SOURCE: *Financial Fraud Magazine*

DATE: *Vol. 1, No. 10*

BY: *Charles Calhoun, CFE*

TITLE: ***Limiting Business Risk with Due Diligence Investigations***

Nobody likes a nasty surprise: Due diligence reduces risk by ensuring the credibility of companies and individuals a company conducts business with.

Today, many companies recognize that confirming the integrity of potential business partners is like buying an insurance policy against risk and exposure.

According to Robert Peterson, president and CEO of Research Associates, Inc. (RAI), Cleveland, Ohio, "Due diligence is like getting to know someone before asking for their hand in marriage. Anyone who has ever experienced a bad association knows how devastating and embarrassing the results can be."

Due Diligence Defined

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 (books, congressional hearings, crime commission reports, newspapers, magazines, etc.) about the company or its officers.

Keep in mind that most reputable investigative firms have a network of worldwide representatives that enable checks to be performed simultaneously in multiple locations if necessary.

Know Thy Prospective Client…Or Else!

Due diligence reduces risk by ensuring the credibility of all companies with whom a company conducts business. Companies that are proactive 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 by filing lawsuits against companies for the poor decisions they made in entering into a new business association. A company may face a legal challenge if the welfare of its employees is threatened as the

result of a bad association. Shareholders may sue on the basis that a company did not perform reasonable due diligence when forming the business relationship. A company that makes this mistake may have to pay for it twice – first from the failed relationship and once again in the form of an employee or shareholder lawsuit.

The Goal Is Building Trust

In any business, people are either your biggest asset or greatest liability. In virtually every major business decision, from mergers and acquisitions to confirming the integrity of potential clients and new hires, the ability to trust people – and companies they represent – is a priceless commodity.

Unfortunately, deceptive people are a fact of doing business. 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 and civil and criminal actions.

Obviously, not all due diligence investigations reveal derogatory findings; however, a recent study done by Research Associates, Inc., revealed that nearly 17 percent of all companies investigated by RAI misrepresented themselves in one way or another. Also, according to RAI's statistics, almost 45 percent of cases in the following industries reveal derogatory findings:

- High technology;
- Casinos and gaming;
- Construction;
- Trash hauling and recycling;
- Import/export businesses; and
- Trucking.

The following are real-life case examples of due diligence findings and what they revealed about potential business associates (all names have been changed for privacy reasons).

Consider the case of Dairy Treats, a prospective new client who asked Partners & Associates (P&A), one of the nation's leading accounting firms, to represent them. Internally, a routine review of Dairy Treats' books showed no red flags – everything appeared in good order. At P&A, standard operating procedure included conducting a due diligence investigation prior to taking on a new client.

P&A's policy paid off. The resulting due diligence investigation uncovered new information about Dairy Treats: The company's CEO was currently under indictment for tax evasion related to donations he made to a well-known charitable organization. Given this information, P&A was able to make the best decision possible and was able to avoid a potential damage to their financial assets and reputation.

Another case that illustrates the importance of due diligence involves Empire Mortgage, a large South Carolina mortgage broker that was planning to purchase a smaller mortgage broker, Allied Mortgage, also located in South Carolina. Before signing the final papers, the CEO of Empire Mortgage decided to conduct a due diligence investigation to ensure that his acquisition decision was sound.

The due diligence investigation revealed a trail of criminal behavior by Allied's principal officer, J.B. Gussy. Included were three indictments for trafficking cocaine, possession with intent to sell, and delivering controlled substances. It also revealed a conviction for domestic violence. Due to these unsuspected findings, Empire's acquisition plans were dropped – possibly saving them from exposure to fraud, embezzlement, or worse.

KEVIN PRENDERGAST, *Esq., is an attorney and is vice president and general counsel to Research Associates, Inc. (RAI), Cleveland, Ohio, an investigative firm for due diligence, preemployment, and litigation support services. RAI's worldwide clients include law firms, accounting firms, small businesses, and Fortune 500 companies.*

Circumstances That Demand Due Diligence

Due diligence investigations can be extremely effective prior to entering any new corporate or business relationship. Investigations are especially critical under the following circumstances:

- *Accepting a new client;*
- *Mergers and acquisitions;*
- *Forming a partnership;*
- *New licensing agreements;*
- *Franchising arrangements;*
- *Overseas relationships;*
- *Initial public offerings (IPOs), whether you are handling the transaction or an investor; and*
- *Hiring new employees.*