Leverage: The Hidden Key in Contractual Due Diligence

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Leverage.

Maintaining superior leverage in an M&A transaction allows a buyer or seller to gain an advantage when negotiating terms of the transaction. If you don't have it, it can cost you tens, hundreds, thousands or millions of dollars, depending on the size of the transaction. Buyers may gain leverage in a transaction during due diligence when the seller has not done its own due diligence prior to delivering requested business information to the buyer. In order to avoid giving up leverage, a seller should conduct internal due diligence well before the business is marketed for sale.

From a seller's perspective, limiting third party control over any aspect of the business at the time of sale is a critical element in maintaining leverage. Each time a seller must seek the consent of a third party to assign a material contract, the seller gives that third party an opportunity to not only impede the transaction, but also demand more favorable terms. Any time this happens, the seller must disclose the change in terms to the buyer, thus giving the buyer leverage to decrease the purchase price or otherwise gain an advantage in the transaction. As a result, the time to review all contractual relationships is not at the point when the contracts are being delivered to the buyer for review. When should a seller begin an internal review of its contractual relationships? The answer depends on the terms of the business' agreements. If a majority of the contracts are long-term agreements, the process should occur at the time the agreement is negotiated. On the other hand, the time to put the business' contractual house in order will be substantially shorter if there are not many long-term agreements.

Some of the contracts that could be subject to an internal due diligence are obvious. For example, if the seller leases its building from a third party, most leases will have a specific clause with respect to assignment and subletting. At the time long term leases are negotiated, the tenant is rarely focused on future events such as the sale of the business and, therefore, does not consider negotiating favorable assignment or sublease terms. Even if the transaction contemplated is a stock sale, many leases have a change of control provision which deems a change in the ownership tantamount to an assignment requiring the landlord's consent. Clearly, the time to negotiate the assignment provision is when no transaction is contemplated, particularly if the tenant has leverage in the lease negotiations. If that is not possible, discussing the factors required by the landlord to consent to an assignment allows the seller to select a potential buyer knowing whether assignment of the lease will be an issue.

While terms of written agreements, such as leases, are, for the most part, straight forward, the terms of supply chain agreements are often times not so obvious. Many contractual obligations within a company's supply chain are "hidden" in proposals, purchase orders, confirmations and invoices. Conducting a due diligence review of supply chain contractual terms is not only a good practice in terms of preparing for an M&A transaction, but should be done on a regular basis as a regular business practice. Prior to supply chain documents being transmitted electronically, it was a common business practice to include a company's standard terms and conditions as an attachment or on the backside of a proposal or purchase order. Signatures were often required. Fast forward to the electronic world of today and terms and conditions of a supply chain transaction are often referenced on electronically transmitted documents with the party being re-directed to a website for the standard terms and conditions. If a seller does not have its own standard terms and conditions incorporated into its supply chain documents, it is at the mercy of the terms and conditions of the customer or supplier. These terms often contain one sided indemnity provisions which could create a liability that is not subject to the seller's insurance policy. While conducting a review of supply chain terms and conditions may be tedious, the seller can be assured that a buyer will undertake the review of these terms and its due diligence during a transaction. The seller's best practice is to create its own set of supply chain documents referring to its terms and conditions of purchase or sale. In addition, the terms should specifically state that they are superior to any other party's terms and conditions. In order to avoid the "battle of the forms", a better practice for the seller is to negotiate definitive supply agreements with its main customers and suppliers.

Another significant contractual relationship often overlooked until a buyer's due diligence review are insurance policies. Many standard business contracts require a seller to provide some type of indemnity. It is important that a seller understand its indemnity requirements and then obtain the appropriate or required insurance coverage. Doing so will insure that the seller is not contractually liable for actions that are excluded from its underlying insurance policy. In terms of an M&A transaction, appropriate coverage is only important to the buyer, but maintaining an appropriate level of coverage for post-closing occurrences is important to the owners of the selling entity. A lack of post-closing coverage may result in owners being legally obligated to return some or all of the transaction proceeds to the company and paid over to the claimant.

Sellers who conduct internal contractual due diligence provide themselves with the opportunity to uncover contractual issues and unforeseen liabilities and correct them in advance of business sale; and maintain leverage during the course of an M&A transaction.

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