

# MAKING DUE DILIGENCE (ALMOST) PAINLESS

Andy Western and Aaron Harmon

Osborn Maledon, P.A.

## Introduction to Due Diligence

- **An All-Too-Common Scenario**

Many founders and management teams experience a rude awakening to a financing or exit transaction when they receive the investor's or buyer's due diligence request list. Typically a 10 - 20 page document, the request list can outline nearly every conceivable category of information about the target company. It further requests that the company provide copies of material (and arguably immaterial) documents related to these categories.

If not well-prepared, the process of collecting, digitizing, organizing and reviewing these responsive documents can be overwhelming (if not impossible) for founders and management teams who still have a business to operate. The all-too-common outcome is a poorly executed due diligence process with incomplete or missing information, seemingly endless follow-up requests from the investor or buyer, and a number of "problems" or "issues" that the target company never knew that it had.

A poorly executed process understandably leads to a lack of confidence from the investor or buyer, which very often results in lowered valuations, increased holdbacks or escrows of proceeds, and/or draconian indemnification obligations on the part of the target company.

- **An Easily Avoidable Scenario**

The real tragedy of the above scenario is that it is completely avoidable by the target company. Founders and management teams can preserve significant value and cash proceeds at closing by engaging in their own internal due diligence process before any transaction ever begins.

This article discusses strategies and tactics that founders and management teams can use to ensure that they (i) are "diligence-ready" prior to commencing a transaction, and therefore, (ii) can efficiently navigate the due diligence process to avoid price renegotiations and risk-shifting.

## **Key Due Diligence Areas**

Prior to getting the target company "diligence-ready," it is important for founders and management teams to understand the areas of information that investors and buyers are likely to put under the microscope. The following are generally key areas of focus of investors and buyers.

- **Ownership and Capital/Debt Structure**

It is critical for investors and buyers to understand the ownership and capital structure of the target company. In a transaction, the investor or buyer needs to understand the identities of the owners of the target company, how ownership is allocated among the owners, and the various rights possessed by the owners.

As part of this analysis, the investor or buyer also needs to understand the debt, if any, the target company has outstanding and if it is going to be paid-off.

Key documents that the target company will need to provide will be the company's articles of incorporation (if a corporation), articles of organization (if a limited liability company), bylaws (if a corporation), operating or LLC agreement (if a limited liability company), any agreement among shareholders or owners (e.g. a shareholders' agreement, investors' rights agreement, voting agreement, right of first refusal and co-sale agreement), any equity incentive or stock option plan and related award agreements, subscription or equity purchase agreements, and any debt-related documents (e.g. credit agreements, security agreements, promissory notes).

Finally, investors and buyers will also need to review a detailed capitalization table identifying all owners, their ownership amounts and percentages, and types of equity owned. The capitalization table should also include similar information for all equity option holders, including related vesting terms.

- **Finances and Taxes**

While it does not involve much time and effort of legal counsel, financial and tax due diligence is probably the most significant due diligence effort. Ultimately, investors and buyers are entering into a transaction based on valuations and projections derived from the target company's financial information and the proposed tax structure of the transaction.

Investors and buyers may involve outside accountants or auditors to review the financial performance of the target company and conduct a quality of earnings analysis to verify the financial statements. Investors and buyers will want to understand whether the target company's financials are prepared in accordance with U.S. generally accepted accounting principles (GAAP) and sound revenue recognition and other accounting methodologies. The target company's chief financial officer and/or

controller will likely spend significant amounts of time assisting an investor or buyer with their financial due diligence efforts.

Buyers, in particular, will review the target company's income tax returns and want to understand any tax elections that the target company has made. Increasingly, buyers are also concerned with decisions by target companies as to whether state and local sales taxes or other use taxes have been paid in connection with the target company's business. The target company's CPA or independent accounting firm will likely need to assist the target company to respond to these due diligence requests from the buyer.

Key financial information that investors and buyers will review will be audited financial statements for past fiscal years, unaudited financial statements for the current fiscal year, monthly financial information, operating budgets, and financial projections prepared by the target company. Key tax information will be filed income tax returns, audit correspondence, and any other sales or use tax filings.

- **Customer and Vendor Relationships and Contracts**

Customer and vendor dynamics are critical to a company's operations and will be diligenced heavily by investors and buyers. It is very likely that the most material contracts of the target company will be with key customers and/or suppliers. Buyers, in particular, will want to be very familiar with the terms of all the target company's material contracts.

As diligence progresses, investors and buyers may want to conduct "diligence calls" with key customers and suppliers. Investors and buyers often want to hear directly from the customers and suppliers as to their relationship with the target company. Founders and management teams should be very protective of customer and supplier relationships and should (i) participate in any such diligence calls and (ii) only permit such diligence calls once they are certain that the proposed transaction will be completed.

Key customer and vendor information will be contracts between the target company and its vendors and customers, a list of top customers (by revenue) and vendors (by expense) looking back over a few years, any warranty policies of the target company in favor of customers, and any information related to how these customer and vendor relationships are expected to grow or decrease in the near term.

## **Other Due Diligence Areas**

In addition to the key due diligence areas noted above, depending on the target company's operations and industry, other areas may also be of significant focus by the investor or buyer. Below are a few examples.

- **Regulatory Issues**

If the target company operates in a moderately to heavily regulated industry (e.g. healthcare, energy, financial, or pharmaceuticals), then one can expect investors and buyers to diligence compliance with applicable regulations. In any transaction involving real property, environmental compliance is always an important due diligence area. Investors and buyers may engage third-party experts to lead this due diligence effort and conduct analyses of the target company's compliance.

Regulatory noncompliance by a target company can result in statutory-based fines, legal liability, prohibitions against contract awards, and other significant penalties. Investors will want to ensure that their invested capital will not be drained from the target company in order to satisfy regulatory penalties, and buyers will want to ensure that they are not assuming liability for such penalties. In certain transactions and industries, regulators may even need to be involved at the due diligence stage in order to provide greater transaction certainty.

A few examples of key regulatory documents and information are correspondence with regulators, Phase I and Phase II environmental reports, and audits conducted by regulators or self-regulatory organizations.

- **Employee Matters**

Recently, employment practices have been subject to greater scrutiny by investors and buyers. Specific attention is often given to compliance with employee/independent contractor classification, minimum wage laws, Affordable Care Act (ACA) compliance, and immigration laws. Target companies that employ large numbers of employees or contract with large numbers of independent contractors, particularly in service-based or trade-based industries, should expect extensive due diligence requests from investors and buyers.

Founders and management teams should be prepared to provide employee offer letters, explanations as to employee/contractor classification, correspondence with the Department of Labor (if any), and human resources outlines or checklists as to minimum wage, ACA and immigration compliance.

- **Intellectual Property**

Depending on the target company, intellectual property due diligence may be an important area of focus by an investor or buyer. If a target company's value is heavily dependent on proprietary technology or registered intellectual property, then investors and buyers will want to validate the protection of such intellectual property. Often, investors and buyers will employ third parties to conduct this due diligence.

Due diligence with respect to intellectual property will likely have two components. First, analyzing the proprietary nature of the intellectual property and confirming that it does not infringe on another party's intellectual property. Second, analyzing the steps taken by the target company to protect against disclosure and infringement of the target company's intellectual property.

Key documents and information that investors and buyers will likely seek are license arrangements related to the intellectual property, registration filings and correspondence (if the intellectual property is registered with the USPTO), information related to any adversarial proceedings (e.g., litigation, USPTO opposition proceedings, cease and desist letters), and, with respect to software, information regarding the use of any open source software.

### **Prepare Now**

The amount of information that can be subject to due diligence by an investor or buyer can very easily seem overwhelming. However, the good news is that founders and management teams can start to get their companies "diligence ready" now before the time pressure of a transaction is looming.

- **Step 1: Build a Virtual Data Room (VDR)**

The typical mechanism for conducting due diligence in a transaction is a web-based virtual data room or VDR. Many vendors such as iDeals, Intralinks, Donnelley, Merrill, and others offer secure proprietary file hosting platforms. Additionally, many transactions utilize more common file sharing platforms, such as Dropbox or Box. Regardless of the platform, consideration should be given to its security and control features in order to protect the target company's information. The basic idea is to have a secure electronic repository of documents and information that is remotely accessible by all parties.

If the target company's goal is to be "diligence ready," then why wait for a transaction to establish a VDR? Founders and management teams should start preparing their own internal VDR today. Think of it more as an internal filing system initially, rather than a file sharing platform.

A great way to organize a VDR is to start with a standard due diligence request list (remember the 10-20 page rude awakening first discussed above). The target company's legal counsel should be able to provide a comprehensive sample for this purpose. By building a folder system based on the topics and numbering system in the checklist, the target company can create an outline for future due diligence with very little time, effort or expense. Folders should be broken down into various subfolders for clear organization. For example, if Folder 8 is designated as "Human Resources," then there will likely be subfolders (e.g. Folder 8.1, Folder 8.2, etc.) for specific human resources related content (e.g. employment contracts, health and wellness plans, 401(k) plan, employee handbook, etc.).

- **Step 2: Populate the VDR**

Once the folder system or outline is set-up in the target company's VDR, founders and management should assign responsibility for folders and the applicable content to the appropriate company personnel. For example, if Folder 8 is designated as "Human Resources," then the target company's head of HR should be assigned ownership of that folder and tasked with populating the content requested in the due diligence request list.

By starting early, and therefore having sufficient lead-time, company personnel can take the time to search for applicable documents, determine whether applicable documentation or information exists, digitize documentation that only exists in hard copy, draft narrative responses where appropriate, and, most importantly, still do their real jobs. Company personnel should keep track of documentation and information requested that (i) does not exist, (ii) isn't applicable to the target company's operations, and (iii) is incomplete.

While it should not require much time initially, it likely makes sense to involve legal counsel in this process. It is very likely that certain diligence requests will be unclear and company personnel will need some guidance as to what documents or information they should be identifying and uploading. Legal counsel should be able to provide this guidance efficiently.

- **Step 3: Identify and Locate Missing Information**

After company personnel have populated their respective folders with available documentation and information, founders and management teams should review what documentation and information is missing or incomplete. Identifying these gaps in diligence early is the proverbial ounce of prevention.

Even the tightest-run ships have missing or incomplete documentation or information: contracts go unsigned, an annual state filing is forgotten in a particular year, etc. The target company should have legal counsel, accountants, and other advisors review the populated VDR to assist in identifying issues and recommending remedial action.

There very likely will be situations where remedial action is not available or where remedial action does not make sense (financial or otherwise) until a transaction is in play. In such instances, founders and management teams (with the assistance of their advisors) should prepare narrative explanations of the issue and why remedial action is not available or has not yet been taken. Such explanations should also be uploaded to the applicable folder in the VDR.

- **Step 4: Keep the VDR Up-to-Date**

Perhaps the most critical component of preparing an internal VDR is to make sure that it stays up-to-date. Once completed, the target company should view the VDR as an internal record-keeping system. As new employees are on-boarded, their executed employment documents should be uploaded. As new customer contracts are executed, those agreements should be uploaded.

Conceptually, if the VDR is kept current, upon receipt of a real due diligence request list from a potential investor or buyer, the target company should be able to very quickly provide access to the VDR or some version of it. Gaps in information should be minimal, with explanations as to why the gaps exist. Legal counsel and other advisors should be up-to-speed on the likely concerns in due diligence and have formulated responses or workarounds. And, hopefully, the potential investor and buyer will quickly have confidence that the target company and its founders and management team are well prepared and ready for a quick and successful transaction.