~~Legal Due Diligence – A precursor to successful investments in startups~~

Introduction

Generally, investments are a significant source of capital for startups, and a startup's ability to attract investments is often the difference between growth and stagnation. This ability also aids the transition from being a bootstrapped entity to a venture-backed company, as a number of significant decisions that impact the startup's growth revolve around this ability.

Startups never exist in a bubble and investment decisions are anchored on a number of questions which revolve around the actual or potential viability of a startup. Due diligence is the task of determining what questions to ask and what the right answers are based on the applicable regulatory requirements and lifecycle of the startup.

Legal Due Diligence Across Board

What is Legal Due Diligence?

Legal due diligence is the comprehensive review of the material information and documents of an entity to ascertain the extent of the entity's compliance with regulatory standards and requirements.

Within the context of an investment, legal due diligence is the audit of a potential investee startup ahead of an investment decision. Beyond viable products and well-crafted pitch decks, the due diligence process creates a lens through which an investor can accurately assess the investible state of an entity.

While the evolution of innovative technologies has improved access to startups across jurisdictions, this advantage has extended the borders of the due diligence process as investors are also required to review the business models and extent of compliance of global startups with relevant regulatory standards as each due diligence process has to consider the regulatory nuances of the jurisdiction.

When Does Legal Due Diligence Start?

The legal due diligence process often commences with an informal interaction between the startup and a potential investor. In 2021, Mr. Sahil Lavinga disclosed that his first interaction with the founders of Cowrywise, a savings and wealth management startup had happened via a direct message on Twitter, an interaction which culminated in an investment in the startup's preseed $3 million round.[1]

[1] Exposure to risk: What tech investors fear and find interesting about Nigeria's Twitter ban | TechCabal
https://twitter.com/razaqahmed1/status/1354985823834402822

The due diligence process often commences with the submission of a due diligence checklist to the founders of the entity being reviewed. The due diligence checklist requests for disclosures which inform the final decision of the investor.

Why is it important?

Startups are largely focused on product development and scaling, investors are focused on the viability of a business and returns on investment. By virtue of this, each investment decision secures an investor's buy-in to the business model and operations of a start-up. The importance of conducting legal due diligence before investing in an entity cannot be overemphasised.

Legal due diligence largely serves as a compass which guides the investor through the business and operational model of the startup, exposing and assessing risks along the way and advising on next steps. By asking the important questions, legal due diligence ensures that an investor does not jump headfirst off a cliff.

For startups and investors, legal due diligence is a coin. For startups, legal due diligence creates an opportunity for startups to improve and raise their standards. On the investor side of the coin, legal due diligence ensures awareness of risks and moderation of expectations ahead of an investment decision which may go one way or the other. These double-sided advantages stem largely from the fact that due diligence focuses on the following crucial areas:

Due Diligence Area	**Required documents**
Corporate Governance and Structure	• Certificate of incorporation of main entity • Incorporation/registration documents for any affiliates or subsidiaries of the startup in the same or other jurisdictions • Memorandum and articles of association/By-laws/Constitution • startup registration or post-incorporation documents (consisting of shareholding allotment, particulars of directors, particulars of officers, alteration of share capital action of incorporator, registered address, statutory forms etc.)

	- Minutes of meetings and written consents/ resolutions for board of directors, board committees (if any) and shareholders - All resolutions filed or to be filed at companies' registry, including the resolutions of subsidiary entities
Material Contracts Startups never exist in a bubble and often execute agreements which create a roster of obligations and benefits with the potential to adversely impact the business of the startup as well as the investment	- Copies of any license agreements (incoming or outgoing) involving patents, trade secrets or other material intellectual property - Copies of any Joint Venture strategic alliances and corporate partnership agreements. - Copies of agreements with competitors (non-compete, etc.) - Copies of material agreements with major customers or suppliers - Copies of agreements, understandings, instruments, contracts or proposed transactions to which the startup is a party or by which it is bound which involve obligations of, or payments to, the startup in excess of $10,000 - Copies of documents evidencing indebtedness for money borrowed or any other liabilities incurred by the startup - Copies of any documents evidencing any loans or advances made by the startup, including documents evidencing loans made to employees for any reason. - Copies of agreements, understandings or

	proposed transactions between the startup and any of its officers, directors, affiliates, or any affiliate thereof (each, a “Related Party”), including without limitation, non-competition agreements, employment agreements and non-form offer letters.
Compliance and regulatory requirements While startups are typically early stage companies, the stage of their life cycle does not exempt them from compliance with regulatory requirements and the documents which reflect compliance with these requirements have to be reviewed extensively in order to determine the level of adherence as well as any risks which have or are likely to result from default.	• Copies of operating licenses and current status of licenses • "Details of Anti-Money Laundering (AML)/Know Your Customers (KYC) • procedure for onboarding customers" • Environmental, Social and Governance (ESG) policy • Data privacy & protection policy • Details of any periodic regulatory compliance obligations and compliance status
Employment Every startup leverages human resources to build the products and implement decisions. The agreements which reflect the nature of the relationship between the startup and its employees have to be reviewed to determine the nature of these contracts as well as potential liabilities	• Resume (including information regarding track record) and any written employment agreements of the MD/CEO, founders and other C-Suite employees • Detailed organisational chart • The standard form of offer letter and/or employment agreement. • List of key employees, including compensation data (base salary, bonus, stock options, etc.) and their employment agreements • Headcount by functional areas and

	locations over the last four quarters ● Payroll document ● "Document(s) which reflects the vesting schedules of any equity, stock or options subject to ● vesting, including any vesting acceleration." ● List of any key employees that have left the startup include date of exit and contact information. ● Details of severance or deferred compensation plans (including any salary deferral agreements, whether oral or written, with employees or consultants). ● "Details and documents which reflect the employee benefit plan, including, without limitation, equity or stock ● option plans, pension or retirement plans and insurance plans" ● The employee handbook/manual ● All startup/Human Resources policies
Fundraising Prior to the proposed investment, the startup may have raised capital and it is important that the documents from previous rounds be reviewed ahead of a investment decision	● Agreements related to the issuance of ordinary shares and any preference shares (including all exhibits/ancillary agreements) ● Agreements related to the issuance of quasi-equity or any other securities (such as SAFE agreements, KISS agreements etc) ● Agreements related to the issuance of debt securities (including convertible debt) or warrants (including all exhibits) ● Other investment related documents e.g.,

	side letters, investment memos, private placement memos etc.
Intellectual Property Generally, in the absence of an agreement to the contrary, intellectual property is by default owned by its creators. Across jurisdictions, it is important that companies retain ownership of intellectual property, especially intellectual property which may be developed by employees or third parties such as contractors.	• List of all registrations or applications for registration of copyrights, trademarks, trade names and service marks (title/mark, application/registration number, country, date of application/registration) • The Invention Assignment and Confidentiality Agreement that the startup requires all employees to sign. Kindly indicate whether all current and former employees have signed." • Documentation relating to the transfer to the startup or any employee of any technology, including, but not limited to, any sale, assignment, or notice of recordation of assignment. • Any documentation relating to any license to the startup or any license from the startup of any technology • Copies of the proprietary information and invention agreements signed by all service providers, including employees and consultants. • The list of any employees, consultants or service providers who have not signed proprietary information and invention agreements, including a list of any periods of time when such employees, consultants,

	or service providers performed services for the startup while not bound by such agreements. ● Documentation relating to startup intellectual property policies, including but not limited to any employee manuals dealing with intellectual property and any invention disclosure and review policies. ● Correspondence or documents relating to allegations of the startup's infringement of the proprietary rights of others or allegations by the startup of infringement of the proprietary rights of the startup ● Details of any potential or pre-existing obligation that might require the startup or any of its agents or employees to licence, grant or otherwise assign rights to a third party in, or restrict the startup's use of, any intellectual property related to a key technology (e.g., obligations to a former employer, an investor or shareholder, or a university, or obligations under any open source licences. ● Details of any source of funding (e.g., a government or university grant) that may have imposed conditions (such as transfers) on the startup's ownership or transferability of intellectual property related to a key technology.

Conclusion

The relevance of legal due diligence to the investment cannot be overemphasised. Legal due diligence is much more than a set of questions as it is not a ticking-the-box exercise. Legal due diligence goes to the heart of an investment decision and should always precede the decision to cut a cheque or walk away from a deal as the disclosures made and documents reviewed during the audit process help investors arrive at an informed standpoint.

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