Welcome

How often do we decide to do something one way and then change our minds? The legal world is no different: circumstances change, clients change their mind etc. Clients may reach agreement on a particular matter but wish to keep the record of it separate from the main documentation. Clients may wish to start work on a project before the main contract has been agreed. In these scenarios, and others, side letters and letters of intent can be useful. They are a part of everyday life in the legal world but do you really know how they should be drafted to be effective? On the other hand, are your clients at risk of inadvertently creating a binding obligation in correspondence, usually e-mail? It is easier than you might think to fall into the trap. In this edition of @risk we look at the general principles surrounding the creation of binding obligations.

Side letters and letters of intent

When are side letters used?

Side letters are used in various commercial scenarios, usually for one of the following reasons:

- **Clarification** – to confirm additional details not known when the principal documents are finalised or to clarify certain points.
- **Reassurance** – to confirm the parties’ intentions, particularly in complex transactions where matters can be delayed.
- **Variation** – to document last minute changes rather than changing the main contract or to document any changes that have been agreed in relation to a party’s standard terms and conditions.
- **Supplementation** – to evidence a binding contract between two of the parties to a multi-party transaction, whether or not disclosed to all other parties.

When are letters of intent used?

A letter of intent is a document outlining an agreement between two or more parties before the contractual agreement is finalised. They are often non-binding in whole or in part and are used to:

- Clarify the key points of a complex transaction for the convenience of the parties
- Declare officially that the parties are negotiating, as in a merger or joint venture proposal
- Provide safeguards in case a deal collapses during negotiation.

Working examples

Below, we set out general principles relating to side letters/letters of intent. Here are some examples of situations where side letters/letters of intent are used and, where appropriate, we set out some of the pitfalls to look out for:

1. **Landlord and Tenant** – the use of side letters in this area of law is commonplace. They are often used to reflect personal concessions agreed with a particular tenant but documented separately from the lease. Side letters should not be confused with comfort letters (for example, a letter saying that the landlord does not consider the tenant’s proposed use to be in breach of the lease). Comfort letters are not intended to be legally binding and, as a matter of good practice, should expressly say so.

Examples of concessions often documented in side letters are:

- payment of rents/turnover rent/service charge monthly rather than quarterly (currently very common owing to the economic climate)
- personal concessions permitting alterations, for example, to the shop front/fascia or internal non-structural alterations without the need to obtain landlord’s prior written consent
- rent free periods/rent reductions/stepped rents
- grant of specific rights to use/install air conditioning plant/aerials etc.
When acting for a tenant in circumstances where a landlord’s concession is being documented in a side letter, be aware of the following:

- The concessions should also apply to group companies of the tenant to ensure the concession survives an inter-company assignment
- Ensure the concession does not fall away on an assignment to a group company by specifically stating this in the side letter
- The side letter should bind the landlord’s successors in title
- Side letters dealing with capital contribution payments to the tenant, or other monetary matters, should be executed as a deed and not just “signed for and on behalf of” a company
- Ensure the side letter is not drafted so as to fall away for minor breaches by the tenant – i.e. the landlord is either granting the concession or not – it can’t have its cake and eat it.

2. Franchising – Franchisors spend considerable time, effort and money investing in their franchise brand and systems and it is this product that franchisees are buying into when they agree to acquire a franchise. This is a key reason why Franchise Agreements are rarely open to negotiation. A side letter can be a useful tool for clarifying and supplementing the terms of a Franchise Agreement and, where agreed, varying specific terms. As the side letter reflects the terms agreed between the parties, upon which their business relationship is based, it is essential that it is enforceable in the same manner as the Franchise Agreement itself (see the general principles below).

3. Corporate – ensure the side letter is a legally enforceable contract and not merely an agreement to agree (see the general principles and the Barbudev case opposite).

4. Construction – letters of intent are used in the construction industry where a client is desperate to start work on site but the contract is not ready. While there are often legitimate commercial pressures to start work before all the contractual terms have been agreed, letters of intent can be problematic. Here are some practical tips for avoiding problems:

- The scope of the letter of intent should be clearly defined – by reference to the work to be carried out under it, the period of validity of the letter of intent and/or amounts to be expended under it.
- Make it clear whether or not the letter of intent is intended to create a contract. If it does create a contract, ensure the parties are certain what matters remain to be resolved in order for a formal construction contract to be entered into.
- Advise clients to consider putting in place internal risk management policies to prevent a project being continued and/or completed where the underlying contract documentation has not been agreed. This may involve diarising key dates and (at least) weekly cost updates.
- A letter of intent should not be regarded as a substitute for a properly drafted construction contract. It is unlikely to contain terms that are adequate to protect clients and may leave many important issues unresolved. Clients may also find that they do not have the contractual remedies that they thought they had when things go wrong.

5. Commercial – letters of intent are used in commercial transactions in similar circumstances as in the construction industry, i.e. when work needs to start on a project before the contract is in place. For example, an IT system build contract with one supplier for the infrastructure and another for the software. The tripartite contract between the customer and the two suppliers is complex and time consuming to negotiate as the roles and responsibilities of each supplier need to be particularised and agreed and a warranty given that the software will work on the infrastructure. To enable work to start, a letter of intent with each supplier is needed – it is likely to be time and money limited and may need extending. The downside is that the longer negotiation goes on and work continues under a letter of intent, the negotiating position of the customer/client is weakened. It is essential to ensure that the work carried out under the letter of intent is part of the main contract when it is finalised.

Side letters and letters of intent – the general principles

A side letter is ancillary to a contract. The key question is whether or not the side letter is binding. Although the usual intention is that side letters will create legally enforceable rights and obligations, this is by no means guaranteed, even if the document is entitled “side letter”. In some cases, a side letter will have nothing more than moral effect.

Side letters are governed by the general principles of contract law:

- First and foremost, the intention of the contracting parties to create legal relations must be clear. If the intention is unclear or absent, there can be no legally binding contract.
- Secondly, there must be certainty as to the terms that have been agreed. If the letter has been drafted to set out terms that are subject to further negotiations, it will be no more than an agreement to agree. Morally binding? That depends on the morals of the parties involved. Legally binding? No.
The recent case of Barbudev v Eurocom Cable Management Bulgaria EOOD & Ors ([2012] EWCA Civ 548) provides useful guidance on the construction of side letters. The side letter in question stated that at a later date the parties would negotiate an investment and shareholders’ agreement in which Barbudev would purchase shares in a company. The Court of Appeal accepted that as the side letter was drafted by lawyers, contained boilerplate confidentiality provisions, used the language of legal relations (such as “in consideration of you agreeing to…”) and made reference to relevant statutes, it demonstrated an intention to create legal relations.

However, the complexity of the proposed shareholder agreement meant that the side letter was no more than an agreement to agree and not, therefore, legally binding. It failed to set out the comprehensive essential terms of the investment which were required for there to be certainty.

Letters of intent resemble written contracts, but are usually not binding on the parties in their entirety. Many letters of intent, however, contain provisions that are binding, such as non-disclosure agreements, a covenant to negotiate in good faith, or a “stand-still” or “no-shop” provision promising exclusive rights to negotiate. A court may find a letter of intent binding if it too-closely resembles a formal contract.

10 top tips when drafting a side letter or letter of intent:

1. Be absolutely clear as to the intention of the parties and the intended effect of each provision. A court will not enforce a side letter/letter of intent if the key commercial terms are still being negotiated.
2. If a particular provision is to be legally enforceable, expressly state this in the letter.
3. If there are matters and terms which are still to be agreed, specify “these provisions are not intended to be binding”.
4. A side letter is a contract and consideration must be provided. Usually, if a side letter is made to clarify details relating to the main agreement, or to document agreed changes, the requirement for consideration is satisfied as the benefit to both parties is obvious.
5. If consideration is not provided, the side letter will not be binding unless it is executed as a deed.
6. Side letters should always be executed as a deed when intended to take effect as a variation of a lease.
7. If a letter of intent is intended to be binding, even if only in part, bear in mind the provisions set out at 1-5 above.
8. Work carried out under a letter of intent should form part of the main contract, unless you are instructed otherwise.
9. Be aware that the longer work continues under a letter of intent, the negotiating position of everyone involved in the project (and in particular the customer) is weakened particularly if major deviations from what is set out in the letter of intent are required.
10. A letter of intent should not be a substitute for a properly drafted contract.

Beware of creating a guarantee by e-mail

The giving of a guarantee by one party to secure the performance of an obligation of another party should always be given careful consideration. It is onerous. Generally, a guarantee is formally documented following agreement of terms. A High Court ruling, that an exchange of e-mails between two companies could create a binding contract, serves as a timely reminder to businesses to avoid creating contracts accidentally when negotiating by e-mail.

The case of Golden Ocean Group Ltd v Salgaocar Mining Industries Pvt Ltd ([2012] EWCA Civ 265) demonstrates how corresponding by e-mail can lead to the inadvertent creation of such a burden.

Mr H was negotiating the charter of a vessel from Golden Ocean on behalf of the defendant, SMI. Basic terms, including a guarantee, were agreed in a series of e-mails. Each exchange of e-mail either accepted or rejected the other parties’ points until all the points were resolved. It was intended that a formal agreement incorporating all the agreed terms would be executed but it was never signed.

The final e-mail in the sequence did not refer to a guarantee. It was simply signed off by Mr H with his first name. When the broker refused to take delivery of the vessel, SMI denied that a guarantee had been created, one of their arguments being that there was no e-mail or signed document incorporating all the agreed terms.

Typically a contract is a signed agreement with terms that are subject to detailed and precise negotiation. However, contracts are flexible and can be created in a variety of ways. This presents a real risk that they may be created unintentionally. Finalising terms by e-mail is usual in the shipping market and the court considered that the chain of e-mails sufficient to give rise to binding obligations. If the parties intended to be bound by the terms set out in the chain of e-mails, then assuming each was signed, the fact that the terms were not all included in one e-mail did not prevent the guarantee being enforceable. The court confirmed that an electronic signature of a person with authority to enter into the contract would suffice, even if it was just a first name, initials or potentially even a nickname.
Don’t let it happen to you/your clients

E-mail is used increasingly to negotiate contract terms. The creation of contracts of this type is commonplace in ship chartering, but it is unclear whether a similar decision would be made in other commercial areas. It is important that you and your clients are aware of the risks. If you are asked to advise a client whether a binding contract exists:

- Ensure all negotiations are expressly stated to be “subject to contract” as this may help to prevent contracts being created accidentally. The safest approach for your client is for the agreement to be finalised before starting work. Commercially this may not always be possible, but your client should be made aware that by starting to carry out work before a contract is concluded, it runs the risk of waiving the protection offered by the “subject to contract” provision.

- Where terms are negotiated over a series of e-mails, ensure a final “recap” or agreement is drafted to document both parties shared intentions (where terms can be established by reviewing a limited number of documents, the courts are more likely to consider them binding). Written contracts should contain an entire agreement clause. This avoids a claim that contract terms exist outside the final version of the agreement.

- If the terms are intended to be binding, ensure they are clear, both in relation to the point at which the parties will be bound and the extent. Ensure also that the person negotiating has sufficient authority to create such obligations. Although dependent on the facts at the relevant time, there is a danger that anybody who reasonably represents that they have authority to act on behalf of a company, whether they have that authority or not, may bind that company to a contract. This person could be an employee or even a third party agent. Authority can be given to a person in writing or by conduct. For example, an employee who negotiates contracts on behalf of a company but fails to state that they need approval from a more senior manager, could be held to have authority to conclude that contract. It is good practice for employees to make clear (preferably in writing) early in the negotiations that they have no authority to conclude the contract. Alternatively, this could be included in the standard wording that is automatically inserted in the footer of every e-mail.

- Beware patterns of behaviour which could imply that informal communications will be binding and keep a clear audit trail in case issues subsequently arise.

- Only a few specialist contracts (such as guarantees and contracts for the sale of land) need to be signed to be binding. Most types of contracts do not need to be signed or even put in writing. Even if a signature is required, this does not mean that the signature must be with a pen. “Signature” means voluntarily making one’s mark on a document. Stamping a document, placing photocopies of signatures on an agreement and even inserting one’s name at the bottom of an e-mail, could all be considered signatures.

- Both contracts and deeds can be varied by a further contract. The variation agreement can be oral or in writing. The key requirement is that the parties must be giving new promises or fresh consideration for the variation to be legally binding. If the original contract or deed has a clause that requires the variation to take a particular form (i.e. be in writing and signed), then these formalities must be followed. However, bear in mind that an exchange of e-mails could be a contract in writing and e-mail sign-offs can amount to signatures.