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What Startups Can Do Now to Avoid Due Diligence Problems

By: Aaron B. Sokoloff | 619.906.5739 | aaron.sokoloff@procopio.com

The time between signing a term sheet and closing a financing can be an incredibly intense period for a startup. As part of the financing process, the company will typically have to provide copies of a wide range of company documents to the investor's lawyers for due diligence review. The more prepared the company is for this process, the more quickly the diligence review is likely to go, allowing the company to get to closing faster. Companies that are unprepared for diligence must often involve their lawyers more closely in the process; thus, being prepared for diligence can help a startup control its legal costs. Furthermore, if a company is prepared for diligence, this helps give the investor and its lawyers confidence that the company is organized and well-run. Conversely, when investor counsel asks for diligence materials and finds them to be incomplete or inadequate, they start to wonder what else the company is doing wrong, and may become more aggressive in their diligence review.

Here are three simple things that startups can do on a day-to-day basis in order to be prepared for the legal diligence process in their next financing. While these may seem mundane, paying attention to these items as you go can help keep legal diligence from delaying or derailing the financing.

- **Contracts.** Investor counsel will typically need to review the company's major contracts, such as intellectual property license agreements, office leases, and any major customer agreements. Very often, startups need to scramble to assemble these when the diligence request arrives. They may have copies of contracts that are signed by one party but not the other, or that are otherwise incomplete. Keeping complete, fully signed copies of any contracts that are important to the business in one place, ideally in PDF or similar format, will allow the company to respond to this category of diligence request quickly and efficiently.
- **Invention Assignment Agreements.** Investor counsel will typically want to confirm that all of the company's employees and contractors (or, at the very least, all employees and contractors that have contributed to the company's technology) have validly assigned their relevant inventions to the company. This is one of the key diligence items for investors in technology companies, because gaps in invention assignment agreements may mean that the company does not legally own the technology that drives the company's value. Chasing down invention assignment agreements can quickly become a nightmare, especially if the contributors are no longer employed with the company; these contributors may perceive that they have their former company in a "hold-up" situation and may demand concessions in order to sign over their inventions. For this reason, companies should be diligent about having employees and contractors sign invention assignment agreements when they start with the company, and keeping the signed agreements on file in an easily accessible place.
- **Option Records.** Investor counsel will sometimes want to review each of the company's option agreements to make sure the agreements match the capitalization records. The option agreements are important not only for diligence purposes in financings, but in determining equity ownership upon a sale of the company. The company should therefore keep signed copies of all of its option agreements on file.

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Aaron's practice focuses on corporate law, including startup/venture capital and mergers and acquisitions. Aaron has represented venture-backed companies in early- and late-stage equity financings as well as debt financings. He has experience representing both buyers and sellers in M&A transactions.