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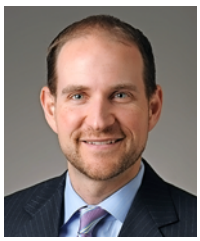
INSIGHT: Common Legal Issues and Recent Decisions in Software Development and Implementation Disputes


By Paul E. Veith, Chad Schafer, and Christopher Y. Lee

In today's competitive and technology-driven world, companies, governments, and large institutions often look to improve their operations by upgrading software systems. Software implementation projects can be ''bet the company'' exercises costing tens or even hundreds of millions of dollars and requiring an enormous amount of energy and human resources. These projects often involve efforts to deploy ''enterprise'' or ''ERP'' software solutions, such as those sold by SAP and Oracle, or non-ERP software (of either off-the-shelf or custom products) tailored for particular industries.

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Large-scale software development and implementation projects often experience significant challenges and cost overruns, some of which can lead companies to abandon projects before completion. Failing or struggling IT projects can wreak havoc with the business and operations of customers, software developers, system integrators, and consultants who work on these projects. Not surprisingly, disputes between customers and vendors occasionally lead to litigation or private arbitration. Every such dispute is unique because the facts of each troubled project are unique, but this article discusses claims and defenses that commonly arise in these disputes as well as recent cases addressing these issues.

I. Alleged Fraud or Misrepresentation on the Part of Vendors

A. Misrepresenting Software's Functionality

Customers suing a software vendor frequently claim that the vendor – anxious to make a sale – misrepresented the software's functionality. For example, in a case against IBM, a customer alleged that IBM promised the software was ''preconfigured'' in a specific way that met the customer's needs even though the software did not have such functionality. *IBM Corp. v. Lufkin Indus., Inc.*, 2017 WL 2962836, at *1, 5 (Tex. Ct. of App., Jul. 12, 2017). After a trial, a Texas jury awarded the customer more than $23 million in damages. *Id.* at *3. On appeal, the court reduced the damages, but held that the evidence supported the jury's finding on the fraudulent inducement claim because IBM's relevant repre-

sentations to the customers were contradicted by internal emails between IBM employees. *Id.* at *5.

Similarly, a customer asserted a fraud claim against a consulting firm that designs and implements SAP-based ERP software, arguing that the firm's statement that it had '' 'ALL the information to identify 100% [of the customer's legacy software program's] functionality,' '' was false. *Copart, Inc. v. Sparta Consulting, Inc.*, 277 F. Supp. 3d 1127, 1149-50 (E.D. Calif. 2017). The customer survived a motion for summary judgment on the claim, and a jury later awarded it more than $20 million in damages.

Where a customer is uncertain whether it can prove that vendors made false statements *intentionally*, it can seek instead to prove *negligent* misrepresentation. *BHC Dev., L.C., v. Bally Gaming, Inc.*, 985 F. Supp. 2d 1276, 1280, 1288-89 (D. Kan. 2013) (granting software vendor summary judgment motion on fraud claim, but denying same motion on negligent misrepresentation claim); *see also Superior Edge, Inc. v. Monsanto Co.*, 44 F. Supp. 3d 890, 902-3 (D. Minn. 2014).

B. Misrepresenting a Vendor's Capabilities

In the sales process, vendors are often quick to tout experience implementing a particular application, and the expertise, depth, and skill level of those they intend to staff on the project. Where the vendor's performance lags and a project experiences problems, customers often claim they were duped into selecting the vendor based on the vendor's representations. In a federal case filed in Hawaii, a customer's fraudulent inducement claims survived a motion to dismiss where the customer alleged that the software vendor falsely represented that it had been designated an ''Oracle Platinum Partner'' and stated on its website that it was an Oracle ''expert.'' *Servco Pacific Inc., v. SkyBridge Global, Inc.*, 2016 WL 6996987, at *8 (D. Hawaii Nov. 29, 2016). Similarly, a court denied a software vendor's motion for summary judgment where the customer alleged that the vendor ''claimed to be implementing a similar project for one of [the customer's] primary competitors,'' but the customer ''[l]ater. . .learned that the project was of much more limited scope, and was in fact just getting off the ground [ ][and] was also a gigantic failure.'' *America's Collectibles Network, Inc. v. Sterling Commerce (America), Inc.*, 2016 WL 9132294, at *15 (E.D. Tenn. Sept. 7, 2016).

C. Defenses to Misrepresentation Claims

In many jurisdictions, a defendant's first line of defense to a fraud claim is to challenge the claim as not having been pleaded with enough particularity. Generalized allegations that a software vendor told the customer the project would be a success or would improve the customer's business are insufficient. For example, a California federal court dismissed fraud claims where the customer's complaint ''does not point to any misrepresentations and identifies only examples of how the product does not work. . . [and] [t]he global representation that can be discerned is only 'the product did not work as promised,'. . . This is not pleading fraud with particularity.'' *Grouse River Outfitters Ltd. v. NetSuite, Inc.*, 2016 WL 5930273, at *10 (N.D. Cal. Oct. 12, 2016). *But see*, *e.g.*, *Edge Adhesives, Inc. v. Sharpe Concepts, LLC*, 2015 WL 12743618, at *4 (N.D. Tex. Aug. 31, 2015) (noting that the pleading requirements for negligent misrepresentation claims under Texas law are lower than the federal pleading standard for fraud).

Similarly, statements of opinion or puffery on the software vendor's part generally cannot support misrepresentation claims. *See Fagan Holdings, Inc. v. Thinkware, Inc.*, 750 F. Supp. 2d 820, 833 (S.D. Tex. 2010) (summary judgment granted to defendant on fraudulent misrepresentation claim based on vendor's statements that the software would make the customer's business ''easier and allow them to serve their clients better'' because these statements were ''opinion[s] on which [the customer] would be expected to exercise its own judgment after receiving all of the Software demonstrations''). Vendors also have defeated fraudulent inducement claims by demonstrating that the alleged misrepresentations were merely promises to perform under the contract, which do not create a separate legal duty. *See*, *e.g.*, *PetEdge, Inc. v. Garg*, 234 F. Supp. 3d 477, 491-92 (S.D.N.Y. 2017).

II. Breach of Contract Claims

A. Customer Alleging Breach

Parties often document software development and implementation projects in detailed written contracts – and sometimes a *series* of detailed contracts that include an umbrella license and service agreement with multiple statements of work, including or incorporating a project plan or schedule for the implementation. A federal court in Hawaii allowed a breach of contract claim to proceed based on a failure to deliver the software on time where the project plan or schedule contained in the agreement was sufficiently specific. *See Servco*, 2016 WL 6996987, at *6 (denying motion to dismiss where customer alleged vendor failed to meet contractual obligations to ''[d]evelop and maintain the project plan,'' ''manage day to day project tasks,'' and ''make sure tasks were being delivered on time and quality.''); *Grouse*, 2016 WL 5930273, at *11-13 (denying motion to dismiss where contract specified that vendor would deliver and implement software by a particular time). The viability and strength of potential claims by a customer under a software project contract demands both a careful analysis of the language of the contract *and* a deep understanding of the parties' course of performance under the contract.

B. Vendor Defenses to Breach of Contract Claims

Contracts governing software implementations often contain disclaimers and limitations of liability and damages that favor vendors because vendors typically write the contracts. For example, the Sixth Circuit affirmed summary judgment in favor of a vendor by upholding the contract's express disclaimer of warranty provision and a provision requiring that all claims be filed within a two-year limitations period. *Irwin Seating Co., v. IBM Corp.*, 306 F. App'x 239, 245-6 (6th Cir. 2009). Vendors also frequently include language in contracts that assigns responsibilities to the customer, essentially documenting the assumptions that the vendor made in promising performance. For example, vendors may insist that customers promise to make qualified personnel available to assist on the project, that the scope of the project be altered only pursuant to a change-control process, and that the customer pledge not to take any action to adversely impact project schedule, staffing, and costs. Whether or not the customer met its own contractual responsibilities often becomes the principal focus of the defense to a breach of contract claim in a software implementation case.

Finally, software vendors can defeat breach of contract claims by demonstrating the customer ''accepted'' the vendor's deliverables. Contracts frequently contain provisions stating that a customer ''accepts'' the vendor's deliverables if the customer fails to reject them after a certain time. For example, a court found that the customer's ''acceptance'' of certain milestones waived its right to sue for defects in the deliverables where the contract required the customer to ''provide a notice of non-acceptance'' if any of the vendor's deliverables ''fail[ed] to satisfy the Acceptance Criteria'' set forth in the contract. *Copart*, 277 F. Supp. 3d at 1142-3.

III. Breach of Implied Covenant of Good Faith and Fair Dealing

Customers also often allege that a software vendor violated the implied covenant of good faith and fair dealing. In some states, the law implies a duty of good faith and fair dealing in all contracts, which essentially prevents either party from acting to destroy or injure another party's right to receive the benefits of the contract. Customers often claim that vendors violate this duty by failing to provide a software system that functions in the way the customer intended. But the implied covenant may *not* be cited simply to reformulate a breach of contract claim. *See*, *e.g.*, *Hatteras Press, Inc. v. Avanti Computer Sys. Ltd.*, 2017 WL 2838349, at *4-5 (D.N.J. June 30, 2017). Nor can a claim of a breach of the implied covenant create a substantive duty beyond that expressly required by the contract. *See*, *e.g.*, *Ronpak, Inc. v. Electronics for Imaging, Inc.*, 2015 WL 179560, at *6 (N.D. Cal. Jan. 14, 2015). And, in some jurisdictions, the implied covenant is limited to certain contexts. *See*, *e.g.*, *Servco*, 2016 WL 6996987 at *7 (dismissing claims because ''the tort of breach of the covenant of good faith and fair dealing has not been recognized in Hawaii outside of the insurance context'').

Notably, vendors occasionally bring counterclaims for breach of this duty on the part of the customer. For example, a court denied summary judgment to a customer on a vendor's counterclaims where the vendor alleged the customer ''fail[ed] to provide the cooperation necessary for the implementation of the [software contract],'' including by ''chang[ing the] scope of the project through numerous customization requests, the lack of engagement from [the customer's] employees, and an unreasonable timeline for completion that effectively ensured [the vendor's] failure.'' *First Niagara Bank N.A. v. Mortgage Builder Software, Inc.*, 2016 WL 2962817, at *7 (W.D.N.Y. May 23, 2016).

IV. Violations of Consumer Protection Statutes

Finally, customers often bring tagalong claims under state consumer fraud or protection statutes, which typically prohibit fraud and deception. The reason to add these claims is that they often provide the prevailing party with the statutory right to recover attorneys' fees or enhanced damages. In addition to standard defenses to such claims, where customers are sophisticated parties, courts have held that such statutes are inapplicable. *See*, *e.g.*, *Irwin Seating Co. v. IBM Corp.*, 2005 WL 1475390, at *11 (W.D. Mich. June 22, 2005) (dismissing claims under the Colorado Consumer Protection Act because the customer was a sophisticated party).

V. Conclusion

Large-scale software implementation is expensive and extraordinarily demanding of a company's time and resources. Where projects struggle or fail, the costs can be enormous. Beyond losing money and the opportunity to deploy human resources elsewhere, companies with troubled or failed projects lose time and competitive advantages and fail to realize anticipated efficiencies and improvements to business operations. Attorneys representing clients implementing large-scale enterprise software would be well-advised to understand the nature of the claims that arise when and if the projects fail. Having a level of understanding will help attorneys in negotiating contract terms, in counseling clients during the course of performance of contracts, and – if a project becomes troubled – in navigating to the best result available under the circumstances.