NAVIGATING DUE DILIGENCE PLANNING AND EQUITY FINANCING

When contemplating making an investment in a newly formed company, due diligence must be performed both by and for the investor. Notwithstanding, the entrepreneur will also benefit from this process and should create their own due diligence plan so they are prepared to answer the difficult financial and operational questions that will be asked by the investor. The nature and scope of the due diligence is dependent upon the type of company that is seeking the financial support and generally falls into five categories; i.e., legal, financial, people, market and technical. Creating a due diligence plan is a critical step for both the investor and entrepreneur and should be thoughtful and comprehensive so that neither party is wasting valuable time before, during and after the process.

The first steps in developing a due diligence plan are to consider the nature of the company seeking the investment; what the funds will be used for (so-called, "use of funds"); what assets and rights need to be in place for the investment to be successful; anticipating the most important questions that will be asked; and being prepared to provide suitable answers. How the investment will impact the business plan is just as important as what the company is seeking to accomplish. Understanding the risks associated with making the investment is a key factor in framing the questions asked during the due diligence process.

Creating the due diligence plan should include an outline of the key players in the company who will be driving the investment and utilizing both legal and financial consultants to formulate the type of questions, which should be relevant to the investor as well as the entrepreneur so that everyone is on the same page during the process of obtaining the requested information. Prior to engaging in the "show and tell" process, the investor must make a judgement as to whether the investment team has the ability to proceed with the process alone or decide if it would be wiser to engage third parties to formulate the questions and analyze the results. The investor also needs to determine early in the process - or even before - what their walk-away position will be and what is needed to gain comfort in assessing the risks of making the investment.

Typical due diligence information needed by the investor to make informed decisions under the five key categories includes:

Legal Due Diligence

Questions pertaining to the legal due diligence process might include:

- How the company was incorporated?
- Are bylaws are in place?
- If the company is a corporation, does a shareholder agreement exist?
- If the entity is a limited liability company, has an operating agreement been executed by the founders?
- What are the voting rights and/ or restrictions imposed by the internal governance documents and do they present an impediment to an outside investment being made by third parties?

The investment team will want to understand any and all legal obstacles, including jurisdictions that the company is permitted to conduct business and if the company is the subject of pending litigation.

Financial Due Diligence

Examining the financial status of the company is obviously critical to any decision by the investor, along with understanding its historical performance. For instance, investor questions such as the following should be anticipated:

- Does the company have debt, filed tax returns and paid taxes?
- Does the company have any financial agreements that must be performed?

How quickly the company spends funds is as important as the use of the funds and determining who owns what and any loan terms will be an important consideration in making a new investment. Financial projections are also critical to the investor analysis in terms of what the founders predict for sales and how much of an investment is needed to achieve the stated goals of the company.

People Due Diligence

Workforce is another area of concern. Due diligence involves an examination of the key people in the company and their respective roles. How they are compensated, who are the primary shareholders and who is on the board are all important considerations for the investor. Understanding the company's culture and its talent pool for expansion should likewise be accounted for during the due diligence process. Concerns raised would be:

- Does the company have employee handbooks?
- Does the company have a best practice model?
- What happens if a key employee(s) decides to depart prior to the investment?

Market Due Diligence

The investor will also conduct due diligence relating to the market and business model for the company. Important questions such as the following will need to be answered:

- What is the company's business model?
- What were the marketing tactics employed to bring the company to the point of needing additional capital?
- How does the company generate business?
- Are customers satisfied with the product or service?

Technical Due Diligence

A final area of due diligence relates to the technical aspects of the product or service. Questions that should be part of the planning process are:

- How is the product or service designed and is it scalable?
- What are the capital requirements to achieve stated goals and what are the specific competitive advantages or threats?
- Does the company have intellectual property and is it adequately protected?
- Who are the individuals who control the intellectual property and do threats exist challenging the intellectual property?

In summary, creating a due diligence plan is critical to the success of the process and making certain that the information gathered is comprehensive and efficiently disclosed will determine the success of the investment. For more information, contact PLDO Managing Principal and business lawyer Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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