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5th Circ. Nixes Software Co.'s \$1.6B Win In IBM Contract Row

By **Hailey Konnath**

Law360 (May 1, 2024, 12:03 AM EDT) -- The Fifth Circuit on Tuesday reversed a Texas federal court's \$1.6 billion ruling against IBM, finding that Houston-based software company BMC lost out to IBM "fair and square" when IBM fulfilled a request by their mutual client AT&T to replace BMC's software in AT&T's mainframe with IBM's.



IBM triumphed in the Fifth Circuit, where a three-judge panel found a lower court was incorrect in finding that IBM breached part of an operating agreement with software company BMC. (Christinne Muschi/The Canadian Press via AP)

The three-judge panel reversed and remanded the **May 2022 decision**, holding that U.S. District Judge Gray H. Miller was incorrect in finding that IBM breached part of an operating agreement between IBM and BMC when it agreed to replace the software.

The Fifth Circuit said that while it agrees the agreement is "unambiguous," it did allow for going ahead with the switchover. The panel pointed to a "non-displacement" provision in the agreement stating that while IBM "cannot displace any BMC customer licenses with [IBM] products, [IBM] may discontinue use of BMC customer licenses for other valid business reasons."

Judge Miller had differentiated between the terms "displace" and "discontinue" and narrowed the scope of "other valid business reasons," finding that the provision bars IBM from replacing BMC software with IBM

software at a customer's request. There are several issues with that interpretation of the provision, the panel said Tuesday.

For one, New York law does not back BMC's "stark dichotomy" between "displace" and "discontinue," it said.

"Such a reading acknowledges that the 'cannot displace' clause prohibits IBM from competing unfairly with BMC by using its outsourcing services to (a) gain inside knowledge as to how BMC's customers use BMC software and (b) sell IBM software to the same customers with this special knowledge," the panel said. "The second clause, however, accepts the reality that IBM, in performing outsourcing services for BMC customers, may be tasked by them to 'discontinue' BMC software for 'other valid business reasons.'"

That simply means that IBM couldn't displace or discontinue BMC software in a customer's mainframe in favor of IBM software without a "valid" business reason that isn't unfairly competitive, the Fifth Circuit held.

In his decision, Judge Miller held that IBM owes BMC about \$717.7 million in direct contract damages stemming from BMC's claim for fraudulent inducement. On top of that, Judge Miller found that BMC was entitled to \$717.7 million in punitive damages because IBM "exploited" it for its own gain by making the switch. He also awarded prejudgment interest.

However, the Fifth Circuit noted that it's undisputed AT&T made the request, without any lobbying or other influence from IBM, for the IBM software to replace BMC's.

BMC's "cramped reading" of the agreement to "categorically bar" IBM from replacing BMC software with IBM software, even in this instance, leads to "absurd" results, according to the decision.

"On one hand, it would allow IBM to replace BMC's software with any other competing software at AT&T's request, so long as the competing software is not that of IBM," the panel said. "Alternatively, Section 5.4 would require AT&T to discharge IBM as its IT-outsourcer if it decided to replace BMC's software with software of the customer's choice, but only if it elects IBM replacement software."

Either way, according to the Fifth Circuit, as soon as AT&T made the decision to switch from BMC software to a competing software, that would be a lost customer for BMC.

"In addition to producing absurd results, BMC's interpretation is commercially unreasonable and therefore unsustainable under New York law," the panel added. And it is "untenable" because it could lead to the agreement being an unenforceable illegal restriction on competition under New York law, according to the decision.

Should the relevant agreement provision be read as BMC suggests, it "imposes a restriction on IBM's servicing of its outsourcing customers with no legitimate purposes," the Fifth Circuit said.

The dispute landed in federal court in 2017, when BMC claimed it and IBM had a mutual client in AT&T. At the time, BMC was providing mainframe software and IBM was providing mainframe hardware. Because AT&T outsourced its information technology services to IBM, and BMC wanted assurances that IBM would not abuse its access to BMC software to "displace" its products and replace them with IBM's own software, the parties entered an outsourcing agreement that contained a nondisplacement clause, according to the suit.

Under the agreement, if IBM wanted to displace BMC's products, it had to purchase a license to do so.

At the bench trial, BMC argued that dozens of IBM communications uncovered in discovery show that executives there understood that was the case, and began plotting how to "manage the nondisplacement language" in the contract soon after signing the March 2013 agreement, counsel for BMC told the court during closing arguments.

According to BMC's accounting, the breaching of the license cost it \$104 million in lost profits, and it was owed as much as \$791 million in damages.

IBM, however, argued that AT&T decided to migrate away from BMC's software on its own, without any input from IBM, after mergers made the technology "duplicative." IBM also attacked BMC's damages model as speculative, arguing it was calculated as if BMC had been able to keep AT&T's business in

perpetuity.

Judge Miller ultimately declined to award BMC the lost-profit damages it sought, finding that there wasn't evidence backing that request.

In August 2022, the judge ordered IBM to pay more than **\$16 million in attorney fees**, plus \$4 million in litigation costs and \$1.2 million in post-judgment and conditional appellate expenses.

IBM and BMC didn't immediately respond to requests for comment late Tuesday.

U.S. Circuit Judges Edith Jones, Carl Stewart and Kyle Duncan sat on the panel for the Fifth Circuit.

BMC is represented by Jeffrey L. Oldham, Walter Allums Simons and Warren W. Harris of Bracewell LLP, Sean Gorman and Christopher L. Dodson of White & Case LLP, Jeffrey B. Wall, Morgan L. Ratner and Daniel J. Richardson of Sullivan & Cromwell LLP and Harriet O'Neill.

IBM is represented by Paul D. Clement, Erin E. Murphy, Andrew C. Lawrence and Joseph J. DeMott of Clement & Murphy PLLC and R. Paul Yetter, Constance H. Pfeiffer and Reagan W. Simpson of Yetter Coleman LLP.

The case is BMC Software Inc. v. International Business Machines Corp., case number 22-20463, in the U.S. Court of Appeals for the Fifth Circuit.

--Editing by Emily Kokoll.

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