



Business Focus | Startup

An Essential Guide to Preparing Your Startup for a Legal Due Diligence Process

Every startup aspires to become a “unicorn”, where the business is valued to achieve over USD 1 billion. However, the path for startups to reach the unicorn status is a bumpy road and to achieve that success, funding becomes a critical element that provides the company the resource to continuously conduct its products/ services development and expand its business.

While obtaining funding is an uphill task itself, one of the most crucial ingredient to obtain funding is the Legal Due Diligence (“LDD”).

What is Legal Due Diligence?

LDD is the process of gathering, understanding and evaluating all legal risks prior to an investment or funding by the investor. The investor conducts LDD to fully understand the benefits and risks for the investment. Prior to the LDD, the potential investor would provide to the business the “Term Sheet”, a document consisting of the framework and key terms that are set up for negotiating in the final definitive agreements such as share subscription agreement and shareholders’ agreement.

Conversely, LDD keeps and prevents startups from conducting non-compliance activities and take effective measures to prevent such conduct.

At every funding stages listed below, LDD is required.

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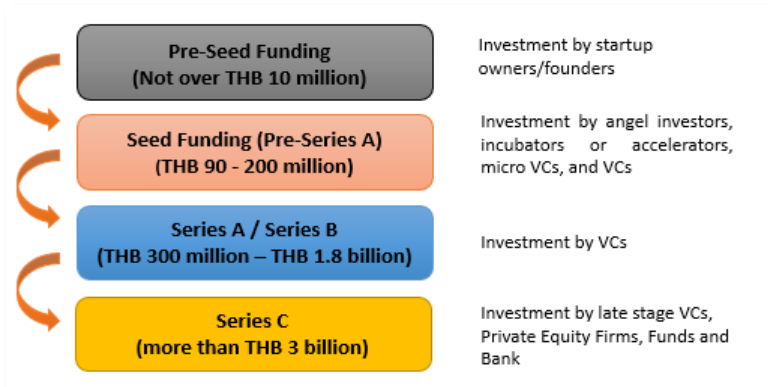
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Before conducting LDD, a startup will enter into the Term Sheet with investors, which is a non-binding document that indicates the proposed terms and conditions of a potential transaction. Key terms of the Term Sheet are generally comprised of provisions on the proposed transaction and valuation, investment instruments, investment considerations, pricing of shares, the condition precedent to closing, share transfer restriction, representations and warranties, drag-along or tag-along rights, exclusivity period, due diligence, non-compete agreement, confidentiality, anti-dilution, governing law, and other relevant provisions.

Once the Term Sheet is finalized, LDD will commence. In this stage, the investors will request to have a face-to-face meeting with founders of the startup and may typically request for a large number of documents that must be carefully examined as follows:

- **Company information:** Stage of business, products, financial and market plan, operation, potential customers and suppliers.
- **Corporate documents and shareholding structure:** Memorandum, Articles of Association, records of all minutes of board meetings and shareholder meetings for the last three years, list of shareholders, share register book, share certificate, and any tax registration.
- **Financial documents:** Audited financial statements for the last three years, recent unaudited financial statements, documents relating to banks or other lenders including financing documents and loan documents.
- **Material agreements:** Material agreements that might adversely affect the transaction i.e. partnership agreement, agreement on supply, maintenance, sale and purchase of

goods, lease agreement, licensing and franchise agreement, and other operating agreement of the business.

- **Assets:** Documents relating to properties and intellectual property-related i.e. trademarks, copyright and patents, immovable property and movable property, and inventory.
- **Permits and licenses:** All licenses including permit, certificate, approval and application issued to a company.
- **Human resources:** Total number of employees, employment agreements including employee entitlements, health benefits and welfares, work rules, HR policy, work permits, and current labor disputes.
- **Insurance:** Insurance policies such as employee health insurance and asset insurance.
- **Litigation:** Pending litigation by or against the company, or any potential litigation, arbitration or investigation, and insurance program that covers liabilities of the company.

When completing the LDD, the results obtained will determine the decision making of all investors, which will directly impact the valuation of the startup.

Considerations

We have highlighted the following common issues that we have previously encountered, which should be taken into consideration when preparing the LDD:

- **Growth:** All investors wish to deeply understand the company's markets and products, and ensure that such startup can grow and, in return, offer strong earnings growth to investors.
- **Incomplete documents:** When a startup cannot provide documents evidencing the registration of the company, share register and share certificate, tax documents, or any other past records, investors become weary amid uncertainty. Lacking such documents may create distrust and startup appearing less credible. Hence, startup should ensure that all documents are properly recorded since the start of its business operation.

- Permits and licenses: Startup fails to apply for relevant licenses and fails to comply with licensing requirements. Also, permits and licenses are not renewed within a specified period of time.
- IP assignments: Technically, the investor wishes to ensure that the ownership and rights of work product created by any employee is properly transferred to the company.
- Loan transaction: As investors wish to ensure that loans do not have legal risks, loan transactions from either directors, employees or external sources must be evidenced in official forms as stipulated by the law.
- Human resources: Work rules that are not in compliance with Thai law including the hiring of foreign workers that do not have a legal work permit needs to be addressed and rectified.
- Litigation: There are lots of pending litigation and arbitration, which put the business at risks.

While tedious, LDD is a process that will help ensure preparedness and maintain transparency, which is highly significant for startups as it helps to ensure the credibility of the startup allowing investors to critically assess the business and be fully informed of their investment before it can consider entering into any transaction with any investors or even listing it in the capital market.

As we are one of the pioneers in providing not only legal expertise but pragmatic business solutions to startup companies, please contact our Startup team at Kudun and Partners for further information.

About Us

Startup Practice

We were one of the few law firms that have a retainer with DTAC ACCELERATE, the number one start up accelerator house in Thailand. To date, we have set up over 40 legal entities under this program alone. We are well equipped to assist startups on all aspects of the incorporation process, including:

- ✓ preparing relevant applications;
- ✓ government filings;
- ✓ constitutional documents;
- ✓ corporate resolutions;
- ✓ minute books;
- ✓ share register books;
- ✓ share certificates; and
- ✓ all other deliverables relating to the incorporation process.