

**CLAIM FOR DAMAGES OF TALGO, INC.,  
AGAINST THE DEPARTMENT OF TRANSPORTATION**

**I. Statement of Facts Supporting Talgo's Claim**

Talgo, Inc. ("Talgo") is the U.S. subsidiary of a manufacturer of passenger trains with a global market presence since 1950. Talgo, together with its affiliated entities, has expanded its operations to countries around the world and today the Talgo brand has trains in service in the United States, Canada, Spain, Portugal, France, Italy, Germany, Bosnia-Herzegovina, Uzbekistan and Kazakhstan.

On May 11, 2009, Talgo and the State of Wisconsin, through the Wisconsin Department of Transportation (hereafter "DOT" or "the State"), signed a Letter of Intent (*see* Exh. 1) for a four-stage transaction: (i) a Purchase Agreement for two train sets, (ii) a maintenance agreement to service the two trains sets, (iii) the procurement of a maintenance facility and (iv) an option to purchase two additional trainsets if the State was successful in receiving a federal grant.

On July 15, 2009, Talgo entered into a contract with the State to design, build and deliver two 14-car sets of intercity passenger rail cars (known as "train sets") for \$47,489,000<sup>1</sup> ("the Purchase Contract") (*see* Exh. 2). The State entered this Purchase Contract to enhance passenger rail service on the existing Amtrak Hiawatha line between Milwaukee and Chicago and for use on a planned high-speed passenger rail extension from Milwaukee to Madison. The Purchase Contract acknowledged the

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<sup>1</sup> The original contract price of \$47,489,000 was later adjusted to \$50,673,392 due to change orders and amendments negotiated by the parties.

State's ultimate goal was to implement new passenger rail service between Madison, Wisconsin and Chicago and Minneapolis, and provided an option for the State to purchase two additional train sets for the expanded service. (Exh. 2, Art. 5.)

At the State of Wisconsin's insistence, the Purchase Contract provided that the train sets would be assembled by Wisconsin workers in a Wisconsin facility. Talgo complied with this request and further agreed that it would "endeavor to use this Wisconsin facility to perform final assembly for other Talgo train sets subsequently sold to Amtrak, other states, or other entities."

The Purchase Contract required the DOT to provide an adequate temporary maintenance facility in Milwaukee at the DOT's sole expense, until the DOT constructed a permanent maintenance facility in Madison after passenger rail service was extended to Madison.

Whenever Talgo or any of its affiliates sell a train set anywhere in the world, they also contract to provide long-term maintenance services on the train sets as a required component of the transaction. These maintenance services are necessary to ensure a high level of availability and reliability of the train sets. This standard practice has resulted in Talgo's provision of 99%-plus reliability rates worldwide in Talgo equipment. The DOT was expressly aware of the benefits of this structure and indeed negotiated pricing that accommodated both the manufacturing and maintenance elements of this transaction with Talgo.

Talgo and the DOT agree that it was never Talgo's expectation to merely sell the train sets to Wisconsin without a long-term maintenance agreement. The Purchase

Contract documented this expectation (*see* Exh. 2, Art. 5). Talgo and the DOT signed a 20-year maintenance agreement on December 30, 2009 to fulfill this express expectation (Exh. 3, the “Maintenance Agreement”). The Maintenance Agreement expressly restates the parties’ intent that the Purchase Contract and Maintenance Agreement together comprised a single, integrated transaction (*see* Exh. 3, page 1). Like the Purchase Contract, Talgo’s services under the maintenance contract would primarily employ Wisconsin workers at a facility in Wisconsin furnished by the State. Thus, in accordance with Talgo’s standard business model, and under the express terms of the Purchase Contract and the Maintenance Agreement, the maintenance agreement was an extension of, and integrated with, the purchase contract.

In March 2010, shortly after entering this transaction with the State of Wisconsin, Talgo entered an agreement with the State of Oregon for the purchase and maintenance of two Talgo Series 8 train sets which are identical (except for colors and minor interior configurations) to the train sets Talgo was to build for Wisconsin. The Oregon train sets were ordered to be used for Amtrak Cascades service between Eugene, Oregon, and Vancouver, British Columbia.

True to the promise it made to the State of Wisconsin, in order to build both the Wisconsin train sets and the Oregon train sets, Talgo commissioned and put into operation an assembly facility in the City of Milwaukee, establishing a regional manufacturing base for passenger train sets in the Midwest.

The State’s plans for implementing high-speed passenger rail and expanding passenger rail service in Wisconsin shifted abruptly when Scott Walker was elected

governor on November 2, 2010. Walker campaigned on a promise to “stop the train” (Exh. 4, <http://notrain.com/>). Even before his inauguration, Governor-elect Walker wrote to U.S. Secretary of Transportation Ray LaHood declaring his intent to reject \$810 million in federal stimulus funding, which was to have funded the capital requirements necessary for extension of high-speed passenger rail service to Madison, the purchase of two additional train sets and the construction of the permanent maintenance facility (Exh. 5, Letter from Walker to LaHood). Secretary LaHood subsequently directed the grant funds to be redistributed to high-speed passenger rail projects in other states (Exh. 6). Although Governor Walker and members of his administration continued to assure Talgo and to state publicly that the State would honor its contracts with Talgo for the purchase and maintenance of the train sets, by February 2011, unbeknownst to Talgo, the DOT began communicating with other states in an effort to sell the unfinished train sets. Secretary Gottlieb personally reported the State of Washington’s lack of interest in purchasing the trains to the Governor’s chief of staff, revealing his concern that the State’s efforts to sell the trains would “become public” if the DOT approached the state of Oregon (Exh. 7).

With Talgo unaware of the State’s efforts to sell the train sets to other states, work on the train sets continued at Talgo’s Milwaukee facility for the duration of 2011.

In December 2011, the DOT submitted a request to the Legislature’s Joint Committee on Finance to authorize \$5,000,000 in passenger rail development bonds for final design engineering of the permanent maintenance facility in Milwaukee. Those costs would have been covered by the federal stimulus funding, had the funding not

been rejected by Governor Walker. The Committee approved \$2,500,000 in bonding to begin design engineering, but directed the DOT to prepare a report comparing the costs of building a permanent maintenance facility in Milwaukee and maintaining the trains at such a facility with the cost of maintaining the train sets at Amtrak facilities in Illinois, including any needed improvements to Amtrak facilities. The Committee also directed DOT to report on the costs and savings if current rail operations continued (i.e., if the aging Amtrak rolling stock continued to be used on the Hiawatha line) and no permanent maintenance facility were constructed.

In March 2012, as construction of the train sets was completed, pending only Pre-Revenue Testing<sup>2</sup>, the DOT requested the Joint Finance Committee of the Wisconsin Legislature to authorize the remaining \$2,500,000 in passenger rail development bonds for final design engineering on the permanent maintenance facility in Milwaukee (*see* Exh. 8). The request, submitted on behalf of the DOT by the Department of Administration, represented that operating the Talgo trains on the Hiawatha line would cost the State \$10 million more annually than continuing to use the 20 to 30 year old Amtrak rolling stock and mothballing the brand new Talgo train sets (*id.*).

In light of the Governor's oft-stated intent to kill the train project, the DOT's analysis was politically motivated and contained several critical misrepresentations of fact, leaps of logic and incorrect assumptions.

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<sup>2</sup> As discussed below, 49 CFR 238.111 requires the railroad, not the manufacturer, to prepare a pre-revenue service acceptance testing plan. Because the State directly purchased the train sets, it took on the obligations of a railroad for purposes of 49 CFR 238.111.

The DOT's analysis assumed that the State would make *no* investment in new or refurbished passenger rail cars or train sets over the next twenty years, despite noting that the Amtrak cars were 20 to 30 years old and "in fair condition at best" (*id.*); it failed to factor in increased revenues from projected increased ridership (which has since, as Talgo had asserted at the time, indeed increased); and it failed to account for the decreased fuel costs of using the lighter-weight Talgo train sets. Further, while the DOT report noted that the State had already invested \$70 million including the train sets, consultant fees, design work, and related costs, it did not mention the cost to the State caused by Governor Walker's rejection of the \$810 million in federal stimulus funding, a portion of which was earmarked for the permanent maintenance facility (*id.*). These and other erroneous assumptions and calculations both substantially exaggerated the comparative costs of operating the Talgo trains and substantially ignored the State's losses if it mothballed the newly constructed train sets or defaulted on the purchase.

Further, as the report acknowledged, the State would face significant problems with state-issued debt if it cancelled or defaulted on the purchase of the train sets. The \$70,000,000 the DOT received from the legislature for this project was funded with bond proceeds, and this bonding authority requires the acquisition of capital assets. If the State does not acquire any capital assets with such funds, the \$70,000,000 must be restored to the bond fund in order to refund creditors.

Along strict party lines, and in a premeditated measure, the Joint Finance Committee rejected the requested funding required to continue work on design of the permanent maintenance facility.

Immediately following the Joint Finance Committee's vote rejecting the requested funding for the permanent maintenance facility, DOT Secretary Gottlieb announced:

Today's decision to not provide funding for the permanent rail maintenance facility means that the state will be unable to put the Talgo trains into revenue service. We hope to work cooperatively with Talgo to resolve any outstanding contractual issues in a mutually satisfactory way. Existing rail service on the Hiawatha route, using Amtrak equipment, will continue without interruption.

(Exh. 9).

In fact, the Legislature's denial of funding for final design work on the permanent maintenance facility did *not* prohibit or prevent the State from placing the Talgo trains into revenue service, as a practical or legal matter. The Purchase Contract expressly anticipated that the train sets would be maintained in a temporary maintenance facility until a permanent facility was operational (*see* Exh. 2, § 6). Likewise, as Talgo officials had proposed to the State, the existing assembly facility had already been established as the temporary maintenance facility and could be repurposed as a permanent maintenance facility.<sup>3</sup> The Joint Finance Committee's action did not abrogate the Purchase Contract, the Maintenance Contract or the sublease on the maintenance facility.

Subsequently, in response to Talgo's objections that the DOT had drawn an incorrect conclusion from the Joint Finance Committee's action, Secretary Gottlieb

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<sup>3</sup> The State had originally agreed with Talgo's proposal to the point that the State committed approximately \$3 million to transform the manufacturing facility into a maintenance facility. The DOT's project management personnel were engaged in this endeavor and a transition plan was agreed upon with Talgo.

advised Talgo in a letter dated March 26, 2012, that the DOT intended to “proceed in accordance with the terms of the Purchase Agreement, Maintenance Agreement, Sublease, and applicable law” (*see* Exh. 10). On those assurances, Talgo continued its work to train personnel and set up maintenance operation for the train sets.

At some point in 2012 the DOT determined that its budget for the project did not include sufficient funding for Pre-Revenue testing of the train sets, as is required by Section 14.02 of the Purchase Contract and pursuant to 49 C.F.R. § 238.111. In an effort to cover these costs without requesting additional funding from the Legislature, the DOT proposed to Talgo that it would advance payments to Talgo under the Maintenance Agreement, in exchange for Talgo applying those State-paid funds to testing costs. The DOT personnel involved were aware that this unorthodox strategy was being utilized to cover its miscalculation and were cautious with the related documentation and electronic communication thereof. To this end, numerous calls and meetings took place to deal with this issue and representatives at the DOT attending these meetings would testify, if required, confirming this point. The resulting arrangement created the appearance that Talgo, not the DOT, was paying for the costs of testing. As a courtesy to the DOT and to facilitate delivery and payment of the train sets, Talgo accepted this arrangement. The DOT began making the advance maintenance payments. However, the DOT later cancelled these payments, presumably because the DOT’s management realized the arrangement was inconsistent with Governor Walker’s goal to reject the train sets rather than complete the purchase. This



goal prompted the DOT to adopt a new stance that Talgo, not the DOT, was responsible for testing costs under the Purchase Contract.

In January 2012, as was required by the Purchase Contract, Talgo advised the DOT that the trains were available for delivery for Pre-Revenue testing and attempted to work with the DOT to make the necessary arrangements for testing. The DOT refused to take delivery of the train sets or to make arrangements with Amtrak to lease and insure a locomotive needed for testing the train sets. It instead erroneously and unreasonably claimed that Talgo was responsible for conducting and financing such testing. On April 4, 2012, Talgo more formally gave the DOT written notice that the train sets were available for delivery for the DOT's testing. (*See* Exh. 11). The DOT refused to take delivery of the train sets for this purpose, refused to arrange for testing, refused to pay for any testing and instead delivered a written notice to Talgo that the DOT did not intend to place the train sets into service and the DOT was unilaterally cancelling the Maintenance Agreement (Exh. 12).

It is now abundantly clear that the State, without regard to the damages it would cause Talgo, had further decided to breach two other agreements it had with Talgo: (1) a sublease agreement for the Milwaukee facility Talgo had secured to allow for a location for the performance of maintenance services for the DOT's benefit, and (2) another purchase agreement for a wheel changer specifically ordered by and manufactured for the State, which is a piece of equipment necessary to perform maintenance.

Further, the DOT failed to make the milestone payment of \$4,599,000 as required under the Purchase Contract (*see* Exh. 2) and declined to pay all subsequent invoices issued by Talgo. To date, the State has paid Talgo \$39,925,392 on the amended purchase price of \$50,673,392. It owes Talgo \$10,748,000 in unpaid invoices, not including interest, under the Purchase Contract alone (*see* Exh. 20, Calculation of Damages).

The State's refusal to take delivery of the train sets or to direct Pre-Revenue service testing caused expensive delays in the delivery and testing of the train sets purchased by the state of Oregon. Oregon originally relied on the fact that the Pre-Revenue testing for the train sets would be led and financed by the State of Wisconsin. Talgo ultimately performed static testing on one the train sets in Milwaukee and moved one of the Oregon train sets to Pueblo, Colorado for successful dynamic testing in the fall of 2012. This static and dynamic testing satisfied the Federal Railway Administration's pre-revenue testing requirement for all the Talgo train sets in this series, including the train sets built for the State of Wisconsin. After this successful testing, the two Oregon train sets were delivered to the Northwest to be placed into revenue service. The FRA approved the Series 8 train sets for Oregon's revenue service without restriction on July 31, 2013 (*see* Exh. 13).

On July 5, 2012, pursuant to Section 25.06 of the Purchase Contract, Talgo served a Notice of Default on DOT Secretary Gottlieb (*see* Exh. 14). The Notice of Default provided the State with the specific details of the State's default under the Purchase Contract and informed the State that it had thirty days to cure the default or Talgo

would have the right to terminate the Purchase Contract and retain the train sets, pursuant to Section 25.06 of the Purchase Contract.

The State denied Talgo's allegation of default, erroneously asserting in a letter dated August 3, 2012, that Talgo had failed to identify a material breach of the Purchase Contract (*see* Exh. 15). The State failed to remedy the material default described in Talgo's Notice of Default.

At Talgo's suggestion, the State and Talgo attempted mediation to resolve the dispute pursuant to the Dispute Resolution procedures contained in Article 32 of the Purchase Contract. During that mediation, Talgo made the DOT aware of its claim for damages and further informed the DOT of its exposure under the bonding authority. Talgo offered to the DOT a remedy that would have allowed the DOT to acquire title to the capital asset it needed in order to avoid having to restore the \$70,000,000 in bond proceeds allocated to the DOT. Instead of acknowledging its own breaches and precarious position with regard to the bonding authority, the DOT insisted on a refund of money it has paid to Talgo, which would have caused Talgo to suffer even larger losses arising from the Governor's decision to kill the train project mid-stream. The mediation failed to resolve the dispute.

Consequently, on November 1, 2012, Talgo terminated the Purchase Contract by personally serving Secretary Gottlieb with a letter informing him of the termination (*see* Exh. 16). In a letter dated November 21, 2012, the State responded to and rejected Talgo's Notice of Termination and issued a Notice of Default to Talgo, alleging that Talgo had violated the Purchase Agreement by failing to conduct testing or to meet

various post-testing obligations under the Purchase Contract even though the DOT continued to inform Talgo and its counsel that the State did not want the train sets and would never put them into service under any circumstances.

## **II. The State Materially Breached Its Contracts with Talgo.**

### **A. The State Defaulted on Its Obligations Under the Purchase Contract.**

The Federal Railway Administration (FRA) requires railroads (not manufacturers) to conduct Pre-Revenue service acceptance testing of passenger train sets before placing the train sets into revenue service. Among other requirements, before using passenger equipment that has not been used in revenue service in the United States, the railroad must prepare a Pre-Revenue service acceptance testing plan for the equipment that contains specified elements. *See* 49 C.F.R. 238.111(b). DOT, through its consultant, Interfleet, prepared the Pre-Revenue Service Testing plan to comply with this requirement (*see* Exh. 17). The Plan identifies three “major stages” of testing: static, dynamic, and endurance testing.<sup>4</sup> The DOT formally delivered the Plan to the FRA long ago as the State’s representation of the stages of desired and required testing.

The Purchase Contract does not use the terms static, dynamic, or endurance testing. Rather, it refers to “production testing” and the 49 CFR term “Pre-Revenue” Testing.

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<sup>4</sup> As defined and described in the WisDOT Trainset Acceptance Testing Plan, static testing is testing the train set’s electronics and other equipment and systems while the train set is not moving. Dynamic testing is testing of brakes and other systems while the train set is moving. Endurance testing requires the train sets to be run continuously in simulated revenue operation. *See* Exh.17, p. 14 & App. B.

The Purchase Contract provides for the testing of train sets and components during production to ensure that technical specifications are met, referred to as “production testing.” See Exh. 2, §§ 4.02, 13.01, 14.02, 43.02, 44.01, 44.02, 44.04. The Contract assigns responsibility to Talgo (“the contractor”) for performing and bearing the costs of such production testing, except that the DOT bears the costs of any additional tests conducted at its direction. See Exh. 2, §§ 13.01, 43.02, 44.01. The Contract indicates that such testing would occur intermittently during production, *before the train sets are delivered*, and be documented in monthly reports submitted by Talgo to the DOT. See Exh. 2, §§13.01, 43.02. The Contract gives the DOT a right to observe such testing and to conduct inspections of train components on site. See Exh. 2, §§12.03, 12.06, 12.07, 13.01, 44.02.

The second kind of testing identified in the Purchase Contract is “Pre-Revenue testing.” The contract provides that “Pre-Revenue testing” is to be conducted “by the operator” *after* Talgo delivers the train sets, *ex works*, to the State. See Exh. 2, §§14.01, 41.01.2. The Contract requires Talgo to place documentation conveying legal title to the train sets in escrow upon delivery, to be held until the State makes full payment for the train sets. Thus, delivery triggers the passing of legal title to the State.

The Purchase Contract uses the term “Pre-Revenue testing” to refer to the Pre-Revenue service testing requirements found in 49 C.F.R. 238.111. See Exh. 2, §§14.02. The Purchase Contract provides that Talgo is *not* responsible for performing the Pre-Revenue testing plan required by the FRA regulations: “All parties acknowledge and accept that 49 CFR 238.111 provides that the Operator (or railroad, as the case may be)

[i.e., Amtrak] and not the Contractor [i.e., Talgo] is responsible for performing a Pre-Revenue service acceptance testing plan.” The Contract requires Talgo to “diligently work with Department and any such Operator to ensure that the Operator’s Pre-Revenue service acceptance testing plan is efficiently implemented.” Exh. 2, §14.02.

The Contract further provides that Talgo shall give the State “access to make a technical inspection and testing of such Train Set together with Contractor for a period of seven (7) days with a view to finding out whether the Train Set meets the requirements of the Contract,” and requires Talgo to give the State at least 20 days’ notice of “when such technical inspection and testing can take place.” Prior to its “invitation to the State to carry out a technical inspection and testing of the Train Sets,” Talgo must “provide documentation to the State verifying that all single components of the Train Sets fulfill the Technical Specifications and the functional requirements set up therein.” Exh. 2, §14.02. The State must give Talgo notice of any discrepancies in the train sets within 7 days of the inspection, and Talgo must promptly remedy the deficiencies. Exh. 2, §14.03. If the State does not give notice of deficiencies within seven days, the Contract provides that “the Train Sets shall be deemed to have been accepted by the State.”

These provisions, viewed in full and in the context of other provisions of the Purchase Contract, clearly reveal the parties’ intent to place the responsibility for conducting and financing post-delivery, Pre-Revenue service testing on the State. The role ascribed to Talgo in Pre-Revenue testing, after delivering the train sets to the State, is simply to “work with the State” to ensure that the testing plan is “efficiently

implemented,” by, among other things, providing the State with notice of and access to the competed train sets.

The State has argued that Section 4.02 of the Purchase Contract requires Talgo to pay for all phases of testing. This interpretation radically misconstrues the contract.

Section 4.02 provides as follows:

The Contractor shall design, manufacture, deliver, test and commission Train Sets *pursuant to the Contract Documents* for purchase by Department hereunder.

(Exh. 2, emphasis added). Contrary to the State’s interpretation, this provision does not impose a general or specific obligation on Talgo to perform or pay for testing. At best, it requires Talgo to perform testing “pursuant to the Contract Documents.” It does not otherwise require Talgo to perform, let alone pay for, any Pre-Revenue testing.

Reference to the other provisions of the Purchase Contract controverts the State’s claim that the Purchase Contract requires Talgo, not the State, to perform Pre-Revenue testing.

Despite its clear responsibilities under the contract, the State attempted to shift both the financial and administrative responsibility for conducting post-delivery, Pre-Revenue testing of the train sets to Talgo, including acquiring a locomotive from Amtrak, arranging for a testing site, and transporting the train sets to the testing site. Although Talgo, in accordance with its obligations under the Purchase Contract, took steps to facilitate the DOT in managing the testing process, Talgo did not assume any financial responsibility for the costs of testing.

Furthermore, in working to facilitate DOT's testing of the train sets, Talgo relied upon DOT's contractual obligation and repeated promises to pay for the costs of this testing and to compensate Talgo for its efforts. In addition to the clear terms of the contract, Talgo relied on numerous representations from DOT that it would pay for the testing costs. Indeed, the State's contracted management firm, Interfleet, prepared detailed budget estimates so that DOT would know how much its testing obligations would cost. Further, DOT previously offered to pay Talgo for all the testing expenses if Talgo would contract directly with Amtrak for such testing. DOT would not have taken these steps if it had not understood its legal and contractual obligations to perform Pre-Revenue testing of the train sets.

Make no mistake, the testing issues were never truly a contractual issue with the DOT. The DOT did not avoid planning, paying for and conducting the testing because of a disagreement over how to interpret the contract. Instead, the State manufactured this contractual dispute out of its desire to kill the train project. Indeed, the State's material breach and lack of good faith relating to the testing of the train sets is further evidenced by the State's public declarations, in no uncertain terms, that it intends to store or sell the Talgo train sets and has no intention of ever placing them into passenger rail service. These actions are further defaults under the Purchase Contract, under which the State makes a legally binding commitment to place the train sets into revenue service (*see, e.g.*, Exh. 2, Art. 9). Moreover, the State's abrupt change of plans with respect to the Hiawatha line is the State's prerogative, but it neither excuses the State's material breach nor absolves its liability under the contracts with Talgo.



**B. The State Improperly Terminated its Maintenance Agreement and Related Sublease with Talgo.**

In addition to the Purchase Contract, and in conformity with its promises under a Letter of Intent, Wisconsin also entered a 20-year Maintenance Agreement with Talgo that would have provided minimum revenues to Talgo of approximately \$4,500,000 per year (more in years in which expected modifications, upgrades or overhauls on the train sets are necessary). The contracts for the purchase and maintenance of the train sets together constitute a single transaction. While it needs no further proof, it is illustrative that the multi-phased nature of the transaction was evidenced by the Letter of Intent signed on May 11, 2009, two months prior the execution of the Purchase Agreement and as stated in the agreements themselves. The Letter of Intent designed a transaction with various phases<sup>5</sup>: first, a purchase agreement, and within six months after the execution of the Letter of Intent and “in conjunction with the execution of the acquisition contract,” “an agreement for the maintenance of the Equipment” (Exh. 1). Indeed, Talgo and its parent company exclusively provide the maintenance services on every train set it has sold worldwide. This scope was expressly understood and desired by the State.

Both the Purchase Contract and the Maintenance Agreement make express reference to the interrelated nature of the agreements, with the Maintenance Agreement providing that:

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<sup>5</sup> The Letter of Intent also included the commitment to build a maintenance facility and to buy two additional train sets.

Talgo and WisDOT acknowledge that the pricing of the Trainsets in the Purchase Contract was based upon Talgo's expectation that it would also be providing twenty (20) years of comprehensive maintenance and repair services on the Trainsets ....

(Exh. 3). This language reveals that a significant portion of the benefit of the transaction to Talgo inheres in the Maintenance Agreement. The price for the train sets set forth in the Purchase Contract alone was not sufficient to induce Talgo to enter into this transaction. Thus, the State expressly agreed to the integrated nature of these two agreements. The benefit of the bargain for Talgo exists in the complete performance of both contracts. The State's wrongful termination of the Maintenance Agreement has frustrated Talgo's expectations, causing losses in excess of \$20,000,000 rather than an anticipated profit, over the course of the agreements, of \$30,000,000. This is a \$50,000,000 swing in Talgo's expectations.

On April 9, 2012, the DOT sent a letter to Talgo purporting to unilaterally terminate the Maintenance Agreement and contingent sublease (Exh. 18). The DOT represented that it does not have sufficient funds to make the necessary payments under the Maintenance Agreement. Specifically, the State wrongfully claims that it was entitled to cancel the Maintenance Agreement pursuant to an appropriations clause, which provides:

Non-Appropriation of Funds. With respect to any payment required to be made by WisDOT under this Agreement, the parties acknowledge WisDOT's authority to make such payment is contingent upon appropriation of funds and required legislative approval sufficient for such purpose by the Legislature. If the requisite state funding becomes unavailable through reduction or failure of appropriation or otherwise, WisDOT shall negotiate in good faith with Talgo for a reduction in the Maintenance Services to a level which WisDOT has available

appropriations, including appropriate adjustments to the Performance Guarantees set forth in Exhibit 8 and the payments due in the event such standards are not met. Such negotiations may include consideration of reductions in frequencies or operation of shorter trains. If such funds are not so appropriated, this Agreement may be terminated by either party. WisDOT agrees not to effect such termination for the purpose of replacing the Trainsets with trainsets supplied by others, or otherwise as a purposeful means of terminating the contractual relationship between the parties or replacing Talgo as the provider of Maintenance Services for the Trainsets.

(Exh. 3, § 22). The State claims that a March 14, 2012 decision by the Joint Committee on Finance (“JFC”) declining the DOT’s request to use \$2.5 million in bond proceeds to fund an engineering study of a permanent maintenance facility for the train sets triggered the non-appropriations clause and released the State from its obligations under the contract.

The Maintenance Agreement contemplates that Wisconsin would construct, at its own expense, a permanent maintenance facility at which the train sets would be maintained. The legislature appropriated sufficient bond proceeds to construct this facility, but tasked the JFC with periodically approving the release of those funds. On March 14, relying in large part on misleading cost estimates and comparisons provided by the DOT, the JFC voted (as orchestrated in advance in meetings between the DOT, Governor’s office and JFC leadership) to withhold a tranche of funds that would have been spent on final engineering studies for construction of the permanent maintenance facility.

However, the Maintenance Agreement provides for such a contingency related to the maintenance facility. First, the parties expressly agreed that a temporary facility

would be used for maintenance of the train sets until the permanent maintenance facility was built. The Agreement states that if the permanent maintenance facility is not available by January 30, 2014, the DOT:

shall compensate Talgo for all additional direct expenses associated with performing the Maintenance Services at a temporary facility, which direct expenses may include Talgo's expenses to modify, improve or expand the Temporary Maintenance Facility efficiently, provided that Talgo shall not so modify, improve, or expand the Temporary Maintenance Facility without WisDOT's prior written consent, which consent shall not be unreasonably withheld.

(Exh. 3, §6.1). Further, the Agreement provides that the DOT will make available the Temporary Maintenance Facility at WisDOT's sole cost, at least three months before the train sets are placed in revenue service (Exh. 3, §6.2, 6.3). It provides that, if the DOT fails to make the temporary maintenance facility available by that date, the DOT shall compensate Talgo for all additional direct expenses associated with performing the maintenance services at an alternative facility (Exh. 3, §6.4).

The DOT bypassed these contractual provisions, seizing on the JFC vote rejecting the use of bond funds for the design engineering for the permanent maintenance facility as a basis for terminating the entire Maintenance Agreement. But none of the points raised by the DOT's termination letter constitutes a valid basis for termination. The JFC's refusal to authorize DOT to use bond proceeds to cover the costs of design engineering of the permanent maintenance facility did not trigger the non-appropriations clause and certainly did not trigger the right to unilaterally terminate the contract.

In fact, in the Maintenance Agreement, the State and Talgo *anticipated* the possibility that a permanent maintenance facility would not be available, and agreed that those circumstances would not entitle the State to terminate the Maintenance Agreement. Instead, the State agreed that, in the event it could not provide a permanent maintenance facility, the State would “compensate Talgo for all additional direct expenses associated with performing the Maintenance Services at a temporary facility” (Exh. 3, §6.1). Moreover, contrary to Wisconsin’s claim, the appropriation clause is triggered only when the DOT has been appropriated insufficient funds to make a “payment” to Talgo under the Maintenance Agreement (Exh. 3, §22). But the JFC’s action did not deny appropriation of funds to pay Talgo under the Maintenance Agreement. Rather, the JFC merely denied additional funding for the DOT to pay an engineering consultant for design work on a possible permanent maintenance facility to be constructed by the State, not Talgo.

In other words, before the State may terminate the contract under the appropriations clause, it is a necessary prerequisite that the State have insufficient funds to pay Talgo to conduct the maintenance activities contemplated in the Maintenance Agreement. But as the State admitted in the letter purporting to give notice of termination, even after the JFC’s action, substantial funds were (and presumably still are) available both to continue progress on a permanent maintenance facility and to make at least \$2 million in payments to Talgo under the Maintenance Agreement. For example, the termination letter concedes that if “the [permanent maintenance facility] costs that were used, or were planned to be used, from the denied bonding authority

must now be issued from the [existing] Passenger Rail Service Appropriations funding,” and “[i]f we were to estimate testing costs at \$1.5 million, the Department could afford to spend approximately \$2 million on all maintenance related activities during FY 2012-2013” (Exh. 18).<sup>6</sup> The termination provisions were not triggered. *Cf. Physicians Health Care Plans, Inc. v. Cook*, 714 So. 2d 566, 567-68 (Fla. Dist. Ct. App. 1998) (despite non-appropriations clause in contract, state agency breached contract by unilaterally reducing payments made under the contract, since legislative action did not actually deprive agency of funds for payments under the contract).

Further, the Maintenance Agreement does not give the DOT a right to terminate the agreement if the permanent facility is not available on the agreed-upon date of January 30, 2014. The contract provides that a temporary facility will be used, at the State’s expense, if a permanent facility is not available on that date (Exh. 3, §§6.1, 6.2).

In short, the failure of the JFC to authorize the use of bonding for design work on a permanent maintenance facility is not grounds for the DOT to terminate the Maintenance Agreement. The State’s deliberate misreading of the agreement as a basis to claim termination is not made in good faith, but rather is a pretext to terminate an otherwise lawful contract.

Even if the State were correct in asserting that insufficient funds were appropriated to allow it to make required payments under the Maintenance Agreement,

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<sup>6</sup> Even more funds were likely available at the time of the purported termination. In 2011 Wisconsin Act 32, the Wisconsin Legislature appropriated more than \$20 million for service of the Hiawatha railway, and specifically appropriated over \$11 million for start-up maintenance of the Talgo train sets. In other words, contrary to DOT’s claim in the termination letter, ample funds were appropriated for payments to Talgo under the Maintenance Agreement.

the State still acted prematurely in giving notice of termination. The Maintenance Agreement requires the State, in that event, to negotiate in good faith with Talgo to reduce the maintenance services to a level for which the DOT has available appropriated funds (Exh. 3, §22). But the State ignored this provision. It never approached Talgo seeking to negotiate a reduction in maintenance services, choosing instead to prematurely terminate the contract. This precipitous action reveals the State's lack of good faith and its intent to use the JFC action as a pretext for terminating its contract with Talgo, regardless of its plain obligations under the contract. The State's failure to comply with the negotiation requirement, by itself, constitutes an Event of Default, as defined in Sections 13.6 and 13.7 of the Maintenance Agreement (Exh. 3, §§13.6, 13.7).

The DOT's termination letter attempts to excuse the State's failure to negotiate in good faith by noting that the JFC did not direct the DOT to "renegotiate the maintenance agreement with Talgo to reduce ongoing maintenance costs" (Exh. 18). However, the Maintenance Agreement places the obligation to negotiate in good faith on the State, acting through the DOT, not the JFC. There is no statute or other law granting the JFC the authority to absolve the State from a contractual duty to negotiate under a lawfully entered contract. The State, acting through the DOT, bears the responsibility for its lack of any attempt to negotiate prior to termination. In fact, the office of Senator Alberta Darling — one of the JFC Co-Chairs who voted against the additional appropriations — confirmed the State's obligation to negotiate with Talgo in good faith following the JFC action (Exh. 19).

The State's decision to renege on the Maintenance Agreement and the Sublease Agreement is also a breach of the duty of good faith and fair dealing under both contracts' plain terms and Wisconsin law, given that the State facilitated the very conditions identified by the DOT as the purported basis for termination. "Every contract implies good faith and fair dealing between the parties to it". *Bozzacchi v. O'Malley*, 211 Wis.2d 622, 626, 566 N.W.2d 494, 495 (Wis. App. 1997) (internal quotation marks omitted). *See also* Wis J I-Civil 3044 ("Every contract implies good faith and fair dealing between the parties and a duty of cooperation on the part of both parties.');" *Chayka v. Santini*, 47 Wis.2d 102, 107, 176 N.W.2d 561, 564 (1970) (mere "compliance in form, not in substance ... breaches the covenant of good faith that accompanies every contract").

The State promised that the DOT would "not ... affect such termination for the purpose of replacing the Trainsets with trainsets supplied by others, or otherwise as a purposeful means of terminating the contractual relationship between the parties or replacing Talgo as the provider of Maintenance Services for the Trainsets, or otherwise as a purposeful means of terminating the contractual relationship between the parties" (Exh. 3, §22). To date, the State is breaching this promise by reallocating maintenance funds intended to the Talgo train sets to Amtrak, which is instead providing different train sets.

Contrary to its express and implied duties of good faith, under Governor Walker the State has repeatedly acted in bad faith to frustrate its agreements with Talgo. To begin with, as described above, Governor Walker declined \$810 million in federal



stimulus funding after the State and Talgo executed the Purchase Contract and the Maintenance Agreement. This federal funding which would have fully paid for the permanent maintenance facility at no direct expense to Wisconsin. In addition, Governor Walker's statements that he intended never to put the train sets into service, and would sell them to another state if possible, leave no doubt that Wisconsin lacked a good faith intent to abide by the Maintenance Agreement or the Purchase Contract's related provisions. Similarly, when the DOT provided to the Legislative Fiscal Bureau its comparison of the costs of operating the Talgo train sets with the costs of operating the existing Amtrak equipment, the DOT exaggerated the Talgo costs while simultaneously ignoring the financial benefits associated with the Talgo equipment. Finally, rather than exercising his power to veto the JFC's action and return it to the JFC for reconsideration under Wis. Stat. §13.10(4), Governor Walker immediately approved the JFC action on March 18, despite an imminent change in the JFC's member composition that likely would have sustained a rejection of the JFC's March 14 action.

In other words, Wisconsin's purported funding shortfall was deliberately staged by Governor Walker and the DOT in an effort to evade the State's contractual commitments to Talgo, contrary to both the Maintenance Agreement's clear language and Wisconsin law. Thus, the State is not entitled to employ either contract's termination provisions for the additional reason that it has acted in bad faith.

To this day, it appears the DOT is failing to acknowledge all the consequences of its behavior. In addition to exposing the State to the substantial damages it must pay to Talgo, the \$70,000,000 in bond proceeds the DOT requested and received from the

legislature must be restored to the bond fund, because that bonding authority required the acquisition of a capital asset which has never been obtained.

### **III. Dollar Amount of Talgo's Claim**

As the first element of the State's liability, the State's material breach of the Purchase Contract and its unlawful termination of the Maintenance Contract and Sublease have resulted in a liquidated debt of \$18,597.003 owed to Talgo. This claim constitutes the total amounts invoiced by Talgo and unpaid by the State under the three interrelated agreements, plus interest through November 1, 2013 (*see* Exh. 20).

However, Talgo's liquidated damages for the state's defaults on the Purchase Contract and Maintenance Agreement do not include other substantial damages, totaling more than \$48,000,000, suffered by Talgo as a direct consequence of the State's material breach and unlawful termination of the contracts. The State's premature termination of the Maintenance Agreement caused damages to Talgo in the amount of \$9,826,998.<sup>7</sup> Further, Talgo's damages include its costs to perform testing on the train sets that should have been paid by the DOT; the costs of storing, preserving and caring for the train sets subsequent to the DOT's breach; and the costs of trying to mitigate its damages (such as efforts to locate a less costly storage facility and to sell the train sets to another buyer). Further, Talgo's damages include insurance expenses, labor expenses, attorney's fees, transportation fees and expenses, and loss of reputation associated with the State's personnel continually defaming Talgo's professional reputation in every

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<sup>7</sup> This figure is net present value, exclusive of the amounts invoiced on the Maintenance Contract and unpaid by the State, and related interest charges, as referenced above.

conceivable forum, etc. Altogether, Talgo's claim against the State presently totals \$65,889,158, as detailed on the attached spreadsheets (*see* Exh. 20), an amount that continues to grow each day.

Because Talgo's claim against the State exceeds \$10,000, Talgo requests that the Claims Board submit a recommendation to the Legislature to pay the claim in the full amount of \$65,889,158, plus interest.