

Across The Board

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Have I got a Deal for You

And, on the surface at least, it looks like a deal you can't refuse. But how can you protect your firm against disappointment—or worse?

by James B. Mintz

Every executive would like to believe that bum deals only happen to other people. But many acquisitions, joint ventures, and other business relationships have been marred by a partner's previously unrecognized financial problems, factual misrepresentation, or outright fraud. Even large corporations and sophisticated financial institutions have on occasion been burned.

Take, for example, the case of ZZZZ Best Company, a now-defunct carpet-cleaning service that once boasted meteoric growth and, in Barry Minkow, an attractive young entrepreneur. Institutions showered Minkow with financing for the company. A Big Six accounting firm blessed his books. The SEC let him go public. Still, some would-be lenders shied away—one after discovering that some of Minkow's private backers were convicted felons and that a multimillion-dollar cleaning contract on Minkow's books was fictitious. ZZZZ Best was later found to be largely a sham operation, and Minkow is now serving a 25-year sentence in Federal prison for racketeering.

Or consider the case of the Bank of Credit and Commerce International, which was seized in July 1991 by the Federal Reserve, the Bank of England, and other regulatory authorities following allegations of massive fraud. BCCI had pleaded guilty to money-laundering charges in January 1990. It had reported large losses a few months later, and needed a bailout by Sheik Zayed Bin Sultan Al-Nahayan, the ruler of Abu Dhabi, to stay afloat. Later still, the Federal Reserve found evidence that BCCI illegally controlled First American Bankshares, the biggest bank holding company in Washington, D.C., and made a criminal referral to the Justice Department.

These developments were all duly reported in major business publications. Yet those caught in BCCI's collapse included numerous commercial banks, brokerage houses, and international corporations. Presumably, more intense due diligence by any one of them might have led to a pullout from BCCI well before its demise.

How can you protect your company from disappointment, or worse, in your next business relationship or major transaction? Here are some bad-deal warning signals to keep in mind:

Mystery financing: A story with elements of both ZZZZ Best and BCCI involves a large multinational company that purchased a boutique electronics firm on the basis of

several foreign government contracts that the boutique had submitted as evidence of its worth. Only later were the contracts found to be bogus, leaving the acquiring company with a big loss, and a lot of egg on its face.

Checking out a potential partner's financial and other claims may be laborious, but the effort is essential. In addition to verifying the content of all key documents, be on the lookout for any red flags—for example, an enterprise whose only business address is an urban post office box, or an individual who has paid off a hefty home mortgage without benefit of refinancing.

Be especially wary of financing paths leading to tax havens (which currently include the Netherlands Antilles and the Channel Islands), bastions of bank secrecy (Liechtenstein and Switzerland, among others), or centers of money laundering (such as Uruguay, Vanuatu, and Panama).

Self-dealing: A national automotive products company was thinking of buying a particular specialty manufacturer. On first visiting its corporate headquarters, however, the prospective acquirer found an executive parking lot full of expensive, high-performance cars. In investigating the financial affairs of the firm's senior executives, the acquirer found that several had enriched themselves through hidden financial relationships with key subcontractors.

Are your prospective partner's managers living beyond their apparent means? If so, look for transactions that may have enriched them at company expense. You may choose to go forward with the deal, but—as the firm in this example did—with appropriate changes of personnel, responsibilities, or administrative procedures.

Dirty business: Some industries, such as gaming, construction, waste management, and trucking, have had more than their share of shady partners. Check out financial associates and backers in these industries as carefully as you do the deal's principals.

It's not a bad idea to do so in other, less notorious businesses as well. For example, one law-enforcement document, which had been marked "confidential" but was found gathering dust in a public file, identified organized crime associates of an executive in the bagel industry. In general, any business largely conducted in cash, or in which certain frequently investigated labor unions have a prominent role, merits careful scrutiny.

Poor track record: A major food service company was planning to purchase a regional concern until it heard rumors that client turnover at the company was unusually high. When the regional concern resisted efforts to examine its client records, the purchaser sought out several of the company's former middle managers. These managers confirmed the high turnover and explained its source: undisclosed quality-control problems. Again, the deal was eventually consummated—but only after improved quality-control techniques were put in place.

Like management misbehavior operational shortcomings need not be deal-killers. But if one or more of a partner's past deals or ventures failed, yours could be next. So the causes of any failure or, particularly, a pattern of failure should be examined thoroughly for improprieties—not to mention plain old incompetence,

Criminal associations: In studying a potential partner's background, don't just look for criminal convictions. An unindicted co-conspirator or an individual associated with law-enforcement targets can be bad news, too.

Litigation history: Usually, before a transaction is finalized, someone checks to see whether any of the deal principals have been sued in state or Federal courts. It's advisable, however, to dig deeper—for example, in the public files of the U.S. Tax Court. You should also determine, whether your prospective partner has a history of lawsuits in county and small-claims courts; if so, he may some day sue you.

Musical auditors: Have there been repeated changes of auditors? Find out, why. Such changes some times point to hidden financial problems.

Real due diligence, the kind that catches the ZZZZ Bests and BCCIs, is a rigorous process. It usually means talking to people—former auditors, college registrars, government inspectors, competitors, labor unions, former employees, and sometimes (though rarely) ex-spouses.

Remember too, that a thorough investigation of a given individual or company—even one in a "dirty" industry or one living or doing business in an offshore tax haven—may reveal a squeaky-clean background that can raise comfort levels and make marginal deals possible.

A small but significant number of deals are presented in bad faith by dishonest people. By taking reasonable precautions to determine that a proposed transaction is legitimate, that its principals are trustworthy, and that there are no booby traps, an executive can cut a deal focused on his venture's future, not his partner's past.

How to Choose an Investigator

Often a corporate executive decides that a problem or matter to be investigated is too sensitive or specialized to be handled in-house. Once a decision is made to hire an outside investigator, finding the right one should be approached with the same cautious "due diligence" as in choosing a business partner. Here are some suggestions:

- Don't trust the yellow pages. Or advertisements that seek to comfort you with "Licensed Detectives" or other badges of honor. Private investigators are not quality controlled, and the licenses required by many states are obtainable by most literate nonfelons with a few years of police detective work under their belts. The best way to begin the search for a private investigator is to ask around for satisfied customers among corporate executives, litigators, investment bankers, and others whom you trust.

- Don't automatically go with the lowest bidder. You will get approximately what you pay for. Like other professionals, most investigators figure their time on a per-hour basis, though some keep the calculations to themselves and quote estimates in lump sums. The first phase of a background investigation should cost \$1,000 to \$3,000 for each person or entity to be investigated. An investigator with a background specifically relevant to the investigation at hand—an alumnus, perhaps, from the world of securities law enforcement, international intelligence, or fraud auditing—may command an hourly fee that approaches those of blue-chip law or accounting firms, in the range of \$150 to \$300. For less specialized assignments, expect to pay about half that amount.
- Ask each prospective investigator for a list of specific steps that he would take to meet your needs; the less mysterious he is about his methods, the better. Although you cannot expect investigators to identify their sources, they should be willing, for example, to script out in advance how they intend to introduce themselves when conducting interviews and what they will do to insure that the investigation proceeds with the utmost discretion. Be leery of investigators who are too quick to push questionable tactics, such as digging through corporate dumpsters; although such practices may be legal, they can often create new problems, rather than solve existing ones.
- An investigator who claims that he can probe an individual's or company's reputation using only computerized data bases, without ever leaving his seat, doesn't know how to investigate. Data bases have revolutionized the information-gathering business, but computers only scratch the surface of what's buried in dusty files and human memories.
