Contracts & **Compliance**

Berkman | Solutions

How to manage the **intersection** of private agreements and public requirements

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Introduction

Why Contracts & Compliance?

Contracts create the network of relationships that allow organizations to thrive. Contracts generate revenue and control expenses. They allocate risks and responsibilities. Contracts create assets and liabilities. Contracts are the foundation of enterprise.

Compliance requirements touch every organization across industries. Regulations can lay down the rules of the road or impose barriers to business. Compliance is essential for success, like good brakes on a car.

In any organization, contract management must be an integral part of compliance. Contracts create unique compliance challenges. General counsel rely on contracts to allocate risks between the parties to the agreement. Contracts also create private compliance obligations for the parties. The conduct of the parties under the contract must comply with external legal requirements.

To complicate matters further, most general counsel want to improve the working relationship with business staff in order to identify legal risks early. Compliance is often a moat between the legal department and the line of business. A well designed system for monitoring contract compliance issues can bridge the divide.

Scope

This white paper examines the two primary sources of compliance obligations related to contracts: performance obligations and government regulations. For each source of compliance challenge, this paper identifies methods to improve compliance and contract management. Finally, this paper examines the kind of reporting that makes compliance more transparent and contract management more effective.

A comprehensive guide to regulatory compliance is beyond the scope of this paper. The objective here is to outline techniques specific to contract-related compliance risk.

Who should read this white paper?

This white paper is written for legal professionals, meaning general counsel, business lawyers, compliance officers, corporate paralegals, and contract managers. Included are tools to identify and manage legal and compliance risks in the contract portfolio. It also discusses how to communicate those risks to a wider audience in the organization.

The value of compliance

Why Does Compliance Matter?

- **Compliance protects reputations**
- **Compliance protects revenue**
- **Compliance controls expenses**

Within the innumerable compliance requirements that impinge on most organizations, there are two categories of compliance issues related to contracts: performance obligations and government regulations.

Compliance protects reputations

Organizations operate on a network of contracts with customers, clients, suppliers, vendors, and advisors. Behind the terms and conditions of those contracts are people. Even in large organizations, people negotiate agreements and operate to fulfill the terms. Human relationships are the foundation of legal relationships expressed as performance obligations.

Compliance with performance obligations is essential to maintaining the organization's reputation within the industry. Performance obligations are the mutual promises at the core of the agreement. Violating a performance obligation may or may not lead to litigation, but it can easily damage a reputation.

Non-compliance with government regulations undermines the organization's reputation on a much bigger scale.

Compliance violations are often public, or become public. In the eyes of consumers, customers, clients, vendors, suppliers and advisors, a regulatory violation raises questions about the trustworthiness, even if the violation is minor or unfounded.

265%

FIGURE 1.1 Relative cost of non-compliance

The cost of non-compliance is 2.65x more than the cost of compliance.

"The True Cost of Compliance: A Benchmark Study of Multinational Organizations." Ponemon Institute LLC, January 2011. This study focused on 46 multinational corporations' compliance risks associated with data security and privacy. The conclusions pertain to compliance risk generally because the study considered indirect costs usually associated with compliance violations.

Compliance protects revenue

Sales contracts, marketing agreements, and distribution contracts are often filed and forgotten after signing. Performance obligations, however, can interrupt revenue unexpectedly.

Incentives, pricing options, and conditional fees are just a few of the many ways that contracts provide significant revenue opportunities. However, much of the time contracts are implemented with the agreed base pricing and terms and little is done to ensure that conditional revenue opportunities are remembered or acted on in the future.

Consider the following typical scenarios.

Scenario 1

An early renewal option guarantees that the contract will continue at the current favorable pricing, but the sales representative responsible for the customer recently left the company and has not yet been replaced.

Scenario 2

Incentive bonus payments are available for early completion of project deliverables, but the project manager is only aware of the committed deadlines.

Scenario 3

Favorable pricing terms are contingent on minimum quantity orders, but the billing department only adjusts prices when the customer service representative notifies them of the orders under the minimum.

Too many organizations are caught unprepared by these sorts of scenarios, losing revenues simply because they do not have effective processes for consistently managing the various terms that impact revenues across all of their contracts.

Compliance controls expenses

Efficient organizations are careful to negotiate various discounts, price guarantees, and caps on spending and increases when it comes to supplier contracts. But despite their very best procurement efforts, organizations inadvertently undo many of the benefits written into their supplier contracts.

Discounts contingent on order volumes or payment timing are missed due to lack of consistent communication between sales, finance, and billing personnel.

The window of opportunity for optional renewals with locked-in prices passes simply because there are too many contracts to monitor across the organization.

Spending often exceeds contractual caps because there is no clear and easy way to verify whether or not the right approvals have been given.

Drafting a contract with detailed and thoughtful terms designed to minimize expenses does not do much good when post-execution management of the contract lacks the same level of rigor.

Performance

Obligations

Performance obligations

What Are Performance Obligations?

- **Provisions that prescribe behavior for one or both parties**
- **Behavior is either required, permitted, or prohibited**
- **Conditions can change the performance obligation**

Problem

Performance obligations arise from the agreement of two (or more) parties to a contract. Performance obligations are "private law" with little or no external influence. Each party accepts the requirements placed on its conduct during the term of the contract.

Example

Performance obligations expose the organization to liability in three ways:

1. **Breach of contract from failure to perform a required action.**

A simple example is delivery of goods. If an online retailer promises to deliver goods by a certain day and the goods do not arrive, then the retailer has breached the contract. When the contract requires one party to report certain information to the other, failure to provide the report can constitute a breach.

2. Breach of contract by taking prohibited action.

Not all performance obligations are affirmative. A confidentiality agreement might prohibit a party from disclosing information. Disclosure breaches the contract and triggers remedies.

3. Breach of contract from non-compliance with conditions.

Just as not all performance obligations are affirmative, some obligations are permissive. This structure is common in the context of a prohibited action. To continue the confidentiality agreement example, disclosure is permitted if a court or agency compels a party to disclose the other party's confidential information.

Individually, a performance obligation might not give rise to enough exposure to warrant a careful analysis. Taken collectively however, the contract portfolio is a web of affirmative, negative, and permissive bilateral obligations.

Solution

To avoid getting tangled in contract disputes, organizations must identify, classify, and track performance obligations for both parties to the transaction.

Contracts are replete with obligations, direct and conditional, that apply to one or both of the parties to the contract. The number and complexity of obligations can challenge the tracking skills of lawyers, contract managers, and compliance staff.

These four steps can improve the quality and quantity of performance obligation tracking:

1. Isolate the performance obligation from the rest of the contract.
2. Classify the obligation type as either: required, permitted, or prohibited.
3. Identify the subject of the obligation which is one or both of the parties.
4. Control for conditions that trigger the obligation or change its classification.

This process facilitates efficient and thorough monitoring of contractual obligations. Lawyers, contract managers, and compliance officers can now examine compliance at a granular level.

Step 1. ISOLATE the performance obligations from the rest of the contract

Performance obligations describe behavior or action by one or both of the parties to a contract. In an agreement to purchase goods, for example, the contract usually specifies how the goods get delivered to the Buyer and by whom. It might be the Buyer's obligation to pick up the goods or arrange for pick up and delivery. The Seller might have to deliver the goods F.O.B. As a rule of thumb, contract provisions that do not circumscribe behavior or action are not performance obligations. Examples of provisions that are not performance obligations include:

- Contract definitions;
- Calculations; and
- Events of default or breach, although these might trigger conditions related to performance obligations.

Performance obligations can be as simple as, "The Licensor shall license..." or "Landlord shall lease...." Performance obligations can also be more complicated:

The Recipient shall maintain Confidential Information in confidence, shall not disclose Confidential Information, or any portion thereof, to any third party, and shall protect Confidential Information with at least the same degree of care as the Recipient uses in maintaining as secret its own confidential and proprietary information, but in no case less than a reasonable degree of care.

Whether simple or complex, effective contract management of performance obligations requires isolation of the terms.

Step 2. CLASSIFY the obligation type as either: required, permitted, or prohibited

Performance obligations come in three flavors.

- Required: a party to a contract must take some action
- Permitted: a party to a contract may take some action
- Prohibited: a party to a contract may not take some action

A few examples will clarify the different types of obligation.

In the Confidential Information provision above, the Recipient shall maintain Confidential Information. This is an affirmative obligation, a requirement to take action. Later in the provision the Recipient shall use a degree of care in the performance of its obligation.

A Non-Disclosure Agreement might accomplish a similar objective with a prohibition: "The Recipient shall not disclose any Confidential Information."

Framed as a negative obligation, the contract prohibits the Recipient from taking an action it might otherwise take.

A contract can expressly permit action, typically when (a) the action is otherwise prohibited, or (b) the nature of the agreement warrants clarification of the permitted activity. In a Non-Disclosure Agreement, for example, the contract might specify:

Either party shall be entitled to assign this Agreement to a successor in interest who obtains all or substantially all of the assigning party's business and assets as a part of a merger, sale of assets, sale of stock, operation of law, or otherwise.

Although this provision uses the word "shall," the substance of the term is permissive: "shall be entitled."

It is important to tag provisions properly. As a general rule, required action uses "shall" (preferred in US drafting practice) or "will." Permitted activity uses "may" and, occasionally, "can." Prohibited behavior uses "shall not," "will not," or "may not." As the above provision demonstrates, however, careful reading of the provision is required.

Step 3. IDENTIFY the subject of the obligation which is one or both of the parties

It is not unusual for organizations to focus on the obligations of the other party to a contract. The organization assumes, explicitly or not, that the risk of breach or non-compliance rests with the counterparty. Legal risk arises, however, from either party's non-compliance. To monitor compliance with contract provisions requires that contract managers, lawyers, and compliance officers group the type of performance obligation by the party to which they apply. It is as simple as using the organizations' names or "us, them or both."

Step 4. CONTROL for conditions that trigger the obligation or change its classification

Unconditional obligations such as delivery of goods or protecting confidential information do not require any additional analysis after Step 3. Since many performance obligations are conditional or contain exceptions, this method needs to accommodate conditions and exceptions. Fortunately, it does.

Conditions and exceptions change the nature of an existing obligation. Consider a few examples:

- Party B is prohibited from disclosing Party A's confidential information (if a court orders disclosure, Party B may disclose);
- Party B may sub-license the software (if Party B does not control sub-licensee, Party B is prohibited from sub-licensing); and
- Party B is required to deliver goods (if a force majeure interferes with the business, Party B may deliver).

These examples illustrate a change in the nature of the obligation according to a condition or an exception. Tracking the conditions quickly and easily enables the organization to improve compliance with important contract terms.

This method applies to almost all contracts, particularly in a business setting. The method supports analysis of both parties equally. Lawyers can now provide reports about legal obligations that business people can read and understand.

Government

Regulations

Government regulations

What Does Compliance Mean For Contracts?

- **Allocation of regulatory risks and responsibilities**
- **Reviews of compliance under the terms of a contract**
- **Following federal, state, and local law as well as internal policies and procedures**

Problem

Compliance related to contracts is a pernicious source of risk because the penalties can quickly eclipse the value of the contract. Compliance violations also compound. A regulatory violation for one contract often applies to all similar contracts, dramatically expanding the impact of the compliance failures.

Example

Contracts create compliance risk in two ways:

- Regulatory references: contracts often refer to specific regulatory provisions. An acquisition might reference provisions of the US Tax Code to clarify the allocation of tax responsibility among the parties. The scope and interpretation of that provision has a material effect on the financial results for the contract.

- Regulatory requirements: even if the contract does not include references to regulations, federal, state, and local laws fence the organization’s conduct. Regulations can also require reports and filings that relate to contracts.

Violating government regulations exposes the organization to wide ranging liability, including injunctions that might limit future business. Compliance failures jeopardize reputations with customers, suppliers, and employees. Penalties from non-compliance with government regulations can have a substantial effect on short- and long-term financial performance.

Solution

Organizations must identify specific regulatory provisions that have a likelihood of creating compliance risk. It is important to link those regulatory provisions to contracts for compliance reviews during the term of the contract.

To improve compliance with government regulations, it is important to make the intersection between contracts and compliance transparent.

Periodic compliance reviews of contracts will provide general counsel and compliance officers with insight into the organization's operations.

Step 1. IDENTIFY key compliance requirements

Compliance requirements are most often federal and state statutes, regulations, and court decisions. However, internal policies like ethics policies, information security, and the like might be relevant to certain contracts.

Maintaining an inventory of regulatory requirements allows the team to link the contract under review to the specific requirement. These links will be useful for reporting.

Step 2. CREATE a contract compliance review form

Consistent assessment of contractual provisions improves the quality of compliance reporting down the line. The form might contain a link to the regulatory requirement, the review questions and answers, a findings field, and preliminary risk rating. The needs of each organization will differ.

The people charged with reviewing individual contracts for compliance should use the form to identify compliance issues. Compliance reviews are best if performed routinely (every month, quarter, or year) and randomly. The results of each review should be stored to analyze compliance over time.

Step 3. PREPARE periodic contract compliance reports

Compliance reports turn detailed data into insights for management. Contract compliance reports can reveal unexpected weaknesses in the organization.

Some useful reports might include:

- Compliance failures by division
- Compliance failures by counterparty
- Compliance results for a [Contract Type] (e.g. "Distribution Agreements")

The objective is to have a portfolio view of the intersection of contracts and compliance. Those reports on the compliance risks in the contract portfolio should go to the General Counsel's office and the Chief Compliance Officer routinely and automatically.

Solutions

Solutions

When it comes to effective compliance, there is no escape from the detailed analysis. To achieve compliance with performance obligations and government regulations related to contracts, organizations must proactively manage specific requirements.

How To Improve Contract Compliance?

- **Identify specific public and private requirements**
- **Monitor activity of all parties to the contract for compliance.**
- **Provide portfolio level reporting on contracts and compliance risks**

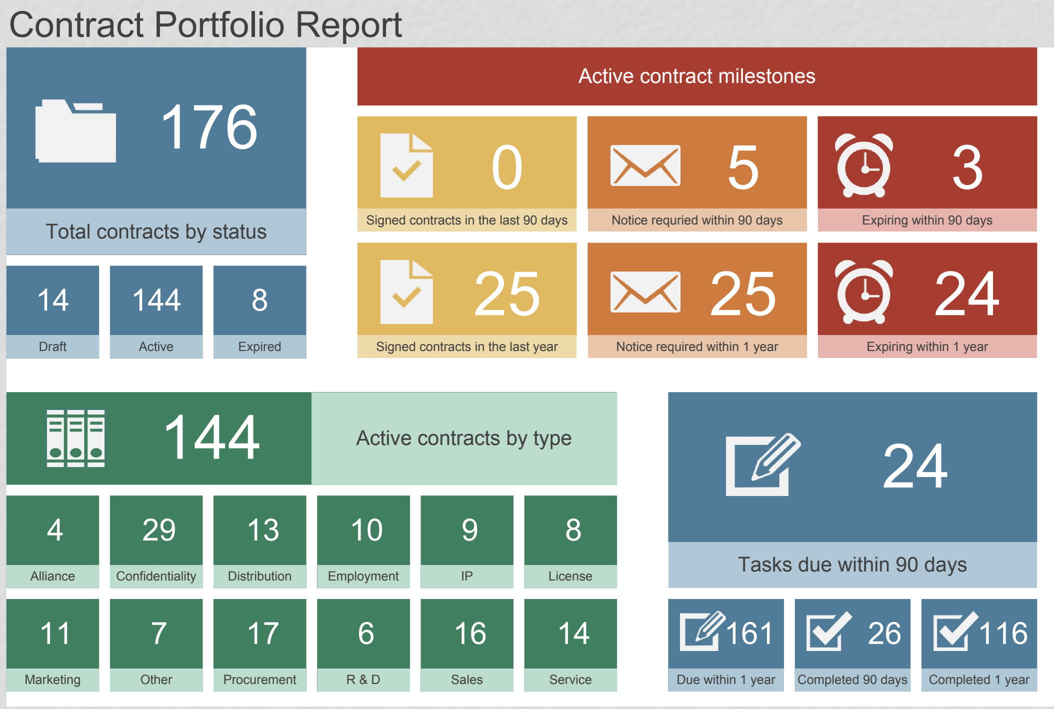

FIGURE 4.1 Contract Portfolio View

This report provides a one page view of all contracts in the portfolio. It also indicates where problems might arise.

Compliance with performance obligations and government regulations have much in common. The tools and techniques apply to both compliance risks.

Four basic activities are part of contract compliance management: inventory requirements, review compliance conduct, report on compliance risks, and schedule alerts. To learn more visit us at berkmansolutions.com.

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