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From the Legal Adviser

Hamish Sandison Esq
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11 December 1998

Dear Hamish

HORIZON: BA/POCL

I attach a copy of a letter of today's date from Richard Heaton, Legal Secretariat to the Law Officers, which records the Solicitor General's views. Also enclosed is a copy of a note from Treasury Counsel Jonathan Crow.

2. May I draw to your attention and to the attention of copy addressees the convention that Law Officers' advice (or the fact that it has been obtained) should not be disclosed outside Government, other than, in this case, the public sector parties and their representatives who need to see it.

Yours sincerely

GRO

R N RICKS

Copy addressees as attached

Hamish Sandison Bird and Bird
(Please copy to Catherine Milton - Bird and Birc
Jeff Triggs Slaughter and May
(Please copy to N Gray -Slaughter and May)
Sarah Graham - DSS
Ron Powell DSS
Clive Osborne - DTI Solicitors
Catherine Churchard - Post Office
Jonathan Evans - Post Office
David Sibbick Director Post DTI
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Geoff Mulgan - No.10 Policy Unit
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11 December 1998

Dear Robert

HORIZON PROJECT

The Solicitor General has now considered this matter, and I am writing to record his views. As you know, he has had the benefit of advice from Jonathan Crow, Treasury counsel (copy attached). The Solicitor General broadly endorses Treasury counsel's reasoning, and would add the following observations.

Introduction

2. The Solicitor General, like Treasury counsel, believes that there is no clearly correct contractual construction favouring the DSS or the POCL approach. Both are respectable. While the DSS approach (if it operates successfully) offers the quickest get-out should Ministers be determined to terminate the contract, it also carries the greater risk of ICL Pathway alleging breach of contract and engaging the public sector parties in uncertain and expensive litigation. On the other hand, the POCL approach is slower, deprives the public sector parties of the element of control, but is legally safer.

Construction of the Authorities Agreement

3. The Solicitor General has seen extracts from the Authorities Agreement (but not from the DSS agreement or the POCL agreement). That Agreement contains a crucial contradiction in how it sets out the parties' right to terminate. The Solicitor notes the guidance offered by Lord Hoffmann in *ICS v West Bromwich BS* [1998] 1 All ER 98, at 115. The words of a contract must be given their natural and ordinary meaning. But where something has gone wrong with the language of a contract, the law does not require judges to attribute to the parties an intention which they plainly could not have had.

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4. In interpreting this aspect of the Agreement, the natural place to start is clause 902 ("Termination of Authorities Agreement"). This sets out a variety of methods for determination such as insolvency, default which the contractor fails to remedy after a period of notice, non-performance of obligations specified in a time-of-the-essence notice (clause 902.2.3) and twelve months notice.

5. Clause 902.1.5 preserves termination provisions elsewhere in the Agreement. One such provision is clause 402.6.2, which allows for termination in relation to the operational trial, although this (with circularity) requires termination in accordance with clause 902.2. But clause 402.13 provides that "in relation to failure of the operational trial system successfully to complete the operational trial", notwithstanding clause 402.6.2, the Authorities must terminate in accordance with schedules A7 and C5.

6. Despite suggestions to the contrary, the Solicitor General does not regard clause 402.13 as having any independent standing. In other words, it is not a termination clause in itself.

7. Schedule C5, to which clause 402.13 refers, provides in paragraph 4.4 that if acceptance of the operational trial is delayed because of Pathway's default for more than thirteen weeks, the Authorities can terminate. That paragraph refers to clause 902.1.5, which indicates that paragraph 4.4 is an independent determination provision of the Agreement.

8. Here, however, is an apparent contradiction. One provision (clause 402.6) says that "time of the essence" is the route to termination in the event of an unsuccessful operational trial. Another provision (paragraph 4.4 of schedule C5) says that delay in acceptance of the operational trial because of Pathway's default for more than thirteen weeks entitles the Authorities to terminate.

9. It has been suggested that the provisions may be reconciled if the time of the essence notice can only be triggered after the thirteen week termination period has elapsed. Another way of reconciling the provisions, suggested by Treasury counsel, is to treat paragraph 4.4 as a particular instance of operational trial failure, namely, operation of trial failure arising from Pathway's default. But even this, in the Solicitor General's opinion, is not entirely convincing.

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Termination under Schedule C5 (the DSS approach)

10. Whatever reconciliation is preferred, the Solicitor General regards it as important that the termination route preferred by DSS requires "that acceptance of the operational trial is delayed *because of the contractor's default*". A key point, therefore, is how confident the public sector parties can be in establishing that the delay in acceptance of the operational trial is attributable to Pathway's default. The Solicitor agrees with Treasury counsel that this introduces an element of uncertainty; he notes that leading counsel for DSS has also described this route as carrying "substantial litigation risk".

11. The Solicitor is in no position to assess whether Pathway are in default (or sufficient default). There is an expert report to that effect; the Solicitor comments that in these types of disputes experts tend to proliferate. In the event of litigation, reports will almost inevitably be produced supporting Pathway.

12. The Solicitor also endorses Treasury counsel's analysis of the additional legal hurdles presented by the DSS approach. In short, it involves the delayed operation of a right to terminate (if any) which accrued over a year ago, by means of a reactivating notice. This is not expressly provided for in the Agreement but turns on the common law of waiver. Pathway can be expected to dispute, with some force, the availability of such a mechanism.

13. The "piggy-back" option is a variant of the DSS approach. It envisages POCL terminating under clause 902.10, in reliance on a termination by DSS under schedule C5. The Solicitor comments that this option carries, at the very least, all the legal risks associated with the approach discussed above.

14. The Solicitor notes Treasury counsel's necessarily limited observations on quantum. He is not in a position to add to them.

Making time of the essence (the POCL approach)

15. If a notice is served making time of the essence, the Solicitor General cannot comment on whether Pathway will comply or walk away, or whether it would still take legal action. He regards the risk of Pathway bringing proceedings as reduced but not insignificant. It could, for example, allege that the Authorities are not entitled to serve the notice because there has not been "undue delay" by Pathway (clause 605.4).

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From the Authorities' point of view, however, this is a lower hurdle than their having to establish default under schedule C5.

16. More dangerously, Pathway could argue that the notice sets an unreasonable period and sue for anticipatory breach of contract. The length of the period therefore becomes critical.

17. Those closer to the Agreement will be in a better position to assess what period might be set; maximum safety points to prescribing the time Pathway itself has said it needs, and the Solicitor General has seen suggestions that the period might be nine months. However, he comments that one aspect of clause 902 is that the Authorities can terminate the entire Agreement on twelve months' notice. Given that, and with the considerable period that the contract has already run, something less than nine months might be appropriate.

18. Finally, the Solicitor General comments that a time of the essence notice will be seen, correctly, as giving Pathway a final chance to proceed according to contract. Ministers should therefore only embark upon this course if they regard the performance of the Agreement as a satisfactory outcome. If their unequivocal wish is to terminate, the Solicitor believes that it would not be right to make time of the essence.

I would be grateful if you would copy this letter as necessary within the interested departments and public sector parties.

Yours,

GRO

RICHARD HEATON

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PROJECT HORIZON

NOTE OF LEGAL ADVICE

Introduction

1. The Department of Social Security ("DSS") and Post Office Counters Limited ("POCL", together "the Authorities") are contemplating terminating Project Horizon. The contractual relations between the Authorities and Pathway under the Project are governed by three agreements ("the Related Agreements"). A difference has arisen between legal advisers to the DSS (Bird & Bird and Roger Kaye QC) and those acting for POCL (Slaughter & May and Nicholas Strauss QC) as to the correct interpretation of the Related Agreements.

2. The Project itself has had a long and not entirely happy commercial history. I will assume that those for whom this Note is intended have some familiarity with that background, and in view of the time constraints I shall not recite it all here. The only significant event to which I should refer is that the Acceptance of Operational Trial should have been achieved by the 21st November 1997; and it is common ground that it was not. Pathway currently estimates that it will need until about July 1999 to achieve Operational Trial.

3. The Treasury Solicitor has been asked to obtain the advice of the Law Officers. A useful meeting was held yesterday afternoon, the 8th December 1998, between lawyers for the Authorities (though not including their Counsel) and for the Treasury. This Note records the matters upon which a consensus was achieved, and also reflects the advice I gave in conference on matters where there remained a difference of opinion between those advising the DSS and those advising POCL.

4. My own familiarity with this case is limited in that I have only seen extracts from the relevant contracts, and indeed I only received instructions on Friday of last week. I fully

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recognise that others are more familiar than I with the detail. The contending views of the DSS and the POCL lawyers are more fully set out in their various letters and memoranda.

The issue

5. The issue between the DSS and POCL concerns the means by which the Related Agreements can lawfully be terminated. The DSS's preferred option is to rely on the service of a 13 week notice, by reference to clause 402.13 and Schedule C5 of the Authorities Agreement. By contrast, POCL's preferred option is to serve notice under clause 902.2.3 making time of the essence for the purpose of achieving Operational Trial by a specified date: the length of that notice could be as much as 9 months. Plainly, the course suggested by the DSS provides a faster exit route, whereas the route suggested by POCL is both slower and does not necessarily achieve the termination of the contracts. The question is to decide which route is preferable, balancing (i) the relative risks to the Authorities of being found to be in breach of contract, against (ii) the policy considerations of the Government.

6. The difference of opinion between the advisers to the DSS and to POCL arises from the difference of wording between clause 402.6.2.3 and clause 402.13. Under clause 402.6.2.3, if Operational Trial is not recorded as being successful on time, the Authorities are entitled to terminate under clause 902.2, which in turn requires the service of reasonable notice or of notice making time of the essence (which in practice is likely to come to the same thing). By contrast, clause 402.13 provides that the Authorities shall have no right of termination of the Authorities Agreement in relation to a failure to achieve Operational Trial except in accordance with Schedule A7 (which for these purposes is irrelevant) or Schedule C5: paragraph 4.4 of Schedule C5 in turn provides that, if Operational Trial is delayed for more than 13 weeks because of Pathway's default, the Authorities shall be entitled to terminate under clause 902.1.5 – ie by notice having immediate effect.

The true meaning of the contract

7. The Authorities both agree that neither interpretation of the Related Agreements is plainly right or plainly wrong. On the face of it, there appears to be an inherent contradiction in the

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wording of the contracts, and it is difficult to see how effect can be given both to clause 402.6.2.3 and to clause 402.13 without doing some violence to the wording of one or the other.

8. The best interpretation I can offer, which gives some effect to both provisions, is to suggest this: that Schedule C5 was intended to deal only with the situation where Operational Trial had not been achieved as a result of Pathway's default, which is why it allows a fixed period of only 13 weeks' grace, after which the contracts can be terminated summarily; but that clause 402.6.2.3 was intended to provide a mechanism for terminating the agreements where Operational Trial was not reached without Pathway being in default, which is why a reasonable period of notice (ie potentially something much longer than 13 weeks) is required under clause 902.2. This interpretation at least gives some force to both clauses 402.13 and 402.6.2.3, and it has the value of providing a mechanism for terminating the agreements in circumstances where Pathway is not in default.

9. However, it ignores the categoric wording of clause 402.13. Accordingly, I am forced to accept that it is impossible to say that there is a correct and an incorrect interpretation of the agreements: the truth is that there is simply an internal contradiction between two different provisions. Any decision about how to terminate the Related Agreements must take into account that uncertainty. The decision must also be influenced by practical considerations, which have a serious impact on the relative strengths of the Authorities' different arguments in the circumstances which have now arisen. I will now turn to those considerations.

Practical considerations affecting the DSS's preferred route

10. Onus of proving that Pathway is in default: In order to rely on paragraph 4.4 of Schedule C5 the Authorities must establish that Acceptance of Operational Trial is delayed for 13 weeks because of Pathway's default. This throws up two questions, in relation to both of which the onus of proof will lie on the Authorities:

10.1. First, does it matter if (as is likely to be the case) the Authorities have themselves not fulfilled each of their contractual obligations to the letter? In my view it is likely that

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this will not matter. I consider that the precondition in paragraph 4.4 is likely to be satisfied if the substantial cause of the delay is Pathway's default.

10.2. Secondly, is Pathway in default as a matter of fact? The preliminary advice from independent contractors is that the answer to this question is "yes", although in forming their view they have not seen Pathway's documents. This provides a considerable degree of comfort, but it has to be acknowledged that there is room for argument.

11. Waiver of breach: Paragraph 4.4 of Schedule C5 entitles the Authorities to serve a notice of termination if Acceptance of Operational Trial is delayed for 13 weeks. Although the Authorities have notified Pathway that they regard it as being in breach of contract, no notice of termination has yet been served, despite the fact that Operational Trial should have been achieved by the 21st November 1997. There is accordingly an argument available to Pathway that the breach has been waived, in that all parties have continued with the Project for the last year. The DSS has sought to protect its position by reserving its rights, stating in a telephone conversation with Pathway that it did not regard the 13 week period as starting immediately after the 21st November 1997, and seeking to trigger the13 week period by serving notice to that effect in May 1998: but that begs the question whether the DSS has any rights to reserve other than the right to serve a notice of termination on the expiry of the 13 week period after Operational Trial should have been achieved.

12. The right to serve a 13 week notice: On the facts, the DSS's argument is therefore wholly dependent on its right unilaterally to suspend the running of the 13 week period specified under paragraph 4.4 of Schedule C5, and then to start that time running by serving a notice to that effect when it chooses. In my view it is highly questionable whether the Authorities have such a right under the Related Agreements. There is no express provision for a 13 week notice to be served under the agreements. The DSS's route involves having to invent an extra-contractual procedure. There is, however, an express contractual provision under clause 605.4 for making time of the essence when it is not already so (and that is exactly what POCL is suggesting should be relied on). In the circumstances, Pathway will be able to argue that the original 13 week period after the 21st November 1997 has long since expired, that no notice of termination was served at that point, that any default on its part was thereby waived, that in order to put Pathway back in breach of contract the Authorities must now

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make time of the essence by specifying a new date by which Acceptance of Operational Trial must be achieved, and that there is an express contractual mechanism for doing so: accordingly, on the facts as they now stand, it is not open to the DSS to invent a non-contractual mechanism for starting the clock running. I do not deny that the DSS may be right in their argument: but the point is very finely balanced, both as a matter of construction and on the facts that have occurred, and I would not want to see the Authorities going into Court with tens, if not hundreds, of millions of pounds at stake on an argument that is very finely balanced if there is a less risky alternative.

13. The piggy-back option: Much time has been spent by the Authorities' lawyers discussing the possibility of POCL terminating its participation in the Project on the back of the DSS's right to terminate ("the piggy-back option"). For present purposes, all that needs to be said is that this option can be no better in law than the DSS's right to rely on the 13 week notice: if that route is flawed, then there can be no piggy-back.

14. Conclusion: Successful reliance on a 13 week notice of termination would undoubtedly provide both certainty (in the sense that the period of notice is fixed) and an exit route (in the sense that it would terminate the Agreements). However, in my view the service of a 13 week notice as suggested by the DSS would be likely to provide Pathway with ample opportunity for contending that the Authorities were in breach of contract.

The practical considerations affecting POCL's preferred route

15. Legal considerations: The legal considerations affecting POCL's preferred route may be shortly stated:

15.1. There is no need for the Authorities to demonstrate that Pathway is in breach of contract. The only precondition that must be satisfied under clause 605 is to show that there has been "undue delay" on the part of Pathway, which in light of what is said in paragraph 10.2 above should be fairly easy to satisfy.

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15.2. Serving a notice that makes time of the essence for achieving Operational Trial by a specified date involves the operation of an express contractual regime: it does not involve inventing or implying any extra-contractual rights.

15.3. The notice must allow Pathway a reasonable period to comply, and this introduces an element of uncertainty: how much time is reasonable, and can the Authorities take into account the delay that has already occurred? However, the uncertainty can be eliminated by simply giving Pathway as much time as they have said they need – ie until July 1999.

15.4. The only basis on which I can see that Pathway could argue that the Authorities were not entitled to make time of the essence would be to rely on 402.13 as providing the only route for termination: however, if that argument were successful, it would lead to the conclusion either that the Authorities were entitled to serve a 13 week notice after all (which would be an own-goal from Pathway's point of view) or, if the 13 week period had gone, that in order to terminate the agreements the Authorities would have to make time of the essence (which is exactly what would have happened).

15.5. For these reasons, I consider that the route suggested by POCL leaves Pathway with less room for manœuvre as a matter of law.

16. Policy considerations: Equally, the policy considerations affecting POCL's preferred route can be shortly stated:

16.1. The most significant consideration from a policy point of view is that the service of a notice making time of the essence does not of itself terminate the agreements. Rather, it gives Pathway an opportunity of fulfilling its contractual obligations. Accordingly, if it is a fixed policy objective for the Authorities to find an exit route as quickly as possible, then this does not achieve that result cleanly. However, on the information currently available it seems that Pathway is unlikely to be able to fulfill those obligations. It would plainly not be attractive for the Authorities to decide unequivocally that they wished to terminate the Project and then to serve a notice making time of the essence in the expectation, and indeed the hope, that Pathway would be unable to complete. However, two results might follow from serving such a

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notice: either Pathway might collapse financially, or it might find sufficient support and complete the Project. If the Authorities decided that they would be equally happy with either result, then I do not consider that it could be regarded as being in any way disingenuous to serve a notice making time of the essence, and then just see what happened.

16.2. The next major policy consideration is that serving a notice making time of the essence would mean that the Authorities would have to continue funding the Project until it was completed, or until Pathway walked away from it. This obviously involves a medium-term financial commitment on the part of the Authorities.

16.3. Thirdly, the service of a notice making time of the essence will not necessarily produce any definitive resolution one way or the other: time will continue to run and the resolution of the Project will be taken out of the Authorities' hands.

The common ground between the DSS and POCL

17. The legal advisers to both DSS and POCL accept that, as a matter of construction, either view mentioned in paragraph 6 above is arguable and both arguments carry inherent weaknesses. Although each naturally prefers its own construction, they both accept that it is impossible to say that either construction is unarguably right or unarguably wrong.

18. It is common ground that the argument espoused by the DSS involves the operation of a mechanism that is not expressly provided for in the contracts, and that it throws up more legal hurdles for the Authorities than the route suggested by POCL: the difference of opinion between the lawyers relates to the height of those hurdles.

19. It is common ground that Pathway is currently in financial difficulties. In that sense time is on the Authorities' side: the longer the existing regime continues, the more likely Pathway is to commit a breach of contract, or even to walk away.

20. It is believed that Pathway would be well-funded for the purpose of taking any possible proceedings against the Authorities. It is also common ground that, although their

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contractual liability under the Related Agreements is capped at £5m each, the Authorities may be held liable for substantially greater sums, and the contractual limitation of their liability may be open to challenge. I have not been asked to advise on this aspect specifically, but it is worth mentioning that, if the Related Agreements were now terminated for convenience there would have to be 12 months' notice and a payment to Pathway of about £350m. Pathway might well seek to contend that this represents its true loss, and to seek damages in that amount if the Authorities act in breach of contract. On any view, there will be a very substantial claim by Pathway if the Authorities do act in breach of contract. That being so, there is a powerful incentive for the Authorities to adopt whichever course is least likely to lead to their being found in breach of contract.

Conclusions

21. For the reasons given above, the legal question is not so much whether the DSS's or POCL's construction of the bare wording of the contracts is correct (which would be a very difficult question to answer for the reasons given in paragraphs 5-9 above), but whether, given the factual situation that has developed since November 1997, the practical course suggested by the DSS or that suggested by POCL leaves Pathway least room to assert that the Authorities are in breach of contract. Put that way, I am in no doubt that the course suggested by the DSS is fraught with more legal difficulties, whereas the course suggested by POCL involves the least risk of the Authorities being found in breach of contract. I consider that those advising the DSS have underestimated those difficulties.

22. It is equally plain that, if the Authorities are unequivocally resolved to terminate the Project, then the route suggested by POCL would not achieve that result cleanly: indeed, it could be said that it would be disingenuous for the Authorities to serve a notice requiring Pathway to comply with its contractual obligations within a fixed timetable if in fact that notice was only being served because the Authorities hoped and intended that Pathway would be unable to comply with it.

23. The only middle ground between the two courses advocated by the DSS and by POCL respectively is for the Authorities to do nothing – ie not serve a 13 week notice and not serve a time of the essence notice either. This would certainly be the least provocative course, in

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the sense that it would give Pathway least cause to walk away or to bring proceedings against the Authorities. The disadvantage is that it would obviously do nothing to bring things to a conclusion, and any substantial period of inactivity might be held to constitute waiver of the breach and of the existing notice on which the DSS would wish to rely. On balance, I would suggest that doing nothing would involve all the disadvantages of serving a notice making time of the essence, but none of the advantages.

24. Leaving aside the option of doing nothing, in my view there is a stark choice between one course which would (if it worked) provide a speedy exit route but which offers Pathway more opportunities for arguing that the Authorities are in breach of contract, and another route which may take longer to work through in practice and will not necessarily produce a termination of the Project, but which affords Pathway far less opportunity to bring claims against the Authorities. At present I do not consider that there is any neat and reliable way of terminating the Related Agreements quickly. My suggestion is that, the Project having been allowed to continue this far, the least bad solution is for the Authorities to remain neutral as to whether they wish to terminate, and for them simply to serve a notice making time of the essence for the Acceptance of Operational Trial by some time next summer. They can then wait and see what happens, while fulfilling their contractual obligations in the meantime. I cannot pretend that this is an entirely satisfactory solution: it offends against all the policy criteria requiring a speedy resolution and a cessation of Government funding of the Project in the immediate future. But if it also minimises the risk of exposing the Authorities to very substantial claims, which would if successful reach £10m (together with interest and costs) and *could* reach over £300m, then it is an option worth careful consideration.

GRO

4 Stone Buildings
9th December 1998