Surviving Investor Due Diligence
Introduction

So, you are serious about attracting external investment into your business. No doubt you will be preparing to beguile them with your pitch and field their questions on your business plan. You may even have made progress towards a term sheet. But have you thought about the investor’s legal due diligence? Once the basic deal is agreed the investor’s lawyers will be sending you the legal due diligence questionnaire and while it may seem an absurdly long document consisting of dense, menacing demands for incomprehensible, trivial or irrelevant information and documents it actually represents both an opportunity to impress your investor and one of the last hurdles between you and that investment.

Why fill out the questionnaire at all?

The questionnaire has two main functions:

- It is an important part of the potential investor’s due diligence, with a particular emphasis on the detail underlying the assets and liabilities of your business. If your responses to the questionnaire reveal some bad news, then this may result in the investor deciding not to go any further or to re-negotiate the valuation. That may sound like a reason not to tell the investor about the bad news, but, as you’ll see below, this does not solve the issue.

- You will also be expected to warrant the accuracy and completeness of your answers to the questionnaire in the investment agreement. This and other warranties will be the investor’s protection against the possibility that you have, deliberately or inadvertently, not disclosed all material information about your business. If you have failed to disclose some material information, both you personally and your company could find yourselves liable to compensate the investor.

But your responses to the questionnaire can have an additional function – they demonstrate whether you and your team are organised, efficient and understand the detailed aspects of your business. An investor will be unimpressed if your replies to the questionnaire are slow in materialising, chaotic or incomplete.

Why are some of the questions irrelevant?

Why, for example, are you being asked to provide details of your leasehold or freehold properties when you work from a short-term serviced office? The fact is that the questionnaire is a standard document which attempts to deal with a wide range of scenarios. The investor and their lawyers fully expect you to answer many of the questions with ‘Not applicable’. However, don’t be too quick to assume that a particular question is totally irrelevant to your business – sometimes your answer to a question should explain why it isn’t relevant. Remember that you will be required to warrant the accuracy and completeness of your answers. This is one of the reasons why your lawyer should be involved in the part of the process. Believe it or not, this can reduce your overall legal fee – if your responses to the questionnaire are incomplete, you and your lawyer will have to duplicate much of the effort later on, in the warranty and disclosure exercise, described in the following paragraph.
Warranties and disclosures

The investment agreement will state that the investor will subscribe for shares in your company at a certain price, and that he does so in reliance upon the warranties. These usually appear in a long schedule to the investment agreement and consist of numerous statements that information given about the business is correct and that various statements are true. To give a simple example – there will be a warranty that the company is not involved in any litigation. If, after the investor has subscribed for shares, it turns out that there was already some litigation, the investor could claim against the company and the founders of the business for breach of warranty. However, at the time the investor subscribes, the company and the founders generally issue a disclosure letter, which sets out exceptions to the warranties. One of the items in the disclosure letter could be a description of any litigation in which the company is involved. In that case, the investor couldn’t claim for breach of warranty because it was aware of the existence of the litigation before investing.

The warranty and disclosure process is complicated, and your lawyer must be closely involved, but the point is that those warranties bear a striking similarity to the questions in the due diligence questionnaire, and your replies to the questionnaire will be very similar to what you say in the disclosure letter. In other words, if you’ve done a good job in your replies to the questionnaire, much of the work necessary for the disclosure letter will already have been done. Indeed, it may be possible for your disclosure letter simply to cross-refer to your replies to the questionnaire, thereby reducing the need for repetition (and reducing your legal bill!).

Your lawyer can not only advise you on how to manage the process, he or she can also advise on the more esoteric points. For example, the questionnaire and the warranties will both in effect ask whether there are any clauses in any of the agreements to which the company is a party which state that the agreement can be terminated by the other party if the company undergoes a change of ownership. If you’ve assembled copies of the agreements, your lawyer can check whether any agreements include such 'change of control' clauses and summarise the information for inclusion in your replies to the questionnaire and the disclosure letter. Another important aspect of this process is that managers of a business should have this sort of information at their fingertips anyway, irrespective of whether their company may be subject to due diligence by an investor.

How can the process be made less painful and more effective?

As so often, the answer is preparation. As soon as possible – ideally before you even start talking to potential investors – you should take the following steps:

1. Go through a typical questionnaire to get an idea of the types of question and of the information sought. (Please get in touch with us and we will send you a questionnaire that is appropriate for your business.)

2. Draft answers to those questions. In particular, your answers should cross-refer to the relevant documents. You will probably need some input from colleagues, your accountant and your lawyer.

3. Quite possibly, you will at this stage identify some potential problems with your business which need to be fixed. A classic example is where a company has paid an independent contractor to develop some software, but ownership of the
intellectual property in that software hasn’t been assigned to the company. Far better to rectify that oversight now, so that you can confidently confirm to a prospective investor that the company owns the intellectual property.

4. Assemble copies of the documents that may need to be provided as part of your responses to a questionnaire.

5. Index those documents and, ideally, upload them to a password-protected website which can then be accessed by lawyers and potential investors.

6. You may need your lawyer to provide some specific answers – e.g. in relation to the ‘change of control’ clauses referred to above. Also, if you ask your lawyer to check and refine your draft replies. Your lawyer will probably identify items which need more detail and more documents. But legal fees incurred at this stage in ensuring the job is done thoroughly may be less than they would be if it’s done in a last-minute rush, and the likelihood of making expensive mistakes will be reduced.

Conclusion

Providing a considered and speedy response to an investor’s legal due diligence questionnaire will:

- Save you money on legals in the long run,
- Impress your investor; and
- Shorten that worrying interval before the investor commits and could potentially get cold feet.

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