**Customer Liability on Termination For Convenience – Part I**

When I am retained by a customer on an outsourcing project, almost invariably, one of the first questions I am asked when the conversation comes around to termination is about early termination of the outsourcing agreement without cause and the resultant costs. This is not usually because the customer plans to do so but rather because it wants the freedom to do so should any number of unforeseen scenarios arise down the road such as a change of control. This posting addresses the potential costs to the customer of such termination in the situation where no staff are moved from the customer to the service provider. Part II of this posting will address the additional issues and costs that arise when staff are transferred from the customer to the service provider and the customer wants to terminate the outsourcing agreement without cause.

## A Clarification

To be clear, I am not talking about termination where there is a breach by the service provider of the underlying outsourcing agreement that permits termination but only when termination by the customer is for its convenience. When discussing this topic with the customer, I always advise the customer to undertake its own analysis of potential costs of termination for convenience in the absence of the service provider (or before the RFP is issued if RFPs are to be issued) so that the customer can be fully prepared for the response from the service provider. As an aside, it is not my experience that service providers will object to this concept but rather that they will make it so expensive that the customer will be disincented to pursue termination for convenience.

## Early Termination Charges - Lost Profits[1]

The first general rule in contract law is that when a contract is breached by a party or terminated for convenience by that same party, the innocent party is entitled to the 'loss of the bargain'. Stated another way, the innocent party is to be made whole as if the breaching party or party terminating for convenience had not done so. The termination of a motor vehicle lease is a useful and simple illustration. Anyone who has leased a motor vehicle has most likely seen a table attached to the lease identifying the amounts to be paid on early termination (the "Early Termination Fee"). The Early Termination Fee primarily reflects the lost pre-tax profit to the lessor based on its expected return on its capital expended on the purchase of the vehicle in question – i.e., the loss of the bargain.

While more complex, the same principles hold true in the calculations that the service provider must make to determine the termination payment to be made by the customer for a termination for convenience.

As a practice note, it is fairly common for the service provider to fail to take into consideration that the amount due on early termination is a prepayment of amounts otherwise due over the balance of the term of the outsourcing agreement (the "Term"). However, to be enforceable as actual damages and not enforceable as a penalty, the amount due should be the net present value of the lost profits discounted by an amount reflecting current interest rates on a term investment

[1] I frequently see contracts where lost profits are categorized with consequential, special and indirect damages. However, lost profits are foreseeable and are actually direct damages.

approximating the outstanding Term. Stated another way, failure by the service provider to apply a net present value in calculating the amount due may be held by a court to be an unenforceable penalty rather than the actual damages suffered by the service provider.

**Early Termination Charges - Additional Charges**

In addition to lost profits, there are other amounts that the service provider will normally be expected to be reimbursed for in the event of a termination for convenience that cannot be built into the pre-determined lost profits calculation described above.

First, there are 'sunk costs'. 'These reflect any one-off costs incurred by the service provider in providing the services under the outsourcing agreement (the "Services") to the extent that they cannot be reduced or eliminated obligating the service provider to make the payments represented by such one-off costs. An example of sunk costs might be the depreciated value of hardware purchased for the provision of the Services which hardware is dedicated to providing the Services and which cannot be otherwise used or sold by the service provider. (*Pro-rata* amounts due for non-dedicated hardware will also have to be calculated.)

Second, there are 'stranded costs'. These reflect costs in connection with any future commitments made by the service provider in anticipation of delivery of the Services to the extent they cannot be reduced or eliminated obligating the service provider to make the payments represented by such costs. An example of stranded costs might be the outstanding lease payments for hardware leased for the provision of the Services which hardware is dedicated to providing the Services that cannot be otherwise used by the service provider.[2] (Again, *pro-rata* amounts due for non-dedicated hardware leases will also have to be calculated.)

Finally, there are 'deferred costs'. While perhaps less common than in the past due to revenue recognition issues for service providers, these are costs incurred by the service provider in providing the Services, and for which the service provider has deferred the payment of associated fees by the customer for (i) service provider marketing reasons, (ii) customer initial year pricing concerns, (iii) the customer business case, or (iv) other reasons.

**Termination Service Charges**

The need for termination services and the fees for such services are now well understood and normally part of any outsourcing agreement. However, service providers often agree to discounted rates for fees for termination services which discounts approximate the discount off list prices for the fees for the Services. However, it is also very common for the service provider to charge list prices for termination services fees if the termination services arise as a result of a termination of the outsourcing agreement by the service provider due to a breach by the customer. Since termination for customer breach and termination for customer convenience are analogous for contractual purposes, the customer can also expect to pay list prices for termination services in the event of a termination for convenience.

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[2] In some transactions I have worked on, the customer contractually limits the service provider from entering into leases for more than a set number of years without the consent of the customer so as to minimize any possible stranded costs.

**Next Post**

In Part II of this posting, I will look at the financial impact on the customer as a result of the termination of employees that are made redundant by the termination for convenience and how they are identified and compensated.