CANCELLATION FEES – HOW MUCH IS TOO MUCH?

There has been considerable discussion of late regarding cancellation fees that are charged by ISOs and credit card processors upon the termination of a merchant agreement. Below I will discuss the various types of cancellation provisions and their impact on our industry.

What Is A Cancellation Provision?:

The vast majority of Merchant Agreements contain a provision that provides for the merchant to pay a cancellation fee if the Merchant Agreement is terminated before the end of its term. The "term" of a Merchant Agreement is the time period the contract will be in effect. The industry standard term for Merchant Agreements is three years.

A typical cancellation situation occurs as follows: A merchant signs up with a credit card processor under a Merchant Agreement that provides for a three-year term. The merchant is then approached by a sales agent that wishes to move the merchant to another credit card processor, usually using the enticement of charging the merchant less fees for processing credit cards. The merchant attempts to cancel its existing Merchant Agreement with its current credit card processor before the merchant has been with the credit card processor for three years. However, the merchant is notified when it attempts to cancel the Merchant Agreement that it is subject to a cancellation fee since the merchant has not fulfilled its obligation to use the credit card processor for the entire three years that it is obligated to do so under the Merchant Agreement.

Types of Cancellation Fees:

There are three main types of cancellation fees that are prevalent in the bankcard industry:

The first type of cancellation fee is the flat fee. The merchant is charged a set amount for canceling the Merchant Agreement prior to the end of the term, regardless of when the cancellation occurs. Consequently, if the merchant cancels the Merchant Agreement one day into the relationship or even 2 years and 11 months into a 3 year term. The merchant pays the same amount as a cancellation fee. The most common cancellation fee utilized in our industry is a flat fee of $295.

The second type of cancellation fee a hybrid fee, that is calculated by multiplying a fixed amount by the balance of the term left in the Merchant Agreement. Agents and credit card processors will typically choose a cancellation fee multiplier that is the sum of the monthly minimum and statement fee payable every month by the merchant such as $35. The $35 is multiplied by the remaining months left in the merchant contract. For example, if a merchant cancels his Merchant Agreement after two years where the Merchant Agreement has a three-year term, there are 12 months left in the term of the Agreement. To determine the cancellation fee, you multiply the 12 months remaining in the Merchant Agreement by $35 to arrive at the total cancellation fee of $410.

The third type of cancellation fee, and potentially the most problematic, is based on lost profit to the credit card processor. The Merchant Agreement provides that the credit card processor is entitled to the monthly profit that it would have made from the merchant for the balance of the term of the Agreement. For example, if the merchant cancelled its Merchant Agreement with a year left on the term of the Agreement, the credit card processor would be entitled to 12 times the average monthly profit it would have derived from the merchant. This includes all dues, assessments and other charges that the merchant may have incurred in the first two years of the relationship on an average monthly basis.

Problems With Cancellation Fees:

The main reason credit card processors have to charge these fees is to dissuade merchants from moving to another processor. If a merchant decides to move to a new processor that is willing to offer the merchants more competitive pricing for its credit card processing services, the credit card processor uses the cancellation fee to try to retain the merchant. The merchant loses because it cannot move to a different credit card processor without paying what may amount to a hefty fee in many circumstances. If the merchant does move, the price it pays in the cancellation fee may more than offset any advantage it will get from a lower rate to process. This practice therefore tends to limits competition in the marketplace.

Cancellation fees have also caused problems for credit card processors that try to assess such fees to merchants. Inadequate disclosure of fees is a common problem. Some processors bury the cancellation fee to be charged in the boilerplate language of the agreement and some do not disclose it at all. There have been a number of lawsuits recently challenging these cancellation fees and some companies in our industry have had to pay substantial settlement payments to address these claims.

While inadequate disclosure is a problem regardless of the type of fee, the most serious consequences can occur when “lost profits” cancellation fees are not fully disclosed. Obscure language in the agreement may make it very difficult to really appreciate the amount of the fee that may have to be paid in the event of cancellation. One almost has to be an expert in the credit card processing industry to understand the consequences of early termination of the relationship. If a merchant does try to cancel its contract, the credit card processor sends out a letter to the merchant alleging it is entitled to a cancellation fee that few merchants could afford to pay. The credit card processor has access to the merchant’s bank account so often it is able to take the cancellation fee straight out of the merchant's bank account before the merchant can object. The merchant is left with the decision to stay with the credit card processor or fight over a termination fee that could bankrupt it.

The continued use of these types of cancellation fees, especially the ones based upon lost profits, is inviting additional scrutiny and regulation of our industry. It might be time for us to consider adopting "best practices" to regulate the imposition of cancellation fees in Merchant Agreements.

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