

Exit management: how to stop the door slamming shut

Resource type: Articles: know-how

Status: Law stated as at 01-Feb-2010

This chapter sets out the key issues to be considered to ensure an effective exit strategy, and some important points that must be addressed in the outsourcing agreement. In particular, it considers when exit can be triggered, when exit management issues should be considered, and the key issues that should be addressed in the exit provisions of the outsourcing contract.

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Outsourcing arrangements are often at the core of a customer's business, given their long-term nature and the increasing trend to outsource business-critical functions. As a result, retaining the flexibility to transition smoothly between suppliers and solutions, while ensuring continuity and quality of service is critical, and having effective exit arrangements in place to provide this flexibility is an important part of any customer's longer-term outsourcing strategy.

That said, when it comes to contract negotiations, exit is often the last thing on the parties' minds. Neither party wants to focus on termination of the arrangement and disengagement before the outsourcing relationship has even begun, and other, more immediate aspects of the outsourcing contract inevitably take higher priority.

As a result, the termination and exit provisions of the agreement often do not get the attention they deserve during contract negotiations. This is a mistake: in second- and third-generation outsourcings, where services are being transferred from the outgoing supplier to a replacement supplier, the ability to transition services, and the success of the transition, is largely down to the level of co-operation and assistance provided by the outgoing supplier.

Waiting until termination is on the horizon before considering what is needed to exit the contract effectively, and with minimum risk to the customer's business, may well be too late. By then, the customer will have limited commercial leverage with the supplier, and there is often little incentive on the part of the outgoing supplier to do anything other than the minimum required by the contract to transition the services (often to a direct competitor). As a result, unless the contract provides the protection needed, transition of the services back in-house or to a replacement supplier carries a high risk of delay or disruption, and at worst means that the customer may consider it has no choice but to continue its relationship with the incumbent supplier.

For these reasons, it is important that the customer's exit strategy is given adequate attention during the contract negotiations and that the customer builds sufficient protection into the contract, ensuring that it gets what it needs on exit to redress some of the imbalance in the parties' positions on termination.

This chapter sets out the key issues to be considered to ensure an effective exit strategy and some important points that need to be addressed in the outsourcing agreement. In particular, it considers:

- When exit can be triggered.
- When exit management issues should be considered.
- The key issues that should be addressed in the exit provisions of the outsourcing contract.

When exit can be triggered

An exit strategy is only effective if it is available to the customer at the right times; comprehensive exit management provisions are of little use if the customer is tied in for the long term. The first issue to address, therefore, is the circumstances in which the outsourcing agreement can be brought to an end. These include some or all of:

- Termination for cause.
- Termination for insolvency.
- Termination for convenience.
- Other termination rights.
- Expiry.

Termination for cause

In a long-term services deal, the customer needs to consider not only standard provisions such as material, unremedied breach; it should also consider termination rights for repeated failures, whether or not those failures are remedied. This is particularly important in outsourcing agreements where the supplier's performance is largely measured by service levels. The customer needs to ensure that it is not locked into an agreement where the supplier repeatedly fails to meet the agreed service levels. In many cases, the contract defines the number of repeat failures in a given period that allow the customer to terminate for cause. Regardless of which party is at fault, exit assistance is still needed; the only variable is whether exit assistance charges are payable to the supplier (*see below, [Payment considerations](#)*).

Termination for insolvency

Similarly, both parties will want the right to terminate the agreement where the other party becomes insolvent. Since, in most jurisdictions, a contract will not, as a matter of law,

automatically terminate on the other party's insolvency, each party needs to consider the circumstances in which it has the right to terminate where the other gets into financial difficulty. From the customer's standpoint, if the contract survives the supplier's insolvency, the customer could find itself in a situation where it has ongoing obligations (for example, to make payment) but the liquidator or administrator of the supplier has chosen to decline performance of the supplier's obligations. The customer also needs to bear in mind that, in some jurisdictions, such as the UK, if the supplier is in liquidation, the liquidator has the power to disclaim "onerous property", which can include unprofitable contracts. If the liquidator disclaims a contract, the other party has an action for breach of contract but joins the list of unsecured creditors with its claim for damages. Ideally, the contract should allow for the right to terminate before insolvency occurs (when there are warning signs that insolvency may follow). By the time the supplier becomes insolvent, it may have lost the ability to facilitate a smooth transition. These warning signs may include:

- The supplier entering into arrangements with its creditors.
- The supplier being unable to pay its debts as they become due.
- The supplier appointing an administrator or other insolvency practitioner.

If it is the supplier that is in financial difficulties, the customer may also require "fast-track" provisions to exit quickly. Where the supplier terminates because the customer is in financial difficulty, the supplier should make the provision of exit assistance conditional on advance payment by the customer.

Termination for convenience

The customer may want to bring the agreement to an end for reasons other than material or repeated breach or supplier financial failure, for example the:

- Customer may be dissatisfied with the supplier or the supplier's performance (for reasons that do not amount to material or repeated breach).
- Market may have changed, such that the customer wants access to more favourable pricing or better technology.
- Customer's sourcing strategy or business requirements may have changed.

In any deal that is longer than a couple of years, it is important that the customer retains the right to terminate for convenience. The supplier will have legitimate concerns about this where it has agreed pricing on the basis of a longer term deal. For example, the supplier may have made up-front investments (in equipment, premises and so on), the costs of which it is expecting to recover

over the life of the contract, or the supplier may have agreed to reduce its margin in the early years of the contract.

In these circumstances, the supplier will, rightly, expect the customer to pay an early termination charge. The contract should be clear on how this charge is to be calculated and, where it is a liquidated amount, the supplier should (before contract signature) provide details of how it has arrived at that amount and what costs it is seeking to recover through the termination charge, so that the customer can validate that the early termination charge is reasonable. In addition, the contract should reflect that the early termination charge reduces over time.

Other termination rights

Other express termination rights that should be considered include a right to terminate where the parties have been unable to implement the recommendations made by a benchmarking adviser, and termination for change of control. Where the customer already has a right to terminate for convenience, a right to terminate because the benchmarking recommendations have not been implemented is only advantageous if the customer does not have to pay a termination charge (or at least the full termination charge) in these circumstances. Ultimately this is a matter for negotiation between the parties.

Expiry

Finally, the contract should not overlook the fact that exit assistance is also needed where the agreement runs its full term and expires. In these circumstances, the trigger point for commencement of exit assistance activities and services are different (in that they are not triggered by a termination notice). This point also needs to be addressed in the contract and/or the exit management schedule.

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When to consider exit management issues

Frequently, the customer and supplier elect not to negotiate and agree a detailed exit management plan as part of the original negotiations. Indeed, it may not be possible to do this if, as is often the case, the supplier is implementing changes to the customer's service delivery model or solution (for example, as part of a transition or transformation programme).

Even in these circumstances, the exit provisions should not be ignored during the contract negotiations. At the outset, the parties should negotiate and agree a detailed set of (legally binding) principles setting out the terms that apply during the exit phase. The supplier should then be required to prepare, after contract signing (normally during the transition phase), a detailed

exit management plan (which addresses how a smooth exit is to be achieved from an operational standpoint).

The contract should specify a date by which the detailed exit management plan must be delivered (for customer review and approval). In addition, to guard against the possibility of delivery of the plan drifting, the customer should consider making part of the transition payments conditional on delivery (and agreement) of the detailed exit management plan (and any other deliverables that are due during transition). The contract should also require the supplier to update the exit plan on a regular basis (perhaps once a year) and following (or as part of) any major change to the services.

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Key issues to be addressed

There are a number of issues that should be addressed in the exit provisions of the contract. These include assets, people, intellectual property, knowledge transfer, re-tendering, change freezes and payment considerations, each of which are considered in further detail below.

Assets

The contract needs to address how each category of asset is to be dealt with on termination, including:

- Equipment and other physical assets.
- Contracts.
- Software.

Equipment and other physical assets. Whether the equipment and other physical assets used to provide the services are to be transferred to the customer as part of the exit strategy depends on a number of factors. The most important of these is whether those assets are dedicated (used only in the provision of services to the customer), or shared (used for the benefit of multiple customers of the supplier).

For dedicated assets, the customer generally seeks to have the option to purchase those assets on termination. The contract should address how the purchase price is to be determined. Frequently, it is agreed that this is at net book value, in which case the contract should specify the depreciation and amortisation principles to be used for the purposes of calculating the net book value.

For obvious reasons, it is rarely practical for the supplier to offer the customer an option to purchase the shared assets.

This has implications for the contract:

- First, the contract should clearly identify from the outset any assets (or asset types) that should be used exclusively for the customer's benefit. This may have an impact on the supplier's costs (and therefore the charges payable by the customer) and this needs to be factored into the price or pricing terms.
- Second, the contract should require the supplier to provide the customer with details of all assets used to provide the services to the customer, including age, location, condition, refresh profile, and whether the asset is dedicated or shared. Among other things, this enables the customer to identify any equipment or other assets that can be purchased from the supplier on termination, and those that will have to be replaced. This information is also important to enable other prospective suppliers to prepare their bids as part of any re-tendering exercise (see below, [Re-tendering](#)).

To address these points, the contract normally requires the supplier to create and maintain a register of all key assets used to provide the services. The supplier should be required to update this regularly throughout the life of the contract (including following any major changes to the services or to the supplier's service delivery model), and to provide the customer with a copy of this at regular intervals. This helps to ensure that an up to date asset register is available to the customer when needed as part of the exit strategy.

In addition, the contract should address the terms on which any assets are to be transferred: in particular, whether the supplier is required to provide any warranties as to the quality or suitability of the assets, or whether these are to be transferred on an "as is" basis. Ultimately, this is a matter for negotiation. As a minimum, the supplier should be required to assign any manufacturer warranties (to the extent these are capable of assignment), and to warrant that the assets will be transferred with full title guarantee (or equivalent) and free from any liens and other encumbrances.

Contracts. Similar issues apply in relation to any contracts to which the supplier is a party that are relevant to the provision of the services. These contracts may include key subcontractor agreements, supply agreements, services agreements, software licences, and hardware and software maintenance agreements.

The outsourcing contract should distinguish between third party contracts that are relevant solely to the provision of the services to the customer, and those that are relevant to multiple customers of the supplier. The former category may include contracts that were novated from the customer to the supplier at the start of the outsourcing arrangement, as well as contracts subsequently entered into by the supplier. The customer normally requires the option to have some or all of the contracts in this category assigned or novated to it on termination.

To facilitate this, the contract should contain a provision requiring the supplier to ensure (or at least to take reasonable steps to ensure) that, where necessary, appropriate assignment or novation rights are included in those contracts. The supplier should ensure that all contracts in this category can be terminated at the same time as the outsourcing agreement, so that it is able to terminate these if they are no longer required by the customer.

The supplier is also likely to have in place contracts with third parties that are relevant to its customer base generally, and clearly these are not appropriate for transfer to the customer on termination. The customer should ensure that the supplier is required to provide details of these contracts on request, as this information can then be used to identify and source an alternative means of supply of the relevant products or services. The supplier is unlikely to be willing to provide commercially sensitive information relating to these contracts (such as pricing), but should be prepared to give sufficient information to enable the customer to understand the products and services being provided under these contracts.

As with the transfer of physical assets, the contract needs to address the terms on which any contracts are to be assigned or novated. For example, the customer needs to know that:

- It has been provided with all terms of the contract (and that there have been no material variations of which it is not aware).
- There are no material disputes between the supplier and the contract counterparty.
- Neither party has served notice of termination.
- The supplier is not in material breach of that contract.
- The supplier has no grounds for believing that the counterparty is in material breach.

In addition, the contract needs to address and apportion responsibility for any liabilities that arise in connection with any third party contracts. Frequently, this is dealt with by way of reciprocal cross-indemnities for liabilities arising before and after transfer of the contract.

Finally, the contract should deal with who bears the cost of any charges imposed by the counterparty in connection with the transfer or assignment (although the imposition of assignment charges is less common than it used to be, and the parties should be able to avoid this by negotiating appropriate terms before the third party contract is entered into).

Software. Particular thought should be given, at the outset, to the position on software licences and maintenance contracts (especially relevant to IT outsourcings, but increasingly important for many business process outsourcings as well). The parties need to agree whether software licences and maintenance contracts are to be bought in the supplier's or customer's name. While there may be a commercial benefit in these licences being bought in the supplier's name (the supplier may have more favourable pricing terms with the software vendor, for example), this can create

complications on exit, unless the parties have managed to include an assignment or transfer right in the relevant licences and contracts.

These points are relevant to licences and maintenance contracts for application software, but the customer is also likely to want to ensure either that any software licences relating to equipment used exclusively to provide services to the customer (for example, operating system licences and firmware) are in the customer's name or that they are capable of transfer to the customer.

People

Regardless of what is stated in the contract, the supplier's employees may transfer to the customer or a replacement supplier on termination by operation of law. In the EU, for example, this may happen under Directive 2001/23/EC on safeguarding employees' rights on transfers of undertakings, businesses or parts of businesses (Acquired Rights Directive) (ARD).

Under the ARD, employees automatically transfer on their existing terms and conditions of employment, with continuity of service, along with all accrued rights and liabilities in connection with their contracts of employment (except those rights and liabilities relating to provisions of occupational pension schemes regarding old age, invalidity and survivors).

Depending on the nature of the services provided, the manner in which they are supplied and the bargaining power of the parties, the customer may be able to negotiate a requirement that the supplier reassigns its employees to other duties immediately before the transfer, purporting to avoid the transfer under the ARD. This may be particularly important where a customer wishes to change supplier because it is dissatisfied with the service standards or service levels being achieved by the supplier's employees.

However, where the supplier's employees are assigned to the services and the supplier does not have other duties to which its employees can be reassigned, the employees automatically transfer under the ARD, unless they object to the transfer.

Where it is anticipated that employees will transfer on termination, the contract should cover a number of matters, such as identifying those employees who will transfer (*see box, [Employees transferring on termination: contract drafting issues](#)*).

IP

In many outsourcing contracts, the supplier and its subcontractors create documentation (in the form of process manuals and help desk scripts for example), software code and other deliverables.

[## It is important that the contract addresses ownership of these deliverables, bearing in mind that in many jurisdictions the default position is that the supplier (as author) retains ownership. Where ownership is not transferred to the customer, the contract

should address whether the customer is permitted to use those deliverables following termination (and on what terms).]

Where items are created as part of a discrete project for the customer (for example, the development of a new software application), for which the customer has paid separate project fees, the customer normally insists that ownership of those items is assigned to it. If this is agreed to, the supplier should consider whether it should have a licence to use the IP rights in those items for the benefit of its other customers (possibly after a period of exclusivity for the customer). The customer would expect any such licence back to be reflected in more favourable pricing terms for the development project concerned, and ultimately these are commercial issues to be negotiated case by case. Where the supplier retains ownership in this scenario, the customer should ensure that it has a perpetual and irrevocable licence to use the items (essentially a licence that gives broadly the same rights as ownership would).

In addition to items created as part of a discrete project, the supplier may also create other IP rights in the ordinary day-to-day provision of the services. This might, for example, include software code allowing different parts of the customer's system or network to interface with each other. Again, the parties need to address, at the outset, who will own this IP and, if the supplier retains ownership, whether the customer is likely to need to use that IP following termination. If there is a possibility that this IP will be needed, the contract should again address the scope of the post-termination licence.

Among other things, the customer should ensure that:

- The licence permits modification of the IP (to allow continued use as the customer's business and operations change).
- The licence permits use by replacement suppliers to provide services to the customer.

For the position on procedures manuals and other documentation created by the supplier in the course of service delivery see below, [Knowledge transfer](#).

Knowledge transfer

One of the most important areas to be addressed as part of any exit strategy (and one that is frequently overlooked) is knowledge transfer.

The customer is unlikely to have retained much internal knowledge of the processes involved in the delivery of the services, which in any event are likely to have changed significantly over the life of a long-term deal. The contract needs to address how this knowledge can be transferred to the customer or a replacement supplier during exit.

This can be achieved in a number of ways:

- Some of the supplier's employees may transfer to the customer or replacement supplier on termination, automatically transferring to the customer or replacement supplier much of the requisite knowledge as to process and service provision. This transfer may happen by operation of law (the ARD in Europe for example) or by agreement between the customer and the relevant employees. In this context, the customer needs to consider carefully before contract signing the scope and duration of any non-solicitation or non-poach provisions that it is being asked to sign up to by the supplier.

In many jurisdictions, there are no legal restrictions on the supplier's ability to change the employees involved in the delivery of the services during the exit period. This can lead to "social dumping" behaviour, where the supplier "dumps" its underperforming employees on the customer (see box, [Employees transferring on termination: contract drafting issues](#)). To guard against this, the contract should include provisions preventing the supplier from making any changes to the employees engaged in the service provision (except for reasons outside its control) either:

- from the point at which a termination notice has been given by either party;
- during the last six months of the contract where the contract runs its full course.

These provisions should be in addition to any "key personnel" terms that apply during the life of the contract.

- The contract should include terms requiring the supplier to prepare a procedures manual, describing how the services are delivered by the supplier, including the processes used. This manual is an important tool in ensuring that the customer can run an effective re-tendering process (see below, [Re-tendering](#)). The supplier is normally required to prepare the manual, for customer acceptance, during the transition phase. The supplier should also be required to maintain and update the manual during the life of the contract, to take account of service delivery and process changes, so that the customer knows that the manual it receives as part of exit is up to date and current. The supplier may have concerns about including in the manual any of its proprietary processes that are confidential or commercially sensitive, in which case the parties need to agree terms that both:
 - ensure that the customer has the knowledge needed to take over (or hand over) the services on termination;
 - do not unduly prejudice any competitive advantage that the supplier's processes may give it in the market.

- The customer should consider whether other mechanisms are needed to ensure an effective knowledge transfer. These mechanisms might include training programmes and workshops, and access rights to supplier employees (these might need to apply not only during exit, but for a reasonable period post-termination). In some cases, the customer may want to have the ability to implement a more formal "work-shadow" process, where the customer's, or a replacement supplier's, employees are permitted to shadow the supplier's employees in their day-to-day operational activities. The supplier should put some limits around any work-shadowing arrangements, among other reasons to ensure that:
 - they do not interfere with the supplier's ability to provide services (to the customer and its other customers);
 - the customer's, or replacement supplier's, employees do not have access to commercially sensitive information of the supplier or its other customers.

Re-tendering

Related to the customer's exit strategy is the process of re-tendering the services. In a second- or subsequent generation outsourcing most, if not all, of the information that other prospective bidders may need to prepare and submit a meaningful bid, is in the hands of the incumbent supplier (unlike in a first-generation outsourcing, where the customer holds (or is in control of) all the information needed to tender the contract on a competitive basis). For obvious reasons, the incumbent supplier may not be motivated to readily hand over all this information to enable its competitors to bid for the services.

Unless other prospective suppliers can be satisfied that there will be a level playing field between them and the incumbent supplier (if that supplier has been asked to re-tender), it can be difficult to attract those suppliers to bid on second- and subsequent-generation outsourcings. This scenario can significantly undermine the customer's ability to exit an outsourcing arrangement.

To avoid this lock-in scenario, it is important that the contract contains terms that redress the imbalance and allow for a level playing field between all bidders. The contract should describe in detail the information that the supplier must provide to the customer and other prospective suppliers as part of any re-tender exercise. The contract should also specify when this information must be provided. It is not sufficient that it be provided during exit: the customer needs to have access to it well in advance of exit, to enable it to prepare for and run a proper re-tendering exercise. For this reason, the customer should ideally be able to obtain the information at any point during the contract term.

The information in question may include:

- Details of the services, including service levels attained. In all probability, the customer will already have this information (in the form of service level and management information reports). It is important that the contract makes clear that the customer either owns those reports, or has the ability to disclose them to third parties, including as part of any re-tender exercise.
- Details of work volumes and staffing requirements in the preceding 12-month period (including details of roles and responsibilities), broken down by location and by whether those staff are dedicated to the customer account or part-time.
- Full details of each employee who is assigned to the services, including their terms and conditions of employment, date of birth, length of service, remuneration and any associated liabilities (including claims brought against the supplier and grievances raised).
- Details of the assets (hardware, software and any other equipment) used in the delivery of the services, including technical specifications and condition of those assets (where appropriate and relevant), age and refresh profiles.
- Organisation charts including details of key subcontractors used.

As a general rule, prospective bidders are likely to need the same information and assistance that the incumbent supplier had access to when it bid for the services at the start of the contract. This is sometimes a principle that is enshrined in the contract.

Change freezes

The contract should also consider whether a "change freeze" needs to be imposed following notice of termination, preventing the supplier from making material changes to the manner in which the services are delivered (or to the assets used to deliver the services) without customer approval.

The reason for this is to ensure stability and minimise the risk of disruption during exit, and to ensure that the assets and service delivery components that the other bidders have used as the basis for their bids do not change significantly.

Note that this is different to the contract change control process (intended to manage and control changes to the service scope), in that it is possible for the supplier to make changes to the assets and/or processes used to deliver the services, without necessarily triggering the contract change control process. The change freeze is intended to address this.

Payment considerations

Payment considerations relating to exit should also be considered upfront and addressed in the contract. There are a number of different approaches here.

First, customers may seek to have exit and termination assistance included as part of the charges, so that the customer does not have to make a significant additional payment during exit. While this has some obvious attractions in principle, the reality is that the parties often do not know what level of input and assistance will be required from the supplier on termination. This depends on a variety of factors, including:

- The reason for the termination.
- Whether the services are being in-sourced or transferred to a replacement supplier.
- The complexity of the services and service delivery model.

For these reasons, this approach means that one party or the other is taking a potentially significant risk.

An alternative approach that is sometimes adopted is to distinguish between the reasons for termination. If, for example, the customer has terminated for cause (poor performance, supplier financial difficulties and so on), it can expect the exit assistance to be provided at no additional cost. The supplier, however, can resist this position on the grounds that, had the contract run its course, the customer would still have required termination and exit assistance, and the only difference is that the requirement for exit assistance (and the customer's payment obligation) has been accelerated.

In practice, some customers take the view that they are prepared to pay for exit assistance services (regardless of the reasons for termination), on the grounds that the quality of the assistance services will be better as the supplier is being remunerated. The customer should, however, ensure that it has agreed a rate card with the supplier in advance, to be used to calculate the exit assistance charges. In addition, the customer will probably want the ability to pay for exit assistance either on a time and materials basis or on a fixed-price basis. The contract should give the customer the right to choose either of these options.

The customer should also consider building into the contract the right to redeploy existing resources (that is, resources that it is already paying for as part of the monthly service charges) from their day-to-day activities to focus on exit activities. This may have a knock-on effect on the supplier's ability to meet other contractual obligations (for example, service levels), and the supplier should ensure that, where existing resources are redeployed with a knock-on effect on performance, it is not penalised for this (whether in the form of service credits or otherwise). Any suspension or relaxation of the service levels as a result of resource redeployment during exit should be agreed before the redeployment and clearly documented to avoid disputes arising at a later date.

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Employees transferring on termination: contract drafting issues

If employees are to transfer on the termination of an outsourcing agreement, the contract should:

- Identify the employees to transfer and include mechanisms to deal with employees who claim to have transferred (or not to have transferred) contrary to the intentions of the parties.
- Detail how employment liabilities are to be addressed (the typical approach is a straight split between liabilities accrued pre-transfer and those accrued post-transfer).
- Set out the apportionment of employment costs (again, the typical approach is a straight split between costs incurred pre-transfer and those incurred post-transfer).
- Detail how information is to be provided to the customer or any replacement supplier to enable the re-tendering process (*see main text, Re-tendering*) and to allow the replacement supplier to undertake due diligence on the workforce and their terms and conditions of employment to evaluate their likely liabilities. (Some national implementing legislation contains minimum obligations regarding the provision of information but customers and replacement suppliers often demand more information.)
- Set out obligations in respect of:
 - the provision of information to the supplier's employees regarding the transfer;
 - the consultation process with them.

- Identify pension aspects.
- Include provisions dealing with any redundancies or reorganisations.
- Set out obligations on the supplier during the notice period or in the period up to the termination or expiry of the contract (such as restrictions on hiring new employees or changing the terms and conditions of employment of existing employees, and restrictions on the removal of employees from the services during the notice period).
- Ensure that any incoming supplier can obtain the benefit of relevant protections provided in the contract (such as indemnity protection for pre-transfer liabilities).

The identification of employees to transfer and the restrictions on the supplier during the notice period are important. This is to ensure that the outgoing supplier does not "dump" its unwanted employees on the contract in the last few weeks and take its best employees off the contract (with

a view to getting rid of the worst employees by means of the transfer and retaining the best ones ("social dumping").