CONTRACTS: GETTING IT WRITE/RIGHT

What is a contract?

A contract is a legally enforceable understanding between two or more persons or legal entities (the contracting parties). The essence of a contract is that it consists of an exchange of promises ("something for something") that is legally enforceable. The "something" can be money, services, property, rights... almost anything. A ‘contract’ describes an ‘agreement’ that meets the legal requirements to be enforced as a binding comment by a court of law.

In some circumstances contract law can fill gaps that have been left by the contracting parties, and will imply a term to deal with an issue which the parties did not expressly discuss or a court can ‘rectify’ a contract to add in a term which the parties did agree but which was left out of the contract signed by the parties.

It can happen that parties think they have entered into a binding agreement, but it is unenforceable because it lacks an essential element to be a valid contract. This information sheet considers some of the common pitfalls that result in an agreement that the parties thought was a binding legal commitment, but is actually unenforceable.

Essential elements of contracts

The Arts Law information sheet Contracts: an introduction describes the 4 elements required by a contract. These are set out below, with the following discussion of the consequences of failing to meet these basic requirements of a contract:

- **Offer**: a clear offer by one person or organisation to another. If an offer is rejected, that offer automatically ends;
- **Acceptance**: the other party must accept the whole offer without conditions. For example, if an art buyer offers you $500 for your painting and you say that you would take $600, you have not accepted the buyer’s offer, but made a new offer that the buyer can accept or reject. This is referred to as a "counter offer". There can be many offers and counter offers before there is an agreement;
- **Consideration**: this is what each party gives to the other as the agreed price for the other’s promises. Remember, the agreed price doesn’t have to be money. It can be another benefit; and

- **Intention**: the people or organisations entering into the contract must intend to create legal relations.

When an agreement is drafted in the form of a 'deed' the agreement is enforceable even if the parties do not exchange something of value, so that a one way promise can be an enforceable contract if it is drafted in the form of a deed.

In addition to the elements of a contract that are described above, there must be certainty about the important terms as to the subject matter of what the parties are agreeing to do or refrain from doing. The failure to agree what are the important matters can result in what the parties believe to be an agreement being an unenforceable 'agreement to agree' or a contract that is 'void for uncertainty.' Providing certainty as to the subject matter of a contract is discussed below in **when is an 'agreement' not a legally binding contract?**

The conduct of negotiations in 'good faith'

The parties may say in an agreement that they are to conduct future negotiations in 'good faith'. However the distinction between good faith and bad faith is uncertain. The courts have not regarded statements to the effect that "the parties will negotiate a binding agreement in good faith" as being legally enforceable. If such a clause is used in an agreement, be aware that such a clause may not have any legal consequences if the negotiating parties fail to reach a binding agreement.

In general terms, where the parties are at 'arms-length' to each other, the parties are not required to be completely open with each other about the strength and weaknesses of their negotiating position or require full disclosure at all times. However there are some circumstances, like the negotiation of insurance contracts, in which the common law imposes and obligation of 'utmost good faith', which requires the disclosure of relevant information related to the insurable risk.

There have been any instances in which courts have accepted that a negotiating party trod a fine line of non-disclosure or engaged in other questionable negotiating techniques but as the negotiating party neither said nor wrote anything which encouraged or mislead to other party to act to its detriment – as a consequence there was no breach of the standard of acceptable commercial conduct prescribed by the *Australian Competition and Consumer Act 2010* (Cth) or by any of the legal duties and equitable obligations that are recognised by the common law and the law of equity.

The analogy of a card game can be used - the negotiating parties can engage in exaggeration, evasion or obfuscation in negotiating the outcome they wish to achieve. However there is a point at which the freedom to negotiate goes beyond what is of acceptable commercial conduct and becomes behaviour that results in legal liability. The Australian Consumer Law (ACL) provides an important standard of acceptable commercial conduct as it prescribes 'misleading or deceptive' conduct and sets out specific misrepresentations which can result in legal action by the Australian Competition and Consumer Commission (ACCC) or by any person that suffers some loss as a result of the 'misleading or deceptive' conduct or misrepresentations.

Some contract pitfalls

The Courts of Australia, in decisions made in contractual disputes, provide guidance as to the rules that can be applied to the interpretation of contracts and the circumstances in which courts will fill in gaps that parties may leave in their agreements. What follows is a description of some of the common pitfalls that people fall into when they set out to make offers and enter into agreements. However, you should note that contract law can be difficult to reduce to simple statements that have universal application as

the specific circumstances of the negotiating parties and how they expressed their agreement is important understanding how contract law principles and doctrines should be applied.

The intention to enter into a legally binding commitment

A unilateral offer – such as an offer made to the whole world - is capable of acceptance so as to create a binding contract. This can be described as an 'if' contract: I will do or refrain from doing X if you will do or refrain from doing Y. It can be 'accepted' and so become binding by the other person doing or refraining from doing Y. An example of a unilateral offer is an advertisement offering an item for sale at a particular price (an offer to every person that sees or hears of the advertisement), which is capable of acceptance by any person that is ready to pay that price. A unilateral offer is an example of an offer made in a form that invites acceptance by conduct, where the intention to be bound in an agreement can be specifically stated or implied from the circumstances.

An example of a binding contract coming into existence as the consequence of an advertisement or offer made to the world occurred when a musician from the United States, lost his computer and external hard drive during a tour of Germany. He offered a US$20,000 reward for the return of his "intellectual property" via YouTube and further publicized his offer on his Twitter and Facebook accounts. He later increased the offer to US$1 million in a video posted to YouTube. When a person returned the computer and hard drive the musician refused to pay the reward. When the finder of the property sued the musician the U.S. court said that the question to be considered was whether a reasonable person would have understood that the musician made an offer of a reward. The court reached the conclusion that the musician was not seeking a promise from an individual who would return his property; rather he was seeking performance - the actual return of his property. In addition, his videos and other commentary could not be reasonably understood as an invitation to negotiate because he was not seeking help in finding his property; rather a reasonable person would understand that the musician was seeking the actual return of his property. As the finder returned the property - the finder should be paid the US$1 million reward.

When does an 'agreement' become a binding legal 'contract' ?

As discussed above, an important element of a legally binding contract is that the people or organisations entering into the contract must intend to create legal relations. When parties to negotiations have reached agreement as to the terms that will form their contractual commitments, (which may exist as an oral commitment or in the form of emails or letters), they may also agree that these commitment should be set out in a formal written contract. Australian courts have identified different possibilities:

(1) The parties intend that they are immediately bound to perform the terms of the agreement, but at the same time the parties intend that the terms of the agreement be set out in a formal contract which will be fuller or more precise but not different in effect to the agreement that has already been made; or
(2) The parties intend that the agreement they have reached will not be performed until such time the parties have signed a formal document that set out the term of the agreement, That is, performance of the agreement is conditional on the parties signing a formal contract; or
(3) The parties intend that there is no concluded agreement at all, unless and until they sign a formal contract that set out the terms; or
(4) The parties have reached agreement to be bound immediately, however they intend to make a further contract that will replace the first, this latter contract containing, by consent, additional terms, such as terms they will agree are the standard terms of the type of transaction.

These four possibilities show that negotiations may appear to be end with an oral agreement or a signed document, with the document between the negotiating parties being titled as the 'agreement' or 'contract' between the parties, however there can be uncertainty as to whether the any oral agreement or document is intended to be immediately contractually binding or whether the commitment to perform what has been agreement only take effect after the signing of a formal contact. The contract law that has been developed by Australian courts is to consider whether an objective bystander would appreciate that: the parties to a negotiation intend their communications (whether oral, emails or letters) to form a legally binding contract or a merely to be an agreement to agree the important terms at some future time.

There is a risk that there will not be a legally binding contract where vague, uncertain or illusory promises are made - such as an amount not specified but to be fixed in the discretion of one of the parties. The High Court of Australia has stated "[t]he meaning of the terms of a contractual document is to be determined by what a reasonable person would have understood them to mean. That, normally, requires consideration not only of the text, but also of the surrounding circumstances known to the parties, and the purpose and object of the transaction." (*Toll v. Alphapharm* [2004] HCA 52 at [40].)

The point of view of an objective bystander - that is, an objective, reasonable person – means that it is the words that the parties to the negotiations use that are important (whether in their oral or written communications or in the document that purports to be the agreement). The point of view of an objective bystander does not take into account the subjective intention of the negotiating parties. That is, the objective bystander does not consider what the parties intended – in their mind – to say or mean in their communications or documents.

Agreements 'in principle'

Communications between parties that are negotiation sometimes state that they are agreeing something 'in principle'. Courts have pointed out that agreements in principle are not binding contracts however there are cases where parties have been held to be in a contractual regime even though some aspects of their contract have not yet been settled.

To avoid uncertainty as to what is meant by and agreement 'in principle' it is important to clarify what is meant, such as by going in to say that the agreement remains 'subject to contract'.

Agreements that are 'subject to contract'

Parties would not have the intention to enter into a contractual relationship if the negotiations were being conducted under the explicit understanding that the negotiations were 'subject to contract' or 'subject to a written contract being signed by the parties'. Australian courts have applied the rule that where negotiations are stated to be 'subject to contract', then there is no binding agreement until a formal written agreement has been signed.

Agreements that are 'subject to approval'

An agreement may state that it is 'subject to the approval' of some person or people, such as a board of directors of a company. Such an agreement may be a conditional agreement. That is, the parties intend that the agreement they have reached will not be binding or be performed until such time as the stated person or people have approved the formal document that sets out the terms of the agreement - performance of the agreement is conditional on the approval of the contract by the stated person or people.

A 'memorandum of understanding' (MOU) or a heads of agreement (HOA)

At the end of a negotiation the parties may complete and sign a document where the parties believe they have signed an 'agreement' or 'contract,' however the title of the document or the contents are qualified by some expression that may be inconsistent to what is understood to be a legally binding contract. For example, the parties may title a document or describe a document as being a 'heads of agreement' (HOA), 'framework agreement', 'letter of intent', 'letter of comfort', 'understanding' or 'memorandum of understanding' (MOU).

Courts have found some documents identified as MOUs or the HOAs (or any of the other titles) to be binding contracts resulting in legal rights, duties and liabilities existing. Conversely some documents identified as MOUs or the HOAs have been held to not achieve the common law requirements necessary for a legally binding contract to exist – resulting in no legally enforceable rights, duties and liabilities actually coming into existence

Notwithstanding a document being titled or described by the parties as a MOU or HOA the objective intention of the parties may vary between:

(1) The MOU or the HOA is intended to reflect preliminary discussions or understandings of the parties, with no intention that binding contractual commitment arises from the document, as the parties intent to further negotiate prior to entering any contractual commitment; or

(2) The MOU or the HOA is an interim understanding between the parties, which is intended to be a binding contractual commitment, but which may be intended to be replace in the future by a more elaborate contract.

MOUs or the HOAs in categories (1) & (2) may contain paragraphs that purport to commit the parties, in the process of negotiating, to:

(a) Provide a 'frame work' for the negotiating process;

(b) Conduct future negotiations in 'good faith';

(c) Conduct future negotiations using 'reasonable endeavours' or 'best endeavours' to reach the intended outcome of the negotiations;

(d) Continue negotiations with each other either generally or as to a specific element (a so-called 'agreement to negotiate' or 'agreement to agree').

The use of these terms can lead to ambiguity as to whether the parties intended the document to be a pre-contractual (not legally binding) or contractual statement (legally binding).

As discussed above, the point of view of an objective bystander does not take into account the subjective intention of the negotiating parties. That is, the objective meaning of the words used in the document determine what is the intention of the parties and no what they intended – in their mind – to say or mean in any document.

If the terms of the document are clearly stated and the required elements of a contract exist (offer, acceptance of that offer and consideration – as discussed above), there is a strong presumption at law that the parties did intend to create a legally binding contract despite the document being called an MOU or HOA or any other expression is used to describe the document, which expression may appear to be inconsistent with a legally binding contract.

If difficulties arise with an MOU or HOA, they will arise from the uncertainty as to what is intended by the parties. It is important to include a specific clause which negates any intention to create a binding relationship. A suitable disclaimer would be:

> *"This document is a Memorandum of Understanding and is not intended to create binding or legal obligations on either party."*

Despite expression of the intention for a MOU not to be legally binding, disputes can still arise as to whether other particular clauses in the MOU were still intended to be legally binding. These disputes can arise from the use of language in the MOU which conveys a binding intention. Use of phrases such as "the parties will" *or* "the parties must" tend to convey such an intention. Hence, if the parties intend the MOU to be non-binding, the use of such expressions should be strictly avoided, while expressions such as *"the parties intend"* should be used.

If intended to be binding, a contract will probably be more appropriate document than a MOU or HOA. For an MOU to have legal effect, its clauses must be sufficiently clear and certain. Expressions such as *"usual terms"* and *"fair and equitable price"* should be avoided, because courts can refuse to give them legal meaning, with the result that the MOUs in which they appear will not give rise to legally binding obligations.

The use of the language usually found in an agreement may imply that the MOU is actually an agreement and therefore the following should not appear in a document intended to be a MOU:

- an ability to vary the contents of the MOU;
- a specific period during which the MOU operates (term);
- a commencement date; and/or
- a termination date.

Resist signing an MOU if no clear understanding has been reached. Alternatively, use a "Record of Discussion" or "Record of Meeting". Such a "record" might state that "both parties will work towards the development of an MOU". If circumstances dictate that an MOU needs to be signed then it is essential that every attempt to avoid misleading or inaccurate statements.

It is very important that nothing in the drafting of the document suggests that the parties are entering into contractual obligations, for if this is the case, any reference to the arrangements as being only "intentions" will be disregarded. It is also wise to avoid details and write in generalities.

'Agreements to agree'

Where a document, which appears to be a signed agreement, fails to included critical terms sufficient to amount to a legally binding contract it can be described an being an unenforceable 'agreement to agree'. Such agreement, to use the formal language of contract law, is unenforceable as the agreement is 'void for uncertainty' as a consequence of the failure to provide certainty about the important terms as to the subject matter of what the parties are agreeing to do or refrain from doing.

There will be differences as to what are the important terms between different transactions. A statement of the test as to what are the important terms is that: a term is to be regarded by the parties as essential if one party maintains the position that there must be agreement upon it and communicates that position to the other party. However some terms may be intrinsically important and the legally essential to the formation of a binding contract.

Possible key terms are:

- what are the specific actions or obligations that are promised;
- who must perform what is promised;
- when is the performance of the promises is to be carried out;
- how is the quality of performance to be assessed; and
- how is payment to be calculated – using 'reasonable' to describe may not be provide certainty as to what is promised.

If there is uncertainty about the subject matter of what the parties are agreeing to do, the risk is that the contract is 'void for uncertainty'. That is, what the parties intended to be a legally binding commitment will not be enforced by a court.

For example, an Australia actor was promised that in consideration of entering the acting agreement, the actor would be paid a 'reasonable' share of profits if the film was successful. The court determined that the commitment as to profit sharing was not enforceable - it was 'void for uncertainty' as a consequence of the failure to agree a specific percentage share of profits.

Negotiations sometime end up with a meeting of the minds of the parties about some actions or obligations; however the parties are unable to reach agreement about some other matter. It is a common practice to document this agreement in the form that the "parties agree to negotiate in good faith" as the parties intend to revisit this matter sometime in the future. The flaw in documenting the intention to negotiate in the future is that courts will consider this part of the agreement to be 'void for uncertainty'. Australian courts do enforce 'agreements to agree' something in the future. Where the parties are unable to reach agreement about some matter the better approach is to establish some workable formula or objective standard or mechanism (such as binding arbitration proceedings) by which certainty as to the matter is to be achieved. For example if a script writer is intending to work on a production in which other writers will be working, but the parties are unable to agreement the fee for the writer's services because the budget is not confirmed. A formula to determine the writer's fee is that it is expressed to be not less than the highest fee paid to any other writer engaged to work on the production.

The courts have stated their reluctant to fill in the detail where parties leave gaps in their agreements. If essential matters (i.e. legally essential or regarded as essential by the parties) have not been agreed upon and are not determinable by recourse to a mechanism or to a formula or agreed standard, it may be beyond the ability of a court to fill the gap in the express terms. Therefore you should avoid vague or uncertain statements as to how promises or commitments are to be performed. Where an intention to contract is found to exist, a court may bridge the gap by implying a term; however the gap left by the parties may be considered to be simply too wide to be filled by the court.

Lack of clarity and plain English drafting

Even when it is certain that the parties wanted to enter into a binding legal commitment, questions may arise as to what the parties intended because the way they expressed the promises and commitments to each other lacks so much clarity that the meaning is uncertain or the contract may be incomplete. That is, the parties may omit important terms or create uncertainty as to how they are expected to perform their promises and commitments.

The point of view of what an objective, reasonable person understands the contractual document to mean directs attention to using words and sentences that have a clear meaning as uncertainty as to the meaning of the language used leads to disputes.

The text of the contractual document therefore must provide clear statements as to the promises and commitments being made by each party to the transaction. You should write any letters, email and other documents that you intend to have legal effect so as to present a clear and easy to understand statement of promises and commitments.

As discussed in the section on "**Do you want a MOU to be legally binding?"**, the use of phrases such as *"the parties will"* or *"the parties must"* convey statements of contractual commitment. The more tradition style of drafting uses *"the parties shall", however the 'plain English' style of drafting uses 'will' is the appropriate word to state a contractual commitment.*

The Australian Office of Parliamentary Counsel (OPC) describes plain English drafting:

- "At the level of vocabulary, plain language drafters try to use words and expressions that are familiar to everyone. Although technical language is sometimes necessary to achieve an acceptable level of precision, unnecessary jargon and gratuitous obscurity are eliminated."

- "At the level of syntax, plain language drafters try to create sentence patterns that are easy for the average person to process". Simplicity and clarity of expression is important to avoid ambiguity, which may be the result of the use of complex sentences that have subordinate clauses. Therefore in plain English drafting, "sentences tend to be short. They rely on verbs rather than nouns, the active rather than the passive voice."

Things to do:

- Think about the layout of the agreement - is the agreement set out in way that is likely to make sense to the reader?
- Think about the punctuation of the sentences, as the punctuation can change the meaning.
- Have someone else read your draft agreement; then have a conversation with the person to find out what they understand to be the commitments being made in the agreement.

When terms are implied in contracts and the rectification of omissions of terms

Implied terms of a contract

Terms are implied into contracts in different ways:

- The operation of a statute, such as the *Australian Competition and Consumer Act 2010* (Cth) that implements the Australian Consumer Law that implies a number of obligations into consumer contracts, which consumer guarantees are enforced by the Australian Competition and Consumer Commission (ACCC);
- Because the term is part of the established custom in relations to a specific type of transaction. Such a customary term may be used to add to but not contradict what has been written in the agreement between the parties; and
- Terms implied by the contractual doctrine established by the courts – these are terms which have not been set out in an agreement, but which the parties 'must' have intended to include.

The assessment of when a term should be implied in any contract has been determined by Australian Courts as follows:

> "for a term to be implied, the following conditions (which may overlap) must be satisfied:

1) it must be reasonable and equitable;
2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;
3) it must be so obvious that "it goes without saying";
4) it must be capable of clear expression;
5) it must not contradict any express term of the contract."

(*BP Refinery v. Shire of Hastings (*1978) 52 ALJR 20 at 26).

Contract law applies a minimalist approach to when a term is to be implied, the choice must be that which does not exceed what is necessary by considering the contract made between the parties and the relevant background to the agreement including the commercial setting in which the contract came into existence. The minimalist approach means that the implication of a term into a contract may only be made if this is necessary, and then only of what is necessary and no more.

For example an Australian court determined that the producer of a film had an implied licence from the writer/director of the film that allowed the producer to distribute the film in circumstances where the parties did not have a written agreement that assigned the copyright in the film to the producer. The court held the producer had an oral agreement with the writer/director that included the fees that the producer was to pay the writer/director. (*Bourke v. Filmways Australasian Distributors Pty Ltd* (Supreme Court of NSW, unreported, 9 October 1979)).

The rectification of a contract

The rectification of a contract occurs when a term was agreed between the parties; however that term was omitted from the signed contract. That is, the doctrine of rectification is designed to remedy the agreement so that it gives effect to the parties actual intention.

The contractual doctrine as to the implication of a term into a contract is not the same as the contractual doctrine related to the rectification of a contract. While each doctrine deals with a deficiency in an agreement. When an agreement in incomplete, because it leave out something that is considered to be important, the contract law doctrine of an implied term recognises that the agreement contains the term that the parties 'must' have intended to include – even if the parties had been unaware of the need to include such a term. That is, the implication of a term is designed to give effect is what is the presumed intention of the parties – if they had thought about the need to include the term.

Further information

Other Arts Law information sheets on contract related issues include:

- Contracts: an introduction
- Contracts: a glossary of jargon
- Exclusion clauses, disclaimers and risk warnings
- Liability and insurance

Additional information on plain English drafting:

- John Pease, Plain English: A Solution for effective communication (2012)
- Government of South Australia, Plain English: Good Practice Guide

Need more help?

Contact Arts Law (www.artslaw.com.au), tel. (02) 9356 2566 or toll-free outside Sydney 1800 221 457

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