more information about the courses and about **construction litigation work**, contact John Zieff (director and national head of litigation) at 021 410 2500 or [jzieff@ens.co.za](mailto:jzieff@ens.co.za), Sue Hayes (director and head of litigation in Johannesburg) at 011 269 7600 or [shayes@ens.co.za](mailto:shayes@ens.co.za) or Martin Müller (associate in the litigation department in Johannesburg) at 011 269 7600 or [mmuller@ens.co.za](mailto:mmuller@ens.co.za)

- For more information about **general (non-litigation) construction work**, contact Kieran Whyte (director in the corporate commercial department in Johannesburg) at 011 269 7600 or [kwhyte@ens.co.za](mailto:kwhyte@ens.co.za) or Deirdre Simaan (associate in the corporate commercial department in Johannesburg) at 011 269 7600 or [dsimaan@ens.co.za](mailto:dsimaan@ens.co.za)
- Need to get your debtors under control? There are faster ways of recovering book debts than issuing a summons and waiting forever to go to trial. Our **Insolvency, Business Rescue and Debt Recovery** department can assist you in making speedy and effective recoveries from your substantial debtors, and can also assist you in securing your exposure to your substantial debtors. Maximising recoveries, managing your debtors. For more information, contact Leonard Katz (director and head of Insolvency, Business Rescue and Debt Recovery) on 021 410 2750 or [lkatz@ens.co.za](mailto:lkatz@ens.co.za)

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