

MANAGING THE DUE DILIGENCE PROCESS FOR INVESTORS AND ENTREPRENEURS

In order for an investor to determine and validate that a company is worth making an investment, they must go through a process called “due diligence.” The phrase due diligence refers to an exercise of care performed by the investor about a prospective company in order to confirm the company is real and has a competent management team. Essentially, to find out everything that a reasonable person should know before actually making the investment. The process of due diligence involves a sequence of steps that move the investor from a term sheet to closing on their investment.



The starting point is the investor’s counsel drafting a schedule of deliverables required of the company that will inform their ultimate decision to risk capital in taking an interest in the company or purchasing it outright. The company’s response to the request for information would be to provide documents, which would include a history of the company’s formation up to and including information relating to its operation, tax returns, contracts, employees, etc. Upon receipt of the requested information, the investor and investor’s counsel will pose additional questions to become satisfied that they have all of the relevant information to inform their decision to move forward with a closing. This process applies whether it is in relation to the acquisition of a company, an investor making an investment, or an entrepreneur seeking capital to expand their business.

A major area of due diligence involves legal issues relating to the company or its operation. The legal aspects include contracts, lawsuits or other material events that may impact the investment. The investor will want to know if the company owns or controls intellectual property, and if it is a manufacturing company, what does its inventory include. The due diligence process will outline all the jurisdictions in which the company operates, at which point the investor will want to investigate if the company is authorized to conduct business in each jurisdiction and determine if the company is current in its tax filings and payments.

Another critical area of due diligence relates to financial issues. The investor will want to understand the company’s financial past, present and projected future. Historical financial statements, which could include prior audits by internal or external accounting firms, provide the basis for an analysis of the company’s current financial status. If the capital investment is in a young enterprise, it is unlikely that there will be audited financial statements; however, reviewed statements would provide some basis for the investor’s decision to proceed with the transaction. The due diligence materials relating to financial matters include the company’s assets and the nature of its liabilities, i.e., short or long term.

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Reviewing the aging of accounts receivables provide the investor with an understanding of the internal mechanisms of the company's operation relating to current cash flow and projected income. This provides a picture for the investor as to how funds are being used and if value is being created that would make it a favorable investment.

Understanding the corporate structure and its key players provides a window into the future of the company and is critical in helping the investor evaluate existing talent and the prospects of bringing new talent to the company post-investment. Having confidence that key employees will remain with the company post-closing is one of the principal factors for an investor. Equally important is having confidence in the customer base or concentration, which translates to the value proposition that the company is providing to the investor. Analyzing the market opportunities or size of the available market is an important metric to be determined during the due diligence process.

In summary, due diligence is a crucial exercise of care that all investors should take before investing in a business. Legal due diligence is performed by lawyers; however, equally important is the due diligence performed by the investor prior to signing an agreement. The process of conducting due diligence is a structured approach to carefully examining every part of a business, essentially putting potential deal partners under the microscope in order to verify all of the relevant facts about the company, including corporate governance, management, key employees, financial stability, risk factors, as well as the potential for future growth and profitability. For further information on the process, structure and management of due diligence, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.



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