The due diligence process – guiding principles for early stage innovative products

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Abstract

Mergers and acquisitions of small, innovative firms require special treatment of the due diligence process. The asymmetry in organisational order of magnitude would otherwise force the smaller, 'target' venture to become a puppet in the hands of the larger, often multinational company.

The aim of this paper is to provide a guideline for smaller, new technology-based firms to face the power disequilibrium. After a brief introduction on the nature of the due diligence process, the paper will discuss dangers of due diligence as perceived by both the disclosing and the receiving party. Special attention will be paid to the concepts of the White Room, the White Book and the need for gradually increasing disclosure of one party and growing commitment – both financially and contractually – of the other. For each phase of the due diligence process, content of the disclosure is discussed, as well as legal, financial and procedural aspects.

Keywords: Due diligence; Innovation; Early stage; New Technology-Based Firm

1 Introduction

The due diligence process in case of valorisation of very early stage innovative products, is at the same time a necessary evil and a hugely risky event. This intrinsic contradiction clearly points out that the due diligence needs for a strict procedural approach where no mistakes can be made. The role of due diligence in the Merger & Acquisition story is "assumed to be objective and neutral in approach" (Angwin, 2003, p.33). Next to the M&A aspect, Due Diligence precedes (merely financial) investment decisions of Venture Capitalists (Zacharakis and Meyer, 1998). This document tries to guide this process without claiming absoluteness.

2 What is a Due Diligence Procedure ?

The Due Diligence process is generally known as a process where some party has to look into every detail of the operation, structure, ownership, assets etc. of another party. The depth of this analysis depends strongly on the goal the due diligence is run for. The due diligence can be performed by a team of people as all the aspects of business might be invoked: science, technology, product development, engineering, production, marketing, sales, human resource management, legal context, liabilities etc (Angwin, 2001; Harvey and Lusch, 1995). All of these skills can hardly be found in one person.

During the process – often lasting several months (Zacharakis and Meyer, 1998) – the IP-owning party has to disclose in a growing manner more and more confident information. Consequently the exposure risk grows also. The commitment of the 'accepting' party should consequently grow also. However, since such processes often go between parties of unequal size or power, the latter -the growing commitment of the receiving party- often lacks or fails to be realistic.

3 What is the goal of a due diligence process?

As a rather basic statement one can position a due diligence as indispensable when an information disclosing party wants to convince an information receiving party to do something like making an investment, becoming a partner, taking a license on a patent, buying a product etc. So the due

diligence process should/can be a decisive part of a process that may determine the future of a company, a person or an idea. It purposes to give the acquirer confidence that they understand the value and risks associated with the targeted company (Angwin, 2001, p.35; Trott, 1998). Due diligences are most common in judicial cases, prior to mergers and acquisitions, as a part of accreditation procedures (ISO 9000, ISO 14000 etc.), in the process of obtaining an insurance policy, a bank loan etc. We will limit ourselves to the case of trying to get innovative ideas sold to interested parties. This interaction may end up in a sale of (a part of) the (property owning) company shares, a partner agreement, a customer agreement, a license agreement, getting a loan or whatever collaboration form thinkable.

4 General considerations

In this section we are going to deal with some generalities concerning the procedure and the set up of a due diligence. These preparative actions are vital for having an efficient process and to minimize loss of time and money (Angwin, 2001), but still achieving the ultimate goal the due diligence was started for. We will consider in this general part the rough procedure, the White Room principle and the White Book principle. We will highlight also the risks intrinsically related to a due diligence procedure as seen by both sides.

4.1 The procedural approach

Due to the risks inherent in a due diligence process, it should be guided by strict procedures and a lot of oral and written information. A structured way of dealing with this process not only guarantees to the utmost maximum that all the phases are being respected with a fair balance between exposure from one side and commitment from the other, it is also for the interest of both parties because everyone knows exactly on every moment what the previous phase did bring, what exactly the next phase shall or should bring and when he or she has to come back with what kind of information. In short, the process is being made more objective, more reliable and more traceable in the interest of all -good willing- parties. No need to say that charlatanism can be detected in an early stage when following these strict procedures.

4.2 The White Room concept

It is strongly recommended to run the due diligence procedure on a neutral location, e.g. a hotel room or a meeting room in a business centre. The receiving party can come to the room with only a limited number of people. They read the documents present and generally -unless explicitly agreed on- no copies or photos may be taken. Nobody leaves the room with pieces of the dossier. In this room at least two people representing the disclosing party are present, a dossier called the White Book (see later) and a separate (blanc) booklet with fixed and numbered pages to note all the questions from the investigating team. Every question will get a unique number enabling effective discussions and answers later on. When coffee- and lunch-breaks are inserted, the room is closed and locked. This concept is generally referred to as a White Room concept.

4.3 The White Book

The White Book is the dossier that constitutes the contents of the due diligence. Nowadays, White Books can be partly made of ICT-based presentations. In that case a computer should be present with only that information on it. The White Book should have a clear content review and should be dealing with all the information required at that particular stage of the process (see later on). The White Book is a fixed entity of uniquely numbered pages. All pages are fixed and can not be made loose without apparent traces. The type of information can be synthesized into some rubrics:

- technology
- market
- material agreements
- operations
- finance
- accounting
- corporate records
- stock records
- employee affairs
- governmental issues
- liability issues

Each of these rubrics will come back more or less in every phase of the due diligence procedure.

5 What are the risks of a due diligence process ?

One general risk for all parties involved remains with cultural differences in the perception of due diligence in general and its added value, its content and its interpretation. Heterogeneity in national cultures and legislations suggests different interpretation of what is considered crucial information for the due diligence process. In addition, the perceived added value of pre-acquisition due diligence differs strongly among countries (Angwin, 2001).

5.1 The risks as seen by the disclosing party

The disclosing party is without any doubt the most vulnerable party in the due diligence procedure, as it will be exposing confidential information to a third party. Therefore it is strongly recommended that this party takes the lead in the whole process and tries to impose it's due diligence process to the buying company. When properly organized and when rigorously following a strict and transparent procedure, there is no reason why a due diligence can not be run by the disclosing party.

Leaks to competitors The risks for the disclosing party are obvious. They are disclosing information beyond the academic or patent context of the invention. This discloser may, once in the hands of the wrong people lead to unethical competition and jeopardize the future of the company.

Loss of time and money A next risk is a tremendous loss of time as this type of due diligence -if run properly- asks for lots of manpower and means to organize it. A negative due diligence process (so one with a negative outcome) is simply loss of time and money.

Loss of business and loss of focus A next risk is the loss of business or loss of focus on the business. As often small companies are subject to due diligence processes, the team of the company should take care of organizing and preparing the due diligence itself. External consultants might help at his level but only at the organization level, not with the contents, mostly

constituting the largest part of the work. This means that such a process has to be carefully planned and will withdraw resources from the daily operation. This may cause business losses and/or loss of focus. This nearly inevitable damage has to be limited to a minimum.

The receiving party wants to steal information The disclosing party should always keep in mind that the intentions of the receiving party might be to get the information and no more than that.

5.2 The risks as seen by the receiving party

Loosing the deal and the opportunity The main risk of the receiving party is to loose the deal it is interested in. Mostly when a due diligence process is being entered by a company, there is a net interest in the offered opportunity. Lots of companies build their expansion strategy and business development on the acquisition of external IP. Loosing the deal means a lost opportunity and may cause a significant draw back compared to competitors.

Loss of time and money Loosing the deal means a lot of time and money lost as much resources have been put into the process of due diligence. Often these type of due diligences are conducted by external law firms or consultants (such as the big four), all of them being very expensive and never working on a no-cure-no-pay principle.

The disclosing party is not disclosing everything A risk to the receiving party is that the disclosing party doe not disclose everything or only a part of the truth. In real life not every company has the same level of ethics and morality, so a risk might exist in the fact that the disclosing company wants to get rid of something, probably a type of liability. A lot of cross-checks have to be foreseen in the procedure.

5.3 Risks should be discussed, not kept secret

One of the big mistakes in general business discussions is the lack -deliberately or not- on openness on risks. Risks should be discussed frankly and in confidence. Good relationships depend largely on the ability to judge risks in the relations. More specifically in the case of

innovation valorisation processes, all the risks - seen from both sides- should be clearly analyzed and eventually remedies should be -at least- thought of if not, presented to the other party. Everybody knows and agrees on risks being present, it renders people confident when these risks are being searched for, identified, analyzed and potentially solved.

6 The four phases of a due diligence process

The due diligence in case of an innovative project is best cut in four phases. These phases are clearly distinguished by a certain degree of confidentiality, a certain degree of commitment and some deliverables. The degree of commitment of the external party will be transformed in a specific financial commitment. Each of the phases will be discussed in the next paragraphs. In each of these paragraphs a rather structured procedure will be given, relying on the same subjects such as:

- timing such as run trough time and deadline
- degree of disclosure
- type of information to be communicated
- communication reference points
- commitment of both parties including financial and contractual binding

6.1 Phase I: the non-confidential part

The first part of the due diligence considers a non-confidential part. A small brochure, containing the most representative non-confidential information on the business and/or the invention has to be made. This document should be used as a teaser toward the other party to get them convinced to go for the deal. Making this teaser is a hell of a job, and is mostly work for communication experts. This document can and should make the difference for building a future relation with the target contact. Besides this information, only the already publicly available information can be given extra. On the basis of this documentation, the third party should be sufficiently interested in going further in the deal.

Information type	Brochure
Timing deadline	1 month
Commitment	No payment
Information type	Publicly available information
Commitment – legal	No contractual binding

Table 1: First step non-confidential

The typical information communicated during this first phase can be summarized in the next table

Market	General business description
	Non-confidential summary of the business plan
	Brochures and leaflets on the companies products and services
	All press releases
Employee	Number of employees
Technology	Non-confidential description of the technology
	Scientific publications
Finance	Financial reports (if published)
Liability	Text of granted and pending patents
	Other IPR than patents
Corporate records	Statutory records

Table 2: Information in Phase I

It is recommended to organize the White Book according to these items. So readability and structure are confident and common to everyone present in the process.

6.2 Phase II: the first part of the confidential part

In this second phase we enter the confidential part of the due diligence procedure. The general line of conduct is to position this second phase as a disclosure on the actual status including facts out of the history. The sight on the future evolution of technology, business and strategy will only be disclosed in a third phase, opposed by a firm commitment by the receiving party. However already during this second phase the exposure is considerable and the risk level rises. Therefore two documents will have to be signed prior to the start of this phase.

6.2.1 The legal framework

The non-disclosure agreement The first document to sign is a non disclosure agreement (NDA) between the two parties. A good non-disclosure agreement contains at least the next items:

1. The exact names of the persons involved in the dossier from both sides. The representatives signing an agreement should have the authority to do so. It is common use to ask for a written statement on this authority delegation.
2. A preamble depicting the framework of non-disclosure. In some cases there will be a reference to another agreement (in this case our second document, i.e. the Collaboration Agreement).
3. A clear description of the subject of the non-disclosure agreement, preferably a description of the purpose of the receiving party is being included and a positive list of documents is being annexed and the non-disclosure is limited to the exact content of these annexes. During the project and as long as the NDA will last, new documents can be added to this annex list, initiated by the disclosing party. The White Book at this stage will be intrinsically part of the annex.
4. A penalty clause when the contract is being breeched, regardless of the damage one may suffer of by the disclosure. This penalty clause should be severe and the amount of money considerable, even when the NDA is being signed by individuals - what is not uncommon (amounts of 100.000 Euro are common). Given the actual situation of increased personnel mobility (much more than it used to be the case), the individual signing an NDA can be traced and sued directly without passing by the level of the "former" employer. The applicable law and arbitration in case of a dispute should also be specified. Commonly the legislation of the disclosing party is chosen.
5. A termination clause describing the termination of the NDA. Mostly this termination will be relied to the other contract, mostly exceeding it by a period of seven years. So if a party is to conclude an agreement to look for an eventual collaboration, and this agreement foresees a period of two years to evaluate the collaboration, than the accompanying NDA should have a termination date coinciding with the one of the collaboration agreement. Upon termination the fact to not disclose the information should at least last for a next seven years.

It is important to limit the number of Non-Disclosure Agreements in order to avoid widespread diffusion of confidential information. For further, more in-depth analysis of Non-Disclosure Agreements in the business and academic world, we refer to De Cleyn and Braet (2006).

The Collaboration Agreement At first sight the naming Collaboration Agreement might seem a rather unexpected nomenclature for a document that in some cases will be called 'Letter of Intent'. However the judicial connotation of a letter of intent is not good: it offers no comfort to the disclosing party and does no bind the receiving party. Therefore we try to enhance the commitment of both parties by calling this document an agreement to collaborate. Amongst others, the next items should be addressed:

1. the aim of the collaboration agreement is to evaluate a close partnership;
2. an exclusivity of the dossier toward the receiving party (buying party), i.e. that both parties agree not to negotiate with other companies (competitors) during the own negotiations;
3. a clear term of validity for this second phase; recommended value six months;
4. a down payment of a substantial fee by the receiving party; this down payment is not refundable but is reduce-able from the final deal flow; explicitly if a sale of the company will be the result of the collaboration agreement the sale price for the shares will be lowered with this amount; if the deal does not take place -at the initiative of the receiving party- there is no refunding;
5. White Room procedure; the White Room procedures with clear tasks and timings including documents to submit will be included in this agreement (may be annexed to keep the text flexible); the no-copy, no-photographs, no-fax, no-reproduction statements have to be described in detail;
6. the White Book contents has to be agreed on;
7. time lines and deliverables will be clearly indicated and agreed on; guidance again takes place by applying a thorough project management approach; as for the time constraints and given the importance of this phase including the exclusivity claim, the whole second phase is recommended to be limited to maximum 3 months after signature of this document.

6.2.2 The Contents of Phase II

Next to the two contracts, the contents of this second phase will be limited to the following items:

Market	Preliminary market tests
	List of jurisdictions the Company qualified to do business
Technology	Technology status report
	Technology behind the patent
Material Agreement	Financial agreements
	Leasing agreement of real property
	Building or construction agreements related to the real property
	Contracts related to fixed assets procurement
	Liabilities and obligations related to the business up to date
Operations	All documents related to existing products concerning design, engineering and production
	Organizational chart of the Company
	Schedule of the real assets of the Company
Finance	Detailed financial reports (if published)
	Review of all loans, credit lines, all evidence of indebtedness
	List of all mortgages, pledges letters of credit
	Corporate and personal guarantees related to the Company's activity
	All current effective financial arrangements, leasing contracts, sale and lease back operations
	All material correspondence with lenders including compliance reports of the Company or its accountants
	Description of all dividend plans and payments
Accounting	All accountants' reports and management letters to the Company
	All audited financial statement
Corporate Records	Minutes of Meeting of the Ordinary General Assembly
	Shareholder Agreements including voting agreements and proxies
	Articles of Incorporation and amendments to these Articles
	List of Subsidiaries and if any all the above information on each of them
Stock Records	Stock books and copies of stock certificates
	List of holding of stocks in other companies
	List of bonds and securities
	All stock purchase options, repurchase agreements, stock restrictions etc.
Employee	Retirement plan, options, bonus, equity participation, insurance plan etc.
	Description of loan structure
	List of officers, key personnel with time allocation percentages
	Employment, Consulting or other agreements with the directors, managers etc holding more than 5 percent of the shares

	List of Directors, Board Committee, Advisory Board etc.
	Consulting or contract service agreements entered into with third parties
	Collective Bargaining Agreements or Labour Agreements
Governmental	All permits and permit applications
	Schedule of Permits, permissions, approvals, accreditations and the like
	All correspondence with the government or authorities concerning these matters
Liability	Filed Patent Applications
	All property, liability, product liability, director's indemnification, accident, indemnity, causality and business interruption insurance and summary thereof

Table 3: White Book Contents Review Phase II

It should be clear to the author of the White Book that not all of these requirements have to be met, because some of the information may be strongly case dependent. If the documents are non-existing, this has to be noted. If some of the items do not apply to the specific case, mention it. It is mandatory that the complete list however is depicted in the White Book. The indication "does not apply" or "not of application" gives more information than simply not quoting the item. The fact that you made the investigation to verify applicability is important information to the receiving party. If the information is not completely known or if there is some hesitation on a certain part of the White Book, this has to be indicated. Also this is important information adding more value than trying to disguise it. Afterward the due diligence will suffer of the lack of information anyway, so bring this discussion forward. Deferring information delivery belonging to this Phase II toward Phase III is simply not good, because Phase III is always entered in with a much higher degree of risk and exposure. Postponing less sensitive information -the contents of which however might jeopardize the deal- to a more sensitive (later) part of the due diligence is to be avoided.

6.3 Phase III: the second part of the confidential part

This third part of the due diligence is the most important one in terms of legal binding. In fact this phase will be entered in on an "if-then" basis. This means that actually parties agree on the final deal but both parties may put some conditions. Consequently, before entering this phase, a next agreement has to be signed.

6.3.1 Conditional Purchase Agreement

The conditional purchase agreement (we choose the purchase agreement as being the outcome of the negotiations, but other outcomes may be possible also) should contain at least the following items:

1. a go/no-go condition for the final deal
2. the buyer should give his conditions for the GO
3. the Agreement should unambiguously quote the requirements and the different criteria to be met
4. the seller should be in the position to assess the feasibility of the requirements and criteria; these criteria can be categorized in two categories mandatory the so-called ”must” and ”nice to have”; the deal flow aspects can be based on these criteria
5. the buyer commits for the conditional go (meaning that if all requirements are met the deal goes on)
6. the seller should also explicitly commit for the conditional GO; of course this can only be done under exclusivity
7. an upfront payment of 5 percent of the total deal flow value will be down paid by the buyer; this down-payment is not refundable (unless in case of non-compliance of the seller on a -predefined- number of criteria); in case of positive continuation, the down-payment is reduce-able from the deal flow amount
8. the seller can not withdraw anymore (unless fraud, bankruptcy, moral issues etc.)
9. a neutral third party should be able to analyze both requirements and criteria and judge the compliance level of the answers

6.3.2 The Contents of Phase III

In this part of the due diligence procedure, the emphasis will be put on completeness of transfer of data. This part also highlights the future vision of the disclosing party. Consequently, the White Book related to this phase contains much more detailed information. Often there will be a need to work with annexes. Anyhow the contents of the White Book in Phase III should at least be composed of the next items:

Market	Detailed Market estimates
	Business Development Potential
	Contracts with distributors/dealers
	Contracts with customers
	Product development pipe line
	Pending applications for business registration
	All Franchise agreements, commission or agency agreements and sales representative agreements
Technology	Experimental Data
	Road Map of actual products including time line and cost
	Road Map of future products including time line and cost
Material Agreement	All joint ventures, partnerships and joint development projects the Company is involved in
	All other Material contracts, reports, appraisals
Operations	All material licensing agreements either to or from the Company
	All material supply o requirements contracts list of all patents, trademarks, design claims, copyrights, whether registered or not registered
	All applications for such IPR (Intellectual Property Rights)
	All material documents related to products under development concerning design, engineering, production items
	List of all material technology assets, including hard- and software developed by the Company
	List of all material contracts related to the sale, lease, rental or license of the Company's products
Finance	Any agreement related to the acquisition of third party assets by the Company
	Any agreement related to the merger, acquisition or sale of the Company or the Company's assets
Accounting	All internal financial plans, budgets and reports
	The Company's most recent Business Plan
Corporate Records	Minutes of Meeting of the Extra-ordinary General Assembly
	Minutes of Meetings of the Board of Directors
	All support documentation to board meetings and all shareholder meetings
	Minutes of Meetings of the Executive Committee
	All support documentation to Executive Committee meetings
	All external reports related to the Company
Employee	All employee information
	Confidentiality agreement and non-competition agreements with employees, consultants, suppliers, board members and executives
	Confidentiality agreement and non-competition agreements of the same people with former employers
Governmental	All correspondence with the regulating authorities
Liability	List of license agreements for third party technology
	List of the licenses on the use of other third party IPR
	List of all contracts with third parties, their nature and

	conditions
Liability Litigation	Schedule of Material threatened or pending litigation, administrative proceeding, or other governmental investigation or inquiries, influencing or affecting the Company's operations
	All correspondence and documents relating to material contingent liabilities
	Legal council's letters to accountants with respect to litigation or and material contingent liabilities
	All correspondence related to alleged or actual infringements of the IPR of the Company
	All correspondence related to alleged or actual infringements of the IPR of third parties by the Company
	All waivers or agreements cancelling claims or rights of substantial value other than in the ordinary course of business
	All settlement agreements, consent decrees or orders to which the Company is a party or is bound, requiring or prohibiting future activities

Table 4: White Book Contents Review Phase III

6.4 Phase IV: The finalization

In this last phase the deal flow will be put into the final agreements. Normally the phases II and III should have brought sufficient information and commitment to get to a fast closing of the final deal. So the continuation of the procedure will be based on the next points:

1. the agreement made under phase III can be converted into a final agreement
2. the buyer pays a next 20 percent of the total deal flow amount
3. the buyer and the seller can not withdraw
4. the final contract should be established and signed within two months from the final date of phase III

The final phase IV is -in the case the outcome of phase II and III are in compliance with the requirements and criteria set forward- the confirmation of the agreements made before. This phase leads to an agreement amongst shareholders, parties, supplier and customers, licenser and licensee depending on the case and the outcome of the previous discussions. However, the final act can be an extra document or agreement e.g. before notary. This however, does not fall within the scope of the due diligence procedure. We strongly advice to imply professional councillors to finalize this last step.

7 Limitations and conclusions

This explorative study on pre-acquisition due diligence can be seen as a general 'manual' to guide the process. The concepts of the White Book and the White Room serve as central elements, in order to limit the power disequilibrium between large, often multinational companies and smaller 'target' ventures. The practical implications provided are structured around the concept of increasing disclosure and (financial) commitment during the due diligence process. In order to exclude due diligence processes initiated to gain confidential information instead of well-meant business interest in the targeted company, the growing commitment – both financially and contractually – is considered a key issue. Too often, due diligence serves as a concealed type of industrial espionage. The White Room concept helps to overcome excessive and undesirable information disclosure. This way, the involved 'target' venture keeps control over the entire due diligence process and over the amount of information disclosed in each phase.

The insights provided result from year-long field experience in both the European and the Anglo-Saxon business and academic world, combining experience in 7 enterprises and at the University of Antwerp. The results do not at all pretend to be the only right solution or guideline for successful and thorough due diligence. In this respect, the study presented is possibly not applicable to all due diligence situations. Each process has its own, distinct characteristics, which makes it difficult to provide a general, one-size-fits-all solution. Each new due diligence story requires adapted information, interaction and commitment guarantees. Despite this limitation, the guideline presented can be useful to all parties involved in due diligence processes, especially in terms of expectations and disclosure timings. It needs no argument that less practised parties can take more advantage of this study than more experienced teams.

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