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Indiana V. IBM: What's At Stake For IT Contractors

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On Oct. 15, 2009, the state of Indiana terminated its $1.4 billion welfare modernization contract with IBM Corp. for cause and sued IBM seeking damages of more than $170 million. On July 18, 2012 the Marion County Indiana trial court ruled for IBM, finding that default was not justified where there was "substantial performance." We reported on that decision in an article for Law360, "What Contractors Can Learn From Indiana v. IBM," dated Aug. 15, 2012. At the time, we commented on the exhaustive and expensive litigation. Before trial, the court considered 12 motions for summary judgment. The trial lasted six weeks and the court heard 92 witnesses. The trial judge reported that approximately 27,800 exhibits were submitted, totaling about 1 million pages of documents.

Our perspective in 2012 was that litigation was a very poor way to resolve disputes over undertakings of the scale and complexity as a transformative information technology modernization project. The trial court's decision, however, was informed and discriminating. While it recognized problems with IBM's performance, the trial court found "substantial performance" where the state had received many benefits from IBM's efforts. The state's operational control over many areas of contract performance figured into the trial court's decision, as did circumstances — notably, the economic recession that began late in 2007 and a series of natural disasters in 2008 — that were outside of IBM's control but which rendered its performance much more difficult.

On Feb. 13, 2014, the trial court's decision was reversed by the Court of Appeals of Indiana. In August 2014, the Supreme Court of Indiana announced that it will decide the dispute.

Indiana procedure indicates that whether a contract breach is material is a question of fact to be decided by the trier of fact. And an appellate court is not to set aside a trial court's judgment unless "clearly erroneous." Nevertheless, the Court of Appeals concluded that IBM was in material breach because IBM failed to satisfy the "overarching policy objectives" that were the "essence" of the contract.

Rejecting the trial court's "substantial performance analysis" in which it balanced the benefits to the state against IBM's performance failures, the appellate court focused on whether "any breach went to the essence of the contract." Even though it acknowledged that IBM's performance had reduced fraud and provided the state with important benefits, the appellate court ultimately concluded that IBM's failings "went to the heart of the contract — which it found in the "Policy Objectives" of the contract. As distilled by the Court of Appeals, these were "to provide welfare services to our poorest in a timely, efficient, and reliable manner within federal guidelines — and that [failure to achieve these purposes] constituted a material breach of the contract." The appellate court found that IBM was in breach on these "overarching policy objectives."

The contract set out eight standards to use to measure "satisfactory performance." One of the eight was the state's "determination" of the contractor's "satisfactory performance." To the trial court, the state's professed dissatisfaction was not dispositive as it was just one of the eight enumerated ways to judge performance. The Court of Appeals, however, elevated the state's "satisfaction" above all other criteria. It explained that one party's evaluation the other party's performance is a valid way to measure performance.

The state argued, and the appellate court agreed, that the state had a reasonable basis not to be satisfied with IBM's performance. Scant attention was paid by the appellate court to the other seven standards — including that of performance "in accordance with and compliance with … work plans, schedules, and milestones agreed to by the Parties."

Several crucial questions are presented by the appellate decision. Complex IT implementation contracts such as that for Indiana welfare modernization are not like most public contracts, even for IT services. The Indiana project is an example of IT "transformation," where a public sector customer seeks to replace inefficient, ineffective legacy systems with modern, highly integrated systems that employ commercially-based "enterprise resource planning" software. Such projects can take years to achieve and are highly "interdependent" in that success requires continued cooperation between purchaser and provider. Key functions may depend upon the timely ability of the public sector customer to perform assigned functions. A recurring problem in IT projects is the inability or unwillingness of the public stakeholders — agencies, departments and the workforce — to adopt the "changed ways" of a new system.

Especially at the state and local level, IT transformation projects are acquired using historical contracting methods. These can work poorly when used to acquire complex solutions. Here, we focus on three key challenges:

What Is the Required Performance?

The genesis for public contracting methods, viewed historically, is to acquire supplies rather than services. Requirements would be described by a "statement of work" and "specifications." Contemporary IT implementation contracts still derive from this model, but the fit is imperfect. For a large-scale project, it can be very difficult to establish exact "requirements" at the time of contract execution. For many projects, final requirements are part of the solution development process that occurs during contract performance.

In the Indiana v. IBM litigation, the appellate court presumed to decide whether IBM's performance met high level "Policy Objectives" of the contract and emphasized the state's declared "satisfaction" over seven other standards. This reduced the question of material breach, on a highly complex undertaking, to achievement of objectives as distinct from adherence to the contract's terms or performance in accordance with plans, schedules and milestones, and it elevated the subjective understanding of one party, the state, over other objective achievements.

In the Indiana v. IBM example, as we have seen elsewhere, IT implementation contracts can be voluminous and contain many layers of policy purposes, program goals, business objectives and the like. These were invoked among the eight contractual measurement standards — but not, it seems, clearly enough. The Court of Appeals treated the state's "satisfaction" as decisive. This frustrates the purpose and value of negotiations to establish detailed requirements and performance process, and puts a contractor at the intolerable risk of not knowing what performance is expected or whether it will be measured objectively. Nor can the appellate decision be reconciled with the actual process of design, development and implementation (DDI) typically employed in IT projects.

How (and When) Is Performance Accepted?

In a simplified supply contract anodyne, a contractor's performance results in the tender of supplies for final acceptance. The reality of a complex IT implementation, however, is far different. DDI may take several years and could include multiple "go-live" events for partial or complete functionality. There could be dozens of discrete, contractual milestone events before "go-live." Final acceptance could occur months after "go-live" where corrections are to follow initial operating experience.

Some implementation contracts include an elaborate process calling for dozens or even hundreds of "Deliverables" (DLVs) that individually or in combination represent contractual milestone events. Each DLV would be subject to its own evaluation and acceptance procedure. Beyond even this, some contracts impose a further process requiring "Deliverable Expectation Documents" (DEDs) to explain how a contractor intends to satisfy future DLVs; these DEDs can have their own evaluation and acceptance procedures.

A contractor's adherence to an elaborated and iterative solution delivery process and customer acceptance of DEDs and DLVs represents achievement and satisfaction of contract requirements. This argument is even stronger where the DED and DLV process is linked to milestone satisfaction and payment. Objective evidence of progress in contract performance is present in DED and DLV delivery and acceptance and in milestone approval and payment.

But there is hardly a consensus on this fundamental point, as evident from the position taken by the state of Indiana against IBM. When a public customer decides that the "purposes" or "core objectives" of a project have not been met, it may threaten or default a contractor even if iterative "way points" have been met (and documented), even though the system goes live and is used, and even after it has paid the contractor for its achievements.

In substance, this position treats the obligations of the contractor as more than the "sum of the parts" of incremental performance. While this serves the unilateral interests of the public purchaser, it substitutes the subjective satisfaction of the purchaser for the detailed mechanics of a highly complex, interdependent undertaking. This is a hazardous and irresponsible paradigm.

What Constitutes a "Breach"?

Indiana v. IBM is an acute illustration of how a judicial process can produce a distorted and unjust result through simplistic reduction of a complex project and use of an ill-suited legal standard of performance.

The trial court was right to apply a "substantial performance" analysis to the question of material default and in seeking to balance what had been achieved of the contract's objectives with what was not. IT implementation contracts rarely lend themselves to simple characterizations of “pass” or “fail.” Termination of a public contract for default is a severe act with adverse reputational and financial consequences. It can impair or even preclude eligibility for future public contracts.

Default is a form of “forfeiture” and in extreme cases can expose companies to liability that threatens enterprise value. Set in this context, the Court of Appeals in Indiana erred in emphasizing achievement of “policy objectives” over compliance with contract mechanics and in the importance it assigned to the state of Indiana’s “satisfaction” with IBM’s performance. This error was not mitigated by the court’s cursory consideration of whether the state was “reasonable” in its dissatisfaction.

In other jurisdictions, such as California, a breach is material if it is dominant or pervasive as in any real or substantial measure to frustrate the purpose of the contract. To be “material,” a breach must “go to the root” or “essence” of the agreement, or be “one which touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract.” See Williston on Contracts (4th Ed. 2002) §63:3. After considerable performance has occurred, a party should not be allowed to rescind a contract for an alleged breach when the breach does not go to the root of the consideration.

Considering the record as reflected in the trial court’s decision in Indiana v. IBM¸ the state did not show a “material” breach against these standards. The state of Indiana used the welfare system created by IBM and its team to process millions of public benefits applications. The system expedited welfare processing, encouraged more people to move from “welfare-to-work” and reduced fraud. IBM was proceeding diligently to remedy problems. Termination occurred less than three years into a ten-year contract.

Contractors should recognize the threat posed by the Court of Appeals decision in Indiana v. IBM — if it survives review by the Indiana Supreme Court. The appellate decision, if it stands, places an IT contractor at risk of being the guarantor of achievement of the supposed “policy purposes” of such projects, measured by its customer’s subjective “satisfaction.” This is beyond any obligation or risk that a prudent contractor should accept. At the very least, such an outcome would narrow the field of systems integrators willing to take on state IT implementation contracts and would cause those who remain in this market to increase their prices to reflect the greater risk premium. Companies entering into these high-value contracts should take extra care in drafting to manage these liability risks.

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