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Sprint's Suit Against IBM Provides Rare Insight into Outsourcing Disputes

On May 25, 2006, Sprint Nextel sued IBM in the U.S. District Court of Kansas claiming a breach of their 2003 application development and maintenance outsourcing deal. Sprint complains that IBM failed to achieve committed productivity improvements, failed to adhere to the agreed methodology for measuring productivity and failed to provide the auditable data called for by the contract to back up its productivity claims. Sprint claims damages of \$6.4 million, the value of 119,000 hours of "free" work which it says IBM owes.

Sprint's complaint alleges that the parties agreed to measure IBM's productivity using "function points," a fairly complex — but not uncommon — method of measuring productivity in AD&M transactions. According to Sprint, the parties first established a function point baseline using AD&M projects completed by Sprint prior to the transition to IBM. After IBM took over the services, it produced reports for the first two quarters of operations comparing its performance to the baseline. Sprint reconciled those reports and accepted them. When the report for the first full year of operations arrived, Sprint found that IBM had expanded the report to include function points created for small projects that were completed using a quick response "PRTT" methodology. Sprint also found that IBM had only estimated the number of function points created on those projects based on surveys covering a "small sampling" of the projects, rather than counting actual points. In Sprint's view, the fourth quarter report could not be used to measure productivity gains since IBM's new methodology was simply not the same as that used to create the

baseline — it compared apples to oranges. Moreover, even if the PRTT projects could be included, Sprint argues that IBM's method for estimating function points on those projects was unreliable and failed to meet the contractual requirement for IBM to produce auditable data backing its claims.

Sprint argued that, since IBM had failed to demonstrate that it had achieved a committed 6.4% productivity improvement, it owed Sprint the equivalent number of hours — 119,000 — at no charge. Sprint claims that, although IBM conceded that the baseline did not include PRTT projects, it nonetheless refused to provide the free work. The suit followed.

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The case is remarkable for its rarity.

Outsourcing disputes are usually treated like "family matters" and settled out of the public eye. The parties usually have little to gain if a problem escalates to formal dispute resolution. Adversarial processes may entrench team members on both sides and damage working relationships that need to run smoothly over the life of long-term contracts.

As a result, most large outsourcing agreements include elaborate contract governance mechanisms that tend to solve disputes before they get out of hand. Layers of internal escalations work to eliminate the emotional aspects and personal economic effects (read: "threat to my bonus") of a dispute and elevate problems to a level where they can be solved by decision-makers with a broader view. If those processes are unsuccessful,

arbitration and confidentiality clauses required by many suppliers keep word of the problem from reaching the market. When a suit *does* get filed, it's always worth a closer look.

Although we now have only Sprint's complaint to look at (Sprint did not file a copy of the contract, noting unresolved confidentiality issues), the case suggests a few observations:

1. Carefully Define Your Pricing Terms

Sprint's case would seem to turn on how precisely the contract defines the function point baseline and the methodologies for calculating productivity improvements and comparative reports. "Money" points like this need special attention from the business and technical experts who will be responsible for managing them after the contract is signed, as well as the lawyers. To assure that all variables are well-defined and to smoke out misunderstandings, we often recommend reducing complex calculations to algebraic formulae and including extensive calculation examples in the contract.

2. Make the Supplier Bear the Burden of Measurement and Documentation

Sprint believes that its contract requires IBM to produce auditable documentation verifying its achievement of committed productivity targets. The complaint repeatedly points out what Sprint sees as fatal flaws in IBM's data gathering practices. If the judge agrees that the contract allocates the burden of proof to IBM, Sprint will have the easy side of the case and IBM would seem to have a challenge in carrying its burden. As a practical matter, since the supplier is almost always in the best position to collect and report service level, unit con-

sumption and pricing data, allocation of the burden to the supplier makes perfect sense. Our form agreements require the supplier to maintain audit trails, implement appropriate measurement tools and provide reports sufficient to verify contract compliance.

3. Make References to Third-Party Arbitrators Mandatory

Sprint's complaint claims that IBM backed out of an agreement to submit certain disputed questions for consideration to a third-party expert, the Counting Practices Committee of the International Function Point User Group (IFPUG). Apparently, reference to that group was not required under the contract. If Sprint believed that the IFPUG Committee was a reliable arbitrator of this sort of dispute, it might have required disputes to be referred for mandatory mediation before an IFPUG expert or included an IFPUG designee in an arbitration panel. Of course, IBM's purported behavior with respect to IFPUG in this case suggests that IBM would not be willing to trust its economic future to anyone other than a judge! When arbitration or mediation is an acceptable option, we have worked with our alternative dispute resolution experts to successfully structure panels and methodologies that require inclusion of special experts, create incentives for rapid resolution (e.g. "baseball-style" arbitration) or otherwise vary to address special circumstances.

4. Size Doesn't Matter

Too often, our largest clients believe that their sheer size and purchasing power will enable them to muscle their way through disputes with outsourcing vendors. While that may be true with some smaller suppliers, this case makes it clear that there is a limit to how much

strong-arming is possible. Sprint is a very big company and, for the moment, Sprint also is a very big IBM customer. *Information Week* reports that, in addition to the AD&M deal, the two have a \$400 million outsourcing pact and a "multi-billion dollar" customer service agreement — though it also reported in January that those deals were in some distress. There is surely more here than meets the eye, but the fact that IBM would allow this case to be filed over a \$6.4 million dispute is ample evidence that it is willing to protect its economic position in these transactions, no matter how big the customer. Even Intergalactic Enterprises should take care to carefully engineer and document all of the elements of its outsourcing transactions, especially those matters which are critical to important savings and which touch key operations.

A copy of Sprint's complaint is available on our web site at http://www.hunton.com/emailblast/pdfs/Sprint_complaint.pdf.

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