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Letters of Intent, Bonds & Guarantees,
Defects Liability Periods



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- The use of the Primavera software for the Management of Infrastructure Projects in Romania;
- Using Dispute Boards. The Romanian experience of Dispute Boards;
- International Contracting - A Consulting Engineer`s Perspective.

PREFACE

Engineers, Lawyers, Contract Managers and Practitioners are required - during the performance of their professions and specialisms in Contract Management and Construction law - to deal with Letters of Intent, Bonds and Guarantees and the Defects Liability Period applicable in some form or other to the projects they will deal with during their careers.

Although the above aspects of Contract and Construction law may appear as straight forward, in reality they are not and much abuse and disputes arise on projects due to misunderstanding of these aspects and lack of understanding of Contract law. This paper aims at providing some clarity to the professional that is called upon dealing with these aspects of contract within an international environment and in respect of the use of Standard Forms of Contract like FIDIC and NEC.



LETTERS OF INTENT

- What is a Letter of Intent (LOI)?



Black’s Law Dictionary provides that the letter of Intent (hereinafter referred to as “LOI”) is *“a written statement detailing the preliminary understanding of parties who plan to enter into a contract or some other agreement; a noncommittal writing preliminary to a contract. A letter of intent is not meant to be binding and does not hinder the parties from bargaining with a third party. Business people typically mean not to be bound by a letter of intent, and courts ordinarily do not enforce one; but courts occasionally find that a commitment has been made.”*

Consequently, it may be construed that LOI represents a communication expressing an intention of a party to enter into a contract with another party at a future date. LOI creates no liability in regard to that future contract but it is intended to give some measure of security to the party commencing work, pending conclusion of the contract.

The phrase “Letter of Intent” is not a term of art, its meaning and effect depend on the circumstances of each case - ERDC Group Ltd v Brunel University [2006] B.L.R 255 Judge Lloyd QC said:

“Letters of Intent come in all sorts of forms. Some are merely expressions of hope; others are firmer but make it clear that no legal consequences ensue; others presage a contract and may be tantamount to an agreement ‘subject to contract’; others are in reality that contract in all but name. There can therefore be no prior assumptions, such as looking to see if words such as ‘letters of intent’ have or have not been used.”

- **When should one enter into a LOI? Expiry of a LOI**

A Letter of Intent should only be used where there are good reasons to start work in advance of finalising the contract documents e.g. in cases of commercial urgency and never as a substitute for a building contract.

In *Cunningham v Collett [2006] EWHC 1771 (TCC)*, (2007) 113 Con LR 142 HHJ Coulson laid down situations where ‘a careful Letter of Intent’ may be appropriate:

- the scope of work is agreed or there is a clear mechanism in place for it to be agreed;
- the price is either agreed or there is a clear mechanism in place for it to be agreed;
- the contract terms are, or likely to be, agreed in the near future; and there are good reasons to start work in advance of the finalisation of all the contract documents.

A LOI would expire if it is not extended by the parties and if the Contract is not signed within the time stated in the LOI.

- **Purpose of a LOI**



The purpose of the LOI is to enable the Contractor to commence the Works and to secure its entitlements to receive the related payment until a binding Contract would be concluded.

In order to assess the specific effects that it produces, each LOI has to be interpreted based on its express wording. However, it has been generally accepted that a LOI is a non-binding statement of the future intention of both parties that entitles one part to start the works and to receive the related payment; otherwise it would be construed as unjust enrichment of the other part. A LOI allows the works to commence.

In order to safeguard the parties' entitlements, the LOI should contain a limitation of the value of the works that can

be executed and paid until the conclusion of a binding contract between the parties.

● Contents of the LOI

Usually, a LOI may comprise the following:

- Aim of the LOI;
- Terms and conditions applying to the works specified within the LOI;
- Insurances;
- Risk management Procedures (internal policies);
- Payment provisions and caps on payments;
- Dispute resolution Procedures;
- Lockout Procedures;
- Ending of LOI arrangement;
- Governing Law.

● Conclusions

The wording of a LOI should not be ambiguous in order to avoid misunderstandings and a LOI should clearly state that it is an interim agreement pending negotiation of the main contract. The Contract procedure provided by FIDIC does not envisage the use of LOI mainly because the Time for Completion is calculated from the Commencement Date.

Under FIDIC there are provisions for the Employer to issue a Letter of Acceptance and

such creates obligations and leads to a sequence of events.

So if for whatever reason the parties wish to sign a Letter of Intent such has to be clearly worded so that it is not confused with a Letter of Acceptance. Under NEC there are no restrictions to the use of Letters of Intent, however there is a lot of criticism from the construction industry when LOI operates for a long period of time as the LOI does not provide the required mechanism for real-time risk and change management that the NEC stands for.

BONDS & GUARANTEES

● Generalities



Commonly, in all forms of Construction Contracts, there are three different types of guarantees/bonds that refer to the advance payment, performance of the works and

retention money, which are called guarantees or bonds, depending on each form of Contract. Thus, within the FIDIC Contracts, the aforementioned documents are called guarantees while the New Engineering and Construction Contract (hereinafter referred to as “NEC”) refers to them as bonds. The advance payment guarantee/bond, the performance security/performance bond and the retention money guarantee/bond represent a payment mechanism and they can differ through their functions, as it will be presented below.

All the guarantees/bonds have to be issued by an entity approved by the Employer (FIDIC Contracts) and the Project Manager (NEC Contract) in the form provided within the contract documents.

- **Advance Payment Guarantee and Advance Payment Bond**

The advance payment is an interest free loan granted by the Employer that is usually used for the Contractor’s mobilization or as otherwise provided for in the contract.

The value of the advance payment (*i.e.* the percentage) and the method of payment (*i.e.*

one instalment or more) are stated in the contract documents - in the Appendix to Tender (FIDIC Contracts) and within the Contract Data (NEC).

The advance payment shall be paid by the Employer only upon receiving of the Advance Payment guarantee/bond covering the advance payment. However, under NEC, there may be cases when a bond is not required.

There is no specific term for the advance payment guarantee to be provided by the Contractor under FIDIC Contracts and the sanction for the Contractor will be the late payment of the advance. In any case no advance payment can be paid by the Employer until the performance security is provided to this.

Under NEC, if the advance bond is required and such is not provided within four weeks of the time agreed for its provision and the related notification of the Project Manager, this represents a severe default and even ground for termination.

The value of the Advance Payment guarantee/bond may be gradually reduced with the amount repaid to the Employer; however the Contractor must ensure that the

guarantee/bond is valid and enforceable until the full repayment of the advance payment.

- **Performance Security and Performance Bond**



The performance security/bond has to be issued in a value (percentage) stated in the contract documents - in the Appendix to Tender (FIDIC Contracts), within the Contract Data (NEC), guarantees the quality, quantity and timely fulfilment of the Contract, and of the Contractor's obligations assumed under the Contract, including the remedy of defects. It is to be noted that within the FIDIC Contracts if no amount is stated in the Appendix to Tender, then there is no requirement for the Contractor

to provide a Performance Security. The situation is similar on NEC when the Parties decide not to apply Option X13. Under both FIDIC and NEC Contracts, failure to provide the performance security/performance bond within the time specified in the contract represents a severe breach and may be used as ground for termination.

The value of the performance security/bond can be reduced once the Works are taken over by the Employer, upon agreement of the parties and also depending on the governing legislation. However, the performance security/bond has to remain valid and enforceable until the Performance Certificate is issued (FIDIC), or the Defects Certificate under NEC.

- **Types of performance bonds/guarantees**

There are two different types of performance bonds/guarantees:

- **Conditional** - a bond/guarantee that is conditional upon the occurrence of a particular event; the beneficiary may called upon the bond/guarantee only after proving a breach and only for the amount that covers the damage that had been proved;

- Unconditional or “on demand” - the beneficiary may call upon the guarantee/bond only in the manner prescribed therein and without proving any breach /damage for the entire amount of the bond/guarantee.
- **Retention Money Guarantee and Retention Money Bond**



The purpose of the retention money guarantee/bond is to assure the Employer that there are sufficient funds for the remedy of the defects and to determine the Contractor to pay attention to the quality of the works performed so as to avoid or even eliminate the defects.

The maximum amount of the retention money shall be stated in the Appendix to Tender

(FIDIC Contracts) or within the Contract Data (NEC) and this amount shall be halved upon the Employer’s taking over of the works. However, such guarantee bond has to be valid until the end of the Defects Notification Period (FIDIC) or until the issuance of the Defects Certificate (NEC).

DEFECTS LIABILITY PERIODS

FIDIC Contracts define the Defects Notification Period as being the “*period for notifying defects in the Works or a Section (as the case may be) under Sub-Clause 11.1 [Completion of Outstanding Work and Remedying Defects], as stated in the Appendix to Tender (with any extension under Sub-Clause 11.3 [Extension of the Defects Notification Period]), calculated from the date on which the Works or Section is completed as certified under Sub-Clause 10.1 [Taking Over of the Works and Sections]*”. Under the FIDIC Contracts, during the Defects Notification Periods, the Contractor has an obligation to remedy the defects notified after the completion of the Works. Distinction should be made either yes or not the defects had been assigned to the Contractor or to the Employer’s use of the Works.

Thus, if the defects are assigned to the Contractor, it shall rectify the defects at its own expenses.

However, if the defects are assigned to the Employer's use of the Works, upon receipt of the Engineer's instruction, the Contractor shall rectify such defects and shall receive the relevant payment.

If the Contractor fails to remedy a defect, the Employer may instruct others or it can carry out the necessary works by itself in order to remedy the defect at the Contractor's cost or can even accept the work including defects and request the Engineer to determine a reduction of the Contract Price.

Further, if the Contractor fails to remedy defects which prevent the Employer to use the Works or a Section for their intended purpose, the Employer shall be able to extend the Defects Notification Period. The Contractor's obligation to remedy the defects shall cease upon the Final Taking Over of the Works and the issuance of the Performance Certificate.

The NEC defects correction period is a period of time specified within the Contract Data and pursuant to these Contracts *"A Defect is a part of the works which is not in accordance with the Works information or a part of the works designed by the Contractor which is not in accordance with the applicable law or the*

Contractor's design which the Project Manager has accepted."

Under NEC, both the Contractor and the Supervisor have a common obligation to notify the other of all of the defects found before or after the completion of the Works. Furthermore, the Contractor is under an obligation to remedy/correct all the defects, either yes or not notified by the Supervisor.

Similar to FIDIC Contracts, under the NEC form of Contract if the Contractor fails to remedy the defect, the Project Manager may instruct others or it can carry out the necessary works by itself in order to remedy the defect at the Contractor's cost, or can even accept the work including defects and reduce the contract Price accordingly.



About the author

Giovanni Di Folco is the Senior Partner and President of Techno Engineering & Associates. He is a highly motivated expatriate multi-discipline professional Civil Engineer with 30 years of experience in the construction and consulting industry (transportation and heavy civil works). Experienced as Projects/Contracts Manager and Claims Expert with extensive international experience gained in multi-disciplinary Civil Engineering Projects in Italy, Iran, Libya, South Africa, Kingdom of Lesotho, Sultanate of Oman, United Arab Emirates, Greece and Romania, who attained professional recognition.

Demonstrated acumen for construction and design engineering and management at all levels, acute awareness of cost control and project planning, ability to provide an immediate and calculated response to situations in the financial, contractual, legal and technical sectors of the profession, proven ability to sustain responsibilities from high level management through to operational level.

He possesses acute awareness of specific Countries and International Law, the importance of quality, safety, the moral and legal responsibilities that they impose. Trained and operating to the most current standards of ISO 9000, ICE, NEC, JCT and FIDIC Conditions of Contract and the strict and controlled safety regimes in force and recognized internationally. Although specialized as a Pavement Engineer by profession, the international experience gained has enabled development of a wide diversity of his skills within the Civil Engineering Industry. During his career he has held positions of high responsibility such as Counsel, Engineer in the sense of "FIDIC", Project Manager, Country Manager, Claim Expert and Adjudicator on major construction projects. He is a FIDIC expert in his own right. He possesses a vast experience in adjudication using the DAB procedure and ICC arbitration either as Expert of opinion, Attorney, Counsel for Claimant, Respondent.

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