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GLOBAL START-UP SERVICE WORKSHOP

LEGAL DUE DILIGENCE FOR START-UPS AT INVESTOR MEETINGS

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GSS Workshop:
Legal Due Diligence for Start-Ups at Investor Meetings

AGENDA

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YOUR KEY EXPECTATIONS AND QUESTIONS

- Avoid common pitfalls and strategic/communication mistakes in due diligence
- How to prepare for investor negotiations?
- What due diligence milestones / timing are required?
- Step-by-step plan for investment and due diligence process.
- Best practice for presenting legal and financial documentation.
- How to due diligence the investor?
- How and when should an NDA be used?
- Better understanding of the parameters important for investors/founders. What are the key parameters when we discussing the term sheets?

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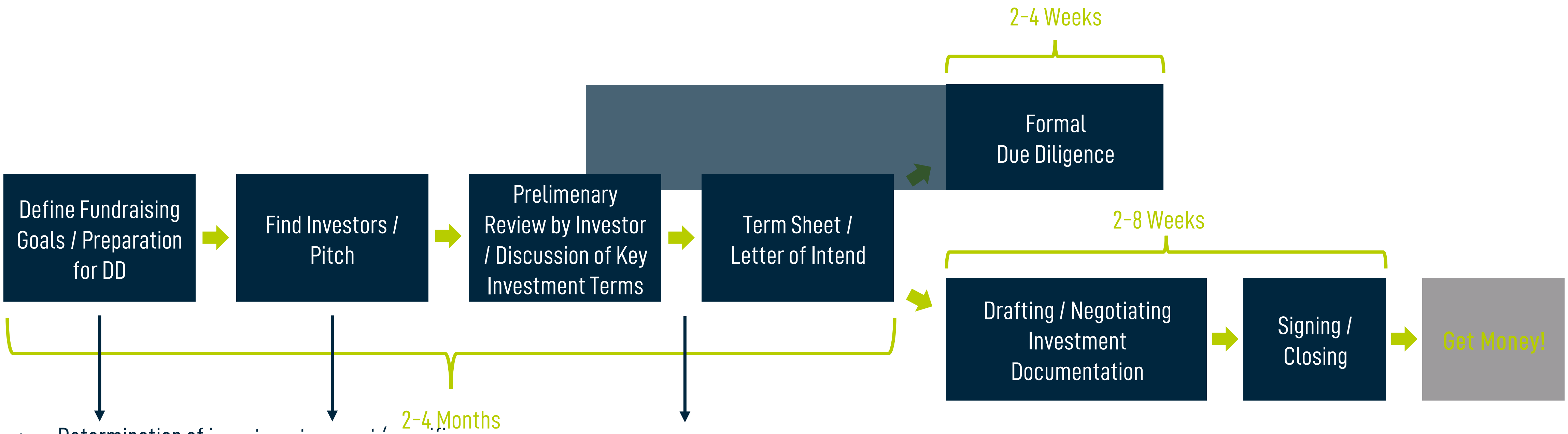
OVERVIEW FUNDRAISING PROCESS TYPICALLY FOR EARLY STAGE STARTUPS



- Determination of
  number, no range
- Milestone vs. cha
- Meet Investors' e
- DD check list

- Fundraising materials
- Simple, clear and consistent
- First impression rules!

- Determination of the final deal structure
- Blueprint of your future relationship

Around 6 Months

WHO ARE THE PLAYERS?

VC / FINANCIAL INVESTORS

BUSINESS ANGELS/ FAMILY & FRIENDS

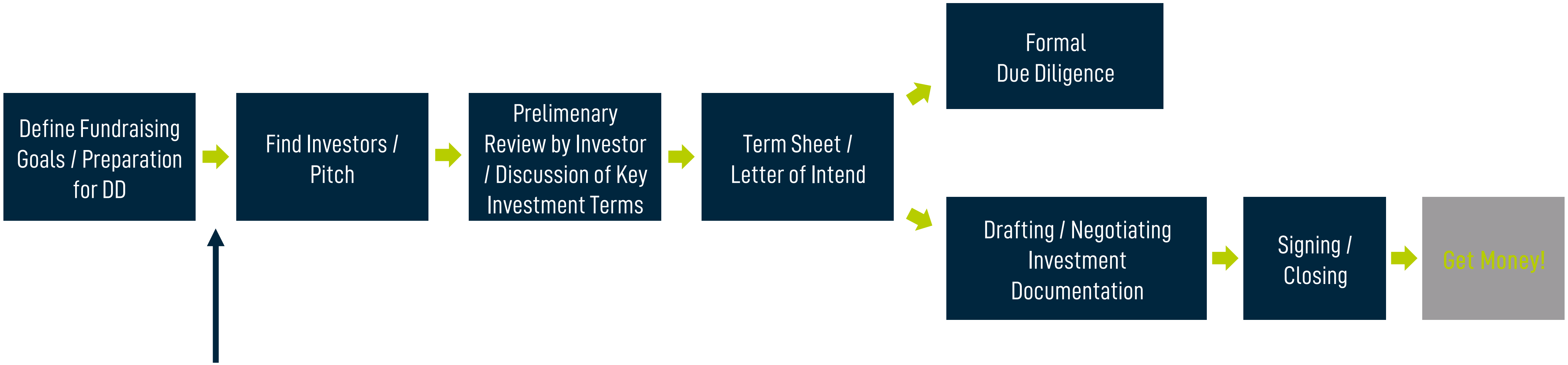
STRATEGIC / CORPORATE INVESTORS

FOUNDER / ENTREPRENEUR

- Center of the businesss
- Vision / Know How
- From „handy man“ to CEO
- Even financing tasks should not be outsourced

LAWYERS AND OTHER ADVISORS

WHEN STARTS DUE DILIGENCE ON INVESTOR?



Due Diligence on the (potential) investor starts when searching for the "right" investor.

HOW TO CONDUDCT DUE DILIGENCE ON INVESTORS?

- **Do desk research**
  - Many information can be found online
- **Have conversations with the investor.**
  - Communicate openly with the investor about your intention to conduct due diligence on them.
  - Ask for references
  - Ask for contact details of the companies/founder they are invested in
  - Evaluate the experience of the investor in your relevant industry. What can the investor offer to you besides money.
- **Speak to other entrepreneurs the investor has worked with.**
  - Credible investor should willingly disclose their past and present affiliations with other entrepreneurs

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3 OVERVIEW AND BACKGROUND

4 WHAT IS A DUE DILIGENCE?

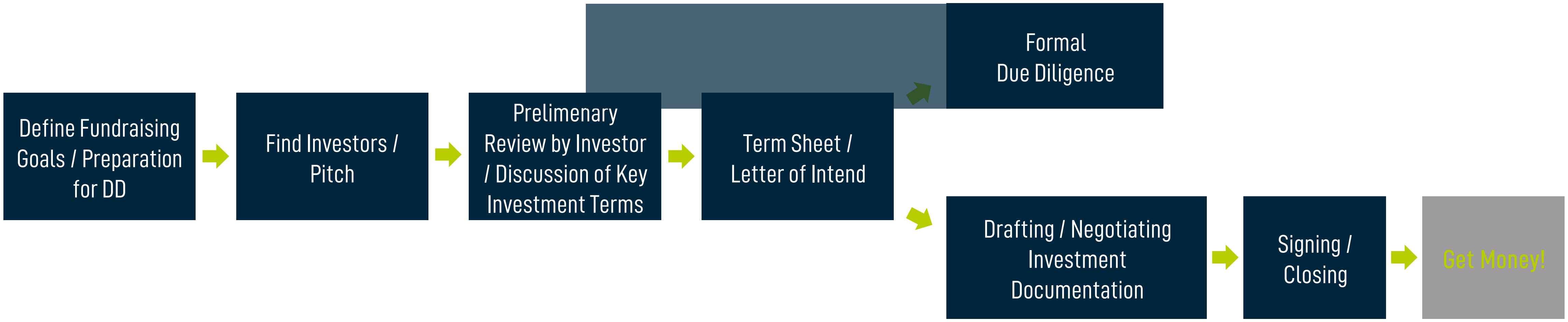
5 TO-DOS FOR DUE DILIGENCE PROCESS – FROM PITCH TO CLOSING

6 CONFIDENTIAL INFORMATION / NON-DISCLOSURE AGREEMENT

7 KEY ITEMS FOR NEGOTIATING INVESTMENT TERMS

8 Q&A

WHAT IS DUE DILIGENCE?



WHAT IS DUE DILIGENCE?

Due diligence involves a thorough assessment of a prospective investment to validate all pertinent information, identify the key risks of a possible investment, and evaluate them against the possible upside of the company.

The formal part of this typically includes reviewing financial records, contracts, and various legal documents.

But other parts like understanding various aspects of the business, including the team, technology, market potential, and competitive environment, are just as important.

WHY DUE DILIGENCE?

- Founders make certain claims about their businesses to attract potential investors.
- Investors undertake due diligence to authenticate these assertions and get a comprehensive understanding of the company.
- Due diligence lets investors spot any warning signs or potential issues that could impact their investment decision.
- Typical questions investors want to be answered for their assessment:
  - What are the potential problems or risks associated with this startup? Can these problems or risks be mitigated?
  - What does the competitive landscape look like and what are the potential rewards of this investment?
  - Is this the right moment to invest in this startup?
  - Has the startup maintained honesty and transparency regarding its operations?
  - Does the startup adhere to all legal and regulatory requirements?
  - Does the startup own the intellectual property (IP) linked to its products and services?

WHEN STARTS INVESTOR'S DUE DILIGENCE?

Informal Due Diligence

Define Fundraising Goals / Preparation for DD → Find Investors / Pitch → Preliminary Review by Investor / Discussion of Key Investment Terms → Term Sheet / Letter of Intend

→ Formal Due Diligence

→ Drafting / Negotiating Investment Documentation → Signing / Closing → Get Money!

DD starts <u>informally</u> the first moment an investor engages with a startup. During initial interaction, investors pose questions to establish a broad understanding of the company. Many investors conduct a lot of diligence <u>prior</u> to offering a term sheet.

AREAS OF DUE DILIGENCE

- **Informal Due Diligence**
  - Starts the first moment an investor engages with a startup.
  - Preliminary review: Investors do an early assessment to understand the fundamentals of the company and the market landscape, such as its business plans, competitive advantage of product or service, and prospective market.
  - Typical Key item: Assessing the management team's credentials and history to assess their knowledge and skills.
  - At this stage be careful to share sensitive information, in particular IP related information

- **Formal Due Diligence**
  - Starts typically after signing of term sheet / LoI.
  - At this point investor will send the startup a venture capital due diligence request list, outlining a series of information requests.
  - The formal part of this typically includes reviewing financial records, contracts, and various legal documents.

FORMAL DUE DILIGENCE PROCESS

- Step 1 : Signing of the Term Sheet / LoI
- Step 2: Planning
- Step 3: Information Request
- Step 4: Virtual Data Room (VDR)
- Step 5: Review of the VDR
- Step 6: Q&A Exchange
- Step 7: Risk Assessment and Synergy Evaluation
- Step 8: Due Diligence Report and Strategy Development

AREAS OF FORMAL DUE DILIGENCE

- **Financial Due Diligence**
  - Financial statements, accounting practices and cash flows.
  - <u>Goal:</u> Assessment of the financial health of the target company and potential financial risks.
- **Tax Due Diligence**
  - Valuation of tax aspects of the company, *i.e.*, corporate and income taxes, VAT, property taxes as well as the examination of current or completed tax audits.
  - <u>Goal:</u> Assessment if the company is following applicable tax laws or is subject to potential tax arrears.
- **Legal Due Diligence**
  - Legal structure and contracts, litigation, intellectual property rights, regulatory compliance, employment and other legal issues.
  - <u>Goal:</u> Assessment of legal risks and/or ongoing or potential litigation.

AREAS OF FORMAL DUE DILIGENCE

- IP Due Diligence
  - Who developed the software?
  - Was Open Source Software being used?
  - Protection of the Software (*e.g.*, NDAs)?
  - Ownership of trademarks and patents?
  - What is your approach towards the new EU AI-Act?

- Corporate Due Diligence
  - Title chain.
  - All shareholders' resolutions.
  - Capital increases in the past, as well as respective investment and shareholders' resolutions.
  - Existing (convertible) loan agreements.

AREAS OF FORMAL DUE DILIGENCE

- **Commercial Due Diligence**
  - Evaluation of the market position, competitive landscape, customer relationships, sales channels and growth.
  - Goal: Assessment of the economic position and potential of the company and potential risks that may arise.

- **Operational Due Diligence**
  - Analysis of operational processes, supply chain, production capacities and operational efficiency.
  - Goal: Assessment of the company's production processes to evaluate potential risks and elaborate the company's efficiency.

- **HR Due Diligence**
  - Review of the workforce including personal characteristics, employment contracts and social benefits.
  - Goal: Assessment of the work force and leading employees, as an early-stage investment in a start-up is always an investment in people as well.

AREAS OF FORMAL DUE DILIGENCE

Key Takeaways

- Due diligence can cover all aspects of a company and aims at providing a comprehensive picture of the company to the investor.
- In practice: For early-stage companies, not all areas are covered by a due diligence.
- Our experience: Financial, Tax and Legal due diligence as the core of a Venture Capital due diligence.
- Depends on the individual structure of the transaction.

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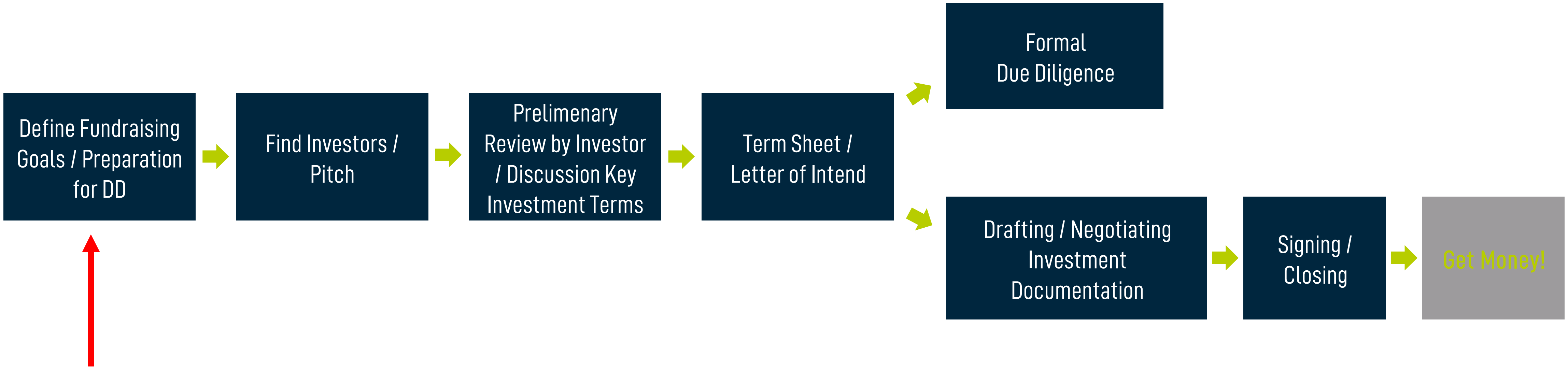
I. HOW TO PREPARE FOR DUE DILIGENCE?



I. HOW TO PREPARE FOR DUE DILIGENCE?

- Documentation
  - *"Keep your house in order":* Documents relevant for the due diligence should be saved digitally in a structured file system.
  - Recommendation: File system should mirror the most relevant areas of the formal due diligence and file names should give an idea of the content of the document.
  - Benefit: Documents requested for a due diligence can be provided quickly and in a structured way accelerating the due diligence process.

- VDR
  - Documents to be uploaded in a Virtual Data Room (VDR).
  - Recommendation: Use a special VDR provider (*i.e.*, iDeals, Datasite).
  - Benefits:
    - Due diligence team gets notified when new documents are added,
    - History of VDR is being recorded and
    - Platforms allow easy communication and exchange of documents.

I. HOW TO PREPARE FOR DUE DILIGENCE?

- **VDR Structure**
  - VDR is the base of the due diligence process for the due diligence team.
  - Recommendation: VDR-structure and documents included should reflect the request list.
  - Benefits:
    - Streamlining workflows,
    - Efficient process and
    - Professional first impression.

II. HOW TO GO THROUGH THE DUE DILIGENCE?

Define Fundraising Goals / Preparation for DD → Find Investors / Pitch → Prelimenary Review by Investor / Discussion Key Investment Terms → Term Sheet / Letter of Intend

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II. HOW TO GO THROUGH THE DUE DILIGENCE?

- Q&A
  - Questions of the due diligence based on the documents provided in the VDR.
  - Recommendation: Complete and extensive answers to the questions and provision of the requested documents.
  - Benefits: Ideally no follow-up Q&A required saving time and fees.

- Expertise
  - Recommendation: Engaging professionals with expertise in the relevant areas.
  - Benefits: Accurate assessment and identification of potential risks and opportunities.

- Timeliness
  - "*Try not to be the bottle neck*"

II. HOW TO GO THROUGH THE DUE DILIGENCE?

- **Thoroughness and Transparency**
  - Recommendation: Comprehensive and thorough approach with full disclosure of all problems or risks.
  - Benefits:
    - Minimizing risks of unforeseen problems in or after the transaction and
    - Building up trust on the investor's side in the company and the founders/management.

- **Responsiveness**
  - Recommendation: One member of the management board of the company to be appointed as point person for any communication.
  - Benefits:
    - Saving time and fees and
    - Professional impression.

III. HOW TO DEAL WITH DUE DILIGENCE RESULTS? – POST-DUE DILIGENCE TO-DOS

- **After having identified potential issues following a due diligence, there are in general three ways to deal with them:**

- **Actions to be completed post closing.**
- Applicable to the majority of findings.
- Issues that do not pose a red flag preventing the investor from investing.

- **Actions to be completed prior to signing.**
- Major findings that pose a red flag for the investor.
- Issues that can be fixed prior to the signing so the investor will invest after having cleared the issue.

- **No action possible**
- Major issues that pose a red flag for the investor.
- Issue is not fixable prior to signing; therefore, the recommendation to the investor is to not invest in the company.

IV. KEY TAKE AWAYS

- Organization and preparedness are key.
- Company's goal should be to disclose all potential risks and problems to the due diligence team by providing all relevant documents in a structured and comprehensive VDR.
  - Rather share too much than too little!
- Efficiency is crucial to avoid higher fees than necessary.
  - You don't want the funding of your company being delayed due too a slow due diligence process.
- Process highly depends on clear and efficient communication.
- And don't worry: Not all findings pose a reason for the investor not to invest, but most findings can be resolved prior to signing or post closing.

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Legal Aspects:

- Designed to protect company's intellectual property and proprietary information.
- Obliges the contracting parties to treat disclosed information confidentially. In particular, the disclosed information may not be used for competitive purposes even after the negotiations have failed.
- In addition, obligation to return or destroy the disclosed information if the investor's participation is no longer pursued.

- <u>However:</u> In practice, confidentiality breaches are very difficult to prove; it is even more difficult to prove the damage resulting from the confidentiality breach.

- Therefore, NDAs have usually more a deterrent effect.

- Contractual penalty can be implemented but will usually not be accepted by investors.

NON-DISCLOSURE AGREEMENT (NDA)

Practical Aspects:

- In general, angel investors and VCs are unwilling to sign NDAs at the pitch stage.
- So when pitching, it's important to find a balance between talking credibly about your expertise without giving away proprietary secrets.
- After you and your prospective investor are past the pitch deck and business plan stage, it's reasonable to ask them to sign an NDA.
- As part of due diligence, you'll share lots of information you don't want to go any further, including detail in employment and commercial contracts.
- NDA should be essential if you deal with strategic investors.

II. NON-DISCLOSURE AGREEMENT (NDA)

Confidentiality Agreement / NDA to be concluded prior to Formal DD at the latest

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KEY ITEMS

ECONOMICS

&

CONTROL

ECONOMICS

- *Valuation, valuation, valuation,....*
    - Company valuation (on a fully diluted or not-fully diluted basis) and price per share
    - Investment volume; pre- or post-money valuation
    - Cap Table, Dilutive effects, VSOP/ESOP Pool
- **Dilution Protection / Down Round Protection**
    - Full ratchet basis (most investor-friendly)
    - Narrow based weighted average basis
    - Broad based weighted average basis (most founder-friendly)
- **Liquidation / Proceeds Preference**
    - Investor gets his money back before anyone else participate in any proceeds
- **Founder Vesting and Lock-up**
    - Market standard: Four-year vesting with one year cliff
    - Bad, Grey and Good Leaver Provisions

Key Take Away:
Understanding of the Cap Table is key!

CONTROL

- **Protective provisions**
  - Veto Rights for investors and/or Founders regarding certain (material) actions
- **Advisory Board / Board of Directors**
  - Responsibilities
  - Composition and size
  - Veto Rights for investors and/or Founder
- **Drag-Along Right**
  - Drag-Along Majority => Who may trigger the Drag-Along right, who can veto the Drag-Along?

Key Take Away:

- Avoid individual veto rights, only certain majorities should have a veto.
- Try to anchor founder's veto rights at early stage

AGENDA

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Lawyer at a leading German transaction law firm, 2016 – 2018

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Legal 500 Germany 2024: Recommended lawyer
Handelsblatt & Best Lawyers 2023: "Ones to Watch" for venture capital law in Germany

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- LUTZ | ABEL is a full-service business law firm founded in Munich in **1994** with offices in Munich, Hamburg, Stuttgart and Berlin.
- The law firm currently employs around **100** lawyers. In total, the LUTZ | ABEL team consists of more than **190** people.
- LUTZ | ABEL is a member of the Geneva Group International (GGI), an international referral network of independent law firms with over **500** cooperation partners worldwide (no network according to Sec. 319b of the German Commercial Code (HGB)).
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