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ENFORCEABILITY OF REASONABLE ENDEAVOURS AND GOOD FAITH OBLIGATIONS IN MOUS AND LOIS

IPT UPDATE

Obligations to "use reasonable endeavours" and "negotiate in good faith" are often found in commercial agreements, and are a particularly common feature of preliminary agreements such as Memoranda of Understanding (MOU), Letter of Intent (LOI), heads of terms, terms sheets and the like. Although these types of obligations are very common inclusions and seemingly have a well understood meaning among commercial parties, there are instances where the meaning and enforceability of these obligations are the subject of litigation.

In this publication we will:

- examine the circumstances in which obligations to "use reasonable endeavours" and to "negotiate in good faith" are enforceable
- consider a recent decision of the Supreme Court of Queensland regarding an MOU that illustrates how the courts apply the identified principles
- look at what these obligations require of contracting parties, which in the case of obligations to act (whether in negotiations or

otherwise) in "good faith", has been an area of some contention in recent decades.

We have identified a number of key takeaways for parties when considering entering into MOUs or LOIs containing obligations to "use reasonable endeavours" and "negotiate in good faith":

KEY TAKAWAYS

- Where obligations to use "reasonable endeavours" or act in "good faith" are included in an MOU or LOI **and** are intended to be legally binding and enforceable, the parties should give as much content and context to those obligations as possible. This includes recording in the MOU or LOI, with as much specificity as possible, those matters which have already been agreed by the parties together with the parameters within which the outstanding matters will be agreed and/or the factors that the parties will have regard to in seeking to reach agreement.
- Consider including "circuit breaking provisions" by which outstanding differences between the parties can be resolved by a third party, such as referral to an expert or

KEY TAKAWAYS

mediation, to provision a pathway to certainty and to increase the likelihood of legal enforcement of the obligations.

- Identify clearly those obligations of the MOU or LOI which are intended to be binding and those (if any) which are intended to be non-binding. For example, provisions about the ownership of intellectual property rights, confidentiality provisions and provisions specifying how costs of pursuing negotiations of a long form agreement are to be borne to by the parties should be clearly agreed and, where this is so, expressed as being binding, even if the obligations to "negotiate" are intentionally non-binding.
- The enforceability of an obligation to "negotiate in good faith" or "use reasonable endeavours" is entirely dependent on the context of the obligation. Courts will consider (amongst other things) whether the parties are in an existing contractual relationship; the extent of the remaining "blank spaces" in the agreement; the nature and complexity of the contractual arrangements.
- Parties should proceed with caution and seek legal advice when they enter into preliminary agreements (such as MOU's and LOI's) which require them to "use reasonable endeavours" and "negotiate in good faith".

Obligations to "use reasonable endeavours" and "negotiate in good faith" - are they enforceable?

Whether or not these types of obligations are enforceable depends on the particular obligation, the context and the particular contract.

Generally speaking, in Australia, obligations to "negotiate in good faith" or "use reasonable endeavours" to achieve an outcome are capable of being legally enforceable.¹ These obligations are more likely to be held to be binding where they arise as part of an existing, (more) fully defined contractual relationship (for example, as part of a dispute resolution clause). One reason for this is that in 'concluded' agreements these obligations are

"anticipated to involve or comprise a discussion of rights, entitlements and obligations said by the parties to arise from a finite and fixed legal framework", rather than requiring open-ended negotiations "about a myriad of commercial interests to be bargained for from a self-interested perspective".²

On the other hand, obligations to "use reasonable endeavours" or "negotiate in good faith" are included in many arrangements which by their "nature, purpose, context, other provisions or otherwise make it clear that 'the promise is too illusory or too vague and uncertain to be enforceable'".³

In *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* the NSW Court of Appeal found that a heads of agreement requiring the parties to negotiate in good faith over a complex joint venture to develop a coal mine was unenforceable. Amongst the factors cited by the court in support of this conclusion were:

1. the absence from the heads of agreement of any mechanism by which a third party could be appointed to settle any outstanding differences between the parties,
2. the complexity of the subject matter (i.e., a complex, major mining development) compared to more familiar types of arrangements like leases
3. the great number of differences between the parties at the time they entered into the heads of agreement and, indeed, still in existence when irrevocable differences were apparent three years later.

A timely example...

In the recent case *Baldwin & Anor v Icon Energy Ltd & Anor*⁴ the Supreme Court of Queensland held that the terms in a MOU requiring the parties to use their "reasonable endeavours" to negotiate and work in "good faith" to develop a gas supply agreement (GSA) were uncertain and unenforceable.

² *United Group Rail Services Ltd v Rail Corporation of New South Wales* (2009) 74 NSWLR 618, 637 (Allsop P).

³ *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1, 27 (Kirby P).

⁴ [2015] QSC 12.

¹ Kirby P in *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1.

Facts

Southern Fairway Investments Pty Ltd (Southern Fairway) entered into an MOU with Icon Energy Ltd (Icon) and its wholly owned subsidiary (collectively, the defendants) in which the parties agreed to negotiate a GSA. Specifically, the MOU contained provisions requiring:

- the parties to use reasonable endeavours to negotiate a GSA by a certain date using the principles set out in a set of 'indicative' terms and conditions. The MOU also listed a number of other key matters which were to be included in the GSA (e.g. the term of the GSA, the quantity of gas to be supplied within a specified range, and that the transportation pipeline quality specifications with which the gas would need to conform)
- each party to work in good faith to progress the GSA in the manner contemplated.

No GSA was concluded and Southern Fairway argued that Icon breached the MOU by failing to perform its obligations to negotiate as required by the MOU in attempting to conclude a GSA.

Issue

The key issue was whether the provisions of the MOU requiring the parties to negotiate in good faith and use reasonable endeavours to negotiate a GSA were enforceable.

The defendants' key argument was that the clauses in the MOU lacked the necessary certainty to be enforceable because they had no legal content.

Southern Fairway argued that the obligations to act in good faith and use reasonable endeavours were sufficiently certain, since the subject matter of the negotiations was agreed in extensive terms and the content of the agreement to negotiate was defined by the well-recognised expression "reasonable endeavours".

Justice McMurdo recognised that in some instances an agreement to negotiate may be enforceable. However, this was not such an agreement. Rather, the defendants' position was accepted, namely that the obligations to "use reasonable endeavours" to negotiate a GSA and "act in good faith" to progress the GSA did not have a sufficiently certain legal content and were therefore unenforceable.

In support of this conclusion, McMurdo J cited the following factors:

- there was no existing contractual relationship between the parties to which a standard of reasonableness or good faith could be measured and applied
- in the context of negotiations "about a myriad of commercial interests to be bargained for from a self-interested perspective" (the court adopting the language of Allsop P in *United Group Rail Services Ltd v Rail Corporation of New South Wales*), the required standard of reasonableness is inapt and uncertain. Further, a duty to carry on negotiations in good faith or reasonably in that context is "repugnant to the adversarial position of the parties when involved in negotiations"
- while the MOU provided some framework for the negotiations by defining certain matters which were to be included in the GSA, this did not provide the necessary content to the parties' agreement to undertake negotiations in a particular manner.

What do obligations to "use reasonable endeavours" and "negotiate in good faith" require of contracting parties?

If an obligation to "use reasonable endeavours" or "negotiate in good faith" is enforceable, the next issue is what does that obligation actually require of the contracting parties?

The High Court recently considered the meaning of "reasonable endeavours" in *Electricity Generation Corporation v Woodside Energy Ltd & Ors*⁵, and although the decision has been the subject of some academic criticism⁶, it sets out principles that are to be applied across Australia for reasonable endeavours. However, there is less clarity around the content of a duty to act or negotiate in "good faith", since it is difficult to distil a core set of principles from the numerous decisions of

⁵ [2014] HCA 7 (Woodside).

⁶ J W Carter, Wayne Courtney and Gregory Tolhurst, "Reasonable Endeavours' in Contract Construction' (2014) 13 *Journal of Contract Law* 36. The authors criticise the majority judgment on the basis that it illustrates that "advances made in most other common law jurisdictions have not yet taken hold in the High Court", and that "the attempt to apply a doctrinal approach to reasonable endeavours obligations, led to a decision which lacks the sound commercial judgment essential to construction". The authors go on to contend that Gaegler J's dissenting judgment is to be preferred to the majority judgment.

intermediate courts regarding the meaning "good faith" obligations.

The following principles will generally apply when determining what obligations to "use reasonable endeavours" and "negotiate in good faith" require of contracting parties (where those obligations are enforceable):

Obligation to use reasonable endeavours to achieve a contractual object	Obligation to act or negotiate in good faith
<ul style="list-style-type: none"> ▪ It is not an absolute or unconditional obligation. ▪ The nature and extent of an obligation imposed is conditioned by what is reasonable in the circumstances, which can include circumstances that may affect an obligor's business. ▪ Some contracts may set out their own standard of what is reasonable, for example, by expressly referencing factors relevant to the business interests of the obligor and/or obligee⁷ 	<ul style="list-style-type: none"> ▪ The parties must act honestly. ▪ The parties must not act dishonestly, undermine the bargain entered or the substance of the contractual benefit bargained for. ▪ The parties must have regard to the interests of the other party (or parties), but are not required to put other parties interests ahead of their own.

More information

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⁷ In Woodside, for example, the sellers were entitled to take into account all relevant 'commercial, economic and operational matters' - i.e. any matter that affected the seller's business interests.

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