Buying Someone Else’s Headache – Top Five Supply Chain Pitfalls To Consider When Expanding Through Acquisition

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As the economic recovery continues to pick up steam, manufacturers are looking to grow their capacity and expand their markets. Many manufacturers choose to expand their horizons by acquiring smaller companies or merging with a competitor. When properly planned and executed, such transactions can bring great economic rewards. However, when the risks inherent in such a transaction are not properly accounted for, companies may find that they wind up purchasing someone else’s headache. While a target’s finances, liabilities, and intellectual property are the subject of intense scrutiny (properly so), many buyers fail to give sufficient consideration to the pitfalls and headaches that could be buried in the target’s supply chain contracts.

No two transactions are exactly the same. Due consideration should be given to the particular circumstances of any proposed acquisition. For example, acquisitions through bankruptcypresent additional considerations. However, in any acquisition, buyers should make sure that they give proper consideration to at least the following issues:

1. Duration of key supply and sales agreements, including early termination rights – Your target’s profit margins may look good on paper, but what are those numbers going to look like in a year? For example, are there productivity give-backs in the agreement that will lower the price the target receives for its goods in the future? What happens if the target’s critical supply and sales contracts expire in the next six months and need to be renegotiated? If the market has changed since the agreements originally were negotiated, the target’s margins could end up looking very different in the long-term.

2. Limitations on, or rights of termination for, assignment and change in control – You have confirmed that your target has locked up its key suppliers and customers to long-term agreements at favorable pricing. However, what would you do if, a month after the deal closes, you receive a notice from a critical supplier terminating its contract under a change in control provision and demanding a huge price increase for any new contract?

3. Conflicting sole source agreements – Many manufacturers operate with their suppliers under requirements contracts or blanket purchase orders that obligate the supplier to provide the manufacturer with 100% of the manufacturer’s requirements. In exchange, the manufacturer frequently is obligated to purchase 100% of its needs for that particular good from the suppler.

Buyers should review the scope of both their own supplier agreements (do the requirements obligations extend to affiliates?) and those of the target to ensure that, following the transaction, the buyer is not left with two different contracts that obligate the buyer to purchase 100% of its requirements from two different suppliers.

4. Mismatched warranties and indemnification rights – Buyers should consider both the warranties given by the target in contracts with its customers and the warranties that the target has received from its own suppliers. If the target has provided broader warranties or indemnification rights to its customers than it is receiving from its subcomponent suppliers, a buyer may find itself responsible for the full cost of any future claims by the target's customers.

5. Government contracts – If the target has contracts with governmental entities, particularly the federal government, such contracts generally require compliance with a host of additional rules and regulations. Buyers should ensure that the target is in compliance with any additional requirements that may come with its status as a government contractor. Buyers also should consider whether the proposed transaction could negatively impact the target's government business by, for example, resulting in a combined entity that no longer qualifies as a small business for purposes of government contracts.

With careful consideration and planning, many of the potential pitfalls presented by these issues can be prevented, or at least mitigated. In some cases, transactions can be structured so as to avoid or minimize the risk posed by a particular issue. Other issues can be resolved through obtaining the appropriate consents in advance of the transaction. However, if an issue cannot be resolved, it is better to know the risks before investing significant capital and resources.

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