



Victorian Government
Solicitor's Office

VGSO Seminar Series
July 2007

Contract Management for Government
Developing Workable Contracts

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Strategic advice
practical legal solutions

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Contract Management – the Legal Framework

Management means, in the last analysis, the substitution of thought for brawn and muscle, of knowledge for folkways and superstition, and of cooperation for force.– Peter F Drucker

Introduction

The topic of today's seminar is the legal dimension of managing public sector contracts.

In a paper entitled Contract Management and the Public Sector, delivered last year at the Australian Government Procurement Conference,¹ the Auditor-General for Australia defined contract management as 'the process that ensures both parties to a contract fully meet their respective obligations as efficiently and effectively as possible, in order to deliver the business and operational objectives required from the contract, and in particular, to provide value for money'.

A friend suggested I look for an apposite quote to set the tone for the seminar. My google search for 'management quotes' returned 106,000,000 results. Thankfully, I didn't have to progress too far down the list to find the above quote from management theorist Peter F Drucker,² which, I think is as pertinent to contract management as it is to management generally. I would particularly emphasise the importance of *knowledge* and *cooperation* to effective management of government contracts.

Knowledge is a key element in the skill set of the contract manager: knowledge of the contract, the industry, procurement processes, accountability requirements and the legal and regulatory environment. There is also increasing recognition of the importance of cooperation in the effective management of complex, long term outsourcing arrangements; building a constructive relationship with the contractor is a critical element in managing the contract so as to achieve the State's objectives.

It is also fitting to quote Peter Drucker for another reason: his Wikipedia entry records that he was an early advocate of the contracting out by corporations of non-core functions. As we all

know, this philosophy has also, over the past 30 years, transformed our public institutions. Outsourcing to the private sector of task and responsibilities formerly performed or discharged directly by government now constitutes a substantial part of public administration.

A report on Contracting and Tendering Practices in Selected Agencies released by the Victorian Auditor-General in June this year noted that expenditure on goods and services in the Victorian public expenditure in 2005-6 was \$14.8 billion.³

A large and extremely diverse range of services are outsourced, including software development and support, web hosting, debt collection, management of confiscated property, construction of roads, prisons, health services and emergency communication services. I think we can safely assume that outsourcing is here to stay. The challenge then is to continuously improve procurement processes within government so as to minimise the risks associated with contracting out, and to achieve the best possible outcomes for the State and the community.

While it may not have always been so,⁴ there is now a clear recognition of the importance of the contract management stage of the procurement process. A body of knowledge and expertise has grown up within the public sector, based on experience gained and lessons learned in managing complex contracts. The key dimensions of effective contract management have been articulated, and the skills needed by contract managers have been identified. This knowledge is reflected in policy documents and guidance material, and informs the development of new, more sophisticated contracting models. These, in turn, give rise to new approaches to contract management. Richard will talk more about this, in the context of Partnerships Victoria Contracts.

It has been recognised that one of the key skills which contract managers must possess is an understanding of how the law shapes and

informs their task.⁵ This paper aims to outline the legal framework within which public sector contracts are managed in Victoria.

The Governance Framework

It is helpful to think of the legal framework as having both an internal and an external aspect. The internal aspect is the financial governance and accountability structure within government; while the external aspect is the law of contract and agency which governs the State's dealings with contractors.

The starting point in considering the internal aspect is the *Financial Management Act 1994* (Vic) (FMA). Under section 8 of the FMA the Minister for Finance has the power to give directions to government departments and public bodies in relation to financial matters, including 'systems and procedures for the purchase and supply of goods and services for and on behalf of the State'.

The Victorian Government Purchasing Board (VGPB) is established as a body corporate by section 54A of the FMA. Its primary functions are to:

- Develop, implement and review policies and practices in relation to the supply of goods and services to Departments
- Monitor compliance with supply policies and Ministerial directions.

Finance Direction 3.4.5 deals with procurement.⁶ The Direction states that all staff of Government Departments must comply with the supply policies of the VGPB, and requires that:

Public Sector Agencies must implement and maintain an effective internal control framework over procurement activities to ensure procurement of goods or services is authorised in accordance with business needs and within a documented framework of procurement policies and procedures.

This framework must be based on the following foundational principles:

- Value for Money
- Open and Fair Competition
- Accountability
- Risk Management
- Probity and Transparency.

The VGPB Policies on contract management⁷ expressly recognise that 'effective contract management is a key component in achieving project outcomes' and that 'the processes, structure and resources that will be applied in the contract management phase should be identified during the procurement planning stage'.

They also state that a contract management plan for higher value and complex procurement must address:

- Monitoring compliance with contract conditions
- Identification of milestones and key deliverables/outcomes
- Roles and responsibilities of participants
- Effective financial management and monitoring
- Monitoring of risks
- Project performance reporting requirements.

Direction 2.4 provides for Ministers to implement and maintain financial delegations of authority within their departments. Contract management plans should be made with these delegations in mind, and where appropriate, instruments delegating authority to make decisions under complex, long term contracts which have financial impacts (for example, the decision to approve a Work Change) should be aligned with existing financial delegations.

In some cases, it may be necessary to make delegations which specifically relate to a particular contract, so as to ensure that the officers who have been appointed to act on the State's behalf in relation to that contract, have the necessary financial authority to do so.

In addition to the general framework for procurement established under the FMA, the *Project Development and Construction Management Act 1994* facilitates the development of public construction projects in Victoria and provides for the setting of standards and issuing of directions in relation to public construction.

The *Partnerships Victoria* policy, introduced by the Department of Treasury and Finance in 2000, provides the framework for a whole-of-government approach to the provision of public infrastructure and related ancillary services through public-private partnerships. Contracting pursuant to the *Partnerships Victoria* policy will be the focus of Richard's presentation.

The Auditor-General also has an important role in ensuring proper management of contracts. The function of the Auditor-General is to conduct performance audits to determine whether, among other things:

- departments and public bodies and entities are achieving their objectives effectively and doing so economically and efficiently and in compliance with all relevant legislation
- Victorian public sector operations and activities are being performed effectively, economically and efficiently and in compliance with all relevant legislation.

As mentioned earlier, the Victorian Auditor-General recently conducted an audit of contracting and tendering practices in selected Victorian public sector agencies to determine whether they complied with government policy and procedure and delivered the expected procurement outcomes for the public sector and the community.

State's Power to Contract

Generally, when the State makes contracts it does so as an exercise of the executive power.⁸

However, in some instances, in particular where a 'core' function of government is involved, specific legislation is enacted which confers on a Minister or other public officer the power to make specific kinds of contracts. Where Parliament passes

legislation that bestows a specific contract making power on government, the source of the power to contract is the statutory provision, rather than the executive power, and the terms of the legislation must be complied with for the contract to be valid.⁹

The contracts entered into by the Minister for Corrections with private prison operators for the provision of correctional services at the Port Phillip and Fulham prisons are examples of this kind of contract. The Minister's power to enter into contracts of this kind is to be found in s 8B of the *Corrections Act 1986*. Section 8C prescribes certain matters which must be included in a contract made pursuant to s 8B, and other provisions provide rights of access to the prison to various officers of the State and gives the Minister emergency powers to intervene in the management of the prison.

Another example is the section 124B of the *Magistrates' Court Act 1989*, which empowers the Attorney-General and the Minister for Police & Emergency Services to contract out the provision of infringement management and enforcement services.

In these cases, the legal context in which the contract must be interpreted and managed includes not only the accountability framework under the FMA and the general law of contract and agency, but also the legislation under which the contract was made.

State Subject to General Law of Contract

When the State enters into a contract, it becomes subject to the ordinary principles of the private law of contract.¹⁰ This means that the State's legal obligations to the contractor are dictated by the law of contract, as are the State's remedies, if things go wrong. Contracting out exposes the State to increased legal risk. If the State breaches the contract, it may be sued for damages. It may also become liable under the doctrines of estoppel and misrepresentation as a consequence of the way the contract is administered.

State One Entity

Complex contracts often involve a number of government stakeholders, but under the law of contract, the State is the contracting entity. Robust governance arrangements are critical to ensure that the State is not exposed to liability under a contract as a result of the actions of a part of government not directly involved in the management of the contract.¹¹ Such arrangements should establish processes for stakeholders consultation within government, while maintaining a single point of contact between the contractor and the State.

Contract Managers are Agents

Government, like a corporation, can only act through its agents. At law, an agent has the power to alter the legal rights and obligations of his or her principal. The key to agency law is the concept of authority. A principal will be bound vis a vis third parties by actions performed by an agent within the agent's actual or apparent authority. The agent's apparent authority is the authority that the principal represents by words or actions, that the agent possesses. A common form of representation is the appointment of an individual to a particular position or allowing him or her to act in a certain capacity in the principal's business. Third parties are not bound to enquire as to whether an agent actually has the authority he or she appears to have.

Applied to the management of government contracts, the principles of agency law can lead to the result that a public servant administering a government contract may alter the legal rights and obligations of the State in relation to the contract, regardless of whether he or she has actual authority to do so.

A particular risk that contract managers need to be aware of is the risk of 'drifting' into an enforceable contract variation. In any long term contract, it is inevitable that changes will need to be made. The contract will invariably provide a formal process for variation. However, it is difficult, if not impossible, to draft a variation clause which is effective to exclude the possibility

of an 'informal' contract variation. There have been a number of cases in which the courts have held that the actions of the parties resulted in a variation of the contract, even though the procedure set out in the contract was not followed.¹²

Exercising Rights under the Contract

Contract managers should be prepared to exercise the State's rights under a contract if the contractor's performance is below what is required.

The State's rights under a contract must of course be exercised in accordance with the express requirements of the contract. Contract managers also need to be aware that of any implied obligations on the State, such as the requirement to exercise powers conferred by the contract in good faith.

The courts will only imply a term into a contract *as a matter of fact* if it is:

- reasonable and equitable
- necessary to give business efficacy to the contract
- so obvious it goes without saying
- capable of clear expression
- does not contradict the express terms of the contract.¹³

Certain terms are always implied into certain classes of contracts, unless expressly excluded. These are terms implied *as a matter of law*. An example is the term implied into contracts of employment imposing a duty on the employee to exercise reasonable care and skill in the discharge of the duties under the contract.

There is strong judicial support in NSW for the implication of a term of good faith and reasonableness in *all* commercial contracts,¹⁴ however these decisions have been subject to strong criticism from some legal commentators.¹⁵ The High Court has yet to determine the issue.

Various formulations of the obligation of good faith are to be found in the cases. It has been said that the duty encompasses:

- the duty to cooperate
- the duty to act honestly
- a duty to recognise and have regard to the legitimate interests of the other party in enjoying the bargained for benefits
- an obligation not to act in bad faith.¹⁶

While the law in this area is not yet settled, contract managers should bear in mind the possibility that a court may find that the State has an obligation to exercise its rights under a contract in good faith, either on the basis of a term implied as a matter of fact into the contract, or as a matter of law. If there is a requirement to act in good faith, then the courts have said that the exercise of remedies including the right to terminate must be exercised reasonably.¹⁷ Any requirement to act in good faith does not mean that a party cannot exercise its right to terminate in accordance with the contract.¹⁸ It simply means that contract managers need to exercise care and due diligence in doing so. Due diligence requires:

- having clear and accurate information on the performance of the contractor which justifies the actions taken
- ensuring that there is no obligation that the State party has failed to comply with
- Knowing what communications have taken place between the contractor and all government stakeholders.

Where the State is considering whether to exercise its rights to terminate for convenience, the duty of good faith would likely require that

the power not be exercised in a capricious or arbitrary manner, or for an extraneous purpose, such as to take advantage of a better offer received after the contract was entered into.

Uncertainty of Meaning

Lawyers strive for maximum clarity in drafting contracts. However, questions as to the meaning of particular provisions of a contract, or how those provisions apply in a particular circumstance, are likely to arise, particularly in long term contracts. The courts interpret contracts according to an objective test: what would a reasonable person consider the clause to mean? When a possible ambiguity is identified, contract managers should seek legal advice, rather than acting on the basis of an interpretation that may turn out to be incorrect. This is where we, at VGSO, can help!

For more information

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The VGSO is the primary source of legal services to the Victorian state government and its statutory authorities, providing strategic advice and practical legal solutions.

This topic was the subject of the monthly VGSO lunchtime seminar held on 26 July 2007.

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The notes are not be regarded as legal advice.

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- ¹ Ian McPhee, Auditor-General for Australia, “Contract Management in the Public Sector – an ANAO Better Practice Perspective” Paper delivered at the Australian Government Procurement Conference, Tuesday 4 April 2006.
- ² Peter F Drucker (1909 – 2005), Austrian born writer, Management Consultant and University Professor. Drucker is regarded as a pioneer in management theory. He introduced the term “knowledge worker” into the lexicon.
- ³ Victorian Auditor-General, *Contracting and Tendering Practices in Selected Agencies* June 2007.
- ⁴ See Nicholas Seddon, *Government Contracts* (3rd ed; 2004), 22-3, 28-9.
- ⁵ Ian McPhee, n 1.
- ⁶ Relevant mandatory elements in relation to procurement are included in Directions 2.1 Financial Code of Practice, 3.1.5 Managing Outsourced Financial Service and 3.4.6 Expenditure.
- ⁷ VGPB Procurement Policies, available on the VGPB website at <<http://www.vgpb.vic.gov.au>>.
- ⁸ *New South Wales v Bardolph* (1934) 52 CLR 455.
- ⁹ *Ibid*, 496 (Rich J); *Kent v Minister of State for Works* (1973) 2 ACTR 1, 22-25 (Smithers J); *Brown v West* (1990) 169 CLR 195; *Attorney-General v De Keyser’s Royal Hotel* [1921] AC 508, 575 (Lord Parmoor).
- ¹⁰ Subject to the operation of the doctrine of the executive necessity. See Nicholas Seddon, n3, 192 – 223.
- ¹¹ As occurred in *State of Victoria v Seal Rocks Victoria (Australia) Pty Ltd* [2003] VSC 84.
- ¹² See eg, *Commonwealth v Crowthall Hospital Services (Aust) Ltd* (1981) 36 ALR 567.
- ¹³ *BP Refinery (Westernport) Pty Ltd v Hastings Council* (1977) 180 CLR 266.
- ¹⁴ *Burger King Corporation v Hungry Jack’s Pty Ltd* [2001] NSWCA 187, *Overlook Management BV v Foxtel Management Pty Ltd* [2002] NSWSC 187.
- ¹⁵ See eg Tyrone M Carlin, “The Rise (and Fall?) of Implied Duties of Good Faith in Contractual Performance in Australia” (2002) 25 *University of New South Wales Law Journal* 99.
- ¹⁶ *Overlook Management BV v Foxtel Management Pty Ltd* [2002] NSWSC 187.
- ¹⁷ *Renard Constructions Pty Ltd (ME) v Minister for Public Works* (1992) 26 NSWLR 234.
- ¹⁸ *Thiess Contractors Pty Ltd v Placer (Granny Smith) Pty Ltd* (2000) 16 BCL 130.