DUE DILIGENCE GUIDE

McCauley PLLC
Investment Risk & Legal Consulting

What is Due Diligence?

Due diligence is the process of researching and analyzing material facts regarding a potential investment (e.g., ownership interest in an LLC) or a general business transaction (e.g. boat purchase).

Why is Due Diligence Performed?

The basic purpose for performing due diligence is to discover any hidden information that you, as an investor/purchaser, would consider important in making your decision on whether to hand over your money for products or services.

Why Outsource Your Due Diligence Work?

All purchases/investments require due diligence. As the price of a purchase and/or amount promised as an investment return increases, so should the amount of due diligence.

Proper due diligence requires an array of skills (such as understanding the laws of various jurisdictions or analyzing investment risk and financial statements) that can only be developed and refined through extensive and consistent experience in various business fields, such as auditing, public accounting, law and investment management. Without proper training from fields similar to these, discovering the full extent of the risks and benefits of a purchase/investment will be difficult. Failure to perform a thorough due diligence may result in the unnecessary loss of funds through fraud, misappropriation, mismanagement and theft.

Which Types of Due Diligence Solutions Available?

Due diligence can be performed on:

- a single, or multiple, document(s), such as a lease agreement, or
- an entire transaction, such as an investment in a business.

Each type of due diligence solution is described in the sections that follow, with due diligence for single, or multiple, document(s) described as Due Diligence I, and due diligence for entire transactions described as Due Diligence II.

Due Diligence I. Single or Multiple Document(s)

If you have, or will receive, any of the following documents, you may send them in for due diligence (note: this is a non-exhaustive list):

- ☐ Prospectus
- ☐ Operating Agreement
- ☐ Official Statement
- ☐ Offering Memorandum
- ☐ Sale and Purchase Agreement
- ☐ Promissory Note
- ☐ Business Plan
- ☐ Promotional Agreement
- ☐ Security Agreement
- ☐ Entity Formation Documents
- ☐ Corporate Governance Documents
- ☐ License Agreement
- ☐ Lease Agreement
- ☐ Promissory Note
- ☐ Stock Option
- ☐ Stock Warrant
- ☐ Partnership Agreement
- ☐ Other: ______________________

Due Diligence I Process

By choosing Due Diligence I, you are electing to have due diligence performed on a single, or multiple, document(s). When Due Diligence I is performed on any of your documents, the following items are generally considered and analyzed:

- Legality of the arrangement
- General business and/or legal structure of the transactions
- Clauses and/or terms that may be exceptionally unfavorable
- Missing information
- Misleading information
- Inconsistent information
- Reasonableness of fees and/or financial requests
- Verification of certain representations
- Completeness of the document
- Personal liability exposure
- Adequate consideration

Due Diligence I Example

> You receive an operating agreement for a planned limited liability company (LLC) that requires you to contribute $400,000.00 to fund startup and initial operating costs. Naturally, you would like to know if there are any items of concern in your operating agreement, and if there are, how should you handle those items with your prospective business partners.
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> In this situation, your operating agreement (and any additional attachments that might be associated with this operating agreement) will be reviewed in detailed under the laws of the state in which the LLC will be formed. Once this review is completed, you will receive a report that identifies issues and provides recommended solutions for those issues. This report can be used to discuss your concerns with your prospective business partners.

Although the *entire transaction* may not be specifically analyzed under Due Diligence I, as it would be under Due Diligence II (as described below), there may be some areas covered due to their significance to, and impact on, the document(s).

Due Diligence I Example (continued)

> Using the same example above, the operating agreement includes references to other LLCs. To determine if these LLCs have been properly formed and are in good standing, their articles of organization and certificates of good standing, if any, will be reviewed.

Due Diligence I Deliverables

Once the research and analysis is complete for Due Diligence I, you will receive the results in a custom report. At a minimum, this report will include the following:

- Description of the issue found and
- Recommendations on solving the issue.

At your request, you can choose to also receive a summary of the report in Microsoft PowerPoint presentation format with your report.

After you receive your report and/or summary, a meeting will be scheduled with you to go over the results and how you would like to proceed with any recommendations provided to you.

Due Diligence II. Entire Transaction

Due Diligence II requires a more extensive analysis than Due Diligence I. If you choose this option, you may select from several areas that you would like due diligence performed or rely on a professional to choose business areas for you.

Generally, formal due diligence procedures include an analysis of most, if not all, of the items listed below under the section labeled *General Investment in an Existing Business*, but if you feel comfortable with certain areas, you may choose to omit them from the due diligence process (see example directly below).

Due Diligence II Example

> You plan to go into business with best friends you've known from childhood. As a result, you may choose to leave out due diligence on Management Matters, as the managers are people personally close to you and the results, good or bad, may not matter at all to your decision.

By choosing Due Diligence II, you will be provided a due diligence request list that you can provide to your business partner(s) after you provide an overview of the transaction. This due diligence request list will identify the documents that will be necessary for due diligence.

Due Diligence II Process

Due Diligence II applies to two types of transactions:

- An investment in an existing business or
- An investment in a start-up

Each type of transaction requires a different type of analysis. The main reason for the difference is because the existing business has a history of financial performance and operations, whereas the start-up generally does not have history of either.

As a result, existing businesses an assessment of historical information and prospective information. Start-ups require a feasibility analysis (i.e., does this business idea even make sense under current and future circumstances) and prospective information.

General Investment in an Existing Business

The following list provides several areas that are generally reviewed during due diligence for an existing business. Each area has an extensive list of questions and factors that will be considered. As each transaction is different, not all areas may be considered.

- ☐ Basic Corporate Documents
- ☐ Subsidiaries
- ☐ Securities Issuances
- ☐ Shareholder Information
- ☐ Material Contracts
- ☐ Litigation and Audits
- ☐ Employees
- ☐ Treasury Matters
- ☐ Work Culture
- ☐ Software Development
- ☐ Manufacturing Matters
- ☐ Operations Matters
- ☐ Sales and Marketing
- ☐ Tangible Property
- ☐ Intellectual Property Matters
- ☐ Environmental Matters
- ☐ Management Matters
- ☐ Financial Matters
- ☐ Research and Development

General Investment in a Startup

The following list provides areas that are generally reviewed during due diligence for a start-up. Each area has an extensive list of questions and factors that will be considered when evaluating.

- ☐ Revenue Assumptions
- ☐ Marketing Assumptions
- ☐ Costs and Expenses
- ☐ Financing Needs
- ☐ Marketing Strategy and Plans
- ☐ Accounting Method and Policies
- ☐ Prospective Financial Information

Combination (Due Diligence I and II)

In some circumstances, due diligence may need to be performed on single, or multiple, document(s) *and* the entire transaction.

Combination Example

You're offered an opportunity to become part owner of an existing burger restaurant that is operated through an LLC. Current LLC members provide you with an operating agreement that includes your expected investment amount (i.e., your capital contribution).

In this situation, due diligence will be performed on the operating agreement itself and the entire burger restaurant business. This means historical information and prospective information of the actual business will be researched and analyzed and the document(s) you will sign to become part owner will be reviewed to make sure the terms are fair to you.

When due diligence is complete, you will receive a report addressing issues and suggested solutions with your operating agreement (under Due Diligence I described above) and a report that discusses the results of the due diligence performed on burger restaurant business itself (under Due Diligence II described above).

Due Diligence II Deliverables

Once the research and analysis is complete for Due Diligence II, you will receive the results in a custom report. At a minimum, this report will include the following:

- Description of any issues found per area and
- Recommendations on solving the issue.

Example

Due Diligence II is performed on an existing business that you're considering for an investment. Research identifies an issue with the business's legal entity (e.g., corporation or LLC) and reveals it is delinquent on its annual report filing with the state of incorporation/formation.

Recommendations to solve this issue may include:

- inquiring on the delinquency and obtaining management's response,

- removing the investment from consideration, and/or
- analyzing the management and its competency to manage the business.

Similar to Due Diligence I, you may choose to also receive a summary of your due diligence report in Microsoft PowerPoint presentation format with your report.

After you receive your report and/or summary, a meeting will be scheduled with you to go over the results and how you would like to proceed with any recommendations provided to you.

Research Deliverables

The results of the due diligence can be provided in two ways:

☐ Due diligence report ☐ PowerPoint Presentation

Typical Outline for the Report:

I. Topic I
   a. Subtopic I
      i. Issue Identified
      ii. Recommendation to solve Issue

You may choose to receive a report and a summary. Regardless of your choice, you will have a chance to go over the information in its entirety via telephone, videoconference or in-person.

Questions

For questions about this Due Diligence Solutions Guide and McCauley, please contact the author of this guide or visit http://www.joinmccauley.com for more information.

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