

Private Equity Central.net

November 17, 2000

An Inspector Calls

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The deal looks like a home run—revenue is growing, the price is reasonable and the employees are enthusiastic. The fact that the CEO of your intended portfolio company was once a major trafficker of heroin, however, does cast something of a pall over the whole transaction. To be sure, this erstwhile dealer of nefarious substances may well have long ago rechanneled his entrepreneurial energy toward legal business activities. But as the fiduciary of millions of dollars of other people's money, the prudent private equity professional will want to at least be aware of this narcotic misstep, or any other particularly interesting personal detail, prior to making an investment. And that's where corporate investigators can be of service.

As private equity activity has increased, so has the business of corporate investigators, who specialize in screening the histories of managers. Recent advances in information technology have made it easier to sift through many facets of a potential business partner's past, including his or her tax history, criminal record, bankruptcies, sexual harassment suits and SEC actions. While private equity professionals have long relied on traditional reference checking to ascertain a manager's record, many of them don't have the time or know-how to dig deep. Corporate investigators are only too happy to help.

As has already been put forth, *ad nauseam*, in this column, private equity investing means investing in people. As deal volume has grown, the process of finding quality people to staff portfolio companies has become among the most crucial tasks of investment professionals. As noted in last week's Central Intelligence, this demand for good people has meant boom times for executive search firms, but it has also meant growth for background checkers, for whom due diligence means a lot more than a few phone calls to past co-workers.

All the major business-consulting firms conduct background investigations (usually in their "dispute analysis" or "forensic accounting" departments), but a number of specialist firms, including Kroll Corporate Services, James Mintz Group, Decision Strategies Fairfax International and BackTrack Reports Inc., have also gained inroads with private equity firms. In an informal survey, every private equity professional I called had hired a background checker at least once. "I think it is becoming more and more common for private equity firms to use investigative services," says Thomas Fedorek, a managing director at Kroll.

""We're not just seeing more deals [with private equity firms], but are becoming more accepted within the private equity industry."

About one-third of Mintz Group's business is with private equity firms, according to a company spokesperson.

Business with private equity firms "has grown tremendously," says BackTrack's president Randy Shain, who estimates that approximately 40% of his company's revenue comes from private equity firms. "It's becoming as accepted as having an accountant look at the books or having lawyers draw up contracts."

Despite growing acceptance, hiring an investigative group to dig deep into a manager's past is still considered a bit of an indulgence by many investment firms. But the fact that private equity firms can pass the cost of the investigations back to their limited partners makes using the services of corporate investigators that much easier, Shain adds.

Corporate investigators, who prefer people refer to their service as "pre-deal due diligence management team investigations," use a variety of tools and tactics to check the background of potential managers. In addition to conducting traditional reference checks, during which investigators interview candidates and their ex-colleagues, they double-check dates of employment on resumes, troll bankruptcy court records and search legal databases and tax records. Almost all of the information accessed is publicly available, so investigative firms differentiate themselves by claiming to specialize in different approaches. BackTrack, for instance, says it excels at the interview process, while Mintz Group advertises a prowess at navigating and mining the cornucopia of databases.

The cost of conducting an investigation varies according to what information is requested, where the manager is located and how complicated the job is. For example, checking out a guy named Robert Smith in Atlanta is difficult because of the sheer number of Robert Smiths in Atlanta - a database search would likely yield too many results. Investigating four managers with more unique names who work at the same company in New York is going to be a more cost-effective job.

BackTrack charges a flat fee of between \$3,000 and \$5,000 per investigation, depending on the aforementioned variables. Mintz Group charges approximately \$2,500 per person. Kroll gives clients the option of being billed on an hourly rate or on a flat, "project fee," basis. A spokesperson for the company declined to give a range for the project fee, but a private equity professional who has used Kroll's services says the company charged him approximately \$20,000 to investigate four managers at the same company.

Costs have come down in recent years, says Mintz, because of greater competition and advances in information technology, the Internet and searchable databases chief among them.

According to Mintz Group literature, the most common “hits” (discovered items) in a manager's background are as follows, in descending order of frequency:

- Omissions of short-term or unsuccessful jobs from the manager's resume.
- Unreported bankruptcies.
- Unreported lawsuits against the manager.
- Secret companies, many of which sell supplies or services to the main company.
- Unreported regulatory actions against the manager by any number of government bodies, including the SEC.
- Unreported tax disputes.
- Unreported legal disputes initiated by the manager, which may indicate a predisposition to litigiousness.
- Unreported criminal indictments.
- Inaccurately reported reasons for leaving a job.
- Unreported drunk driving charges.

BackTrack's Shain estimates that his company discovers “hits” in approximately 10% to 20% of its searches, though he adds the numbers may be skewed by the fact that firms often come to BackTrack only when they suspect there is a problem with a candidate's record. Other investigative firms also put their hit rate near 10%.

Likewise, a spokesperson from the Mintz Group says the firm finds a “problem” in almost 70% of its cases, and a potentially deal-altering problem in about a third of its investigations.

Discovering that your potential manager may have conveniently forgotten to mention a stint as a marketer of NuSkin products may be fairly uninteresting. But every now and then, corporate investigators uncover exceedingly interesting secret histories. Some examples:

- According to Fedorek, Kroll once undertook a background check of the CEO and sole shareholder of a consumer services company on behalf of a private equity client. Kroll discovered that the CEO had, 18 years earlier, been a major trafficker of heroin. In addition, the manager had also filed for personal bankruptcy, and had at one time been charged with real-estate fraud. Kroll discovered the drug information within 24 hours of launching its investigation.
- A venture capital firm hired BackTrack to investigate a potential CEO for a tech portfolio company. That manager had already gone through four previous background checks without having anything turn up, but when BackTrack checked court records from another state, the company discovered that he had been convicted of a "pretty disgusting" sexual offence 17 years earlier, according to Shain. The venture capital firm decided to pass on the manager. "It was tough to avoid the fact that, if it got out, there would be a real embarrassment factor" for the portfolio company, Shain adds.
- Mintz Group once investigated a manager who, it turns out, had arrived in the U.S. from Europe and completely reinvented himself. The manager had left his hometown in Europe in the middle of a bankruptcy and had failed to mention this crucial legal matter to his potential private equity investors.

Despite these horror stories, not every manager warrants a thorough background check. Mistakes are more easily made in red-hot deal markets where entrepreneurs shop seemingly strong business ideas around to scores of eager capital providers. But under normal circumstances, private equity firms often draw on top management from a network of managers with whom the firms have had longstanding relationships. "When you're backing a group of 28-year-olds, a background check is more important," says Bruce Rauner, the founder of Chicago private equity firm GTCR Golder Rauner, a firm whose *raison d'être* is finding and backing strong management. "Most of the executives we use have been around for a long time. To be honest, if a guy is unethical, it's going to come out in some way. But if he's done really well as a manager over the past 25 years, I don't care if he said he went to Harvard but really went to Ohio State."

Indeed, "hits" are not always deal breakers. When a private equity firm wants to make an investment, and when it finds a talented manager to oversee that investment, the firm often is willing to overlook fairly serious past transgressions in order to close the deal. At the very least, doing a few background investigations can teach a firm how best to structure deals that control for the shady-manager factor.

One venture capitalist, who asked that her name not be used, relates the story of a manager to whom her firm was considering making a sizeable commitment,

who nevertheless could not resist the wildly unprofessional urge to hit on her. "This guy's behavior was so bizarre," she says. "I'm about to put \$70 million into his company and he's flirting with me."

The venture capitalist had someone take a look into the manager's legal history and, sure enough, he had received several sexual harassment complaints from assistants. However, the venture capitalist's firm decided not to drop the deal. "We needed him," she says. "But [with the background check] I knew what my liability was."

Even the firm who discovered that its potential manager used to deal heroin went ahead with the deal, according to Fedorek. Having the knowledge of the CEO's history allowed the firm to restructure the transaction in a way that put controls on the manager's ability to move money around. The firm's heightened awareness of the manager's past also caused it to pay closer attention to his accounting practices. A year after the deal closed, a little forensic accounting revealed that the CEO was too aggressively reporting his numbers by booking business prematurely. "At least the firm went in with their eyes open," Fedorek says. "Had the G.P.s not known that this was a guy who might not have the most upstanding business practices, they might not have noticed the [unorthodox] accounting practices."

Amazingly, the private equity firm still kept the CEO on board, Fedorek says, adding investigative firms present their findings to clients without making any recommendations about what to do next. In most cases, Fedorek says, he does not ultimately know whether or not a firm ends up investing with a manager.

The decision to hire a corporate investigator ultimately comes down to a private equity firm's appetite for risk. If putting money behind one problematic manager every 10 investments is a risk a firm can stomach (and afford), that firm will tend to conduct its personnel due diligence the old-fashioned way - through a firm handshake and a few phone calls to industry sources.

For other firms, though, this informal background check is ineffective and not enough to lend piece of mind. "People in private equity are very provincial," says one industry professional who hires outside help. "They use the same network of friends again and again for references."

Not that background checkers are the only way to dig a little deeper. The industry professional mentioned above occasionally uses investigative firms, but prefers an approach she claims is a "pretty common" practice in the private equity world - putting someone at the Justice Department on payroll. She says there are many staff lawyers at the Justice Department who, for a retainer fee, will gladly run searches on a prospective manager to make sure there are no legal blemishes in his or her past.

General partners who read this article and begin to feel empowered with visions of voyeuristic grandeur should take note - the practice of using corporate investigators to check the histories of private equity fund managers is increasing in popularity, as well. In particular, funds-of-funds, placement agents and gatekeepers now occasionally hire background checkers to make sure they aren't about to commit money to a shady management team, particularly when that team is raising a first time fund. Private equity firm's don't have near the "hit" rate of hedge funds, say investigators, but as the market gets larger, all kinds of questionable characters are liable to wander in.

The smartest managers are the ones who pull all their skeletons out of the closet and don't wait for a company like Mintz Group to force them to fess up. Still, a surprising number of investment groups are willing to forgive an omission or two on the resume. 'It is a general human emotion to put your best face forward when you go to get financing,' Mintz says, adding: "But shame on the guys with the money when they don't attempt to peel that mask back."
