

## 1. Introduction

- 1.1. Contracts have the power to impose a range of rights and obligations on the parties which range from the absolute (employing words such as “ensure”; “must”) to conditional. Of course it is trite law that in order to be enforceable, the terms of the contract must have certainty and therefore an expression that is incapable of a practical commercial definition may result in being unenforceable. Thus expressions used to depart from the absolute obligations must be employed with caution. As the following discussion will demonstrate, a departure from the employment of absolute expressions may result in interpretation that is imposed by the Court which may differ markedly from the understanding that at least one of the parties may have formed unilaterally. So when a party is excused from an absolute obligation by being committed to a lesser obligation of employing “reasonable or best endeavours”, what factors come into play in determining what is reasonable or best? The High Court considered this issue in *EGC v Woodside Energy Ltd & Ors [2014] HCA 7*.
- 1.2. Of course, a contract is not worth the paper it is written on if it does not contain incentives on the parties thereto to perform their obligations. The incentive may not necessarily be in the form of the fruits of the bargain (the carrot) but also in the form of the punishment for non-performance (the stick). Liquidated damages is a commonly utilised “stick”. Notwithstanding, the “light touch” approach of the common law which allows parties freedom of contract, it is settled law that the entitlement of one party to impose liquidated damages on the other party for non-performance is not unfettered. It is well understood that liquidated damages imposed for a breach of contract cannot be a “fine or penalty”. The question addressed by the High Court in *Andrews v ANZ [2012] HCA 30* was whether the penalty doctrine could also operate where there has not been a breach of contract.

## 2. Best or reasonable endeavours

- 2.1. When parties approach the preparation of a contract the statement of requirements recorded in the document can range from the absolute to the conditional. Absolute requirements ought to be stated quite simply and without ambiguity by the seasoned draughtsman. This can even be true of conditional requirements where the pre-conditions themselves can be stated with certainty.
- 2.2. Conditional requirements that import elements of judgement within stated or unstated contexts present different challenges. By its very nature, often these elements of judgement are not and cannot be expressly stated in the contract because they are not known at the time the contract is drafted or that they are too numerous to list. Parties sometimes employ such conditional provisions when they acknowledge that the imposition of an absolute obligation on a party may create situations where the obligation may be unduly onerous or be incapable of performance. Not uncommonly arise where an insurer of one of the parties is involved in vetting the terms of a draft contract, there is an attempt to water-down absolute obligations because terms of an applicable insurance policy may exclude certain types of liability which a contract may seek to impose in absolute terms. Parties in such situations can be tempted to press ahead with the essential bargain by employing “fuzzy logic” believing that at the time they are ad idem as to how the situation would be resolved or in the hope that when encountering circumstances in the future that would invoke these elements of judgment, all the parties to the contract would come to essentially the same conclusion. The only certainty when such expressions are employed is that the consequences could be uncertain even to the extent that they would not have been in the contemplation of the parties when they entered into the contract.
- 2.3. Of course, courts employ an objective approach to the interpretation of contractual clauses and therefore the view held subjectively by one of the parties would be of no or insignificant relevance in that process leading to unexpected outcomes for one or all the parties.
- 2.4. For the draughtsman, the challenge is to incorporate into the contract the parties’ desire for “fuzziness” but not to the extent where the provision becomes uncertain. It is trite law that an uncertain term in a contract is void and unenforceable at law.
- 2.5. A not uncommon expression that parties employ to avoid an absolute obligation is “best or reasonable endeavours” or some close variant thereof. The expression “best endeavours” appears to be more prevalent in the general community and it is not uncommon to hear even lawyers invoke it. How does it differ from another expression (more likely than not employed by the draughtsman when requested to insert “best endeavours” requirements) “reasonable endeavours”? The understanding of the common person would be that a standard employing “best” would surpass a standard seeking mere reasonableness.

2.6. It seems that unlike in England, the courts in Australia generally see no significant difference between the expression “best endeavours” and “reasonable endeavours” preferring them to mean essentially the same thing. This position was arrived at by the High Court in *Hospital Products Limited v United States Surgical Corporation* (1984) 156 CLR 41 in which Chief Justice Gibbs held that:

“ On the one hand, an express promise by an agent to use his best endeavours to obtain orders for another and to influence business on his behalf “necessarily includes an obligation not to hinder or prevent the fulfilment of its purpose”: *Shepherd v. Felt and Textiles of Australia Ltd.* (1931) 45 CLR 359, at p 378. On the other hand, an obligation to use “best endeavours” does not require the person who undertakes the obligation to go beyond the bounds of reason; he is required to do all he reasonably can in the circumstances to achieve the contractual object, but no more: *Sheffield District Railway Co. v. Great Central Railway Co.* (1911) 27 TLR 451, at p 452; *Terrell v. Mabie Todd & Co. Ltd.* (1952) 69 RPC 234, at p 237. “ at [24].

2.7. The courts in Australia, therefore, appear prepared to read down “best” to mean “reasonable”. It is a prudent approach as one would envisage that any attempt to give “best” its natural and ordinary meaning would create all manner of difficulties that could be best summed up by the question: by which or whose standards? It is not too difficult to see that such an enquiry could very rapidly lead to the conclusion that the expression produces an uncertainty. This does not mean, however, that a lay person when promised “best endeavours” is expecting a standard of behaviour falling short of “one’s level best” or one where the person making the promise is expected to get away with doing less than “pulling out all stops”; but in Australia that is exactly what such a person should be counselled not to expect. In other words, whatever one’s subjective expectations of “best endeavours”, what one can only expect is “reasonable endeavours”.

2.8. “Reasonableness” is a more familiar concept to the law and it is regularly resorted to by the law where it is called upon to impose an “objective” standard or test. So, an important question then is what would constitute “reasonable endeavours” when it conditions the performance of an obligation. By what standard is reasonableness determined?

### 3. *EGC v Woodside Energy*

3.1. The contract in question concerned the purchase of gas by EGC (then known as Verve) and other suppliers of gas from the producers which included Woodside. The contract contained a base level of supply referred to in the agreement as the Maximum Daily Quantity (**MDQ**) and a second tier of supply in the event that the suppliers such as EGC required more, referred to in the agreement as the SMDQ.

3.2. The relevant clause that covered the SMDQ and which was under consideration by the High Court was clause 3.3 which is reproduced from the judgement below (the italics were inserted by the High Court):

#### “3.3 Supplemental Maximum Daily Quantity

a) If in accordance with Clause 9 (‘Nominations’) the Buyer’s nomination for a Day exceeds the MDQ, the Sellers must use reasonable endeavours to make available for delivery up to an additional 30TJ/Day of Gas in excess of MDQ (‘Supplemental Maximum Daily Quantity’ or ‘SMDQ’).

b) In determining whether they are able to supply SMDQ on a Day, the Sellers may take into account all relevant commercial, economic and operational matters and, without limiting those matters, it is acknowledged and agreed by the Buyer that nothing in paragraph (a) requires the Sellers to make available for delivery any quantity by which a nomination for a Day exceeds MDQ where any of the following circumstances exist in relation to that quantity:

i) the Sellers form the reasonable view that there is insufficient capacity available throughout the Sellers’ Facilities (having regard to all existing and likely commitments of each Seller and each Seller’s obligations regarding maintenance, replacement, safety and integrity of the Sellers’ Facilities) to make that quantity available for delivery;

ii) the Sellers form the reasonable view that there has been insufficient notice of the requirement for that quantity to undertake all necessary procedures to ensure that capacity is available throughout the Sellers’ Facilities to make that quantity available for delivery; or

iii) where the Sellers have any obligation to make available for delivery quantities of Natural Gas to other customers, which obligations may conflict with the scheduling of delivery of that quantity to the Buyer.

c) The Sellers have no obligation to supply and deliver Gas on a Day in excess of their obligations set out in Clauses 3.2 and 3.3 in respect of MDQ and SMDQ respectively.”

3.3. When an explosion at Varanus Island, a major gas processing plant, significantly reduced the availability of gas, EGC sought to rely on the SMDQ clause in the agreement which allowed them to nominate and purchase gas in excess of the normal amount. Woodside supplied the additional amount but only after EGC agreed to pay a higher price. Clearly aggrieved, EGC subsequently sought in the proceedings to invoke the delivery undertaking of Woodside under clause 3.3 for which a lower price was payable.

3.4. The court had heard arguments on the basis that 'reasonable' and 'best endeavours' were substantially similar obligations and so there was no opportunity to reconsider the Hospital Products decision referred to above.

3.5. The High Court held 4:1 (French CJ, Hayne, Crennan and Kiefel JJ, Gageler J dissenting) that Woodside was not required to supply SMDQ in circumstances where it was contrary to its own business interests. The 'reasonable endeavours' requirement did not require Woodside to act for the common benefit of both parties in an arm's length commercial contract. In other words, it was reasonable for Woodside to prefer its own interests, ignore (reasonably) the obligation under clause 3.3 and to negotiate a more advantageous bargain under which the additional supply was made.

3.6. The Court made 3 general observations about the obligation to use 'reasonable endeavours'.

- a) It is not an absolute or unconditional obligation.
- b) The nature and extent of an obligation imposed in such terms is conditioned by what is reasonable in the circumstances.
- c) The obligee's freedom to act in its own business interest is not to be sacrificed by an obligation to use reasonable endeavours to achieve a contractual object.
- d) Some contracts that have a 'reasonable endeavours' obligation will often be linked to an internal standard of reasonableness, or an express reference relevant to the obligee's business interests.

3.7. In respect of the last point, the court was referring to clause 3.3 (b) and construed that provision to provide guidance to the obligation in clause 3.3 (a) to determine what would be reasonable in the circumstances. Clause 3.3 (b) expressly contemplates that Woodside could have taken into account its own commercial and economic circumstances. It is important to note, however, that the High Court would have come to the same conclusion notwithstanding the internal standard of reasonableness in clause 3.3 (b). The court found that the mere obligation to use "reasonable or best endeavours" does not require the person bearing the obligation to perform the obligation where to do so damaged its own business interests.

3.8. The dissenting judgement of Gageler J however interprets these provisions quite differently and probably in a more literal fashion. His Honour Mr Justice Gageler departs from the majority in two significant and compelling ways:

- a) his Honour considered that an "objective" standard of reasonable endeavour should have been applied which could not be overridden by Woodside's own economic interests. His Honour considered that to do otherwise would make the obligation valueless; and

- b) his Honour construed the instructions contained in clause 3.3(b) to take into consideration Woodside's commercial, economic and operational interests as applying only to Woodside's ability to perform the additional supply; not to its willingness to do so. As his Honour observed, Woodside was always able to perform the additional supply but was reluctant or unwilling to do so.

## 4. Construction point

4.1. The High Court also took the opportunity in this case to reinforce its prevailing views about interpretation of commercial contracts. The majority noted at [35]:

"This Court has reaffirmed the objective approach to be adopted in determining the rights and liabilities of parties to a contract. The meaning of the terms of a commercial contract is to be determined by what a reasonable businessperson would have understood those terms to mean. That approach is not unfamiliar. As reaffirmed, it will require consideration of the language used by the parties, the surrounding circumstances known to them and the commercial purpose or objects to be secured by the contract. Appreciation of the commercial purpose or objects is facilitated by an understanding "of the genesis of the transaction, the background, the context [and] the market in which the parties are operating". As Arden LJ observed in *Re Golden Key Ltd* [2009] EWCA Civ 636 at [28], unless a contrary intention is indicated, a court is entitled to approach the task of giving a commercial contract a businesslike interpretation on the assumption "that the parties ... intended to produce a commercial result". A commercial contract is to be construed so as to avoid it "making commercial nonsense or working commercial inconvenience"

4.2. This has generally been interpreted as the High Court now leaning towards the so-called "contextual" approach to interpreting a contract and away from the rule articulated by Mason J in *Codelfa Construction Pty Ltd v State Rail Authority* (NSW) (1982) 149 CLR 337 which has been applied so as to exclude reference to extrinsic material to aid the interpretation of a term where there is no ambiguity on the face of the document first identified. His Honour said in that case:

"The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning. Generally speaking facts existing when the contract was made will not be receivable as part of the surrounding circumstances as an aid to construction, unless they were known to both parties, although, as we have seen, if the facts are notorious knowledge of them will be presumed.

It is here that a difficulty arises with respect to the evidence of prior negotiations. Obviously the prior negotiations will tend to establish objective background facts which were known to both parties and the subject matter of the contract. To the extent to which they have this tendency they are admissible. But in so far as they consist of statements and actions of the parties which are reflective of their actual intentions and expectations they are not receivable. The point is that such statements and actions reveal the terms of the contract which the parties intended or hoped to make. They are superseded by, and merged in, the contract itself. The object of the parole evidence rule is to exclude them, the prior oral agreement of the parties being inadmissible in aid of construction, though admissible in an action for rectification. Consequently when the issue is which of two or more possible meanings is to be given to a contractual provision we look, not to the actual intentions, aspirations or expectations of the parties before or at the time of the contract, except in so far as they are expressed in the contract, but to the objective framework of facts within which the contract came into existence, and to the parties' presumed intention in this setting. We do not take into account the actual intentions of the parties and for the very good reason that an investigation of those matters would not only be time consuming but it would also be unrewarding as it would tend to give too much weight to these factors at the expense of the actual language of the written contract."

- 4.3. The High Court in a joint judgement of three judges rather famously, controversially and robustly reiterated this view in [Western Export Services Inc v Jireh International Pty Ltd](#) [2011] HCA 45 when considering a special leave application thus:
- 3) Until this Court embarks upon that exercise and disapproves or revises what was said in *Codelfa*, intermediate appellate courts are bound to follow that precedent. The same is true of primary judges, notwithstanding what may appear to have been said by intermediate appellate courts.
  - 4) The position of *Codelfa*, as a binding authority, was made clear in the joint reasons of five Justices in *Royal Botanic Gardens and Domain Trust v South Sydney City Council* and it should not have been necessary to reiterate the point here."
- 4.4. This shift was recognised by the Court of Appeal of the Supreme Court of New South Wales in *Mainteck Services Pty Ltd v Stein Heurtey SA* [2014] NSWCA 184:

"To the extent that what was said in *Jireh* supports a proposition that "ambiguity" can be evaluated without regard to surrounding circumstances and commercial purpose or objects, it is clear that it is inconsistent with what was said in *Woodside* at [35]. The judgment confirms that not only will the language used "require consideration" but so too will the surrounding circumstances and the commercial purpose or objects. Although the High Court in *Woodside* did not expressly identify a divergence of approach, *Jireh* was notoriously controversial in precisely this respect." : per Leeming JA at [71].

- 4.5. The Court of Appeal however considered that this was not a departure from the rule in *Codelfa* in that the determination of ambiguity can be made contextually.
- 4.6. One can anticipate that this approach to interpretation could lead to an increase in the evidence that a court could be required to consider in the construction of terms and also forgive poor drafting.
- 4.7. The High Court was not required in this case to struggle with the a contract in which both "best endeavours" and "reasonable endeavours" had been used interchangeably. Would the court in those circumstances be compelled to give a different meaning to "best endeavours" and if so would such a clause be held to be uncertain and therefore void? This would have to be a matter for another court to consider.
- 4.8. This case highlights the difficulty that could be posed by the employment of "reasonable endeavours". In the warm glow of sealing the bargain, it is conceivable that parties would understand that "reasonable endeavours" does not impose an absolute obligation but nonetheless something approximating it. It is quite clear now that such an understanding would be deeply flawed.
- 4.9. Parties to contracts should therefore refrain from a liberal sprinkling of "reasonable endeavours" simply as a mechanism for avoiding coming to grips with thorny issues surrounding the allocation of obligations under a contract. The risk that parties run is one of uncertainty in that when in the future such a provision were to be invoked, the outcome that it could produce may not be one that the parties would have contemplated at the time the contract had been entered into. Permitting the party bearing the obligation to consider its own interests opens up potentially a large scope for that party to avoid an obligation, a concern which was raised in the dissenting judgement by his Honour, Mr Justice Gageler. Since reasonable or best endeavours are invoked to soften unconditional obligations, parties could better employ their energies to properly consider what the obligation entails and perhaps drafting additional procedures for dealing with them which may provide a greater degree of certainty of outcome to the parties than using a potentially problematic shorthand such as reasonable endeavours

- 4.10. A simple lesson for drafters and negotiators of contracts from this decision has to be that wherever possible “reasonable endeavours” should not be employed without much thought given to its possible consequences and whether or not alternatives are available. As was sought to be done in the gas supply contract, the parties could apply their energies to providing a mechanism for interpreting what “reasonable endeavours” would entail; however, as any draughtsperson would know, despite one’s exhaustive efforts, one cannot be confident that all future combinations and permutations could be contemplated and included in the drafting.
- 4.11. Also, parties should avoid using “best endeavours” and “reasonable endeavours” in the same contract because of the potential difficulty in interpreting them that as noted above. One expression should be adopted and used throughout the contract.

## 5. Liquidated Damages - Fine Or Penalty

- 5.1. Building contracts commonly employ liquidated damages to compensate the Owner where the Builder has failed to meet a date for delivery of the works. Doubtless there are other circumstances and commercial activities where they are also employed.
- 5.2. The overarching and guiding principle in calculating liquidated damages is that it must be a genuine estimate carried out at the time the contract is entered into of what the likely quantum of loss would be in the event the obligation is not performed - in the case of a building contract if the works are not handed over on the specified date. The figure arrived at in a building contract would commonly include considerations such as financial costs incurred in servicing the building loan, loss of revenue and the like - but as reasonably estimated at the time the contract is entered into. In general terms, if such elements exist in the calculation of the liquidated damages, then there is a very good chance that a court would not strike it down.
- 5.3. It is well understood, however, that where a contract prescribes the payment of some compensation upon a breach of that contract, the courts will not enforce such compensation if it amounts to a “fine or penalty”. In simple terms, the prescribed compensation will be held to be a fine or penalty if it disproportionately exceeds what would have been a genuine pre-estimate of the loss in the event of such a breach. This assessment is to be made at the time the contract was entered into and not when the breach occurs. As a general rule, the common law provides that there is a presumption that a pre-estimate of loss will not be genuine where a single set sum is payable on the occurrence of various events. In other words, it is more prudent to prescribe rates or a formula. Thus building contracts, for example, prescribe a daily rate to be applied for delay rather than one fixed amount that could have no relationship to the length of delay.

Further, a loss will also be considered not genuine if it is “extravagant and unconscionable” or “out of all proportion” to the loss suffered. A penalty that is approximate to the loss is more likely to be considered a genuine pre-estimate of the loss. This does not mean that the law requires absolute accuracy in the calculation. Overarching test is that a genuine attempt is to be made when the calculation is carried out. In such circumstances, if the estimate does not reflect the actual loss in due course, the error would generally be forgivable. Indeed, courts would readily recognise the difficulties that parties may have undergone in anticipating the quantum of future losses when carrying out the estimation.

- 5.4. Intervention of the court is not always guaranteed. Courts are faced on one hand by the policy of freedom of contract and on the other hand to strike down unconscionability. This tussle is demonstrated by the following extract from the judgement of their Honours Mason and Wilson JJ in *Amev-Udc Finance Ltd v Austin* (1986) 162 CLR 170 at [41]:

“Instead of pursuing a policy of restricting parties to the amount of damages which would be awarded under the general law or developing a new law of compensation for plaintiffs who seek to enforce a penalty clause, the courts should give the parties greater latitude to determine the terms of their contract. In the case of provisions for agreed compensation and, perhaps, provisions limiting liability, that latitude is mutually beneficial to the parties. It makes for greater certainty by allowing the parties to determine more precisely their rights and liabilities consequent upon breach or termination, and thus enables them to provide for compensation in situations where loss may be difficult or impossible to quantify or, if quantifiable, may not be recoverable at common law. And they may do so in a way that avoids costly and time-consuming litigation. But equity and the common law have long maintained a supervisory jurisdiction, not to rewrite contracts imprudently made, but to relieve against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory. The test to be applied in drawing that distinction is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff’s conduct in seeking to enforce the term. The courts should not, however, be too ready to find the requisite degree of disproportion lest they impinge on the parties’ freedom to settle for themselves the rights and liabilities following a breach of contract.

The doctrine of penalties answers, in situations of the present kind, an important aspect of the criticism often levelled against unqualified freedom of contract, namely the possible inequality of bargaining power. In this way the courts strike a balance between the competing interests of freedom of contract and protection of weak contracting parties (see generally Atiyah, *The Rise and Fall of Freedom of Contract* (1979), esp. Ch.22)."

- 5.5. It is not uncommon however in the building industry for parties to be unable to resist the urge to stipulate the same amount of liquidated damages as may be applicable under a higher level contract or to insert the same amount that would be payable to the contractor for delay costs. This is a flawed practice and would in all likelihood result in the amount being set aside for being a fine or penalty if challenged.
- 5.6. Even if a party is not entitled to assert the specified liquidated damages, that party still has the common law right to general damages.
- 5.7. Until the decision of the High Court in *Andrews v ANZ* the doctrine of a fine or penalty was only available strike down compensation specified consequent upon a breach of contract. *Andrews v ANZ* has extended that doctrine to other circumstances.

## 6. **Andrews v ANZ**

- 6.1. *Andrews v ANZ* concerned a representative action commenced by 38,000 ANZ customers against the bank, challenging the legality and enforceability of honour, dishonour, late payment, non-payment, and overlimit fees, collectively known as 'exception fees', charged by ANZ. They argued that certain provisions were unenforceable on the basis that the fees were penalties.
- 6.2. At first instance, the Federal Court held, consistent with the authorities existing then, that since the fees were not charged upon breach of the contract, they could not be classified as penalties. *Andrews* and the group subsequently sought leave to appeal to the High Court.
- 6.3. One of the main issues determined by the High Court was whether the penalty doctrine was limited to cases involving a breach of contract.
- 6.4. The High Court held unanimously that relief from the penalty doctrine was available, even if there was no breach of the contract. In determining whether a fee attracts the penalty doctrine (and is therefore not enforceable), the Court held that the proper approach is to consider whether the fee's purpose is, substantively, to secure performance of an existing contractual obligation.

There is a distinction to be made between:

- a) a payment to secure performance of a primary or stipulated obligation; and
- b) a payment for further services or accommodation.

If the imposed payment or detriment is only for the purposes of securing the primary obligation, the penalty doctrine would be applicable. However, if the payment is to enable additional services or accommodation, the penalty doctrine is not available to determine whether the amount is a penalty and cannot be held to be unenforceable for that reason. In the latter circumstances, the specified amount is characterised as merely consideration for the additional services or accommodation rather than in the nature of compensation for non-performance of an existing obligation.

- 6.5. The Court also noted that where a genuine pre-estimate of loss could not have been made the doctrine would also not be attracted notwithstanding its application to an existing obligation.
- 6.6. The approach of the High Court in *Andrews v ANZ* must raise the question for every draughtsman whether he or she has the option to draft clauses in a way so as not to fall within the operation of the penalty doctrine. To do this the clause would have to be drafted in a way that does not characterise the compensation as being payable upon the non-performance of an existing obligation but rather for an accommodation or additional service. Since the High Court suggests that when construing such a clause the court should be guided by substance over form, a clause that is plainly drafted to overcome this decision may yet fail which means that the safer option is to always ensure that there has been a genuine attempt to calculate the payment or detriment and for good measure to keep a record of that calculation for use in any future dispute.
- 6.7. If it quacks like liquidated damages for non-performance of an existing obligation, it must be liquidated damages and not payment for further services or accommodation. In those circumstances, one's client should be carefully advised about the requirements to avoid the penalty doctrine and one should assist the client in meeting those requirements. Prudence dictates that any remedy, if it is required, is not in the drafting of the clauses but in the calculation of the amount.

*I acknowledge the assistance that I have been given by William He and Brody Millington in the preparation of this paper.*