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Memorandum of understanding

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Introduction

At the outset of a project (and often throughout a project), parties often look to record the basic terms of a transaction, in advance and in anticipation of more detailed terms and conditions.

This preliminary agreement comes in many forms and is commonly referred to as a memorandum of understanding (**MOU**), a heads of agreement, or a term sheet.

This paper examines the typical contents of an MOU and the practical and legal implications which arise as a result of entering into an MOU.

Purpose of an MOU

An MOU can be useful in giving commercial certainty (even if not a legally binding agreement). An MOU can serve a number of purposes, including:

- providing a framework for negotiations
- having parties decide on a general commitment to the particular project
- giving focus to the key commercial terms (permitting key commercial terms to be negotiated in principle without the need to settle detailed/legal aspects)
- assisting parties in raising funds or outlining the project details to third parties
- allowing for regulatory processes to be initiated, including merger clearance or FIRB approvals.

However, entering into an MOU may not be appropriate in certain circumstances. It may limit flexibility in future negotiations or distract the parties from negotiating a more complete agreement. There is also a risk that the parties inadvertently enter into an MOU that amounts to a legally binding arrangement when this is not intended or the parties breach competition rules without appropriate clearances or approvals in place. Whether an MOU or any preliminary agreement is legally binding depends on its terms.

Contents of an MOU

Every MOU is, by definition, unique to the particular project. There are, however, terms and conditions that are commonly found in an MOU. These are usually included to provide the basic legal framework and confirm the legal relationship between the parties, particularly in relation to the time between the execution of the MOU and the execution of the long form agreement. Terms can be binding or non-binding in a legal sense.

Common terms include:

- identification of the parties to the project
- statements in relation to the legal status of the MOU eg whether it is binding or which components are binding
- key commercial terms, including conditions to completion
- due diligence arrangements and processes
- an agreement to negotiate in ‘good faith’ along with project timing and key deliverables (binding)
- standstill/‘lock-out’/exclusivity arrangements (binding)

- confidentiality (if not already provided for in a confidentiality agreement) and terms in relation to announcements (binding)
- allocation of costs of preparation and negotiations (binding)
- governing law and jurisdiction (binding).

Of the terms above, the final 5 items (listed as 'binding') are often intended to legally bind the parties.

Binding or non-binding?

Apart from the key terms noted above, it is not usual for an MOU to be binding on the parties. There is a myriad of case law relating to the enforceability of MOUs, where one party may renege on a commitment or not follow through on the project. The drafting of MOUs is critical.

The preeminent case relating to enforceability is the High Court decision in *Masters v Cameron*.[1] In essence, the case confirms that MOUs will fall into one of three categories.

Further case law in Australia[2] has suggested there is a fourth category, beyond those identified in *Masters v Cameron* (which may be considered as another example of a Category One or Category Two situation). Each of these categories are set out below:

- **Category One (binding on the parties)**: The parties have agreed to the terms and intend to be bound, but also intend to restate their agreement in a more complete or precise manner
- **Category Two (binding on the parties)**: The parties have agreed to the terms but performance is conditional on an event, such as the execution of a formal agreement
- **Category Three (not binding on the parties)**: The parties' intention is to not agree or finalise the terms until they execute a formal agreement
- **Category Four (binding on the parties)**: The parties intend to be bound by the terms, but also accept that a further more formalised contract will be put in place in substitute for the original agreement.

While Category Four may be simply a variation on Category One or Two, the categorisation is an indication of the courts willingness to find a binding arrangement despite the circumstances not aligning precisely with Category One or Two. Precise drafting is essential to achieving the intended outcome of whether an arrangement is binding or not.

At the time of drawing up the MOU, it is important for the parties to decide whether they wish to be bound by the terms of the MOU. This is a decision that will change from project to project. However, it is common practice for an MOU to be part binding and part non-binding.

The question as to whether an MOU is binding is essentially one of formation principles found in contract law.

A contract will be binding if there is consideration, intention to be legally bound (often evidenced by an offer and acceptance) and certainty of the terms. For an MOU, the intention of the parties at the time of signing the MOU and certainty of terms are particularly important.

Intention to create binding obligations

Historically there is a strong presumption that commercial parties intend to create a legally binding contract if the terms of are certain, clearly defined and supported by consideration.[3] However, more recent authority, such

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1 (1954) 91 CLR 353.

2 See, for e.g. *Baulkham Hills Private Hospital Pty Ltd v GR Securities Pty Ltd* (1986) 40 NSWLR 622.

as *Ermogenous v Greek Orthodox Community of SA Inc*,[4] instead stresses the focus on an objective assessment of the parties' intentions in the particular transaction. In this judgment it was stated that:

"To be a legally enforceable duty there must, of course, be identifiable parties to the arrangement, the terms of the arrangement must be certain, and, unless recorded as a deed, there must generally be real consideration for the agreement. Yet "[t]he circumstances may show that [the parties] did not intend, or cannot be regarded as having intended, to subject their agreement to the adjudication of the courts"."[5]

Ultimately the court looks to the objective intention of the parties (looking to what a reasonable person would understand by what the parties have documented), to identify whether or not there was the requisite intent to contract in any given context.[6] In this regard:

- if the parties do not wish to be bound by the MOU (or any terms within it), then the parties should state clearly and unambiguously their intention not to be bound
- the terms of the agreement will be assessed objectively, and intention will be assessed by the content not the title or label of the document (ie just because the document is entitled MOU or similar, it may still be construed as binding)
- given this is a question of whether a contract has been formed, extrinsic evidence is admissible when determining whether a contract has been formed (as contrasted with the assessment made where the issue is construction or interpretation of a contract).

Using words such as "subject to contract", "subject to board approval", and "subject to formal agreement" are not always construed to indicate an intention not to be bound immediately by a document. Accordingly, it is advisable to include a clause in any MOU which clearly states which provisions of the MOU are binding and which are not. A suggested clause would be:

Except for the provisions of clauses […], this MOU does not constitute or create, and shall not be deemed to constitute, any legally binding or enforceable obligations on the part of any party.

The requirement of certainty

The courts do not require commercial documents to be drafted with strict precision to be enforceable, provided the intention of the parties is clear. For an MOU to have legal effect, the essential terms must be sufficiently clear and certain. For example, terms such as "usual terms" or "fair and equitable price" may be too vague and, depending on the circumstances, the court may not be able to give meaning to them, rendering the MOU unenforceable.

As mentioned earlier, it is important to understand that under Australian law, an MOU may still have legal effect even though it contains uncertain terms or the words "subject to contract". However, if this creates sufficient uncertainty in the document, the MOU will not give rise to contractual obligations.[7]

If terms that objectively seem important to the particular arrangement have not been included, it is unlikely the MOU would be binding[8] If however all the terms are agreed to at the time of the MOU, except for uncertainties which are anticipated (such as the name of a purchaser to be finalised in a formal contract), the MOU will be binding.[9]

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3 *Edwards v Skyways* [1964] 1 All ER 494.

4 (2002) 209 CLR 95.

5 (2002) 209 CLR 95, [24] (Gaudron, McHugh, Hayne and Callinan JJ).

6 *Gate Gourmet Australia Pty Ltd (In Liq) v Gate Gourmet Holding AG* [2004] NSWSC 149, 213 (Einstein J).

7 *LMI Australasia v Baulderstone Hornibrook* [2001] NSWSC 886.

8 *British Steel Corp v Cleveland Bridge Engineering Co* [1984] 1 All ER 504.

9 *Damon Compania Naviera SA v Hapag-Lloyd International SA* [1985] ANZ ConvR 333.

Agreements in relation to negotiations

As mentioned above, an MOU can be expressed to be non-binding as to some of the terms (typically the commercial terms) and binding as to others (terms such as confidentiality and governing law).

For this reason, it is possible to include in an otherwise non-binding MOU, legally effective terms which create some sort of obligation on the parties to continue the negotiation process.

These may include:

- agreement to negotiate in good faith
- standstill/“lock-out” agreement
- confidentiality obligations.

Agreements to negotiate in good faith

An MOU often contains a statement to the effect that the parties undertake to negotiate in good faith with a view to finalising the terms of a formal agreement to be entered into between them. For example, a standard clause would be:

The parties agree that during the negotiation period described in ***[ ],*** *they will negotiate with each other in good faith in order to endeavour to reach the concluded arrangements described in* ***[ ].***

Such a clause would have symbolic significance, however, may not be enforced without further detail as to what is required by the parties during the negotiation. [11]Even with enforceable negotiation clauses damages for breach will be minimal (and not amount to the loss of the bargain for the project itself).[10]

Standstill agreements: 'lock-out' clauses

Similar to an “agreement to negotiate in good faith’, the purpose of a “lock-out” clause in an MOU is to provide an incentive to the parties to continue the negotiation process.

A “lock-out” clause is essentially a negative covenant where the party bound by the clause agrees not to negotiate with third parties. In other words, a “lock-out” clause locks the party out of negotiation with third parties. It does not, however, in a legal sense oblige the party to complete the transaction.

A narrow form of a “lock-out” clause is called a “no-shop” clause. The essential effect of a “no-shop” clause is to restrict one party from soliciting third party offers. The party, however, can entertain an offer by a third party if the approach is unsolicited. A wide form of a standstill agreement is called a”no-talk” clause.

A 'no-talk' clause is basically an agreement not to negotiate with a third party even where the approach is unsolicited.

There are two essential elements to a “lock-out” clause:

- good consideration
- length of “lock-out” is restricted to a definite period of time.

A “lock-out” clause may not be binding if the length of the “lock-out” clause reaches a point where the agreement falls foul of the restraint of trade doctrine or laws governing unconscionable conduct. In addition, a

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10 In *Coal Cliff Collieries v Sijehama* (1991) 24 NSWLR 1, Kirby P acknowledged that, in some circumstances, a promise to negotiate in good faith will be enforceable.

"lock-out" clause may give rise to issues concerning directors' duties eg if restricting the company's freedom to deal with other potential parties is not in the interests of the company.

Best or reasonable endeavours

An MOU often requires parties to undertake particular contractual obligations with "best endeavours" or "reasonable endeavours". For example, the parties may agree to use their best (or reasonable) endeavours to obtain board approval. The issue of whether the parties should undertake best or reasonable endeavours is often a difficult issue raised during the negotiation of the terms of an MOU.[11] Please refer to Reasonable Endeavours – KaL FAQs for further information on these terms.

Conclusion

When entering into an MOU, it is important to be aware of the legal and practical implications. MOUs may unduly limit future negotiations and/or impose binding obligations on the parties.

From a legal perspective, the enforceability of an MOU largely depends on the circumstances of the negotiations and the language of the terms agreed by the parties. Whether the language indicates an intention to create legal obligations is key.

The nature and extent of remedies available when there is a breach of an MOU will depend on which terms are legally enforceable (or whether there are other potential causes of action available including misrepresentation, misleading or deceptive conduct or estoppel). If terms are found to be binding, normal contractual or equitable remedies will flow (including damages and specific performance).

From a practical perspective, although an MOU may help to secure some form of commitment of the parties to the negotiation process, its ability to secure certainty in relation to commercial terms and conditions may be more moral than legal.

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11 See, for e.g. *Electricity Generation Corporation v Woodside Energy Ltd* [2014] 88 ALJR 447.

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