WARNING TO PARTIES ENTERING INTO ARRANGEMENTS UNDER HEADS OF AGREEMENT

Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd

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Major construction projects often involve Heads of Aqreement ('HoA's') which are drawn to cover pre-contractual arrangements between the parties prior to project: 'kick off'. Often, during the life of these agreements, parties undertake 'preliminary' work (i.e. design and/or 'pre-mobilisation' tasks—for example procurement) before the formal construction contract is executed.

A recent decision of the High Court of New Zealand sounds a warning to parties entering into arrangements under HoA's which are expressed to be 'non-binding' until a formal construction contract is entered into.

This case highlights the importance of careful drafting in respect of HoA's and the consequences of HoA's which can be implied by the courts.

OVERVIEW

Fletcher Challenge Energy Ltd v Electricity Corporation of New Zealand Ltd[1] is a recent decision of the High Court of New Zealand which determined the enforceability of a 'Gas Contract Heads of Agreement' ('HoA'). Fletcher Challenge Energy Ltd ('FCE'), New Zealand's largest oil and gas producer entered into the HoA with the Electricity Corporation of New Zealand Ltd ('ECNZ') on 28 February 1997. FCE claimed, inter alia, that the HoA was a binding and enforceable contract for the supply of gas worth between $NZ 1.2 and $ 1.8 billion over a 17 year term, whereas ECNZ contended FCE was attempting to enforce an unsuccessful and uncompleted negotiation as binding on the parties.

The three issues to be determined by Wild J were:

1. Did the parties intend to be legally bound by the HoA?;
2. Is the HoA complete and enforceable?; and
3. Did ECNZ fail to meet the 'reasonable endeavours' obligation if it was legally binding?

FACTUAL BACKGROUND

In late 1995, ECNZ and FCE held discussions with respect to the supply of gas for ECNZ's Huntley dual gas/coal fired power station beyond 2002, as that was the date that its existing supply would come to an end. While unsuccessful, negotiations for the supply contract continued throughout 1996 and did result in some measures of agreement.

During 1996 FCE approached Western Mining Corporation ('WMC') regarding the acquisition of WMC's 40% interest in the Kupe Gas Field. On learning WMC was selling its interest, FCE submitted a tender and subsequently discovered ECNZ was also bidding. FCE consequently approached ECNZ with a view to a mutually beneficial proposal. ECNZ accepted the proposal, which was negotiated, recorded in a letter of agreement and signed by the parties' respective CEO's on 28 February 1997 and referred to by Wild J as the 'Fletcher/Frow letter'.

The Fletcher/Frow letter provided, inter alia, that:

(ii) By the end of today, ECNZ and Fletcher Challenge Energy will enter into the Heads of Agreement for long-term gas supply. The gas to be supplied under this Agreement will be sourced by Fletcher Challenge Energy from a variety of sources available to it. This Heads of Agreement will specify all essential terms, for it to be a binding agreement; including annual quantities, max/min flow rates, start date, duration, prices throughout, force majeure terms. This Heads of Agreement will be conditional on ECNZ approval within thirteen days; and

This document is necessarily, brief. The parties agree that in the event of ambiguity or uncertainty, Messrs

Frow and Fletcher will interpret the current intent and that will prevail.

On 27 and 28 February 1997 the parties met to negotiate the HoA referred to in the Fletcher/Frow letter. As was the case in the earlier 1996 negotiations, ECNZ desired to secure a firm gas supply to 2017 while FCE was unable to commit itself to a firm supply beyond 2011. The HoA was however signed towards the end of the afternoon on 28 February, covering three and one half pages. A factor in a formula with respect to calculating liability in one clause was marked 'to be agreed', two other clauses were marked 'not agreed' while above the signatures were the words 'Agreed (except where indicated)'.

Pursuant to the Fletcher/Frow letter the parties resubmitted their previous bids to WMC with respect to its interest in the Kupe Gas Field. WMC advised FCE of the success of its bid on 4 March 1997, while ECNZ's board passed the following resolution on 12 March 1997:

(i) the Heads of Agreement for the contract for the sale of gas between FCE and ECNZ be approved, subject to challenging the provision that FCE should only deliver gas in the period 2011–2017 if such delivery were to be economic;

(ii) the Committee of the Board comprising Messrs Cushing, Gentry and Wu and that that Committee be authorised to approve the final contract for the Sale and Purchase of the Gas with Fletcher Challenge Energy and to authorise the execution of that document.

The parties throughout the remainder of March 1997 agreed to focus on the agreements in order to complete the purchase of WMC's interest in Kupe Gas Field. These agreements were signed on 14 and 27 March 1997.

On 3 April 1997 negotiations for the full Sale and Purchase Agreement as contemplated by the HoA commenced, continuing throughout 1997 until negotiations broke down on 9 January 1998.

LAW WITH RESPECT TO CONTRACTUAL ENFORCEMENT

Wild J acknowledged that only intention to be bound and certainty of terms were in issue. To this end, His Honour referred to *Hillas & Co Ltd v Arcos Ltd*:

[T]he problem for a court of construction must always be so to balance matters, that without violation of essential principle the dealings of men may as far as possible be treated as effective and that the law may not incur the reproach of being the destroyer of bargains.[2]

His Honour held that while this principle is directed at construction, it surely applied equally to the determination of whether a contract was formed at all. His Honour then referred to numerous judgments, including the Australian judgments of *York Air Conditioning and Refrigeration (Australasia) Pty Ltd v Commonwealth* where Williams J said:

If the court comes to the conclusion, that parties intended to make a contract, it will if possible give effect to their intention no matter what difficulties of construction arise,[3]

and in *Toyota Motor Corporation Australia Ltd v Ken Morgan Motors Pty Ltd* where Brooking J said:

If the court comes to the conclusion that parties intended to make a contract it will if impossible give effect to their intention by overcoming difficulties said to result from uncertainty or incompleteness.[4]

DID THE PARTIES INTEND TO BE LEGALLY BOUND BY THE HOA?

Wild J asserted that for the HoA to be enforceable, the parties must have intended that it bind them on execution, that is, that their intention must have been once executed the proposed full agreement would supersede the HoA failing which, the HoA would continue to be binding. He said that the existence of the full agreement did not necessarily mean the HoA was not binding, and referred to the authority of, *France v Hight* where it was held that:

[I]n each case the Court has got to make up its mind on the construction of the documents and on the general surrounding circumstances whether the [HoA was] not to have contractual force until a [full agreement] was signed.[5]

His Honour then applied a number of factors as suggested by Professor D W McLauchlan[6]:

(a) the importance and complexity of the transaction;

(b) the degree of formality/informality and the terminology of the agreement (e.g. was there a signed agreement, an exchange of correspondence or only an oral exchange);

(c) the amount of detail settled by the agreement;

(d) the parties' previous dealings and their conduct at the time of and following the agreement;

(e) any actions taken in reliance upon or part performance of the agreement;

(f) the fact that the agreement is one of a series of interrelated agreements between the parties,

and consequently in consideration of the HoA itself the commercial circumstances in which it was concluded, and given the subsequent conduct of the parties, His Honour reached the firm view that the parties intended the HoA as binding on execution.

WAS THE HEADS OF AGREEMENT A COMPLETE AND ENFORCEABLE CONTRACT?

Wild J rejected ECNZ's test of essentiality[7] insofar as the issue at hand was not whether a breached term was so fundamental as to justify recession, but rather, what terms are necessary to contract efficiency and force in the first place. Accordingly, His Honour adopted the test proposed by FCE, that is, did the HoA contain all terms necessary to make the HoA workable?

ECNZ then invoked the *May and Butcher Ltd v R*[8] line of authority by relying on the authority of Viscount Dunedin insofar as:

To be a good contract there must be a concluded bargain, and a concluded contract is one which settles everything that is necessary to be settled and leaves nothing to be settled by agreement.[9]

ECNZ again referred to *Toyota Motor Corporation Australia Ltd v Ken Morgan Motors Pty Ltd*:

It is not only failure to agree on some essential term that tells against the existence of the intention to make an immediately binding contract. Failure to reach agreement on matters which, while not essential, are nonetheless matters which are ordinarily agreed upon in transactions of the class in question has the same tendency.[10]

ECNZ relied on the authority of Ormiston J in *Vroon BV v Foster's Brewing Group Ltd*[11] where His Honour held:

I would accept that in commercial transactions the court should strive to give effect to the expressed arrangements and expectations of those engaged in business, notwithstanding that there are areas of uncertainty and notwithstanding that particular terms have been omitted or not fully worked out. Where one should draw the line is difficult to state and equally difficult to apply.[12]

Wild J then noted submissions from FCE with respect to the difficulties the Courts have encountered in developing a coherent framework in cases where parties to an agreement have expressly left some aspects of the transaction to be resolved at a future time.

His Honour suggested that if it were open to the Court, he would adopt as law applicable to the HoA the *American Restatement (Second) of Contracts* which relevantly provides:

When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court... The fact that a term is left open 'may show that a manifestation of intention is not intended to be understood as an offer or as an acceptance', but if the parties' intention to conclude a bargain is otherwise established the contract will only fail if the court is unable to settle on a term that is 'reasonable in the circumstances'.

His Honour also referred to Professor Farnsworth[13] whereby:

If the agreement with open terms is enforceable, a party may be liable if the failure to reach agreement on those open terms results from a breach of that party's obligation to negotiate. If, despite continued negotiation by both parties, no agreement is reached on those terms so that there is no ultimate agreement, the parties are bound by their original agreement and the other matters are governed by whatever terms a court will supply.[14]

Accordingly, turning to the issues at hand His Honour discussed the following:

As His Honour was satisfied the parties intended to be bound by the HoA, the court would imply any terms to overcome any defect of uncertainty or incompleteness as permitted by law. He also emphasised that uncertainty will not render a contract unenforceable unless it affects a term(s) to the workability of the contract.

1. *Liability for non-delivery* (the K factor being part of a formula limiting FCE's liability for non-delivery of gas or an alternative fuel other than force majeure or wilful act)—'to be agreed'.

The HoA was complete and workable with respect to the K factor, notwithstanding 'to be agreed' indicating this was reserved in negotiations. As the K factor was capable of measurement following non-delivery, the term was not essential to the efficacy of the HoA given the urgency of the document.

2. *Other Liabilities*—'Additional clause to cover non-supply liabilities'.

It was held that the parties regarded the contemplated clause as non-contentious, accordingly not rendering the HoA unenforceable.

3. *Force Majeure*—'Not Agreed'.

Wild J found that a force majeure clause whilst usual in a long-term gas supply contract is not necessary to its workability—in its absence risk is allocated by the general law of the doctrine of frustration of contract.

4. *Prepaid Gas Relief*—'Not Agreed'.

Again His Honour held that whilst such a clause is invariably found in a gas supply contract, its effective absence did not render the HoA unworkable.

5. *Maximum Delivery Obligation and Notifications*

While the terms were workable in present form when read together, the parties contemplated fuller terms and failing agreement to that end, the Court will supply those fuller terms using comparable clauses in existing agreements as to what is reasonable.

6. *Dispute Resolution*

Wild J held that while desirable a dispute resolution clause is not necessary as to the workability of the HoA.

WERE THE TERMS OF THE HOA SUFFICIENTLY CERTAIN TO BE ENFORCEABLE?

His Honour provided that the HoA would fail if the Court could not place upon its necessary terms one sensible and definite meaning upon which the Court could safely act. He referred to the authority of Saville J in *Vitol BV v Compagnie Europeene des Petroles.*[15]

If the words are not clear and admit of more than one sensible meaning, then the ambiguity may be resolved by looking at the aim and genesis of the agreement, choosing the meaning which seems to make the most sense of the contract and its surrounding circumstances as a whole.[16]

As His Honour was satisfied the parties intended to be bound by the HoA, the court would imply any terms to overcome any defect of uncertainty or incompleteness as permitted by law[17]. He also emphasised that uncertainty will not render a contract unenforceable unless it affects a term(s) to the workability of the contract.

Accordingly, His Honour resolved all uncertainties or concluded that the contract was not unworkable as a result of those uncertainties, those of which His Honour was unable to resolve.

DID ECNZ FAIL TO MEET THE 'REASONABLE ENDEAVOURS' OBLIGATION IF IT WAS LEGALLY BINDING?

His Honour referred to *UBH (Mechanical Services) Ltd v Standard Life Assurances Co*[18] where it was held that:

The phrase 'reasonable endeavours' is probably a middle position... implying something more than reasonable endeavours but less than best endeavours.

His Honour referred to *Phillips Petroleum Co UK v Enron Europe Ltd*[19] where it was held that a party obliged to use 'reasonable endeavours' may take into account its own commercial interests, and other pertinent factors. Furthermore, His Honour held that a covenant to use 'best endeavours' or 'all reasonable endeavours' to some definite end is enforceable, provided it is sufficiently clear and certain what is to be done.

His Honour considered that ECNZ did not use all reasonable endeavours to reach full agreement, but rather endeavoured to first negotiate a different agreement, and then to substantially get out of any agreement.

RESULT

Wild J made a declaratory order that the HoA was a valid and binding contract for the purchase and sale of gas in accordance with its terms, ECNZ breached its obligation to use all reasonable endeavours to agree a full sale agreement and that FCE was entitled to relief compensation.

This case sounds a warning to owners, contractors and other third parties entering into HoA's to ensure that they obtain advice before entering into the arrangement and that the drawing of the HoA takes into account the risks inherent in this approach.

REFERENCES

1. [2001] 2 NZLR 219.
2. (1932) 147 LT 503 at 512.
3. (1949) 80 CLR 11 at 26.
4. (1994) 2 VR 106 at 130.
5. [1990] 1 NZLR 345 at 353.
6. (1998) 18 NZULR 77 *'Rethinking Agreements to Agree'* as endorsed in *Spengler Management Ltd v Tan* [1995] 1 NZLR 120.
7. *Tramways Advertising Pty Ltd v Luna Park (NSW) Ltd* (1935) 38 SR (NSW) 632 at 641: *Associated Newspapers Ltd v Bancks* (1951) 83 CLR 322 at 337; *Holes v Burgess* [1975] 2 NZLR 311 at 318 .
8. (1934) 2 KB 17.
9. Ibid. at 21.
10. [1994] 2 VR 106 at 131.
11. [1994] 2 VR 32.
12. Ibid. at 67.
13. [1987] *'Precontractual Liability and Preliminary Agreements: Fair Dealing in Failed Negotiations'* p250.
14. See for example *Masters v Cameron* (1954) 91 CLR 353 at 360 and *Pagnan SpA v Feed Products Ltd* [1987] 2 Lloyd's Rep 601 at 619.
15. [1988] 1 Lloyd's Rep 574.
16. Ibid. at 576.
17. See five point test laid down by Privy Council in *BP Refinery (Westernport) Pty Ltd v President, Councillors and Ratepayers of the Shire of Hasting* (1977) 16 ALR 363 at 376.
18. QBD UK The Times Law Reports 13 November 1986.
19. Court of Appeal, Civil Division, England, 10 October 1996.