EVENTUS ADVISORY GROUP

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Preparing *for* Due Diligence

A Practical Guide for Founders

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Don't Blow Your Only Chance to Make a First Impression.

Introduction

You have decided to raise funds for your company or to sell your company. For the investor or acquirer this transaction represents opportunities, but also poses risks. In negotiating a deal with you, they have made certain assumptions about the prospects of your business, its profit potential and the risks that your company faces. The officers, directors and managers of your investor or acquirer typically have a fiduciary duty to undertake due diligence to verify the soundness of their assumptions and to discover all potential material risks that the company confronts.

The linchpin of the due diligence process is a due diligence questionnaire sent out by the investors or acquirer and the data room set up by the company to respond. This article discusses the negotiation and diligence process, details the information that will be requested and provides practical advice on how to disclose information in a manner that will be most helpful to the due diligence team.

The Due Diligence Process when looking for an investor is slightly different than when you are looking for an acquirer, however, most of the differences are in degree rather than content. To simplify this article, we have focused on investor diligence. Also, this overview focuses on US-based companies and investors. Transactions with foreign companies or with foreign investors will be similar but often have material differences.

Overview: Investment Process

Before we go further, let's talk about the actual due diligence process. It's made up of a lot of parts, so we'll go through each one.

Fundraising (Debt or Equity)

Fundraising (or "pitching") is likely to involve a large number of meetings with potential sources of funds. In some cases this process might be assisted by investment bankers who can help identify funders, although, especially in the early stage, this is uncommon. A critical early question is whether the fundraise will be funded by one entity or will be "syndicated" among several. If the financing will be syndicated, typically one funder will be identified as a "lead" and will handle most of the negotiations and diligence.

Initial Disclosure

Initially you will present some high-level information about your business, its product/service, its market and the management team. On the financials side, it's usually standard financial statements (income statement and balance sheet), a three-year projection, and at least a short pitch deck presented to investors. Very often, venture capital firms will not sign non-disclosure agreements at this stage, so sensitive company information is generally not shared. This presentation will also include the "ask" – the amount the company is looking to raise and if equity, in what form will it be raised (SAFE/Convertible Note/Priced Equity).

Pro-Tip: Keep updating your pitch deck to match your current projections. If not, you could have a case where your pitch deck to the previous set of investors shows a significantly different future than you are at now and are projecting in the future. Usually, your projections reflect your optimism but reality may be quite different. You don't want potential new investors seeing how far off base you were in your last projection or they could lose confidence in your current projections.

Negotiation

At this stage, negotiations will largely center on critical economic terms, primarily valuation and funding amount. In the context of debt, it will typically include interest rate, maturity, secured/unsecured and covenanted/non-covenanted.

Pro-Tip: Know what you want, what you are willing to bend on and your "walk away points" before you go down this process or the odds of you getting an offer you are happy with will be much lower.

Term Sheet

The investor will generally issue a term sheet. For priced equity investments, the term sheet usually follows an industry standard template maintained by the National Venture Capital Association (NVCA). Term sheets for debt and convertible debt are more varied. All term sheets will address the main economic terms and a handful of other key terms. Terms sheets are generally non-binding except for confidentiality and exclusivity.

Pro-Tip: This will be the initial structure of the deal, so make sure everything significant you want is in the term sheet. Odds are the deal will get less favorable for you post-term sheet, so if it's not in the term sheet, it's not going to happen.

Exclusivity

Many term sheets provide the investor with an exclusivity period in which to complete diligence and the negotiations of definitive documents. Essentially the company agrees to be "taken off the market" for a limited period of time and in consideration, the investor/acquirer agrees to devote substantial resources

to diligence. If the parties are close to the deadline, but making good progress, it is fairly common for the exclusivity to be extended for short periods of time. Exclusivity periods will typically range from 30 to 90 days depending on the size of the company and the complexity of its business.

Deep Dive Diligence

At this point, the company will provide the investor with access to a data room. See the diligence discussion below.

Pro-Tip: You need to ensure you have an efficient process as well as decide how much data you will show a potential investor – especially if the investor is a strategic investor and as a result, a potential competitor. There is always a risk the investor walks away and now has a blueprint to how to compete against you. Balancing what and how much you show is all part of the process.

Draft, Negotiate and Execute Definitive Documents

There is some variability as to who drafts the definitive documents. For lending activities, usually lender's counsel creates the initial draft. For equity investments and convertible instruments, company counsel will often create the first drafts, although in particular on the East Coast in the US, investor counsel may create the initial draft. For priced equity investments, most US investments utilize documents based on models maintained by the NVCA – the typical financing will include an amendment Certificate of Incorporation, Share Purchase Agreement, Voting Agreement, Co-Sale/Right of First Refusal Agreement and Investor Rights Agreement.

See https://nvca.org/model-legal-documents/

Funding

Often a funding will have an initial close at which time a majority of the anticipated funds will be raised and then one or more additional closings where additional investors can invest on the same terms. Usually, the investment documents limit how long the funding round will remain open and the maximum amount that can be raised.

Legal Costs

In both debt and equity transactions, it is fairly common that in addition to its own legal costs, the company will reimburse the legal expenses of the investor/lender. If there is a syndicate, reimbursement is generally limited to the lead.

Issuing Equity

Historically equity issuances included the issuance of physical stock certificates. That is increasingly becoming rare. Companies generally turn to one of several cloud-based services that maintain a company's stock ledger and issue digital stock certificates. In some cases, the Company's bylaws provide that the company does not need to issue stock certificates in tangible form or digital form.

Overview: Sale Process If You Wish to Be Acquired

While most of the due diligence process is the same dealing with an investor versus an acquirer, there are some important distinctions which we will explain below. Assume the process is the same except for what we mention.

Looking to be acquired will involve a much more invasive process from a buyer than an investor. Make sure you know what you want post-acquisition before you even go down this route.

- Do you want to have a role in the future company?
- What are the expectations of your other investors?
- Do you have a staff and want to protect their jobs post-acquisition?
- How much money do you want for the sale, and:
- How long are you willing to wait to get it?
- Are you willing to have some of the consideration (e.g., payment) be contingent on the performance of your company as part of the acquirer?
- Are you willing to work in the company post-acquisition to meet various targets?

Getting a clear idea of the answers for all of these questions before you even start down the path of a sale will save time and give you and your sales team (e.g., bankers) the necessary clarity to evaluate potential buyers and offers.

Sales Process - Bankers

A banker's main role is to find you a buyer, manage the sale process, and serve as your face in negotiation. Realize, your banker's incentive is to close a deal, not necessarily the best deal for you. Be firm in the process about what you want and balance that with being realistic about what you can get.

You can end up wasting a lot of time and money with a banker with nothing to show for it, so make sure your banker has the experience in selling a company like yours for the terms you want.

Sales Process - Buyer Initiated

These usually come as a surprise, even if someone has been talking to you for a while. They can be

more lucrative for you since you might not need as many banker professionals to represent you and find a willing buyer. These deals also could lend themselves to a great future for your company since the buyer theoretically knows you more than someone a banker is pitching you to and has done their own research before approaching you.

The number one item to be wary of is how much of the inside of your company you disclose since if the deal doesn't go through, the buyer could use all that knowledge to compete against you.

Negotiation (Acquisition)

Anything and everything are on the table here. If this is banker led, meaning you are looking for a buyer, you will be presenting the initial terms and the potential buyer will comment and counter.

Deep Dive Diligence (Acquisition)

It is even more important than when dealing with a potential investor to be careful about what you disclose. There is always a risk the buyer walks away and now has a blueprint to how to compete against you.

Execute Acquisition Documents

This is your attorney's time to shine. However, do not leave this up to the attorney. You have to review all documents yourself, line by line. If you don't understand something, make sure your attorney explains it to you. Make sure that the deal you want is directly reflected on the contact or you will be in for a rude surprise post signing.

Pro-Tip: It is important to have experienced M&A counsel. One of their important value-adds is bringing tax expertise to the transaction and creating a deal structure that is most tax efficient for you.

Stock Purchase

A stock purchase is equivalent to buying your entire company, or part of it. If it is not a 100% stock purchase, you still own some of the company outright.

Make sure you and the buyer have plans for your remaining shares – is there a plan for them to purchase them over time? If not, are you maintaining control of the company post-acquisition? Being a minority shareholder when you were "the boss" can be a difficult place to be, especially if you don't have a plan to sell the remaining part of the company.

Asset Purchase

Unlike a stock purchase, an asset purchase is a sale of part of your business. Usually this happens when a buyer doesn't want to inherit the potential liability of your company. The end result is that usually you will get a sum of money to close up the current company and the net remaining amount you keep. It's more of a headache in a lot of ways, but might be the only option you have depending on the health of your company. You will also have the obligation to wind down the selling company.

Pro-Tip: The Asset Purchase v. Stock Purchase decisions also has tax consequences that you should understand.

Funding – Sign and Close

Ideally what happens here is you and the buyer both sign a document, and then a sum of cash is deposited in your account. There are variations to this and distributions to other investors, but the main takeaway is that once you sign, the deal closes and you get your cash and/or stock in the acquirer. Make sure your attorney explains to you the process and you and the buyer have a clear set of checkpoints to get you and the other shareholders the money and stock.

Funding - Sign with Closing Conditions

This can be a much more drawn-out process. The conditions you agree to might hold up you and your investors getting paid for a significant period of time.

Post-Closing Payments; Earnouts and Escrows

Often the purchase price is not paid entirely at closing. In some cases, the purchase price is paid out in installments that are triggered only by the passage of time. In some transactions, the post-closing payments are part of an earnout that can be contingent on the performance of the acquired business or other milestones. In addition, in many transactions part of the purchase price is held in escrow, either by the purchaser or a third party and is released upon the satisfaction of identified post-closing conditions or the expiration of the relevant period to make claims for breach of certain representations and warranties.

What Does a Due Diligence Checklist Look Like?

A due diligence checklist is a list of requests for information and documents. The list is divided into multiple categories and subcategories. In some cases, the requests are for specific documents or a list of names. Other requests may require a few sentences or several paragraphs of response. The due diligence list you receive from a potential acquirer/investor is likely to look irritatingly generic.

The reason for this is the request is designed to capture "everything under the sun" – the worst-case scenario for the acquirer/investor would be that material information was not disclosed because it was not requested. As a result, do not be surprised if your response to a fair number of the diligence requests are "N/A" (not applicable).

How Do You Respond to a Due Diligence Checklist?

In most instances, responding to a request on a Due Diligence Checklist requires the disclosure of specific documentation. This documentation is typically gathered into a "Data Room." Historically, this was literally a room, often packed with documents and acquirers/investors were provided access to this room. Today, in almost all instances, the documents are uploaded to a cloud-based storage service and acquirers/investors are provided access to the room. Although cloud-based access has many advantages, it also requires a process for archiving the final version of the Data Room to make sure there is no dispute as to what was disclosed.

In addition to documents, some diligence requests will require a written response. This can range from a couple of sentences to a couple of paragraphs. Disclosures related to sensitive areas and any disclosure related to actual or potential litigation, should be reviewed by counsel. Narrative responses should be kept as short as possible, just enough to put the acquirer/investor on notice of a potential issue. For example, if there is a claim against the company, other than noting that the company rejects the claim, this is not the place to argue why you are right.

How Will the Response to the Due Diligence Checklist Be Used?

Due diligence will allow an acquirer/investor to confirm that the company matches the description of the company provided as part of the "pitch" and will provide greater detail about the operations and finances of the company, as well as issues and risks. In some cases, information discovered during diligence may require a renegotiation of the transaction terms. In extreme cases, it may cause an acquirer/investor to walk from a deal. Most commonly, it identifies risks that the acquirer/investor will require the company or the selling shareholders to assume.

Acquisition agreements and investment agreements always contain representations and warranties by the company and/or its shareholders and they assume liability if the representations turn out to be inaccurate. However, the agreement will also almost always have a disclosure schedule which allows the company/shareholders to list exceptions to the representations. In other words, situations where the representations are not accurate. The company/shareholders generally are not liable for items on the disclosure schedule and the disclosures made during the diligence process are usually the basis for much of the disclosure schedule. In other words, not being fully candid and complete in the diligence process will usually work against you.

Finally, in an Asset Deal, due diligence responses will be used to compile the schedule of assets and liabilities to be transferred as part of the transaction.

Preparation for Due Diligence

Assembling Documents

Organization is the key to success in assembling the documents. There will be various different sources of documents, so you'll need to coordinate the gathering and review with multiple people.

Common Pitfalls/Tips: Odds are if you are being acquired, not everyone in your firm should know that. Keeping things secret is tough enough, especially if you need input from multiple people. It is a best practice to keep a due diligence folder up to date for any time you need to do a capital raise, so if you have that practice in advance, you will have a good excuse to ask people for information without disclosing a sale.

Many document checklists are standard, all-encompassing lists from attorneys and bankers, most of it is not applicable to the investment. Sometimes you'll be dealing with multiple parties, each with their own request list. To avoid administrative burden, review the request lists and let each party know what you feel is non-applicable and encourage the use of one data room. If you can't use one data room or need to keep certain information confidential, keep a cross-reference document that shows what documents you put into each data room so if you have to update a document, you make sure all data rooms get the updated document.

Verifying Completeness and Signatures

Make sure you have the most updated documents, that they are complete, and all of them are signed. Unfortunately, there are many times you have an incomplete document in your file or never got a final copy signed. Take the time to review each document to ensure its completeness before it goes into the data room. It's better to have an uncomfortable conversation with an employee that you need them to sign an NDA that they should have done so two years ago versus submitting incomplete documents to a potential investor or buyer.

Uploading Documents to an Online Data Room

The name of the game here is organization. You want everyone to find the documents they are looking for as easily and quickly as possible. The less time spent on hunting down documents and requesting documents that have already been delivered the better.

Pro Tips: the following are some of the best practices when it comes to managing a data room.

1. Have a very clear table of contents with a clear file naming methodology
2. Create folders that map to the diligence checklist
3. Label documents with clear and complete file names
4. Only upload what is requested. Do not have extraneous data

Creating a Process for Controlling Access to the Data Room

Make sure only one person and a backup has admin access to grant people access to the data room. All investor access needs to be approved by the company and you need to make sure that everyone on the investor side is covered by an NDA.

Company access should be view only for everyone but the admin to enforce document version control.

Creating a Process for Responding to Additional Data Requests

Additional data requests must be approved by the banker, attorney, and any other trusted advisor along with the executive team. It is the company's choice what to disclose.

Agree on a process along with a response time so every party has the appropriate expectations. It is typical to get last minute, late evening, urgent data requests (especially when exclusivity is about to expire). Agreement to a process won't always prevent these from happening, but it sets the tone and hopefully avoids some of the last-minute requests.

Ensuring Confidentiality

Non-Disclosure Agreements (NDA's)

Signing an NDA should precede the start of due diligence. The key elements of an NDA are:

1. Limitation on purpose – disclosed information should only be usable for evaluation of the investment/acquisition and any subsequent transaction negotiation.

2. Duration of confidentiality – confidentiality should be for no less than 3 years and preferably 5 years from disclosure, with ongoing obligations for trade secrets.

3. Limitation on recipients – at a minimum, disclosure should be limited to those that have a "need to know" in order to evaluate and negotiate the transaction. Disclosure is typically allowed to professional advisors, but the investor/acquirer should retain liability for any disclosure by them.

Tiered Disclosure

It is important to remember that an NDA is at most the right to bring a claim in court. Enforcing NDA's can be very expensive.   As a result, it is prudent to tier disclosure so that the most sensitive information is disclosed only as the likelihood of the transaction increases.

Disclosing to a Competitor

Often the counter-party in a potential transaction is a competitor. This makes managing disclosure more difficult and important. Practices to consider include restricting disclosure to named individuals and potentially including third party consultants to evaluate sensitive information (for example, using a third-party service to evaluate software (under NDA), so that the competitor does not directly evaluate it).

Disclosure

Organization

Was your company properly formed and maintained and is it properly authorized to do business everywhere it in fact "does business." Due to the increasing use of DIY tools, issues frequently are identified. Correction of these issues can often take some time, so these issues should be addressed well in advance of a transaction.

Corporate Documentation

For a corporation – Certificate of Incorporation, Bylaws.   For an LLC – Operating Agreement.

Data on Subsidiaries

If your entity has subsidiaries, you will need to provide their corporate documentation, as well documentation of the transaction by which they were established as subsidiaries of the parent entity.

Corporate Resolutions/Minutes

Many early stage companies do not hold regular board meetings nor maintain high quality minutes. The reality is, that at the time of disclosure as part of diligence "they are what they are" but to the extent they exist they should be part of the disclosure. There are, however, some corporate activities that require Board or shareholder approval.   Where that approval has not been documented, in some situations it can be remedied by a subsequent Board or shareholder ratification.   Counsel should review the minutes to identify any missing approvals and to the extent possible, document ratifications.

Legal Entity Chart

If the company has a complex subsidiary/affiliate structure, the data room should include a chart that identifies all entities and the relationships between them.

Capitalization

Acquirers generally want to know that they are acquiring the entire company and investors want to know what percentage of the company they will own after their investment. In both cases, the worst-case nightmare is that shareholders or individuals with claims to equity emerge after the acquisition/ investment. To avoid issues, the company will be asked to create a cap table that shows all outstanding equity and owners, as well as contractual rights to equity such as convertible notes, SAFEs, warrants and options. As further confirmation, the company will often be asked to create a pro forma cap table that shows what the cap table of the company will look like after the financing. The company will be required to produce all documentation relevant to equity contractual rights.

Common issues in this part of diligence include:

1. Failure to document equity grants or informally/imprecisely documenting grants.
   a. Example: "In return for this project, I will grant you 3% of the company"
2. Failure to follow the legal requirements for stock option grants
3. Failure to document forfeiture of equity that was conditionally granted
4. Failure to document share transfers
5. Failure to record all share grants/transfers on the company's stock ledger (whether maintained on a spreadsheet or a cloud based service).

Financials

In general, make sure that all financial statements and backup tie to each other as well as the forecast and any deck or other presentation that the investor will receive. Any competent investor will look to tie the financial data to the projections. You will lose legitimacy quickly if your data doesn't tie. Below are the major items asked for in financial disclosure:

Income Statement, Balance Sheet, Statement of Cashflow

Usually this is the prior three years (if available), plus as close to the current month as possible.

Be aware that you may be asked to convert the statements to accrual and GAAP compliant if they are not already.

Audited Financial Statements

If you don't have audited statements, you may be required to have your statements audited usually within 180 days of closing the transaction. Sometimes money will be put into escrow until the audit is complete. Some transactions allow the investor/buyer to withhold some of the investment/purchase price if there is any material difference between what was expected and the audited version.

Current Accounts Payable – Aging List

The main thing being tested here is how much money you owe others and how long do you take to pay. It's a reflection of your cash health.

Current Accounts Receivable – Aging List

i. Two questions are normally asked in regards to AR:
    1. How long does it take you to collect
    2. How much of your AR balance is uncollectible (usually determined by age).

ii. Pre-empt any issue by trying to get your cash collections sooner as well as write off anything that is uncollectable before you go into diligence. A sophisticated investor will automatically take those balances out.

Bank Statements

These are used to back up your cash balances. Make sure they tie to your financials (e.g., Cash Balance on the Balance Sheet).

Fixed Asset Rollforward

This only exists if you have depreciable assets. It's just a schedule of your fixed assets and the depreciation expected for the next few years. Normally you would have a schedule of the entire depreciation by asset.

Cash Runway Analysis

The two most common questions asked about cash are:

1. How much net cash do you spend per month, which is usually called your burn rate (how much cash are you "burning" through per month).
2. Your cash runway, which is how many months do you have left based off of your projected burn rate before you run out of cash.

You can back into your burn rate and projected burn rate by using your Cashflow from Operations as a proxy.

Taxes

Previous year's tax filings:

An investor is going to want to see your tax filings to determine
1. Is there any legal risk? – meaning did you not file your taxes.
2. To triangulate your reported earnings in your financial statements to your tax returns. If there is a large difference you will need to have a walkthrough ready to explain the gap.

R&D Tax studies and other tax planning docs:

There are plenty of tax breaks both state and federal available to companies. R&D tax credits are a standard one. If you haven't engaged in a study, it probably is worth it before you go into diligence mode. It normally doesn't take that long and shows the investor that you have a good handle on your financials. If you have not undertaken a study, just have a reasonable reason why (e.g., you were advised it wouldn't be worth the cost vs the potential savings, etc.)

Employment

Personnel is the largest single cost in most companies. Understanding the terms of employment or contracting is critical to understanding the company's obligations to these individuals. There is also increased focus on deemed employment/employee misclassification – situations in which individuals were nominally hired as contractors, when legally they were required to be treated as employees.

Typically requested documents include:

1. All employment agreements/offer letters
2. All contractor agreements
3. All Intellectual Property/Confidentiality/Non-Compete/Non-Solicitation Agreements
4. Professional Employment Organizations (PEOs) Agreements – many companies use PEOs to handle payroll and benefits. Acquirers will want to review the relevant agreements to determine if they will continue to use the provider post-acquisition.
5. Benefits Plans – Acquirers are interested in your benefits plans since they need to see how they compare to their own. If you offer richer plans than the acquirer, it can cause an issue since the acquirer either has to risk your employees being upset at a worse plan post-acquisition or the acquirer has to deal with their own staff being upset that new employees have a better plan.
6. All equity plans and all equity grants, including a summary of all option holders, grant dates and vesting terms.
7. Corporate policies
8. Employment/labor disputes – disclosure on this topic should follow the same guidelines as litigation.
9. Employee Roster – typically would include title, start date, compensation and bonus and any special terms.
10. List of critical employees – Acquirers may plan on downsizing the company's team and need to know the employees critical to the company's success to both retain and incentivize.

Financial Commitments

These are incredibly important to an investor, especially in a stock deal where the investor will probably have to take on your debt. These are normally netted against the purchase price.

Loans and Guarantees

Make sure you have the fully executed documents along with proof of interest and other required payments. If you are behind in payment, make sure you have some sort of documented agreement from the lender granting you a grace period.

Liens and Encumbrances

The fully executed documents need to be in the data room.

Consents/Permits

Companies, particularly in regulated industries, may require permits in order to operate at the local, state or federal level. Also, with respect to certain acquisitions, governmental consents are required. Acquirers/investors will want to see relevant documentation. Since obtaining consents/permits can often require considerable lead time, it is important to identify any missing permits and any required consents early in the process.

Insurance

Liability Insurance:
Property, Casualty, Directors and Officers (D&O), and Cyber are all Liability insurances. The acquirer/investor will want to make sure that the right kinds of coverage for the business have been purchased, with the right amount of coverage. The acquirer will want to make sure not only are you covered now, but also in the past since they won't want to inherit a potential claim (e.g., lawsuit). While preparing for diligence, it is a good time to consult with your insurance broker and address any gaps in coverage.

Claims History:
The acquirer/investor will want to know about any claims that have been made under any insurance policies.

Litigation

The last thing an investor/acquirer wants to do is buy into a lawsuit or a threatened lawsuit. As a result, diligence will require the disclosure of all pending and threatened litigation. It will also generally require disclosure of historic litigation since it may reflect on the management of the company or reflect business risk that may recur. Disclosure in this area is especially sensitive and should be reviewed closely by counsel since the disclosure is not subject to the attorney-client privilege and could be discoverable.

Summary of litigation:
Disclosure should be brief and factual and should not attempt to argue the case. Historic litigation should identify the claim and outcome, as well as any reported decision. For pending litigation, the claim, the court in which the case is being heard and the status should be included in each summary.

Summary of threatened litigation:
The question here is what constitutes "threatened" – not every heated complaint to customer service is threatened litigation. Clearly any threatening letters received from counsel should be included. Non-lawyer letters should be evaluated individually with a general bias to disclosure.

Intellectual Property

Intellectual Property consists of several categories of assets. In some cases, they are registered with the government. Intellectual property may be registered in multiple countries and disclosure should include each national registration or pending registration. This is the typical disclosure for the various forms of intellectual property. Investors/acquirers may also ask to see the application files with the Patent and Trademarks Office for patents and trademarks.

Intellectual Property	Registered/ Unregistered	Description for Schedule
Patent	Registered	(i) Title and (ii) Serial Number (pending)/ Registration Number (issued) (iii) Filing Date/Issue Date
Copyright	Registered/Unregistered	For registered copyrights: (i) Title (ii)Registration Number (iii) Issue Date For unregistered copyrights – generally not listed unless very material, in which case would typically be registered
Trademark (can be word and/or logo)	Registered/Unregistered	For registered trademarks: (i) Mark/Logo (ii) Serial Number (pending)/ Registration Number (issued) (iii) Filing Date/Issue Date For unregistered trademarks – (iv) Mark/Logo
Trade Secrets	Unregistered	While trade secrets often are part of the transaction, they are usually not described in the disclosure schedule.
Domain Name		List the domain name

Acquirers/investors will also want to see a description of any claims involving the IP – either that the operation of the company is infringing the IP rights of a third party or the company is infringing the IP rights of a third party.

Although it may sometimes be in the contract section of the diligence request, the diligence request typically includes a request for license agreements –

a. Inbound licenses – licenses from third parties that are required to operate the company. The request will typically not extend to generally available "off the shelf software."

b. Outbound licenses – licenses of by the company of its IP to third parties. The request will typically not extend to the commercial agreements by which the company generally sells its products, which generally will be included in the contract section.

Property, Plant, and Equipment

For larger assets, the legal documents proving acquisition need to be put into the data room.

An investor might choose to write down some of your current Property Plant, and Equipment or change the useful life based off their assessment of its value.

Inventory (if applicable)

An inventory count, ideally tying back to the general ledger and cost of goods sold. An investor will want to know what inventory needs to be written off due to damage or obsolescence.

Commercial Relations

Major Contracts and Leases

An acquirer is especially interested in any change of control/assignment clauses. These could invalidate a contract if the ownership of the company changes hands. This is especially problematic if you have a locked in favorable contract and price terms. Other times, companies may use the right to veto a contract's assignment as leverage to obtain a price change or a change to other unfavorable contract terms.

These contracts also indicate what commitments you have made as a company, some of which might cause an acquirer to remain in an unprofitable or obsolete contract or restrictive to their future strategy for your company.

List of External Vendors Used

This is mainly of interest to an acquirer to see if there are any synergies with their current vendors. If they use the same vendors you do, there could be potential savings (e.g., consolidation of accounts or

additional buyer power).

Current Customer List

List of current customers.

Pro Tip: Be careful here. You are under no obligation to offer all of the customer data. This can be a bad idea, especially if you are worried about this information leaking. What you can do is offer a redacted list, basically the number of customers, the contract amounts, and the names of the largest 3 or 5 customers. If the acquirer asks for more detail, you can explain your concern, and come to some sort of accord.

Samples of Major Contracts

This is mainly for the acquirer to understand what a typical contract looks like.

The other interest is to evaluate the quality of future earnings. For instance, if you have a five-year deal agreement and are in your second year, technically you have three more years of revenue locked in, which has a larger value to the acquirer due to its certainty than non-booked projected future business.

IT

Description of Infrastructure

Brief narratives are ok for this. In the beginning, just have your head of IT write up the list of software you use. This is to assess the quality of your IT infrastructure, not your codebase.

SOPs and Process Maps

It's ok if you don't have these. It's not common to request these and if you don't have them, the acquirer usually won't ask for them pre-acquisition. They may require them as part of the terms of the transition post-acquisition.

Security & Privacy

With the increases in data breaches and increasing global regulation of privacy, investors and acquirers will want to verify that you have at least reasonable security measures in place and that your handling of personal information complies with governmental regulations in each relevant jurisdiction. They will want to review your privacy policy. You should review your company's status with respect to security and privacy prior to the start of diligence and address any gaps. Particularly if your business handles personal information, compliance failure in this area will be a clear red flag.

Conclusion: You Only Get One Chance to Make a First Impression

It is difficult to overstate the benefit to the company of running an organized due diligence process. Similarly, it is difficult to overstate the harm to the company if diligence disclosure is disorganized, sloppy, and full of gaps. An organized data room conveys a sense that the company is well managed. Inevitably, issues will be identified in diligence, but in the context of a well-run process, the company will generally get the initial benefit of the doubt. On the other hand, if the data room is a mess, investors and acquirers will suspect that the company was poorly run and when issues arise, it will validate those concerns and cause even deeper inquiry.

About the Authors

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Aaron is a seasoned on-demand and full-time Chief Financial Officer for start-ups and mid-cap firms experiencing rapid change. He is a finance and operations "CEO enabler" who has led finance, accounting, and business intelligence teams through rapid growth, transactions, and organizational change. His specialty is bringing "order from chaos" by cleaning up financial books and records and revamping financial operations so executives can make data-driven decisions. He has advised and led many capital raises and helped CEOs get their boards and investors comfortable with their financials.

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