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INTERNATIONAL DUE DILIGENCE: A WORLD VIEW

A background investigation professional takes a world view of the subject of due diligence and will treat the subject from an investor and lender viewpoint. A significant component of this due diligence process is assessing the “off-balance sheet” risk that may come with the owners or management team of a prospect business.

Most mergers or acquisitions contain a leverage component in their final capital structures, creating the need to account for the lender’s perspective in all matters regarding due diligence and risk assessment. A significant component of this due-diligence process is performing background investigations and assessing the “off-balance sheet” risk that may come with the owners or management team of the business being acquired and financed.

There are certainly other aspects of due diligence in every business purchase and financing decision that weigh heavily on the assessment of country and currency risk when a foreign investment or investors are involved, especially in these tough economic times. Generally, lenders must make these assessments (which include the foreign country’s economic system, workforce, infrastructure, transportation quality and systems, geology and climate) before and after a financing and must continually monitor them. But beyond this are risk elements in every investment and lending decision that are more specific to the company being acquired and financed — such things as industry risk, financial and balance sheet risk, client concentrations, competition, integration and “headline risk.” There are also some particular changes to the international business, investment and lending landscapes over recent years

that require investors and lenders to prioritize a thorough assessment of the management team that will “carry on the business of the business” being acquired and financed.

What are these elements? For international background investigations, the following is a short but critical list of factors that may have forever changed the investment and lending landscape across international borders:

- ▶ Company owners and managers are involved in more businesses than ever, many of which cross country borders and may involve different and multiple partners. These “off balance sheet” entities could distract owners and management from the daily management of the “subject” business.
- ▶ Investors and lenders often participate with other equity providers and lenders in the same capital structures, thereby sharing the increased risk. Participants often rely upon the lead investor or lender’s pre- and post-closing due diligence, for which the lead investor will be held accountable.
- ▶ The world market is a greater target for new business and new business partners, and investors and lenders are more in need of the most current and most accurate information in order to make informed decisions.
- ▶ The media plays a more intense role in

delivering critical information and increasingly operates in “real time,” both nationally and internationally. Business acquirers and lenders must know more than the media knows, and they must verify what the media reports, both nationally and internationally.

- ▶ The world is more litigious, and lenders must perform due diligence and background investigations on possible foreign litigation involving foreign nationals, if any, with the same level of care they give to similar U.S. issues. Litigation costs time and money. It is best to get the most accurate information up front in order to detect domestic and foreign legal issues that can easily be avoided.
- ▶ Time is more of the essence when businesses are competing for the same investment or loan. Investors and lenders share the same desire for a speedy decision, requiring the fastest due diligence possible, whether domestic or foreign.
- ▶ Corporate fraud, scandals and corporate governance have become common topics of discussion, and these issues cross country lines as more foreign nationals than ever populate the ownership and management teams of U.S. companies. Corporate scandals, domestic and abroad, are now front-page news, and the executives convicted of these illegalities against

shareholders, investors and lenders are being held accountable.

In the United States, banking regulations require lenders to follow a Know Your Customer (KYC) policy and conduct a certain level of background investigation. A few short years ago, no insurance requirements or federal statutes existed that required a state or national bank or federally chartered savings and loan institution to check a list for terrorists, narcotics traffickers or those engaged in the proliferation of weapons of mass destruction. The FDIC and the FSLIC changed all of that when the USA Patriot Act of 2001 became law. The Office of Foreign Assets Control (OFAC), a division of the United States Department of the Treasury, maintains a list of such individuals, as do similar entities in foreign countries, along with lists of Politically Exposed Persons (PEP). A person on one of these lists is prohibited from opening a bank account at a U.S. bank and from importing or exporting goods into and out of the United States.

Furthermore, the completeness and accessibility of public record information varies among countries, with the United States ranking first in this area. Even our closest neighbor to the north, Canada, has public-records laws that vary from province to province. Only a few provinces disclose criminal records (in other provinces, privacy laws protect the information). Mexico only makes limited information regarding civil litigation public, and information involving criminal investigations usually only includes felony cases that resulted in condemnatory sentences.

Public records in European countries are generally much more limited than in the United States as well. As a general rule, in most European countries the public cannot perform criminal litigation searches; only the local media are able to determine if a criminal action has been filed against an individual or company, including in the UK (although the UK otherwise has more searchable public records than most other European countries).

In Asian countries, public information is also generally more limited compared to the United States. In India, the acces-

sibility of public records is similar to the United States, as is Australia. In South America, the availability of public records varies significantly from country to country, and a few countries greatly lack searchable public records.

The following cross-border international investigations illustrate how due diligence can lead to a decision not to move forward with an investment and financing decision because of the potential for headline risk.

A Murder... in the End

The first situation was a proposed investment in, and financing of, a new business in the United States. One of the partners brought essential product and industry knowledge to the business and was a Russian citizen. He was a long-time leader in the metals industry — an industry believed to be heavily controlled by the Mafia. The new company was planning to take a fabricated metal product to market in the United States, selling it to the automotive, airline and other industries.

Likely confirming the Mafia association of the Russian partner's business, the company discovered within days of completing the background investigation and closing the loan with a U.S. bank that the Russian investor's daughter and future son-in-law were killed execution-style in his villa in Switzerland. The investor and the lender, fearing the headline risk from any association with the Russian murders, backed away from the deal.

The key to the discovery was the investigation of the Russian subject in every jurisdiction where he owned real estate and investment property. Altogether, the Russian subject was investigated in three countries.

Alleged Securities Fraud

The second situation was a secondary offering of stock in a U.S. public company and a refinancing of the company's balance sheet. The company's recently recruited president and CEO was a Canadian citizen and the former CEO of a Canadian public company. He was apparently not well vetted before being hired, as we discovered that he was under investigation for securities fraud in Canada

— a criminal accusation for which he was ultimately found guilty. The U.S. company's board of directors, fearing headline risk, industry ridicule and future liability, fired the executive after the client bank shared the results of our investigation. The prospective loan was denied as well and for the same reasons.

The key to this discovery was a media search of the subject in every jurisdiction of every country in which he lived, owned real property and did business — in this case Toronto, Canada, where a media article detailed his alleged securities fraud. Of course, the appropriate authority confirmed the charges.

A Few Truths to Live By

- ▶ Establish written KYC risk assessment, due-diligence and background investigation guidelines to live by, and follow them without exception.
- ▶ Back up your best interviewing skills and intuition with the best information available, and confirm all domestic and foreign information that is not discernable through a search of public records.
- ▶ Always hire a background investigations firm with national and international investigations capabilities.
- ▶ Business owners and management teams ultimately repay the loan. Discover the real truth about their backgrounds.
- ▶ Maintain your sense of humor because, when the loan fails and you're left to manage a liquidation and work out a loan deficiency because of a (should have been) known felon who ravaged his last three ventures and committed untold acts of indiscretion, you'll need it. **TSL**

Jerry Oldham is co-founder and CEO of 1stWEST Financial Corporation, an industry leader in providing background investigations services to the corporate finance industry. He has a broad senior management background in commercial banking and corporate and real estate finance. Oldham is past Champaign Chair of the Education Foundation of the Commercial Finance Association and a member of its Governing Board and is on the faculty of the Commercial Finance Association's Fraud Awareness Workshop.