Service Performance Remedies In Outsourcing Agreements: Lessons To Learn From State Of Indiana V. IBM

For a customer of outsourcing services, it is crucial that the outsourcing services agreement include well-drafted, clear and specific remedies to address vendor service performance failures that will have a material impact on the customer. A good example of what can happen when a service agreement is deficient in this area are the recent decisions in the ongoing litigation between the State of Indiana and IBM over a ten-year period, $1.3 billion contract for IBM to modernize and manage the State of Indiana's welfare system.

Less than three years into the ten-year contract, the State terminated the contract for cause citing IBM's performance issues. The parties subsequently sued each other alleging breach of contract. The primary issue in dispute was whether or not the State was properly entitled to terminate its agreement with IBM for material breach (i.e. for cause). The State sought over $170 million in damages, and IBM sought almost $100 million in damages.

The Indiana trial court (*State of Indiana v. IBM*, No. 49D10-1005-PL-021451 (July 18, 2012)) granted IBM summary judgment for $40 million in assignment fees and, after a six-week bench trial in 2012, found no material breach on IBM's part, awarding IBM an additional $9.5 million in equipment fees, $2.6 million in early termination fees, and $10.6 million in prejudgment interest, totaling $62.7 million. On appeal, the Indiana Court of Appeals (*State of Indiana v. IBM*, No. 49A02-1211-PL-875 (February 13, 2014)) reversed the trial judge's finding that IBM did materially breach the agreement. However, the Court of Appeals upheld IBM's entitlement to the $50 million in assignment and equipment fees on the basis that those fees were bargained for as consideration for valuable contract rights and that the State would be unjustly enriched if it could keep IBM's equipment and assume certain IBM subcontracts without paying anything. The case has been remanded to the trial court to determine the State's damages.

Both the trial and appeals decisions in *State of Indiana v. IBM* are a recommended read for anyone involved in the negotiation of outsourcing service agreements. Among other things, these decisions highlight the importance for customers of the following in outsourcing deals:

1. Having service levels that measure the key elements of service performance that will determine whether a deal is successful or not;
2. Allocating meaningful monetary remedies (i.e. service level credits) to service level failures and not agreeing that those monetary remedies constitute liquidated damages or an exclusive remedy;
3. Negotiating specific events, such as specific chronic failures of services levels, that trigger termination for cause rights, rather than simply including a standard commercial agreement termination for cause provision (e.g. right of customer to terminate for cause arising upon a "material breach" by the vendor not being cured within specific period of time);
4. Ensuring any objectives of the deal set out in the agreement are well-drafted and include all objectives that are key to the deal, since they can play an important role in the interpretation of the agreement, including the determination of whether a material breach of the agreement has occurred and a termination for cause right arises; and
5. Planning for the possibility of early termination and clearly setting out in the agreement the consequences of early termination, including payments owing, which should be different in a termination for cause versus termination for convenience scenario.

An outsourcing agreement should have specific and clear remedies that are triggered by vendor service performance issues that are material to the customer and those remedies should be commensurate with the potential impact of those issues on the customer. As the *State of Indiana v. IBM* case illustrates, when those remedies are not present, it can lead to lengthy and costly litigation in which both the customer and vendor lose.

To view original article, please click here.

Article by David Crane

McCarthy Tétrault LLP