GRAVE OVERSIGHTS:

The Dangers of Inadequate Due Diligence and Best Practices to Mitigate Them

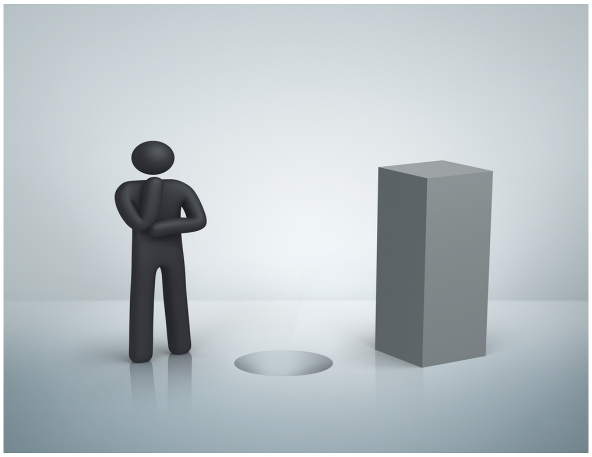
Business Intelligence Advisors

DUE DILIGENCE MATTERS

Inadequate due diligence can cost companies and investors millions of dollars in expenses, as well as reputational damage, organizational turmoil and potential legal consequences. The most fundamental objective of the diligence process is to avoid investing in a company engaged in illegal, unethical or inappropriate business practices. Equally critical, though not always viewed as such, a comprehensive diligence can provide valuable insight on issues such as the character and background of key executives, their leadership styles, potential role suitability, and organizational fit to minimize the risk to the investment.

A 2016 KPMG study[1] has shown that approximately 60 percent of individuals who perpetrated fraud held senior-level supervisory and management positions. The examples detailed throughout this paper demonstrate that while firms typically conduct due diligence, it may only be a cursory review to check the diligence box, and therefore deficient to adequately assess the investment—ultimately leaving them exposed. Because each poor investment decision avoided or inadequate executive not hired mitigates reputational risk and saves money in both tangible and intangible ways, it is critical to follow the best practices noted below.

Allegations of fraud and unethical conduct are among the most highly publicized and serious consequences of inadequate diligence. Recent history yields many examples, including that of Joshua Bryce Newman who helped found two CrossFit gyms in New York City. Newman received millions from lenders and investors. For a variety of reasons—he was the subject of several favorable *New York Times, Forbes,* and *Wall Street Journal* articles, he had many acquaintances from Yale, and came highly recommended through mutual friends—few investors conducted a thorough enough diligence to scrutinize his background. As a result, investors failed to uncover that Newman had falsely raised money through the National Pro Grid League (a CrossFit competition league), and was using money raised from new investors to pay back existing investors. He had also been terminated by all his former companies.



Equally costly losses, albeit less quantifiable, can result from the disruption to an organization when an executive's management style is not a good fit. To share an example, in July 2005, five years after losing several key managers, the American Red Cross Board Chairman Bonnie McElveen-Hunter told Marsha Evans, the CEO, that the Board's executive committee was unhappy with her communication and collaboration with the 50-member Board of Governors and that the Board believed she needed to change her "command-and-control" management style. The relationship between Evans and the board further deteriorated, and Evans resigned in December of that year. That hiring mistake cost the Red Cross $780,000 for Evans' severance package.

[1] https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/profiles-of-the-fraudster.pdf

BEST PRACTICES

Given these potentially dire consequences, investors should implement a robust due diligence process to better protect themselves when making a substantial investment in a company and evaluating its C-level hires. A robust process would include both **open source research**, collected from a wide array of publicly available sources, and **primary source information**, direct or firsthand perspectives from credible human sources.

Primary source collection focused on senior executives is a powerful tool to help identify potential issues and evaluate salient attributes, leadership and decision-making styles, as well as the propensity to engage in risky behaviors. A Georgetown University study found that CEOs and CFOs with prior legal infractions are more likely to perpetrate fraud. Further, this same study found evidence that executives who are willing to violate other rules are also more willing to violate securities laws.[2]

Conducting an extensive due diligence investigation can be challenging as well as time-consuming and requires varying skill sets. It often requires a broad domestic and foreign intelligence network and specialized licenses or in-person research to legally access the necessary databases or otherwise obtain critical public records during the open source research. The information available through open source research is limited, particularly in foreign environments. Critical to the success of the primary source diligence is demonstrated expertise in identifying and interviewing unique and authoritative sources. The bottom line is that acquiring, analyzing, and corroborating both open and primary source information is vital to an in-depth diligence effort.

Best Practice Solutions:

Open Source Research

Primary Source Research

Objectivity

[2] Davidson, Robert H. and Dey, Aiyesha and Smith, Abbie J., Executives' 'Off-the-Job' Behavior, Corporate Culture, and Financial Reporting Risk (February 27, 2013). Chicago Booth Research Paper No. 12-24; Fama-Miller Working Paper. Available at SSRN: https://ssrn.com/abstract=2096226 or http://dx.doi.org/10.2139/ssrn.2096226

OPEN SOURCE RESEARCH

A thorough due diligence process should encompass open source research that includes:

1. Biographical verification: employment, board of directors, education, licenses, and patents.
2. Available domestic and foreign public records, i.e. bankruptcy, judgments, liens, criminal records, and litigation.
3. Foreign Corrupt Practices Act records (FCPA).
4. Social media presence.
5. English and foreign language press/media review, with identification and analysis of inconsistencies or arrogance in public statements.

A thorough open source diligence verifying the biographical information of Scott Thompson, Yahoo CEO, likely would have yielded that he falsified his resume. He indicated that he had both a computer science degree and an accounting degree, when he had only a degree in accounting and the institution from which he graduated didn’t offer a computer science degree. The “error” in his resume led to much turmoil in the Company, investor losses, and ultimately, his resignation.

Searching public records would have forewarned the Pixelon board when they chose Michael Fenne as CEO of the internet video firm. As it turned out, Michael Fenne was in reality David Stanley and had been on Virginia’s most-wanted list for several years.

When interested in a foreign entity or individual, check the Foreign Corrupt Practices Act (FCPA) records. The fact that one may not have actual knowledge of the specific behavior that results in a violation is not a defense under FCPA or similar anti-corruption and anti-money laundering regulations. As noted in a recent Harvard Law School forum, “2016 was a precedent-setting year for the Foreign Corrupt Practices Act (FCPA). After several years of consistent enforcement numbers, the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) produced what arguably is the most significant year of enforcement in the statute’s 39-year history.”[3]

Social media should also be closely examined for instances of questionable judgement or erroneous facts. To share a recently publicized example, Matt Harrigan, founder and CEO of the cyber security start-up PacketSled, resigned after making statements on his Facebook page saying he was going to “kill the president-elect.” A thorough due diligence review allows instances of questionable judgement to be known and evaluated in advance of finalizing the investment decision.

Inconsistent, arrogant or otherwise concerning comments in public interviews or other statements should also be taken seriously. In one study, researchers quantified narcissism based on things such as the size of the CEOs’ photos in annual reports, number of biography lines in the Marquis Who’s Who database, number of perks, etc. The narcissism score was then correlated to proven involvement in financial misstatement or fraud.[4] The correlation indicates that narcissistic CEOs are willing to ignore the “long term interests of shareholders and employees, and engage in high risk and unethical behaviors which jeopardize organizations.”[5] As open sources often yield limited information on personality traits, findings of this type must be followed up with deeper primary source research.

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[3] Rijsenbilt, J.A. (2011, June 23). CEO Narcissism: Measurement and Impact (No. EPS-2011-238-STR). ERIM Ph.D. Series Research in Management. Erasmus Research Institute of Management. Retrieved from http://hdl.handle.net/1765/23554
[4] Rijsenbilt, A., & Commandeur, H. (2012). Narcissus Enters the Courtroom: CEO Narcissism and Fraud Journal of Business Ethics, 117 (2), 413-429 DOI: 10.1007/s10551-012-1528-7
[5] http://brainblogger.com/2014/04/16/executive-pathologies-the-relationship-between-ceo-narcissism-and-fraud/

PRIMARY SOURCE RESEARCH

As stated, it is generally advisable to conduct an inquiry based on primary (human) sources to follow up and expand on concerns and issues developed during open source research. Primary sources are valuable in assessing personality, character, leadership traits and other key attributes. There is data to suggest that CEOs with exaggerated self-confidence pay larger premiums for acquisitions and lead to losses of shareholder wealth.[6] Identifying and interviewing unique and authoritative sources who have known the senior executive at various points in time and worked with him or her in various capacities can provide useful insights into the level of hubris.

There are some primary sources that should be avoided or handled carefully. Except for general background information, sources should not be part of an expert advisory network to ensure that their perspectives are specific to the inquiry and limited to the client. Plus, paying sources raises potential compliance concerns and may also bias the source.[7] Additionally, sources should be independently identified and should not be limited to a reference list provided by the prospective business partner or executive of an acquisition or investment.

Primary sources can uncover some of the most valuable information. An example is Jody Sherman, CEO of EcoMom, an e-commerce startup. An interview with one past employee emphasized, “he was not a numbers guy…Critically, he did not understand margin…He did not understand, after three years of negative margin, that increased sales resulted in increased losses.” Five months after raising initial funding, EcoMom ran out of cash. A primary source interview with someone who had worked with Mr. Sherman in the past could have raised this concern before it became a problem.

OBJECTIVITY

The best approach to comprehensive due diligence not only examines the information, but also evaluates the reliability of the information. For this, investors should consider using an independent third party to conduct comprehensive diligence to mitigate potential biases and ensure the objectivity of the inquiry. Because third-party providers do not have a vested interest in the outcome, preconceived perspectives on the investment opportunity, or the viability of the senior executive(s), they can increase the objectivity with which the diligence is conducted. Implementing a strict and objective due diligence methodology is the best way to allow the discovered information to be evaluated consistently and confidentially.

[6] Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris Mathew L. A. Hayward and Donald C. Hambrick Administrative Science Quarterly Vol. 42, No. 1 (Mar., 1997), pp. 103-127
[7] Russell ML, Moralejo DG, Burgess ED Paying research subjects: participants’ perspectives Journal of Medical Ethics 2000;26:126-130.

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For the past 15 years, BIA has mitigated risks for investors, performing over 600 due diligence investigations across 37 countries on six continents. BIA has uncovered past fraud and/or legal problems that were not already known, and identified personality traits that would conflict with the organization's goals. An investment decision based on a BIA due diligence investigation mitigates reputational risk and saves money in both tangible and intangible ways: actual hiring compensation and expenses, potential revenue losses from mismanagement, any reoccurrence of fraud, and the turmoil of having an ill-fitting executive leading the company.

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