

Outsourcing Disputes

Two Recent Cases Provide Some Rare Insight into What In-house Counsel Need to Know

By **Randall S. Parks**

A spectacular smash-up always draws a crowd. In the outsourcing world, where the wreckage is nearly always kept under wraps, that's even more true. When a problem deal does break into view, it's always worth watching for lessons in how to manage — or how not to manage — these complex transactions. Counsel with responsibility for managing outsourcing relationships or contemplating new ones have two new cases to chew over that offer intriguing glimpses into troubled deals: A suit filed by Sprint Nextel against IBM in May, and an English case decided in June involving Vertex Data Sciences and its client Powergen.

SPRINT TAKES AIM AT IBM

Sprint Nextel's dust-up with IBM stayed in view only briefly. On May 25, Sprint Nextel sued IBM in the U.S. District Court of Kansas, claiming a breach of their 2003 software application development and maintenance (AD&M) outsourcing deal. (A copy of the complaint is available at www.hunton.com/emailblast/pdfs/Sprint_complaint.pdf. A more detailed comment on the case is available at www.hunton.com/files/tbl_s10News/FileUpload44/13172/Sprint-IBM-Client-Alert.pdf.)

In short, Sprint complained 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 claimed damages of \$6.4 million, the value of 119,000 hours of "free" work that it said IBM owed.

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Sprint alleged that the parties agreed to measure IBM's productivity using "function points," a complex method of measuring productivity in AD&M transactions. Though the parties agreed on a method for baselining creation of function points and counting them in the future, Sprint claimed that IBM's point counts didn't adhere to that methodology and inappropriately included certain points. Further, Sprint alleged that IBM actually didn't count points in some cases, but instead estimated them. Not only did IBM not use the proper methodology in the first place, argued Sprint, but IBM also failed to meet the contractual requirement to produce auditable data backing its productivity improvement claims.

Unfortunately for practitioners who might have preferred a more definitive and public resolution of the issues, the parties appear to have settled their differences and the suit was voluntarily dismissed in late July. While Sprint's complaint might be read as a lesson for outsourcing customers in carefully defining key economic terms or the benefits of allocating the burden of measurement and documentation to the supplier, the case is truly interesting because it was filed at all.

Too often, the largest customers believe that their sheer size and purchasing power will enable them to muscle their way through disputes with outsourcing providers. Just as often, those same customers are reluctant to litigate for fear of damaging a relationship that must continue to operate with a high degree of goodwill. However, the Sprint case makes clear that, at least in IBM's case, it may be necessary for customers to view litigation simply as another (albeit unpleasant) tool for achieving the right result. IBM apparently has concluded that it can tolerate the fallout associated with an occasional lawsuit in order to protect its economic position — even where the dispute is worth as little as \$6.4 million and the customer relationship is worth hundreds of millions of dollars, as the Sprint relationship is reported to be. If suppliers are willing to play tough and litigate, customers must be willing to play the same game or resign themselves to

losing the close cases where privately flexed muscle alone is not enough to prevail.

VERTEX TRIES TO ENJOIN ITS CUSTOMER'S TERMINATION

If the modesty of Sprint and IBM in settling their case out of the public eye disappointed outsourcing voyeurs, the decision in a recent English case, *Vertex Data Sciences Ltd v. Powergen Retail Ltd.* (www.bailii.org/ew/cases/EWHC/Comm/2006/1340.html) gives the curious much more to ogle.

In October 2002, Powergen, an energy supplier in the United Kingdom, acquired a regional energy company that had previously outsourced much of its customer-relationship management operations to Vertex Data Science in a deal worth nearly \$2 billion. Following claims by Powergen of Vertex's breach, Powergen and Vertex renegotiated the deal in April 2005, resulting in a new Master Services Agreement (MSA), calling for Vertex to provide more limited services in nine areas for total payments of roughly \$200 million over 7 years.

The new deal broke down almost immediately, and Powergen sent Vertex a termination notice in March 2006. Powergen contended that it could terminate due to material breaches and an "overarching repudiatory breach" based on Vertex's inadequate performance. Vertex disagreed and, surprisingly, sought an interim injunction to prevent Powergen from terminating or otherwise hindering Vertex's performance.

The decision — which the presiding judge, Justice Tomlinson, reminds us is often a recitation of Powergen's partisan account — is a catalog of an outsourcing lawyer's nightmares and worth reading for the scare factor alone. Justice Tomlinson recites in some horrifying detail Vertex's allegedly defective services and the ultimately futile efforts of Powergen to manage and improve Vertex's performance through a series of correspondence, meetings and escalations. Along the way, he exposes and leaves by the roadside dozens of gruesome issues that he is not compelled to resolve since the case is postured only as an application for

injunctive relief. In the end, the decision focuses on a highly technical analysis of the arbitration clause in the MSA and the ultimate question of whether an injunction can be issued at all in the circumstances.

The arbitration clause occupies much of Justice Tomlinson's attention. Powergen argued that the clause was intended to foreclose the parties from seeking permanent injunctive relief in all cases. To customer-side practitioners in this area, Powergen's position might seem dangerous and odd. Usually, the customer worries that its business will crash if a supplier refuses to perform and, therefore, argues that injunctive relief must always be available. In that light, Powergen's position appears to be an opportunistic defense based on oddities in the arbitration provision, rather than a reflection of what might normally be expected to be their contractual intent. If the shoe were on the other foot and Vertex were abandoning the contract, it would be hard to believe that Powergen would meekly concede its right to injunction and accept the maximum £8 million in damages allowed under the MSA. After much anxiety and analysis, the court concludes that the parties could not have meant to foreclose resort to the courts for injunctive relief and proceeds to consider the merits of Vertex's application.

As a warm-up, Justice Tomlinson takes pains to outline the complexity of the contract, the divide between the parties and the poorly defined performance that Vertex seeks to compel from Powergen. Significantly, he concludes that:

[w]hat is to my mind critical is that it is plain that the agreement requires extensive mutual cooperation if it is to work and there is scope for real and genuine disagreement as to what is the nature of the cooperation required of Powergen in order to enable Vertex to properly perform its obligations.

In support of his conclusion, he notes that the agreement includes a general provision that "Vertex shall not be liable to Powergen for any failure to provide the relevant Services ... to the extent ... attributable to any failure by Powergen to meet its obligations." He also notes, without deciding the point, that Vertex claims that the MSA must include an additional implied covenant that Powergen would "provide all such cooperation as [Vertex] reasonably required of it" to perform its obligations. Finally, Justice Tomlinson surveyed the English cases and noted a distinction between applications for injunctions compelling a party to achieve a result and those compelling a party to carry on an activity.

Taking a practical approach, the court held that an injunction compelling performance of a contract is inappropriate where hostile parties must work together to carry out the contract. Justice Tomlinson considered that it was "unrealistic" to order the parties to cooperate in

such circumstance, that Powergen's obligations not to prevent or hinder Vertex's contractual duties were not sufficiently clear, and that these "sophisticated parties" provided for a damages remedy.

The case should be disturbing for outsourcing customers, notwithstanding the fact that Powergen carried the day. The court's extensive treatment of the flawed arbitration clause is really only a sideshow; perhaps useful as a caution to future draftsmen to be careful with what is commonly dismissed as boilerplate. The court's grounds for refusing to issue the injunction are where the action really lies.

LESSONS LEARNED

Justice Tomlinson cited testimony that the parties had a "very complex, multilayered commercial relationship," and noted that the MSA was 173 pages long. He also noted in detail Powergen's loss of confidence in Vertex, the highly fluid nature of the necessary performances by both parties and the lack of definition of many of those obligations. In light of that complexity and lack of specificity, Justice Tomlinson was unwilling to referee a multitude of daily interactions between the parties. Understandable as that may be, an outsourcing customer reading the case is left to wonder whether it could obtain an injunction against a non-performing supplier in the more typical case where the contract and related exhibits are hundreds of pages long.

The practice points falling out of this case read like an outsourcing primer for customers:

1. Maintain Your Leverage. It is axiomatic that the customer's leverage drops sharply the moment after the contract is signed. Since outsourcing arrangements are best viewed as continuous negotiations, the customer is wise to embed in the agreement opportunities to recoup that lost leverage. Tools such as benchmarking with automatic price adjustments and termination for convenience with a reasonable termination charge, backed by termination assistance requirements, are just two examples of contractual provisions that help re-level the playing field. The Vertex case also makes clear that exit planning and preserving self-help remedies are essential, since governance and dispute resolution provisions may fail and judicial remedies may fall short. Had Powergen been seeking an injunction to require Vertex to perform, it may have found Justice Tomlinson just as unwilling to grant it relief. A viable, certain exit strategy and contractual leverage to support negotiated solutions are almost always superior to litigation.

2. Eliminate the Supplier's Right to Seek an Injunction. Vertex's request for an injunction must have surprised Powergen. The customer's principal obligation under an outsourcing contract is to pay the supplier's fees when due. If the customer doesn't pay, the supplier needn't perform. Further, while many

of the supplier's services depend on performances by the customer, the contract usually relieves the supplier if the customer fails to deliver. Moreover, if the contract provides for termination for convenience upon payment of a fee, it would seem that the parties have already agreed that an early termination can be remedied through payment of a fixed sum — a fact that would usually be fatal to a request for an injunction. Accordingly, it is hard to imagine a case where a supplier ought to be entitled to force its customer to perform on pain of contempt of court. To avoid a "Vertex surprise," customers should consider affirmatively foreclosing the supplier's ability to seek an injunction. Of course, since the customer is dependent on the supplier's performance, the customer should retain that right.

3. Don't Lightly Leave Important Provisions TBD. Justice Tomlinson made much of the fact that the parties had left certain key service levels "to be determined" later and never agreed upon them. While the effect of that omission on his decision on the injunction is informative, the fact that this gap is raised at all points out the danger of leaving important provisions to another day. In big outsourcing transactions, there is always a practical balance struck between the pressure to finish negotiations and the necessity to agree definitively on all key points. Service levels and detailed transition plans are the usual casualties. One unfortunate result of deferral is highlighted in the Vertex case. Of course, contractual perfection in this area is usually too ambitious. Practically, a thoughtful, risk-managed approach to the inevitable gaps — supported by well-drafted leverage-recovery tools — is a more realistic aim.

4. Specifically Define the Customer's Obligations. Much work goes into specifying the obligations of the outsourcing supplier. Typically, much less work is done to specify the customer's required performances. Where that is the case, customers seeking to force a supplier to perform — or to terminate or seek damages for deficient performance — may find a Justice Tomlinson reluctant to assist them where the scope of customer support required is unclear. As importantly, specific definitions should help head-off claims of unexpected "implied duties" like those made by Vertex.

