

CHAPTER 3

Contracts

Review of the target company's contracts requires effective coordination between purchaser's counsel and the operating officers of the purchaser. The experienced business lawyer generally will be able to identify and bring to the purchaser's attention contractual provisions that are out of the ordinary for transactions in the target's lines of business. However, without advice from the purchaser regarding its expectations as to the target's contractual relationships, it is difficult for counsel to identify all of the provisions that may be of interest to the purchaser. If counsel reviewing the target's contracts is not experienced, for example, in intellectual property law or in the law of particular classes of contracts (e.g., franchise, government procurement contracts), it may be appropriate to refer any material contracts in those areas to specialists.

The sample Form of Document Request included as Appendix A to this volume refers to numerous substantive classifications of agreements. Although some contracts identified in the Form of Document Request may not apply in an individual acquisition, reference to the Form of Document Request will be useful in most cases as a checklist of subjects counsel can use to shape the scope of the acquisition review. The materials in this chapter focus primarily on recurring issues in review of the target company's contracts and the rendering of timely advice to the purchaser, rather than the specified details of various types of contracts. The chapter also assumes that the contract review by purchaser's counsel will be confined to documents and other information provided by the seller and that counsel will not seek information from other sources.

A. Documents Customarily Reviewed

___ All material contracts (and amendments) currently in effect, including, without limitation, leases, sales, purchase, financing, distribution, franchise, intellectual property, employment, insurance, employee benefit, and joint-venture contracts;¹ currently outstanding contractual offers by and to the target company also should be requested.

___ Correspondence with contracting parties regarding contract interpretation, claims, or threats of contract litigation.

___ Documents relating to the target company's internal determinations as to whether it can, or should, fulfill a particular contract.

___ Documents relating to material acquisitions and divestitures for the immediately preceding five years, particularly agreements involving covenants by or in favor of the target company.

B. Procedures to Be Followed

Current Contracts

___ Confirm that all current contracts remain in existence and are not in default.

___ Identify any rights of approval or cancellation by other parties that

may be created by reason of the change in control of the target.

___ Identify any "take or pay" or minimum commitments on the target company's part.

___ Identify any unusual commercial exposures, such as rights of renegotiations or termination against the target (e.g., government contracts), unusual limitation of liability or warranty commitments, or limitations on the target company's exercise of its rights in the event of default.

___ Identify any provisions creating rights of first refusal or other priority rights in favor of the target company or another contracting party.

___ Identify any contracts that may be expected to produce significant losses, particularly (where the target company is the seller) those with firm prices or a limited escalation on prices or (where the Company is the purchaser) those with no "meet-or-release" clauses.

___ Determine whether the target company actually can produce the contract product (as to both amount and specifications).

___ Identify any unanticipated limitations on the target's activities contained in any past acquisition or divestiture agreements.

Contract Policy

___ Review the target company's policies for (i) issuing sales contracts, invoices, and acknowledgments, and (ii) issuing purchase contracts and purchase orders.

___ Review the target company's contract forms to determine whether the proper boilerplate terms and conditions are included.

___ Review the target company's policy for obtaining letters of credit or granting "retention" rights in construction contracts.

___ Review recent internal or external accounting audits for additional information on any material contract exposure.

C. Comment

Purchaser's counsel should review all significant agency, sales representation, distributor, marketing, and franchise agreements. Special attention should be focused on any quantity performance obligations and the extent of any exclusivity granted to or by the target company and the performance levels required to maintain the position. The target's product distribution system frequently is a source of contractual and antitrust problems, in regard to both the contractual limitations often contained in such agreements and the rights of the target to terminate existing arrangements to conform to the purchaser's distribution system. Particular study should be made of any contracts in which a breach or alleged breach was made by the target and of other contracts the purchaser may consider discontinuing because of unprofitability. In each such instance, counsel should provide the purchaser with advice on the rights of the target and the likely range of consequences if the contract is

terminated. Reviewers many times fail to consider adequately the significance of utility contracts. Natural gas and electric contracts can often have "take or pay" or contract minimums that can restrict the purchaser's future flexibility in determining which manufacturing locations to utilize or sell.

Counsel for the purchaser will have the opportunity to assess the legal sophistication of the target when reviewing the target's standard purchase and sales forms. Counsel should identify whether the target has request-for-quotation forms and purchase orders with the appropriate boilerplate to protect the target (e.g., force majeure, strong warranty, meet-or-release, favored nation, and patent warranty) and whether the target's sales contracts, invoices, and acknowledgements have the appropriate protection for a seller (e.g., force majeure, limitation of warranty, limitation of liability, patent disclaimer, and the ability to pass on certain increased costs). Technical brochures and advertisements of the target should also be analyzed during this contract review to determine whether the proper warranty disclaimers are clearly and conspicuously present.

In situations in which the purchaser contemplates that some or all of the target's existing financing arrangements will remain in place, counsel should carefully review all such agreements to determine whether the acquisition will trigger any right of cancellation or renegotiation by the lender or a trustee and whether the target is in compliance and will remain in compliance with its covenants regarding any post-acquisition changes contemplated by the purchaser. In reviewing all contracts, purchaser's counsel should have in mind the contractual consequences of any pending or proposed transactions by the target outside the ordinary course of its business, including any major financing, significant acquisition, disposition or joint venture, or any start-up of a new division or discontinuance of a division.

NOTES

1. Intellectual property contracts, insurance contracts, and employee-benefit contracts are discussed in detail in separate chapters of this volume.