Due Diligence Post 9/11 & Enron Must Dig Deeper

By Christopher T. Marquet, CEO, Marquet International

It's time to raise the bar on due diligence. In addition to being extreme examples of terrorism and fraud, the World Trade Center catastrophe, Enron debacle and other recent major accounting scandals have hoisted bright red flags that should drive corporate leaders to take a hard look at who they're *really* doing business with.

Many money-chasing deals that fueled the last burst of growth were closed at a fast and furious pace, with corporate leaders impatient to sign the joint venture agreement, finalize a new distribution arrangement or get a new employee on board. They frequently ignored major liability risks—a familiar dilemma for corporate counsel—and rushed headlong into business relationships with people they didn't know well and into situations where they didn't have all the facts.

Feeding every in-house counsel's nightmare, those executives often short-circuited due diligence cycles and bypassed the rigorous business intelligence investigations designed to reduce risks arising from business decisions based on incomplete or misleading information. They often rationalized their decisions not to conduct a thorough background investigation of a business partner or employee this way: "It's not worth the cost." Or, "I now know these people, and they're fine."

Today's less-secure, global business climate, with its burgeoning, sophisticated cross-border deals, has never been more complex and risky, and investigative due diligence has never been more vital—especially since CEOs now bear liability for their firms' conduct. Moreover, with the sweeping corporate reform bill stepping up pressure on lawyers to report evidence of fraud and other misconduct, corporate executives must push for more effective due diligence.

They need solid facts from independent sources to provide reassurance that their company's activities and those of their business partners are fully above-board. We're all familiar with the recent WorldCom, Adelphia and Global Crossing disasters. But fraudulent accounting practices, failure to detect unsavory backgrounds, weak competitive positions, undisclosed regulatory problems and other serious issues are neither restricted to big companies nor always obvious. Some cautionary tales:

- A new internet search engine, eager to recruit a seasoned CEO who could open doors and raise capital, "fell in love" with the "perfect candidate." Impressed with his résumé, high energy and sharp mind, the young executives bypassed recommended—but time-consuming—due diligence. However, the blush of romance faded fast. His "intimate" industry sources had never heard of him, and it soon became clear he'd exaggerated his experience, lied about his age and fabricated accomplishments. The new CEO was soon gone, but the executives' confidence was shattered and shareholder's trust in their decision-making ability was tarnished.
- Wanting to divest itself of one of its divisions, a corporation found the asset's value dropping as a new competitor began to underbid. Investigative due diligence revealed that senior employees had established the

competitor. They were leaking bids to the new company, planned to buy the division at a low price and then "merge" the competitor into the new firm. Armed with this information, the company took civil action against the employees, protected their rights and recovered losses.

Not all due diligence investigations produce such dramatic outcomes. But they do have a common goal: to reduce risk by providing accurate, timely, carefully assessed intelligence that enables companies to make more informed strategic and operating decisions.

The classic SEC-mandated due diligence process can be woefully inadequate. Of course, in accordance with legal requirements of securities legislation, public records must be scrutinized, references checked and financial statements, investment records and tax returns analyzed. But that's not nearly enough.

Modern due diligence digs deeper and wider, going well beyond public records, conversations with bankers, lawyers and accountants, and "meeting and greeting." It casts a wide net to capture information on financials, management, strategic direction, competition, customers, vendors, marketing plans, human resources and matters pertaining to reputation, ethics and integrity. Whether the deal involves a complicated international joint venture or merger and acquisition, activities of competitors and vendors, the recruitment of a CEO or even staff employees' behavior, contemporary due diligence provides strategically important information that is not readily available.

Skilled business intelligence investigators don't trust résumés (more than one third are "embellished" with falsehoods and carry "sins of omission"), don't rely on references (most are only positive) and don't limit their searches to public records. Delving deeper, they *verify* basic public information such as business and litigation history, banking relationships, educational credentials, professional background, social security number(s) and even names and addresses.

They also, ask hard questions of their clients and of people who have, or have had, relationships with the object of the investigation: litigant adversaries, business associates, employees, clients, vendors, industry sources, journalists and even neighbors.

Questions include:

- **Are the key people who and what you think they are?** (Have they ever used aliases? Do they have integrity? Are they ethical? Are they living beyond their means? Are they in debt? Do they have a criminal background? What vices do they have? Do they have undisclosed business relationships? Who are their social and political connections? Are they being cooperative and are their explanations verifiable?)
- **Have forensic accountants looked at the financials and business controls?** (Who are their auditors? Are they accurate, reliable? Have they overstated assets and revenues? What does profitability really look like? Do they have unrecorded and understated expenses? What are their funding sources? Are the reserve numbers accurate?)
- **Are there hidden issues?** (Are projections unrealistic? Have they had significant litigation? Do they have undisclosed liabilities, liens or judgments? Are there regulatory problems, such as hidden environmental

liabilities? Are there hidden ownership interests, management issues, misrepresentations of facts? Are there gaps in the information or resume?)

- **Has an independent competitive assessment been conducted?** (What do their customers think about them? What is their true market share? Will their key sources of competitive advantage be maintained? Will other factors, such as new technology, affect their competitiveness?)

It's even more important—and more difficult—to conduct effective due diligence for international business transactions. When dealing with foreign companies, settling for less than optimum intelligence increases the risk of falling prey to investment scams, phony companies and other forms of fraud. Potential business partners come from unfamiliar settings and cultures; they have different approaches to legalities, financial niceties and the exchange of "private" information. Reducing the risks inherent in complex international business ventures requires due diligence provided by experts in specific regions, countries, industries, geopolitical issues and other specialized areas.

The consequences of inadequate due diligence today are grave and can include:

- **Significant fraud** – Vendor fraud, financial shenanigans and other accounting irregularities may lead to a wide range of problems from criminal investigations to bankruptcy.
- **Asset devaluation** – Partners may counterfeit or gray market products. Employees with ethical problems may compromise intellectual property.
- **Failed ventures** – Financing and significant investments may be lost because of a business partner's misrepresentation or inadequate knowledge of business customs and regulations in a foreign country.
- **Integrity and reputation damage** – Business partners may cause public embarrassment (e.g., by utilizing child labor) or drag a firm into a Foreign Corrupt Practices Act criminal situation.
- **Employee misconduct** – Workplace violence, harassment or fraud may generate costly litigation and greatly increase enterprise risk.

In a shocking percentage of frauds, crimes and workplace disruptions, the warning signs are usually there for anyone who bothers to look below the surface and beyond the numbers. Since so much can be at stake and there is less margin for error in the post 9/11 and Enron era, corporate counsel can't simply pay lip service to due diligence. To reduce the risk of doing business today, modern due diligence should be a systematic and standard operational procedure, not a casual postscript to a business transaction.

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