University of California
Office of the President

Office of the
Associate Vice President —
Business and Finance

Contracts and Grants Office

Memo
Operating Guidance

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VICE CHANCELLORS — BUSINESS AND FINANCE/ADMINISTRATION*
CONTRACTS AND GRANTS OFFICERS (NON-LAB)
OFFICE OF THE PRESIDENT FUNCTIONAL MANAGERS

Subject: Termination Clauses in Cost-Reimbursement Contracts with Commercial Sponsors: Uncancelable Obligations

BACKGROUND

At the Spring C&G Conference last June, Patent and Copyright Officer Pat Brennan discussed a problem that the Los Angeles campus had with an early termination of an industrial research agreement. Although many of the issues involved were unique to the terms of that particular agreement, part of the dispute centered on the meaning of certain terms typically used in most termination clauses in cost-reimbursement contracts with industry and other for-profit organizations. This has prompted within OP C&G an evaluation of language used in such termination clauses.

As part of this evaluation, a survey was conducted of the nine campuses.

RESULTS OF CAMPUS SURVEY

Eight of the nine campuses currently use similar language in the termination clauses of their cost-reimbursement contracts with commercial sponsors. The following is fairly typical of the language used:

> This agreement may be terminated by either party at any time upon the giving of ninety (90) days prior written notice to the other party. Upon the giving of notice of termination by either party, University shall exert its best efforts to limit or terminate any outstanding commitments and to conclude the work. All costs associated with termination (including uncancelable obligations) shall be allowable, including costs incurred prior to termination which have not been reimbursed to the University. University shall furnish, within ninety (90) days of the effective date of termination, a final report of all costs incurred and all funds received and shall reimburse sponsor for funds which may have been advanced in excess of total costs incurred.

The Los Angeles campus had been using similar language. After its recent experience, however, it has changed its practice and is using the following clause as a starting point in negotiating its non-clinical commercial research agreements:

*Note: The addressees above represent the standard distribution of Contract and Grant Memos. Additional addressees, if any, may be added based on the subject of the Memo. See cc's.

> Either party may terminate this agreement by giving ____ days written notice to the other party. In the event of termination by sponsor, University shall be reimbursed for all expenses incurred to the effective date of such termination, including uncancelable obligations and reasonable close-out costs.

Most of the campuses have experienced no problems with early termination. It is a rare occurrence and when it happens there is usually no dispute between parties about a final settlement of costs.

A few disputes have arisen on two campuses because notice of termination was directed by the sponsor to the wrong campus office. It was sent to the Academic Department rather than to the C&G office. This resulted in disagreements over when the termination was effective, but in all cases the parties came to an amicable understanding.

REVIEW OF LOS ANGELES CASE

In the Los Angeles case, there were two relevant problems. The first concerns the meaning of the phrase "uncancelable obligations." After a termination, a sponsor will usually be invoiced for some obligations that were not cancelled with the explanation that they could not have been. The sponsor, however, may not accept this explanation. The resulting stand-off highlights the fact that what counts as an uncancelable obligation is subject to interpretation.

The second problem has to do with sponsor expectations in the event of early termination. The typical language (above) suggests that, during the period following notification and before the termination date, costs will be incurred at a relatively low and declining rate, compared to the rate at which costs were incurred before the termination notice. In fact, however, the opposite may occur. The rate of spending may actually increase, for two different reasons:

1. There may be extra costs associated with the unanticipated closing down of the project, such as clerical or accounting costs, which would not have been incurred but for the early termination; and,

2. Expeditiously handled close-out costs and the previous month's usual expenditures, when combined, may appear as a sudden surge in expenditures.

SUMMARY OF POTENTIAL PROBLEMS

The campus survey and related analysis indicate that the language typically used in termination clauses in cost-reimbursement contracts with commercial sponsors is not complete enough to prevent all misunderstandings with respect to the following questions:

1. Where should notice of termination be sent?

2. What obligations are uncancelable?

3. What additional or total obligations might the University incur up to the date of termination?

The University's experience has been that the number of early terminations is small, and the number of misunderstandings even smaller. Thus the guidance below is offered for use in those cases where the risk of early termination is thought to be higher than normal.

GUIDANCE

1. Notice of Termination

   To minimize the risk of the termination notice being sent to the wrong office, language could be inserted to the effect that written notice should be directed to the appropriate individual named in the "Notices" article of the contract.

2. Uncancelable Obligations

   To minimize the risk of a dispute arising over what kinds of obligations are likely to be uncancelable, certain items could be specified, as follows:

   Salary and fringe benefits (including vacation accrual) of personnel engaged on the project during their severance period

   Purchase orders and other agreements with outside vendors which cannot be cancelled

   Inventory storage and disposition costs, for items produced under the contract and due to be shipped to the sponsor, destroyed, or otherwise disposed of

   Indirect costs associated with the above costs

3. Rate of Cost Incurrence

   One way to minimize the risk of a dispute arising because of unrealistic sponsor projections of total obligations would be to say in the termination clause that the sponsor is liable for costs incurred prior to termination including those which had not been invoiced prior to the notice, and, when the sponsor initiates the termination, is liable for any additional clerical and accounting costs.

SAMPLE CLAUSE

A sample termination clause which addresses the uncancelable obligations issues raised in this Memo is enclosed. This sample is for illustrative purposes only, and is not meant to be a standard model. The sample may be supplemented to cover other issues such as the disposition of advance funding, the re-pricing of deliverables, and the protection of human subjects who might be involved in the study.

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Subject Index: 02, 22
Organization Index: P-500

David F. Mears

David F. Mears
University Contracts and
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Enclosure

Enclosure to
C&G Memo 85-22

TERMINATION

This agreement may be terminated by either party at any time upon the giving of ninety (90) days prior written notice to the other party. Written notice shall be directed to the appropriate individual named in Article _____ ("Notices") of this Agreement.

Upon the giving of notice of termination by either party, University shall exert its best efforts to limit or terminate any outstanding obligations. University shall be reimbursed for its actual costs for all work performed through the effective termination date, and for all outstanding obligations which cannot be cancelled. Such obligations may include salary and fringe benefits (including vacation accrual) of personnel engaged on the project during their severance period; purchase orders and other agreements with outside vendors which cannot be cancelled; inventory storage and disposition costs, for items produced under this Agreement; and indirect costs associated with these obligations. In addition, in the event of termination by __________, University shall also be reimbursed for additional costs which may be incurred as a result of termination, including reasonable clerical and accounting costs.

University shall furnish, within ninety (90) days of the effective date of termination, a final invoice for settlement of all costs to be reimbursed. This invoice may include costs incurred before the notice of termination was given but which were not yet billed.