

# Fundamentals of Due Diligence

## Review of Basic Corporate Records for New Jersey Transactions

by Gianfranco A. Pietrafesa

**D**ue diligence refers to the investigation of the affairs of a company involved in a corporate transaction. One aspect of due diligence is the review of corporate records. This type of due diligence is done for several reasons.

One reason is to learn about the company through the review of its corporate records. Another is to identify problems with the company's corporate status that may well affect the transaction.

Due diligence of corporate records is also done to verify the accuracy and completeness of the representations and warranties to be made in the transaction documents. The information disclosed during due diligence may identify exceptions to certain representations and warranties. Likewise, due diligence provides support for the opinions to be given by counsel.

Typically, both the buyer and the seller will undertake some level of due diligence investigation of corporate records. The buyer wishes to learn about the seller and to identify problems. Likewise, the seller will often perform due diligence on its own corporate status to enable it to make the required representations and warranties. In addition, the seller may undertake a similar due diligence investigation of the buyer, especially when the consideration to be paid to the seller consists of the buyer's stock or a promissory note.

For purposes of illustrating these issues, this article will assume the

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buyer is making the due diligence investigation.

### DUE DILIGENCE REQUEST

Due diligence begins with the buyer requesting documents and information from the seller. Sometimes, the seller may have already gathered all of the pertinent documents and placed them in a *data room*. If so, the buyer may still request additional documents and information not present in the data room.

There are a number of forms available setting forth comprehensive lists of documents and information for review. Forms have their purpose (e.g., as a checklist or as a starting point); however, do not be a slave to a form. Instead, tailor it for your particular transaction. Carefully review and revise a form to prevent embarrassment, misunderstanding and wasting time.

A very basic list of documents to request for a due diligence review of corporate records includes the following:

1. Certificate of incorporation and all amendments and restatements
2. Bylaws
3. Minute book, including minutes of meetings, resolutions and

written consents of the board of directors and shareholders

4. Stockholder agreements and other comparable agreements
5. Stock records, such as a stockholder list and the stock transfer ledger
6. List of jurisdictions where the company does business or has property

The proposed representations and warranties in the transaction documents and the opinions in the legal opinion letter must be considered when drafting a due diligence list, especially in light of the possible liability of the parties and counsel for misrepresentations, breaches of warranty and incorrect opinions. A review of the typical representations/warranties and legal opinions on corporate matters is therefore warranted.

### REPRESENTATIONS AND WARRANTIES

Transaction documents will normally include representations and warranties by both the seller and the buyer. Both seller and buyer typically make representations and warranties about corporate status. Standard representations from the American Bar Association Model

Asset Purchase Agreement include:

### 3.1 ORGANIZATION AND GOOD STANDING

Seller is a corporation duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, and to perform all its obligations under the Seller Contracts. Seller is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the activities conducted by it, requires such qualification ....

Here is a summary of the general meaning of the foregoing provisions:

*Seller is a corporation* — This simply means the company was and continues to be incorporated. It does not mean it was incorporated on a specific date and in accordance with the law.

*Seller is duly organized* — This means the company complied with the corporate statute in effect at the time of incorporation, as well as at the time of any amendments. It also means the company has complied with its certificate of incorporation and bylaws. For example, the company properly held its first meeting of the board of directors, adopted bylaws, elected officers and issued stock.

*Seller is validly existing* — This means the company is still in existence. In other words, it has not ceased to be a corporation due to, for example, a dissolution, merger or consolidation.

*Seller is in good standing under the laws of the state of New Jersey* — This means the company is entitled to receive a certificate of good standing with no qualifications from the treasury department. For exam-

ple, the company has filed its annual reports and paid its annual fees.

*Seller has full corporate power and authority to conduct its business, to own or use its properties and assets, and to perform all its obligations under the transaction documents* — This means the company has the legal capacity to conduct its business and own its property and assets: a) under the corporate law of New Jersey, b) under the corporate law of any other jurisdiction in which it owns property or does business, and c) under its certificate of incorporation and bylaws. It also means it has the corporate authority to perform its obligations in the transaction documents through proper corporate action as memorialized in minutes of meetings, resolutions or written consents of the board of directors, the shareholders, or both, as appropriate.

### OPINIONS IN OPINION LETTER

The opinion of counsel will often include opinions that mirror these representations and warranties. Opinion No. 2 in the letter opinion of seller's counsel attached as Exhibit 7.4(a) to the ABA Model Asset Purchase Agreement provides:

Seller is a corporation ... duly organized, validly existing and in good standing under the laws of [its state of incorporation] with corporate power and authority to execute and deliver the Agreement and consummate the Contemplated Transactions and is duly qualified and in good standing as a foreign corporation in each other jurisdiction in which it is authorized to do business ....

The documents and information requested must be reviewed to verify the above representations and warranties on corporate matters [redacted] made by the seller and [redacted] the legal opinions on corporate matters [redacted] issued by counsel.

### CERTIFICATE OF INCORPORATION

First, counsel should review the certificate (or articles) of incorpora-

tion and all amendments and restatements. In addition to the documents provided, one should request certified copies of these documents from the Department of the Treasury (formerly, the secretary of state) to be sure to have everything. Small companies frequently misplace such documents.

Counsel should also request a certificate of good standing (long form) from the treasury department. This will disclose whether the company has filed its annual reports and paid its annual fees. If it has failed to do so for two consecutive years, the treasury department will revoke its certificate of incorporation. If the certificate is not reinstated in a timely fashion, the corporation will be considered dissolved by operation of law.<sup>1</sup>

The purpose of reviewing these documents is to verify they comply with the corporate statute. Counsel should note any important or unusual provisions that may affect the transaction. For example, rights and preferences of various classes of stock, special voting requirements and provisions regarding actions of the board of directors may all affect how the transaction must be approved.

Counsel should also review the corporate statute that was in effect at the time of incorporation, as well as versions of the statute that were in effect at the time of any amendments or restatements. A fact as simple as the date of incorporation can be very important in a merger sale of a corporation's assets. For example, unless otherwise provided in the certificate of incorporation, a corporation organized prior to January 1, 1969, must obtain the approval of two-thirds of the shareholders for many transactions.<sup>2</sup>

### BYLAWS

Next, the bylaws of the corporation should be reviewed to determine whether there are any provisions that may affect the transaction. It is also important to remember that some governance

provisions may be included in the bylaws *instead of* the certificate of incorporation.<sup>3</sup>

Counsel should verify the bylaws provided are those approved and adopted by the corporation by review of the relevant minutes, resolution or written consent adopting the bylaws. The secretary of the corporation can also provide a written certification confirming this.

Counsel should also review the bylaws to verify they comply with law and with the certificate of incorporation. The bylaws must not contain provisions inconsistent with provisions contained in the certificate.

The bylaws must also allow for governance of the corporation in a manner consistent with approval of the transaction.

#### **MINUTES, RESOLUTIONS AND WRITTEN CONSENTS**

Counsel should also review the corporate minute book to determine whether the actions taken by the directors and shareholders comply with the certificate of incorporation, the bylaws and applicable law. The minute book should include notices of meetings, minutes of meetings, resolutions and written consents of both the board of directors and the shareholders.

These documents should provide context of prior material corporate transactions and matters, such as officer employment agreements, collective bargaining agreements, pension plans, loans, acquisitions, and other transactions involving officers, directors or shareholders. For any meetings involving matters material to the pending transaction, counsel should verify that the meetings followed the requirements of the corporate statute, the certificate of incorporation and the bylaws. For example, one should verify the meetings were properly noticed; minutes, resolutions and written consents were properly signed; a quorum was present at the meetings and votes were recorded.

If these documents reference a prior transaction or matter material to the pending transaction, counsel should request and review the documents that relate to such matter as part of the due diligence investigation. For example, if the minutes reflect the approval of a license of incorporation, intellectual property, counsel should request a copy of the agreement.

Counsel should also verify, among other things, that officers and directors were validly elected and that stock was properly authorized and issued.

A small corporation may not have recorded minutes or kept records for resolutions. In such an event, counsel should obtain an officer's certificate for a board or shareholder meeting explaining why the minutes or resolutions of a particular meeting are unavailable and identifying any material action properly taken at such a meeting. If counsel cannot verify that certain material matters were formally approved, he or she can request that such matters be formally ratified by new action of the board of directors or shareholders, as appropriate.

#### **STOCKHOLDER AGREEMENTS**

Shareholder agreements, voting trusts, voting agreements or other comparable agreements should be reviewed to determine the existence of any restrictions on stockholders' ability to sell their stock or vote their shares. These documents may include, for example, provisions concerning rights of first refusal, restrictions on the transferability of stock and super-majority voting.

#### **STOCK RECORDS**

The corporation's stock records, including the list of stockholders and the stock transfer ledger, should be reviewed to determine the number and identity of stockholders, the number of shares owned by each stockholder and how the stockholders received their shares. Counsel must also review records

of transfers, cancellations and exchanges of stock.

Counsel should verify the total number of authorized, issued and outstanding shares, and that the shares have been properly authorized and issued by the corporation, that the shares were issued in exchange for valid consideration and that they are fully paid for and are non-assessable. You should also determine that cancelled shares have been properly recorded as such by the corporation.

#### **QUALIFICATION TO DO BUSINESS IN FOREIGN JURISDICTIONS**

Counsel should determine where the corporation owns property and does business. This information should be obtained from the officers of the corporation, and supported by a certificate from the appropriate officer. Counsel should then review the laws of these foreign jurisdictions to determine whether the corporation must be qualified to do business in the jurisdiction and, if so, whether it is so qualified.

#### **CONCLUSION**

A careful review of corporate records, and thoughtful discussions with management, will provide counsel with the information to: a) correct any problems with the corporate status, b) confirm that the transaction has been properly authorized, c) support the customary representations and warranties in the transaction documents or provide a basis for an exception, and d) support related legal opinions. ■

#### **ENDNOTES**

1. See N.J.S.A. 14A:4-5(5) and 14A:12-1(1)(g).
2. See N.J.S.A. 14A:10-3(2) and 14A:10-11(1)(c).
3. N.J.S.A. 14A:2-9(3).

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