Article Information

Authors: Florian Ammer, Hannah Veldre, Thomas Nicholls
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Negotiating contracts: when am I bound?

This insight discusses when and in what circumstances parties can become bound by terms being negotiated before a contract is executed, an issue of importance in any subsequent dispute.

Negotiating agreements

Negotiating commercial agreements can take months, even years. Particularly where agreements are intended to cover broad, dynamic or complex commercial arrangements. Parties involved in negotiating such contracts may commence dealing with each other in relation to the matters the subject of the contract before negotiations have concluded and a contract has been executed. In those circumstances, parties may find themselves in a dispute as to whether, and if so when, the parties became bound by the terms of any agreement.

Where parties that have been in negotiation reach agreement upon the terms of a contractual nature, and agree the matter of their negotiation shall be dealt with by a formal contract, they will typically fall into one of the following categories[1]:

- Category 1: The parties may have finalised "all the terms of their bargain" and intend to be bound immediately, but propose to restate the terms in a form which is fuller or more precise, but not different in effect. Here, the parties are bound whether or not the formal contract is ever signed or executed.
- Category 2: The parties may have "completely agreed upon all the terms of their bargain" and do not intend to vary those terms, but "have made performance of one or more terms conditional upon the execution of a formal document". The parties here are bound to bring the formal document/contract into existence.
- Category 3: The parties may not intend to make a binding agreement at all unless and until they execute a formal contract. Cases of this nature do not have any binding effect.
- Category 4: The parties are content to be bound immediately and exclusively by the terms which they had agreed upon, whilst expecting to make a further contract in substitution for the first contract containing, by consent, additional terms.

Which category applies depends upon the intention disclosed by the language the parties have used. There is no need to use special words to ensure that there will be no binding contract prior to formal execution. Words such as "subject to contract" are not required to produce a result in which the preliminary agreement is not binding. However, where such words or similar expressions are used, it will typically mean that no final enforceable agreement will exist, as those words clearly indicate that the parties intended a future contract, not a present one.

Whilst intention of the parties in this context will necessarily be based on the specific factual circumstances of each case, guidance can be drawn from the following cases on how this is approached by the courts.

In *Air Great Lakes Pty Ltd v KS Easter (Holdings) Pty Ltd*[2], the court posed three questions when considering the existence of a binding contract. Firstly, did the parties arrive at a consensus? If they did, was it such a consensus as capable of forming a binding contract? If it was, did the parties intend that the consensus at which they arrived should constitute a binding contract? The court held the use of and reference to terms in a preliminary document such as "further agreement" and "proposed agreement" did not prevent the finding of an intention to be bound until a formal contract came into existence. It was said that the use of these terms evidenced only an intention that a formal document should be drawn up and did not evince an intention that the parties would not be bound until this document was executed.

In *Australian Broadcasting Corporation v XIVth Commonwealth Games Ltd*[3], the parties were in negotiations with a view

to entering a formal contract in respect of television broadcasting rights. Both contemplated that the detailed terms of their agreement would be contained in a formal document signed by the parties. The parties exchanged drafts of the contract over a period of about 18 months, before one decided to take up another deal. The other party contended that although it was contemplated that a more formal contract would come into existence, a binding agreement existed at the point in time when the parties had agreed the price of the contract and it had paid half of the money under it. The court however found there was no intention to be bound, as despite the parties coming to an agreement on price, they contemplated that there would be express agreement on a number of important matters that they had not yet got around to discussing, or any discussions about those matters were at an incomplete stage.

In *Geebung Investments Pty Ltd v Varga Group Investments (No 8) Pty Ltd*[4], the court stated that if after an informal agreement the parties' correspondence refers to important terms and conditions that were not addressed in the negotiation, it may be more readily inferred that those negotiations do not give rise to a binding agreement, and that earlier discussions amount merely to preliminary negotiations. It was also stated that where the parties have not used solicitors but intended to do so for the drawing up of a formal agreement, that may be a factor pointing toward the non-existence of a binding agreement until the formalities have been agreed and completed.

When is a draft unexecuted contract binding?

For various reasons, parties may have prepared a draft (even a final draft) contract but not executed it. Non-execution of the document does not always mean that the parties are not bound by its terms.

In *PRA Electrical Pty Ltd v Perseverance Exploration Pty Ltd and Another*[5], the court held that where subsequent to the preparation of an unexecuted document which the parties intended should constitute a contract between them, those parties acted consistently with the document's provisions, it might be concluded, from the standpoint of an *objective bystander*, looking at all the facts, that they had entered into an informal or implied contract in the terms of that document and from a date identified by particular conduct.

A leading case in this context is *Empirnall Holdings Pty Ltd v Machon Paull Partners Pty Ltd*.[6] Empirnall engaged Machon Paull to commence building work. Machon Paull commenced work and submitted a written contract to Empirnall which was never executed, yet the parties continued to deal with each other, and Empirnall paid Machon Paull in accordance with the contract. Kirby P held that by such actions, Empirnall gave its assent to the contract sent by Machon Paull. Kirby P stated the reason this was so was that "the *objective bystander*, looking at all the facts, would conclude that Empirnall had accepted that Machon Paull was carrying out its performance of their agreement according to the printed contract which it had supplied and agreed to that course." Kirby P also stated that the relationship between the parties was important, highlighting that it might be less readily inferred that parties intend to be bound where there is a personal association as opposed to a contract arising out of a 'regular business or professional association' in which the relationship is a continuing one for commercial purposes.

There may not always be an obvious, precise point in time in which the criteria of a valid contract can be said to come into being. In *Integrated Computer Services Pty Ltd v Digital Equipment Corp (Aust) Pty Ltd*[7], McHugh JA stated "agreements concerning terms and conditions which might be too uncertain or too illusory to enforce at a particular time in the relationship may by reason of the parties' subsequent conduct become sufficiently specific to give rise to legal rights and duties. It is necessary therefore to look at the whole relationship and not only at what was said and done when the relationship was first formed".

Deeds: beware

In the context of deeds, it is important to note that one party may be bound but not the other. This is one of a number of important distinctions between agreements and deeds. Once a deed has been signed, sealed and delivered by one party, that party is bound even if the other party has not executed the deed.

This extends to deeds delivered in escrow. The use of delivery in escrow is common where it is intended that the terms of the deed are not to be immediately binding (that is, there is a condition precedent to performance of the terms of the deed). For example, performance of the terms of the deed might be subject to both parties executing and exchanging the deed by a specified date or time. Once a party has signed, sealed and delivered the deed in escrow pending fulfilment of the condition, that party is bound by the deed in the sense that it cannot withdraw it during the period between delivery and the time for the condition to be fulfilled. If the condition is stipulated as being required to be fulfilled within a certain time, then the escrow will lapse if the condition is not met within that time, and the party that delivered the deed can no longer be bound by it. If the condition is not stipulated as being required to be fulfilled by a certain time, it must be satisfied within a reasonable time.

The effect of variations on term of contracts

Parties to contracts often use written variations to extend the term of an existing contract. Where this occurs prior to the expiry of the term of the existing contract, the variation operates as intended. However where the term of a contract has expired and the contract has therefore come to an end, the contract cannot be varied. Variations executed after the term of a contract has expired are ineffective as variations. However, in such circumstances, parties will generally be found to have agreed to be bound by a new contract on the same terms as the expired contract (but as varied consistent with the parties' intention evidenced by the variation).

Difficulties can arise, however, where the contract sought to be varied provides for a term (or initial term) and a right of one or either party to extend that term by a further period by giving the other party notice. If a variation extends the term or initial term (which will be defined in the contract by reference to a period of time) after a party has already exercised its right to extend the term by a further period, the variation might have the effect of preserving or reinstating that party's right to extend the term of the agreement. Not infrequently, disputes arise as to whether or not a party has a right to further extend the term of the contract after it has already been extended by a variation.

Care needs to be taken therefore when drafting any variation seeking to extend the term of a contract by ensuring that the variation is clear as to whether the extension applies to the original term of the contract with the effect of preserving or reinstating (as the case may be) a party's right to extend the term for a further period, or whether the intention is that the contract expires at the end of the new term provided for by the variation, with no further right of extension.

[1] *Masters v Cameron* (1954) 91 CLR 353 at 360 (in relation to categories 1-3); *Baulkham Hills Private Hospital Pty Ltd v G R Securities Pty Ltd* (1986) 40 NSWLR 622 at 628 (in relation to category 4).

[2] (1985) 2 NSWLR 309.

[3] (1988) 18 NSWLR 540.

[4] (1995) 7 BPR, 14,551.

[5] (2007) 20 VR 487.

[6] (1988) 14 NSWLR 523.

[7] (1988) 5 BPR 11, 110.