

LEGAL DUE DILIGENCE

A CONCISE GUIDE FOR
LAWYERS, INVESTORS, AND STARTUPS

This guide is meant for informational purposes only. It is always advisable to consult with a professional before carrying out a comprehensive legal due diligence process.

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Introduction to Legal Due Diligence

Purpose of the Guide

Startups stand at the threshold of potential growth and significant business opportunities. The purpose of this guide is to understand the complex process of legal due diligence, which serves as a critical component in various stages of a startup's business journey, including fundraising, mergers and acquisitions, or partnership formations. Legal due diligence is a meticulous investigation into your company's legal and business affairs that potential investors, acquirers, or partners will scrutinize to evaluate risks, uncover liabilities, and ensure compliance with applicable laws and regulations.

Scope of Legal Due Diligence

Legal due diligence encompasses a systematic review of a company's legal matters—ranging from corporate structure and governance, intellectual property, employment matters, to contracts and financial liabilities. This investigation aims to provide a comprehensive picture of the company's legal health, identify any red flags or areas of concern, and facilitate informed decision-making by stakeholders. For startup founders, understanding this process is vital to prepare your company for scrutiny and to expedite negotiations and transactions with confidence.

The Importance of Thorough Document Review

Central to the due diligence process is the review of a myriad of documents that reveal the legal standing of a startup. This guide will delineate the types of documents required, the significance of each, and the insights they offer into a company's operations. A thorough document review not only helps in asserting the company's value but also in identifying any potential legal issues that could impair future business transactions or growth.

In preparing this guide, I have distilled complex legal practices into actionable insights. My objective is to empower startup founders, investors, and fellow legal professionals with the knowledge to conduct an informed due diligence.

Preparing for Due Diligence

Assembling the Due Diligence Team

The first step in the due diligence process is to assemble a team with the requisite expertise to conduct an in-depth review of the company's legal and business documents. This team should include:

- **Legal Counsel:** Experienced attorneys who understand corporate law, intellectual property rights, contracts, and employment law are essential.
- **Financial Advisors:** Professionals who can analyze financial statements and assess the fiscal health of the startup.
- **Industry Experts:** Individuals with deep knowledge of the specific industry in which the startup operates can provide invaluable context.
- **Internal Management:** Key members of the startup's management team, including CEOs, CFOs, and CTOs, will provide insight into the company operations and strategy.

Assemble a team that is thorough, detail-oriented, and understands the nuances of both the startup ecosystem and the industry-specific legal framework.

Understanding the Company's Background

Conducting a background check on the company is a crucial component of due diligence. This includes reviewing the history of the company, its market position, competitive landscape, and any past legal issues. Founders should be prepared to provide a clear and comprehensive history of their company to potential stakeholders.

Gathering Initial Information

Gathering all relevant information before the due diligence process begins can save time and resources. This includes:

- **Corporate Documents:** Gather and organize all corporate documentation, such as incorporation papers, shareholder agreements, and organizational charts.
- **Intellectual Property (IP):** Compile a list of all IP assets, including patents, trademarks, and copyrights.
- **Contracts:** Assemble all current and past contracts, including vendor agreements, employment contracts, and customer agreements.
- **Financial Records:** Ensure that all financial records are in order, including audited financial statements and tax filings.
- **Litigation History:** Compile details of any past or ongoing litigation or legal disputes.

Founders can facilitate a smoother and more efficient due diligence process by preparing this information in advance. It is crucial to provide accurate and complete information to avoid any potential issues that could hinder future business engagements.

Corporate Matters & Capitalization

Reviewing Corporate Documents

Incorporation and Amendments

- **Certificate of Incorporation:** Ensure availability and verify the accuracy of the original certificate and any amendments.
- **Governing Documents:** Scrutinize the latest versions of the Memorandum of Association and Articles of Association for any irregularities or outdated provisions.

Filings and Compliance

- **RoC Filings:** Review all filings made to the Registrar of Companies since inception, including payment challans, to ensure full compliance with statutory requirements.

Assessing Company Offices and Auditors

Office Registrations

- **Registered Office:** Confirm the location is consistent with Form INC-22 filings and that any changes have been duly reported.
- **Branch Offices:** Verify the existence and proper registration of all branch offices, both domestic and international.

Auditor Information

- **Statutory Auditors:** Check the validity of the appointment and qualifications of the statutory auditors as per Form ADT-1.
- **Internal Auditors:** Assess the engagement and scope of work of internal auditors to ensure adequate internal controls.

Examining Management Structure

Organizational Hierarchy

- **Management Details:** Compile a comprehensive list of current managers, including job titles and areas of responsibility.
- **Organizational Chart:** Present an up-to-date organizational structure, reflecting the chain of command and reporting lines.

Directorship Analysis

- **Director Details:** Review Form DIR-12 for accuracy regarding director appointments, retirements, and other changes.
- **Business Interests:** Investigate directors' other business interests for potential conflicts of interest, as disclosed in Form MBP-1 and DIR-8.

Analyzing Shareholding and Control

Shareholder Details

- **List of Shareholders:** Create an updated list of shareholders, detailing share classes, percentages, and any significant changes.
- **Control Structures:** Examine any arrangements, such as voting trusts or buy-sell agreements, that could affect control or influence over the company.

Equity Analysis

- **Capital Changes:** Review Form PAS-3 and SH-7 for any modifications in share capital or securities issued for non-cash consideration.
- **Preferential Allotments:** Scrutinize Form MGT-14 filings related to any preferential share allotments to ensure regulatory compliance and proper disclosure.

Inspecting Corporate Governance

Governance Records

- **Minutes and Records:** Evaluate the minutes of board and committee meetings for consistency and proper authorization of corporate actions.
- **Statutory Registers:** Confirm that all statutory registers are maintained accurately, reflecting the company's compliance with the 2013 Act.

Regulatory Filings

- **RBI Filings:** Inspect all documentation filed with the Reserve Bank of India for any foreign transactions or compliance under FEMA regulations.

Miscellaneous Corporate Documents

Corporate Identity

- **Company Letterhead:** Obtain the latest version of the company's letterhead, ensuring it meets legal requirements for official correspondence.
- **Name Board Image:** Verify that the name board displayed at the company's registered office complies with legal standards.

Financial Documentation

- **Financial Statements:** Gather the most recent audited or unaudited financial statements to evaluate the company's financial health.
- **Share Certificates:** Collect copies of all issued share certificates along with associated stamp duty challans for verification of share issuance.

Operations

In legal due diligence, examining the operational aspects of a startup is fundamental. This includes evaluating customer and client relations, service agreements, and an assortment of operational contracts that govern the day-to-day business transactions. It is imperative to scrutinize these elements to assess potential risks, obligations, and the sustainability of the business model.

Customers / Clients

Service Agreements of the Company

- **Review of Agreements:** Analyze all service agreements to identify terms that could impose significant obligations or liabilities on the company.
- **Termination Clauses:** Assess the conditions under which these agreements can be terminated and the consequences thereof.

Structure Note Depicting the Operations of the Company

- **Operational Overview:** Prepare a detailed description of the company's operational structure, illustrating the flow of services or products to the clients.

Description of Any Oral Agreements

- **Informal Agreements:** Document all verbal agreements that the company relies on with customers or clients, including pricing policies and established practices.

Standard Sales and Service Terms

- **Contractual Terms:** Evaluate the standard terms and conditions of the company's sales and service contracts to identify any unusual or onerous provisions.

Discount Policy, Settlement Terms, and Accounting Treatments

- **Financial Policies:** Examine the company's policies on discounts and settlements to understand their impact on revenue recognition and financial reporting.

Current Price Lists and Significant Sales and Service Policies

- **Pricing Strategies:** Review current price lists and significant sales and service policies, including those related to discounts, services, and returns to ensure they align with industry standards and the company's financial health.

Recent Customer / Client Survey Data

- **Market Perception:** Assess any customer or client survey data to gauge satisfaction, service quality, and areas for improvement.

Agreements or Contracts Material to the Business

- **Key Contracts:** Identify and review all key contracts and agreements that are material to the business's operations, including exclusivity agreements or long-term service contracts.

Product and Sector Analysis

- **Revenue Streams:** Catalog the products and delineate the sectors in which they are used, noting the percentage of revenue generated from each to understand market dependence and diversification.

Third Party Consultants and Partners

- **External Collaborations:** List all partnerships with third-party consultants or other partners that are integral to the company's operations.

Other Contracts

Material Consultancy Agreements

- **Consultancy Engagements:** Review all material consultancy agreements to determine their scope, deliverables, and any obligations that may affect the company's operational capabilities.

Computer Service and Maintenance Agreements

- **IT Infrastructure:** Examine agreements related to computer services and maintenance to ensure they provide adequate support and terms favorable to the company.

Intragroup Agreements

- **Group Company Transactions:** Scrutinize any agreements entered into with group companies, looking for arm's length terms and compliance with transfer pricing regulations.

Licensing and Royalties

- **Intellectual Property Agreements:** Review license or royalty agreements to verify that intellectual property rights are adequately protected and compensated.

Joint Ventures and Partnerships

- **Collaborative Ventures:** Assess the terms and conditions of any joint venture or partnership agreements to understand both the benefits and the obligations they impart on the company.

Continuing Contracts

Significant Ongoing Commitments

- **Long-Term Agreements:** Identify any continuing contracts with annual expenditures exceeding INR 500,000 or those of particular importance to the company's operations.

Restrictive or Non-Market Terms

- **Unfavourable Clauses:** Investigate any agreements containing non-competitive, exclusivity, or other restrictive terms that may limit the company's operational flexibility or market activities.

Property

The evaluation of a startup's property assets is a critical component of the legal due diligence process. This section involves a rigorous assessment of the company's real property and other tangible assets that are central to its business operations. It is necessary to ascertain the legal ownership, status of the property, and any encumbrances that may affect the company's interest in such assets.

Property Operations

List of Property

- **Ownership and Leases:** Compile a comprehensive list of all the properties owned or leased by the company, including details such as size, location, use, and any associated land use permissions or approvals.

Title Documents

- **Documentation Review:** Gather and assess all title documents for the company's real property to confirm proper ownership or valid leasehold interests.

Use Agreements

- **Premises Utilization:** Examine copies of all agreements executed by the company for the use of its premises to ensure compliance with the agreed terms and to identify any potential liabilities.

Assets

Major Assets Description

- **Asset Inventory:** Provide a description of major assets owned or leased by the company, detailing their condition, use, and importance to the company's operations.

Asset-Related Agreements

- **Maintenance and Leases:** Review agreements relating to the maintenance or lease of major assets, ensuring that they are favorable to the company and do not impose undue restrictions or liabilities.

Acquisition Arrangements

- **Assets Acquisition:** Assess any agreements or arrangements made by the company to acquire assets, ensuring that such acquisitions have been properly documented and do not pose any legal risks.

Management, Employees, and Consultants

The evaluation of the company's human resources is an integral part of the legal due diligence process. This section scrutinizes the management structure, employment agreements, consultant contracts, and any related legal obligations or liabilities. It also includes reviewing employment practices, policies, and any potential or ongoing disputes involving staff.

Management and Board Details

List of Directors/Management Board

- **Directorship Information:** Compile information on the directors and management board members, including nationality, address, date of appointment, remuneration, and other business interests. Assess if any officer is not fully devoted to the company's business.

Employment Agreements and Policies

Employment Contracts

- **Standard Agreements:** Collect and review the company's standard offer/appointment letters and employment contracts, especially those pertaining to key employees. Ensure these documents are compliant with current labor laws and meet industry standards.

Company Policies

- **Handbooks and Policies:** Examine the employee handbook or similar documents that outline the company's policies and practices, including conditions of employment, disciplinary procedures, and codes of conduct.

Employee Compensation and Benefits

Compensation Structure

- **Employee Compensation Details:** Compile a list of all employees with details including their date of hire, annual compensation, incentive compensation potential, and identify key employees.

Agreements with Management and Staff

- **Management and Consultant Agreements:** Review any agreements, understandings, or proposed transactions between the company and its officers, directors, employees, and consultants, including employment agreements, severance agreements, loans, or guarantees.

Conflicts of Interest

- **Material Interests:** Document any other agreements or transactions where an officer, director, employee, or consultant has a direct or indirect material interest.

Employee Benefits and Claims

Benefit Plans

- **Benefit Arrangements:** Review all employee benefit plans and arrangements, such as bonus plans, pension plans, and stock option plans, along with all ancillary documents.

Disputes and Claims

- **Claims Against the Company:** Detail any claims against the company by management or claims against members of the management or supervisory board relating to the exercise of their duties.

Stock Ownership Plans

ESOPs and Phantom Stocks

- **Equity Incentive Plans:** Assess the ESOP Policy/Phantom Stock Agreement or any other oral agreement/arrangement/ commitment made to employees regarding stock-based compensation.

Litigation, Claims, and Disputes

A meticulous investigation of any legal entanglements is a crucial aspect of due diligence. This section aims to uncover any ongoing, pending, or potential litigation, claims, or disputes that could have a significant impact on the company's financials, reputation, and operational capabilities.

Litigation and Legal Proceedings

Ongoing and Threatened Litigation

- **Documentation Review:** Gather all documents, notices, and correspondence related to current or threatened legal actions, suits, or investigations involving the company or its executive officers and directors. Evaluate the nature, status, and potential impact of these proceedings on the company.

Legal Orders and Judgments

- **Orders and Settlements:** Review any notices, orders, injunctions, judgments, decrees, and settlement agreements. Analyze the terms of settlements and their implications for the company's present and future operations.

Assessment of Litigation Risks

- **Risk Analysis:** Conduct a risk assessment to evaluate the potential for disputes to lead to litigation. This includes analyzing any dispute patterns, the company's litigation history, and the effectiveness of its dispute resolution mechanisms.

Loans and Borrowings

The financial obligations of a company, particularly those related to loans and borrowings, must be thoroughly examined during the due diligence process. This section focuses on understanding the extent of the company's debts, the terms of its borrowing agreements, and the implications of its financial arrangements.

Documentation of Borrowings

Loan and Credit Agreements

- **Documentation Compilation:** Assemble all documents and agreements evidencing borrowings, whether secured or unsecured, including loan and credit agreements, promissory notes, lines of credit, financial leasing, and other financing arrangements of the company.
- **Terms and Conditions:** Evaluate the terms of these agreements, including interest rates, repayment schedules, affirmative and negative covenants, and any conditions precedent to borrowing.

Loan Agreements Specifics

- **Detailed Review:** Examine each loan agreement entered into by the company to understand the obligations and rights it confers, as well as any guarantees of third-party obligations related to the company.

Analysis of Security Interests

Guarantees and Third-Party Obligations

- **Guarantee Assessment:** Review any guarantees made by the company of third-party obligations to assess the extent of potential liabilities and the circumstances under which the company may be called upon to fulfill these guarantees.

Encumbrances on Property

- **Security Interests:** Identify and assess the details of any encumbrances, charges, liens, and pledges created on the company's assets, including mortgages, deeds of trust, and security agreements.

Financial Health Indicators

- **Debt Profile:** Provide an overview of the company's debt profile, including the ratio of secured versus unsecured borrowings and the implications for the company's financial stability and creditworthiness.
- **Compliance with Loan Agreements:** Verify the company's compliance with the terms of its loan agreements and assess any potential breaches or defaults.

- **Impact on Operations:** Consider the impact of the company's debt on its operational flexibility and ability to raise additional capital or pursue strategic initiatives.

Insurance

The presence and adequacy of insurance coverage are vital checkpoints in legal due diligence. This section evaluates the company's risk management strategies and ensures that it maintains appropriate insurance policies to protect its assets, operations, and personnel against potential liabilities and losses.

Overview of Insurance Policies

List of Insurance Policies

- **Compilation of Policies:** Create a list of all insurance policies currently held by the company, including property, liability, key person insurance, and any other relevant policies.
- **Coverage Limits:** Examine the coverage limits of each policy to ensure they are commensurate with the risks faced by the company and its operations.

Insurance for Directors, Officers, and Employees

- **D&O and Employee Policies:** Review policies catering to the directors, officers, and employees, such as directors' and officers' (D&O) liability insurance, errors and omissions (E&O) policies, and personal accident and health insurance plans.

Claims and Disputes

Pending Claims

- **Claims Review:** Assess any pending claims against the company's insurance policies, including the nature of the claims, potential liability, and the status of the claim process.

Claims History

- **Historical Analysis:** Analyze the history of claims made under the company's insurance policies to identify patterns that may indicate operational risks or areas of concern.

Policy Management and Compliance

- **Renewals and Premiums:** Confirm that all insurance policies are current, with premiums paid and renewals managed in a timely manner.
- **Compliance with Policy Terms:** Verify that the company's operations are in compliance with the terms and conditions of its insurance policies to avoid any risk of coverage denial.

Intellectual Property

The safeguarding of intellectual property (IP) rights is a cornerstone for many startups, as these assets can constitute a significant portion of the company's value. The due diligence process must rigorously assess the status, validity, and security of the company's IP portfolio. This scrutiny involves understanding the company's IP strategy, identifying all IP assets, and ensuring that these assets are adequately protected and leveraged.

Inventory of Intellectual Property Assets

List of Intellectual Property

- **IP Asset Compilation:** Compile a comprehensive list of all patents, trademarks, service marks, trade names, copyrights, domain names, trade secrets, and any other IP rights used by the company, whether registered or unregistered.
- **Registration Status:** Verify the current status of all IP registrations and applications, including any necessary renewals or extensions that are pending or required in the near future.
- **International Rights:** For IP rights that have international implications, ensure that international registrations, where applicable, are filed and maintained in key markets.

Agreements and Assignments

Proprietary Information and Invention Agreements

- **Employee and Consultant Agreements:** Review agreements with past and present employees and consultants to confirm that proprietary information and inventions created by them are properly assigned to the company.
- **Licensing Agreements:** Examine all licensing agreements, assignments, and any other agreements related to the procurement or usage of IP rights to ensure they provide the necessary protections and benefits to the company.

Unbound Employees or Consultants

- **Non-Disclosure and Non-Compete Clauses:** Identify any employees or consultants who have not signed agreements protecting proprietary information or restricting competition, and address any periods when services were rendered without such agreements in place.

IP Litigation and Disputes

Intellectual Property Claims

- **Pending or Threatened Litigation:** Document any claims, proceedings, or potential disputes that challenge the company's IP rights or allege the company's infringement on third-party IP rights.

- **Infringement Issues:** Assess any instances of alleged IP rights violations or infringements by the company and evaluate the potential impact of such claims on the company's operations and reputation.
- **Defensive and Offensive IP Strategies:** Understand the company's strategy for defending its IP rights and pursuing action against infringers, including any ongoing or contemplated litigation.

IP Strategy and Management

IP Portfolio Strategy

- **Strategic Overview:** Gain insight into the company's overall strategy for its IP, including how it fits into the company's broader business goals and competitive landscape.
- **Innovation Pipeline:** Evaluate the company's pipeline for new IP creation, including research and development efforts, and how these are managed and protected.
- **IP Valuation:** Where possible, assess the valuation of the company's IP portfolio, including any valuations performed for investment or accounting purposes.

A thorough IP audit will not only reveal the robustness of the company's protective measures for its intangible assets but also provide an assessment of the IP's contribution to the company's market position and future growth potential. Such evaluations are key to ensuring the company's IP assets are a true reflection of its value and are not encumbered by any legal issues that could jeopardize future operations or transactions.

Financials

A thorough analysis of the startup's financial health is a cornerstone of legal due diligence. This section investigates the financial statements, tax compliance, and internal financial controls. The aim is to gain an accurate picture of the company's financial stability, performance trends, and any potential risks that could affect its valuation or ongoing operations.

Financial Statements and Reports

Audited Financial Statements

- **Historical Financials:** Review the audited financial statements for the last three to five years, including balance sheets, income statements, cash flow statements, and statements of shareholders' equity.
- **Auditor Reports:** Assess the independent auditor's reports for any qualifications, emphasis of matter, or other remarks that may indicate financial or accounting issues.

Interim Financial Statements

- **Recent Performance:** If audited statements are not available for the current year, review interim financial statements or management accounts to understand the company's recent financial performance.

Accounting Policies and Procedures

- **Accounting Standards:** Evaluate the accounting policies adopted by the company and ensure they are in accordance with the applicable financial reporting framework (e.g., IFRS, GAAP).
- **Internal Controls:** Examine the company's internal financial controls for recording and reporting financial transactions, and assess their effectiveness.

Taxation

Tax Returns and Assessments

- **Tax Compliance:** Review all tax returns filed by the company, including income tax, sales tax/VAT, service tax, and other applicable taxes. Confirm that all tax assessments are up to date and that there are no outstanding issues with tax authorities.
- **Tax Contingencies:** Identify any current or potential tax liabilities, including any disputes or areas of non-compliance that could lead to tax penalties or additional charges.

Tax Planning Strategies

- **Tax Efficiency:** Understand the tax planning strategies employed by the company and evaluate their effectiveness and compliance with tax laws.

Debt and Equity

Debt Schedules

- **Debt Obligations:** Compile a schedule of all the company's debt obligations, detailing creditor names, interest rates, maturity dates, collateral, guarantees, and covenants.

Equity Financing

- **Capital Raises:** Document the history of the company's equity financing, including venture capital, private equity, and angel investments. Review the terms of each financing round and the post-money valuations.

Internal Financial Analysis

Budgets and Forecasts

- **Financial Planning:** Review the company's historical budgets and financial forecasts to assess the accuracy of past projections and the reasonableness of future expectations.

Financial Analysis Ratios

- **Performance Indicators:** Analyze key financial ratios and performance indicators to assess the company's financial health, including liquidity, profitability, and solvency ratios.

Capital Expenditure Plans

- **Future Investments:** Evaluate the company's plans for capital expenditures and investments, and how these are expected to be financed.

This section outlines the essential financial documents and analyses that provide insight into the startup's financial integrity and stability. A thorough financial review not only helps to identify potential risks but also aids in validating the company's reported financial position, ensuring that stakeholders can make informed decisions based on reliable and transparent financial information.

Concluding Due Diligence

Upon completion of the legal due diligence process, it is imperative to compile the findings into a comprehensive report that succinctly synthesizes the information gathered, highlights any areas of concern, and provides a balanced view of the company's legal and financial health.

Finalizing the Due Diligence Report

Summary of Findings

- **Consolidated Overview:** Construct a summary of key findings from the due diligence process, providing an executive overview that highlights any significant risks, liabilities, or concerns identified.

Identification of Red Flags

- **Critical Issues:** Clearly identify and explain any red flags that may affect the company's value, operations, or future prospects. These may include gaps in IP protection, ongoing litigation, regulatory non-compliance, or financial instability.

Risk Mitigation Recommendations

- **Actionable Steps:** Offer recommendations for mitigating identified risks, including legal strategies, compliance measures, or financial plans to address the issues raised during the due diligence process.

Due Diligence Follow-Up

Addressing Gaps in Documentation or Compliance

- **Corrective Measures:** Propose a plan of action for the company to remedy any gaps in documentation or areas of non-compliance with legal or regulatory requirements.

Negotiation Points for Transactions

- **Leverage in Deal-Making:** Use the due diligence findings to inform negotiation strategies for potential investments, mergers, acquisitions, or other strategic transactions.

Ongoing Monitoring and Review

- **Continual Assessment:** Recommend protocols for the company to implement ongoing monitoring and periodic review of compliance and risk management practices.

Epilogue

In the often-unpredictable ecosystem of startups, due diligence stands as a critical pillar for informed decision-making. This guide is crafted as an initial framework to provide stakeholders with the necessary tools to peel back the layers of a business, revealing its core potential and latent risks.

While comprehensive, this guide is merely a starting point. The true depth and value of due diligence will unfold through its application—meticulous review, critical questioning, and strategic analysis in practice. As investors, founders, or legal professionals in the startup ecosystem, you must build upon this foundation, adapting and expanding your approach to suit the unique challenges and opportunities of each venture.

Remember, in the world of innovation and entrepreneurship, due diligence is not just a process—it's a discipline that can make the difference between success and failure.