



# **PREPARE YOUR COMPANY FOR INVESTMENT GET YOUR HOUSE IN ORDER**

Module 3

**Module 3: Prepare your company for investment – get your house in order**

# Introduction

## Lesson 1



# Introduction

Imagine you have attracted a top tier venture capital firm, and signed a term sheet for a Series A financing.

What is the next step?

Due diligence.

Due diligence document request list.

The best time to start preparing for due diligence is now. That's what this module is about: Getting your house in order.

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# Corporate Formation, Organization and Maintenance

## Lesson 2



# Corporate Matters

- Copies of the company's minute books (records of shareholder meetings and consents, board of directors meetings and consents, filings with secretaries of state, etc.)
- Copies of the capitalization records (all equity interests, including shares, options, warrants, convertible securities – have they been properly authorized, validly issued and fully paid? Any undocumented "promises?")
- All agreements among shareholders.
- Any consent decrees, regulatory notices, or other dirty laundry?

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# Intellectual Property Matters

## Lesson 3



# Intellectual Property Matters

Confirm that ALL founders, employees, developers, creatives and advisors have signed and dated, without exceptions, a Proprietary Information and Inventions Assignment Agreement (PIIAA), or some other appropriate agreement protecting company IP.

Outsourced developers – they need to sign and date, too.

What about any “Open Source” concerns?

Any and all provisional or formal patent applications, trademark registrations – be careful not to inadvertently blow IP protection.

Third-party software license agreements.

# Intellectual Property Matters

Potential consequences if IP due diligence problems surface:

- Best case: Request for more disclosure.
- Middle case: Clean-up that can be time-consuming (going back to everyone required), expensive (legal fees) and embarrassing.
- Next to worse case: Shifting risk to founders through indemnification and/or changing valuation.
- Worst case: Investors walk away.



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# Management, Employees, and Consultants

## Lesson 4



# Management, Employees, and Consultants

Audit yourself

Make sure that you have copies of all appropriate agreements:

- PIIAA and other IP agreements, including NDAs.
- Employment offer letters and agreements.
- Employment benefit plans and equity incentive plans, including all agreements, authorizations and filings related thereto.
- Any unpaid or undocumented obligations, contingent or otherwise?
- Note: make sure you comply in all relevant jurisdictions.

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# Debt Financing and Liabilities

## Lesson 5

# Debt Financing and Liabilities

Anything and everything that could or should be reflected on the company's balance sheet, including reserves and contingent liabilities:

- Any loans or unreimbursed expenses?
- Any lease agreements, including real property and equipment?
- Any security interests, perfected or not?
- Any personal guarantees by founders, directors, shareholders or others?
- Any pending or threatened litigation?

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# Other Material Agreements, Market Due Diligence and Business Due Diligence

## Lesson 6



# Other Material Agreements

**Question** – what is “material” in the context of venture finance?

## **US Supreme Court:**

“A fact is material if there is a “substantial likelihood” that a reasonable investor would view it as “significantly alter[ing] the ‘total mix’” of available information.”

## **EU Transparency Directive:**

- Does not define or use the term “materiality.”
- But single passport prospectus must “contain the necessary information which is material to an investor for making an informed assessment of the assets and liabilities, profits and losses, financial position, and prospects of the issuer . . . the rights attaching to such securities; and the reasons for the issuance and its impact on the issuer.”

# Examples of Material Agreements

Real property leases.

License agreements.

Joint venture agreements.

Letters of intent (LOIs).

Memorandums of understanding (MOUs), possibly.

Basically: any agreement that might be important, individually or within a larger context, to a prospective investor.

# Market Due Diligence

## Market due diligence – company supplied

- Total addressable market (TAM).
- Competitive matrix.
- Comparable analysis of recent deals (financings and M&A).
- Relevant analyst reports.

## Market due diligence – supplied by third parties

Sophisticated investors will also gather data from industry experts, competitors, customers, and sometimes suppliers and other third-party market participants.



# Business Due Diligence

## Business due diligence

Reputation and character of founders, officers, directors.

- Criminal background checks.
- Any disclosable items or skeletons in closet?

## Customers

- Are they satisfied?
- What is the threat they will seek another sources of supply?

## Suppliers

- What is chance they will forward integrate?
- Perception of target vs competitors.

# Role of Investors' Counsel & Advisors

Objective is to identify any potential problems, including, legal, market, or business issues that need to be addressed.

Obviously, if problems are identified, then this proves the “value” of hiring them, and may also lead to future work.

In most VC financings (and some angel financings), the investee company must reimburse the reasonable fees and expenses of investors' counsel and advisors.

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# Summary of “House in Order”

## Lesson 7



# Summary of “House in Order”

Is there an alignment between the story you tell the world about you and your company, and the true state of affairs?

Example: The Wizard of Oz scene: “Pay no attention to that man behind the curtain,” the Wizard yells in vain.

Due diligence includes three main categories:

- Legal
- Market
- Business