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Dos and Don'ts when an IT Project is in difficulties

A recent English High Court decision, *De Beers UK v Atos Origin IT Services UK Ltd* [2010] EWHC 3276, provides guidance on addressing issues that may arise when an IT project is in difficulties and what negotiating ploys may or may not be permissible. For a supplier to demand that a contract be repriced on the grounds of "scope creep" and to suspend work when that repricing was not forthcoming, was not permissible. The supplier's conduct amounted to a repudiatory breach leading to termination of the original contract, for which the supplier was held liable in damages in the amount of the cost of procuring a replacement system. On the other hand, a customer temporarily withholding payment of a £300,000 invoice in order to gain a bit of leverage in discussions was (in the circumstances) not a repudiatory breach: provided it was combined with other behaviour which demonstrated a willingness to continue performing its contractual obligations.

The decision, although based on specific contractual terms and underlying facts, also highlights (i) the difficulties in demonstrating a repudiatory breach which justifies termination of the contract, (ii) the risk that the supplier will be held responsible if it has underestimated the complexity of the project due to its own fault, (iii) how delay breaches can be waived by agreeing to reschedule the project, (iv) the concept of "scope creep" and the complexities of proving it, (v) how a deliberate repudiatory breach can be treated as a "deliberate default" to which the limitation of damages clause in the contract did not apply, and (vi) how damages for repudiatory breach can be measured based upon the difference between the cost of implementing a replacement system less what it would have cost to complete the system under the original repudiated contract.

Key Issues

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The Project

The customer, a well known diamond trading company, issued a tender for the provision of a new IT system. Following the tender Atos was selected. After an initial analysis phase was carried out between July and October 2007 on a time and materials basis, a fixed price contract was entered into with the supplier in November 2007, for delivery of the system in June 2008 for about £2.9 million. Various delays took place. In March 2008 the supplier told the customer that they were not able to deliver the system until mid-October 2008.

At about the same time the customer refused to pay a 3 March 2008 invoice for £320,000 claiming they were dissatisfied with delays and the quality of the work and alleging that various key deliverables for milestones had not been met. It was subsequently found by the court that the relevant milestones had been met and that the customer had withheld payment in breach of contract in order to apply pressure.

In May and June 2008 matters escalated. The supplier alleged that progress had been delayed by the customer's lack of cooperation and increases in the scope of the project. They made clear in writing that unless the customer agreed to pay on a time and materials basis about £4.6 million more than the original £2.9 million fixed price, they would suspend all work. The customer refused to agree to do so and the supplier suspended work. The customer accepted that walk out as a repudiatory breach terminating the contract and moved on to obtain an alternative system.

The Negotiating Ploys

The question was whether the withholding of payment or the suspension of work amounted to an intimation of an intention to abandon and refuse performance of the contract, entitling the other party lawfully to terminate and to claim damages. Recent authority had confirmed that the test was:

> *"whether looking at all the circumstances objectively, that is, from the perspective of a reasonable person in the position of the innocent party, the contract breaker has clearly shown an intention to abandon and altogether refuse to perform the contract".*

The judge concluded that the failure to make payment of the £320,000 invoice, while a clear breach of contract, was not a repudiatory breach because, in withholding the money, the customer was not evincing a general intention not to be bound by the terms of the contract. In addition he considered it relevant that, under an express term in the contract, the supplier was given the right to suspend work in the event of a failure to pay a sum due and could also serve a notice of material breach entitling it to terminate if the breach wasn't remedied within 30 days. No such right to suspend had been exercised and no notice had been served.

The judge also noted that the reschedule which had been agreed effectively gave the supplier an extension of time and the customer's implicit acceptance that the supplier had a claim for an extension of time was inconsistent with the assertion that the customer intended not to be bound by the contract.

By contrast, the judge held that, when the supplier suspended work unless and until the contract was renegotiated, it was expressing an intention to complete the work on very different terms, namely a time and materials basis and not a fixed price basis and therefore not upon the terms originally agreed. The supplier was also demanding that the customer agree to waive any claim it may have as regards the past conduct of the project and that again was something upon which the supplier had no right to insist. The fact that the supplier asserted its willingness to complete the project was irrelevant where it was insisting on doing so on its own terms which were not the contract terms but involved an increase in price of £4.6 million.

(i) Difficulties in demonstrating a repudiatory breach which justifies termination of the contract

The supplier alleged against the customer various individual breaches of contract which were claimed, both in themselves and collectively, to amount to a repudiatory breach but the judge held that, while they may constitute breaches, they did not amount to a repudiatory breach justifying the acceptance of the contract as being terminated. Some of the allegations concerned entitlements under the contract and so did not amount to allegations of breach at all. Others involved amounts of less than £20,000 and so were not a basis for a repudiatory breach on the grounds that they were de minimis. Other allegations were found to be overstated. A number of further allegations were technical points and so did not amount to a repudiatory breach (even though they gave rise to a claim of about £59,000). Claims for a total of £300,000 in relation to delays in providing requirements were compensated for by an extension of time and were considered minor in the context of the project as a whole and so not a repudiatory breach. In relation to requests made under the change control procedure, while it was true that the customer took the line that the supplier was not entitled to the majority of the change requests that were made, it did accept some of them and its rejection of others was a position, which it claimed in good faith that it was entitled to take. The judge concluded this did not amount to evidence to support

an allegation that the customer was not prepared to comply with the change control procedure as a whole (that might have amounted to a repudiatory breach). He found that the customer took a different view to the supplier as to how this procedure should be operated, but that was not evidence of an intention not to be bound by the terms of the contract.

It pays therefore to take care, when adopting positions and exercising rights under the contract, to demonstrate that such conduct is taking place within the context and limits of the contractual procedures and not as a complete rejection of such procedures.

(ii) The risk that the supplier will be held responsible if it has underestimated the complexity of the project due to its own fault

The court concluded that the supplier went into this contract with its eyes at least half open as to the risks and the consequent implications for the development of the site both in terms of time and resources. The court concluded that this was not a contract of the utmost good faith and that a reasonable business organisation in the position of the customer having indicated some of its concerns about the supplier's performance during the initial phase was entitled to leave the supplier to assess the risk for itself and to put forward a price that included a realistic contingency in case the project proved more complex than was apparent. However, the court also held that the customer should have learnt that it was absolutely essential that some of its employees had to be made available to the supplier as a matter of priority. The judge held that these features were part of the factual background to the agreement that was entered into.

The court concluded that a reasonable organisation in the supplier's position in October 2007 would have realised that it had only captured the customer's requirements at a high level, that it was likely that a significant amount of information leading to further detailed requirements would emerge and that it would therefore be necessary for an appropriate contingency to be included for this when the final price of the contract was concluded. Given those factors, the court concluded that the supplier had knowingly taken the risk of extra time and resources being required to detail the requirements and could not claim for those.

In contrast, where express assumptions had been included in the contract as to the nature of the project and those provisions had been breached, the supplier was entitled to claim for the extra time and costs arising from those breaches. In particular, the court awarded £125,000-£150,000 in respect of 200 man days incurred by the supplier because of the breach of an assumption that there were no significant differences between the requirements of different countries in which the customer operated.

In relation to the customer, the court concluded that it was on notice of the fact that the initial phase had not fully achieved its objective and that the supplier might still not have grasped the full complexity of the customer's processes. This made it incumbent on the customer to ensure that key personnel were available during the life of the contract.

(iii) Claims for Delay

In April 2008, the customer agreed a revision of the project programme which put back the dates of delivery. The court held that this reschedule effectively compromised and waived any mutual claims for the delay to that date. However it also considered the claims for delay without regard to the reschedule.

The court found there were five reasons for the delays (as is the case in many such projects) and attributed responsibility as follows:

1. Change requests and the change in a scope particularly in relation to a process called Splitting. The customer was responsible for this.

2. Additional work for the elaboration of the high level requirements which did not amount to changes in scope. The supplier was responsible for this, as discussed above.

3. Failures and delays by the customer in finalising the requirements. The customer was responsible for this.

4. Errors in the design of the system such as a lack of proper systems analysis (in this context it was alleged that the agile style of development was not working and there was a need for system analysis and the waterfall style of development), delays in producing reference architecture and delay in introducing a workflow engine. The supplier was responsible for these.

5. Lack of effective communication between the supplier and its India affiliate. The supplier was responsible for this.

The Change Request for Splitting, for which the customer was responsible in seeking a change, was not agreed in relation to time. Accordingly time for completion of the Splitting change was at large and the court held that the supplier's only obligation in relation to the delivery of Splitting was to achieve it within a reasonable time.

The Splitting Change Request, for which the customer was responsible and the other causes of delay for which the supplier were responsible were both affecting the completion date. Each party was therefore responsible for delay to the critical path to completion and these causes were operating concurrently.

The court explained the general position in construction and engineering cases that, where there is concurrent delay to completion caused by acts for which both employer and contractor are responsible, the contractor is entitled to an extension of time but it cannot recover in respect of the loss caused by the delay. In the case of the former, this was because the rule where the delay is caused by the employer is that not only must the contractor complete within a reasonable time but also the contractor must have a reasonable time within which to complete. It therefore does not matter if the contractor would have been unable to complete by the contractual completion date if there had been no breaches of contract by the employer (or other events which entitle the contractor to an extension of time) because it is entitled to have a time within which to complete which the contract allows or which the employer's conduct has made reasonably necessary. By contrast the contractor cannot recover damages for delay in circumstances where it would have suffered exactly the same loss as a result of causes within its control for which it is contractually responsible.

The court held that this meant that as things stood at the date of termination the supplier would have been entitled to an extension of time until mid-December 2008, but it would not have been entitled to recover the prolongation costs consequent upon the delay up to that date.

This analysis can be applied to other projects where delay has arisen, although inevitably the fact pattern and contractual framework in each project will be different and this would need to be considered in each case separately.

(iv) "Scope Creep" and how you prove it

The supplier alleged that the customer had breached the contract in introducing changes in the scope of the project both in introducing direct on their face changes, such as the Change Request for Splitting referred to above, and in introducing indirect change by what is called "Scope Creep". Expert evidence was give on these two types of change. The first type, described as a change in breadth, was explained as changes that introduced functionality that was clearly outside the scope of the project when it was planned. The second type of change added scale or complexity to work that was legitimately envisaged on the basis of the stated requirements. They did not extend the required functionality into wholly new areas and so could not be said to amount to a clear change in scope but the added scale or complexity could be costly to implement. The second type was referred to as a change in depth or as scope creep.

The judge noted that allegations of scope creep were often contentious because the customer may have understood the complexity from the start and assumed that the supplier did too, whereas the supplier may legitimately have understood the requirement to be something far simpler than it turned out the business actually needed.

A test for the second type of scope increase was claimed by the supplier's expert to be: "Is there a reasonable solution that meets the stated high level requirement and at a significantly lower cost or effort than the minimum solution that would meet the business requirements as revealed by a detailed analysis". If the answer was yes, the additional complexity could be claimed to be a scope change of the second type. If it was material then it was claimed it should be the subject of formal change management.

The judge did not accept that the test proposed was necessarily appropriate for anything other than the most straightforward cases. The judge concluded that the only test to apply was one specific to the project in question.

The judge commented that, even applying the test proposed by the expert, the expert had failed to identify a reasonable lesser solution in the present case that would have met the high level requirements that existed at the time the contract was made. In the absence of being able to identify a lesser solution, he concluded the supplier had not overcome the burden of proof to establish scope creep. He also concluded that if a business process could be said to fall within an activity described in one of the requirement definition documents, then it was likely to be within scope. Applying this type of approach is likely to assist a customer seeking to defend allegations of scope creep.

He concluded that an elaboration of the requirements that had been identified in headline form was something that the contract required to be done and consequently did not represent a change in scope. In the circumstances of that project, he did not think that there was some identifiable other reasonable minimum solution that a supplier could legitimately assume would meet the requirements and therefore the solution that was detailed was the only solution.

It is illustrative in terms of demonstrating the nature of the breaches and how the court addressed them to review a few of the many detailed claims by the supplier of breaches by the customer in relation to the conduct of the project. This shows how so much depends on a party being able to demonstrate and prove its case by reference to time sheets and other supporting evidence.

By way of example, the judge awarded £125,000-£150,000 in respect of 200 man days incurred because of breach of an assumption that there were no significant differences between each country's requirements but rejected a claim alleging breach of an assumption that bandwidth would be of a certain nature.

Equally the judge allowed a claim for £17,000 arising out of the fact that the requirements of the finance department were not signed off until 9 April 2008.

An allegation which was more evenly balanced was one that the introduction of an electronic data store constituted a breach of the agreement. The customer argued that they introduced it in order to make it easier for the supplier to interface with the other parts of the legacy systems and reduce integration complexity. No complaint was made by the supplier at the time the data store was created and the judge rejected the claim finding that the introduction of the data store was not a breach of contract.

Another claim was made for loss alleged to have arisen by reason of the unavailability of the customer's staff. However the judge held that he found it difficult to disentangle the time spent on further elaboration of the requirements, which was for the supplier's account as not being an increase in the scope of work, and additional time spent arising by reason of unavailability of staff. He concluded the supplier had a claim for only a portion of the extra costs, to the value of £50-100,000. This showed the need for supporting records.

A claim was made for eight business analysts brought on to the project additionally. The judge concluded that the need for these was because the supplier had significantly underestimated the complexity of the customer's processes and that the responsibility for that underestimate which one which very broadly was to be borne by the supplier.

There was a further claim for lack of ready access to the system and the judge allowed £20,000 for that. The judge also allowed £10,000 for delays in providing a list of information about devices and peripherals.

A further claim was made for an alleged 130 man days wasted between September and December 2007 because of failure to provide access and make available the customer's resources. The judge concluded that it was difficult to separate out time which had been wasted from that which was attributable to the increased complexity of the requirements and allowed only a portion of the claim: £25,000 to £50,000.

(v) a deliberate repudiatory breach can be treated as wilful default to which the limitation of damages clause may not apply

The amount of damages claimed was less than the limit in the limitation clause in the contract so the clause did not bite. However the judge ruled in any event that, in committing a repudiatory breach of the contract, the supplier knew that the course upon which it had embarked would amount to a breach of contract. The judge therefore concluded that the supplier had committed the breach of contract deliberately and that this amounted to both wilful and deliberate default, events that were expressly excluded from the impact of the limitation clause.

(vi) measuring damages for a repudiatory breach leading to termination of a contract.

As a starting point, such damages can be measured as the difference between the cost of implementing a replacement system less what it would have cost to complete the system under the original repudiated contract.

The judge held that the customer was in principle entitled to recover the costs of procuring a replacement system and calculated these by reference to the costs associated with the work in modifying its legacy systems, the staff costs in giving ongoing support to the legacy and the cost of rebuilding the replacement system and this came to about £4.4 million. The customer's loss needed to take into account sums which it would have had to pay if the contract had been performed in full and these included the remaining milestone payments which would have been payable, the valuations of the two change requests where figures had been agreed and the amount in which the supplier's other unresolved or disputed claims would have been valued or compromised in the round.

In that context the court concluded that neither party would probably have had a claim against the other in respect of the delays to completion, but various other adjustments were allowed in respect of alleged breaches.

As the court had concluded that the supplier was entitled to an extension of time because the delays had been caused in part by the customer, when considering the customer's loss, the customer was not entitled to any sum in respect of an accrued liability for damages for delay and the supplier was not entitled to a deduction in respect of any claim for prolongation costs.

Conclusion

In conclusion, although the decision in De Beers v Atos rests on its particular facts, the judge's approach confirms how difficult it can be for a supplier to establish a repudiatory breach justifying termination, and serves as a warning that suppliers should be sure of their contractual ground before taking action such as suspending work even if their customer has committed a clear breach of contract.