

Audit clauses in supply and outsourcing agreements

New UK case: there's more to drafting these clauses than expected; they can have a strong tactical role in dispute resolution.

Speedread

While the effect depends on the wording, audit clauses can be used by customers to get wide-ranging information to enable audit and verification of cost and other performance issues. That includes the supplier's after-the-event management and project reports, board papers and minutes, internal audit reports, etc. Also included are related information such as time and cost methodologies.

Suppliers and customers should address where the line is drawn when drafting these clauses: they often don't get the focus that's deserved. As we outline below, clever use of audit clauses can drive much better results for customers in dispute resolution scenarios. Though audits are rare, audit clauses can be a powerful tool.

January 2013 Large agreements such as outsourcing contracts often contain an audit clause to enable a customer to audit and verify cost and other performance aspects such as compliance with its obligations by the supplier. Not a lot of time is spent on drafting these boilerplate provisions. But a December 2012 case in the English High Court – *TGM v Thales*¹ - indicates a few issues that can be ironed out by drafting that is specific to the circumstances. Plus, the audit clause could be a powerful weapon in the context of dispute resolution even though actual audits – and cases on audit clauses – are rare.

Key issue in the case?

It's "What are the documents the supplier has to hand over to the customer to enable the audit?" We'll give examples below of what was in and out of the obligation in this case. The dividing line won't be the same for all audit clauses – standard audit clauses differ as do circumstances – but the examples will help focus attention. Often the dividing line will be the same under other clauses. Looking at the list will help suppliers and customers to consider what should be in and out when drafting an audit clause.

In *TGM v Thales*, a large project was running several years late and three times over budget.

The customer knew there was a dispute on charges payable to the supplier. In that context it wanted to see a wide array of supplier documents, to audit the costs and performance. This case indicates that, even in fixed price contracts, the supplier's costs can be relevant and documents on cost need to be disclosed. Cost, said the court, can be a barometer as to performance; anyway, there can be additional cost-based claims on top of the fixed price.

What documents must be disclosed by supplier to customer?

The court said the supplier had to disclose the following:

- Documents generated on cost and performance directly related to the project, such as time and cost records, invoices from sub-contractors and so on. (That's not particularly controversial once it's decided that costs can be used as a barometer for fixed price contracts).
- More controversial are the subsequently created documents, and those more removed from direct involvement in the project. That includes:
 - o Relevant board minutes and board papers

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in supply and
outsourcing
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- o The supplier’s internal audit reports in relation to the project blow-out;
- o Internal reports to senior management identifying the problems, including a high level, after-the-event, analysis of some of the difficulties experienced;
- o Internal project reports concerning cost and delay;
- o Relevant audit reports from the supplier’s external auditors;
- Supplier’s internal procedures relating to time and cost. The court did not buy the supplier’s contention that these should be withheld as they are commercially sensitive, in part because the customer had an overall confidentiality obligation. Therefore, commercial sensitivity is not usually going to be a ground to withhold.

What documents not to be disclosed?

As can be seen, the documents captured by the obligation are wide-ranging.

There were three main reasons why some documents did not have to be produced:

- Documents involving the lawyers, under the standard legal privilege grounds (e.g. generally, legal advice does not have to be disclosed).
- Where the reason for seeking documents looks like a “fishing expedition”. For example, they weren’t entitled to details as to why there had been turnover of four project directors. While that can be a sign of problems, this was a fishing expedition in these circumstances.
- Where the customer has not specified the documents it wants with sufficient certainty.

The last two reasons flow from the long-standing restrictions on court applications for specific

performance of obligations (here, specific performance of the supplier’s obligation to produce documents). That point emphasises the fact that, to enforce these clauses, ultimately the customer might need to go to court. But, as we now address, often that may not be needed.

Dispute Resolution tactics

Although not stated, and, therefore, not certain, this English case has all the hall-marks of the customer forcing the supplier to disclose its internal material, particularly after-the-event managerial and board material commenting on the problems, with a view to driving a better outcome such as settlement. Many suppliers would settle just to avoid airing the dirty linen. Some may be particularly worried that allocation of time and cost, and other matters, might come to light.

This says a lot about potential and powerful uses of such provisions. While much of the same information would come out in discovery in a court case:

- Where arbitration applies, the scope for discovery may differ;
- Some countries may have court discovery rules that include less documents;
- The customer here got, within 2 months, the orders for disclosure of documents in 6 weeks from those orders. That’s rapid and inexpensive compared to court or arbitration.

In cases like the English case, this might be enough to get the parties moving to settlement. Suppliers generally hate the idea that their inner workings can be seen.

Though audits are rare, audit clauses can be a powerful tool.

1. [2012] EWHC 3717 (TCC)

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