

CHAPTER 1

Introduction to Due Diligence

Chapter Contents

- § 1.01 Due Diligence: The Key to Successful Business Transactions**
- § 1.02 Key Terms and Concepts**
- § 1.03 Benefits of the Due Diligence Investigation**
 - [1] Full Disclosure**
 - [2] Transaction Evaluation**
 - [3] Limitation of Professional Liability**
- § 1.04 Requirements of an Effective Due Diligence Process**
 - [1] A General Frame of Reference: The Proposed NASD Standards**
 - [2] Establishing Accountability: the Responsible Attorney**
 - [3] Establishing Accountability: the Diligence Attorney**
 - [4] Scope and Budget**
 - [5] Documenting the Due Diligence Investigation**
- § 1.05 Overview: General Guidelines for a Due Diligence Investigation**
 - [1] Guidelines for All Transactions**
 - [a] Entity and Affiliate Overview**
 - [i] Organization**
 - [ii] Target Company and Industry Profile**
 - [b] Organizational Records**
 - [i] Articles of Incorporation or Other Charter Documents and Amendments**
 - [ii] Secondary Governance Documents and Amendments**

- [iii] **Proceedings of Equity Holders, Directors, Partners, Joint Venturers and Special or Standing Committees**
 - [iv] **Equity Issuance Records, Ledgers, etc.**
 - [v] **Jurisdictional Qualifications**
 - [vi] **Entity's Jurisdictional Status: Good Standing and Tax Status**
 - [vii] **Ownership Structure: Affiliates and Subsidiaries**
- [c] **Financial/Accounting**
 - [i] **Indebtedness**
 - [ii] **Encumbrances**
 - [iii] **Material Investment Holdings**
- [d] **Real and Personal Property**
 - [i] **Real Property**
 - [A] **Deeds and Other Instruments**
 - [B] **Property Encumbrances**
 - [C] **Title Reports**
 - [D] **Local Ordinances**
 - [ii] **Equipment and Other Personal Property**
- [e] **Pending or Threatened Legal Proceedings**
- [f] **Environmental Compliance**
- [g] **Relevant Business Practices**
 - [i] **Sales and Distribution Procedures**
 - [ii] **Product Liability Procedures**
 - [iii] **Standard Form Purchase Orders and Sales Orders**
 - [iv] **Sales Agents and Representatives**
 - [v] **Warranties and Related Claims**
 - [vi] **Material Contracts and Other Agreements**
- [h] **Regulatory Compliance**
- [i] **Employment and Labor Matters**
 - [i] **Management**
 - [ii] **Employee Health, Welfare and Other Benefit Plans**
 - [iii] **Equal Employment Opportunities**
 - [iv] **Health and Safety**
- [j] **Executive Leadership and Management**
 - [i] **Material Terms of Key Employment Contracts**

- [ii] **Material Terms of Key Consulting Agreements**
 - [iii] **Compensation Schedule**
 - [iv] **Related Party Transactions**
 - [k] **Intellectual Property**
 - [i] **Summary Schedule**
 - [ii] **Regulatory Filings**
 - [iii] **Key Licenses**
 - [l] **Other Considerations**
 - [2] **Checklist Items for Corporate Finance Transactions**
 - [a] **Summary of Proposed Securities Offering**
 - [b] **Entity Records**
 - [c] **Financial**
 - [d] **Products**
 - [e] **Sales**
 - [f] **Management and Industrial Relations**
 - [g] **Plants and Other Facilities**
 - [h] **Production Processes**
 - [i] **Research and Development**
 - [j] **Controls**
 - [3] **Investor/Principal Questionnaire**
 - [a] **Overview**
 - [b] **Form: Principal Involvement Guidelines**
 - [c] **Comprehensive Due Diligence Guidelines for Principals**

§ 1.01 Due Diligence: The Key to Successful Business Transactions

Perhaps more than any other single area of the business transactions process, due diligence is a “zero defects” business. A single oversight or miscalculation can be the difference between a successful transaction and a colossal economic failure. Nonetheless, many investors and transaction professionals think of due diligence as a mundane, unimportant, and sometimes irritating task reserved for analysts, junior associates, and legal assistants.

In today’s increasingly adversarial and litigious business environment, due diligence should be viewed in a totally new light. Without complete and accurate information, investors and the professionals working with them will be unable to identify and address potentially significant areas of possible loss or liability. At best, this can lead to

a failure to pay or receive a fair price for the target company or its securities and, at worst, can result in significant liability for the investor and the transaction professionals (such as accountants, bankers and consultants) representing him. For these reasons, the investor as well as the transaction professionals involved in the process must clearly understand the scope and nature of the work they are performing and must appreciate the magnitude of the risk associated with an inadequate due diligence investigation. In the wake of several high-profile scandals, investor confidence in publicly available corporate and financial information has fallen dramatically. Material that was previously considered reliable, such as audited financial statements and other data certified by third parties, may now require independent verification by investors and their transaction professionals. Thus, as companies consider potential investments, the due diligence investigation has become more critical than ever before.¹ The ultimate economic and strategic success of any transaction (and the liability of the professionals involved for their mistakes and oversights) depend significantly on the quality and detail of the due diligence investigation itself.

The overviews, guidelines and checklists set forth in this book are just that. They are not exhaustive, definitive or foolproof tools in the conduct of a due diligence investigation. By following these guidelines and using the workforms and checklists contained herein, however, investors and transaction professionals can improve the quality and effectiveness of their due diligence investigations. As a result, all involved parties will make informed business decisions and will limit exposure to liability claims associated with inadequate due diligence. In using the tools offered in this book, one must constantly keep in mind the fundamental goal of all due diligence investigations—to discover and analyze all information reasonably necessary to enable the investor or other relevant parties to understand all the pertinent aspects of the target business and to both identify and offer a means of addressing any material areas of concern. This goal cannot be achieved through blind reliance on forms.

¹ See Hildebrand and Klosek, “Intellectual Property Due Diligence: A Critical prerequisite to Capital Investment,” available at <http://library.findlaw.com/2003/Dec/1/133278.html> (last visited Sept. 16, 2011).

§ 1.02 Key Terms and Concepts

While there is no definitive “due diligence vocabulary” that all investors and transaction professionals use uniformly, some terms or phrases are common, and one engaged in a due diligence investigation should be familiar with them. The following terms are used throughout this book with the meanings set forth below.

“Attorney Specialist” or “Specialist” refers to an attorney or other member of the diligence team who has specialized expertise relevant to the due diligence investigation. The responsibilities of specialists include reviewing documents and agreements relating to their areas of expertise in order to identify any significant areas of concern that should be brought to the attention of the investor or others on the diligence team. Specialists will review the pertinent provisions of the transaction documents to protect the interests of the investor or client. Attorney and other specialists include tax, employee benefits, labor, real estate, international transactions, intellectual property, and environmental professionals, among others.

“Corporate Finance Transaction” as used here means a transaction involving the public or private issuance of debt, equity or hybrid securities (hybrid securities combine elements of both debt and equity). Corporate finance transactions also include lending transactions, whether secured or unsecured, and proxy, annual report and other disclosure-intensive processes with respect to a target company.

“Data Room” refers to the physical or virtual site housing key documents and information requested or made available as part of the due diligence investigation. Increasingly, data rooms are virtual, allowing authorized persons to access the data via the Internet or a secure network connection. In prior times, data rooms were physical locations, such as a dedicated conference room at a law firm or in the target company’s headquarters or other secure, controlled-access location.

“Diligence Attorney” refers to the attorney who is primarily responsible for the conduct of the due diligence investigation, including the form, content and accuracy of the diligence compendium, the periodic diligence memoranda, and, when applicable, the disclosure schedule. Depending upon the size and complexity of the transaction, the diligence attorney may be a senior to mid-level associate whose duties include the supervision and oversight of the junior attorneys, legal assistants, and other individuals involved in the due diligence review process. His or her role will also include coordination with other diligence professionals, including accountants, risk managers, and the like.

“Diligence Compendium” refers to the final written memorandum that summarizes all of the material findings, on a topic-by-topic basis, of the diligence team’s investigation. Because this document represents the final written expression of the results of the due diligence investigation, it is among the most important elements in the firm’s due diligence file. The diligence compendium is a principal area of focus in the context of any proceedings involving post-closing disputes, such as breaches of warranties or allegations of professional misconduct in connection with the due diligence investigation.

“Diligence Memoranda” refers to the periodic (often weekly) memoranda prepared by the diligence attorney that summarize the diligence team’s interim review and findings. The most important purpose of the diligence memorandum is to highlight the various areas of concern that require more detailed investigation or that should be considered in negotiating the economic and other terms of the definitive agreement.

“Diligence Team” refers to the entire group of principals and professionals involved in the due diligence investigation. These include legal professionals (e.g., the diligence attorney, the responsible attorney, the attorney specialists) and other transaction professionals (e.g., accountants, investment bankers, actuaries, environmental auditors) who are responsible for ensuring a complete and comprehensive due diligence investigation.

“Disclosure Schedule” refers to an attachment to the one or more of the transaction documents in which the target company discloses various material facts relating to its business and operations. For example, the disclosure schedule lists exceptions to the representations and warranties. In the event the disclosure schedule is inaccurate, it can serve as the basis for legal action. Attorneys on both sides of the transaction have a primary interest in the accuracy and completeness of the disclosure schedule.

“Merger/Acquisition Transaction” means a transaction involving the purchase or sale of a target company, or a joint venture or other business combination with a target company. A merger/acquisition transaction can be contrasted with a corporate finance transaction (see definition above). Often, one transaction will involve both a merger and an acquisition and one or more corporate finance transactions.

“Responsible Attorney” refers to the attorney, generally a partner, who is primarily responsible for working with the principals to negotiate the terms of the transaction. The responsible attorney serves as the overall team leader for all aspects of the transaction, not just the due diligence investigation. In addition to assuring that the agreed

upon business terms of the transaction are properly documented, the responsible attorney must work closely with the diligence attorney, attorney specialists, and other transaction professionals to assure that any concerns identified in the due diligence investigation are brought to the client's attention and are properly addressed in the documentation relating to the transaction.

“Risk Evaluation Specialist” generally refers to a member of the diligence team who is not a member of the legal profession. For example, an environmental auditor, an accountant, and an actuary would all be considered risk evaluation specialists.

“Securities Act” means the Securities Act of 1933, as amended.

“Securities Exchange Act” means the Securities Exchange Act of 1934, as amended.

“Target Company” refers to the company issuing the securities in a corporate finance transaction. It also refers to one or more of the companies involved in a merger/acquisition transaction. Target company, as used in this book, may include joint ventures, partnerships, or other commercial entities.

§ 1.03 Benefits of the Due Diligence Investigation

If not carefully conceived and managed, due diligence investigations can become expensive boondoggles that never end and never lead anywhere. It should be kept in mind that process without results is useless. The due diligence investigation is all about producing valuable, usable results in the context of the transaction itself. A host of benefits accrues from a well conceived, properly implemented, and skillfully executed due diligence review. Three of the most important of these benefits are: (1) full disclosure, (2) transaction evaluation, and (3) limitation of professional liability. Others include the elimination of inefficiencies, the identification of potential areas of cost savings, and the implementation of improved corporate planning and policy making. Effective due diligence can save time and money, minimize the potential for costly mistakes and misunderstandings, and facilitate informed business decision-making.

[1]—Full Disclosure

A well conceived and executed due diligence investigation will facilitate the appropriate level of informational disclosure needed for a smooth and trouble-free transaction. In every business transaction, at least one party is required to disclose information to its counterpart on the other side of the transaction. In merger and acquisition and lending transactions, these disclosures usually are contained in the representations and warranties section of the transaction documents and generally relate to the target company, its assets and liabilities. In the context of a securities offering, the registration statement, prospectus or private placement memorandum must contain a materially accurate and complete description of the issuer, its business, and the other information required to be disclosed. To the extent in either context that such disclosures are misleading, inadequate or incomplete, liability for damages may result.

[2]—Transaction Evaluation

By its very nature, a business transaction involves the exchange of one commodity for another. In the case of corporate finance transactions, the issuer sells stock, bonds, debentures or other securities for cash or some combination of cash and other consideration. In merger/acquisition transactions, securities or assets are exchanged for cash, securities, other assets or some combination of these. In case of lending transactions, a lender advances funds to a borrower in anticipation of repayment plus interest. In all of these transactions, absent some political or other non-financial motive, each of the parties has every intention of striking an economically and strategically

advantageous deal. In order to maximize the likelihood of achieving this result, all of the materially important information about the target company must be disclosed and evaluated.

Effective due diligence conducted by a skilled multidisciplinary team is the best way to ensure the adequacy of such disclosure and evaluation. For example, if the target company has a unionized workforce and the collective bargaining agreement expires shortly after the anticipated closing, the acquiror clearly will need to factor into its pricing analysis both the possibility of disruptions of production and additional labor costs in future years (and the seller will need to disclose this information since it is clearly material). Or, if one of the principal assets of the target company is the lease on its primary manufacturing facility, then the acquiror will want to ensure that such lease is assignable without undue cost, complication or delay. In each of these situations, and in countless others, each party needs reasonable disclosure in order to make an informed investment decision.

[3]—Limitation of Professional Liability

Increasingly, lawyers, accountants, investment bankers, actuaries and other transaction professionals have found themselves, their professional reputations, and their assets exposed to risk in the context of post-closing disputes. Sometimes the liability results from representation of new clients that perhaps the firm, in hindsight, wishes it had screened or evaluated more vigorously. In other instances, such liability or allegations derive from the failure to investigate fully the scope and character of the client's business activities, either generally or specifically in connection with a given transaction. And, despite the abundance of conditions, assumptions and exclusions contained in legal opinions, law firms still incur liability when such opinions are inaccurate or incomplete. In each of these instances, effective due diligence is an important component of a broader program of limiting a firm's vulnerability to allegations of malfeasance or misconduct.

Among the elements of a successful due diligence program are careful documentation of the procedures employed by the various transaction professionals and the scope and character of the activities undertaken. By using the forms and checklists contained in this treatise, and by preparing the periodic due diligence memoranda and other reports suggested herein, transaction professionals can establish that a reasonable degree of care and prudence was employed in the due diligence investigation, thereby limiting its potential liability.

§ 1.04 Requirements of an Effective Due Diligence Process**[1]—A General Frame of Reference: The Proposed NASD Standards**

Because each transaction is unique—the parties, the circumstances, the business, the facts and the budgetary constraints—due diligence is a relative concept. Certain basic themes and concepts, however, may be seen as common to most due diligence investigations. In 1973, the National Association of Securities Dealers proposed (but did not adopt) the following standards concerning underwriter inquiry and investigation in connection with issuances of securities. Although these standards were drawn up in the context of public corporate finance transactions, they also provide some very helpful guidelines for merger and acquisition transactions. It should be noted that the NASD proposal was never intended as a definitive and comprehensive statement, but merely as a reasonable overview of what constitutes effective due diligence practices. Following is an excerpt from the NASD proposal.

“(a) Every member engaged in investment banking activity as a managing underwriter shall establish and maintain written procedures which shall be followed by it in its inquiry and investigation of any issuer for whom it is acting in connection with the distribution of an issue of securities to the public. Such procedures shall not necessarily be limited to the following:

“(1) Review by underwriters’ counsel of the issuer’s corporate charter, by-laws, and corporate minutes;

“(2) Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding ten-year period or for the entire period of the issuer’s existence if less than ten years;

“(3) Review of all changes in auditors by the issuer within the preceding ten-year period if applicable and the reasons therefor;

“(4) Review, with the issuer’s auditors, of the financial statements which will appear in the prospectus or offering circular;

“(5) Review of the issuer’s budgets, budgeting procedures, and order/backlog figures;

“(6) Review of internal projects of the issuer, including the intended use of the proceeds of the offering, planned or pending capital expenditures, etc.;

“(7) Review of all pertinent marketing, scientific and/or engineering studies or reports concerning the issuer or its products during the previous ten-year period or for the term of the issuer’s existence if less than ten years;

“(8) Consideration as to the necessity of third party review of appropriate portions of the inquiry if the issuer is a promotional organization or engaged in marketing high technology or previously unmarketed products;

“(9) Investigation of the issuer’s current and past relationships with banks, creditors, suppliers, competitors and trade associations;

“(10) Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer’s business and the role of each of the above individuals in the business operation;

“(11) Inspection of the issuer’s property, plant and equipment;

“(12) Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;

“(13) Review of available information with respect to the issuer’s size, standing and competitive position within its industry;

“(14) Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer;

“(15) Preparation and maintenance of memoranda pertaining to meetings and/or conversations regarding the issuer;

“(b) At least one member participating in the distribution to the public of an issue of securities for which there is no managing underwriter must assume the obligation of establishing, maintaining and following written procedures concerning inquiry and investigation of the issuer as delineated in paragraph (a) hereof and those obligations of certification and record keeping contained in paragraphs (c) and (d) hereof.

“(c) On or prior to the effective date of the distribution of an issue of securities to the public, the managing underwriter shall certify in the agreement among underwriters that it had established adequate inquiry procedures in accordance with the provisions of subsection (a) hereof, and that in respect to the underwriting which is the subject of the agreement, it had followed procedures thus established. In the event there is no agreement among underwriters, the said certification shall be made to all selling group members. If there is no selling group, or if the required inquiry and investigation is performed by a member subject to the provisions of paragraph (b), the certification shall be made in the prospectus.

“(d) Every member subject to the provisions of paragraph (a) or (b) hereof shall keep and preserve appropriate written documentation demonstrating compliance with paragraphs (a) and (c) hereof.

These records shall be preserved for a period of not less than five years, the first two years in an easily accessible place.”¹

[2]—Establishing Accountability: the Responsible Attorney

In most due diligence investigations, the responsible attorney has ultimate accountability for the effectiveness of the investigation, including coordination with all specialists. The responsible attorney is often a partner or senior associate. Although much of the “hands-on” work of the investigation will be delegated to the diligence attorney, the responsible attorney must ensure that all members of the diligence team understand the character and scope of their responsibilities.

Once the due diligence investigation has begun, the responsible attorney will monitor the progress and results of the investigation through regular oversight, frequent individual and team meetings, and by reviewing the various periodic diligence memoranda. As appropriate, the responsible attorney will meet with the diligence attorney, the attorney specialists, and the other transaction professionals to seek additional information or clarification regarding important issues. This process of informing, monitoring and probing will help ensure that during negotiations and document preparation important issues are focused on and resolved in a timely manner. Finally, the responsible attorney will be involved in the review and finalization of the diligence compendium, which summarizes the firm’s efforts and findings in the due diligence investigation.

[3]—Establishing Accountability: the Diligence Attorney

If the responsible attorney is the CEO of the due diligence investigation, the diligence attorney is the COO. The diligence attorney is responsible for the day-to-day operations of the due diligence investigation, including the various written memoranda prepared by specialists and other team members. Although historically the diligence attorney has been a first- or second-year associate, an increasing awareness of the importance of and risks associated with the due diligence investigation has made it more common that mid-level to senior associates assume this role.

Among the first duties of the diligence attorney is educating himself and his team about the transaction, the parties involved, the timetable and the appropriate scope of investigation. Often, this starts with, among other things, a thorough review of all available

¹ “Proposed Article III, Section 35 of Rules of Fair Practice concerning underwriter inquiry and investigation standards respecting distributions of issues of securities to the public,” NASD, Notice to Members 73-71 (March 14, 1973).

documents relating to the target company and the transaction. These may include company annual reports, press articles, Internet searches, and public documents filed by the target company (some of this information may already be in the possession of the responsible attorney or another member of the diligence team, so the diligence attorney should check prior to requesting the documents from the target company or ordering them from a commercial information service). Among the most important initial duties of the diligence attorney is to ensure that each member of the diligence team reviews this information and these documents. If a term sheet, letter of intent, or draft of the registration statement or purchase and sale agreement for the transaction is available (or a recent registration statement or purchase agreement of the same client), it should also be reviewed by the diligence attorney and the team early in the process. If these are not available, then the diligence attorney will need to prepare a summary of the proposed transaction and use it as an agenda item in his first meeting with the diligence team. As noted earlier, effective due diligence requires that each process be tailored to fit the individual circumstances of a given transaction. In order to achieve this level of customization and “right sizing,” all of the team members need to understand as much about the transaction, the parties and the industry as is reasonably practicable. Without this broad base of knowledge across the entire team, the diligence attorney will be handicapped and the process will not proceed efficiently or effectively.

As soon as the diligence attorney is identified, he or she should meet with the responsible attorney to review the transaction and the proper scope of investigation, including the budget. In particular, the diligence attorney and the responsible attorney should review potential problem areas, the time and responsibility schedule for the transaction, and any other issues or information material to the proposed transaction and the due diligence investigation. The responsible attorney and the diligence attorney will also want to identify the members of the target company’s management who will be coordinating various elements of the due diligence review and the data room. Because each responsible attorney has his own ideas about, and procedures for, due diligence investigations, the responsible attorney/diligence attorney initial meeting should also focus on the technique, forms, scope, format and cost considerations relevant to the process as defined by the responsible attorney. All such issues should be resolved prior to commencing the due diligence investigation itself.

[4]—Scope and Budget

Each due diligence investigation is unique. As a result, each requires a different level of staffing, investigation and expense. The

level of due diligence activity appropriate for a \$12 billion public transaction (where the acquiror will not receive the benefit of any representations and warranties) is much greater than the level of investigation to be undertaken in the context of a \$500,000 acquisition of a small, privately held company. Accordingly, prior to beginning the due diligence investigation, the responsible attorney and the diligence attorney should assess the individual transaction and discuss with the client their recommendations as to the appropriate scope of, and budget for, the due diligence investigation. All such judgments should be made in light of the risks associated with a particular transaction and the principal's tolerance for such risks. Once the responsible attorney, diligence attorney, and the principal are in agreement on this point, the members of the diligence team should be fully briefed regarding the scope, time and cost restrictions under which they will be working.

An unfortunate truth in commercial practice is that smaller transactions often merit the most careful due diligence investigation. Records are often poorly maintained and the level of attention given to matters such as contract and regulatory compliance can be quite low. This means that the risk of potential problems is high and the likelihood of ferreting them out quickly, easily or inexpensively, low. Such issues are best addressed early, with the principal fully involved in the decision-making process.

[5]—Documenting the Due Diligence Investigation

The checklists, questionnaires and forms that will be used in performing the most fundamental elements of the due diligence investigation (e.g., real property lease reviews, debt instrument restrictive covenant analyses, corporate record reviews, etc.) are primarily tools intended to aid in the efficient, effective and timely discovery of material information. Nonetheless, these materials constitute an important component in the process of documenting the due diligence investigation. The periodic diligence memoranda produced by the diligence attorney for the responsible attorney will be derived almost entirely from these questionnaires and forms, and the notes and other records created by the attorneys and the risk evaluation specialists in the course of performing their investigations. Each firm will have its own views with respect to the ultimate destiny of these first-tier materials. Many have policies that call for the destruction of these materials at the conclusion of the transaction. Others insist that they be organized and retained in the firm's permanent files. Accordingly, the diligence attorney and the responsible attorney should understand and follow the firm's policy in this regard. If there is no policy, then the responsible attorney should define one for that particular due diligence investigation.

Conversely, second-tier written product such as the periodic diligence memoranda and the attorney specialist memoranda will often constitute a permanent part of the due diligence investigation record. On occasion, such memoranda may be shared with the client to facilitate identification and resolution of issues. In all instances, the responsible attorney will rely on the periodic diligence memoranda, and to some extent, the attorney specialist memoranda, in structuring and directing the negotiations, in analyzing and negotiating the various representations, warranties and covenants to be contained in the operative documents, and, in the case of a corporate finance transaction, the contents of the registration statement, private placement memorandum, or other disclosure document. Accordingly, these memoranda become the principal link between the negotiating/documentation team and the due diligence team. As a result, the diligence attorney must take extraordinary care to ensure that memoranda are accurate, complete, comprehensible and timely. They must contain “usable data in a usable format.”

The final step in documenting the due diligence investigation is the diligence compendium. At its most basic level, the compendium memorializes the firm’s efforts and findings. It will be relied upon, at least in part, by the principal after closing in making various business and strategic decisions. As a result, the diligence compendium is one of the most important documents in the process of documenting the due diligence investigation and its results.

Preparation of the diligence compendium is the responsibility of the diligence attorney, although the responsible attorney will be involved in reviewing and ultimately approving the final product. The diligence compendium should incorporate all of the relevant and material findings from the periodic diligence memoranda and attorney specialist memoranda, as well as the final resolution or disposition (or the client’s decision to proceed despite a lack of such resolution or disposition) of the issues raised in them. Obviously, all open due diligence issues should have been resolved prior to closing (or a decision made by the client to proceed despite a failure to resolve such issues), and therefore the diligence compendium should reflect these decisions. To the extent any issues are left open, the compendium should note them and who made the determination.

§ 1.05 Overview: General Guidelines for a Due Diligence Investigation

[1]—Guidelines for All Transactions

Before beginning any due diligence investigation, each member of the team should have a clear understanding of the scope and character of the review as well as the context in which the review is being performed. Although due diligence is situational and not all of the matters outlined here will apply in every circumstance, many of the items summarized here are likely to be important components of typical due diligence investigations. However, where, for example, diligence team members have the benefit of “cumulative due diligence” (knowledge of the target company derived from prior involvement with the company or from the public record in the case of well-followed public companies, or both) some of these steps may not be necessary or applicable.

By distributing these guidelines to team members early in the process, the diligence team leader can help ensure that each team member has a chance to ask questions and raise issues. Many firms and investors use relatively inexperienced staff members for the more administrative or mundane aspects of the diligence investigation. Although this is not uncommon or necessarily inappropriate, it is important that such members be properly mentored and supervised through the process. For example, in certain instances, less experienced team members may not be familiar with some of the items listed here or the terminology used throughout the diligence process. These guidelines will make it easier to identify the relative skill levels of more junior team members and, ideally, improve those skills before the investigation begins in earnest and as it proceeds.

[a]—Entity and Affiliate Overview

[i]—Organization

This is simply a chart—boxes and lines—showing where the target company fits within the context of its broader organization, including parent companies, subsidiaries, and other affiliates. It is a graphic representation of the target company’s organizational and ownership structure, showing all subsidiaries and parent companies, and ownership interests. For each entity, the jurisdictions of incorporation or organization should be listed, and other relevant data should be prepared by a junior member of the diligence team. This document helps define the overall landscape for the team and facilitates clear communication regarding entities as the investigation progresses.

[ii]—Target Company and Industry Profile

The target company profile is a means of acquainting the diligence team members with the target company and its industry. All documents, brochures, and other materials describing the target company, its history, business, management, industry sector and the like should be assembled and reviewed for material information that may bear on the investigation.

[b]—Organizational Records*[i]—Articles of Incorporation or Other Charter Documents and Amendments*

For the attorney members of the due diligence team, it is important to understand the charter documents for the company or companies that are the subject of the investigation. These documents should be reviewed to determine that they are consistent with law and to determine whether they impose any restrictions or limitations on the contemplated transaction, including special equity holder votes, supermajority provisions, restrictions on sales of stock, assets, and the like, or otherwise contain information relevant to the investigation.

[ii]—Secondary Governance Documents and Amendments

These documents, which include, in the case of a corporation, bylaws (among others), should be reviewed for general sufficiency and to determine what procedures relevant to the contemplated transaction are mandated. Although it is rare that these secondary governance documents have material impact, particular attention should be paid to any unusual provisions, such as limitations or expansions of traditional officer powers, notice provisions, and the like.

[iii]—Proceedings of Equity Holders, Directors, Partners, Joint Venturers and Special or Standing Committees

Minutes and other records of equity holder meetings, director meetings, finance committee, audit committee, compensation committee and similar bodies' meetings can be a treasure trove of useful information for the diligence team. Were stock issuances properly authorized? Who approved the compensation of senior executives and on what basis? What concerns were raised by the audit committee and how detailed were its processes? Exploration of these and other areas is an important component of effective due diligence. Specifically, these records should be reviewed in the context of applicable law to determine:

(1) The capitalization of the target company and whether the issuance of all shares (or other equity interests) of all classes has been duly authorized;

(2) Whether the outstanding shares (or other equity interests) have been issued in accordance with all applicable express or statutory preemptive rights, and other restrictions that may have been imposed by equity holder or director action or otherwise;

(3) Whether the outstanding shares (or other equity interests) have been fully paid and are non-assessable (to the extent that such information can be derived from the corporate or other proceedings);

(4) Whether there are any outstanding warrants, options, convertible securities, directors' shares, etc.;

(5) Whether there are any restrictions on transferability of shares (or other equity interests);

(6) Whether the issuance of all of the outstanding shares (or other equity interests) has been in conformity with applicable securities laws;

(7) Whether the corporate or other proceedings have generally been regular and in accordance with applicable law (this will require a knowledge of, among other things, the law of the jurisdiction of the organization both at the time of such action and subsequently);

(8) Whether the directors, the equity holders or any committees have taken any action that has implications for the contemplated transaction or the procedures to be followed in effecting the contemplated transaction; and

(9) Whether there is anything else noted there that may be material to the contemplated transaction (e.g., employment agreements, bonus plans, pension plans, related-party transactions, union contracts, licenses, and the like).

[iv]—Equity Issuance Records, Ledgers, etc.

Equity issuance records (e.g., stock, LLC interests, partnership interests, etc.) will be important to both the legal and the financial teams. Each will want to confirm that equity was properly issued and that appropriate consideration was paid and received. These materials will be reviewed, in the context of applicable law, to determine the number of outstanding shares (or other equity interests), number and identity of equity holders, whether the number of shares (or other equity interests) shown to have been issued is the same as the number authorized in all respects, and whether all issuances have been in compliance with applicable laws.

[v]—Jurisdictional Qualifications

A company doing business in a state or other jurisdiction is typically required to register with that jurisdiction. Failure to do so can affect the company's rights to enforce its contracts in that state or in some instances can result in fines and penalties. It will be necessary to determine in which states the target company may be required to qualify to do business (by noting the states in which it has facilities, operations, employees, etc.) and whether the target company is in fact so qualified.

[vi]—Entity's Jurisdictional Status: Good Standing and Tax Status

Often, because of administrative oversight, a company can find that it did not pay a local assessment or make a required filing, and as a result is not in good standing in a state. Failure to be in good standing can affect the company's rights to enforce its contracts in that state, or in some instances can result in fines and penalties. This information will be obtained by ordering such certificates from the appropriate authorities both in the state of organization and in other jurisdictions where the company is qualified to do business, or in some jurisdictions, checking these online.

[vii]—Ownership Structure: Affiliates and Subsidiaries

Some target companies have complicated ownership matrices, including parent companies, wholly owned subsidiaries, minority interest subsidiaries, investments, and joint ventures. All relevant entity or other organizational records of the target company should be reviewed to identify any subsidiaries or other equity investments. Depending upon the nature of the contemplated transaction, it may be necessary to conduct the due diligence procedures described here with respect to all significant subsidiaries of the target company and material entities in which the target company has an equity interest.

[c]—Financial/Accounting*[i]—Indebtedness*

Appropriate members of the diligence team should have an understanding of the company's debt position. How many lines of credit does it have? Is there any seller paper (i.e., debt owed to sellers of assets previously acquired by the company)? What about industrial development bonds with local authorities or government entities?

Understanding these areas is important to an effective diligence investigation. All debt instruments (e.g., indentures, credit agreements, industrial development or revenue bonds) should be reviewed to determine whether there are any affirmative or negative covenants precluding or affecting the contemplated transaction or with respect to which the target company is in violation and, in the case of an acquisition, whether any such provisions would have an undesirable effect if the debt arrangements were continued following the acquisition (e.g., limitations on indebtedness, dividends).

[ii]—Encumbrances

Appropriate members of the diligence team need to understand which of the company's assets are encumbered by collateral security interests held by lenders or others. In acquisition transactions, it is possible that these interests will need to be released prior to or at the closing. Any security interests in or encumbrances on the target company's property should be identified on a schedule. A Uniform Commercial Code (UCC) and tax lien search should be made in all states where the target company has property or operations to determine whether there are any financing statements on file.

[iii]—Material Investment Holdings

All of the target company's significant investments should be reviewed as part of the diligence investigation. These will often include joint venture investments, non-marketable securities, real estate, and other areas that will help guide and focus the diligence investigation.

[d]—Real and Personal Property

[i]—Real Property

Each material parcel of real property owned or leased by the target company should be reviewed with both the client and an attorney specialist from the firm's real property section. In some instances, previously owned property, such as manufacturing sites, should be noted so the potential for trailing liabilities¹ can be assessed.

[A]—Deeds, Leases and Other Instruments

All deeds and leases should be identified on a schedule, and should be reviewed to determine their general adequacy and to assess

¹ See the discussion of environmental due diligence at Chapter 8 *infra*.

whether there are any restrictive provisions that could affect the contemplated transaction. In the case of leases, one should assess whether there are any prohibitions on assignment, subordination or other provisions requiring a consent or other affirmative action.

[B]—Property Encumbrances

All material encumbrances, including mortgages, liens, rights of way, restrictions, reversions, and the like, on any of the real property owned by the target company should be reviewed for principal terms and their implications for the contemplated transaction.

[C]—Title Reports

All material title reports, abstracts, opinions and insurance should be identified on a schedule, and reviewed to decide, among other things, the form and extent of insurance needed going forward and the need for any additional contractual protections.

[D]—Local Ordinances

Material zoning and other local ordinances should be reviewed, if appropriate, with an attorney specialist from the firm's zoning and land use section to assess the target company's compliance therewith.

[ii]—Equipment and Other Personal Property

Any material leases of personal property to which the target company is a party should be identified on a schedule. In some transactions, it will be necessary or desirable to secure a schedule of all leased and owned personal property (usually in the form of a computer printout provided by the target company's financial officers). All such leases and related documents should be reviewed generally, with special attention to their termination and assignment provisions and to the existence of any chattel mortgages,² conditional sales contracts, and the like.

[e]—Pending or Threatened Legal Proceedings

All pending and threatened litigation or other legal disputes involving the target company should be reviewed with both the client and an attorney specialist from the firm's litigation section. The pleadings in connection with all significant litigation should be reviewed or, when appropriate, information should be obtained from counsel representing the target company.

² "A term used when describing a mobile or manufactured home mortgage. Specifically when the home is not financed with the land." <http://www.investopedia.com/terms/c/chattelmortgage.asp#axzz1Xr0V8i6z> (last visited Sept. 12, 2011).

[f]—Environmental Compliance

A general analysis should be made of compliance by the target company with all applicable and material environmental ordinances and regulations. In some cases, an environmental survey or audit will be conducted and the results reviewed in connection with the contemplated transaction. All environmental matters should be discussed with and reviewed by an attorney specialist from the firm's environmental section.

[g]—Relevant Business Practices*[i]—Sales and Distribution Procedures*

The target company's sales and distribution practices should be reviewed to determine their general adequacy from a legal standpoint (Robinson-Patman Act;³ Sherman Antitrust Act;⁴ etc.). An attorney specialist from the firm's antitrust or other relevant section should be involved in this review.

[ii]—Product Liability Procedures

The target company's insurance and procedures for product liability claims should be reviewed with the client.

[iii]—Standard Form Purchase Orders and Sales Orders

These should be reviewed generally to determine their sufficiency, with regard to both prior transactions that may have involved such documents and their adequacy for continued use.

[iv]—Sales Agents and Representatives

A list of sales representatives (broken down by location) and the target company's standard form of contract should be obtained. All such form contracts or variations of them should be reviewed with appropriate personnel to determine the general adequacy of the arrangements.

[v]—Warranties and Related Claims

In applicable circumstances, it will be desirable to gain a general understanding of what procedures are used by the target company in connection with product warranty claims, and to review all warranties and warranty disclaimers with regard to enforceability, duration, implications of any implied warranties and the like.

³ Pub. L. No. 74-692, 49 Stat. 1526 (1936).

⁴ 15 U.S.C. §§ 1 *et seq.*

[vi]—Material Contracts and Other Agreements

All material contracts for the sale of products or the purchase of materials or capital goods should be reviewed to determine their implications for the contemplated transaction and, if applicable, their assignability.

[h]—Regulatory Compliance

Material federal, state and local regulations affecting the target company should be understood and, where appropriate, reviewed with the target company and or special counsel. Additionally, it may be desirable for a member of the target company's management to assemble a list of material licenses and permits that it possesses in connection with the operation of its business or the ownership of its property. These lists should be reviewed generally in connection with the contemplated transaction and specifically to determine whether any material licenses or permits have expired, or whether transfer or reissuance will be required.

[i]—Employment and Labor Matters*[i]—Management*

A schematic representation of the target company's management structure may be useful. Also, some familiarity with the number and types of employees, including their affiliation by business segment, may be appropriate.

[ii]—Employee Health, Welfare and Other Benefit Plans

All of the target company's benefit plans (e.g.: defined benefit, defined contribution, insurance coverages, tuition sharing and the like) should be reviewed with an attorney specialist from the firm's employee benefits section. Copies of the plans, trusts, Forms 5500,⁵ determination letters, ESOP, and similar plans should be reviewed to determine their implications for the contemplated transaction.

[iii]—Equal Employment Opportunities

A general inquiry should be made, and any pertinent documents should be reviewed, with respect to the target company's equal employment opportunity practices. These matters should then be reviewed with an attorney specialist from the firm's labor section.

⁵ Forms 5500 are used to satisfy reporting requirements under ERISA and the Internal Revenue Code. See <http://www.dol.gov/ebsa/5500main.html> (last visited Sept. 12, 2011).

[iv]—Health and Safety

Where appropriate, a general inquiry should be made, and any pertinent documents should be reviewed, with respect to compliance with working condition requirements. These matters will then be reviewed with an attorney specialist from the firm's labor section.

[j]—Executive Leadership and Management*[i]—Material Terms of Key Employment Contracts*

All material employment contracts should be identified on a schedule and reviewed for provisions that could affect the contemplated transaction (e.g., golden parachutes, deferred compensation, severance provisions and the like).

[ii]—Material Terms of Key Consulting Agreements

All material consulting contracts should be identified on a schedule and reviewed for provisions or issues, such as lack of deductibility for payouts made thereunder, which could affect the contemplated transaction.

[iii]—Compensation Schedule

Material wage and salary obligations (above an agreed-to threshold) should be reviewed by and with the appropriate personnel.

[iv]—Related Party Transactions

All such transactions should be identified on a schedule, reviewed carefully, and discussed with the client. Particular attention should be given to the compliance of such arrangements with requirements of the target company's organizational documents, debt instruments, equity holder's agreements, and disclosure documents.

[k]—Intellectual Property*[i]—Summary Schedule*

Where applicable, the target company's patents, patent applications, trademarks, trade names, service marks, copyrights and similar or related items (whether registered or unregistered) should be reviewed. Relevant topics typically include an understanding of the patent or mark, the date filed, the expiration date, the jurisdiction filed in, and other relevant information such as the patent or mark's importance in the target company's business. This information should then be reviewed with the client and, as appropriate, with an attorney specialist from the firm's intellectual property section.

[ii]—Regulatory Filings

In some cases, especially asset acquisitions, it will be desirable or necessary to make certain filings in various jurisdictions to ensure post-closing protection of the patent or mark. This process should be handled by an attorney specialist from the firm's intellectual property section.

[iii]—Key Licenses

Any licenses or similar arrangements should be identified on a schedule and reviewed with regard to their legal adequacy, termination, assignability and other material terms.

[I]—Other Considerations

In general, material contracts, agreements, permits, licenses, etc. (e.g.: raw materials, contracts and other supplier contracts, customer orders, computer/MIS services, leases, dealer agreements, employment agreements, collective bargaining agreements, guarantees, powers of attorney, operating permits, equipment licenses, and the like) should be reviewed for an understanding of the material terms and to check assignability, enforceability, breaches/defaults, expiration, escalation clauses and other material provisions.

[2]—Checklist Items for Corporate Finance Transactions

The following checklist should prove useful to the diligence team leader in corporate finance transactions, especially one involving a public offering of securities. In general, the diligence team leader will want to "check off" each of these items early in the process, and ensure that team members have easy access to these data throughout the diligence investigation. As noted previously, all due diligence is situational. Therefore, not all of these will apply in every setting or situation. It is also possible that through the effects of cumulative due diligence, not all of these areas will require specific investigation.

[a]—Summary of Proposed Securities Offering**A. Basic Information**

1. Issuer of Securities
 - Name of Issuer
 - Jurisdiction of Organization
 - Type of Business or Enterprise
2. Securities
 - Type of Offering
 - Registered or Unregistered

- Primary and Secondary Offering⁶
- Description or Title of Securities
- Number of Equity Interests, Principal Amount or Liquidation Preference⁷
- Description of Use of Proceeds of Offering (what the company intends to do with the proceeds from the sale of the equity securities)
- 3. Managing Underwriter(s) or Placement Agent(s)⁸
- 4. Co-Managing Underwriter(s) or Co-Placement Agent(s), if any
- 5. Legal Counsel⁹
 - Issuer
 - Underwriter
 - Trustee, Warrant Agent, etc.
 - Special Counsel
 - Local Counsel
 - General Counsel¹⁰
- 6. Trustee, Warrant Agent, etc.¹¹
- 7. List Accountants, Environmental Auditors, and Other Specialists
- 8. Registration and Listing Information
 - Registration Form (if applicable)¹²
 - Stock Exchange¹³
- 9. Special Attributes of Securities
 - Debt Securities
 - Maturity Date¹⁴
 - Sinking Fund¹⁵

⁶ A primary offering is made directly by the issuer; a secondary offering is made by one or more holders of securities who are not the issuer.

⁷ A liquidation preference is the right to receive a stated value per unit ahead of other equity holders in the event of a sale or other liquidation of the company.

⁸ This is the securities professional (or professionals) who manages the overall process of marketing, selling and, if applicable, listing the securities

⁹ Each party involved in a securities offering will commonly have its own legal counsel who will work closely with their counterparts.

¹⁰ Some issuers or others involved in the offering process will have a full employee general counsel who will work with or oversee outside counsel.

¹¹ Some securities issuances, such as debt instruments or options, will involve a third party fiduciary, such as a trustee, who is charged with ongoing administrative matters, such as holder notifications, etc.

¹² If the securities are to be listed on an exchange, that exchange will have its own application process and protocols that must be followed.

¹³ *Id.*

¹⁴ The date on which repayment in full is required.

¹⁵ A sinking fund is a segregated account into which the issuer of debt makes payments to be held by a third party, as an assurance of partial repayment for the benefit of those who own the debt.

- Interest
- Cash or Pay-in-Kind¹⁶
- Interest Rate
- Redemption Features¹⁷
- Subordination Features¹⁸
- Equity Securities
 - Convertibility Features¹⁹
 - Call or Redemption Features²⁰

[b]—Entity Records

- A. Issuer Overview
 1. Organizational and Ownership Structure of Company and Subsidiaries, Joint Ventures, etc.
 2. Jurisdictions of Organization
 3. Company Profile
 4. Brochures
 5. Annual and Periodic Reports
 6. Press Releases
 7. Press Clippings
- B. Issuer Organizational Records
 1. Articles of Incorporation or Other Charter Documents
 2. Bylaws
 3. Secondary or Tertiary Governance Documents
 4. Minutes or Other Records of Proceedings of Equity Holders, Directors, Partners, Joint Venturers and any Committees Thereof (some joint ventures, even those that are merely contractual in nature, will establish governance and decision-making processes)
 5. Capital Structure
 6. Authorized and Outstanding Shares or Other Equity Interest
 7. Preemptive Rights or Other Equity holder, Partner, or Joint Venturer Agreements (preemptive rights grant to the holder the privilege of advance subscription to any future issuances of securities)

¹⁶ Some interest and dividends must be paid in cash; others can be paid by the issuance of additional securities.

¹⁷ The issuer may have rights to redeem the securities prior to their maturity date.

¹⁸ Many debt instruments provide that other holders of the same company's debt enjoy priority and must be repaid ahead of the securities being issued.

¹⁹ Some equity securities are convertible into (can be exchanged for) other classes of equity or debt securities.

²⁰ Some equity securities can be redeemed by the issuer at stated dates or upon the occurrence of certain milestone events.

- C. Stock or Other Equity Interest Records or Ledgers
- D. Foreign Qualifications (these can relate to domestic jurisdictions other than the jurisdiction of formation, or can relate to non-United States jurisdictions, or to both)
- E. Good Standing and Tax Status
- F. Organization and Other Records of Subsidiaries and Downstream Affiliates

[c]—Financial

- A. General Identify independent auditors and officers responsible for financial data.
- B. Financial Status Discuss with responsible attorney extent to which required prior to commencing review and degree of involvement by accounting professionals.
 - 1. Statement of Condition (last audited and last unaudited balance sheets)
 - 2. Analysis of Assets on Balance Sheets
 - Cash Position (identify seasonal or cyclical fluctuations, if any)
 - Receivables (condition, turnover, bad debt experience and reserve)
 - Inventories
 - Raw Materials, Work in Process and Finished Goods Inventories in Relation to Production and Sales Requirements²¹
 - Forward Commitments on Raw Materials²²
 - Vulnerability of Business Because of Rapid Price Change of Materials and Time Element in Manufacturing Process. LIFO-FIFO²³
 - Condition and Obsolescence²⁴
 - Working Capital Position and Requirements
 - Investments
 - Officers and Employees Loans
 - Analysis of Prepaid Expenses²⁵

²¹ These will generally not apply to service or intangible property-based issuers.

²² These will generally not apply to service or intangible property-based issuers.

²³ FIFO (first-in, first-out) and LIFO (last-in, first-out) are accounting techniques used in managing inventory and financial matters involving the amount of money a company has tied up in inventory of various things. http://en.wikipedia.org/wiki/FIFO_and_LIFO_accounting (last visited Sept. 12, 2011).

²⁴ These will generally not apply to service or intangible property-based issuers.

²⁵ Prepaid expenses might include items such as security deposits or advances against delivery for undelivered goods.

- Analysis of Deferred Charges
 - Properties
 - Operating and Non-Operating²⁶
 - Extent Depreciated and Rates²⁷
 - Insurance Coverage
 - Goodwill²⁸
3. Analysis of Liabilities
- Bank Loans (amount, dates, sources and rates over past two years)
 - Accounts Payable (policy on discounts)
 - Special Reserves²⁹
 - Contingent Liabilities
 - Pending and Threatened Law Suits
 - Notes and Obligations Guaranteed
 - Contract Liability
 - Other Commitments
 - Long-Term and Short-Term Leases
 - Status of Income Taxes (Federal, State and Local) (is the issuer current in its payment of due and payable taxes?)
 - Trend and Status of Real Estate and Personal Property Taxes (is the issuer current in its payment of due and payable taxes?)
 - Analysis of Long-Term Indebtedness
 - Holders (person or entity to whom the debt is owed)
 - Restrictive Terms
 - Prepayment Schedules
 - Analysis of Deferrals
4. Review of Minutes of Audit Committee Meetings
5. Review of Auditor's Letters to Management³⁰
- C. Financial Operations Discuss extent required with the responsible attorney prior to commencing review and degree of involvement by accounting or other finance professionals. Note that many of these items will not be applicable to services or intellectual property-based issuers.

²⁶ An operating property is one that is used in the issuer's business; a non-operating property would be an investment or other asset not used in the business.

²⁷ GAAP requires that certain assets be depreciated in accordance with a standard schedule for the type of asset; depreciation rates usually refer to the total number of years during which that class of asset is depreciated.

²⁸ Goodwill is the difference between the purchase price and the book value of an asset.

²⁹ Companies set up reserves against anticipated liabilities, such as a pending office relocation or a litigation settlement.

³⁰ In connection with the annual audit process, the issuer's auditors send to management a letter outlining their significant finds, recommendations and concerns.

1. Statement of Operations (last audited and unaudited profit and loss statements)
2. Analysis of Sales and Income
 - Annual Sales by Category During Last Five Years
 - Present Backlog by Category, Compared with Prior Year
 - Other Income
3. Analysis of Trends of Manufacturing Costs and Gross Profits
4. Analysis of Trends of Expenses
5. Analysis of Profit from Operations by Categories, Divisions, Branches, etc.
6. Earning Record for Five-Year Period
 - Cash Gains or Losses from Operations
 - Earnings as a Percent of Sales
 - Earnings as a Percent of Invested Capital
7. Dividend Record for Five-Year Period
 - Kind and Amount of Dividends Paid (whether in cash or in kind)
 - Percent of Earnings Paid Out in Dividends by Years
 - Dividends in Arrears, if any³¹

[d]—Products

- A. General Discuss Extent Required with the Responsible Attorney Prior to Commencing Review; Note that many of these items will not be applicable to services or intellectual property-based issuers.
1. Major Classifications and Relative Importance
 2. Analysis of Major Products
 - Catalogs and Sales Literature on Products
 - Description and Application of Products
 3. Competition
 - Principal Competitors
 - Ranking in Industry—Past and Present
 - Percent of National Business vs. Local Business Obtained
 4. Trend of Percent of Market Captured by Issuer Market Acceptance
 5. Trade Name Practices and Value
 6. Styling and Packaging—Status and Importance
 7. Completeness of Lines (are other products not produced by issuer required to implement the solution the issuer's products relate to?)

³¹ Dividends in arrears are dividends that have been declared but that have not actually been paid.

8. Seasonal Sales Patterns
- B. Markets and Prices
 1. Characteristics
 - Geographic Locations in Which Issuer's Products or Services Are Sold
 - Economic Factors Influencing Size and Reach of Markets
 - Stability of Markets and Prices
 - Susceptibility to Competition and Overview of Likely Competitors Including Their Advantages/Disadvantages
 2. Competitive Practices
 - Competitive and Trade Practices Overview/Compliance with Applicable Regulations
 - Exposure to Imports, Tariffs and Quotas
- C. Business with Government Agencies (Domestic and Foreign)
 1. Description of Product and Terms of Key Contracts
 2. Status of Supply Contracts
 3. Methods of Pricing and Payment
 4. Present Competitive Situation
 5. Future Business Outlook
 6. Compliance with Any Applicable Most-Favorable-Pricing Requirements (MFP provisions require that the issuer charge the customer its lowest price and that no other customer have a better price or terms.)

[e]—Sales

- A. Distribution
 1. Types of Distribution Used (e.g., retail, sales agents, online, etc.)
 2. Methods of Securing and Franchising Distributors, if applicable
 3. Lists and Ratings of Principal Customers³²
 4. Concentration of Sales Among Important Accounts
- B. Sales Organization
 1. Organization
 2. Sales Methods Employed
 3. Compensation of Salesmen
 4. Branch Offices
- C. Sales Policies
 1. Prices (and Pricing or Discount Formulae Used and a Description of when Such Discounts Are Applied)
 2. Service and Returns

³² Ratings refers to the creditworthiness rating issued by an outside agency such as Dunn and Bradstreet, among others.

D. Advertising and Promotion

1. Internal Activities
2. Agency Activities
3. Advertising Budgets
4. Public Relations

[f]—Management and Industrial Relations**A. General Organization**

1. Organization Chart
2. Number and Type of Employees by Departments and Geographic Location
3. Directors, Officers, Committees and Their Duties
4. Transactions with Management and Directors
5. Data on Directors and Executive Officers
6. Employment Contracts

B. Labor

1. Union Contract Status
2. Past Labor Issues Such as Strikes or Slow-downs, etc.
3. Present Labor Situation
4. Pending Problems, if Any

C. Personnel Policies and Practices

1. Stock Option Arrangements
2. Bonus Arrangements
3. Profit Sharing
4. Pension Program
5. Employee Purchases (and what discounts, if any, are applicable to employee purchases)

[g]—Plants and Other Facilities**A. Land and Buildings**

1. Location and Ownership of Real Property
2. Appraisals
3. Insurance Policy Summary
4. Condition of Buildings/Repairs Needed

B. Equipment

1. Description, Age and Value of Major Items of Machinery
2. Condition and Ownership of Equipment

C. Adequacy of Facilities

1. Location with Respect to Material, Labor and Markets
2. Present Use of Facilities (any idle plants? Types of activities conducted at plants)
3. Expansion Possibilities and Plans

[h]—Production Processes

- A. Efficiency of Production Operations
- B. Degree of Automation

[i]—Research and Development

- A. Research Personnel
- B. Research Facilities and Laboratories
- C. Intellectual Property
 - 1. List of Patents, Trademarks, Copyrights and Any Applications for Such Items (including status)
 - 2. Importance to Product(s)
 - 3. Patent Policies, Pools and Licensing Arrangements
 - 4. Patent Assignment Agreements with Employees

[j]—Controls

- A. Financing Controls
 - 1. Budgets of Sales, Production, Costs, Profits, Cash Requirements, etc.
 - 2. Methods of Controlling Costs
 - 3. Adequacy of Internal Checks
 - 4. Methods of Controlling Capital Expenditures
 - 5. Accounting Methods Employed
- B. Production Planning and Controls
 - 1. Master Schedules—How Set
 - 2. Coordination Between Sales and Production
 - 3. Adequacy of Product Specifications
 - 4. Production Scheduling and Machine Loads
 - 5. Purchasing Methods and Lead Times
 - 6. Material and Inventory Control
 - 7. Cost-Estimating Procedure
 - 8. Time Study

[3]—Investor/Principal Investigation**[a]—Overview**

Successful and effective due diligence requires meaningful involvement by the principals. By becoming actively involved in the process, the principals themselves can help minimize the risk of post-closing surprises. The responsible attorney or the diligence team leader must take proactive steps to bring the principals into the diligence process and to keep them involved.

In many circumstances, the following questionnaire can be a helpful tool. It is particularly useful if reviewed with the client early in the project and the diligence exercise, then referred to, as appropriate, periodically throughout the process. In some cases, it may be prudent to include in the closing documents a certificate whereby the principal confirms receipt, review and comprehension of the questionnaire, but this decision should be made on an individual basis, taking into account all the relevant circumstances, and the form should be modified accordingly. In using this form, it should be kept in mind that it is rarely appropriate to hand the form to the principal and ask him or her to fill it out. Rather, the form is best used as a guideline for the responsible attorney or diligence team leader in a face-to-face meeting with the client.

[b]—Form: Principal Involvement Guidelines

A. “Big Picture” Questions and Answers

1. What is the principal’s motivation for effecting this acquisition or securities offering (e.g.: to generate excess cash flow, to produce above-market returns, to achieve a strategic goal, to achieve a personal goal or ambition not related to economic consequences, etc.)? How does the acquisition fit into the overall business strategy?

2. If involving an acquisition, has the principal set a walk-away price? How was the price calculated?

3. What level of confidence does the principal have that it is paying a fair and appropriate price, and upon what facts is that level of confidence based?

4. If one year from now it is determined that the principal overpaid by as much as 20% in connection with the transaction, what would the consequences be?

5. If the amount of overpayment were 50%, what would the consequences be?

6. What sources of funding are being used and what additional sources can be drawn upon, if required, to operate the business or service its debt?

7. What is the principal's tolerance for risk? Is it the same for all types of risk?

8. To what extent is the principal competent to manage this business, and to what extent am I relying on current management to do that job?

9. Is this the principal's first experience in this industry? What experience or knowledge does the principal have that is relevant to success in this industry?

10. Is this the principal's first acquisition? If not, how many acquisitions has the principal done, and did they involve similar degrees of financial risk and exposure?

11. If projections concerning the future financial performance of this business prove overly optimistic, from what sources will the principal generate sufficient capital to continue the enterprise?

12. Whom does the principal consider to be the primary due diligence team responsible for a successful investigation?

13. What does the principal consider to be its role in the due diligence exercise?

14. What internal personnel resources will the principal commit to the due diligence investigation (e.g., CEO, COO, CFO, etc.)?

15. Who will be the head of the principal’s internal due diligence team (i.e., the person primarily responsible for being the liaison between the principal and the retained diligence team)?

[c]—Comprehensive Due Diligence Guidelines for Principals

Unlike the preceding questionnaire, the following guidelines can be provided directly to the principal involved in the transaction. In many instances, it will be desirable for the entire principal diligence team to review these items. These guidelines are crafted from the buy-side perspective of an acquisition transaction. If the transaction involves a securities offering, the guidelines should be modified accordingly.

Most of these items are important business, operational and financial considerations as distinct from important legal considerations (although some legal topics are included as well). As such, these guidelines can help focus the principal business team on key economic and business matters that are beyond the competence of the legal or accounting diligence team members. This list is quite comprehensive and therefore should be viewed as a guideline, not a form. It attempts to cover business topics of interest to a broad range of companies—manufacturers, research and development companies,

and more. In any event, this listing should be modified as appropriate to the particular circumstances of the given due diligence investigation.

1. If buy-side principal, investigate the reputation of owners, directors, management and professional advisers.
2. Research and understand the target's market share, competitive position, etc.
3. Assess whether this is a growth opportunity or a turn-around/restructuring situation.
4. Analyze and understand the extent of government regulation under which the target operates.
5. Research and understand all material external factors (e.g., labor, raw materials, macro-economic trends, interest rates, consumer confidence, etc.) that affect the target.
6. Review material recent developments that should be taken into consideration in connection with the proposed transaction:
 - Industry-wide trends
 - New products
 - Capital expenditures
 - Labor costs
 - Other
7. List the competitive advantages, if any, enjoyed by the target:
 - Technical
 - Cost
 - Market
 - Geography
 - Product/Service
 - Reputation
 - Barriers to entry
 - Management
 - Other
8. List all pending litigation and determine whether any such litigation is major or threatening in other ways.
9. Review and understand any cyclical factors that affect the industry or the target.
10. Order a credit report on the target, and assess the implications of its credit rating and the reasons for it.
11. Determine whether any operations have been discontinued in recent years or are expected to be (or should be) discontinued in the near future.
12. Determine whether any material contracts or leases are approaching expiration. Understand the economic and other implications thereof.

13. Determine whether any labor negotiations are pending or are scheduled to occur in the near term.
14. If buy-side principal, conduct a background check on the target's officers or directors. Confirm whether they have been involved in criminal proceedings, regulatory disputes, or civil litigation.
15. Confirm that you understand the real reason the target is being offered for sale.
16. Determine how long the target has been for sale and whether there have been any prior "busted deals." If so, be sure you understand why the prior deals collapsed.
17. Determine what pre-sale steps may have been taken by the current owner to make the target look more attractive for sale.
 - Reducing discretionary expenditures for advertising, maintenance, research and development, new product introductions, capital improvements
 - Deferring compensation increases
 - Avoiding regulatory compliance
 - "Enhancing" sales figures
 - Accounting changes
 - Change in law firm or auditors
18. Understand the key factors for success in the industry and how the target measures up in these areas.
19. Determine what factors make the target more attractive than other companies in the industry. Identify the target's principal competitive advantage. Determine what could cause the target to lose that advantage.
20. Ensure that you understand each of the following:
 - History of the business, any predecessor companies and changes in capital structure, or capitalizations
 - Description of products, markets, principal customers, any subsidiaries and their lines of business
 - List of officers and directors, with their affiliations, ages and number of years in office.
 - Number of people employed and their major areas of activity
 - Capitalization and stock distribution, including the number of equity holders and names of principal equity holders, rights of each class of stock, and stockholders' agreements
 - Terms of outstanding warrants, options and convertible securities. Find out if these would have to be dealt with by issuing additional shares
 - If the stock is publicly traded, the exchanges on which it is traded or, if over the counter, the dealer-making markets, the

extent of public float, institutional holdings, trading volume and total market capitalization. Obtain any SEC filings and a equity holder list, if available

- Organization chart
- Names, addresses and contacts of company's professional advisers, including attorneys, auditors, principal bankers and investment bankers
- List all changes required in the target's management or business to meet your expectations.

21. Understand why the investor is making this acquisition.
22. Understand the investor's tolerance for risk and how much risk is involved in the proposed transaction.

PRODUCTS/SERVICES; MARKETS; COMPETITION

A. Products

1. Understand why customers buy the company's products or services:
 - Price
 - Quality
 - Credit terms
 - Right of return or consignment
2. Identify patterns of product or service changes affecting the industry as a whole.
3. Identify related products or industry segments the target has abandoned or into which it might expand.
4. Analyze warranty terms, conditions, and cost, including historical trends and comparisons to industry averages.
5. Analyze any significant product liability exposure.
6. Analyze patent and trademark protection adequacy.

B. Markets

1. Identify types of customers that buy the target's products or services:
 - Commercial
 - Domestic
 - Government
 - International
2. Confirm whether the target's market is "mature" or "emerging."
3. Understand whether demand is domestic or export-driven. Assess risks.
4. Identify and understand the factors that affect demand for the target's products or services:
 - Macroeconomic conditions
 - Population or demographic trends

- Technological innovation
 - Advertising or promotional
 - Customer growth
5. Understand whether the target's consumer market is elastic or inelastic (in elastic markets changes in price can create a magnified change in demand).
 6. Assess how the market can be segmented:
 - Price Point
 - Customer
 - Quality/Availability
 - Geographic location
 - Product and/or pricing
 - Channels of distribution
 7. Identify and assess sales patterns; understand factors affecting depth and duration of seasonality.
 8. Review historical product sales performance. Note any significant modifications. Relate trends to both external factors and target actions or developments.
 9. Develop a reasoned projection of sales and revenue growth (or contraction) for the target's key product lines and for the industry or industries.
 10. Prepare your own independent forecast of sales expectations, share of market, revenue, earnings before interest taxes depreciation amortization (EBITDA), and net income. Do not rely on the Seller's forecasts.
 11. Prepare your own independent estimate of the industry's ability to supply present and anticipated demand and of the target's position in that industry. Do not rely on the Seller's assessment.
 12. Study customer continuity trends.
 13. Analyze pricing drivers for the target's products and services, considering:
 - Market satisfaction
 - Sensitivity of the market to price changes
 - Raw material costs
 - Excess capacity in the industry
 - Imbedded and variable overhead
 - Whether the target has been able to pass along cost increases to customers
 14. Analyze present and potential domestic and export customer base:
 - Countries involved and regulatory issues related to same
 - Total number and types of customers and the percentage of sales to each type
 - Currency fluctuation risks

- Geographical locations and percentage of sales by location
 - Hedging opportunities and other risk management tools
 - Extent of government contracting subject to cost regulations or price redetermination
 - Special discounts and credit terms
 - Possible loss of customers as a result of proposed acquisition, including, without limitation, customer-driven vendor diversification policies and the extent they may be triggered by post-transaction customer account consolidation
15. Analyze methods the target and its industry competitors use to distribute and sell, including:
 - Dedicated sales
 - Channels of distribution
 - Nature and importance of the field sales effort
 - Manner of compensating sales personnel
 - Advertising and sales promotion practices at the target and in the industry
 - Changing patterns in the distribution process
 16. Review advertising, media and other sales promotion programs for quality, “feel,” cost and effectiveness; determine whether current budget is adequate and well-spent.
 17. Analyze distribution and selling costs to determine possible shifts in profitable customers and products.
 18. Analyze the trend of bidding success and costs of responding to bids, if relevant in the target’s industry.
 19. Review trends in the major elements of marketing, including:
 - Advertising and promotional costs
 - Market forecasts compared to actual performances
 - Sales cancellations and returns
 - Customer service costs
 - Shift in product mix profitability
 - Customer complaints and lost customers
 - New accounts generated
 20. Analyze whether the target is over dependent on one or a few customers and review five-year history to assess trends.
- C. Competitive Landscape
1. Prepare a list and ranking of each of the companies that operate in this industry; note whether that number has been declining or increasing.
 2. Review recent merger, acquisition and divestiture deals that have occurred in the industry.
 3. Analyze trends in the prices paid for those deals, and compare to proposed acquisition.

4. List recent plant closings or openings, and identify reasons for same.
5. Analyze whether foreign companies are entering this market and what this new dimension of competition will mean to your business.
6. Determine whether the market leaders are specialists in this industry or whether they are diversified into other businesses.
7. Identify factors critical to success in this industry and where target fits in the competitive landscape.
 - What role does access to capital play?
 - What role does skilled labor or innovation play?
 - How critical is R&D?
 - Who are the industry leaders and why?
 - What are the principal bases of competition:
 - Price (low gross margin)
 - Quality (high gross margin)
 - Innovation (high R&D expenses)
 - Other
8. Develop growth projections and secure copies of industry analyses:
 - Growth trends in the industry predicted by industry players
 - Industry trends predicted by outsiders
 - Review financial, investment or industry analysts reports on target and industry
9. Prepare your own trends analysis. Do not rely on those prepared by the seller
10. Identify external factors that can or do influence the industry's health, including:
 - Existing or pending litigation (e.g., class action suits)
 - Governmental regulations (e.g., proposed price controls, raw materials limitation, wage increases, etc.)
 - Potentially adverse political, social or economic conditions

OPERATIONS

A. Bricks and Mortar; Physical Plant and Manufacturing/Production Checklist Items

1. Summarize or prepare a list of the following information:
 - Location and description of plant or plants and property
 - Proximity to transportation facilities, materials sources and labor supply
 - Description of the area, including climate and natural hazards
 - Restrictions imposed by building codes and zoning laws
 - Utilities, including availability, usage and rates

- Real estate taxes and other fixed costs
 - Quality of title to realty and title insurance policy
 - Adequacy of insurance coverage
 - Any liens or actual or potential condemnation proceedings
 - Cost Basis
 - Assessed value and fair market value of all facilities
 - Current and possible future use and value
 - Description, pictures and current use
 - Cost, accumulated depreciation and depreciation rates and policies (or lease terms)
 - Assessed and fair market (appraised) value
2. Prepare a machinery and equipment schedule outlining the following:
 - Principal machinery and equipment showing cost, age and condition, accumulated depreciation, location and departmental use
 - Depreciation rates and policies (or lease terms)
 - Material additions to capital equipment during last five years, by categories
 - Fair market value
 - Technological obsolescence
 - Health and safety considerations—does the current owner find out if the plant complies with OSHA and EPA regulations?
 - Level of maintenance that has been performed/Review what major repairs or betterments will be required
 3. List any surplus and idle buildings and equipment.
 4. Analyze estimated future plant, machinery and equipment requirements.
 5. Evaluate maintenance practices.
 6. Assess capitalization vs. expense policies for repairs and maintenance.
- B. Operations and Production Processes
1. Understand the nature of the manufacturing process
 2. Understand the important elements in the manufacturing process³³
 3. Evaluate:
 - Historical changes in production processes
 - Production schedules
 - Production methods, efficiency and layout

³³ This typically includes capital investment, know-how, design of plant, skilled labor, pool of available labor, and other relevant areas.

- Job-site safety measures
 - Facility security practices (systems and policies)
 - Storage and inventory requirements and warehousing practices
 - Raw materials, availability and price prospects
 - Hazardous materials used; handling and storage practices
 - Inventory controls and subcontracting done by others
 - Quality control
4. Prepare a list and understand the general elements of production costs (materials, direct labor, indirect labor, manufacturing expenses) and the proportion of each to the whole. Compare these to industry standard practices.
 5. Determine the relationship between fixed and variable costs, the break-even point and the relation of volume to the break-even level.
 6. Understand significant trends in manufacturing overhead costs.
 7. Review recent trends with respect to the following:
 - Safety record; on-job injuries
 - Idle time—stoppage, delays, etc.
 - Labor pool stability and efficiency
 - Waste and scrap processing, handling and value extraction
 - Absenteeism, grievances and other labor force disputes
 - Goods manufactured for others; extent of commitment and assurance
 - Take-or-pay arrangements
 - Labor turnover
 - Excess production times and the reasons for them
 - Delays in delivery time, incomplete deliveries, damaged deliveries
 - Returned goods
 - Downtimes and the reasons for them
 - Preventive and emergency maintenance costs
 - Facility and process upgrades or need for same
 8. Review the trend in the number of days required to process a customer's order through the plant.
 9. Identify changes in production methods that could make the manufacturing process obsolete.
 10. Evaluate the efficiency of the target's production process in relation to the industry.
 11. Determine what factors might lead to an increase in production costs.
- C. Raw Materials; Components; Purchasing Functions
1. Prepare a graphic chart of the purchasing cycles from raw materials through customer delivery.

2. Understand the relationship of raw materials to goods bought for resale.
 3. Understand the percentage relation of material costs to sales over the last five years.
 4. Identify principal raw materials or products required, including an analysis of future price trends, market conditions, raw materials supply, competitors' activity and general economic conditions.
 5. Evaluate all principal suppliers, locations and materials of products supplied.
 6. Determine whether there are multiple sources of supply for critical materials. Assess whether there are any monopoly suppliers.
 7. Review target's policy on carrying inventories of regularly used materials and assess whether inventory level is adequate.
 8. Analyze the procurement function and related processes.
 9. Assess efficiency of purchasing department organization and personnel.
 10. Analyze and understand the procurement procedures, requisitions, priced purchase orders, receiving, supplier payment, etc.
 11. Determine whether any of the following programs or policies are used in the purchasing department:
 - Supply chain management processes or software
 - Purchasing manual
 - Economic order quantities
 - Vendor evaluation files
 - Standardized materials and supplies
 - Competitive bidding procedures
 - Lead times protocols by product and vendor
 - Classification of "Rush," "Emergency" and "As Soon As Possible" orders
 - Make-or-buy analysis, annually or periodically
 - Use of inventory and usage records as purchasing guides
 12. Assess whether there is undue concentration of purchases of any items from individual vendors.
- D. Inventory Issues
1. Categorize types of inventory held, how held and where. Understand risk management as relates to "shrink" (the term "shrink" refers to items of inventory that cannot be accounted for and that are often attributable to employee theft or mishandling) and damage to inventory.
 2. Assess trends in inventory levels by reporting category (e.g., raw materials, work in progress, finished goods).
 3. If possible, analyze inventory by breaking it down into value by fast-moving, slow-moving, excess and obsolete inventory.

4. Assess impact of seasonal inventory fluctuations on financial projections, personnel needs, etc.
5. Assess inventory turnover (ratio of average inventory to cost of sales) by product line, line of business, division or subsidiary.
6. Assess basis of valuation (FIFO, LIFO, average costs), any recent changes to it and their effect on reported performance.
7. Assess trends in customer service levels.
8. Assess sales and write-offs of obsolete stock.
9. Assess maintenance and plant equipment parts inventories.
10. Assess arrangements for and experience with inventory held by others.
11. Understand what inventory-related costs are included in overhead.
12. Understand how overhead is distributed.
13. With respect to lower of cost or market, understand how market is determined (i.e., on a unit basis, by class or product, or on the inventory as a whole).
14. With respect to long-term contracts, analyze the following:
 - Contracts entered into, noting products, types of customer, price terms, payment schedules, extent of subcontracting and dollar volume
 - Method of recording income and provision for losses
 - Cost-estimating procedures and an analysis of cost overruns or underruns
 - Bidding procedures and strategy
 - If contracts are with government, adherence to its cost accounting and price adjustment requirements
 - Any disputes or litigation with customers or subcontractors

HUMAN RESOURCES AND LABOR

1. List and understand the number of employees by gender and age, grouped into production, sales, purchasing, engineering and administration and approximate total wage or salary cost of each category. Determine whether the character of the workforce raises any issues.
2. Examine all union affiliations and contracts for significant agreements.
3. Determine average pay scale and fringe benefits for production employees.
4. Review strike, stoppage, slow down, lock-out, etc. history for the past five years—dates, duration, issues and settlement terms.
5. Determine whether there are any formal charges pending before federal or state labor agencies. Determine how similar cases have been resolved in the past.

6. Understand what labor unions are represented in the industry and the general area. Determine if there is any special organizing effort going on in the area.
7. Assess the incentive system, average rates (incentive and hourly), date they were established, and date of the last updating of standards.
8. Assess labor morale and the handling of labor relations.
9. Assess working conditions, statistics on turnover, and reasons for it.
10. Assess accident frequency and safety inspection reports.
11. Assess medical problems and sick leave frequency.
12. Understand training programs and apprenticeship systems—their effectiveness and costs.
13. Understand the productivity of the labor force.
14. List and assess any unfilled positions.
15. Measure the cost and effectiveness of the personnel department.
16. Assess the general labor market, including:
 - Types of skills available in the area
 - Current pay rates and personnel practices of the industry and of other companies operating in the immediate area
 - Area transportation, community recreation facilities, housing and schools
 - Overall labor situation
 - What union demands were made in the last bargaining process and what demands will likely be made in the next
17. Chart and assess the organization of management functions and responsibilities.
18. Assess make-up, attitude, etc. of management and key employees, including position, career path, age, compensation, retention outlook and management training received.
19. List and review all material employment agreements or unwritten understandings.
20. Understand management succession plans, including any replacement candidates for present management.
21. Assess recent key personnel losses to competitors.
22. Assess the character and attitude of key personnel—satisfied, disgruntled, exhausted, etc.
23. Understand the details and costs of pensions, profit sharing, life insurance, disability insurance, medical benefits, travel, accident, bonus, deferred compensation, and severance plans.
24. Understand the funding status of benefit plans and the performance of fund managers.

25. Understand benefits and salary levels compared to competition. Determine if target needs to upgrade its benefit programs or salaries as a result of the transaction. If so, estimate the cost.
26. Understand vacation and sick pay policies.
27. Understand the number of company-provided cars.
28. Understand any stock option or stock bonus plans and the number of outstanding options and relation to industry practice.

FINANCIAL CONSIDERATIONS

A. Financial Records and Public Data

1. Read and understand audited financial statements and any public filings such as Form 10-K and other SEC filings, if the target is publicly held.
2. Read and understand recent registration statements.
3. Read and understand comparative financial results by major division.
4. Read and understand the most recent unaudited financial statements.
5. Read and understand all recent press releases.
6. Analyze tax returns for the last five years, IRS reports, schedule of unused loss and investment credit carryforwards.
7. Review and study projected operating and financial statements.
8. Review and study accounting practices.
9. Analyze sales backlog information.
10. Review and study operating results, analyzing:
 - How sales have been affected by the macroeconomic environment
 - Trends in sales, net income, earnings per share, dividends and return on stockholders' equity
 - Effects of acquisitions, dispositions and changes in accounting presentation
 - Cost of goods sold, selling expenses and general and administrative expenses. Review these for significant trends, especially in controllable costs such as advertising, travel and entertainment, and repairs
 - All extraordinary and nonrecurring expenses for the period reviewed. Schedule significant items in other income and expenses
 - Annual interest expense and other fixed charges
 - Compensation paid to officers and key personnel
 - Legal retainers, consultants' fees, and similar arrangements

- Terms of the following agreements, where applicable, and of any other pertinent contracts or agreements affecting income (extracting if possible):
 - Bonus or profit-sharing plans
 - Royalty agreements
 - Union contracts and employment contracts
 - Long-term leases
 - Sales contracts and dealership agreements
11. Analyze and understand all relevant financial ratios, including:
 - Current assets to current debt
 - Net profits to net sales, tangible net worth, and net working capital
 - Net sales to tangible net worth, net working capital, and inventory
 - Collection period (number of days sales in accounts receivable)
 - Fixed assets, current debt, and total debt to tangible net worth
 - Inventory to net working capital
 12. Analyze other financial ratios relevant to your industry niche.
 13. Analyze ratio of sales and revenue to cost of goods sold.
 14. Analyze ratio of sales and revenue to selected operating expenses:
 - Fixed overhead
 - Debt service
 - Compensation of officers
 - Rent paid on business property
 - Repairs
 - Bad debts
 - Interest
 - Taxes
 - Amortization, depreciation and depletion
 - Advertising
 - Pension and other employee benefit plans
 15. Understand all relevant market trends.
- B. Assets and Liabilities Review**
1. Understand the target's current and projected cash position— assess adequacy of available cash and cash management systems.
 2. List banks where the target maintains accounts and related balances as of the balance sheet date.
 3. Review monthly cash balances and note unusual fluctuations.
 4. Determine whether idle cash balances are promptly invested.
 5. Determine whether seasonal bank borrowings are required.
 6. Evaluate the target's cash management techniques.

7. Analyze the total accounts receivable balance for amounts due from customers, officers, employees and others.
8. Obtain “aged” balances of the accounts receivable accounts. Compare them to aging percentages for previous years and note any trends.
9. Assess all material customer receivables, including:
 - Customer phone calls or interviews when appropriate
 - Terms of sales, discounts, etc.
 - The number of customers constituting 80% of sales
 - The names of large customers and volume of annual sales to each by product line. Find out if there are any unusual arrangements with any of these customers
 - Customer base stability or turnover
 - Credit policies and procedures for monitoring same
 - The amount of unfilled orders
 - The effectiveness of the credit department
 - The real significance of credit limits
10. Assemble and compare the ratio of returns and allowances to sales by month for the last year and assess fluctuations. Note any evidence of dissatisfaction with the company’s products.
11. Determine whether customers’ receivables are discounted to finance operations.
12. Identify all “off balance sheet” financing techniques used by the target.
13. Ascertain the purpose and repayment terms of loans (other than minor amounts) to officers and employees.
14. Assess the collectibility of receivables and adequacy of bad debt reserves.
15. Analyze how the target establishes credit terms, and how it monitors them.
16. Analyze collection efforts for appropriateness, effectiveness and compliance with law.
17. Obtain a listing of securities and investments held by the target, showing the cost, carrying value, and market value of each item.
18. If the target carries any investments on the equity method, obtain details of the origin of the investments, their cost, market value (if available) and earnings and dividend history.
19. Obtain details of all intellectual property owned by the target.
20. Determine the amortization policy for any prepaid expenses or deferred charges.
21. Determine how any goodwill or other intangibles arose and how they are being amortized.
22. Investigate the nature of any other assets.

23. Obtain an analysis of the type of accounts payable and accrued expenses (vendors, taxes, payroll, payables on reimbursable contracts, etc.).
 24. Determine whether the target takes appropriate advantage of discounts for prompt payment.
 25. Obtain a list of the target's principal suppliers, together with the approximate annual amounts purchased, and delinquencies.
 26. Understand all amounts of outstanding purchase commitments.
 27. Understand all nonfinancial current liabilities.
 28. Understand the target's policy on vacation and sick pay accruals.
 29. With respect to all contingent liabilities, review, analyze and understand:
 - How many (and how material) such arrangements are
 - Contracts and agreements to which the target is a party
 - Price redetermination or renegotiation
 - Sales subject to warranty and service guarantee
 - Product liability exposure
 - Unfunded past service costs of pension plans
 30. Assess and understand all environmental regulations applicable to the target's business and operations, and assess financial implications (contingent or otherwise) associated therewith. In particular, understand:
 - Whether the target has received a waste treatment, storage and disposal permit
 - Whether the target discharges wastewater into something other than a publicly owned treatment works
 - Whether the target generates hazardous wastes and, if so, how handled
 - Any environmental disclosures in public documents
 31. Determine the purpose of any reserves.
- C. Borrowings/Capitalization
1. Schedule and analyze all amounts of financial liabilities and determine the general terms of notes, bonds and mortgages payable (e.g., lender, payment schedules, interest rates, seniority, guarantees and other pertinent information). Assess how these obligations fit with the "go forward" plan of the business.
 2. Understand the nature and amount of assets pledged as collateral.
 3. Assess aggregate payments due.
 4. With respect to amounts due to officers or stockholders, understand the nature of the advances and repayment terms.
 5. Review the terms of indentures and confirm that the business has complied with all covenants.

6. Understand all restrictions in the indentures.
 7. Obtain credit reports.
 8. If debt is publicly held, obtain bond ratings.
 9. Understand all terms of capitalized leases and long-term non-capitalized leases. Determine the nature of property subject to the leases and what renewal or purchase rights exist, if any.
 10. Understand all “off-balance sheet” financing agreements (take or pay contracts, etc.) and guarantees of debt of other entities.
 11. Determine existing lines of credit, terms and unused amounts available.
 12. Understand the details of any preferred stock outstanding.
 13. Review the list of equity holders.
 14. If there is more than one class of common stock, determine and understand the rights of each class.
 15. Review any treasury stock acquisitions, determine whether any treasury stock is “tainted” for purposes of pooling of interests, and ascertain that none is carried as an asset.
 16. Determine whether the target has any obligations to issue or repurchase shares.
 17. Review the target’s past dividend policy and payments.
 18. Determine the percentages of the target’s capitalization represented by the various types of long- and short-term obligations.
 19. Determine interest and fixed charge coverages.
 20. Determine the extent to which the target’s growth has been (or could have been, ignoring nonrecurring transactions) financed by internally generated cash. Analyze the implications for the combined enterprise.
 21. Review and understand the target’s capital budgeting procedures.
 22. Evaluate the target’s relationship with banks, lenders and the financial community in general—friendly or strained?
 23. Review the capital budget and planned sources of funds.
 24. Determine whether the existing debt repayment schedule can be met from operating cash flow. If refinancing will be necessary, determine the effect of current interest rates.
- D. Pro Forma Projections
1. Develop projections of earnings and cash flow and compare to the target’s internally generated models. Do not rely on the seller’s projections.
 2. Evaluate the reasonableness of the assumptions used.
 3. Determine whether projections are consistent with industry and overall business expectations.
 4. Review projections in light of historical growth trends, industry conditions and known factors.

5. Adjust projections for any items resulting from the transaction or other contingencies.
 6. Review cash flow projections to determine that investment in working capital, new plant and equipment, and scheduled debt maturities is appropriately provided.
- E. Financial Management Team
1. Interview financial management and formulate an independent opinion about the overall credibility and reliability of the accounting and reporting of the target.
 2. Meet with the target's independent accounting firm. Investigate the firm's reputation. If the target does not have an independent auditor, require retention and financial statement opinion.
 3. Specifically inquire about auditing work, any adjustments proposed by the auditors, problem areas and any differences of opinion between the target and its auditors.
 4. Review the adequacy and sophistication of the internal auditing department. Determine whether "operational audits" have been conducted and what the results were.
 5. Assess the adequacy of internal accounting controls and the target's attitude toward strong controls.
 6. Be alert to any practices adopted to make the target appear more attractive, including:
 - Adoption of less conservative accounting policies
 - Cutbacks in discretionary expenses, such as advertising, personnel development and maintenance
 - Overly aggressive accounting judgments, such as inappropriate provisions for sales returns, obsolete inventories, or contingent liabilities
 - Target expenses being paid by stockholders, directly or through bargain pricing (e.g., lease arrangements)
 - Whether stockholder-managers are drawing inadequate compensation
 7. Assess the strength of the financial team and controllership function.
 8. Understand the following:
 - How centralized the accounting function is
 - Whether subsidiaries have autonomous accounting departments that may not be functioning uniformly and, if so, how overall control is exercised
 9. Assess and understand how management information reporting is integrated with financial accounting. Find out if management reports compare results to budget and prior years. Assess systems for obsolescence.

F. Management Information Systems/Global Information Systems/Information Technology

1. Assess the sophistication of the management information system (MIS) installation and the extent to which various needs are integrated.
2. Understand whether the MIS function is centralized.
3. Obtain a list of hardware used by the target and understand lease terms, if any.
4. Understand the target's short- and long-term hardware plans.
5. Assess whether any MIS functions are being performed by third parties.
6. Investigate how the MIS function will integrate.

G. Risk Management

1. List and review insurance that is currently in effect. Assess adequacy, quality of underwriters, industry standards.
2. Understand whether the target has assumed large deductibles or self-insured retentions.
3. Assess whether the target has unusual risks or products or whether there have been events the target has been unable to insure (e.g., hazardous waste disposal, pharmaceutical products, satellite launching).
4. Assess whether insurance coverage is written on a "claims made" basis. Understand whether the rights to purchase extended discovery period coverage have been exercised.
5. Determine whether any liabilities have been assumed or transferred through contractual arrangements.
6. Determine whether any financial techniques are being used (e.g., premium financing, deferrals, use of captives, etc.).
7. Review loss experience for insured and uninsured claims. Review reporting and reserving practices.
8. Determine whether any insurance policy aggregates have been penetrated or exhausted.
9. Determine whether there are any unusual circumstances that may give rise to claims in the future that are as yet unreported.
10. Determine who has liability for all prior acts. Assess creditworthiness.
11. Determine whether there is any potential for cancellation of coverage such as Director's and Officer's liability insurance due to the sale, or potential bonding problems because of a highly leveraged condition.
12. Determine whether there are any outstanding premium adjustments and whether the buyer or seller will receive credits or charges for them.
13. Assess the management of the function.

H. Federal, State and Local Taxes

1. Review the principal taxes to which the target is subject and the amounts paid for the past three years.
2. Obtain detailed reconciliations of the target's effective tax rate for the past three years.
3. Determine any significant disparity between tax basis in stock and tax basis in underlying assets (this may drive the form the transaction will take).
4. Assess whether recent changes in the tax law would affect the target.
5. For federal taxes on income, understand:
 - What years are still open
 - What adjustments the company was required to make as a result of the most recent revenue agent's examination
 - If the balance sheet accrual for open years has been adjusted to give effect to the agent's adjustments for years already examined
 - If there are any examinations currently in progress. Find out whether there have been any preliminary findings or matters under appeal
 - A schedule reconciling book income to taxable income for the last three years. Determine that treatment has been proper
 - Amounts and expirations of any carryovers of net operating or capital losses, investment tax credits, foreign tax credits, and other tax credit carryovers. Consider how the transaction will affect the status of these carryovers
 - What is the tax basis of the target's assets. Determine the effect on purchase price allocation under the residual method
6. For other taxes, understand:
 - In what state the target is domiciled and in what states it has locations from which it accepts orders and/or does business? Find out if it is required to file income, franchise, intangible or other business tax returns in those states and, if so, whether they have been filed and taxes have been paid
 - If all state and local taxes have been accrued and paid currently. Determine if any of these taxes are in dispute
 - What percentage of federal taxable income is being reported to all states in which the target files returns. Consider whether the target could owe taxes in states where it is not currently filing
 - If there are or have been any state tax audits
 - If adjustments to federal taxable income made by revenue agents' examinations have been reported to the states affected

- If the state tax returns have been amended to reflect Internal Revenue Service adjustment
 - If the target is collecting and remitting all required sales and/or use taxes
 - If all payroll taxes have been withheld from employees and deposited promptly in our authorized depository
7. Assess whether the target has any significant foreign taxes or any significant U.S. tax problems relating to its foreign operations, such as:
 - Subpart F³⁴ income
 - Exposure to denial of foreign tax credits because of potential allocation of expenses to foreign source income
 - Intercompany pricing and reallocation of income or expenses between related entities
 - Any transfers of intangible property to a foreign corporation
 8. Review any private letter rulings or determination letters obtained by the target.
 9. Interview the target's tax department. Find out how many people are employed and what functions are performed.
 10. Understand to what extent the target relies on outside attorneys or accountants for tax planning and return preparation.
 11. Understand how oriented the target is to tax savings.

MANAGEMENT STYLES AND PRACTICES

A. Management Approach

1. Categorize the basic approach of management as: entrepreneurial, authoritative or management-by-objectives. Determine the extent of centralization or decentralization of authority.
2. Assess how the target's management approach will fit with your own.
3. Determine whether management will be integrated or permitted to operate autonomously. Decide if there are any areas in which functions of the target could be fully integrated.
4. Determine whether existing management will remain. Consider whether the buyer will need to provide management expertise in any areas.
5. Determine whether the target has management or operating expertise that complements any weaknesses in the buyer.
6. Assess the success of the target relative to the industry.
7. Determine to what extent the success of the target can be attributed to good management or a good market and industry.

³⁴ See http://www.law.cornell.edu/uscode/usc_sec_26_00000952--000-.html (last visited Sept. 12, 2011).

8. Identify the strategies management is using to increase market share and profitability.
 9. Determine whether management is as small in scale and as low in cost as possible. Measure the ratio of administrative managers to total personnel and otherwise reduce administrative overhead.
 10. Determine whether management seems to work as a smooth integrated whole or is constantly dealing with crises and emergencies.
 11. Find out if executives are spending most of their time preventing problems from arising, or if they are using their time to solve the same problems over and over.
 12. Assess whether management is using basic concepts and tools of good management, including:
 - Training and skill set enhancement
 - Documented objectives
 - Strategic and tactical plans
 - Responsive organizational structure and controls
 - Effective policies and procedures
 - Adequate management information systems
 - Budgetary control and responsibility accounting
 - Standards of performance and control
 - Management and manpower development
- B. Strategic Planning
1. Determine whether strategic planning is a real management tool used by the target.
 2. Have you determined who in the organization is responsible for long-range plans?
 3. Determine whether sales forecasts are based on real assessments of the market. Assess how costs are estimated and how far down into the target the budgeting process extends.
 4. Determine whether budgets embody realistic assumptions of the availability of manpower, productive capacity, and working capital.
 5. Determine to what extent long-range plans are integrated with capital budgeting and financial planning.
 6. Determine whether long-range plans reflect competitive realities.
 7. Determine whether plans include alternative strategies. Determine if they are sufficiently flexible in relation to the operating environment.
 8. To what extent are the objectives monitored for execution?
 9. Determine whether the target has a history of meeting its goals.
 10. Determine whether the budgeting and internal accounting functions are integrated so that actual performance is reported on the

same basis and under the same assumptions as budgets were prepared.

11. Determine whether the budget is regularly updated.
12. Identify what procedures are used to monitor the marketplace, such as:
 - Tracking competitor financial performance
 - Tracking competitor press releases
 - Tracking competitor advertisements
 - Tracking market share of all competitors
 - Tracking bases or activities of competition
 - Tracking attitudes of customers
 - Tracking governmental developments

LEGAL MATTERS

A. Legal Matters

1. Assess whether any charges are pending against the target by any federal or state agency.
2. Assess whether the target has in-house counsel. Assess whether it would be more effective to use outside attorneys.
3. Obtain a copy of the most recent legal representation letters sent to the company's auditors.
4. Determine whether the target is in compliance with environmental, EEO, and OSHA requirements.
5. Consider obtaining legal opinions that stock is validly issued, fully paid, and non-assessable and that the corporation is in good standing in the state of its incorporation and in all states in which it is doing business.
6. Identify what outstanding legal matters should be dealt with in the transaction documents.
7. Determine what legal problems competitors have experienced.

MISCELLANEOUS/GENERAL

1. Be familiar with all relevant SEC Staff Accounting Bulletins and assess whether target management is sensitive to and in compliance with same.
2. Be alert to any conflicts of interest, especially those related to financial matters:
 - Stock ownership for payment of services
 - Investments and borrowings of employee retirement funds
 - Investments and borrowings of employees and certain relatives
 - Outsourcing arrangements and other management activities

- Compilation and attestation of purchase accounting
 - Appraisal and attestation of purchased in-process R&D
3. Understand the economics of the target's business.
 - What are the Value Drivers?
 - Quality of products
 - Marketing position
 - Management
 - Technology
 - Competitive advantages
 - Barriers to entry
 - Research and development
 - Scalability of the business model
 - Synergies with existing business
 4. Identify business risks.
 - Commodity pricing
 - Regulatory changes
 - Reliance on key personnel
 - Interest rate exposure
 - Product life cycles
 - Future capital requirements
 - Customer concentrations
 - Availability of financing sources
 - Alternative supplier sources
 - New economy strategy
 - Foreign exchange exposure
 - Operations aligned with corporate strategy
 5. Confirm appropriate valuation of the target's business.
 - Discounted Cash Flow Analysis
 - Present value of expected future free cash flows
 - After-tax operating cash flows less capital expenditures, less working capital; or "Free Cash Flow"
 - Multiples of EBITDA are used to value a business. EBITDA is a proxy for operating cash flow, "Earnings Before Interest Taxes Depreciation Amortization"
 - Price/earnings ratios
 - Revenue multiples
 - Asset multiples
 - Hidden asset values
 6. "Trouble shoot" the target's financials, including:
 - Assessing whether or not the financial statements are reflective of the true earnings of the target's business
 - Linking value drivers to the financial statements and accounting records

- Understanding target's financial trends
 - Assessing quality of earnings
 - Identifying unrecorded liabilities
 - Analyzing potential impact of identified business risks
 - Understanding all financial trends
 - Assessing how achievable the projected results are
 - Analyzing how volatile the earnings stream is
7. Look for earnings-related "red flags":
- Sales pushes to enhance EBITDA
 - Changes in estimates or accounting methodologies
 - Purchasing pushes to take advantage of rebates/deals
 - Unusual and nonrecurring items
 - Capitalization and deferral policies
 - Discretionary spending and reserve movements
 - Charges to purchase accounting and restructuring reserves
 - Web site development costs
 - Valuation of barter transactions
8. Look for unrecorded liabilities:
- Workers' compensation and health benefits
 - Pension and post-retirement medical benefits
 - Litigation reserves
 - General and product liability
 - Income and sales tax exposures
 - Environmental compliance and remediation costs
9. Assess integration costs:
- Information Systems
 - Management Systems and Reporting
 - Adequacy of Internal Controls
 - Consider People, Process and Technology Integration Costs
10. Understand the form of acquisition being structured, and why:
- Purchase of assets
 - Purchase of securities
 - Merger/Joint Venture
 - Combinations (e.g., purchase of stock immediately followed by merger)
11. Understand the characteristics of the acquisition vehicle and why it is being used:
- Often, a newly formed, non-operating corporation organized expressly for purposes of the acquisition
 - A holding company may be formed for tax or other reasons
 - Equity owners may include private investors, institutional investors, members of management and, in some cases, the sellers, all of whom may require a certain form of entity

- Considerations in developing the structure of the acquisition vehicle from tax, financing and other relevant perspectives.
12. Understand all material characteristics of the target:
- Form of the target:
 - Privately held company
 - Public company
 - Divisions and subsidiaries of larger companies
 - Preferred business characteristics of the target from a financing perspective:
 - Strong, proven operating management that understands cash flow, asset management and return on investment
 - Manufactures and sells products that are not subject to rapid technological changes
 - Manufactures or distributes proprietary products and enjoys a strong market position
 - Manufacturing efficiencies establish it as a “low cost producer” within an industry
 - Can pass through inflationary cost increases each year (e.g., not subject to intense foreign competition) and is capable of internally generating adequate working capital to support sales growth
 - Normally not subject to wide or prolonged cyclical swings of profitability
 - Has multiple types of businesses, most or all of which have the above characteristics. Note that conglomerates tend to be undervalued by the market, have businesses that are at different points in the business cycle (resulting in more constant earnings and cash flow) and present opportunities to realize on the investment through sales of assets or businesses
 - Preferred financial characteristics of the target, from a financing perspective:
 - Well-established, low growth business with a track record of steady earnings, cash flow and growth
 - Business with a low debt to equity ratio
 - Purchase price should normally result in little or no goodwill after a revaluation of the assets to the present market value
 - Business without inordinate liability for unfunded pension costs
13. Understand the structure of debt financing:
- Senior debt:

- Typically provided by term and revolving credit loans. This credit is senior to other debt and it is often secured by most, if not all, of the target's assets and/or the stock of operating subsidiaries. Senior debt often includes working capital financing, which may be secured by inventory, accounts receivable, etc. The interest rate is usually relatively attractive since the debt is senior and secured.
 - Sources are typically large commercial banks or other institutional lenders. Sources may include commercial finance companies, factoring companies and, in unusual cases, the seller.
 - Subordinated debt:
 - Provided by the issuance of subordinated notes or debentures. This financing is generally not secured, but it is commonly issued with an equity kicker such as a conversion feature or common stock warrants, which may have registration rights attached. The interest rate will vary with the degree of subordination and the strength of the borrower, but the rate will obviously be a premium over the senior debt rate. Use of zero coupon bonds allows cash flow in early years to be used to pay off senior debt.
 - Sources
 - Institutional investors, including some of the same type of lenders that provide senior credit facilities
 - Sellers
 - Advantages of public vs. private debt:
 - The covenants imposed upon the buyer generally are less restrictive. This is because of the fact that there is a market for junk bonds so the holder has the ability to get out of the deal.
 - Generally, there are longer grace periods, defaults are harder to call, and there are other beneficial terms.
 - The financing can be arranged fairly quickly. _____ claims to be able to arrange junk bond financing in a minimum of three to five weeks, but admits that it can sometimes take months.
 - Disadvantages of public vs. private debt:
 - Higher costs and the equity kicker may be for a larger percentage of the target.
14. Understand the character and structure of equity financing being used:
- Private investors
 - Management participation

- Structure of participation:
 - Direct purchase for cash (majority equity partner may help arrange financing)
 - Purchase for notes
 - Options
 - Tax-free rollover of equity interest in acquired company
 - Subordinated lenders
 - Preferred stock
 - Equity holder agreement, if any
15. Understand the legal issues involved in the transaction itself:
- Bulk sales
 - Antitrust
 - Securities (proxy solicitation, going private, etc.)
 - Fraudulent conveyances under Bankruptcy Code³⁵
 - Fraudulent conveyances under state statutes³⁶
 - Equitable subordination³⁷
- Equitable subordination will be applied only in the following circumstances:

³⁵ The validity of the security interests, liens or guarantees granted to lender may be subject to the fraudulent conveyance and obligation provisions of state law or Section 548 of the Bankruptcy Code. The statute of limitations in the Bankruptcy Code is one year. However, the statute of limitations under state fraudulent conveyance statutes generally does not expire for much longer periods and Section 544(b) of the Bankruptcy Code allows a trustee in bankruptcy or debtor in possession to avoid completely the lender's security interests under such state statutes even if only a single unpaid creditor of the target was in a position to do so. The fraudulent conveyance provisions of the Bankruptcy Code create two separate causes of action that may be used to set aside security interests and guarantees granted to the lender, thus subordinating the lender's claim. See generally, http://www.foley.com/files/tbl_s31Publications/FileUpload137/1044/murch_fraudtrx.pdf (last visited Sept. 1, 2011).

³⁶ The fraudulent conveyance statutes of many of the states are based upon the Uniform Fraudulent Conveyance Act, which is similar to the Bankruptcy Code fraudulent conveyance provision. The UFCA provides that a transfer may be voided if the debtor makes a transfer for less than fair consideration and is or is made insolvent, is left with unreasonably small capital, or believes that it will incur debts beyond its ability to pay. Insolvency exists under the UFCA when the present fair salable value of the debtor's assets is less than his probable liability on existing debts as they mature. See, e.g., <http://www.kslaw.com/imageserver/KSPublic/library/publication/2011articles/8-11NYLJSteinbergBoies.pdf> (last visited Sept. 1, 2011).

³⁷ The combination of the provisions of the loan agreements and the lender's subsequent inequitable conduct to the detriment of other creditors may lead to subordination of the lender's security interests and liens on equitable grounds by bankruptcy courts. Section 510(c) of the Bankruptcy Code codifies the existing case law on equitable subordination. See generally, http://www.kayescholar.com/news/publications/2004008/_res/id=sa_File1/Smolev2080420NYLJ.pdf (last visited Sept. 1, 2011).

- The creditor must be deemed to have had a fiduciary relationship with the debtor. A fiduciary relationship may arise if the lender exercises control over the target through such methods as holding a majority of its stock or managing its daily operations;
- The creditor must be engaged in inequitable conduct injurious to debtor's other creditors, i.e., the creditor must have misused its fiduciary relationship with the debtor. The basic question is whether the transaction was for the benefit of the debtor or for the benefit of the controlling person; and
- Equitable subordination must be consistent with the principles of the Bankruptcy Code.

RESEARCH AND DEVELOPMENT

A. Research and Development

1. Understand the industry's basic source of effective research and which organizations are dominant in providing data related to same.
2. Review industry expenditures for research and how the target's research expenditures compare.
3. Review the target's policy on research and development. Review the percentage of sales it has been spending on research and development, any significant new products under development and the known R&D activities of competitors.
4. Evaluate the target's technical activities and services by classification (e.g., contract, services, customer services, company R&D, manufacturing engineering, tool design, product engineering).
5. Review the current and proposed staffing and personnel requirements for each component of research and development.
6. Review the methods of authorization, funding and reporting for product engineering and target R&D, related to overall research plans and market requirements.
7. Formulate an opinion about the caliber of the research staff. Find out if the staff has dealt with long-term research as well as day-to-day product engineering.
8. Determine whether the research program actually produced any new products.
9. Assess the relationship of customer services to market activity, product sales and profitability.

10. Assess the type, condition and adequacy of engineering space and laboratories.
11. Determine whether proprietary rights on all products under development are adequately secured to the target.
12. List any patents and trademarks held or that have been applied for by the target.
13. Determine whether the target has protected its intellectual property rights in foreign as well as United States markets.
14. Review agreements under which the target is a licensee or licensor. Determine what the estimated royalties are.
15. Determine whether any key patents are held by equity holders, management or other individuals. Are the target's rights to these patents satisfactory?
16. Determine whether there are any infringement suits or claims outstanding.