Concept Paper

Not peer-reviewed version

The Perils of Poor Contract Design: The Case of Mergers and Acquisitions

Paloma Azcona Mengod , Ana Cruz Gonzalez Calzadilla , Juan Manuel Ramon-Jeronimo *

Posted Date: 9 October 2024

doi: 10.20944/preprints202410.0625.v1

Keywords: M&A; Contract Design; Disclosure; Due diligence

Concept Paper

The Perils of Poor Contract Design: The Case of Mergers and Acquisitions

Paloma Azcona Mengod, Ana Cruz Gonzalez Calzadilla and Juan Manuel Ramon-Jeronimo *

Department of Financial Economics and Accounting, Pablo de Olavide University, 41013 Seville, Spain
* Correspondence: jmramjer@upo.es

Abstract: Mergers and acquisitions (M&A) represent pivotal moments for businesses, with the potential to unlock growth, synergies, and market power. However, the success of such transactions is heavily dependent on the robustness of the contractual agreements that define them. Poorly designed contracts introduce numerous risks that can derail the benefits of the deal, leading to financial losses, legal disputes, or operational inefficiencies. This work examines the core risks associated with inadequate contract design in M&A, supported by academic research.

Keywords: M&A; contract design; disclosure; due diligence

---

1. Insufficient Due Diligence and Disclosure

Due diligence is a comprehensive and systematic process that potential buyers undertake to assess and evaluate a target company's business, financial, legal, and operational aspects before finalizing an acquisition. This process is used to uncover potential risks, liabilities, and opportunities associated with the target company, ensuring that the buyer makes an informed decision. Through due diligence, the acquiring party can verify the accuracy of the seller's representations, identify any hidden issues, and determine the true value of the target company.

Insufficient due diligence and disclosure during mergers and acquisitions (M&A) can lead to significant financial, legal, and operational risks for the acquiring company. Due diligence is a critical process that enables the acquirer to thoroughly investigate the target company, uncovering potential liabilities and risks that may not be immediately apparent. Contracts that fail to mandate detailed due diligence can leave buyers exposed to unforeseen liabilities, as evidenced by notable cases in corporate history.

One prominent example is Hewlett-Packard's (HP) 2011 acquisition of Autonomy, a British software company. In this case, HP later wrote down $8.8 billion of the deal's value due to alleged accounting fraud that was not identified during the due diligence process. This significant financial loss underscores the importance of rigorous due diligence in uncovering potential problems before finalizing an acquisition.

Boone and Mulherin (2007) emphasize that thorough due diligence is essential to reduce information asymmetry between the buyer and the seller. Information asymmetry occurs when one party in a transaction has more or better information than the other, leading to an imbalance in the transaction. By conducting comprehensive due diligence, the acquirer can gain a better understanding of the target company's financial health, legal standing, and operational capabilities, thereby minimizing the likelihood of post-acquisition surprises.

Contracts that do not enforce due diligence provisions can leave the acquiring firm vulnerable to significant financial exposure. For example, without detailed due diligence, the buyer may not identify hidden liabilities such as pending lawsuits, regulatory issues, or financial irregularities. These unforeseen liabilities can result in substantial financial losses and reputational damage for the acquiring company.

In conclusion, insufficient due diligence and disclosure in M&A transactions can expose acquirers to significant risks and liabilities. As demonstrated by the HP-Autonomy case, the failure

 doi:10.20944/preprints202410.0625.v1

to conduct thorough due diligence can lead to substantial financial write-downs and other negative consequences. To mitigate these risks, it is crucial that acquisition contracts mandate detailed due diligence, thereby reducing information asymmetry and protecting the interests of the acquiring firm.

2. Ambiguity in Contract Terms

A major risk in M&A contracts arises from ambiguous or poorly defined terms. Given the complex nature of the deals, contracts must clearly articulate all key provisions, from pricing mechanisms to post-closing obligations. Ambiguities can lead to disagreements and disputes between the buyer and seller, particularly regarding contingent payments such as eran-outs. As Reuer, Shenkar, and Ragozzino (2004) emphasize, earn-out provisions are a frequent source of post-closing conflict, as the parties may have different interpretations of the performance triggering the payments.

For example, in the acquisition of a high-growth tech startup, the seller might project rapid future growth, while the buyer expects more conservative performance. If the contract does not clearly define how performance metrics are measured, disagreements could arise, leading to costly litigation.

These potential disputes highlight the critical link between clear contract terms and the due diligence process. Through thorough due diligence, the acquiring party can identify and clarify potential ambiguities in contract terms before finalizing the deal. This process allows the acquirer to verify the accuracy of the seller's projections and representations, ensuring that the performance metrics and other key provisions are well defined and agreed upon.

By addressing these issues during due diligence, the parties can reduce the risk of post-closing conflicts and ensure that the contract terms align with the actual business conditions and expectations. Thus, thorough due diligence is essential not only for uncovering hidden liabilities, but also for ensuring that all contract terms are clear, precise, and enforceable, thus minimizing the likelihood of future disputes.

3. Misaligned Incentives and Incomplete Representations

Misaligned incentives between buyers and sellers are common in M&A, especially in deals involving performance-based payments like pay-outs. Sellers may present overly optimistic projections to secure a higher price, while buyers prefer conservative estimates to justify a lower valuation. Kaplan and Stromberg (2009) highlight the need for M&A contracts to address these misalignments by clearly defining performance metrics and ensuring accurate representations from both parties.

Failure to align incentives or address misrepresentations can lead to post-deal conflict and litigation. A classic example is the merger between AOL and Time Warner, where strategic misalignment and cultural differences led to massive value destruction and public shareholder dissatisfaction (Hitt et al., 2009).

4. Inadequate Post-Closing Provisions

Post-closing obligations are crucial to ensuring a smooth integration process after an M&A deal is finalized. Contracts that do not specify these responsibilities risk causing operational inefficiencies or disputes between the buyer and the seller. The integration of technology, employees, and business processes can be particularly problematic without a well-defined plan. According to Graebner, Heinmeriks, and Huy (2017), post–closing obligations play a vital role in facilitating successful integration, especially in retaining key personnel and aligning organizational cultures.

Poorly designed contracts that neglect these critical obligations can lead to operational disarray and hamper the potential synergies that M&A deals aim to create.

 doi:10.20944/preprints202410.0625.v1

5. Regulatory and Legal Risks

A fundamental component of M&A contracts is the addressing of regulatory and legal risks, such as compliance with antitrust laws and sector-specific regulations. Failure to include provisions that address regulatory hurdles can lead to delays, penalties, or even the collapse of a deal. The failed $39 billion merger between AT&T and T-Mobile in 2011 underscores the importance of regulatory considerations. The U.S.

The Department of Justice blocked the deal on antitrust grounds, resulting in a substantial $4 billion breakup fee for AT&T (Vlacic et al., 2019).

Contracts must outline clear steps in case regulatory approval is delayed or denied, providing mechanisms for both parties to handle such situations without unnecessary losses.

6. Dispute Resolution and Legal Recourse

Disputes are almost inevitable in complex M&A transactions, making it essential for contracts to include clear dispute resolution mechanisms. Contracts lacking well-defined methods for resolving conflicts, such as arbitration or mediation clauses, expose parties to lengthy and costly litigation. Reuer and Ariño (2002) emphasize the importance of contractual provisions that outline how disputes will be handled, ensuring that conflicts can be resolved efficiently and without excessive financial or reputational damage.

Mergers and acquisitions (M&A) can unlock growth and market power but are heavily dependent on well-designed contracts. Poor contract design introduces risks such as financial losses, legal disputes, and operational inefficiencies. Insufficient due diligence can lead to unforeseen liabilities and significant financial losses. Ambiguous terms, misaligned incentives, and inadequate post-closing provisions can result in disputes and operational challenges. Addressing regulatory risks and including clear dispute resolution mechanisms are crucial to mitigate potential pitfalls and ensure successful M&A transactions.

References

Boone, A. L., & Mulherin, J.H. (2007). How are firms sold? *The journal of the American Finance Association*.

Graebner, M. E., Heimeriks, K. H., Nguyen Huy, Q., & Vaara, E. (2017). The process of post-merger integration: A review and agenda for future research. *Academy of Management Annals*.

Hitt, M. A., King, D., Krishnan, H., Makri, M., Schijven, M., Schimizu, K., & Zhu, H. (2009). Mergers and Acquisitions: Overcoming Pitifalls, Building Synergy, and Creating Value. *Management Faculty Research and Publications. Marquette University.*

Kaplan, S.N., &Strömberg,P. (2009). Leveraged Buyouts and Private Equity. *Journal of Economic Perspectives*, *23*(1), 121146.

Reuer, J. J., & Ariño, A. (2002). Contractual Renegotiations in Strategic Alliances. *Journal of Management*.

Reuner, J. J., Shenkar, O., & Ragozzino, R. (2004). Mitigating Risks in international mergers and acquisitions: the role of Contingent Payrolls. *Journal of International Business Studies*, 19-32.

Vlacic, E., Dabic, M., Daim, T., & Vlajcic, D. (2019). Exploring the impact of the level of absorptive capacity in technology development firms. *Technological forecasting and Social Change*.