Contract Considerations

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Introduction

As lawyers we all know that a sales transaction involves negotiating terms and conditions, concerning warranties, representations, exclusions clauses, and restraint of trade provisions. We also all know that these provisions need to be considered. But what is the theoretical reason for why we need to do this? In this paper we look at the reasons for why these provisions need to be considered and negotiated, how we determine when a provision is needed to be negotiated, and look at some of the provisions, in a practical sense, so as to utilize them better.

The Reasoning Behind Sales Transactions Negotiations - Risk and (expected) Return in commerce

People engaging in commercial activities, such as, buying a business, lending money, or investing money in a research project, do so to earn what they expect will be a return on their efforts, or the investment of their money. What each of these and indeed all commercial activities have in common is that none are without risk. The very act of engaging in such activities is risky. There is always the chance of the business not being as profitable as the purchaser thought, or through the intervention of the purchaser the business fails. As there is risk in all commercial activities from which people expect to earn a return, it is inevitable that the inherent risks of these activities will be borne by one or other of the transacting parties[1].

For instance when selling, a vendor may be asked to accept payment on a terms basis or to finance the purchaser's acquisition of the business. In doing so, the vendor is taking on the credit risk of the purchaser being able to complete the payments when and as promised. This is illustrated by ***WR***

[1] Boyce, T, ***Commercial Risk Management***, Thorogood Ltd, 1995, p 6

***Ruffler Pty Ltd v Idohold Pty Ltd & Ors** (NSW Supreme Court, 19 November 1990, Unreported decision C9001737).* The case concerned the sale by Ruffler to Idohold of an amusement machine business for $600,000 with the payment of the balance of $475,000 to be secured by a fixed and floating charge granted by Idohold. Idohold took possession of the business, paid most of the purchase price but defaulted and eventually went into liquidation. As illustrated, the risk of the vendor not receiving payment came to fruition.

As well as clearly identified risks in commercial transactions there can be unseen risks. For an example of unseen risks, look at the implied contract terms cases, such as, ***Codelfa Constructions Pty Ltd v State Rail Authority of New South Wales***[2]**.** In Codelfa Constructions Pty Ltd, Codlefa had to bear the risk that it could not amend the contract when injuncted from being able to perform the works in the manner expressly agreed upon and stated between the parties. This case illustrates that where the parties to a commercial transaction do not clearly determine who is to bear certain risks or how the risks are to be shared, each may end up bearing or sharing risks they never contemplated: as a consequence of a court after the event determining who has to bear the risk by implying a term into the contract.

To ensure that there is clarity and certainty, it is therefore less risky and less costly for all concerned to clearly determine at the outset where the risks of a commercial transaction lie, who is to bear them or how are the risks to be shared.

Commercial law is the process of identify the inherent risks of commercial transactions, to manage the risk bearing and sharing of those risks through negotiating the terms of the sales agreement between the vendor and purchaser and thereby hopefully minimizing the risks inherent in the transaction for all concerned.

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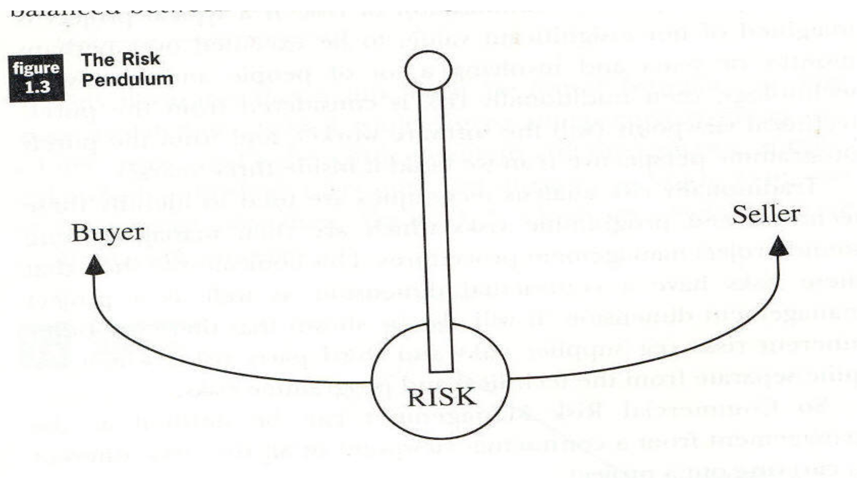
[2] (1982) 149 CLR 337

How do we determine what risks to bear, or share - The Risk Pendulum

As Boyce says:

> "Perhaps in an ideal world the risk pendulum would lie perfectly balanced between the two sides (figure 1.3).



> However, **in reality the position of the pendulum largely depends upon the bargaining positions of the two sides**. Theoretically it should be decided purely on the basis of which side can best cope with or absorb the risk. For example, in a contract in which a UK company is buying from a US supplier the question will arise as to whether payment of the contract price should be in Sterling or Dollars. …Each would prefer its own national currency. If the US company also makes purchases from the UK in Sterling he is in the best position to avoid the currency risk by using Sterling earned in one transaction to fund another transaction. He is logically in the better position. On the other hand, if the US company wishes to be paid in Dollars, it will get its way if the UK company has no alternative source of the product."[3]

As the real world is where we practice law, then the bargaining positions of our clients will be the determinative factor in who bears or shares the commercial risk inherent in each transaction. Although the bargaining

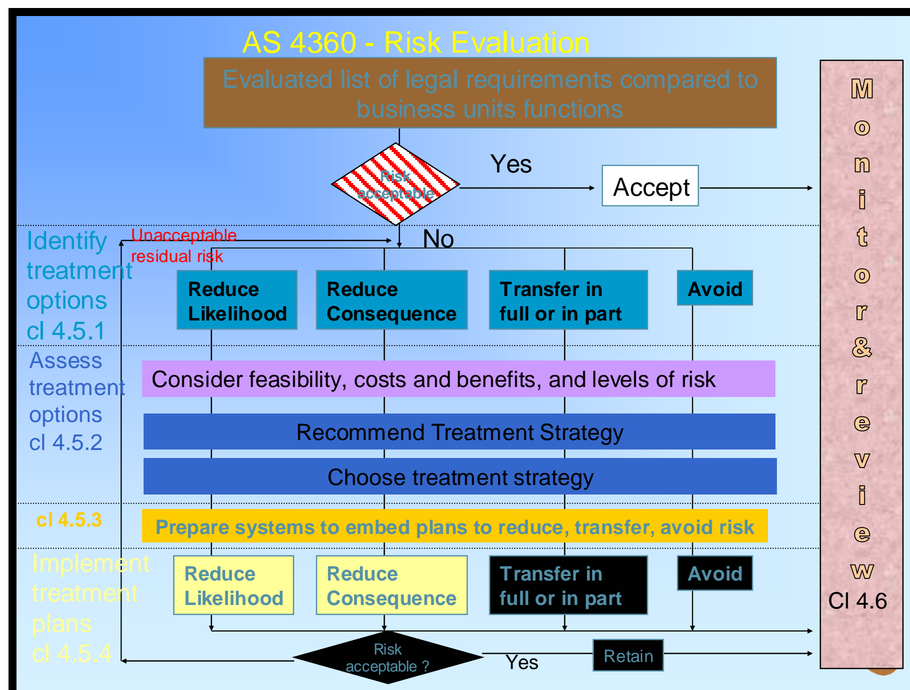
[3] Boyce, T, ***Commercial Risk Management***, Thorogood Ltd, 1995, p 6

strengths of the parties is a determinative factor on how bears the inherent risks of the transaction, as lawyers we must still fully inform our clients of the risks and provide recommendations as to how they should deal with the risks identified, having regard to the practical reality of the relative bargaining strengths of the vendor and purchaser. Our role is to inform vendors and purchasers of the risks of the proposed transaction and the ways of dealing with each risk so that they may make informed commercial decisions on how they wish to deal with them. The process used to identify the risks that our clients should consider in arriving at a concluded agreement, is the process known as risk analysis.

Risk Analysis

There are numerous methods of analyzing the inherent risk in commercial transactions. One method is that proposed by AS 4360 – Risk Evaluation. This Australian Standard offers 4 methods of dealing with an unacceptable risk as can be seen in figure 1.

Figure 1



The four risk bearing or sharing tools from this risk analysis model comprise taking actions that:

1. Reduce the likelihood of an event;

2. Reduce the consequences of an event;

3. Transfer in full or in part the consequences of an event (Negotiate a price to accept the risk); and/or

4. Avoid the event.

Once the risks are identified, and the risk analysis undertaken for each risk, your client will have a better understanding of what steps to take in deciding how to bear or share such risks. While this can be done in isolation, in sales transactions it is usually undertaken by the negotiation of the terms and conditions in the sales agreement. The risk assessment process then moves from ascertaining the inherent risks to negotiating with the other side, who is to bear the risk or how the risk is to be shared.

Negotiating the Sales Agreement having regard to risk bearing and sharing

- **Legal Risk Management**

In acting for parties to sales transactions legal advisers are involved in ascertaining, and highlighting for their clients the risks inherent in the transaction by identifying the risks in the transaction so:

a. that the risks that can be quantified, for example, that a purchaser may not pay all of the purchase price when the purchase price is to be paid by installments, are quantified; and

b. the risks that cannot be quantified, for example, acquiring a business that manufactures products and as such there is the risk of a product re-call due to the product being manufactured by the vendor still being in the market post the purchasers acquisition of the business are made known to the parties;

for the parties to be able to frankly discuss who is better placed to share or bear those risks and if not able to be borne or shared how to adjust the sales price so as to made the party who is having to take the risk willing to proceed with the transaction.

In purchasing or selling a business all of the risk bearing and sharing tools in AS 4360 can be used by the vendor and purchaser. Examples of how vendors and purchasers use these four risks tools are as follows:

Reduce the likelihood of an event

One method of reducing the likelihood of an event is through due diligence. In the context of buying businesses, mergers and acquisitions, due diligence describes the purchasers general duty to exercise care in proceeding with the transaction. As such, it spans investigation into all relevant aspects of the past, present, and predictable future of the business the target of the sale, merger or acquisition to minimise the risk of unknown events suddenly occurring at a time when the cash flow of the purchaser can least bear it.

Conducting proper due diligence helps purchasers avoid the following problems:

- Confirm that the business is what it appears to be;
- Identify potential "deal killer" defects in the target and avoid a bad business transaction;
- Confirm that the corporate entity that conducts the business if being taken over is sound and without unknown contingent liabilities;

- Gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions;
- Verification that the transaction complies with investment or acquisition criteria;
- Discovering that the purchase price of the business is too high;
- Avoid misunderstandings as to the type and condition of the business being bought;
- Investigate the state of management of the business;
- Confirm the status of pending lawsuits; and
- Identify the extent and quantum of contingent liabilities

By a purchaser conducting a thorough due diligence investigation of what it is that the purchaser intends to purchase, the purchaser will be embarking on the transaction with their eyes open, being fully appraised of the good and the bad that the purchase of the business will bring them. By appraising themselves of what it is they are purchasing, purchasers reduce the risk of unforeseen events arising which would detrimentally affect the business they have just acquired and give themselves material to negotiate contractual terms that reduce the consequences of an event, and or transfer the risks of the occurrence of an event.

Reduce the consequences of an event

Warranties, liquidated damages clauses and restraint of trade clauses are all contractual methods of reducing the consequences of an event.

Purchasers want to ensure that the profitability of a business is maintained (if not increased) after it has been acquired by them. Confident vendors will provide a warranty that turn-over will not decrease after the purchaser takes control. By providing a warranty, the purchaser is reducing the consequences of the event of a change in control of the business. However, by providing a

warranty the vendor can ask for a higher price given that they are willing to stand behind and financially support the success of the business in the hands of the purchaser.

Not all vendors are willing to offer warranties that profit will not change after a purchaser has taken over their business. Vendors are concerned that purchasers may not deal with the customers as they have done as a consequence of this different relationship, the purchasers may sustain a decrease in profit. Vendors do not want to have to return part of the purchaser price to a purchaser due to a purchaser not being as good in the business as the vendor was. To reduce the consequence of this event, the parties negotiate various provisions such as:

1. tuition periods prior to and post sale;
2. contracts of employment;
3. consultancy contracts; and
4. restraint of trade provisions.

In sales contracts, the parties can use exclusion clauses to limit or exempt one party from liability which might otherwise fall on them. The areas that are subject to exclusion are:

1. the liability for breach of the contract; and
2. the liability to perform as expected.

For an exclusion clause to be effective the follow criteria must be satisfied[4]:

1. Notice of the clause must have been given at the time of the contract;

[4] See Yates, D ***Exclusion Clauses in Contracts***, Sweet & Maxwell, 1978, especially chp 2

2. notice must be in the contract;

3. the clause must apply to the event to which it was intended to apply.

For most, if not all business sales agreements that are negotiated the above criteria will be satisfied.

Liquidated damages and damages clauses can be used to reduce the consequence of an event. For instance, if a party is confident that an event will not occur, they are generally willing to provide a warranty. By providing a warranty they are standing behind their opinion that the event will not happen. By providing the warranty should the event occur, then the other party will be entitled to damages to compensate them and thereby to reduce the consequence of the event happening.

Transfer in full or in part the consequences of an event

Having decided to proceed to buy or sell a business, then the most pressing question arises as to what allowances should be made or taken in the price to cover the identified risks of buying or selling (as the case may be).

Theoretically, if the price is high enough a party will take any and all risks. Purchasers do not have unlimited funds to offer vendors to accept all the risks. In practice sales occur once the parties negotiate a cost-risk sharing regime. The level of sharing a risk is a function of the desire to buy juxtaposed the desire to sell which results in the relative bargaining strengths between the buyer and seller of the business.

Where cost-risk sharing is in operation the degree of allowance to build into the scheme must nevertheless be assessed and discussed. Cost-risk sharing depends upon the nature of the payment structure negotiated for the business:

Firm Price	A price which is not variable for any reason
Fixed Price	A price, the final value of which is fixed by reference to some variable parameter such as inflation, currency exchange rate, or maintainable profits of the businesses
Earnout/workout Price	A price based on the post acquisition profits of the business so that the seller shares in the on going growth of the businesses

The setting of the price is the tool most often used to manage who bears, or more often than not, is used to share or distribute the quantum of the risk inherent in commercial activities between the vendor and purchaser. We have already seen in the case of ***WR Ruffler Pty Ltd v Idohold Pty Ltd & Ors*** *(NSW Supreme Court, 19 November 1990, Unreported decision C9001737)* that time payment provisions create a credit risk for vendors. Time payment provisions render vendors, lenders. As a lender the vendor to compensate themselves for the inability of not being paid the full price on completion negotiates an interest return (the price of the loan) taking into account the following factors:

1. the credit risk of the purchaser not paying;

2. the duration of the loan term to the purchaser;

3. the level of security, if any, provided by the purchaser;

4. the currency of the money to be paid;

5. the country in which the balance of the purchase price is paid.

Other examples of a transfer in full or in part of the consequences of an event are:

- dealing with transmission of employees; and

- earn out provisions.

The way vendors and purchasers deal with the transmission of employees in a business is a negotiation revolving around transferring in full or in part of the consequences of the transferring of employees and the consequences to the purchaser and the failure to transfer, resulting in redundancy payments having to be made by the vendor.

Vendors will seek to transfer all of the on going liabilities for holiday pay, sick leave, to a purchaser. Conversely, purchasers will seek to have the vendor pay for all entitlements of the employees remaining in the business by paying the amounts to the employees (where possible), reducing the purchase price by an amount to compensate the purchaser for assuming the liabilities to the employees; be it full or partial compensation.

Work out or earn out provisions operate on an incentive to a vendor to make sure that a new sold business maintains or increases profitability. The parties negotiate a provision whereby the purchaser is to pay more after a certain time if profit is maintained or is increased. Work out provisions thereby reduce the consequences of the business not being as profitable after it is sold then before.

The types of considerations vendors and purchasers need to deal with when negotiating work out provisions include provisions to minimize the purchasers ability to make significant changes in the acquired business during the workout period that will impact the vendors opportunity to receive the earnout. The vendor should consider provisions that the purchaser will not[5]:

[5] Bonenfant, M, ***The Challenge of Earnout Provisions In Acquisition Agreements***

- fail to operate the acquired business in the ordinary course and substantially in the same manner in which the vendor operated prior to completion;

- make any material decisions to the business without the prior consent of the vendor;

- create any indebtedness other than liabilities arising in the ordinary course of business as currently being conducted and consistent with the business prior to completion;

- grant any security interests on the assets acquired business;

- cause the acquired business to guarantee any third party obligation including the purchaser and its related entities;

- pay dividends or make any distributions out of the earnings or assets of the acquired business until any earnout payments for the period have been paid;

- liquidate, dissolve, sell, lease, or dispose of all or a substantial part of the acquired business or the purchaser;

- enter into any merger, joint venture or other business combination;

- provide capital or financing to operate and grow the acquired business; and/or

- have rights to approve material decisions effecting the acquired business.

The purchaser should seek to negotiate acknowledgements from the vendor that:

- the purchaser has no obligation to operate the acquired business in a manner to maximize the earnout;

- there is no assurance the earnout will be achieved and the vendor has made no representations that the earnout will be achieved in full or in part; and or

- the purchaser owes no fiduciary duty to the vendor.

Avoid the event

Avoiding an event is also used in the sale and purchaser of businesses. In many instances, a business is operated by a company. In such instances, the purchaser may either acquire the shares in the company, thereby acquiring the business, but in doing so will be liable for the known and unknown debts and liabilities of the company, or can purchase from the company the assets, equipment and goodwill of the company and thus obtain the business of the company. By purchasing the assets, equipment and goodwill a purchaser avoids the event of taking on the liabilities of a company. Off course in some instances, where this in unavoidable the other methods have to be employed to minimize the effects of the consequences of doing so.

Risks can be eliminated from various sources for instance:

- Passing the risk on to customers of the business post acquisition by increasing prices;

- Using insurance to cover the risk; or

- Passing the risk on to suppliers of the business by reducing their supply price or using different purchase order terms and conditions or the use of subcontractors.

The ultimate means of avoidance is to not proceed with the transaction. In some instances, making the ultimate decision while frustrating and disappointing can be the better decision.

Practical use of contracts as risk management systems

As seen all sales of business contracts, establish a risk management system. Consequently as lawyers for our clients we should use the contract as a risk management system so as to:

- identify the risks inherent in the sales process – for vendor and purchaser;
- agree how those risks will be dealt with; and
- take care to ensure that the contract itself does not create risks, such as contractual uncertainty.

As a general proposition, risk sharing should not be a hidden process. The risk of vendor and purchaser are different, because their interests are different. As the negotiation process identifies risks the nature of the risk and how it is to be dealt with should be openly discussed. Ideally the party that can most ably manage the commercial risk should bear the risk. In sales transactions as the risk is able to be commercially shared through the price that is negotiated, either party depending on the price can bear the risk. As such in most sales negotiations, rarely will an attitude that “that is your problem, not mine” result in the successful sale of a business[6].

As the method of resolving the dealing with risk should be clearly spelt out in the sales agreement. Always remember, that contracts being risk management tools operate whereby the parties list:

- what each has to do,

[6] Calvert & Reid p 472, para 15.16

- when they have to do it and

- how each has to do what they have promised to do.

In this way, contracts are checklists of who is to do what, when it is to be done and how it has to be done[7]. Being checklists of who is to do what, when and how, the contractual provisions should be clear and as plainly as possible dealt with. Often this means that contracts are long but for the checklist approach to be comprehensive this is unavoidable.

By the contracting parties clearing setting out what each expects of the other they are able to ensure performance and allow their performance to be objectively measured, thereby reducing the risk of non-performance on their behalf, and on behalf of the other party or parties to the contract.

Our roles as legal advisers require us to appreciate our client's expectations from the sales process and in doing so clarify their expectations. For example, using the contract as a risk management system that contains clear statements about what is and what is not warranted, indemnities, disclaimers and warnings[8].

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[7] Haines, G ***The Manager's Guide to Supply Contracts and Tenders for Products and Services***, Information Australia, Melbourne, 1991 pp 17-28.

[8] Calvert, M & Reid, I, ***Technology Contracts: A Handbook for Law and Business in Australia***, 2nd edition, LexisNexis, 2002, p 470 para 15.5.

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