

## Corporate Due Diligence in the Modern Era

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Several years ago, I undertook a due diligence investigation into an apparently well-respected and sophisticated Colombian gentleman being considered for a joint venture with a prominent U.S. client. The Colombian investor presented himself as a maritime industry executive, and indeed owned a sizeable shipping fleet. Our investigation, however, revealed a less reputable source of the Colombian's wealth-cocaine trafficking. It was only through interviews with Colombian law enforcement sources that we uncovered the well-documented investigations of which the Colombian gentleman had been a target.

Several years after our investigation, the Colombian was arrested, extradited to the United States and prosecuted for smuggling an estimated 100 tons of cocaine per year into the United States aboard his ships. The potential damage to the valuable brand of the U.S. client could have been significant had the deal been consummated and the joint venture partner's past later discovered. Fortunately, this outcome was averted when the transaction was cancelled based on the information unearthed in the due diligence.

Whenever I speak to a client who is considering an investment, an acquisition or a joint venture, particularly overseas, I raise the issue of conducting a due diligence investigation of the company. The response I generally receive is along the lines of: "Well, we got audited financials from the company, and everything checks out."

Perhaps my twenty years of law enforcement, intelligence and private sector investigations' work has jaded me. Or perhaps my skepticism is fueled by headlines but a few statistics illustrate the point. In 2007 there were 776 investigations initiated by the SEC, 262 civil proceedings, and 394 administrative proceedings. The investigations and proceedings covered a range of malfeasance, including corporate financial fraud, stock option backdating, insider trading, mutual fund fraud, and violations by broker-dealers. These enforcement actions resulted in \$1.6 billion in disgorgements and penalties.

Whatever the basis for my own cynicism, my clients' refrain that their "due diligence" consisted of examining a company's financials reflects the need for a new paradigm for proper corporate due diligence, in which an examination of the books is but one aspect. We live in a global economy and have witnessed a massive increase in foreign direct investment in the past 20 years. The value of U.S.-owned assets abroad increased from approximately \$930 billion in 1980, to \$2.1 trillion in 1990, to \$6.2 trillion in 2000, to \$13.7 trillion in 2006, according to the U.S. Commerce Department's Bureau of Economic Analysis.

Consequently there is a vital need for reliable, in-depth information regarding the companies and principals with whom we are dealing, particularly in foreign markets where transparency is often lacking. The potential damage to a company's bottom line and its reputation by involving itself with an unscrupulous actor can be enormous. Add to that recent legislation promulgated by Western governments, such as the USA Patriot or Sarbanes-Oxley Acts in the United States, and the need for due diligence skyrockets. The requisite due diligence goes far beyond "looking at the books".

The failure by U.S. companies to recognize the potential consequences of transactions with dubious foreign entities and to adequately research these entities and the people behind them

can be devastating. However, the risk of civil litigation, criminal sanctions and reputational damage, while very real and potentially costly, is limitable if companies implement a due diligence regimen as a matter of corporate policy. The question often is to whom to turn for these services.

### *Of Databases and Dun & Bradstreet*

There is a perception among many corporate executives, fueled in part by the ubiquitous Internet, that there is plenty of information available online about virtually any individual and any company. While it is often true that much raw data may be present online about a subject, the more important question is: what is the credibility of the information I am obtaining via the Internet or, for that matter, from proprietary databases?

While information obtained from an Internet search can be useful for initial lead information about a subject, much of the information found online is from unknown sources, may be distorted or false, hardly an objective cornerstone for sound financial decision making. Although Internet research is naturally incorporated in any thorough due diligence investigation even proprietary database information must be considered inherently suspect. Much of the information supplied about a company in, for example, a Dun & Bradstreet report is volunteered by the principals of that very company. Most of the operational history of the company, biographical information of principals and officers, and some of the financial information of a corporation is supplied by the company being reported upon.

I mention this shortcoming not to discredit Dun & Bradstreet, which markets a useful research tool that does have its purposes; rather, I cite it as an example of the limitations of business profile services. These limitations are true of all such electronic corporate reporting services, particularly with respect to foreign entities. The profiles found in these reports provide useful leads for investigators, and even the information supplied by company principals is important for an investigator to have, because the investigator can corroborate it through secondary sources. If a company owner or senior executive is found to have provided false or misleading information to a business reporting service, that knowledge itself may be important to a client.

Apart from the questionable quality of the information found online about an individual or company, oftentimes there simply will not be much information available online about companies located overseas, particularly small or low-profile companies, or companies situated in remote or technologically undeveloped countries. Given the increasing push by Western companies into resource-rich, but often underdeveloped, markets, this handicap becomes ever more pronounced.

### *Pounding the pavement*

Much like a modern war cannot be won by air power alone, a Western company considering investing in a foreign entity cannot rely simply on Internet searches, databases and emailed information from a potential investment target when considering an investment. Investors must review corporate filings and financial records maintained in the foreign country's government agencies, gather criminal and civil litigation records located in the country where the subject company is located, and interview local industry players and analysts knowledgeable about the company in question. It is also vital that the research include local investigators who have the language skills, knowledge of the local market, and access to well-informed sources, as well as the ability to conduct their work discreetly.

The importance of on-the-ground examination of a foreign entity acquisition or investment can be illustrated by the following example. While conducting research for a client considering a multimillion dollar investment in an Asian company, we gathered the requisite corporate records and made checks with relevant government agencies. However, it was not until we discreetly visited the location of the alleged "office" of the subject company that we

discovered it was actually a night stall in a local marketplace rather than the robust operation our client believed it to be. The principals of the company had grossly overstated their financials, revealed by an actual look at their operation.

In cases like these, the vital information needed by our clients could not have been uncovered solely from electronic research; yet it is easy to drown in raw data without discerning reliable information when making a strategic investment decision.

### ***Companies don't lie, people do***

What we occasionally see clients lose sight of is that companies are only as ethical as the people who own and manage them. Frequently we will be asked to conduct a due diligence investigation of a company, but a company is simply a legal construct for activities engaged in by people, so any determination of a company's legitimacy must focus upon the legitimacy of its principals.

Such an examination would include a thorough review of media reports, criminal records, civil litigation, industry certification and disciplinary records, educational credentials and other records pertaining to the senior executives. If a principal defrauded someone in the past, or has otherwise engaged in unethical or illegal behavior, the odds are very high that the behavior will repeat itself in the context of the deal under consideration.

Performing such a thorough due diligence investigation in advance of a transaction serves to demonstrate a company's commitment to good corporate governance. In the case of public companies, a well-prepared due diligence report can also serve as a vital legal bulwark in management's defense in a shareholder lawsuit should a deal turn disastrous.

### ***The art of the deal***

Due diligence today - particularly in foreign countries -requires skills and contacts more akin to intelligence officers than the traditional gumshoes of popular imagination. Not surprisingly, the best firms engaged in this niche industry are founded and staffed frequently by retired intelligence officers, criminal investigators with international experience, and military intelligence officers and analysts who had been stationed overseas.

These highly qualified persons often have in-depth, expert level knowledge of foreign cultures and may speak any number of languages. They frequently have networks of high-level, sensitive contacts in countries in which they perform research — contacts developed and maintained oftentimes over decades. They understand their clients' need for discretion, responsiveness and reliable information. Perhaps most critically, they have 'access': specialist knowledge of how to obtain information in foreign cultures. Given the disparate localities from which information is required in today's global economy, with its patchwork of laws, traditions, information archival systems and forms of government, international business intelligence is an art form that should be a component of any dealmaker's repertoire.

Credible and timely information translates into higher profits and protected reputations. Due diligence is no longer a luxury. It is vital to maintaining a company's competitive edge and remaining compliant with the law.