Due Diligence Defined

By Kevin Prendergast

MANY COMPANIES TODAY recognize that confirming the integrity of potential business partners is akin to buying an insurance policy against risk and exposure.

Due diligence, by definition, is the verification of all information given to a company by any prospective business associate. The process includes:

- An in-depth credibility assessment of the company and its key executives
- A check of county and federal civil, criminal, and bankruptcy records to uncover suits, liens, judgments, convictions, and bankruptcy filings
- Database searches for any information printed publicly, (e.g., books, magazines, newspapers, congressional hearings, crime commission reports), about the company or officers

Keep in mind that most reputable investigative firms maintain a network of worldwide representatives who can perform multiple location checks simultaneously, if necessary.

In any business, people are either your biggest asset or greatest liability. In virtually every major business decision, from mergers and acquisitions to taking on new clients or new hires, the ability to trust people and the companies they represent is priceless.

Indeed, due diligence investigations are especially critical under the following circumstances:

- Accepting a new client
- Completing a merger or acquisition
- Forming a partnership
- Finalizing a franchise or a license agreement
- Establishing overseas relationships
- Handling or investing in an initial public offering
- Hiring new employees

Unfortunately, deceptive people are a fact of doing business today. Many people misrepresent themselves and their intentions. For example, in order to secure a deal, a company may overstate its capabilities, inflate its assets, camouflage its lack of financial stability, or even neglect to reveal bankruptcy, civil or criminal actions.

The following are real-life examples of due diligence findings and what they reveal about potential business associates (the names have been changed).

Consider the case of Dairy Treats, a business that asked Partners & Associates, an accounting firm, to represent it. Internally, a routine review of Dairy Treats' books showed no red flags and everything appeared in good order. However, at Partners & Associates, a standard operating procedure was to conduct a due diligence investigation prior to taking on a new client.

The accounting firm's policy paid off. The investigation revealed that Dairy Treats' CEO was under indictment for tax evasion related to donations he made to a charitable organization. Given his information, the accounting firm was able to reconsider taking on this client and was able to avoid potential damage to its financial assets and reputation.

Another case that illustrates the importance of due diligence involves a large mortgage broker, Empire Mortgage, that was planning to purchase a smaller brokerage. Before signing the final papers, the CEO of Empire Mortgage decided to conduct a due diligence investigation, which revealed a trail of criminal behavior by the smaller brokerage's principal officer. Included were three indictments for trafficking in cocaine, possession with intent to sell, and delivering controlled substances. It also revealed a conviction for domestic violence. Due to these unsuspected findings, Empire dropped its acquisition plan, possibly saving itself from exposure to fraud, embezzlement, or worse.

Obviously, not all due diligence investigations reveal derogatory findings. However, a recent study done by our firm revealed that nearly 17 percent of the companies we've investigated misrepresented themselves in one way or another.

Due diligence reduces risk by ensuring the credibility of all companies and individuals with whom a company conducts business.

Companies that are wise conduct due diligence investigations routinely to verify information and uncover discrepancies, overstatements, and unrevealed facts. This extra check ensures that everyone involved in a proposed relationship is accurately presented.

Increasingly, shareholders and employees are lashing back at companies with lawsuits for the poor decisions made in entering into a new business association. A company may face a legal challenge if the welfare of its employees is threatened because of a bad association. Shareholders may sue on the basis that a company did not perform responsible due diligence when forming a business relationship that became troubled. If the company makes such a mistake, it may have to pay for it twice – once from a failed relationship, and again in the form of an employee or shareholder lawsuit. **CE**

Kevin Prendergast is vice president and general counsel at Research Associates, Inc., a Cleveland investigative services company.

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