

## A New Approach To Contract Due Diligence In M&A

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Contract due diligence in mergers and acquisitions is an investigative process through which a party or parties to the transaction review the contracts of the counterparty to the transaction to understand the business and legal risks attendant to the purchase of those agreements and their impact on the value of the transaction.

Contract due diligence in M&A transactions is typically focused on identifying:

- Legal risks associated with acquisition of the contracts, such as nonassignment and change-of-control provisions in the contracts that may prevent or otherwise impact closing of the transaction;
- Transaction risks contained within the contracts, such as important company contracts that may not be transferable to the purchaser or that require notice to be transferred; and
- High-level business risks associated with the transaction, such as noncompetes and other contractual restrictions or covenants that may pose a risk to the acquirer or diminish the value of the acquired business.



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While there is nothing inherently wrong with this focus on transaction-related issues, it may ignore other issues regarding the contracts that will only become apparent after closing. Following consummation of the transaction the purchaser will be required to expend additional effort and incur costs that could be avoided through minor changes to the pre transaction due diligence process. As such, a more comprehensive approach to contract due diligence may be called for in certain transactions.

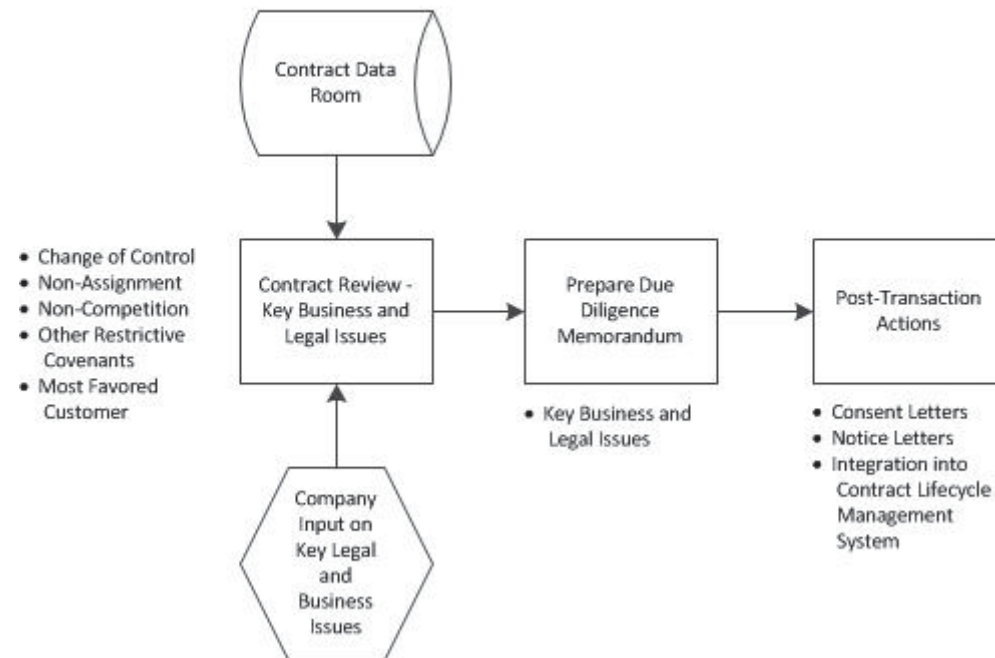
### Existing Due Diligence Paradigm

Whether handled in-house, or by outside counsel, the due diligence process is typically the same, consisting of the following steps in which the attorney:

1. Reviews each contract to identify the most relevant sections;

2. Identifies and flags common legal issues and transaction risks, such as change of control provisions, noncompetes and other restrictive covenants;
3. Identifies and flags important business issues that have been identified by the purchaser, for example, most-favored-customer provisions or contracts with competitors; and
4. Drafts a memorandum outlining risks and issues identified.

### Typical Contract Due Diligence Workflow



When the transaction closes, either the purchaser or the law firm will follow up with required actions that were identified during due diligence. For example, if it was determined during due diligence that certain contracts require consent from the counterparty, consent letters must be drafted and executed. This is an administrative headache when performed by the purchasing organization itself, and costly when handled by outside counsel.

The problem with the existing due diligence paradigm is that it does not take into consideration risks in contracts that were not considered material to the transaction — risks that will become apparent following closing as these contracts are integrated into the contract management processes of the purchaser. A modification of the traditional due diligence process will enable a purchaser to conduct contract due diligence while simultaneously preparing for immediate post-transaction integration of the acquired contracts into the purchaser’s contract management systems, reducing costs in the process.

### **The Relationship Between Due Diligence and Contract Lifecycle Management**

Companies are increasingly implementing comprehensive contract lifecycle management programs into their businesses. These include the use of contract management databases that serve as a repository for the purchaser’s contracts, as well as comprehensive contract management policies and procedures that include the use of contract templates designed to reduce risk inherent in more ad hoc contracting processes. For example, templates may codify the company’s established maximum limitations of liability, or contractual language that it uses for other potentially risky contractual provisions, such as

confidentiality, indemnification or intellectual property ownership. These may be subject to rigorous guidelines that prevent negotiation of these provisions outside of pre-approved fallback positions. In some cases, stringent policies and procedures are put in place to address specific risks, such as those associated with anti-bribery and corruption and other compliance issues.

It is common for companies that have developed mature contract lifecycle management processes to perform contract management using external providers that specialize in this area. In any case, contract lifecycle management would not be handled by external M&A counsel conducting traditional due diligence. Similarly, if a company uses its own employees to conduct due diligence, those employees are unlikely to be the same attorneys who handle routine contract negotiation for the company.

This ultimately results in a disconnect. Those performing due diligence will identify key transaction risks, but having no involvement with the contract management function, will not identify associated contracting risks, and will not consider the importance of activities such as reviewing contracts for compliance with standard contractual positions, or ensuring that contracts are not duplicated between the company and the acquired business. For example, those performing due diligence often will not have access to the purchaser's contract database to determine whether the purchaser and the target company both have contracts with a particular company, e.g., an enterprise license with Microsoft or a master service agreement with a consulting vendor, that need to be harmonized post-closing.

Because of this disconnect, the purchaser faces significant cost duplication as part of the transaction. First, the contracts will be reviewed by M&A counsel or in-house attorneys to determine transaction and business risks. Then the same contracts will be reviewed by the purchaser's contract management personnel or outside legal service provider to ensure compliance with the companies contracting policies and procedures and to identify duplicate contracts. In fact, few companies conducting due diligence give significant consideration to post-acquisition contract integration until after the transaction has closed.

### **A New Model for M&A Due Diligence**

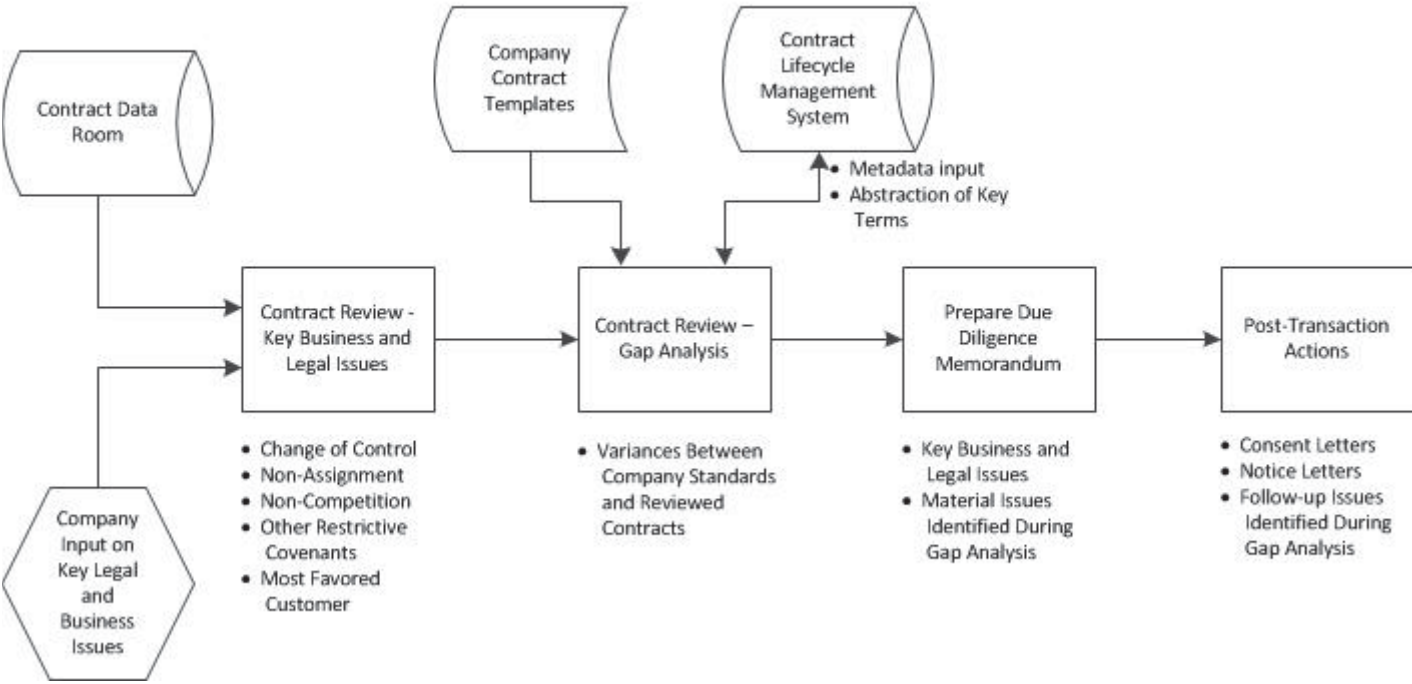
While pre-transaction due diligence has a fundamentally different focus than post-transaction integration analysis, the acquirer may benefit from a service provider that comprehends pre and post transaction concerns and deploys methodologies that both reduce the cost of contract due diligence and post-transaction contract integration, and mitigate the risks inherent in current acquisition processes with regard to contracts. This will achieve significant cost reduction by combining due diligence and post-transaction integration into a single process, and reduce risks associated with the transaction and post-closing integration of the acquired contracts into the business of the purchaser by flagging important post-closing contractual issues while the transaction is still pending.

One method would be to perform analysis during due diligence that provides a "gap analysis" to identify material differences between the target company's contracts and the purchaser's contracting standards. When due diligence is completed, the purchaser will not only have an analysis of the legal and business risks associated with the transaction, but also an analysis of material differences between the target company's contracts and those contractual positions acceptable to the purchaser. In addition to enabling the purchaser to have a better view of the risks of the transaction as a result of the normal due diligence process, it will provide the purchaser with a roadmap for integrating the target company's contracts into its business either by identifying contracts that require amendment, or by at least identifying additional contractual risks of the acquisition.

In addition, as part of the due diligence exercise, the party performing due diligence can extract metadata and abstract key terms from the target company’s contracts, consistent with the metadata and key terms that the purchaser maintains for its own contracts, so that following closing of the transaction, these contracts can immediately be incorporated into the purchaser’s contract lifecycle management system.

Under this model, the steps for conducting due diligence incorporate many of the post-transaction integration steps. As depicted in the diagram below, in addition to the traditional due diligence activities, the individuals performing due diligence will also broaden the scope of the relevant sections analyzed, perform a gap analysis, enter contract metadata and key abstracted provisions into the purchaser’s contract management system, and produce a written outline of the results of the gap analysis, including recommendations relating to contract amendment or contract termination.

### **Modified Contract Due Diligence Workflow**



If the party performing pre-transaction due diligence also has experience with contracting templates and standards, this alignment of commercial due diligence and post-transaction integration can avoid the cost of having each contract reviewed twice by different people, and more importantly, enable the purchaser to identify business and compliance risks that would not otherwise be considered during pre-transaction due diligence.

In this way, for companies that are using or are considering using an external provider for contract lifecycle management, the use of the same provider to conduct M&A due diligence while simultaneously performing post-acquisition integration activities can streamline and significantly reduce the cost and risk of M&A contract due diligence.

—By David M. Klein, QuisLex Inc.

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