Is a Contract Worth the Paper It's Written On?

I have seen, recently, a significant increase in clients having problems with contracts. You might think it's a sign of the times with the recession dragging on longer than imagined and people finding themselves in desperate financial circumstances. But the reality is, both of the following examples are not the result of the recession but rather, greed, and who knows, maybe some dishonesty...

So what is a contract anyway? Contracts are quite a simple concept; it's the detail behind the contract that makes it complex. There are five components to a contract. First is the offer. A clear and unambiguous offer is made to purchase or to sell (either party, purchaser or seller, can commence the contract process). The next is acceptance. This is the second signature on the contract essentially and is accepting the offer that has been proposed. The next piece is consideration. Essentially, this is money or a monetary alternative and is the quid pro quo. The other two aspects are age – each party must be of legal minimum age to enter into a contract, which is 18 – and the other is mental capacity. The parties entering into a contract must have the mental capacity to know the impacts of entering into a contract.

These components are necessary regardless of what the contract is for. We might be talking about buying and selling goods and services, real estate or a business, or a contract to govern a relationship, such as a shareholders' agreement.

To set the scene for these examples, first you have to understand that it is very important which party draws up a contract for sale of a business – the vendor or the purchaser? Generally, it is the purchaser or their advisers that draw up the contract. The rationale behind this is that it is much more important to the purchaser to get the detail right, to ensure the correct transfer of the assets and rights that are the subject of the sale. The purchaser usually includes various warranties that are tailored to the unique business situation. All of these are designed to ensure the purchaser gets what they anticipated out of the deal.

So, in this case, the purchaser does indeed draw up the contract. They do so with no legal input (warning bells) and the vendor takes neither legal nor accounting advice (big warning bells). Settlement takes place and the purchaser takes over the business, only to then default on many of the clauses contained in his own contract, even down to not actually parting with any money for the business.

The vendor starts taking action to recover the money and the purchaser digs in for the long haul. His strategy appears to be, wear down the vendor with legal fees and get the business for nothing or a significant reduction in the agreed price.

The problem is that the strategy can, and often does, work. Justice comes at a price and if you cannot afford to take a court case, it pretty much stops there. Of course, on top of that, even if you can afford the legal fees, there is no guarantee of getting a judgement that goes your way, let alone one that adequately compensates for the time you will put into the case, the legal fees and the emotional turmoil that you will go through.

The other example I saw recently was a shareholders' agreement, drawn up by one shareholder and signed by both, again with no external advice. It's a pretty straight-forward and logical agreement; nothing to actually be concerned about. The agreement pretty much says everything, is 50/50, which makes total sense in the situation. The parties get down to business and things go OK for eight months or so, then the shareholder who drew up the agreement wants out. He does not want to adhere to the shareholders' agreement in any way, even the special clauses that he inserted to cover the situation where they go their separate ways in the first year!

Professional fees are always a concern to business owners. However, there is no doubt that it's cheaper to pay for the fence at the top of the cliff and not the ambulance at the bottom! You can get best value out of your accountant and lawyer by using them as part of your trusted team of advisers. Get both to review or draft your contracts. An experienced eye can save so much money in the long run. The simple reality is that the parties (both vendor and purchaser) are usually emotionally involved in the sale and purchase process. That involvement leads to mistakes, whereas the external adviser is more able to be objective and see things with clarity.

Another thing to consider with professional fees is, drafting contracts, shareholders' agreements and other business tools to govern the business relationship or transaction being undertaken are relatively straightforward. These are, for the most part, based on precedents. This means that putting together a rock-solid contract that safely represents the interests of all parties is not a difficult process and is therefore, relatively economical (ask for a quote). Taking or defending a court action based on a poor contract is pretty much an open cheque book. My suggestion is to back the horse that gives most certainty. This means a well-drafted contract and correct, independent advice.

The top ten things on my checklist for contracts are as follows:

1. Understand the art of negotiation. The contract process can be used as part of the approach to negotiation. Negotiation is an art form and by upskilling in this area, you can understand the emotions that come into play during negotiations and will be better equipped to get the most out of the negotiation.

2. Be clear and unambiguous about the offer being made, leave nothing to assumption.

3. Any conditions applicable to the offer need to be clear and the way of fulfilling the conditions needs to be clear.

4. Contracts should be in writing. Most contracts are legitimate even if they are verbal (exclusions to this are contracts for the sale of real estate and for entering into guarantees) but it's easy to realise that verbal contracts can be very ambiguous.

5. It should be easy to identify the consideration for the offer. Again, nothing is left to assumption.

6. The terms and conditions should lay out the implications for non-performance by either party, so you understand what will go wrong if you fail to perform the contract once it's entered into.

7. Due diligence is required both for the purchaser and the vendor. The purchaser wishes to ensure they get what they anticipated. The vendor has to be wary about the ability of the purchaser to complete the contract. Does the purchaser have the financial wherewithal to complete the contract? Is the purchaser truly committed to fulfilling the contract?

8. Obtain independent and objective advice.

9. What if? Ask yourself, what happens if things go wrong? And contemplate what can go wrong from as many angles as possible. By doing this, you can "test" the contract and get a feel for areas of weakness.

10. Clear and unambiguous acceptance. This completes the contract process. If you accept with further terms, this actually becomes a re-offer with the further terms required to be accepted by the other party. Until these further terms are accepted by the other party, you don't actually have a contract.

You may ask, why such an article from an accountant, at my firm? We are active in reviewing contracts for taxation impacts, as well as many commercial law aspects, so we see what works and what doesn't. Also, I have an interest in forensic accounting and so have been involved in many of the "Ambulance" cases where I gain a strong understanding of the issues, how they arose and the costs involved.

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