Steve O'Rourke's

Counselor's Corner

Corporate Law Issues and Answers

In this issue, corporate attorney Steve O'Rourke demystifies "Due Diligence."

In the "Crash of 2008," some of the world's biggest banks, hedge funds, the super rich and famous, pensions and charities all wish they had been more careful with their investments. Our concept of due diligence has origins in the Crash of 1929, and today it has broad meanings. What we once called "post-Enron" is now "post-Lehman" and "post-Madoff," with more expected to come. Investors need to learn due diligence basics. Expect directors, officers and professional experts to know and conform to high standards relating to any issuance, report, audit, merger, acquisition, debt finance or reorganization. In the micro-cap market, investors and corporate leaders are likely to influence the scope and budget of due diligence. Unfortunately, the greatest need for due diligence often arises in the micro-cap market, in which even people with integrity can fail to follow proper due diligence practices.

The due diligence concept arose from legislation making it painfully expensive for underwriters, directors, officers, accountants and other experts to fail to act as required. The New Deal's federal securities statutes required issuers to file with the SEC a registration statement that includes an informational prospectus. The theory is that investors need information that is true, materially complete and not misleading. The same concept applies to annual or quarterly statements or proxy statements. Many disclosure requirements also apply to unregistered securities, with the scope of information varying by the circumstances. These circumstances include company size, sophistication of offeree and his relationship to the company and the nature, scope, size, type and manner of the offering. For unregistered securities, the issuer might provide the investor a "private placement memorandum", a "circular", or nothing.

These legal requirements have teeth because securities laws (federal and state) impose significant liability on offenders. Of course, not everyone is *absolutely* liable to investors; the law provides certain defenses to civil liability. With respect to registration statements, Section 11 of the Securities Act of 1933 provides one such defense for non-issuers who held reasonable

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beliefs after having conducted a "*reasonable investigation*." The attempt of professionals to meet that standard became known as conducting due diligence and, in that context, did not apply *to investors* but rather was a defense to be asserted *against investors* or governmental enforcers. Due diligence is not defined in the statutes, and SEC Rule 176 and judicial opinions are of little help beyond requiring the care of a "prudent man in the management of his own property". Other SEC rules acknowledge that due diligence requirements differ, depending on the type of issuer, the types of security and what's reasonable when the person depends on statements from officers and employees. Case law does tell us that due diligence certainly requires digging beyond the "facts" appearing in statements by company officers and in company documents. It requires detailed examinations to verify those statements and, further, to investigate generally the company's affairs to determine whether the scope of disclosures includes all information that a reasonable investor would likely consider important to his investment decision.

Over time, "due diligence" has come to mean any investigation by any party into a company, fund, borrower or "partner" in any financial transaction. In this context, due diligence is not limited to the application of statutory securities liability and defenses. Rather, it describes similar probing, *in this case by the investor*, beneath the information given by the other parties. It translates into to having street-smarts, making an effort, allowing enough time, and remaining alert. The lesson from the Madoff scandal is not that we need more governmental regulation but rather is that we each need to be careful before we invest.

For example, in the context of someone buying out your small-cap company, think of due diligence as the final investigation before closing. At the earlier stages, the parties will have preliminary discussions to determine mutual interest. Each will review public information about the other. After signing a non-disclosure agreement, the parties will reveal confidential information to determine if the dance should continue. Then, perhaps after a non-binding letter of intent, the parties will begin their due diligence. The term simply means that both parties continue to deliver and verify information and conduct interviews. Because due diligence is time consuming and expensive, the definitive merger or stock sale agreement will often be signed before due diligence is complete. If so, the final closing will be subject to satisfactory results of the due diligence work. Sadly, this due diligence phase is often the first time that accountants, attorneys and other experts will be called in. Those professionals will each follow what they think is required by law.

As an investor, you should not treat due diligence as something done solely to comply with laws. You as an investor want more and should lead your own investigation. Your due diligence should address your sound business objectives:

1. Verify the company's statements and corporate documents. In the micro-cap world, the company might not have the desire, budget or expertise to assure full compliance with law and best practices relating to corporate

governance, intellectual property, employment, competition, stock plans, environment, export, tax, insurance, reporting regulations, licenses, leases, international operations, etc. Have a corporate law expert review all company organizational documents, stock issuances, board minutes and key contracts, licenses, patents, etc. You should also learn the rules about "internal controls over financial reporting" for public companies. And are good guidelines for private companies.

2. Verify risk matters beyond corporate documents, such as the industry's future and the company's projected market share and the basis on which such projections are made.

3. Compare the company's historical financial results to competitors'. Whatever the results, find the explanation. Ratios that are out of line with the industry can mean good management, good luck, or bad accounting. Creative accounting can cook the books, albeit in legal ways. Watch for inventory "channel stuffing", "big bath write downs", off-book operations, profit realization violations, "transfer pricing", and capitalization/expense allocation abuses.

4. Establish multiple bases for key facts. Investigators will interview officers, directors and key personnel. Because experts' opinion letters can be forged, experts ought communicate directly with other experts. Public documents will be accessed directly. It's all part of playing devil's advocate.

As a micro-cap investor, expect your company to know and follow the standards that acquirers, underwriters and regulators will expect of your company. The process must be performed eventually, so try to get the benefits now and attract attention by demonstrating that due care has been taken well before any financial transaction. It may also uncover problems; if so, seek competent legal advice to understand who might be liable to you for consequent losses.

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