

## DUE DILIGENCE FOR ENTREPRENEURS



### WHAT IS A DUE DILIGENCE?

Venture capital due diligence is the process of appraising a company's current state of affairs and its commercial potential. Due diligence for VCs means getting a deep understanding of the target company, its assets, its liabilities, and its management

The purpose of this exercise is to ensure all risks are accounted for and understood, there are no obstructions to the investment, and that the target company has a good foundation to grow from.

### DATA ROOM

Before querying investors, there are some steps to prepare you company for the fundraising process.

Build a data room that contains the necessary data, financial statements, customer validations, and more.

### SET UP

First, you have set up the structure to build that data room. Here are some tips:

1. Recommended to use [Google Drive](#) or [Dropbox](#). There are some other options as well, but they can be costly and both Google Drive/Dropbox have intuitive, free versions. For tighter security entrepreneurs use [DocSend](#) to build their VDR.
2. Create a folder structure that is clean and easy to navigate. Investors time is valuable, ensure your structure is as simple as possible.
3. Allow read-only rights! You do not want 3rd parties downloading/editing your company data.
4. Create separate data room access for each investor so you can tailor the content. Depending on investor, you'll want to target some of your messaging.
5. Create an update cadence. Once a month, once a quarter. Whatever your goals are, make sure documents are fresh.

## COMPANY DOCUMENTS

*It is advice to connect with your team and organize all these documents in a Data Room. Here is a list of items to include in your data room:*

1. Amended and restated articles of incorporation.
2. Voting agreements
3. Investor rights agreements (IRA) – Find template attached
4. First refusal & co-sale agreements
5. Stock purchase agreements (SPAs) – Find template attached
6. Capitalization table
7. Any documents/details on previous raises (if any)

### **Board of Director Materials**

1. All board meeting minutes
2. Board consents and actions

### **Financials**

1. Profit and loss statements
2. Pro-forma statements for next year
3. Projections

### **Marketing Materials**

1. One-pager
2. Pitch deck
3. Branding guidelines and vision

### **Intellectual Property**

1. Granted and filed patents
2. Trademarks
3. IP strategy

### **Market Research**

1. Market studies
2. Competitive analysis w/ features & pricing

### **Sales**

1. Sales process
2. Sales pipeline

### **Staff**

1. List of all current employees, titles and salaries
2. Employee agreements
3. Future critical roles and hires
4. List of contract workers and firms

### **Technology**

1. System architecture diagram
2. API documentation
3. Details on any large integrations
4. Product backlog export and release map
5. Screenshots of existing products

## WHAT IS AN INVESTOR RIGHTS AGREEMENT (IRAs)

An investor rights agreement (IRA) is a typical document negotiated between a venture capitalist (VC) and other concerns providing capital financing to a startup company. It provides the rights and privileges afforded these new stockholders in the company. They typically cover subjects such as stock registration rights, “rights of first refusal” or “pre-emptive rights” when additional shares are offered to the public, and other rights that sweeten the deal for the VC.

Investors obtaining only a minority interest in a closely held corporation desire this form of agreement to protect their interest. Corporations grant these rights because they receive a capital investment that might otherwise not materialize and want the deal as attractive as possible to the investors.

### Features of an Investor Rights Agreement

The most common rights usually granted to investors by a company are:

- **Liquidity of stock:** The VC requires that the stock be registered with the SEC as part of an initial public offering, which means the stock can be traded on the stock market (usually after what is called a lock-up period).
- **Right to receive corporate reports:** These reports include financial and management reports, and other periodic updates from the company.
- **Participation rights:** Typical examples of these rights include rights of first refusal and pre-emptive rights that protect the investor’s percentage of ownership of the company.

Other rights can be negotiated, and usually reflect the amount of control the startup is willing to grant in return for the investment. These include:

- **Board membership:** Startups can agree to allow the VC to be represented on the board of directors or to serve on board committees with the authority to approve extra-budgetary financial expenditures.
- **Dividend rights and calculations:** VCs are allotted preferred stock as part of their investment, and a feature of these stocks is the priority the holder receives in terms of dividend payments and anti-dilution protection.
- **Indemnification and expenses:** An indemnification clause provides VCs additional protection from liability due to board decisions, and expenses are often paid because VCs may have to travel to attend meetings in the location of the startup.
- **Observer rights:** The startup provides the VC with notice of and the opportunity to attend all board and committee meetings.

- **Inspection rights:** The investor is given the authority to inspect the startup's corporate record books and discuss finances and accounts with the officers.
- **Provisions to address unique concerns:** In the event unexpected expenditures or board action is required, the VC is accorded a wide range of rights to influence or offer consent in these situations.

## Registration Right

The registration right provision is often one of the most important components in an investor rights agreement to investors. It gives the investor the authority to require the startup to list the shares publicly on the stock market. This allows the investor to capitalize on the investment by selling the shares to other parties.

It is an issue that a privately held company should not approach lightly if it wants to retain complete ownership of the company. Granting a registration right may be necessary to raise capital, but a registration right forces the company to become a publicly traded corporation.

In most cases, it is the majority block of shareholders that make the determination of if and when the company will go public, and the minority block has no say in the matter. However, even a minority shareholder can force this action if they have been granted registration rights.

There are reasons the startup should guard against granting these rights.

- The IPO filing process can be expensive and drain funds that would be better allocated to operations and research and development.
- Employees must devote time to collecting and preparing documents that are required by the SEC for IPOs rather than running the business.
- Market conditions may not be optimal, and the startup may not get an adequate price for each share.

Even if an investor demands that a registration be included in the investor rights agreement, there are steps a startup can take to limit the impact they may have on the company. It is possible to prevent a registration right from being exercised before a negotiated future date when the company may be in better financial shape. The company can insist that the registration right be piggybacked onto existing plans for a future IPO at the company's convenience.

While an investor rights letter is a typical component of the early capitalization of a young company, care should be taken that the startup does not relinquish important facets of control.

**Please find attached: Investor Rights Agreement - TEMPLATE**

## WHAT IS A STOCK PURCHASE AGREEMENT (SPAs)

Stock purchase agreements (SPAs) are legally binding contracts between shareholders and companies. Also known as share purchase agreements, these contracts establish all of the terms and conditions related to the sale of a company's stocks.

Their primary purpose is to establish the price of the stock being sold. SPAs achieve this by:

- Listing out the prices of the stock being sold
- Providing a roadmap for the transaction to prevent and mitigate risk.

Since risk prevention and mitigation is one of the primary goals of writing an SPA, SPAs spend a lot of time covering potential situations and variables that could put the investment at risk.

Like most other agreements, SPAs don't have a standard format. The clauses and language contained within each SPA differ greatly depending on the needs, industry, and size of your company. However, every SPA should have some essential features to ensure that the transaction goes smoothly.

### What to Include?

- Buyer's Name;
- Seller's Name;
- Description of Shares;
- Purchase Price;
- Closing Date; and
- Due Diligence Period

### Classes of Stock

Classes of stock commonly have different **voting rights** allowing a group of individuals make the primary decisions of the company.

For example, ABC Company has three (3) different classes of stock:

- Class A Stock: Allows 3 votes per share.
- Class B Stock: Allows 2 votes per share.
- Class C Stock: Allows 1 vote per share.

**Please find attached: Stock Purchase Agreement - TEMPLATE**