

What Contractors Can Learn From *Indiana V. IBM*

Law360, New York (August 15, 2012, 1:30 PM ET) -- Performance of highly complex information technology contracts is challenging, rarely goes as planned and is often subject to changes in scope and even requirements. Special challenges are presented when doing business with state and local governments, especially when the task is to replace “legacy” systems with new, integrated solutions. Experience in performance often shows that requirements require more work and time than expected. Problems regularly arise both in the validation of new solutions and in “conversion” of accumulated historical records to work in new systems.

Companies who do business with state and local governments often face cost overruns, schedule delays and difficulties in meeting performance objectives. Every reasonable effort should be made to resolve these issues short of dispute. However, some situations reach a point where the government customer issues a “cure notice” threatening default. Then, it is in the best interests of all parties to work out a cure — rather than litigate. This is shown all too clearly in the recent decision, *State of Indiana v. IBM*, where a default and the resulting litigation produced an expensive “lose-lose” outcome. (See <http://www.indy.gov/eGov/Courts/Documents/Final%20Order%20signed%20and%20file-stamped%20July%2018%202012.pdf>.)

In late 2006, IBM and a coalition of companies were awarded a \$1.4 billion contract to overhaul Indiana’s welfare system. One of the main goals of the contract was to move away from personal caseworkers to a remote computer and phone-based solution, thought to be more efficient and cost effective. IBM apparently was on track to achieve contractual purposes, albeit with many difficulties, when the state decided to make a fundamental change in the implementation strategy (changing from a remote system back to a personal caseworker system).

This significant change in scope and a number of independent events combined to make IBM’s performance much more difficult. In a relatively short time, the state went from a posture of praising IBM to attempting to terminate it for “material breach” during a period the state was experiencing budget difficulties. Moreover, there was evidence that the state sought to “cut out the middleman” (IBM) and use monies that had been intended for IBM to complete performance relying largely upon state resources.

After going through an apparently successful cure process, on Oct. 15, 2009, the state of Indiana abruptly announced termination for material breach. Evidence at trial suggested the state was motivated by budgetary constraints that had not been anticipated when the project was launched. The subsequent litigation was hard fought, disruptive and costly. The state of Indiana originally requested \$437 million in damages, including refund of all monies paid, though a later state court ruling reduced the amount that the state could claim to \$125 million. IBM counterclaimed for approximately \$100 million in disputed fees and equipment.

The litigation was exhaustive and undoubtedly expensive to all sides. Before trial, the court considered 12 motions for summary judgment. Because the state asserted “executive privilege” with respect to communications from Indiana Governor Mitchell Daniels, the court reviewed in camera 150,000 pages of documents. The trial lasted six weeks and the court heard 92 witnesses.

Testimony was received from the governor’s chief of staff and most of the governor’s executive staff, as well as state officials with Indiana’s Family & Social Services Administration; several key IBM executives; numerous statistics, mathematics, welfare eligibility and damage experts from around the country; welfare advocacy groups; and welfare recipients. Approximately 27,800 exhibits were submitted, totaling about 1 million pages.

At trial, the state sought to justify the termination for various nonperformances which the court considered immaterial. Some of the complaints of the state could not be linked to express contract requirements. Applying Indiana law, the court applied a doctrine of “substantial performance” and found that a termination for material breach could not stand where there was evidence of substantial performance and where the state had received, and recognized, many benefits from performance up to the time of termination. Judgment was ultimately granted in IBM’s favor for just over \$52 million (including subcontractor assignment fees of \$40 million awarded to IBM by an earlier ruling).

IBM Senior Vice President and General Counsel Robert Weber praised the decision: “This case was all about whether the state would fulfill its clear and explicit contractual promises.” “The court’s decision is an important one for all companies who do business with the state because it makes clear that the state is not above the law.”

Yet, with due respect for the outcome, it is hard to see this dispute as producing any “winner” though it is clear, as the presiding judge concluded, that “Indiana’s taxpayers are left as apparent losers.”

The objective of responsible companies seeking to perform state and local IT contracts is to perform the contract, complete the assignment successfully and facilitate the public customer’s achievement of the project objectives. Indiana’s welfare modernization project was a failure by this standard. There are several lessons to be learned from the IBM case — and from similar cure/default situations we have faced with clients.

- As a contractual matter, companies are well advised to negotiate terms that impose, or at least do not preclude, the ability to establish that “substantial performance” is sufficient to avoid a claim of default. Some implementation contracts, reflecting the complexities and shared responsibilities, explicitly recognize that schedules may need to be changed and requirements may need to be adjusted. In the real world, “perfect” performance is all but impossible (or if possible is prohibitively expensive). It serves as a check against overzealous or unreasonable customer administration if the adequacy of performance, at least insofar as default is concerned, is measured by “substantial performance.”
- External events in the IBM case proved to make performance much more difficult and expensive than had been anticipated. The economic recession increased workload on welfare case management. Declining state revenues curtailed funds available to support the project. Contractors must be alert to such events, and should communicate and document concerns where they have an effect upon the required performance or upon the customer’s ability to live up to its obligations.
- At the tactical level, the IBM decision emphasizes the importance of enterprise-level “dispute management” and controls over contractual and customer communication. The evidentiary record included reference to many communications that were exchanged while the controversy developed. Some of these were in the nature of concessions, apparently offered to assuage the customer. In the event, that purpose was not achieved. Such communications can produce a “bad record,” should litigation occur.
- Our experience shows that often there is a period, after performance problems arise, when parties are struggling to find a solution. Vendors, to appear cooperative and work out a solution to complex technical challenges, may offer concessions or accept blame for performance problems. These gestures may be made in “good faith” but they can work against a vendor if the negotiations fail and litigation ensues.
- Similarly, vendors should take care to preserve and communicate positions that explain or justify performance problems, or that might shift responsibility back to the customer. It can be tempting to “suppress” these, in tense situations, out of concern not to further aggravate the customer relationship. If the problems turn for the worse, however, failure to communicate defensive positions, or grounds for affirmative claims, may mean the opportunity to raise these later is compromised or even lost.
- It is very important to alert management early to serious performance problems. Some issues can be resolved by speedy and decisive management intervention with customer counterparts. Developments, such as missed milestones, canceled customer meetings, or demands for concessions, may be “red flags” of more serious problems. The legal team needs to be informed throughout, even if kept in the background.
- If performance problems are heading to the brink, a company can prepare for a cure notice by assembling key facts, defenses and counterclaims in advance. This helps prepare the strongest answer during the limited period usually allowed for a “cure.” Great attention should be devoted to the solution, because the best way to avert a default — and the lengthy, costly litigation that inevitably follows — is to answer the customer’s concerns and make the project succeed.

- Should a cure notice be issued, where the customer is responsive to a potential solution it should be willing to conduct discussions under the protection of a confidentiality agreement. Such an agreement helps promote candid discussion of expectations, failures and solutions, without fear such communications will be used to either parties' advantage or detriment should litigation occur.

The problems experienced in Indiana's welfare modernization and the unfortunate litigation that followed serve to remind contractors of how much is at stake when large-scale system implementations fail. Vendors should be cautious not to take risks beyond their control or assured competency. At the same time, the decision shows that states cannot act with impunity. Should a company take a default to trial, states must recognize that they are subject to discovery and that their contribution to a project's problems will come to light.

Some implementation projects begin with high confidence but turn sour. One way that a vendor can protect itself is to extract from the contract documents a very precise understanding of the customer's obligations, when they are due, and by tracking performance against this baseline. "Exceptions" should be documented and must be communicated. There is no substitute for having a contemporaneous record. A legitimate grievance, or defense, if known but not communicated, may be as good as lost. A rigorous change management approach imposes continuing overhead costs; in a known risk situation, however, that cost is well worth paying.

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