

APPENDIX 8

ISSUES TO CONSIDER IN DUE DILIGENCE

CORPORATE STRUCTURE AND GOVERNANCE

(REVIEW DOCUMENTS AND INTERVIEW MANAGEMENT, BOARD, AND ADVISORS)

- ▶ What is the company's corporate structure? C corp., S corp., LLC or LP? Does this model allow for a liquidity event and/or return on investment?
- ▶ Is there an exit strategy?
- ▶ Is the corporate structure overly complicated? If so, why, and might it be simplified?
- ▶ How many existing shareholders? Too numerous, and, if so, why?
- ▶ Does the corporate structure fit with the business model?
- ▶ Does the corporate structure allow for growth?
- ▶ What is the founder share allocation? Do they have a large enough stake to have the incentive to succeed, but not so large as to ignore board and other advisors? Is the founders' stock vested over time?
- ▶ Who is on the board of directors? Do they have the right background for the company? Is there a sufficient number of outside directors? How are board members compensated?
- ▶ Does the company have a board of advisors and, if so, who is on the board? Do the advisors actively participate in the company's development? How are advisors compensated?
- ▶ Has the company been involved in any litigation or been threatened with litigation?
- ▶ Does the company have all required permits and licenses?

FINANCIAL ASSUMPTIONS AND REVENUE SOURCES

(REVIEW ALL FINANCIAL DOCUMENTS)

- ▶ Has the company completed one-, three- and five-year financial projections?
- ▶ Have the financial documents been properly developed according to applicable accounting rules?
- ▶ Has the company used an outside, independent accounting firm to compile, review, or audit financials?

- ▶ How good are the assumptions? (rate of growth, acceptance rate, pricing, multiple revenue streams, costs)
- ▶ Are revenues realistic?
- ▶ When does the company reach cash flow positive, and what cash requirements will it take to get there?
- ▶ Has the company already received funding, and, if so, how much; what are pre-money valuation and terms?
- ▶ What are the follow-on funding requirements and sources? Has the company properly anticipated future needs, and is it already working on those?
- ▶ Have all tax returns been properly filed?
- ▶ What is the company's debt carry? What are the ratios?
- ▶ Is the company's current valuation aligned with its current stage of development and market potential?

MARKET ASSESSMENT

(DO INDEPENDENT MARKET ANALYSIS AND REQUIRE CUSTOMER REFERENCES IF APPLICABLE)

- ▶ Does the company's product or service address a new or existing market?
- ▶ Is the product or service platform-based, with the opportunity for additional products or services? Or is this potentially a one-trick pony?
- ▶ Does the company have a well-thought-out sales and marketing plan?
- ▶ Does the company have key relationships in place, or is it working on the same, with marketing and/or sales partners?
- ▶ Does the company have or need key joint venture relationships?
- ▶ Is the company focused on the appropriate market development, or are they trying to do too much at one time?
- ▶ Have they chosen the right first market?
- ▶ Does their product or service represent a market push or pull?
- ▶ What is the potential market size?

- ▶ Have they conducted thorough market research to support their financial assumptions, revenue model, and valuation?
- ▶ What is their stage of development? Concept, alpha, beta, or shipping?
- ▶ If the company has already introduced its product or service into the market, what is the number of current and potential customers?
- ▶ What is the length of its sales cycle?
- ▶ What are the channels of distribution?
- ▶ Does the company's product or service have a seasonal aspect?
- ▶ Is this a stable market and are COGS stable?

COMPETITIVE ARENA (DO INDEPENDENT COMPETITIVE ANALYSIS)

- ▶ Who are the company's competitors?
- ▶ Has the company realistically assessed its competitors?
- ▶ What is the company's market differentiator? Is this enough to make them superior to competition from the customer's perspective?
- ▶ Is this a market or product consolidation?
- ▶ How entrenched are the competitors?
- ▶ What is the financial stability of competitors?
- ▶ What does the market share look like?
- ▶ How will this company win?
- ▶ Has the company done a detailed feature-by-feature analysis?

MANAGEMENT TEAM

(INTERVIEW ALL TEAM MEMBERS AND KEY EMPLOYEE REFERENCES)

- ▶ What is the caliber/pedigree of the team?
- ▶ What is the team's overall track record?
- ▶ Do they have the combined requisite skills and experience?
- ▶ Do they recognize limitations in management, and are they seeking candidates?
- ▶ Is the management open to discussion and suggestions on improvement to their business model?
- ▶ Has the management team been previously funded?
- ▶ How are management and all other employees being compensated?
- ▶ Does the company have an option plan, and have options been granted to all employees? What percentage do the founders have as compared to other key management?

TECHNOLOGY ASSESSMENT

(MAY NEED EXPERT OR PROFESSIONAL ASSISTANCE IN TECHNOLOGY ASSESSMENT)

- ▶ Do they have market requirements and functional specifications?
- ▶ At what stage is development? Concept, alpha, beta, shipping?
- ▶ Does the company have any usability studies?
- ▶ Does the company have adequate intellectual-property protection? Does it need it?
- ▶ Is the company relying on being first to market, rather than on any IP position, for competitive advantage, and is this realistic?
- ▶ What is product quality assurance like?

- ▶ Is it proprietary architecture or open-source code?
- ▶ Do they have adequate systems in place to identify and protect IP?
- ▶ Who in the company is focused on these issues?
- ▶ Has the company properly set up relationships and documentation to ensure ownership of all intellectual property?
- ▶ Does the company own all necessary intellectual property through internal development or licenses?
- ▶ Do any other companies have potential claims to the IP resulting from previous employment relationships or for any other reason?

OPERATIONS

- ▶ Does the company have an operating plan or outline of the same if early stage?
- ▶ Has the company considered all aspects of operation to successfully launch a product or service?
- ▶ Does the operating plan anticipate growth? Is anticipated growth realistic?
- ▶ Has the company received any citations or notices of violation?
- ▶ For more mature companies, does each division of the company have an operating plan, and are they compatible?
- ▶ Does management meet regularly to ensure compliance with plan or make needed adjustments?
- ▶ Has the company been able to stay on plan?
- ▶ Does the plan take into consideration all cash needs and anticipated cash flow?
- ▶ Does the company have an alternative plan if assumptions do not hold, such as for product rollout, cash needs, and market response?

COMPARABLES:

- ▶ Recent IPOs (10Ks, annual reports)
- ▶ Recent companies funded in this space
- ▶ Third-party (including government) databases, reports, publications, and market analysis
- ▶ Comparable financial models

WHAT TO WATCH OUT FOR:

- ▶ **Unrealistic valuation (or revenue model)**
 - ▶ Affects percentage ownership
 - ▶ Affects possible subsequent rounds
 - ▶ May end up with “down-round” on next financing
- ▶ **Complicated investment terms**
 - ▶ Preferred fine, but be careful of other complicated features such as rights of first refusal; onerous liquidation preferences; registration rights; no lock-ups; co-sale
- ▶ **Heavy debt**
 - ▶ New investment dollars should be used for advancing the company, not for paying old obligations
- ▶ **Missing key assumptions about market or financial model**
- ▶ **One-trick pony (one-product or -service company)**
- ▶ **No board per se**
- ▶ **Inexperienced management**
- ▶ **Poor advisors**

APPENDIX 9

DUE DILIGENCE CHECKLIST TABLE

The documents and materials itemized below constitute a list of materials which should be reviewed for any financing. Keep in mind that many early-stage companies will not have some or many of these documents, as certain events may not have occurred. Request should be made for all documents or disclosures listed below.

| TITLE OF SECTION AND SUBSECTION | DOCUMENTS REQUESTED | SHOULD HAVE | DATE RECEIVED | DATE DELIVERED | REVIEWER'S INITIALS | COMMENTS |
|---------------------------------|--|-------------|---------------|----------------|---------------------|----------|
| I. | General corporate materials (The Company, all subsidiaries, partnerships and joint ventures). | | | | | |
| A. | Business Plan , including executive summary, market analysis and plan, operational plan, and complete financials. | | | | | |
| B. | | | | | | |
| 1. | Minutes | | | | | |
| | Minutes of stockholders' meetings, including those of any predecessor corporations. | | | | | |
| 2. | Minutes of board of directors, including those of any predecessor corporations. | | | | | |
| 3. | Minutes of permanent committees of the board, including those of any predecessor corporations. | | | | | |
| 4. | Authorizing resolutions relating to this offering and related transactions. | | | | | |
| C. | | | | | | |
| 1. | Charter Documents | | | | | |
| | Articles or Certificate of Incorporation, as amended to date, including current drafts of pending charter amendments and recapitalization documents. | | | | | |
| 2. | Drafts of documents related to proposed reincorporation. | | | | | |
| 3. | Bylaws, as amended to date. | | | | | |
| 4. | Good standing (and franchise tax board) certificates. | | | | | |
| 5. | List of jurisdictions in which the Company or any of its subsidiaries or affiliates is qualified to do business, | | | | | |

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|---------------------------------|--|-------------|---------------|----------------|---------------------|----------|
| D. | Corporate Organization | | | | | |
| 1. | List of officers and directors. | | | | | |
| 2. | Management structure organization chart. | | | | | |
| 3. | Stockholders' lists (including list of optionees and warrant holders), including number of shares and dates of issuance, and consideration paid. | | | | | |
| 4. | Information regarding subsidiaries, i.e., ownership, date of acquisition of stock and/or assets, all closing binders relating to acquisitions. | | | | | |
| 5. | Information regarding joint ventures or partnership, i.e., partners, date of formation, all closing binders relating to joint ventures or partnerships. | | | | | |
| 6. | Agreements relating to mergers, acquisitions, or dispositions by the Company of its subsidiaries or affiliates of companies, significant assets or operations involving the Company or any of its subsidiaries or affiliates since inception, including those of any predecessor or subsidiary corporations. | | | | | |
| E. | Capital Stock | | | | | |
| 1. | Stock records, stock ledgers and other evidence of securities authorized and issued. | | | | | |
| 2. | Agreements relating to the purchase, repurchase, sale or issuance of securities, including oral commitments to sell or issue securities. | | | | | |
| 3. | Agreements relating to voting of securities and restrictive share transfers. | | | | | |
| 4. | Agreements relating to preemptive or other preferential rights to acquire securities and any waivers thereof. | | | | | |
| 5. | Agreements relating to registration rights. | | | | | |

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| 6. | Evidence of qualification or exemption under applicable federal and state blue sky laws for issuance of the Company's securities. | | | | | |
| 7. | Documents relating to any conversion, recapitalization, reorganization, or significant restructuring of the Company. | | | | | |
| II. | Litigation | | | | | |
| A. | Any litigation, claims, and proceedings settled or concluded, including those of any predecessor corporations and subsidiaries. | | | | | |
| B. | Any litigation, claims, and proceedings threatened or pending. Please include potential litigation—e.g., employees who may be in breach of non-compete agreements with prior employers. | | | | | |
| C. | Any litigation involving an executive officer or director, including executive officers or directors of predecessor corporations and subsidiaries, concerning bankruptcy, crimes, securities law, or business practices. | | | | | |
| D. | Any consent decrees, injunctions, judgments, other decrees or orders, settlement agreements, or similar matters. | | | | | |
| E. | All attorneys' letters to auditors, including those of any predecessor corporation and subsidiaries. | | | | | |
| III. | Compliance with Laws | | | | | |
| A. | Any citations and notices received from government agencies, including those of any predecessor or subsidiary corporations, or with continuing effect from an earlier date. | | | | | |
| B. | Any pending or threatened investigations and governmental proceedings. | | | | | |

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| C. | All material governmental permits, licenses, etc., of the Company presently in force, together with information regarding any such permits, licenses, etc., which have been canceled or terminated, required to carry out the business or operations of the Company or its subsidiaries or affiliates, including such permits, licenses, etc. required by foreign, federal, provincial, or local authorities, and any evidence of exemption from any such permit or license requirement. | | | | | |
| D. | All documents filed with the SEC or any state or foreign securities regulatory agency, if any. | | | | | |
| E. | Any material reports to and correspondence with any government entity, municipality or government agencies, including the EPA and OSHA, including those of any predecessor corporations or subsidiaries. | | | | | |
| IV. | Employee Matters (Including items regarding any predecessor or subsidiary or affiliated corporations and all items presently in force and drafts of any pending amendments or new items) | | | | | |
| A. | Employee agreements. | | | | | |
| B. | Consulting contracts. | | | | | |
| C. | Employee benefit and profit-sharing plans, including stock option, stock purchase, deferred compensation, and bonus plans or arrangements. | | | | | |
| D. | All other employee compensation, bonus, incentive, retirement, benefit (e.g., Life or health insurance, medical reimbursement plans, etc.), or similar plans. | | | | | |
| E. | Employee Confidentiality and Proprietary Rights Agreement | | | | | |
| F. | Officers and directors questionnaires. | | | | | |
| G. | Contracts with unions and other labor agreements. | | | | | |

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|---------------------------------|---|-------------|---------------|----------------|---------------------|----------|
| H. | Loans to and guarantees for the benefit of directors, officers or employees. | | | | | |
| I. | "Key person" insurance policies. | | | | | |
| J. | Listing of employees by office and department. | | | | | |
| K. | Affiliation agreements with advertising agencies or public relations firms. | | | | | |
| L. | Stock ownership of directors and of the five most-highly compensated officers. | | | | | |
| V. | Real Property | | | | | |
| A. | Deeds. | | | | | |
| B. | Leases of real property. | | | | | |
| C. | Other interests in real property. | | | | | |
| D. | Any documents showing any certification of compliance with, or any deficiency with respect to, regulatory standards of the Company's or any of its subsidiaries' or affiliates' facilities. | | | | | |
| E. | Financing leases and sale and lease-back agreements. | | | | | |
| F. | Conditional sale agreements. | | | | | |
| G. | Equipment leases. | | | | | |
| VI. | Intellectual Property Matters | | | | | |
| A. | List of all foreign and domestic patents, patent applications, copyrights, patent licenses and copyright licenses held by the Company. | | | | | |
| B. | List of any trademarks, trademark applications, trade names, or service marks. | | | | | |
| C. | Claims of infringement or misappropriation of others' patents, copyrights, trade secrets, or other proprietary rights. | | | | | |

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| D. | Copies of all agreements in-licensing or acquiring any technology, including without limitation software licenses, patent licenses, or other technology licenses, or any development or joint-development agreements. | | | | | |
| E. | Copies of all agreements out-licensing or selling any technology, including without limitation any software licenses, patent licenses, or other technology licenses, or any distribution, OEM, VAR or sales-representative agreements. | | | | | |
| VII. | Debt Financing | | | | | |
| A. | All debt instruments, credit agreements, and guarantees entered into by the Company, including lease financing, which are currently in effect. | | | | | |
| B. | All material correspondence with lenders, including all compliance reports submitted by the Company or its accountants. | | | | | |
| C. | Any loans and guarantees of third-party obligations. | | | | | |
| D. | Any agreements restricting the payment of cash dividends. | | | | | |
| VIII. | Other Agreements | | | | | |
| A. | Marketing agreements. | | | | | |
| B. | Management and service agreements. | | | | | |
| C. | Forms of secrecy, confidentiality, and nondisclosure agreements. | | | | | |
| D. | Contracts outside the ordinary course of business. | | | | | |
| E. | Indemnification contracts and similar arrangements for officers and directors. | | | | | |
| F. | Agreements with officers, directors, and affiliated parties. | | | | | |
| G. | Any agreements with competitors. | | | | | |

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| H. | Any agreements with governmental agencies or institutions. | | | | | |
| I. | Any agreements restricting the Company's right to compete or other agreements material to the business. | | | | | |
| J. | Any material insurance arrangements (including property damage, third-party liability, and key employee insurance). | | | | | |
| K. | Agreements requiring consents or approvals or resulting in changes in rights in connection with change-of-control transactions. | | | | | |
| IX. | Financial Information | | | | | |
| A. | Audited/Unaudited financial statements, including those of any predecessor corporations. | | | | | |
| B. | Interim financial statements. | | | | | |
| C. | Budget plan, including revisions to date with respect to the budget plan for the current fiscal year for the Company and its subsidiaries and affiliates. | | | | | |
| D. | The Company's long-range strategic plan, any other documents concerning its long-range plans, and any information concerning the Company's compliance therewith. | | | | | |
| E. | Disclosure documents used in private placements of the Company's or any of its subsidiaries' or affiliates' securities, or institutional- or bank-loan applications since inception. | | | | | |
| F. | Any other material agreements with creditors. | | | | | |
| G. | Significant correspondence with independent public accountants, including management letters. | | | | | |
| H. | Any reports, studies and projections prepared by management on the Company's or its subsidiaries' or affiliates' business, financial condition, or planned operations, including business plan. | | | | | |

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| I. | Any reports and studies prepared by outside consultants on the Company's or its subsidiaries' or affiliates' business or financial condition. | | | | | |
| J. | Reports and materials prepared for the Company's board of directors or a committee thereof. | | | | | |
| K. | Contracts with investment bankers and brokers. | | | | | |
| X. | Tax Matters | | | | | |
| A. | Federal, state and local tax returns, including those of any predecessor corporations. | | | | | |
| B. | Audit adjustments proposed by the IRS. | | | | | |
| XI. | Acquisitions/Divestitures | | | | | |
| A. | Acquisitions or divestitures (including related documentation). | | | | | |
| B. | Current plans or negotiations relating to potential acquisitions or divestitures. | | | | | |
| XII. | Public Relations | | | | | |
| A. | Annual reports and other reports and communications with stockholders, employees, suppliers, and customers. | | | | | |
| B. | Advertising, marketing, and other selling materials. | | | | | |
| XIII. | Press Releases and Clippings | | | | | |
| A. | Analyst reports. | | | | | |
| XIV. | Miscellaneous | | | | | |
| A. | Supply copies of all market research or marketing studies concerning the Company's business conducted. | | | | | |
| B. | Significant agreements currently in draft stage. | | | | | |