

LESSONS FROM LITIGATING TECHNOLOGY SERVICE AGREEMENTS

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by Blaine Green and Michael Murphy



Blaine Green

Litigation

+1.415.983.1476

blaine.green@pillsburylaw.com

Blaine Green is a partner with Pillsbury Winthrop Shaw Pittman, in the San Francisco office. Blaine litigates and arbitrates technology service and implementation disputes – as well as other complex commercial matters – with a particular focus on the transportation, telecommunications, energy and hospitality industries. In addition, Blaine leads Pillsbury's Native American law practice.

Commercial lawyers ink thousands of contracts every day. Faced with an ever-shortening business cycle, they do not have the luxury of seeking perfection in the contracting process. In-house lawyers in particular must behave like other executives and managers – triaging issues and focusing their efforts on a select few critical business issues and fundamental risk allocation terms. Fortunately, very few contracts become contentious and even fewer end up in litigation, but when they do, we sometimes wish we had paid more attention to the finer points of the contract. A formal dispute process seems to bring out the worst in commercial lawyers' written work product, particularly missing, conflicting, ambiguous, and unfavorable terms.

Complex technology-based service relationships are especially vulnerable to disappointment, if not outright dispute, even as they have become an essential part of the operating fabric of the modern corporation. For most companies, third-party consultants, outsourcers, technology providers, and other service providers play a substantial role in the company's daily operations. In the context of technology implementation agreements in

particular, we tell our clients to set their expectations using the rule of threes – the project will cost three times as much, and take three times as long, as the contract provides. But very often clients are in the greatest hurry to implement these projects.

Although the reality of practicing business law is not likely to change, there are things we can do to reduce the odds that our contracts will work against us if there is a dispute. Based on our experience in negotiating, implementing, disputing, and litigating these kinds of agreements, this article suggests some areas of a typical service contract that should not be overlooked during the contracting process.

Our suggestions fall into three categories:

1. **Substantive deal terms** – the deal terms that naturally draw attention because they relate directly to the services provided.
2. **Dispute-related terms** – which for the purposes of this article means the “standard” contract terms that do not rise to the level of substantive deal terms, and typically receive less attention in drafting and negotiation.

3. Parties' behavior – clients do not always appreciate that the way they conduct themselves during the course of a dispute can have profound effects on the outcome.

1) Substantive Deal Terms

a. Rights to Sever and Disaggregate Services.

Customers may select services from a menu of standard offerings, hand-tailored to the specific needs of the customer organization, or a combination of both. Often the services are drawn from different lines of business, which are also sometimes referred to as service towers and lines of service, within the service provider's organization. The service categories may be described in separate sections within a single statement of work or they may be described in separate statements of work, each with its own terms.

The customer's ability to restructure the service relationship during the contract term can depend on how the services are organized. A key question is whether the client has the unilateral right to terminate individual lines of service while continuing to purchase non-terminated lines of service. It is usually in the customer's interest to have as much flexibility as possible, while the service provider's interest is in maintaining the overall size and scope of the transaction as a single, integrated service relationship. The contract terms should clearly state how this conflict is resolved.¹

At one end of the spectrum, the contract could give the customer

the right to terminate any services in its discretion at any time. This is common in consulting engagements and situations where the service provider is operating on a time and materials basis. At the other end of the spectrum, the contract could stipulate an all-or-nothing approach requiring the client to exercise termination rights with respect to the entire service relationship. The middle ground involves selective termination rights for certain designated categories of service but not others, or certain categories as an interdependent group. In all cases, there could be termination fees, which should be defined with precision.

b. Termination Assistance.

In most technology-based service relationships, a customer cannot simply replace a service provider on a walk-in, walk-out basis. The service provider will most likely own, control, or possess important information and materials that the client needs to continue its operations. This could include software, equipment, process documentation, third party contracts, and the customer's confidential information. Critical process information could be held by service provider personnel without being recorded in a transferable form.

Most service providers cooperate in transferring customer-specific materials and information upon termination, but clients cannot count on a service provider's goodwill in a dispute. Clients do not like being held to ransom when they believe the service provider has failed to perform. To minimize this risk, the contract

should address:

- The customer's right to obtain all client-specific data and confidential information in a usable electronic form;
- Transfers of equipment, software licenses and third party contracts that are required for the ongoing performance of the services;
- The customer's right to continue using the service provider's proprietary technology, at least for a transitional period until a new service solution is implemented; and
- Access to service provider personnel to provide knowledge transfer to the new service provider.

A clear exit path with contractually mandated support from the service provider can provide a powerful incentive for the parties to resolve their differences efficiently without resorting to litigation pressure tactics.

c. Governance and Contract Administration.

During the contracting process, customers may spend weeks or even months documenting their service requirements in intricate detail. After the contract is signed, the focus shifts to implementation and we often hear clients say that they "put the contract in the bottom drawer." Implementation teams are rightly focused on overcoming implementation challenges and adapting to changing business needs and priorities. They often lack the

time and tools to document these changes contractually.

It is easy to lose sight of the impact of daily incremental decisions on each party's accountability for the outcome of the project. Project sponsors are sometimes surprised to learn that the watertight contract they invested significant time and money to negotiate is out of date soon after it is signed: firm deadlines may have slipped with the project team's concurrence; the service provider's accountability for deliverables may have been compromised by architectural decisions or approvals given by the customer's project team; and the customer's project team may have taken responsibility for performing project tasks that were originally assigned to the service provider. Although each of these situations may make sense in isolation, together they can result in an expensive mess if the project goes off track and falls into dispute.

Some basic steps can reduce the chances of a dispute over changes in a project's scope, functional performance or cost. During contract negotiations the parties should establish a contract governance framework. At a minimum, the framework should:

- Address the frequency and composition of project review meetings, including meetings between the executive sponsors for each party. For important projects, executive review should occur at a level above the project team to provide a forum for a truly strategic assessment

of the project's status and proposed changes.

- Stipulate the level of formality required to implement various contract changes. For example, changes to core terms and conditions should be binding only if documented in a formal contract amendment signed by designated representatives. Adjustments to critical project requirements (such as changes to key project deadlines, the removal of functional requirements or the deferral of functional requirements to a later project phase) might be permissible with a less formal, but clearly documented, set of approvals such as signoffs from an executive steering committee or executive sponsors at scheduled review meetings. Non-critical changes could be approved by designated lower level managers by email.
- Require the service provider to document the effect of a proposed change on key project parameters such as delivery dates, functional performance and cost as a precondition to consideration by the client's decision makers. For this purpose, the contract should include a standard project change request template that is consistent with the governance framework.

2) Dispute-Related Terms

While the substantive deal terms are likely to have received the most attention during negotiations at the outset of a technology implementation, there are a handful of dispute-related provisions that can

have a profound impact in threatened or actual litigation. This section will identify and briefly address some of these provisions and their significance in the event of dispute.

a. Notice of Breach and Opportunity for Cure.

In technology implementation projects, as in other commercial contexts, the first formal step on the way to litigation is typically a notice of breach (sometimes referred to as a notice of default) communicated by one party to the other. The notice of breach tells the counter-party how it's failing to perform its side of the bargain and demands performance in accordance with particular provisions of the contract.

The notice of breach is important as a practical, legal, and evidentiary matter. As a practical matter, the notice shows the issuing party is serious about insisting on the requirements of the contract and provides the receiving party with the opportunity to conform its behavior to the contract, salvage the commercial relationship, and avoid litigation. Providing notice is also critical as a legal matter because, as a general matter, providing notice and a reasonable opportunity to cure is a necessary step to terminating the relationship for material breach. The notice of breach is also critical from an evidentiary perspective: it "makes a record of" the alleged breach and the issuing party's insistence on performance of the contractual requirement at issue.

But how must the notice be provided: when and in what form? How much

time should be provided for cure, and are there circumstances in which no cure opportunity should be required?

To avoid uncertainty at the outset of a dispute, it's useful for technology implementation agreements to address each of these issues. The parties may require that notice be in writing (generally a good practice anyway from an evidentiary perspective), and be served on a particular person (e.g., the project manager or, perhaps, a designated senior official) and by a particular method (e.g., hand delivery, registered mail, etc.) to emphasize the importance of the notice. The parties also have the chance to contract around the common law rules – which vary by jurisdiction and can be fact-and case-specific – concerning opportunities for cure. For example, the agreement may say the breaching party is not entitled to opportunity to cure if it is in default of certain fundamental contract provisions; the agreement may strictly limit the cure opportunity to a short period of time (e.g., days rather than weeks or longer), or may otherwise define what is a “reasonable” cure period.

b. Rights of Termination.

At common law, the non-breaching party has a right to terminate the contract for uncured material breach, but there is no right to terminate “for convenience” or other reasons. This is why, as a legal matter, it is critical to provide a notice of breach and opportunity to cure.

However, there can be quite a bit of uncertainty about what constitutes a “material breach” (discussed further below) and what agreement

or agreements may be terminated. This is especially true in technology implementations, where the parties frequently enter into a master services agreement and multiple statements of work. For example, can the customer in a technology implementation terminate the entire relationship based on a material breach of a single statement of work? Or, for that matter, can the customer terminate only certain statements of work, while preserving others in place? The parties can provide answers to these questions, before any dispute arises, by carefully drafting the master agreement and statements of work.

While there is no common law right to terminate for convenience or any reason other than material breach, the parties may choose to include such a right in the contract. From a practical business perspective, the right to terminate for convenience can be useful and efficient: it allows the parties a possible way out of the contract without the time and expense of litigating whether there was a material breach. The right to terminate for convenience is often paired with the obligation to pay a “buy-out” price or liquidated damages to compensate for early termination.

c. Material Breach: Basic Functionality and Time of the Essence.

Because the common law right to terminate can be exercised only in the event of material breach, there is great potential for disputes over what constitutes “material breach.” On a technology implementation project, it is usually in the customer's interest to specify, when possible, what constitutes a material breach. While not every type of material

breach can be anticipated at the time of contracting, on all technology implementation there are some basic requirements: most notably, required functionality and schedule for implementation.

At the time of contracting, the parties should be able to identify – and define as required elements of the project – the basic functionality the project is intended to achieve. By contract, the customer may specify what “core” functionality must be achieved by the service provider; and if the service provider fails to implement that core functionality, that failure is a material breach.

Also at the time of contracting, the parties should know the schedule for implementation of the project. The service provider will typically provide the customer with an implementation timeline. But whether the provider's failure to meet the schedule constitutes a material breach will depend on a number of factors, including whether the schedule was specifically committed to and made a part of the agreement, whether the agreement states that “time is of the essence” with respect to the project schedule, and how the agreement defines (if at all) material breach.

d. Waiver and Amendment.

Technology implementation and service agreements often contain boilerplate language – typically buried in “miscellaneous” or “other” sections near the end of the contract – relating to waivers and amendment. Although frequently overlooked in drafting and negotiation, these provisions can play a significant role in the event of litigation on these projects.

Technology implementation projects rarely proceed exactly as planned. After an implementation contract is signed, there can be surprises on both the service provider and customer side: the service provider may have internal staffing or technology challenges with implementation; the customer may encounter its own problems responding to requests for information, reviewing designs and specification from the service provider, or integrating the technology with customer's existing systems. Any of these factors can cause a "miss" in core functionality or "slip" in the schedule.

If a technology implementation dispute reaches litigation, the parties may defend against claims of breach by arguing that a breach was waived by the counterparty, or that the obligation at issue was changed (or even negated) by amendment. How effective these arguments are can depend on what the contract says about waiver and amendment. A contract may limit the potential "waiver" argument by stating that any waiver, to be effective, must be in writing and signed by the party to be charged; and by stating that a waiver of breach of one obligation shall not constitute a waiver as to breach of any other obligation. With respect to amendment, the contract may specify that any amendment be in writing signed by an authorized representative of each party.

e. Pre-Litigation Requirements.

The agreement may require that, before a party may file a suit or submit claims to binding arbitration, the party must provide a written notice to the other party identifying

the dispute or claims (and perhaps specifying a demand) and that the parties undertake some pre-litigation attempt to resolve the dispute (e.g., a meeting of senior executives or non-binding mediation). These types of provisions are intended to facilitate a negotiated resolution – and possible preservation of the commercial relationship – before litigation begins.

f. Venue and Choice of Law.

Most technology implementation agreements contain venue and choice of law provisions, and these provisions take on great importance when a dispute arises.

Though it has no impact on the substantive merits of a dispute, a venue provision can significantly influence litigation outcomes in several ways. If venue is exclusive in the home state, county court or judicial district of one party and the other party is out-of-state or otherwise distant, it can make litigation much more burdensome (in time, cost and effort) for the latter party. In addition, a favorable venue can provide a "home-court" benefit to one side, which can serve as a psychological (and in some cases real) advantage. Similarly, where the choice of law is the law of the state where only one of the parties is based, that party should have an advantage in familiarity with the law and, in some cases, one party or the other may be substantively advantaged by the particular law of that jurisdiction.

g. Liquidated Damages.

Liquidated damages are damages in a specified amount for the injured party to collect as compensation upon a specific breach. In the context

of a technology project, the parties may identify liquidated damages for late performance or failure to meet service levels.

However, contract negotiators should be aware that liquidated damage clauses are not always enforced. At common law, a liquidated damages clause will not be enforced if its purpose is to punish the breaching party rather than to compensate the injured party. For a liquidated damages clause to be upheld, two conditions must be met. First, the amount of the damages identified must roughly approximate the damages likely to fall upon the party seeking the benefit of the term. Second, the damages must be sufficiently uncertain at the time the contract is made, so that such a clause would save both parties the future difficulty of estimating damages.

h. Limitations of Liability.

Service providers may insist on limitations of liability to reduce their potential exposure to damages a customer may suffer as a result of a failed or delayed implementation. Though not unique to technology implementation projects, limitations of liability can be particularly important in this context because of the magnitude of harm customers may suffer, directly and indirectly, from a failed or delayed implementation. A service provider may try to limit its liability to the amount paid by customer (to service provider) on the project, or even to the amount paid by the customer during some smaller period of time immediately preceding the breach. Providers may also demand that customers waive any claims for consequential damages

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– that is, losses that do not flow directly from a breach, but are caused indirectly by it.

But, as with liquidated damages, limitations of liability are sometime unenforceable. A party may not limit its liability for intentional misconduct.² And, in cases of fraud, limitations of liability do not apply or cannot be enforced.³ Thus, a party to a technology implementation project may assert claims for intentional wrongdoing or misrepresentation in an attempt to avoid a contractual limitation on damages.

3) Parties' Behavior

In litigating any breach of contract case, the terms of the contract at issue are obviously important – but the actual behavior of the parties, both before and after the dispute arises, can be even more important (than the language of the contract in isolation) in determining who wins in court or arbitration.

a. Pre-Dispute Conduct

Technology implementation projects are complex. In most implementations, the service provider and customer each have responsibilities; there are many interdependencies, uncertainties, and surprises; and the success or failure of the project can turn on the behavior (unilateral and bi-lateral) of either or both parties.

By its nature, litigation involves failed projects, and the factfinder will naturally be interested in whose “fault” it was that the project failed:

the provider, the customer, or both? This can be as much a question of who are the “good guys” and who are the “bad guys,” as of who breached the contract. While the ultimate judgment or award will determine “breach,” that determination is informed by the factfinder’s sense of which party – if either – behaved better.

A customer may be viewed as behaving badly during the pre-dispute phase if it failed to set clear goals and requirements for the project, delayed in providing information or approvals necessary for the provider’s implementation, or enlarged the original project scope or requirements. A provider may be viewed as behaving badly if it underestimated and/or misrepresented the scope, requirements or timeline for the project, failed to devote adequate resources to the project, failed to communicate problems or delays of the project, or misrepresented the project status.

In addition, pre-dispute behavior may be relevant to show or rebut a waiver of breach or an amendment of the contract. And the parties’ behavior may also be used to interpret ambiguous terms of the contract.

b. Post-Dispute Conduct.

Just as the factfinder will want to know whose fault it was the project failed, he or she may also be influenced (consciously or not) by the behavior of the parties after the dispute arose and during the course of litigation. The factfinder may

wonder why the parties were unable to work out their differences and, specifically, which side was being more unreasonable.

Besides the contract, the most important documents in any commercial litigation – including a technology implementation dispute – are often the documents that reflect the initial notice of breach and response thereto.

The party whose position appears stronger (as a factual and legal matter), more contract-based, and more reasonable in those initial communications is likely to have a significant advantage with the factfinder.

Parties can also behave well or badly during the course of litigation itself, and this behavior, too, can influence litigation outcomes. For example, if one party takes or threatens some business action that it knows will harm the other party (e.g., a service provider cutting off services to a customer), that party may be perceived as the bad actor. Lastly, the credibility – of both parties and their lawyers – is crucial in court and arbitration. Claims seen as inconsistent, ever-changing, overreaching, or otherwise weak can undermine credibility. At all stages of dispute, parties and advocates should keep this in mind (i.e., as they prepare positions, assert claims and defenses, and support or rebut damages).

Endnotes

- 1 Absent language that specifically addresses the issue, some courts have held that a contract may be partially terminated or cancelled in stages. *See, F & F Copiers, Inc. v. Kroger Co.*, 391 S.E.2d 711, 714 (Ga. Ct. App. 1990) (stating that “[T]here is no merit in F & F’s contention that Kroger could not effect a piecemeal termination. A contract may be partially terminated . . . and nothing inherent in this contract prevents a cancellation by stages”). *See also, J. R. Watkins Co. v. Brewer*, 73 Ga.App. 331, 343, 36 S.E.2d 442 (1945) (holding that contracts may be partially terminated.)
- 2 *McFann v. Sky Warriors, Inc.*, 603 S.E.2d 7, 14 (Ga. Ct. App. 2004) (holding that “exculpatory clauses do not relieve a party from liability for acts of gross negligence or willful or wanton conduct” and holding that a jury question existed as to defendant’s gross negligence and/or willful and wanton conduct, which precluded summary judgment on limitation of liability issue).
- 3 *Lenny’s, Inc. v. Allied Sign Erectors, Inc.*, 318 S.E.2d 140, 142 (Ga. Ct. App. 1984) (denying summary judgment on limitation of liability provisions because of fact issues as to whether plaintiff was fraudulently induced to lease fire protection system, and whether defendant acted willfully and wantonly in failing to fully inform plaintiff of system capabilities, and failing to inform plaintiff that system was inadequate for its needs).

