An **Innovative** **Approach** to **Contract Compliance Systems**

WHITEPAPER

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BACKGROUND

Institutions nowadays are entering into more and more contracts. It is not unusual for a company to be subject to hundreds or even thousands of different commercial agreements, each with its own set of different rights, obligations and deadlines. For example, one provision may give a party the right to buy out equity stakes at favorable terms if exercised within six months, while another provision requires proper notice to preserve a claim. Institutions face an overwhelming burden of maintaining compliance with such rights and obligations on a timely basis.

How can institutions (and not just individual employees) optimize resources (both in-house and outside) to ease the burden of contract management and, especially, contract compliance?

In this paper, we will discuss the traditional approach of contract compliance, its shortcomings and an innovative approach which we more effectively solve the problem.

TRADITIONAL APPROACH

How do institutions traditionally approach contract compliance? Considering the creation of complex contracts, institutions typically engage external legal counsel to draft and negotiate. Yet as soon as the negotiation is done and client signs, external legal counsel will dump the contracts back to the client and move on to the next deal. After that, the client has to manage this contract, but how? Senior management focuses on negotiation. The compliance department focuses only on regulatory issues. In some cases, if there is a receipt of payment or an obligation to make a payment, that level of information will make its way to the finance department so that they can

manage that at least. The small in-house legal department is generally responsible for managing outside counsel, but might not be responsible for negotiating the contract, and in many cases, is not necessarily involved in the concept of contract management going forward. If they do, they have no system or capacity to deal with the compliance of hundreds or thousands of different commercial agreements. A lack of an internally coherent system for managing this type of data and set of obligations characterizes the contracts that institutions sign on a day to day basis. Worse still, perhaps nobody on the client side will actually read the entire contract and understand the key obligations and rights.

Traditional law firms do not manage post-signing contract compliance either. Sophisticated big law attorneys specialize in getting deals done and negotiating complex terms. They do not have any experience or expertise in managing the process post-closing. Institutions that do not have a big in-house counsel group, or maybe do not even have one at all, will only go to external legal counsel when compliance issues arise. But that is often after somebody noticed a breach or an event of default is accidentally triggered. A gap exists between what clients need for managing contract compliance and what big law traditionally provides.

INNOVATIVE APPROACH

The traditional model's short-term transactional approach focuses on getting a deal done and has proven to be ineffective at managing long-term demands of contract compliance . We need to take a new approach:

first, to understand what's in their contracts, firms should EXTRACT KEY CONTRACT PROVISIONS in a standardized way that converts them from legal text to standardized legal data;

second, firms should build a DATABASE that can capture such data and make it available to key people in an institution who, in turn, can perform various DATA ANALYTICS on the entire set of documents; and

third, a REVERSE ENGINEERING FEEDBACK LOOP can be set up, whereby a firm's approach for current and future transactions is informed by the institutional knowledge acquired from past deals, as stored and analyzed in the database.

The innovative approach described here is thus holistic rather than transactional; it emphasizes developing systems that prevent fires (breaches and loss of rights) from getting started in the first place, whereas the traditional model creates conditions ripe for sparking fires (which then need outside counsel to help put them out).

REVERSE ENGINEERING

Draft and negotiate contracts in a consistent and systematic way to facilitate data extraction

AUTOMATING SYSTEM

Automate deadline reminders, trigger alerts, internal reports, document production

DATA EXTRACTION

Turn legal text into analyzable "data" using Legal AI

CONTRACT

DATABASE MANAGEMENT

Maintain key data points and results of analysis

DATA ANALYSIS

Analyze the result of data extraction

LEVERAGING LEGAL ARTIFICIAL INTELLIGENCE

The first step of contract compliance process is understanding what the key terms in the contract are. That is a daunting task, given the large volumes of documents firms accumulate. Fortunately, the latest legal AI technology can greatly reduce the time and money of data extraction.

We can clarify the advantages of legal AI for data extraction by comparing and contrasting it to the traditional approach, which is to engage junior associates or in-house personnel to review contracts and jot down, perhaps in a spreadsheet or Word document, the key contract provisions. Such an approach is expensive, time-consuming and prone to all kinds of errors. The information extracted is unlikely to be standardized either (consider in the case of contract review where three associates are involved, one may put "CA" in the governing law section, the other may put "California" and the third may put "State of California"). With legal AI tools, data extraction can be done better, faster, and more accurate than ever before; with proper instruction and programming, data output can be readily standardized for future analytics. Note that this kind of legal AI is designed and created specifically to extract data from contracts. A tech-savvy attorney, skilled at using legal AI, would ask the AI 'yes' and 'no' questions and to extract specific kinds of provisions, or multiple-choice, as the case may be, to 'bucket' provision possibilities into the key categories they might want. The traditional way of searching for a specific clause, such as "assignability", can be programmed into the AI and greatly assist a human lawyer to find such clauses more quickly (and therefore, more cost-effectively). The machine learning component of AI – that is having a human correct the AI in case of error – allows it to get better over time at answering the kinds of questions that it is given. Furthermore, by speeding up certain types of data extraction, the legal AI can allow for more detailed analysis than is feasible under the traditional approach.

Once data is extracted, it can be stored in a database to implement and operate against that data set. Under the traditional approach, data is usually saved in an Excel sheet, often in a way not amenable to data analysis, and rarely is analysed with an eye towards long-term contract compliance concerns. While under the innovative approach, a portal or dashboard can facilitate managing the data and automate flagging of relevant provisions and triggers to alert key people of certain relevant events. In addition, with all key information saved in one central database, a push of a button is all that is needed to generate reports. Leveraging an effective database opens up a variety of fruitful applications – but all that depends on having the database of key terms in the first place, which legal AI provides.

REVERSE ENGINEERING

After firms put themselves into the mindset of contract compliance, they can "reverse engineer" the kind of contract drafting and negotiation process they should take to lighten the workload for subsequent deals. To make the post-signing contract compliance process more efficient in real practice, for example, firms can negotiate contracts in a consistent and systematic way so that it will be easier for legal AI to extract information once the document is executed.

Substantively, the content of negotiated provisions should be informed by the wealth of legal data accumulated from past deals.

An example of the reverse engineering process is the negotiation of NDAs. Traditionally, an institution engages a law firm to negotiate NDAs and most likely a junior associate would be tasked with the negotiation. Clients probably will not have confidence in the work product of such a junior associate and there may not be consistencies across NDAs signed by the clients because there is more than one junior associate working on the NDAs signed by one institution. Yet the client still has to pay hourly rates for a product they might not be happy with. Under the innovative approach that reverse engineers the process, the client will first consider the terms in the NDAs and put their preferred terms in a playbook; an external team will then negotiate the NDAs on behalf of the client using this agreed upon playbook with oversight by experienced deal lawyers. Under this approach, NDAs can be negotiated consistently which makes post-signing management a lot easier.

PROPER USE OF LEGAL ARTIFICIAL INTELLIGENCE

Legal AI, when properly used, can be a powerful tool to speed up extracting data, which is an important ground step of contract compliance process. Using legal AI effectively, however, requires attorneys skilled at both the law and the legal AI technology to find the right provisions for extraction. Legal AI technology does not do the work for the attorney, but assists a skilled attorney in getting the job done better and faster. The attorney should also think holistically in anticipating how data should be standardized so that the output is amenable to data analytics and automation. Also note that training the legal AI for industry-specific (or client-specific) extraction needs is itself costly and time-consuming, but worth it if there is a large enough volume of documents to be extracted. Lastly, it takes experience using legal AI for an attorney to know which kinds of tasks are better suited to legal AI application and training, and which tasks require closer human oversight. The optimal use of legal AI is to have a skilled, senior attorney program the group of data points to be extracted, let the AI have a first pass at the document, then have a junior associate review those results, and then a senior attorney to check that and answer questions. Such a process lets you get the most out of what the legal AI can do better and faster than a human in a way that allows for more time for the human to analyze the more complex legal issues.

PROS & CONS OF THE TRADITIONAL AND THE INNOVATIVE METHOD

	Traditional approach	Innovative Method
Speed	🐢	»
Complete		✔
Analyzable data	⊘	✔

CONCLUDING REMARKS

The problem of managing contract compliance for large volumes of documents can be greatly facilitated by thinking holistically rather than transactionally about contract formation and management. The first step to managing contracts is to know what's in them, and legal AI makes that possible in a cost-effective way. Leveraging legal AI to extract key contract provisions as legal data allows for easy storage in a database of key terms. Once in the database, automatic reminders and triggers can be integrated to make sure the knowledge is a part of your institution, rather than locked inside the heads of individuals.

Furthermore, various legal analytics can be run on the dataset to inform future deal negotiations, so you have a better understanding of what provisions do and don't work for you, at least some idea of where market is, and what your willing to give or take in a compromise. Lastly, internal reports can be automated based on the database and even legal documents can be automated as firms refine a system (and depending on how standardized companies can make their deals). Implementing the innovative approach simplifies various aspects of in-house counsel life, thus freeing them up to focus on other important tasks that bring more value to their company.

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ON THE COVER: Christopher S. Harrison is the founder of Sterlington. He is focused on innovation in law through the use of process management, data analytics, and technology-enabled services. He is the author of Make the Deal: Negotiating Mergers & Acquisitions, which was published by Bloomberg and ranked as the #1 New Release in Corporate Finance and M&A on Amazon. He comes to the firm with profound experience, having managed billions of dollars in successful investment transactions during his eight years at Cravath, Swaine & Moore as well as his role as Co-Head of the market-leading asset management M&A practice of Schulte Roth & Zabel. For eleven years, he has been teaching popular courses on M&A at the NYU School of Law. Chris also serves as the Chief Investment Officer of The Falconwood Corporation, a substantial family office for the family that founded a variety of technology and financial ventures, including Moviefone in the 90s, Interactive Brokers, and Gresham Investment Management.

Richard ("Rick") Canedo is Director of A.I., concentrating on artificial intelligence applications to legal services, such as life settlement diligence and NDAs. Prior to joining Sterlington, Rick's practice focused on structured finance and securitizations at Schulte Roth & Zabel LLP. Before practicing law, Rick was a management consultant at The Boston Consulting Group, founded an online education start-up, and earned a Ph.D. in Philosophy from UC-Berkeley. He graduated cum laude at Duke University and at the Duke University School of Law.

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