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**WHAT TO DO WHEN I.T. CONTRACTS ARE
GOING WRONG (AND WHAT TO DO TO
REDUCE RISK)**

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IT contracts are notorious for failure and underperformance. While not many cases go to litigation, it is as well to know what the risks are and what the options are when things go wrong.

Other than simpler deals (eg: sale of PCs) most IT contracts are complex (eg: software development, hardware supply, systems integration, outsourcing, e-commerce/supply chain, etc). No agreement can hope to cover all issues. So there should always be focus on the main risk issues. We'll deal with what to do when things go wrong. This can happen at many different levels ranging from "day to day" contract problems, through to meltdown problems. We'll also look at some ways to minimise risk.

While factors such as project requirement definition, project design and management, and the ability and integrity of the parties are important, contracts (and fulfillment of their requirements) can help minimise risk when things go wrong. But risk can't be eliminated.

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1 INTRODUCTION

- 1.1 Other than simpler deals (eg: sale of PCs) most IT contracts are complex (eg: software development, hardware supply, systems integration, outsourcing, e-commerce/supply chain, etc). No agreement can hope to cover all issues. So there should always be focus on the main risk issues. We'll deal with what to do when things go wrong. This can happen at many different levels ranging from "day to day" contract problems, through to meltdown problems. We'll also look at some ways to minimise risk.

2 “NORMAL” DISPUTE RESOLUTION

- 2.1 Most IT contract disputes will be resolved with little or no reference to the contract, other than the specifications and other project detail. Things will be sorted out one way or another. This highlights three points:
- 2.1.1 The integrity and experience of both parties is very important (and in terms of risk reduction, this can be more important than the flashiest of agreements). While both vendor and purchaser have conflicting commercial interests, little beats parties acting capably and with good faith in IT projects, with a view to the long-term interests of both parties. A big factor in IT procurement decisions should be the quality and integrity of the supplier organisation, and the individuals within that organisation. Sometimes those people are so important (eg: in a large outsourcing or ERP deal) that the customer should lock in the supplier’s key personnel as far as it can.
- 2.1.2 One contractual way of encouraging a more positive approach, which has risk and benefit, is to have a JV, strategic partnership or similar relationship. For more detail, see our February 2003 paper <http://www.wigleylaw.com/GettingCloserAndBuildingPositiveRelationships.html>.
- 2.1.3 A good dispute resolution clause will have an escalation path, with, say, the project managers trying to resolve things first. If they can’t, then the clause escalates the problem to the CEOs. That puts pressure on the project team to nail things before the boss gets involved! If that doesn't do the trick, then have compulsory mediation. There are differing views as to whether mediation should be imposed on parties. It’s a facilitative settlement process that generally requires voluntary participation to make it work. However, we strongly suggest it is imposed, and that its use is encouraged earlier not later. The alternatives (litigation, arbitration, etc) are too lousy not to have a relatively inexpensive, if imperfect, shot at mediation. If meditation doesn’t settle things, then we’re off to litigation (or if the parties so decide, arbitration or expert determination). See our May 2003 paper <http://www.wigleylaw.com/TyingUpLooseEndsAndDisputeResolution.html>. In that paper we float another quick fire dispute resolution option: expert determination. This could be a useful process for the common situation when parties want to sort out a problem quickly, perhaps by having a third party set the price, acceptance test criteria, determine breach of SLAs, etc.

3 THE SERIOUS CASES

- 3.1 The parties may drill down to the detail of the contract terms only in extreme situations. It's often in those situations, usually rare, where the big dollar risk lies. But it's the infrequent and big dispute where the real dollar risk lies. Small claims can and should be resolved quickly and relatively cheaply in overall risk terms. It's part of normal business.
- 3.2 Over many years, We've heard so many suppliers and purchasers say something like "*We've never had any problems before so there's no need to do fancy contractual documentation now. The risk is low because we've never been sued.*" Even lawyers say this stuff. We think this is very wrong. There are lots of examples where suppliers and customers have operated for years without problems that can't be resolved quickly, and then comes the big one. Mercury Energy deliver electricity for years, then..... Police IT operates well for years, then..... Hersheys chocolate runs supply chain well, installs an ERP system, then.....The list is endless throughout the world. Without an adequate limitation of liability clause, a supplier could be exposed to multi million or even billion dollar exposure depending on the circumstances (enough to sink the company). See our paper <http://www.wigleylaw.com/LimitationOfLiabilityAndRelatedIssues.html> *February 2004 Update*. It's just not worth betting the company on one deal, whether supplier (who could be sued for large loss of profit) or customer (who's business could fail if a computer system falls over).
- 3.3 Yet people seem to think a relaxed approach is OK because big claims happen so rarely. We suggest good contracts are important (other stuff's important too of course such as integrity, project requirement analysis, project management etc). IT projects are notorious for failure. They often affect business operations in mission critical ways. More and more cases are hitting the courts. We've had 2 in 2003 in the Court of Appeal, for example, which in relative terms is high. And there are other cases besides, in arbitration and litigation. Very few cases actually go to trial. They settle. Only a single figure percentage of cases, in which court proceedings are issued, go to trial. So the court cases are just the tip of the iceberg. There are many more IT disputes which don't reach issue of proceedings. Experience and anecdotal information suggests these are frequent and there are many high dollar value spats. Suppliers often cave in on payment claims. Customers often feel the product doesn't meet expectation.

4 WHAT DO AGREEMENTS SAY ABOUT BREACHES

- 4.1 Contract breach allows the innocent party to have the problem fixed (the bug patched; the bill paid), damages paid for breach and/or the contract terminated. Usually the first step is to get the problem sorted (and head off to dispute resolution if it's not).

- 4.2 Suppliers well know that getting full payment on a bill can sometimes be a problem because of disputes about work done, whether it's in scope, etc. This is an Incis type of problem and highlights how critical it is for scope to be clearly defined at the outset, for acceptance testing criteria to be defined, and for change control process (and other processes) to be carefully followed. It's amazing how often this doesn't happen despite plenty of examples where things have gone wrong in this sector, where projects are inherently prone to failure. Often it happens because things get on a roll and the parties don't get around to sorting out and implementing change control process (it's time consuming and there's critical path stuff happening all the time).
- 4.3 Customers also need to have these things sorted out, for they're at risk too.
- 4.4 Apart from a supplier getting a limitation of liability provision in place (and sorting IP rights), We consider that the biggest risk in the contract usually lies in the detail (the schedules such as statement of work, project management plan, acceptance test criteria, etc). The legal decisions demonstrate this time and again. The devil is in the detail. When you read a legal contract, many of the terms, from a high dollar risk perspective, are just noise and don't really matter too much.
- 4.5 For larger and higher risk deals, the lawyers can't (as they often do) shy away from understanding and reviewing the detail. Looking only at the "boilerplate" won't work even if it says that it takes priority over the schedules. There's further reason for this arising out of the procurement process including in relation to the Fair Trading Act. See our paper <http://www.wigleylaw.com/TendersRFSCCompetitivePurchasing.html>.
- 4.6 Of course lawyers can't get to grips with all the technical detail. But the technical people can't fully follow all the legal issues. It's a team job, which ideally calls for a trusted technical person who understands risk and legal issues, and a lawyer who understands technical issues and who takes the time to understand the project. There is no prospect of eliminating risk but this approach greatly reduces it.
- 4.7 We're asked to review numerous IT contracts. A couple of examples. Around half the time, the work has already started before the contract is signed (obviously risky). In most cases the acceptance test criteria are to be defined later. Yet this is a pivotal part of the contract for both parties (it's the objective measure of when the project or a step in the project is finished). Without it, there's great uncertainty. They should be defined at the outset. Or, if not, a calculated risk should be taken (and risk reduced as far as possible).
- 4.8 That sounds great in theory. One of the common problems is that it's hard or impossible to determine the criteria at the outset. That's demonstrated by the fact that very few software development projects end up looking like when they were planned at the outset. Of course the

parties can choose to take the risk. But that should be a calculated and considered risk and often it's not. Or they can look at alternatives, such as phased projects (with eg: acceptance test criteria defined at the end of the design phase, the customer being able to pull out at the end of that phase), agile programming (eg: extreme programming, DSDM, etc), benchmarking, etc. We're not saying the risk shouldn't be taken (often there's no choice). But it should be a considered risk and steps taken to minimise the risk.

5 DAMAGES

5.1 One party (usually the customer) could have incurred loss as a result of the breach. Even the most sophisticated contracts often don't expressly set out what happens when the contract goes wrong, in relation to damages. They will generally say what the parties are required to do, whether as to warranty or in some other way. We go into more detail on indemnities and other remedies in our *Limitation of Liability* paper. The failure (eg: to meet a warranty) is a breach of the contract. Damages will generally be left to general judge-made law and the Contractual Remedies Act to determine. However usually there are outer limits around damages entitlement, the most obvious of which is the limitation of liability clause (for more detail see our *Limitation of Liability* paper). Liability can be capped under a limited liability clause and certain types of liability, eg loss of profit, can be excluded. Many limitation of liability clauses are not optimal, as our paper on that topic demonstrates.

6 TERMINATION

6.1 Typically however an IT contract will provide for the circumstances where the contract can be terminated (if it doesn't, that's sorted out under the Contractual Remedies Act). Often this will revolve around a "material" breach (with only "material" breaches giving a right to terminate). It is difficult to define clearly what is a material breach (that is, something that is sufficiently severe to justify termination). Usually the defaulting party is given a certain number of days within which to fix the breach otherwise there can be termination. Like everything, if a party is looking at terminating, it must follow the process in the contract strictly, or it could end up being in breach itself. So it must give notice of the material breach, strictly according to the contract, and then give notice terminating if the breach is not cured. If the contract is cancelled, there may well also be rights to damages or compensation.

6.2 Of course the innocent party may well want to choose to continue with the contract. For example, if it is in the middle of a software development it can face real problems if it has to change horses part way through. This can be the case even if there are "off ramp" provisions as there often are in more sophisticated IT agreements such as those providing for a customer to get out in certain circumstances (or if it unilateral provides). These provisions can extend to rights requiring the defaulting party to continue providing support and transitional services

until the new supplier steps in. That all sounds fine in theory but in practice it can be difficult particularly when the product or project is relatively unique and difficult for another supplier to support. The defaulting supplier can be sued for damages but that can be messy, difficult, and hampered by, for example, limitation of liability provisions.

- 6.3 The downside of terminating is one of the typical sort of risks that is faced in IT contracts. The lawyers can do various things to minimise the risk but ultimately it's a commercial risk. That highlights a key point: the contract is only a backstop protection. Of more importance is the design and conduct of the project, and the experience, integrity and quality of the participants in the contract (both vendor and purchaser). It sounds trite but experience suggests that QA'ing the experience and integrity of the parties to the contract is sometimes not often given the importance it deserves. IT projects and contracts are complex and fancy paper work can only reduce not eliminate risk.

7 **LDs AND SLAs**

- 7.1 Some IT contracts will set out the regime by which payment is to be made if there is a breach in certain circumstances. These are often called Liquidated Damages clauses and Service Level Agreements (SLAs) with rebate provisions. For example, a certain number of dollars is payable for each day that there is delay (the Liquidated Damages Clause). Or there is a specified rebate against fees payable to a supplier if there is a failure of the Service Level (for example, failure to fix a service within a specified number of hours). As our paper on *Limitation of Liability* notes, rebates and payments under SLAs and LD clauses tend to be very small (much smaller than the actual loss incurred by the affected customer). Further, while in theory they look great, in practice they can be difficult to claim (for example, there may be so many assumptions and variables, and changes that took place since the agreement was first signed up, that it is difficult to make and succeed with the claim). But on the other hand, there are sound economic reasons for keeping suppliers' liability to a relatively low level (otherwise the service could be impossible or too expensive to provide). And they have some "skin in the game" to encourage compliance (it doesn't look good to breach service levels even if the immediate dollar impact is low).

8 **INSURANCE**

- 8.1 As we note above, it is important to follow the processes in the contract. Before taking any step however, the potential claimant should check whether it has insurance cover. If there is insurance cover that applies, any steps taken before a claim is made can invalidate that cover.

9 **COURT AND ARBITRATION**

- 9.1 Going to Court or arbitration is an appalling option in virtually every case. It will almost always destroy any prospect of a relationship between supplier and purchaser. It will be expensive (not just for lawyers' charges, but for management time also). It is very important to note that it will almost never produce an outright victory for one party or the other. Of all the cases where proceedings are issued (or arbitration commenced) only a fraction end up going to full trial. The rest fade away or, usually, settle. Even where a case goes to court, it's rare for one party to end up feeling it won a victory in principle. Reputations are rarely vindicated (NEVER pursue a court case to vindicate reputation!!). Reputation damage is minimised far better by settling as quickly, quietly and as honourably as possible. Judgments are rarely that clear-cut, and they come at huge cost. Settlement almost always involves compromise by both parties.
- 9.2 Yet it is common for parties to start things on the basis that they want to bring the case as a matter of principle. This is commercially unrealistic. Unfortunately many litigation lawyers seem to be OK about this approach, despite the overwhelming statistical evidence to the contrary: that hardly any cases end up going to trial, and hardly any case ends up with a full victory for one party. So three key principles:
- 9.2.1 Park at the door the idea of getting a victory in principle, except in very exceptional cases. Park egos at the door. Try hard to get a resolution short of going down the litigation or arbitration path (it's worth kissing goodbye to a lot of money to achieve this).
- 9.2.2 Watch the litigation lawyers. As a breed, they're often focused on going to and winning a trial, seemingly overlooking the reality that almost all cases settle (and therefore any step that is taken should be aimed at trying to settle as quickly, optimally and inexpensively as possible). This is a real problem in practice. Not all are like this of course!! That's not to say fighting hard in litigation is wrong. But the true reason for litigation in practice in most cases is as a mechanism to get settlement, and that should be factored in, when deciding strategy. It may be that pursuing litigation is the mechanism to get to the point where settlement is possible.
- 9.2.3 Look for lateral solutions. They're often available (there's often more than just payment of a figure somewhere along a continuum between what vendor and purchaser want).
- 9.3 Of course some people willing to try and resolve things will often meet with a difficult person on the other side. But it's still worthwhile trying to work ways around this (and compromising more than appropriate just to get the awkward character out of your hair even though that really irritates!). And with the right people, perhaps relationships can be salvaged and even improved.

9.4 In the right cases, having a third party facilitator come in to try and solve matters is a great option. Unfortunately, among parties and their lawyers, while this is an increasingly prevalent dispute resolution method, it is often only used as things are getting close to trial (that's when many cases settle anyway). It would be great if people would look at the mediation type of option earlier on. Good mediators are very capable and experienced at bringing parties together, and can help facilitate by going backwards and forwards and utilising information which is shared secretly with them by each party, but not shared between the parties. It is particularly hard job. Most lawyers can't do it. It is important to choose a good person. It's a darn sight cheaper than full blown litigation even if the lawyers are involved in acting for both parties. And the success rate with a good mediator is nearly 100%.

10 PREPARATION AND BEING HOISTED BY WHAT YOU WRITE

- 10.1 It is important to remember that parties will often be stuck with what they say in correspondence (in litigation and arbitration, it is often the documents which end up being the most important, rather than what people say happened). When a major dispute is apparent, a party should take particular care in what it writes to the other party (if it cuts corners, and gets it wrong because it hasn't done proper research (this is very common with complex IT situations), it could be stuck with what it said in letters or emails). Things could look bad because of the approach inadvertently taken. Remember also that in arbitration and litigation, virtually all documents (including those labelled confidential, emails and other electronic material) get disclosed to the other party (this includes internal reports about the problem, reports to the Board about the problem etc). A key exception is communications between a lawyer and its client, which generally are protected from disclosure. Parties can talk much more freely in that environment.
- 10.2 A very common problem is that the prospect of dispute is expanded because of poor paperwork earlier in the project. First, getting the paperwork right at the outset is important and yet can be difficult. Good general terms of contract should be used (tailored as appropriate with specific legal input in relevant cases), but often the main risk area lies in the specifications, project management plan and other schedules and documentation. In appropriate cases, it is important that it is reviewed by lawyers familiar with technical issues, although there is no substitute also for a review by a trustworthy IT person in-house who is familiar with the risk areas (this is a teamwork issue). IT lawyers time and again see the same problems coming up (whether acting for suppliers or customers) such as overclaimed performance, inadequate scoping, lack of acceptance test criteria etc.
- 10.3 The specifications of course should follow appropriate methodology, and come back to the initial requirements (ideally drafted by the customer) and should take an objective approach. In theory the customer will be

pushing for deliverables based on business outcomes with the supplier pushing for deliverables based on functionality. There are arguments both ways, although all prudent suppliers will insist on functionality only as it is too difficult to promise certain business outcomes. Again, this can be a source of litigation and difficulty.

- 10.4 Hard is making sure the roles of various providers integrate well, particularly where customers using several vendors (eg hardware from one supplier, software A from another, software B from a third party, support from elsewhere etc). Inter-operability between systems (eg: the new system and the legacy systems) is a related risk area. There is a risk and price assessment as to whether (a) to have a prime contractor which in turn subcontracts (thereby minimising the risk of things falling between the cracks) or (b) to use several suppliers with strong project management from or on behalf of the customer, with a particular attention to integration between the components.
- 10.5 While good IT contracts provide mechanisms for changing the structure of the project and the contract as it proceeds (most usually a change control procedure) frequently the people undertaking the project simply don't walk the talk and just go ahead and make informal changes without going through the process. The problem is that the process itself is time consuming, everybody is flat out, working to deadlines and they don't have time to follow the process. Then it all blows up later when things have got out of control. To unravel this is difficult.
- 10.6 The point of unravelling is further highlighted by the inherent uncertainty of the judicial process (with only around two of the judges having a particular familiarity with IT issues, and many examples internationally of judges not fully understanding IT concepts). And even inappropriately chosen arbitrators can get it wrong as well. There is always an uncertainty aspect with any type of commercial litigation and even more so with complex projects such as IT.

11 “DAY TO DAY DISPUTES”

- 11.1 We have dealt so far with the bigger type of problems. While the principles are relevant to day to day disputes, we need to think about the latter as well. The same points apply (for example, the parties should try and resolve these as carefully and amicably as possible). One of the problems is to try and find a mechanism which enables particularly long term contracts to continue even where there is some friction or matter to be resolved. Following the procedures is useful (eg change control, and resolution as between project managers followed by escalation if necessary to chief executives etc). One option, which is not often used in New Zealand yet (although is used internationally), and can provide for quick resolution, is so called “expert determination”. We deal with that in our May 2003 paper, *Tying up loose ends and dispute resolution in ICT contracts: Quicker, Simpler and Cheaper Solutions*

12 CONCLUSION

- 12.1 IT projects (particularly more complex projects) are marked by a high failure rate. Additionally, there has been a marked increase in the number of cases hitting the Courts of recent times. While factors such as project requirement definition, project design and management, and the ability and integrity of the parties are important, contracts (and fulfillment of their requirements) can help minimise risk when things go wrong. But risk can't be eliminated.

Wigley & Company is a specialist technology (including IT and telecommunications), procurement and marketing law firm founded 11 years ago. With broad experience in acting for both vendors and purchasers, Wigley & Company understands the issues on “both sides of the fence”, and so assists its clients in achieving win-win outcomes.

While the firm acts extensively in the commercial sector, it also has a large public sector agency client base, and understands the unique needs of the public sector.

While mostly we work for large organisations, we also act for SMEs.

With a strong combination of commercial, legal, technical and strategic smarts, Wigley & Company provides genuinely innovative and pragmatic solutions.

The firm is actively involved in professional organisations (for example, Michael is President of the Technology Law Society and Stuart van Rij its secretary).

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