

# W H I T E P A P E R

## Reducing Investment Risk with Software Technology Due Diligence

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### **About the Author**

Programmer, Entrepreneur, CEO, Consultant – Charles Mills wrote a successful software product, started and managed a profitable software company, cashed out, and worked for four years from the other side of the table assisting the acquirer in buying software companies. Now he uses a unique combination of technology, business, and financial experience to help acquirers, lawyers, executives, and investment bankers avoid undue risk with software technology due diligence.

This white paper describes Mr. Mills's methodology for software technology due diligence.

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“Risk comes from not knowing what you’re doing.”  
– Warren Buffett

## Executive Overview

Due diligence – informally defined as “making sure you get what you pay for” – is important in virtually every financially significant transaction. To avoid undue risk in a transaction involving software assets, specialized software due diligence skills and a systematic software-specific methodology are essential. This paper describes a methodology and the skills necessary for software technology due diligence to reduce investment risk.

## Do You Need Software Technology Due Diligence?

If you are responsible for an investment in or a loan to a software technology company, an acquisition or merger involving software technology assets, or a strategic partnership with a software company – then you need to understand software technology due diligence. You need this understanding if you are an executive with overall responsibility for investment management and transactions, or if you are the manager, attorney, or staff member who will actually conduct due diligence.

Without software due diligence, you could acquire a company that was about to be bankrupted by a patent infringement suit. A client of ours *almost* acquired just such a company. Does your acquisition target actually own “their” software? We worked with a client that *almost* acquired a

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Software technology due diligence is not limited to “classic” transactions such as acquisitions and venture investments. If you work for a large manufacturing company about to sign an enterprise-wide license with a small software company, wouldn’t you like to know if you are in danger of exposing your company’s confidential information on the Web? If you are a software vendor contemplating the resale of an add-on package for your customers, shouldn’t you know whether the developer of the add-on has the ability to maintain the software to your customers’ satisfaction?

## Who Will Conduct Software Due Diligence?

We assume that anyone involved with software due diligence will have a general knowledge of software, software development, and the software business. Anyone who will actually conduct software due diligence needs a detailed knowledge of software development and maintenance, an ability to communicate with software developers, and a general knowledge of software legal and marketing considerations. (This is a combination of skills that can be difficult to find in one person or one small team.) As a former programmer who then managed programmers for more than ten years, the author wants to emphasize how critical it is

that anyone conducting due diligence be able to engender trust with developers and understand the “programmer culture.”

For simplicity’s sake, we will refer to the target of the transaction as the “company.” The potential investor, lender, acquirer, or partner will be referred to as the “investor,” and the person or persons conducting due diligence as “you.”

## Your Goal in Due Diligence

Your goal as you conduct due diligence is the same as the investor’s: you both want a profitable transaction, free from hidden risks and surprises. However, as you may be a third-party consultant, or an employee of the investor’s firm who is somewhat removed from the investment manager responsible for the deal, we will treat you (the person conducting due diligence) and the investor as distinct entities.

Software due diligence must be approached with thoroughness and a certain degree of skepticism. Remember, however, that the role of due diligence is not to kill deals; it is to support fully informed decision-making.

## Due Diligence at a Glance

Legal definitions of due diligence say something like “due diligence is a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent person under the particular circumstances; not measured by any absolute standard but depends on the relative facts of the special case.” In plain terms, to an investor, due diligence means “making sure you actually get what you think you are paying for, and making certain that there are no hidden problems.”

Due diligence is a significant part of nearly *any* substantial transaction, including real estate investments and any business acquisition or investment, for both

technology and non-technology businesses. For any business investment, due diligence includes obtaining a disclosure of and fully understanding all of the assets and obligations of the company: debts, bank accounts, patents and trademarks, pending and potential lawsuits, leases, insurance, warranties, customer agreements, employment contracts, and so forth. The usual method of obtaining this information is for the investor to present to the company a list<sup>1</sup> of the information required. The company is then responsible for providing the information well in advance of the expected closing date of the transaction. The investor typically has its attorneys and others review the supplied documentation, and then “dig deeper” as indicated.

Real estate, equipment, fixtures, cash, and similar “hard” assets are often called Tangible Assets. Software, patents, and similar items are called Intangible Assets.

## The Methodology

This paper presents a methodology for the due diligence tasks particular to transactions involving significant software technology assets. We do not address “general” (sometimes called “legal”) due diligence beyond the brief summary in the preceding section.

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For software and other technology company transactions, due diligence typically includes verifying the status of patents, trademarks, and copyrights (both those of the company and those of others possibly infringed by the company). These areas of due diligence – *especially* patents – may require very specialized legal expertise. **This paper provides suggestions for finding “red flags” but it is not a substitute for appropriate legal advice.**

The methodology is equally relevant to all types of software – enterprise, small business, personal, entertainment, etc. –

and all computing platforms, from gameboxes to mainframes.

It should go without saying that software is typically among the most valuable assets in a software company transaction. “Old-fashioned” tangible assets – capital equipment, cash, real estate, receivables, and so forth – may be minimal in small and medium-sized software companies. The prices paid for software companies are often driven primarily by the companies’ intangible assets such as intellectual property, know-how, and people. These are the assets that we will address.

### What Type of Transaction?

Your emphasis while conducting due diligence will vary depending on the type of transaction contemplated. If the investor is a software company intending to integrate the company’s development team with its existing group, then the cultural fit of the development staff is important. If the investor’s primary interest is financial, then culture may be less important, except for avoiding major clashes – for example, if the investor is a defense contractor and the developers are pacifists! In this sort of financial transaction, however, developer retention after the transaction would be key. As various areas of due diligence are introduced, we will point out their relative importance in various types of transactions.

Not every factor discussed here is even relevant to every transaction; we try to err in the direction of thoroughness. You should decide which factors are relevant to

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your transaction. A negative answer to any one question – *other than a significant problem with clear title to intellectual property* – is probably not a deal-killer. You should include all negative factors, however, so that the responsible executive can decide whether to kill the deal, *use the information in negotiations*, or flag the problem area for attention after the deal closes. The relevance of some factors will depend on the form of the product. For software with a significant license fee and paid support contracts, the lack of a formal support incident tracking system is a red flag. On the other hand, a list of open bugs on a whiteboard may be adequate for a \$39 retail product.

Before starting, you should understand the nature of the transaction, not just its financial form (investment, acquisition, strategic partnership, etc.) but also the “why.” Is the investor looking for a strategic fit with other technology, for a significant financial gain, or to get a “foot in the door” in a new area of technology? You should understand the investor’s expectations with regard to the company and the technology:

- Is there supposed to be an existing, marketed product set, or is it “futures” technology? If the product is not yet marketed, when does the investor expect that it will be? You will be looking for any mismatch between expectation and reality; for example, if the investor believes that the company will have a marketable product in a few weeks, but the developers are talking in terms of months or years.

**This introduction is only about a third of the full white paper. A complete copy may be requested by visiting [StrategicDueDiligence.com](http://StrategicDueDiligence.com).**

<sup>1</sup> A sample list of general due diligence documentation for a software company transaction may be found at [CharlesMillsConsulting.com/ConsultingDownloads.htm](http://CharlesMillsConsulting.com/ConsultingDownloads.htm).