Transparency In Due-Diligence Background Checking: Setting A Standard

By James Mintz and Edward Frost

Individuals and organizations considering relationships with each other—through investments, acquisitions, joint ventures or employment—clearly need to assess each other's business, background and reputation. The willingness and ease with which each party conducts due diligence on the other is often a good barometer of future compatibility. We would argue that if both parties agreed to the standards outlined here, the resulting transparency would help the process go more quickly and with less expense, and increase the chances of a transaction's success.

The importance of performing thorough background investigations was highlighted last year in changes to the corporate Sentencing Guidelines, which reinforced the need for corporations to take reasonable steps to hire executives who meet compliance and ethics standards. And for a front-page example of a failure in pre-hiring due-diligence, we need go no further than the recent implosion of Bernard Kerik's nomination as Homeland Security director.

We are an investigative firm that conducts thousands of background investigations for clients who are in various sectors of the business world—investment banks, search firms, multinational corporations and leading non-profits. We try to answer their most common questions: Has this person ever been in criminal or regulatory trouble? Was she successful and trustworthy at prior jobs? Has he been truthful about his background? We're on the due-diligence firing line every day.

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No clear expectations

Unfortunately, there's no clear expectation in business transactions about what the scope of these investigations should be and, as a result, deal-makers sometimes walk away from relationships because they can't learn enough, or because of unfounded suspicions. Their prospective partners sometimes walk away feeling hurt and distrusted by questions about their backgrounds.

We believe that people on both sides of a transaction or relationship—those commissioning an investigation and those being investigated—ought to have the same understanding about what's fair game and what's off limits in these background checks.

Recent headlines about the theft of information from data brokers have heightened concerns about the commercial use of sensitive personal information. What follows is an outline of how we conduct due-diligence investigations within a variety of legal guidelines, including the Fair Credit Reporting Act; various laws protecting the privacy of financial and health care information; and common-law privacy practices.

We believe our guidelines establish a standard of transparency in due-diligence

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investigations that meets the expectations of the parties on both sides: enough information so that the institutions contemplating a new relationship can feel comfortable, and reasonable assurance for business people being investigated that these background checks can be done without unduly burdening them or invading their privacy.

First step: Navigating a sea of information

We start due-diligence investigations by diving into a sea of millions of records—criminal histories, lawsuits, liens, bankruptcies, SEC and regulatory filings—almost all of which include data such as addresses, birth dates, Social Security numbers, and other personal identifiers.

In order to navigate this sea accurately, we need to have similar identifiers on the subjects we're looking at. These are essential in order to determine, for example, that the John Smith who filed for bankruptcy in 2003 in New York (with a particular Social Security number) is not the same John Smith sitting across the desk from our client.

Although many people consider these identifiers private, in fact they are available on various databases to investigators with a permissible purpose. Courts have also ruled that obtaining such information does not constitute a privacy violation so long as investigators only disclose it to their clients.

We'll often work with our clients before our investigation starts to obtain this information, which can help save money and time going forward. So, under our "what's fair game" standard, we would argue that business people should expect to provide their personal identifying information before getting into relationships.

Is the resume truthful?

It's not unheard of for a business person to omit from his resume a job that could be seen as problematic or embarrassing, such as a board member who dropped mention of service on the audit committee of a company later accused of accounting fraud, or the airline executive we investigated who excised the several months he worked for a gambling-related company.

People should expect their resumes to be cross-checked. We use external sources such as news articles, press releases, regulatory filings, even college alumni bulletins to verify dates and titles.

If our clients approve, we'll also call current and past employers to confirm dates of employment and salary. In a background check of prospective employees, the Fair Credit Reporting Act triggers increasing provisions of notice and other rights to the subjects of an investigation if the inquiry goes deeper than these questions.

We're often asked to go further and figure out, for example, why someone left a job. When appropriate, investigators are adept at identifying, locating and quietly interviewing former co-workers for their confidential and candid assessments of their ex-colleague's tenure. Subjects of due-diligence background checks should expect such inquiries.

What generally falls out of bounds is asking personal questions about matters irrelevant to business; for example, whether his or her children have had disciplinary problems.

Education claims are another area we scrutinize carefully. We've run across business people whose resumes have inflated a three-week course at Harvard's executive training program into an MBA from its business school.

Due-diligence investigators routinely call universities to confirm claimed degrees, but subjects can expect grade transcripts to remain confidential.

Is there trouble in the past?

We start every investigation by compiling a list of a person's home addresses over the past 10 years or more. Past addresses show us where to look for criminal convictions, lawsuits and other on-the-record trouble.

Whether someone has a criminal record is the number one piece of information that prospective business partners want to know. Conviction records found in local and federal court archives after a case is over are fair game, and more and more of them are easily accessible online. If, for example, a businessman got into a fight after a car accident, was arrested and pleaded guilty to assault, he can expect it to be uncovered and reported to his prospective partner.

One exception: "rap sheets," the consolidated records of someone's criminal history kept by law-enforcement agencies and compiled in various state and FBI computer databases, are off-limits in most jurisdictions.

Another way we check for past trouble is by looking at driver's license records in states where this information is publicly available. We pay particular attention if there is a pattern of accusations of driving while under the influence of alcohol or drugs; this is one of the clearest ways to find out if a prospective business partner has a substance abuse problem.

However, this window into someone's behavior is relatively narrow. While it might indicate past drinking problems, obtaining the medical records that might show whether he spent time in a rehabilitation clinic is clearly out of bounds. A number of state and federal laws place an expectation of confidentiality on medical information from an individual's doctors or health insurance company, and impose significant criminal and monetary penalties for knowing violations.

Investigators are free in most due-diligence contexts to go as far back into someone's past as necessary, particularly if a lead (such as a news article) suggests a relevant older criminal case. However, in pre-hiring background investigations we're guided by the Fair Credit Reporting Act, which puts limits on reporting information more than 10 years old—although that limit is lifted in background investigations of people making more than $75,000.

'Stewardship' issues in past jobs

In looking at an executive's business career, we pay particular attention to stewardship issues—what happened at a company while our subject was in charge.

We especially want to see whether the person we're looking at has ever been sued over performance issues in his or her business roles. We've found that the worst disputes in someone's business career are played out in court battles, and we focus particular efforts on finding these on-the-record files.

Among the problems we've found: A CEO whose past company was accused in a suit by the Justice Department of keeping two sets of books to deceive federal regulators; a director who served on the audit committee of a company later sued by the SEC for overly aggressive accounting; and a major investor who sat on the board of a company that pleaded guilty to a federal antitrust charge.

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Business people should expect the due-diligence process to put these kinds of issues on the table. But in the course of our work, we'll also come across lawsuits that at first glance look less relevant—everything from motor vehicle accidents to divorces. Because these are all part of someone's public-record paper trail, it's fair game to report details of them to our clients, although we sometimes make judgment calls based on what our clients have told us is relevant to them.

In divorce filings, for example, information about someone's financial status could be particularly significant if it contradicts what he or she is telling a prospective partner. At other times, entirely personal information such as allegations of adultery may be part of the public record, but still not appear to be reliable or relevant.

Another large part of a business person's past extends to his or her relationship with various levels of government. For someone working in highly regulated businesses, we expect to find documents in government files.

For example, we might find that a federal Food and Drug Administration inquiry at a drug company led to a Justice Department investigation during a pharmaceutical executive's tenure, or that a state insurance commission fined a company while our subject was its CFO.

When our subject is a lawyer, accountant or stockbroker, or holds some other job that requires official licensing, we routinely call licensing authorities or run checks on their websites to see if there are any disciplinary actions on file.

Is the claim of wealth a façade?

Business people, particularly when seeking to obtain financing, often signal their wealth to prospective partners by entertaining them in lavish homes or on fancy boats. They should expect due-diligence investi-

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gators to test the depth of their pockets in some ways but not others.

We might first look at property records and compare the purchase price on the deed with the amount of the mortgage to see how much equity someone has in his or her home.

Another legitimate source of information about someone's financial status is the existence of judgments, and federal and state tax liens. We'll also look for bankruptcy filings and if we find one, identify the creditors. Often we'll interview one or two of those creditors; sometimes they'll show that the bankrupt is a bad bet, and other times our investigation may indicate that, while under financial pressure, a subject was trustworthy and responsible.

While such records and interviews can give a glimpse of someone's financial status, there are strict laws regulating how much information is available to investigators.

The federal Gramm-Leach-Bliley Act was written to protect the privacy of people's financial information. It specifically prohibits what some so-called "information brokers" allegedly did—making false statements or using impersonation to obtain someone's bank balances or similar information. Since the law was passed, the Federal Trade Commission and several states' attorneys general have aggressively pursued such "pretexting."

Similarly, while tax liens and U.S. Tax Court cases are fair game in a due-diligence investigation, federal law protects the privacy of tax returns, and due-diligence investigators cannot obtain them.

So, to recap, we would propose that Social Security numbers, litigation, drunk-driving charges, property records, tax liens are all on the table. In the absence of a release, medical records from hospitals, tax returns from the IRS or state agencies, and financial information from banks are off the table.

If both sides to prospective relationships agree to this due-diligence standard, the parties to be investigated should volunteer information to the investigating party with the attitude: "Here's what you're going to find out about us anyway."

In the more transparent deal-making environment that would result, relationships could proceed (or be turned down) more efficiently and based on better information. ❑