When Regretted Decisions and Poor Contract Management Collide: GEC Marconi Systems Pty Limited v BHP Information Technology Pty Limited

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1 Introduction

In what appears to be a growing trend in Australia, courts have played host once again to IT litigation between dissatisfied customers and their IT suppliers. Following from the *Unisys*[1] and *Memorex*[2] decisions, the Federal Court handed down its judgement on 12 February 2003 concerning complex litigation between the Commonwealth, its IT contractor BHP Information Technology Pty Limited (**BHP-IT**), and a sub-contractor, GEC Marconi Systems Pty Limited (**GEC**). In opening his judgment, Finn J stated:

'The title of Alan Farnsworth's recent book, *Changing Your Mind: The Law of Regretted Decisions*, encapsulates the burden of this proceeding and the issues it raises. Two of the principal actors, GEC Marconi Systems Pty Ltd and the Commonwealth, made contractual commitments and then sought to resile from them. This litigation reflects the consequences of their actions.'[3]

Illustrative of the risks inherent in multi-faceted IT contracts, the case concerned a breach of a key provision common to both the head and sub-contract, resulting in a web of claims and cross-claims involving all parties.

2 Facts

The disputed contracts formed the basis of the second stage (known as 'Release 2') of a project to upgrade and enhance the Australian Diplomatic Communications Network (**ADCNET**) for the Department of Foreign Affairs and Trade (**DFAT**). The ADCNET project was commenced in 1988 and, in its first stage, involved the replacement of the existing communications network of DFAT (used to carry messages, telephone, facsimile and data transmissions) with a single ADCNET network. Stage 1 had been carried out by EASAMS (Australia) Ltd (a predecessor of GEC). Following invitations of expressions of interest for the further upgrading and enhancement of ADCNET in late 1989, BHP-IT and EASAMS entered into a teaming arrangement in preparation of a joint venture to develop the necessary software. The tender was submitted by BHP-IT in July 1990, and was successful, ultimately culminating in two contracts being entered into on 14 September 1994.

The software to be designed for Release 2 was required to meet the security baseline defined specifically for the ADCNET system. This involved boundary security devices which prevent classified data being sent from ADCNET to less secure networks.

Prior to entering into the contracts, the Defence Signals Directorate (a unit within the Department of Defence) had informed DFAT that the Defence Science and Technology Organisation (another unit within the Department of Defence) had built a prototype version of a boundary security device called STUBS. This was described as the most effective security device for ADCNET. When DFAT was subsequently informed that the STUBS devices were to be commercially exploited by a company called AWA Defence Industries Pty Ltd (**AWADI**), DFAT commenced discussions with AWADI concerning possible acquisition and use of STUBS for ADCNET. DFAT advised both BHP-IT and EASAMS that STUBS was the preferred boundary security device.

2.1 The Contracts

On 14 September 1994, the Commonwealth and BHP-IT entered into a fixed price contract to develop the ADCNET software. Under the Head Contract, the Commonwealth was responsible for the supply and functionality of STUBS to BHP-IT. BHP-IT undertook to integrate the STUBS devices with the Release 2 software. Delivery of STUBS by the Commonwealth to BHP-IT was to be by 1 December 1994. At the time of execution of the Head Contract, the Commonwealth had not concluded its agreement with AWADI for the supply of STUBS.

On the same day, BHP-IT entered into a 'back to back' fixed price contract with EASAMS, which was later assumed by GEC. Under clause 5, BHP-IT was to supply GEC with certain 'Customer Supplied Items', including STUBS, in a 'fair and reasonable manner' and 'within the time prescribed' under the Sub-Contract. In return, GEC was obliged to 'supply software development services and to integrate the System in accordance with the provisions' of the Sub-Contract[4] which included meeting certain milestones for the delivery of project deliverables.

On 1 December 1994, the Commonwealth failed to deliver the first scheduled STUBS related deliverable, the Software Interface Specification, to BHP-IT. BHP-IT consequently failed to deliver it to GEC. This led to a course of correspondence in which alternatives to STUBS were suggested and examined. Furthermore, from virtually the beginning, GEC found itself unable to meet the contracted milestone dates.[5]

2.2 Variation of the Contracts

Clause 45 of the Sub-Contract provided that:

> '45.1The provisions of this Contract shall not be varied either in law or in equity except by agreement in writing signed by the Customer (BHP-IT) and the Contractor (GEC)'

From the time that it became apparent to the Commonwealth that it would not be able to supply STUBS, the Commonwealth considered alternative options to the security devices. Numerous correspondence crossed between all three parties. On 6 September 1995, DFAT raised a change request (CR 3049) under the Head Contract seeking the development of STUBS emulation software (described as the 'Emulation Variation Agreement'[6]). CR 3049 was forwarded to GEC on 8 September 1995 with a request for a quotation for undertaking the scoping of the change request. On 26 September 1995, the Commonwealth wrote to BHP-IT and GEC confirming that STUBS would not be supplied for acceptance testing. GEC signed a quote for scoping CR 3049 on 5 October 1995. The quote was forwarded by BHP-IT to DFAT for approval the following day.

Following negotiations between BHP-IT and GEC, the Commonwealth signed a Contract Amendment to give effect to CR 3049 on 26 October 1995. The amendment was signed by BHP-IT on 1 November 1995. No such amendment was formally signed for the Sub-Contract, although BHP-IT notified GEC on 1 November 1995 that DFAT had given its formal approval.

On 8 November 1995, DFAT raised a further change request (CR 3057) which proposed a change to the functional requirements specification for ADCNET insofar as it dealt with STUBS. Throughout November, a number of other change requests were made so as to remove from the Head Contract references to STUBS devices and to add references to STUBS emulation software.

On 25 November 1995, GEC sent an Acceptance Test Plan modified to reflect the changes to the Head Contract. On 28 November 1995, GEC sent a similarly modified Architecture Design Document to BHP-IT for approval.

2.3 Breaches of the Contracts

The failure to deliver STUBS resulted in alleged breaches of both contracts. This was further complicated by the fact that contractual claims arising out of one contract had flow-on effects into the other.

On 28 March 1996, GEC wrote to BHP-IT proposing that the contract be concluded on payment of Milestone 4000 and enclosed an invoice for their work. Following BHP-IT's failure to pay, GEC served BHP-IT with a Notice of Breach on 3 April 1996. This notice was forwarded by BHP-IT to DFAT on 11 April 1996 and served as BHP-IT's Notice under the Head Contract.

On 17 April 1996, both the Commonwealth and BHP-IT responded to their respective notices, denying any breach. GEC served a notice of termination of the Sub-Contract on BHP-IT on 10 December 1996.

When GEC purported to terminate the Sub-Contract, BHP-IT argued a number of defences, including estoppel, affirmation by election and waiver. The resultant litigation involved claims and counter-claims by all parties in respect of the breaches of contract.

Considerable evidence was adduced suggesting that, in light of the correspondence between the parties, variations to the original contracts had been made. This was examined in detail in the judgment.

3 GEC's claim

GEC claimed that the failure of BHP-IT to provide STUBS as required under the Sub-Contract and to pay GEC for the achievement of 'Milestone 4000' justified GEC terminating the contract. It sought pecuniary damages to recover the reasonable costs of performing its work.

3.1 Non-provision of STUBS

In its defence, BHP-IT argued that the Sub-Contract had been amended by agreement in the November 1995 correspondence pursuant to which BHP-IT was released of its obligations to provide STUBS and in lieu of which GEC agreed to develop and deliver the STUBS emulation software under the Emulation Variation Agreement. It further argued that:

- in any case, GEC had elected to affirm the contract following notice of the first breach and had consequently lost its right to terminate;
- as a result of representations made by GEC and relied upon by BHP-IT, GEC was estopped from denying that BHP-IT was no longer required to provide STUBS;
- in the circumstances, GEC had waived or dispensed with BHP-IT's obligation to deliver STUBS;
- the non-provision of STUBS was not a repudiatory breach at common law or under the terms of the Sub-Contract; and
- when GEC terminated the Sub-Contract, it was not itself ready, willing and able to perform the Sub-Contract.

(a) Emulation Variation Agreement

In its defence, BHP-IT argued that, whilst no formal Contract Amendment was entered into for the Sub-Contract to reflect the Emulation Variation Agreement, numerous correspondence between BHP-IT and GEC in October and November 1995 regarding emulation of the software and quotations for its development reflected GEC's agreement to the variation.

An invoice for developing the STUBS emulator had been rendered by GEC on 6 February 1996. This was paid by BHP-IT on 19 February 1996. However, only after forecasting a considerable loss under the ADCNET contract as a result of the use of STUBS emulation did GEC communicate to BHP-IT that it perceived 'that the inability of DFAT

to supply STUBS as per the contract may constitute a default on the part of DFAT and BHP-IT'.[7]

In relation to the variation agreement itself, GEC submitted that clause 45 of the Sub-Contract required that any contractual variation be in writing. The issue then was whether or not the legal effect of clause 45 'was to render ineffective any subsequent implied or oral contract the purpose or effect of which was to vary the Sub-Contract'.[8]

In finding that clause 45 did not render such agreements ineffective, the Court relied on Australian cases dealing with non-compliance with contractually-imposed modification clauses which held that, 'notwithstanding the writing requirement, it is open to the parties by express oral agreement or by contract implied from conduct to impose further or different rights and obligations on each other from those contained in the original contract'[9]. It was therefore sufficient that GEC had purported to agree with the variations to the Head Contract and proceed on that basis.

GEC also argued that no change to the parties' contractual rights was intended unless and until agreement was reached on a replacement. In other words, as no written contract existed for an alternative to the STUBS devices, the original agreement stood. Furthermore, it submitted that the agreement proposed by BHP-IT was so inherently uncertain as to be incomplete and unenforceable.

The Court dismissed GEC's claim and found that the parties *had* contracted to vary the Sub-Contract in the Emulation Variation Agreement. This provided a complete defence to the claim brought by GEC insofar as it was founded on a continuing failure to supply STUBS.

When examining the possibility of a post-contractual agreement being formed, the Court took into account the 'dynamic character' of the parties' relationship, particularly in light of the contingent provision of the STUBS technology . Finn J stated that:

> 'There is no little artificiality, in my view, in having to subject the communications and conduct of the parties over time to a traditional offer and acceptance analysis. Equally, in my view, the dynamic character of the parties' relationship rather suggests that the temporal differentiation between when an agreement was reached and when it was being performed for the purpose of determining the terms of the contract can be likewise artificial... In relational contract settings at least, I would suggest that there is much to be said for the view that [post-contractual] conduct (insofar as it reflects the parties' common interpretation of their contract)... should be admissible in the interpretation of their agreement.'[10]

Specific to the present situation, the Finn J found that factors peculiar to the Head and Sub-Contracts indicated that GEC was well aware of the effects of Emulation Variation Agreement. These were that.[11]

- it was envisaged from 'early in the life of the ADCNET contracts that emulation of the STUBS devices could be necessary... to minimise the effects of possible delays in the provision of STUBS related items'
- notwithstanding the requirement to supply STUBS under the both the Head and Sub-Contracts, it was appreciated by both BHP-IT and GEC 'from at least 20 February 1995 that there was some possibility that STUBS might never be available', and
- the Commonwealth had already been twice in contractual default in relation to the delivery of STUBS.

The combination of these factors supported BHP-IT's submission that GEC was well aware and in agreement with the Emulation Variation Agreement, the key terms of which were that:

- GEC would develop STUBS emulation software
- the software should emulate the STUBS devices to the extent necessary to complete the development and testing of ADCNET software that depended on the functioning of the interfaces to STUBS devices
- the emulator would be used in acceptance testing of the ADCNET Release 3 software
- BHP-IT was no longer contractually obliged to provide STUBS devices under the Sub-Contract as Customer Supplied Items, and
- the parties would amend all subsidiary contractual documentation (including the Functional Requirements System) so as to enable emulation to be used for acceptance testing.[12]

(b) Other Defences

The Court held that GEC had clearly affirmed the existing Sub-Contract following BHP-IT's failure to deliver STUBS and that its purported termination was 'an attempt, opportunistically and too late, to avoid a "regretted decision" it had long since made'.[13] Finn J found that 'negotiations after breach, depending on their context and subject matter, may warrant or preclude the inference that the contract had been affirmed'.[14] It therefore found that GEC had elected to affirm the Sub-Contract following notice of the first breach.

The Court further held that, having regard to the unambiguous and continuing representations during correspondence regarding the emulation of STUBS software, and its knowledge of BHP-IT's reliance on them, it would be unfair and unconscionable for GEC to rely on the non-supply of STUBS as a breach of the Sub-Contract. It was therefore estopped from doing so.

Given the Court's support of the first three defences raised by BHP-IT, it did not examine the waiver and 'ready, willing and able' defences in any depth.

3.2 Non-payment of 'Milestone 4000'

'Milestone 4000' constituted the approval and review of GEC's work to date on ADCNET, known as the Test Readiness Review (**TRR**). On 12 March 1996, GEC invoiced BHP-IT for its work on Milestone 4000. BHP-IT contended that the requisite review was never completed and failed to pay

the invoice. GEC subsequently terminated the Sub-Contract and claiming pecuniary damages.

Clause 10 of the Sub–Contract required the parties to perform their obligations regarding the TRR in accordance with the Implementation Plan of Schedule 8. This consisted of, amongst other items, delivery of the Software Development System Design Document and Test and Acceptance System Design Document. In turn, BHP-IT had the responsibility to approve or review the documents. When this occurred, an invoice could then be rendered under clause 16.3.

Clause 16.1 of the Sub-Contract provided that:

> 'The Customer shall make progress payments in accordance with the milestone payment schedule in Schedule 8 upon the Delegate *being satisfied on reasonable grounds* that the *supply* of the Documentation, Developed Software or integration of that part of the System referable to that milestone payment *meets the requirements of this Contract.*'[15]

The issues in contention as to the construction of this clause were:

- was the payment obligation triggered by the mere delivery of those documents for approval or review, or was approval or review a precondition to payment?
- what was required for there to be 'approval' or 'review'?[16]

The Commonwealth and BHP-IT both submitted that, before payment became due under Schedule 8, all the requirements for the TRR must be met. This included review and approval by BHP-IT. On the other hand, GEC contended that delivery of the documents was sufficient and that no approval or review was necessary. It argued that Schedule 8 did not stipulate a pre-condition for payment[17].

The Court held that 'the clear contemplation of clause 16, when read in light of Schedule 8, was that a contracted milestone payment became due and payable when the requirements of that milestone had been met'.[18]

In finding that the review had not taken place, the Court placed considerable weight on the absence of any recorded determination of a result. It held consequently that GEC had not satisfied the requirements of Milestone 4000 and that BHP-IT's refusal to pay the invoice therefore did not amount to a breach of the Sub-Contract.

4 BHP-IT's cross-claims

4.1 Against GEC

In its cross-claim against GEC, BHP-IT argued that GEC repudiated the Sub-Contract when it purported to terminate it. As a result, BHP-IT suffered loss in the form of lost profits and liabilities to the Commonwealth under the Head Contract. Applying the usual repudiation of contract principles, the Court therefore found that GEC had no valid ground for terminating the Sub-Contract and had therefore repudiated it. The Court was scathing in its reproach of GEC's behaviour, finding that it had 'manipulated and knowingly misinterpreted contractual obligations and engaged in disingenuous conduct to avoid having to complete the Sub-Contract'[19].

BHP-IT also argued that in terminating the Sub-Contract, GEC had breached an implied term of good faith and fair dealing required in giving any notice under clause 40 (the termination provision). Finn J left the argument open, refusing to examine the detail in any length in light of his findings of repudiation by GEC[20].

BHP-IT was entitled to an award of damages for lost benefit of the Head Contract, project costs incurred following GEC's misrepresentations and third party liability costs as against the Commonwealth. Finn J, however, refused to grant BHP-IT damages for dispute management costs and incurred personnel costs.

4.2 Against the Commonwealth

In the face of liabilities to GEC, BHP-IT brought a cross-claim against the Commonwealth for breach of contract, contravention of s.52 of the Trade Practices Act and negligent misrepresentation. The alleged breach related to the Commonwealth's failure to satisfy its obligation to supply Customer Supplied Items, including STUBS, under the Head Contract (which mirrored the obligation of BHP-IT to do the same under clause 5 of the Sub-Contract). BHP-IT further submitted that the Commonwealth had failed to keep it fully and accurately informed of the availability of STUBS and that it had misrepresented to BHP-IT that it was willing and able to supply the STUBS devices.

In light of the its findings on GEC and BHP-IT's first cross-claim, the Court considered only the issue of liability in BHP-IT's cross-claim against the Commonwealth and found that the losses claimed would be able to be recovered by BHP-IT though its claim against GEC.

(a) Breach of Contract

Under the Head Contract, the Commonwealth was obliged to:

- take all reasonable measures to maintain the processing environment as constituted by the elements of the Customer Supplied Items (clause 5.1)
- manage the project risks that were identified as its responsibility under the Head Contract, including the provision of STUBS as stated in the Schedules to the Head Contract (clause 5.4)
- act in a 'fair and reasonable manner' in discharging these obligations (clause 5.6(a)), and
- where a risk is identified which 'may have a significant effect on the implementation of the Implementation Plan', report that risk to BHP-IT and undertake management of it (clause 10.3).[21]

In relation to the breach of contract claim, the Court found that 'a duty to act fairly and reasonably in performing one's functions is not breached simply because it can be shown that something could have been done more openly, more expeditiously or in a more effective way'[22]. It found, nevertheless, that the Commonwealth had breached its contractual obligations to act in a fair and reasonable manner and effectively manage any identified risk.

Evidence was adduced of a 'change of tactics' decision made by the Commonwealth in June 1995, to which Finn J found that the Commonwealth, for its own practical reasons, had determined that no steps would be taken 'to commit to the purchase of STUBS for the purpose of the Head Contract, regardless of the provisions of the Head Contract'[23]. It was not until September 1995 that the Commonwealth formally decided to cancel the procurement of STUBS from AWADI. It informed BHP-IT of this decision shortly after.

In examining the Commonwealth's liability under clause 10.3, Finn J examined closely the actions of the Commonwealth following its 'change of tactics' decision. He held that the Commonwealth's liability under clause 10.3 only extended to the period between the 'change of tactics' decision in June and formal notice of the demise of STUBS in September. He attributed DFAT's conduct 'in part to a mentality quite unattuned to contract management'[24]. Furthermore, the conduct of those decision-makers involved demonstrated 'an apprehension that openness with BHP-IT could prove costly to the Department'[25].

Finn J found, however, that the Commonwealth's conduct leading to this period had not been likewise unreasonable, nor was the decision to cancel the procurement of STUBS unfair or unreasonable. While the decision ensured that the Commonwealth remained in breach of its obligation to supply STUBS under the Head Contract, clause 5.6(a) did not prevent it from taking the decision. The risk had effectively been assumed by BHP-IT.[26]

(b) Trade Practices Act claim

In considering the Trade Practices Act claim, the Court found that the Commonwealth *had* engaged in misleading and deceptive conduct in that it had represented that it was willing and able to supply STUBS under the Head Contract. However, the Court held that these misrepresentations were not made 'in the course of carrying on a business' as provided under s52A of the Trade Practices Act and, therefore, BHP-IT's claim was dismissed.

5 Commonwealth's cross-claim

In the final chapter of litigation, the Commonwealth brought a counter-claim against BHP-IT for damages in respect of losses incurred as a result of its late delivery of the software and subsequent default under the Head Contract. The Court had no difficulty in finding BHP-IT liable for its failure to perform the Head Contract on time. However, it found that damages were limited to project management costs and rental and relocation expenses following the breach.

6 Conclusion

In short, all the parties involved were held to be varyingly liable for their part in the breaches of the Head and Sub-Contracts. However, it was not so much the nondelivery of STUBS as the subsequent actions and misrepresentations of the parties, particularly GEC, that most coloured Finn J's judgement.

Further, the saga was not concluded by Finn J's judgment. Third party liability costs against the Commonwealth in favour of BHP-IT are yet to be calculated, as well as damages for fit out expenses owed by BHP-IT to the Commonwealth. The question of costs was adjourned to a date to be fixed.

The case illustrates the risks involved for parties entering back-to-back fixed contracts. It is also a timely reminder that parties who intend to vary a contract must do so in the clearest terms, explicitly confirming their intentions as to whether or not the original contract is to be altered or overridden. Furthermore, it highlights the dangers of 'sitting' on a breach of contract or an issue where there are problems of delivery. Expeditious action in the wake of such problems is the most effective manner of limiting liability for breach.

Most importantly, the case is another example of the complexity and cost associated with this type of litigation and that, despite it all, there is unlikely to be a clear winner.

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1 *RACV Insurance Pty Ltd v Unisys Australia Ltd* [2001] VSC 300
2 *Memorex Telex Pty Ltd v National Databank Ltd* [2002] NSWSC 1111
3 [2003] FCA 50 at 1
4 [2003] FCA 50 at 13
5 Ibid
6 Ibid at 39
7 Ibid at 31
8 Ibid at 65
9 Ibid at 66
10 Ibid at 105
11 Ibid at 76
12 Ibid at 87
13 Ibid at 110
14 Ibid at 112
15 Ibid at 159
16 Ibid at 162
17 Ibid at 162
18 Ibid at 163
19 Ibid at 263
20 Ibid at 271
21 Ibid at 378
22 Ibid at 394
23 Ibid at 384
24 Ibid at 396
25 Ibid
26 Ibid at 398