

# Managing IT contracts: Lessons from the GEC Marconi decision

*Paul Armarego and Richard Morrison, Clayton Utz*

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Paul Armarego is a Partner in Clayton Utz, Canberra, who specialises in domestic and international major projects especially in areas relating to outsourcing, technologies, information technology, defence industries and government.

Richard Morrison is a Special counsel whose principal areas of specialisation are in the fields of major projects, technology, tendering, outsourcing and probity.

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## 1 Implications for clients

This decision is yet another strong reminder that a contract will not necessarily protect a party from its conduct. Although the concept of contractual variation by conduct is not new, the facts on which the findings in the GEC Marconi case were based indicate that prudent organisations – particularly those involved in “relational”, “evolutionary” or other sophisticated arrangements – should review the way they approach project and contract management to avoid being “caught out” by their conduct.

For such purposes, it is suggested that there are 4 key lessons to be drawn from GEC Marconi.

The first lesson is about focus. There is much emphasis these days on managing the relationship with contractors, and in meeting and exceeding project objectives. Although sound, in adopting that emphasis it is important not to subordinate contractual roles, rights and responsibilities in the process.

The second lesson is about vigilance. In all projects – but particularly in the context of “relational” or “evolutionary” projects – if and when project requirements or plans change, managers should not pursue or be “drawn into” courses of action without considering the full potential impact upon the existing contractual relationship. Managers should also be vigilant in identifying changes as they arise, and caution should be exercised when making any representations to the other party about problems, changes and potential courses of action.

The third lesson is about diligence. It is not always possible to determine a party's rights and obligations by mere reference to the original written contract, particularly in “relational” or “evolutionary” contracts. For this

reason, managers should be diligent in record-keeping and knowledge management to ensure that, at all times, the “deal” is clear, and can be understood in its entirety. Clarifying correspondence will almost always be prudent, and communications such as performance reports and meeting minutes will need to be more carefully reviewed for their possible legal implications, and where necessary clarified.

The final lesson is about pro-activity. When contractual problems occur, decisions should not be postponed for an extended period of time. To do so may limit or prevent a party's ability to exercise its contractual rights. As such, managers should regularly audit and actively monitor contractual compliance and performance to preserve control over performance problems and the project's future.

## 2 Summary

Change control mechanisms in written contracts do not necessarily protect contractual parties from conduct which is capable of being interpreted as a waiver or variation to the contract. The case raises issues of how to properly administer and manage evolving and dynamic relationships covered by written contracts, and how best to draft contracts to protect against *GEC Marconi*-type findings. In its factual context, the case starkly illustrates the great care that must be taken in any informal communications, especially when dealing with unforeseen situations and performance problems. In order to protect themselves against commercially unexpected results and unintended risk transfer, contract parties will now need to reassess their contract management practices, and be prepared to assume a much higher level of formality and guardedness in their dealings with contractual counterparties.

The implications for acquirers of IT systems are far-reaching. The number and complexity of IT projects which possess “relational” or “evolutionary” aspects (particularly in the context of IT-based initiatives, developing technologies, and large-scale outsourcing) make it an imperative to review project management practices and reassess project risks in light of the *GEC Marconi* decision.

## 3 Background

In 1994, the Department of Foreign Affairs and Trade (“DFAT”) contracted with BHP Information Technology Pty Ltd for the development and integration of software for the second phase of the Australian Diplomatic Communications Network (“ADCNET”) project. Under this contract, the Commonwealth undertook to supply BHP-IT with a certain prototype boundary security device (known as “STUBS”) for the purposes of BHP-IT's software integration obligations. In turn, BHP-IT entered into a subcontract with a company that became GEC Marconi Systems Pty Ltd for the development of the software. The subcontract involved a commitment from BHP-IT to supply GEC with access to the STUBS devices and specifications.

Following the formation of those contracts and the commencement of the project, DFAT was informed by the manufacturer of STUBS that development and production of the STUBS device would not continue. Although DFAT initially followed a course which kept BHP-IT uninformed of what DFAT's actual intentions were about STUBS, it eventually informed BHP-IT that “sufficient” STUBS devices would not be available for testing the ADCNET project software. For project momentum to continue, DFAT requested BHP-IT to develop

software to emulate the role of STUBS within ADCNET. This request was passed onto GEC, which proceeded to undertake scoping and quotation for the changed requirement.

The quote was considered acceptable by DFAT, which then formally amended its contract with BHP-IT (although, importantly, the subcontract with GEC was not similarly altered).

DFAT then disclosed that the STUBS devices could not be provided at all, and a further change request was made by DFAT in relation to the provision of a replacement for STUBS. Again, GEC engaged in various scoping and quotation activities over a period of time. During all of this, it became increasingly apparent to GEC, however, that it was likely to make a significant loss on the project and a decision was made to issue notices of breach, and ultimately terminate the subcontract on (among other things) the basis that BHP-IT had failed to provide STUBS as was required under that agreement. GEC then brought this action against BHP-IT for (among other things) breach of contract.

#### **4 Legal issues**

Although, on an initial view, GEC appeared to have a claim for breach of contract, BHP-IT asked the court to consider whether GEC's conduct somehow mitigated or extinguished its claim against BHP-IT. In particular, BHP-IT argued that:

- the subcontract terms relating to STUBS were varied by agreement between the parties;
- GEC had elected to affirm the subcontract, even though STUBS was not provided;
- GEC had waived the obligation that STUBS be provided; or
- GEC should be estopped from asserting that STUBS was required to be provided.

##### **4.1 Variation by agreement**

Any agreement can be altered through mutual assent in various ways. Usually, the written document that embodies this agreement will provide mechanisms for the manner and

circumstances in which any variation may be made.

In this instance, BHP-IT argued that GEC had entered into an unwritten variation agreement of the subcontract which relieved BHP-IT of its obligation to provide the STUBS device, even though the contractual mechanisms for variation had not been followed. BHP-IT stipulated that GEC's conduct, as well as various communications between the parties, indicated that GEC had acknowledged and accepted the changes in the nature of the project.

The court was prepared to accept that the subcontract had indeed been varied in such a manner, thereby removing BHP-IT's obligation to provide STUBS. Although the variation did not comply with the writing requirement provisions of the subcontract pertaining to contract changes, the court appears to have considered that the "relational" or "evolutionary" nature of the parties' contract was such that their conduct should be given prominence in any interpretation of the agreement. This was so even though the contract contained the usual boilerplate clauses about waiver and an entire agreement.

##### **4.2 Affirmation by election**

It is a general principle of contract law that a party attains a right of election upon a serious breach by the other party – that is, the breach enables it to choose between terminating the contract or insisting upon its performance. Such a decision must be made within a reasonable amount of time, and once made, it cannot be reversed.

The election may be either explicit (eg. by written notification) or implicit (eg. by conduct).

BHP-IT argued that GEC had elected to affirm the existence of the contract through its conduct and could not subsequently reverse that decision by terminating it. On the facts, the court was prepared to find that GEC had indeed affirmed the contract – in particular, its communications to BHP-IT, participation in the change requests and continued performance of its contractual obligations indicated that the contract was still on foot.

Notably, the court was highly critical of GEC's strategy relating to the termination, and said that the breach "was not a sleeper that *GEC Marconi* could awaken for its own advantage five months after the cancellation of STUBS was announced" (para. 368).

##### **4.3 Waiver**

A party to a contract may waive or dispense with another party's obligations under their agreement – either explicitly through communication or implicitly through conduct. BHP-IT suggested that GEC had waived its obligation to supply STUBS through the substitution of emulation software as an alternative mode or manner of performance. Given the other findings of the case, the court refrained from "expressing a view on this submission other than to observe that it appeared to be a particularly optimistic one" (para. 470).

##### **4.4 Estoppel**

In certain situations, a person may be estopped (or prevented) from departing from an assumption of fact that they have caused another to adopt or accept, where the other person has acted to their detriment in reliance upon such an assumption.

Here, BHP-IT argued (among other things) that GEC's conduct had caused it (in BHP-IT's dealings with DFAT) to rely upon the continued existence of the subcontract (including the variation discussed above), and that it had suffered detriment as a result of this reliance. The court accepted this proposition, and was therefore prepared to find that GEC should be estopped from relying upon the non-provision of STUBS as a breach of the subcontract.

#### **5 Implications for acquirer of IT systems**

This decision is yet another strong reminder that a contract will not necessarily protect a party from its conduct. Although the concept of contractual variation by conduct is not new, the facts on which the findings in the *GEC Marconi* case were based indicate that prudent organisations –

particularly those involved in “relational”, “evolutionary” or other sophisticated arrangements – should review the way they approach project and contract management to avoid being “caught out” by their conduct.

For such purposes, it is suggested that there are four key lessons to be drawn from *GEC Marconi*.

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The second lesson is about **vigilance**. In all projects – but particularly in the context of “relational” or

“evolutionary” projects – if and when project requirements or plans change, managers should not pursue or be drawn into courses of action without considering the full potential impact upon the existing contractual relationship. Managers should also be vigilant in identifying changes as they arise, and caution should be exercised when making any representations to the other party about problems, changes and potential courses of action.

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