Key project and procurement concepts

04 Key issues for tendering and pre-contract arrangements

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The tender process and other pre-contract steps

Tendering is an essential element of the contractual process and can take many forms, but its key purposes are to:

- convey to the market the Principal's requirements and preferred legal and commercial terms
- test the market's response to those preferences
- elicit an offer capable of acceptance from the tenderers
- position the Principal to maximise competition between tenderers to obtain the best offer in terms of scope, price, time and legal terms
- result in the formation of a contract.

In the construction industry the tender process is the last time that the Principal is truly on level terms with the Contractor. Once the contract is executed the bargaining power shifts to the Contractor in a practical sense. Therefore, the tender phase must be carefully considered by the Principal and be part of a well considered strategy to obtain the best deal from the market and enter into a contract that is balanced, sustainable and clear.

The steps to the formation of the contract will usually consist of:

- pre-tender market soundings
- the invitation to tender (**ITT**)
- the tender
- post-tender negotiations
- a letter of intent or memorandum of understanding
- contract formation.

Pre-tender market soundings

For major projects the tender process is time consuming and expensive for all concerned.

The Principal can save time and money for all stakeholders and refine its tender strategy by engaging with the market participants and obtaining their feedback to inform its decisions about key issues such as the best delivery method, current market trends, joint venture possibilities and technology choices.

The market soundings should be conducted after the Principal has enough information to clearly define the project and its expectations, while leaving enough time in the procurement schedule to allow it to incorporate the findings in the tender strategy.

The invitation to tender

The ITT is typically comprised of:

- the terms of tender
- the tender administration details
- the information the tender should contain
- the scope of the works and services that are the subject of the contract
- the Principal's preferred form of contract.

Terms of tender

Process contract

The terms of tender set out the legal basis of the tender process.

The threshold decision is whether the Principal prefers that a contract is formed in relation to the tender process itself, that is, that it and the tenders agree to follow and not depart from the process outlined in the tender documents in a legally binding manner.

In complex projects it can be desirable for a process contract to be formed so that the parties have clarity as to the status of the terms of tender and their consequent rights and obligations. For example, if the Principal wants to ensure that it can share tendered information or amend the process initially set out, those rights should be expressly stated and made clear and binding. It must be noted however, that if the Principal does conduct a legally binding process, it will not be permitted to depart from those rules without the express right to do so or the agreement of the tenderers.

This is a critical issue and must be dealt with expressly.

If the Principal does not want any process contract to be formed, so that the tender process is directory only, it must expressly stipulate that position.

If the Principal wants a process contract to be formed then it should expressly state which terms form that contract. A deed poll that is executed by the tenderer as a pre-condition to receiving the tender materials is a suitable method of entering into such an agreement.

Terms

Typical terms include:

- the Principal is not obliged to accept the lowest or any offer
- whether non-conforming offers may be lodged and whether a conforming tender must be lodged
- whether the Principal is obliged to consider non-conforming tenders
- the extent to which information in the ITT and the tender is confidential and how any such information may be utilised by the Principal
- the extent to which any information provided with the ITT or provided as part of the tender process can be relied on
- the acceptance of late tenders
- the tender process, for example, short listing and the negotiation process
- amendment of the tender process
- inclusion of new tenderers
- the period for which the tender cannot be amended or withdrawn
- termination of the tender process
- how enquiries can be made and whether replies will be shared with other tenderers
- whether there will be workshops or site visits
- how departures are expressed
- how the tender is submitted and executed
- the tender evaluation criteria (which should be indicative, not binding).

Returnable schedules

The Principal must give careful consideration to the information it requires from the tenderers as part of the tender and the form and level of detail that is preferred.

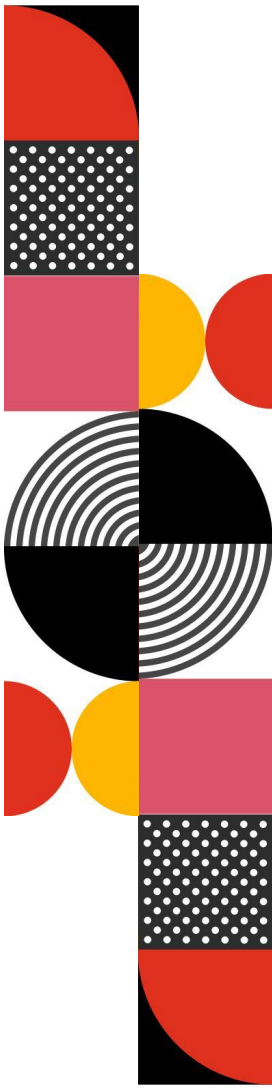
That information is usually included in schedules that are to be returned by the tenderers.

A good guide to the information to be obtained are the details that are required for the contract to be prepared and executed.

Some information might be provided in stages. For example, the Programme that is attached to the contract will probably be very detailed and include the logic in its native form. Such a Programme is time consuming and expensive to prepare. Therefore, at an early stage a more general Programme might suffice.

Similarly, pricing might be refined as the tender process evolves.

The guideline is that the Principal should obtain all information required to make a detailed assessment of the tenderers.



Letters of intent

Ideally, construction work should not proceed on a project until a full and complete contract has been entered into by the parties. The benefits of entering into a formal contract are significant and include:

- certainty of rights and obligations
- certainty of price
- clear allocation of risk between the parties
- detailed description of the scope of works
- provision for the resolution of disputes between the parties
- provision for the termination of the agreement in clearly defined circumstances.

However, sometimes it is not practicable or commercially desirable to delay the commencement of construction until a contract has been signed. In these circumstances, the parties may wish to proceed on the basis of a letter of intent, sometimes referred to as a letter of agreement or letter of acceptance (**LOI**). This alert raises and comments on the critical issues for a Principal or Developer to consider if it is contemplating proceeding with construction before executing a contract with its Contractor (or design with its consultant).

The primary disadvantages for a Principal in relation to many LOIs are as follows:

- There is often uncertainty as to whether an LOI creates a binding agreement. As a result, the parties' rights and obligations in relation to carrying out the work and the payment for that work are not certain.
- Often there is little incentive for the Contractor to complete negotiations and execute a final contract, since the uncertainty referred to above will generally benefit the Contractor.

Nonetheless, a properly worded LOI is generally better than proceeding without any documentation, but it is no substitute for a complete contract.

Binding or non-binding?

The main issue to consider is whether the Principal wants to merely express an intent to enter into a contract or actually enter a contract for the commencement of certain works whilst the contract is finalised and executed.

If the Principal wants to express intent but not be bound by the LOI, then the LOI needs to clearly state that position. Specific legal advice should be sought on the content of any LOI before it is issued to a Contractor or consultant.

Although it is not strictly necessary if the LOI is clearly drafted, the following paragraph can be added to the LOI for certainty:

> *This non-binding letter of intent is simply a statement of the parties' present intentions with respect to its contents. Each party represents to the other that no reliance will be placed on this letter. This letter does not and is not intended to constitute a binding obligation.*

In most circumstances the Principal's purpose with an LOI is to authorise certain works to commence before the contract is signed. In this case, the LOI is in fact a contract and therefore the usual pre-requisites for a contract must be present.

It is crucial that the LOI does accept the Contractor's or consultant's proposal or submission (usually as part of a tender process). This is important regardless of whether the letter is merely expressing intent to enter a contract or is a binding contract itself. By accepting a Contractor's proposal, certain qualifications, exclusions or contractual terms that conflict with the Principal's requirements may be incorporated into the deal inadvertently.

Essential terms for a LOI

Payment and scope of the works

The critical portion of the LOI is dealing with payment, the scope of the Contractor's works and the standard of performance required of the Contractor. In this regard, the LOI should cover the following:

- The basis upon which the Contractor is to be paid for work under the letter (for example, cost plus margin, lump sum, etc.).
- Timing and processes for the submission of invoices for payment (it may be appropriate for no payments to be made until the contract is signed – this can be a useful incentive for the Contractor to sign the contract).
- A cap on the amount payable to the Contractor under the letter, which can be extended at the discretion of the Principal (this is to avoid the risk of the Contractor incurring significant costs and then claiming for these costs).
- Identify as precisely as possible the scope of the works to be carried out.
- Provision for the Principal's right to vary the scope of the works.

- where appropriate, a completion date for the works
- a statement of the Contractor's standard of care to be adopted in performing the works
- a right of set-off for the Principal.

Termination

It is critical that the letter clearly sets out the circumstances under which the agreement contained in the LOI comes to an end. There are three ways for the agreement to end:

- the parties sign a formal contract
- the parties do not sign a contract by an agreed date
- the Principal elects to terminate the agreement.

Following termination under the second and third dot points above, the LOI should prescribe a procedure for the Contractor to stop work, make the site safe, vacate the site and return any equipment or documents provided to it by the Principal.

The LOI should state that the Contractor's entitlement to further payment following termination is limited to any amounts outstanding for work performed up to the date of termination. And in all cases payments under or in connection with the LOI should be subject to the overall cap.

Draft contract

If, at the time of entry into the LOI, a draft detailed contract is in existence, it is suggested that one of the following approaches is adopted:

- Attach the whole of the draft terms, and specify that even though they have not yet been agreed by the parties as forming the final contract, the full terms will be binding with respect to the whole of the works until the LOI is replaced by the final contract.
- Simply identify the relevant terms of the draft contract which have been finalised to date, for example, contractual conditions in relation to insurance, and intellectual property rights.

Intention to enter into a contract

Given the purpose of the LOI is to bridge the time between commencement of construction and execution of a final contract, it should state that the intention of the parties is to enter into a formal contract and that the parties will use their best endeavours to execute the contract as soon as reasonably possible.

Whilst such a provision is unlikely to be legally enforceable, it provides an important indication of the parties' commercial intent for a more detailed discussion about agreements to enter into a formal contract. The LOI can be drafted such that it creates incentives for the Contractor to execute the final contract, for example, there should be no limitation of liability for the Contractor (also see the termination regime referred to below).

Retrospective effect of a contract

The LOI should also provide for the retrospective effect of the final contract. For example, by providing that:

> *If and when the contract is signed, the terms and conditions of the contract will retrospectively govern the work carried out by you pursuant to this letter. Any monies paid to you in respect of works performed pursuant to this letter shall form part of the contract sum under the contract.*

It is also essential that a similar provision is included in the final contract.

Failure to enter into a contract

The LOI should provide that, if no contract is entered into, the LOI covers the whole of the works.

Other terms

There are a number of other terms that should be included in the LOI. Ideally these terms should be the same as those contained in the draft contract attached to the LOI. These should cover the following topics:

- insurance (including a clear statement of what insurance the Contractor is required to effect and maintain)
- approvals (which party is to obtain)
- intellectual property
- subcontracting
- confidentiality
- governing law and language of the agreement
- dispute resolution.

Conclusion on LOIs

Although an LOI should never replace a complete contract, an LOI covering the issues discussed above can significantly reduce the risks inherent in commencing construction in the absence of a full and complete contract between the parties.

Memorandum of understanding

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 e.g., 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 five 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 is 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.

1 (1954) 91 CLR 353.

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

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 the formation principles found in contract law.

A contract will be binding if there is consideration, intention to be legally bound (often evidenced by 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 are certain, clearly defined and supported by consideration.[3] However, more recent authority, such 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 (for example 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 that 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]

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.

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 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 clause [#], they will negotiate with each other in good faith in order to endeavour to reach the concluded arrangements described in clause [#].*

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. 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]

'Lock-out' clauses in standstill agreements

Similar to an 'agreement to negotiate in good faith', the purpose of a 'lock-out' clause in an MOU is to provide an incentive for 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 'lock-out' clause may give rise to issues concerning directors' duties. For example, 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 on MOUs

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.

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.

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

How to contact us

If you have any questions about this paper, please contact the editor, Damian McNair, Partner, Energy Transition.

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