Obligation to “Negotiate in Good Faith”

This is one of a series of articles in which we review the judicial interpretation of some words and phrases that are commonly used in contracts. In this article we look at the meaning of the phrase “negotiate in good faith”.

Context

An express obligation on parties to “negotiate in good faith” is used in the following contexts:

- As an obligation to negotiate a more complete agreement in a “preliminary document”, such as a heads of agreement or memorandum of understanding. For example, the parties to a proposed sale of business transaction may set out the key commercial terms in a MOU, which is stated to be non-binding except for the obligation to negotiate in good faith to finalise the complete agreement.

- As an express term of an existing and complete contract requiring the parties to “negotiate in good faith” in the performance of some aspect of the contract. For example, the dispute resolution mechanism in an agreement may have a requirement that the parties meet and negotiate in good faith to resolve a dispute as a first step before resorting to court proceedings or reference to an independent expert.

Is an obligation to “negotiate in good faith” enforceable?

Traditionally, an agreement to negotiate has been considered to be unenforceable for its lack of certainty. In the words of an English court, “no one could tell whether the negotiations would be successful or would fall through; or if successful what the result would be”\(^1\).

Similar sentiments were expressed by Handley JA the 1991 New South Wales Court of Appeal case of *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd*,\(^2\) who observed that parties to a negotiation “may withdraw or continue; accept, counter offer or reject; compromise or

---

1. *Courtney & Fairbairn Ltd v Tolaini Bros (Hotels) Ltd* [1975] 1 WLR 297 per Lord Denning.
refuse, trade-off concessions on one matter for gains on another and be as unwilling, willing or anxious and as fast or as slow as they think fit”.

While the obligation to negotiate a more comprehensive joint venture agreement in the Coal Cliff Collieries case was ultimately held to be unenforceable on the basis of uncertainty, the prevailing majority judgement disagreed with the traditional view adopted by Handley JA and expressly rejected the proposition that a court would never enforce a promise to negotiate in good faith. In their view, such a promise will be enforceable in certain circumstances, such as where an identifiable third party has been given power to settle ambiguities and uncertainties associated with the negotiation. This position was confirmed and expanded upon by the NSW Court of Appeal in 2009 in United Group Rail Services Limited v Rail Corporations New South Wales, in which the Court also provided some guidance as to what is required of parties who are subject to an obligation to “negotiate in good faith”.

What does “negotiate in good faith” mean and require?

The obligation to negotiate in good faith in the United Group case was included in the dispute resolution clause of an engineering contract between the parties. The clause required the senior representatives of the parties to “meet and undertake genuine and good faith negotiations with a view to resolving the dispute or difference”. If the dispute was not resolved within 14 days, the clause then directed the parties to resort to mediation and arbitration. The central legal issue was whether the “genuine and good faith negotiations” requirement lacked certainty to the point of being incomplete and unenforceable.

The NSW Court of Appeal upheld the clause on the basis that there was an objective yardstick by which the Court could determine whether there had been compliance with it. The Court held that “an honest and genuine approach to settling a contractual dispute, giving fidelity to the existing bargain, does constrain a party”. This constraint requires the honest and genuine assessment of rights and obligations, and it requires a party to negotiate by reference to such.

The Court also provided some examples of what is required under an obligation to negotiate in good faith:

- a party may not be entitled to threaten a breach of contract in order to bargain for a lower settlement sum than it genuinely recognises is due;
- a party would not be entitled to pretend to negotiate, having decided not to settle what is recognised to be a good claim, in order to drive the other party into an expensive arbitration that it believes the other party cannot afford; and
- if a party recognises, without qualification, that a claim or some material part of it is due, the obligation may require payment to be made.

It should be noted, that the dispute resolution clause in the United Group case included finite limits for the obligation; that is, the express requirement that negotiation was to be conducted by senior representatives over a limited 14-day period, and that if that failed, the final step was arbitration. A “negotiate in good faith” obligation without some similar constraints or boundaries is likely to be too vague to be enforceable.

---

3 Above n2 at 41-42 per Handley JA (dissenting).
In the 2010 case of *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service*, the NSW Supreme Court of Appeal again emphasised the need for an objectively ascertainable structure to an obligation to “negotiate in good faith”. The Court indicated that, where enforceable, the obligation will usually include:

- an obligation to act honestly and with a fidelity to the bargain;
- an obligation not to act dishonestly and not to act to undermine the bargain entered or the substance of the contractual benefit bargained; and
- an obligation to act reasonably and with fair dealing, having regard to the interests of the parties (which will, inevitably, at times conflict) and to the provisions, aims and purposes of the contract, objectively ascertained.

While these obligations do not require the interests of one party to be subordinated to those of the other, it does require a party to have due regard to the legitimate interests of both parties.

**Practical implications**

A simple undertaking to “negotiate in good faith” is likely to be held to be unenforceable by the courts. However, if there is some identifiable process upon which the obligations can fasten, the commitment may be binding. This will ultimately depend upon the specific terms and the context of the obligation.

The courts are likely to accept that an obligation in an existing contract to renegotiate specific terms (such as key performance indicators or pricing) “in good faith” is enforceable. However, where the negotiation relates to reaching agreement on a new matter that is not covered by the existing terms, it is more likely to be unenforceable for lack of certainty.

Even where an undertaking to negotiate in good faith is held to be enforceable, the practical requirements inherent in the obligation are limited.

Accordingly, before agreeing to an obligation to “negotiate in good faith” in a commercial document, you should consider the following:

- **What is the likelihood of the obligation being enforceable?** Is it part of a preliminary agreement or an existing contract? Is the obligation sufficiently certain?

- **What does or should the obligation to negotiate in good faith require the parties to do?** Consider setting out a process to be followed, ideally involving fixed time periods and some recourse to an independent body to resolve the dispute. It is also important to keep in mind that the obligation means that you will not be able to engage in any bargaining technique that is inconsistent with the notion of “good faith”.

- **Is there a risk that the other party will not act in good faith?** If the answer is yes, and you are concerned with incurring significant expenses during the negotiation, it may be a good idea to provide explicitly in the contract that if the parties fail to come to an agreement during the allocated period of negotiation, the parties will share any expense reasonably incurred in anticipation of the deal under negotiation.

---

The assistance of Chuanchan Ma, Graduate, of Addisons in the preparation of this article is noted and greatly appreciated.

For more information please contact:

David Ferguson, Partner
Telephone: +61 2 8915 1053
Facsimile: +61 2 8916 2053
Email: david.ferguson@addisonslawyers.com.au

Kristy Dixon, Senior Associate
Telephone: +61 2 8915 1057
Facsimile: +61 2 8916 2057
Email: kristy.dixon@addisonslawyers.com.au