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TO: GRO Kevin CORRIGAN COMPANY:POCL

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DEC -1 11:01

Date 1st December, 1998

Document number CA983350.042

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Total pages (inc. this) 9

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LITIGATION PRIVILEGE**

To: Robert Ricks HMT

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Adam Sharples HMT
David Sibbick DTI

From: Jonathan Evans POCL

30th November 1998

**BA/POCL AUTOMATION PROGRAMME:
STRATEGY IN THE EVENT OF A DECISION TO TERMINATE**

As agreed at the Progress Tracking Group on Friday, I attach our submission for consideration by the Law Officers.

We understand that a submission is being prepared by Hamish Sandison on behalf of DSS. We should point out that he has not been instructed to do this in his capacity as programme lawyer.

Jonathan Evans

Network Director
Post Office Counters Ltd

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POCL/DSS/ICL PATHWAY

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TERMINATION STRATEGY

A. DOCUMENTATION

We understand that Law Officers will have access to copies of the following agreements dated 15th May, 1996:-

"Authorities Agreement" among DSS, Post Office Counters Ltd. ("POCL") and Pathway Group Limited ("Pathway");

"DSS Agreement" between DSS and Pathway;

"POCL Agreement" between POCL and Pathway;

"Contract A" between DSS and POCL; and

"Contract B" between DSS and POCL.

The Authorities Agreement, DSS Agreement and POCL Agreement are together referred to as the "Related Agreements". They govern the contractual relationship of the parties in relation to delivery of the Horizon Programme.

Contract A governs the provision of benefit encashment services by POCL to DSS. Contract B governs certain aspects of the contractual relationship between POCL and DSS as it relates to the Related Agreements.

B. BACKGROUND

The Horizon programme is well behind schedule and negotiations have been taking place among the parties with a view to agreeing terms under which the programme can be continued and the Horizon system duly delivered. Pathway has to date requested very significant enhancements to the Related Agreements as a price for continuing with the programme and negotiations have proved difficult.

Should the parties fail to reach a negotiated settlement, ministers may wish to take steps to bring the contracts to an end. Legal advice has been sought as to the best way of achieving termination.

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C. RELEVANT CRITERIA

The following criteria have been applied in seeking advice:-

- (i) ministers will wish to avoid engaging in time-consuming, expensive and messy litigation if possible;
- (ii) ministers will wish to avoid either of the public sector parties (the "Authorities") being liable in damages to Pathway for wrongful termination;
- (iii) if a decision to terminate is made, Ministers would prefer to terminate quickly, both for political reasons and to stem the ongoing costs of continuing with the programme.

D. RISK FACTOR

The major risk factor to be borne in mind when considering termination of the Related Agreements is the risk that Pathway may successfully sue the Authorities for wrongful termination of the Related Agreements or successfully allege that termination fell into the contractual category of "termination for convenience" rather than termination for Pathway's breach. In either case, the result would be a liability for the Authorities to pay to Pathway compensation measured in hundreds of millions of pounds.

A claim for wrongful termination is, therefore, something to be avoided and any political desires around termination have to be weighed against this risk.

E. GROUND FOR TERMINATION

Under the Related Agreements Pathway is obliged to achieve certain contractual milestones. One is to achieve acceptance of Operational Trial by November 1997. That milestone has not yet been reached and this failure gives the Authorities grounds on which they are entitled to terminate the Related Agreements.

In order to terminate the Authorities Agreement, DSS and POCL have to act jointly. In addition, under paragraph 3 of Schedule 18 to Contract B neither Authority is entitled to terminate its separate agreement with Pathway without the consent of the other (except in circumstances which are not likely to apply).

The fact that there is a valid ground to terminate does not mean that Pathway will not allege that responsibility for the delay lies with the Authorities and that the Authorities are, therefore, liable in damages to Pathway. Indeed, such an allegation is a virtually certain consequence of the Authorities taking steps to terminate.

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F. LEADING COUNSEL'S ADVICE

Slaughter and May, acting for POCL, have sought the advice of leading Counsel, Nicholas Strauss Q.C., as to the best way to terminate the Related Agreements should ministers decide to take that step.

Counsel has advised that in order to achieve termination it will be necessary for the Authorities to serve notice on Pathway making time of the essence. Provision for a time of the essence notice is made in clause 902.2.3 of each of the Related Agreements.

Counsel for POCL and for DSS have both agreed, in their discussion on 22nd October, 1998, that it is not possible safely to terminate the Related Agreements with immediate effect without a significant risk of the Authorities being in breach of contract.

The appropriate duration of a time of the essence notice has been the subject of some debate. Counsel have advised that it should be a reasonable period for Pathway to achieve acceptance of Operational Trial. That currently points to a period of around nine months on the basis of the current indicative timetable.

Proceeding to terminate without giving a time of the essence notice would give rise to a serious risk of the Authorities being held to have acted in breach of contract, which could, in turn, give rise to a liability for damages of hundreds of millions of pounds.

It is important to bear in mind that if a nine month time of the essence notice is served on Pathway that does not necessarily mean that the Related Agreements will continue for the full period of that notice. Faced with the prospect of continuing to spend what we understand to be around £10 million a month without any certainty that the system will be accepted at the end of that period (and aware that, even if the system is accepted, the contract will be unprofitable to Pathway) we think that it is likely that Pathway would be forced to walk away from the Related Agreements at a much earlier date. This is all the more likely given Pathway's current financial position and the law relating to trading whilst insolvent.

G. THE DSS VIEW

DSS are concerned that once ministers have decided to terminate it would be preferable to terminate as soon as possible. This would be politically more attractive and would save DSS the cost of continuing with the programme.

DSS's view is that it is not necessary to serve a time of the essence notice at all. Instead termination may be effected under Schedule C5 of the Related Agreements. This, according to DSS, requires the service of a "thirteen week notice" under Schedule C5. Such a notice was served by DSS back in May 1998. Accordingly, DSS

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argues that it can now terminate immediately, whereas POCL first has to serve a "thirteen week notice".

DSS also argues that, rather than serve a thirteen week notice, POCL could simply wait for DSS to terminate on immediate notice under Schedule C5 and then itself terminate, not on the grounds of delay but simply on the grounds that DSS has terminated (which entitles POCL to terminate under clause 902.10 of the Authorities Agreement).

H. POCL's ARGUMENTS AGAINST THE DSS VIEW

POCL's concerns in relation to the DSS's arguments for the Schedule C5 route and the clause 902.10 "Piggy-back" option are as follows:-

SCHEDULE C5

There is no "thirteen week notice" requirement in Schedule C5. What Schedule C5 says is that if Acceptance of the Operational Trial is delayed, because of Pathway's default, for more than 13 weeks, then the Authorities are entitled to terminate. The right is an immediate right which arises when, as a result of Pathway's default, acceptance is more than 13 weeks overdue. Nothing in Schedule C5 requires any period of notice to be given.

Acceptance is clearly much more than 13 weeks overdue. On the assumption that Pathway is responsible for the delay one might reasonably consider, at first blush, that the Related Agreements are therefore now terminable by immediate notice. However, there are four main arguments against this view:-

(a) Contractual Interpretation

The contracts provide a number of different routes to achieve termination. One route is under clauses 402.6.2.3 and 902.2, which requires the giving of a "time of the essence" notice. Another is the schedule C5 route, which does not expressly require such a notice. DSS's argument rests on the assumption that one can terminate under the schedule C5 route and effectively ignore the time of the essence requirement in Clause 402.6.2.3. Though arguable, Counsel have advised that this is a dangerous argument. They think that there is a significant risk that a court will regard the time of the essence requirement under 402.6.2.3 and 902.2 as one which the Authorities are not entitled to ignore but must comply with. Indeed they have described that view as the more credible.

(b) Waiver

Since 21st November, 1997 (the date for acceptance of the Operational Trial) Pathway has continued to work under the Related Agreements under what has

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effectively been an open-ended extension of time. In the circumstances it is likely that a court would hold that, regardless of their stated reservations of rights, the Authorities have effectively waived their rights to terminate the Related Agreements without now giving a further reasonable time for completion of the Operational Trial.

Counsel do not believe that the DSS has effectively protected its position in this regard by its so-called thirteen week notice served back in May 1998.

(c) Burden of Proof

If the Authorities were to seek to terminate by immediate notice (or thirteen weeks' notice) under Schedule C5 they would have the burden of proving that the delay was due to Pathway's default. Although there appears to be some confidence that this burden can be discharged it is dangerous to be too confident before we have seen Pathway's allegations and evidence in their pleadings.

(d) Pathway's likely reaction

If the Authorities were to seek to terminate by immediate (or thirteen weeks') notice under Schedule C5 there is every likelihood that Pathway would serve a writ alleging wrongful termination (or, effectively, describing the Authorities' action as termination for convenience) and accordingly claim hundreds of millions of pounds in damages.

If instead the Authorities were to serve a reasonable time of the essence notice it would be much more difficult for Pathway to claim that the Authorities had terminated. Indeed, in these circumstances Pathway may well be forced to walk away, placing the Authorities in a much stronger position in any litigation, for the following reasons:

- (i) Pathway would have the burden of proving that the Authorities were in repudiatory breach of the Agreements, which would be fairly difficult;
- (ii) assuming Pathway failed to carry out its contractual obligations and failed to establish repudiatory breach by the Authorities, there should be relatively little argument about the Authorities' right to bring the contract to an end.

These are all fairly technical arguments but our view is that they argue strongly in favour of giving the time of the essence notice of nine months (or whatever is established as a reasonable period to achieve Acceptance of the Operational Trial), especially when one bears in mind the unlikelihood of Pathway continuing with the contracts for the full period of the notice.

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CLAUSE 902.10 "PIGGY-BACK" OPTION

The risk of POCL relying on its right to terminate under clause 902.10 as a result of DSS terminating is that Pathway may successfully allege that DSS was not entitled to terminate without further notice under Schedule C5, and therefore that its termination amounted to termination for convenience. In those circumstances Clause 902.10 expressly provides that POCL's termination under 902.10 will also be treated as termination for convenience, thus exposing POCL to the same claim for damages.

To put it another way, if DSS's termination were wrongful, POCL's would be wrongful too.

I. DSS'S ARGUMENTS AGAINST THE POCL VIEW

The DSS argues that the giving of a time of the essence notice is unnecessary. Its arguments as to why it is an undesirable route for the DSS are, however, political and financial rather than legal. There are three arguments of which we are aware:-

(a) "Risk" of Programme Success

DSS argues that if a nine month time of the essence notice is served there is a "risk" that Pathway might successfully achieve the deadline set, so that at the end of the nine month period the Related Agreements would not be capable of termination.

(b) Costs of Continuing

DSS argues that to give a time of the essence notice would involve continuing to incur the costs of managing the programme throughout the period of notice.

(c) Publicity

DSS argues that if it were to give a time of the essence notice it would not yet be able to make a public announcement to the effect that ministers were terminating the Related Agreements.

J. POCL'S REBUTTALS OF DSS'S ARGUMENTS AGAINST THE POCL VIEW

POCL responds to these DSS arguments as follows:-

(a) "Risk" of Programme Success

Against the background of the current negotiations POCL considers it virtually inconceivable that, if those negotiations broke down and nothing further were offered to Pathway, Pathway would simply go ahead with the programme and achieve acceptance of Operational Trial.

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Pathway has made it clear that it would not be able to proceed with the programme even with the public sector concessions which have been offered to date. In particular, Pathway has made it clear that it could not continue to commit £10 million a month to the programme without significantly greater concessions than have been made to date over commercial terms, acceptance issues and its funding requirements. To suggest that if all the current concessions were taken off the table Pathway would then knuckle down to spending £10 million a month to arrive at what at worst would be a failure to achieve acceptance (so throwing away a further £90 million for nothing and still suffering termination) and at best would be achieving acceptance and so perpetuating a heavily loss-making contract, appears somewhat fanciful.

It may be suggested that Pathway could continue to work on the programme throughout the nine month period on the assumption that it could ultimately be funded by a damages claim against the Authorities. We have seen no evidence that Pathway considers its case to be sufficiently strong to justify such action, in the light of Pathway's current financial condition.

In any case, POCL would argue that the prospect, however fanciful, of Pathway achieving acceptance within nine months without any contractual concessions from the public sector would be something to be warmly welcomed, not treated as an unacceptable "risk".

(b) Costs of Continuing

For the reasons stated above, it is unrealistic to assume that the giving of a nine month time of the essence notice would result in work on the programme actually continuing for that nine month period. It is far more likely that Pathway would be forced to bring the contract to an end much earlier. The alternative for Pathway would be to spend a further £90 million or so without much greater certainty that the Related Agreements would not in any case be terminated for failure to achieve acceptance of Operational Trial in nine months' time. That would, for Pathway, amount to throwing good money after bad. In any case, continuing the contract would cost Pathway a great deal more than it would cost DSS.

DSS should thus weigh the small risk of having to continue to incur such costs against the greater risk of being sued for a much greater sum on the grounds of wrongful termination.

(c) Publicity

It is accepted that if a time of the essence notice is served on Pathway it would be wrong for the Government to issue a press release saying that the Related Agreements were being terminated. However, it would be possible (subject to contractual confidentiality restraints) to announce that Pathway had been given

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a notice to complete by a specified deadline and that the Authorities had reserved the right to terminate upon failure to meet that deadline. It is suggested that such an announcement would in practice have materially the same effect as an announcement that ministers had decided to terminate the Related Agreements.

In any case it is suggested that the nature of the announcement should be determined by the route which ministers choose to take and not vice versa.

K. CST LETTER

It is suggested that the Chief Secretary of the Treasury need not send a substantive letter to Pathway should POCL's proposal of sending a time of the essence notice be adopted. All he would need to do would be to indicate his regret that negotiations had broken down and to inform Pathway that it might expect to hear further from the Authorities in due course.

The Chief Secretary could suggest to Pathway that it would be better to negotiate an agreed basis for termination rather than indulge in litigation. Our view is that that would not be appropriate. It is almost inevitable that the parties will seek to negotiate and in the event that Pathway wished to litigate rather than negotiate such a suggestion is unlikely to deter it. Indeed, it may even encourage Pathway, if Pathway were to interpret such a suggestion as a sign of weakness. This is, however, more a question of tactics than substantive risk.

Slaughter and May (JRT)
30th November, 1998

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