

Fund Director Intelligence

Your digital platform for *Fund Directions*

Dec 20, 2012 - - **Geoffrey Kaiser, Kaiser Law Firm**

Due Diligence On Execs, Board Vital When Sizing Up Companies

Any institutional investor who seriously is considering taking a sizable stake in another company always will perform close due diligence on that company's financials—e.g., income statement, balance sheet, cash flow statement, etc.—in order to gauge the financial health of the company in which it is about to sink millions or billions of dollars in investment capital. What sometimes takes a back seat in the due diligence process, however, are the human assets running the target company.

Far too often, the investor will perform only perfunctory background checks (if any) on the target company's executives and directors near the very end of the process, when everyone is in "deal heat" and nobody wants to stop the train. At that point, the investor usually is hoping not to find any problems that could derail the deal—not exactly an environment conducive to objective and sober decision-making. Even when the investor is planning to acquire the target company outright and install new managers and directors, it is important to understand who is being replaced and how their previous conduct may bear on the risks entailed in consummating the deal. Where the investor is merely a stakeholder in the new company, and is relying on the existing management team and board to move the company forward, it is that much more vital in assessing the merits of the investment to know the quality of the management team that is already in place. Are the company's senior executives and directors likely to run the company toward a profitable future, or are they more likely to run the company into the ground? No institutional investor can rationally decide to invest the money of its members or shareholders without knowing the answer to this very important question.

There is much that can be revealed by thoroughly vetting the people who occupy leadership positions within the target company. One need look no further than the many prominent examples of resume fraud that have been committed at major corporations over the years to realize that, when evaluating human assets, things are not always as they seem:

- The former CEO of **Yahoo**, **Scott Thompson**, was forced to step down earlier this year after it was discovered that his official biography falsely indicated that he had obtained a computer science degree from **Stonehill College**.
- The former CEO of **Bausch & Lomb**, **Ronald Zarrella**, falsely listed an MBA degree from **New York University** on his resume.
- The former CFO of **Veritas**, **Kenneth Lonchar**, falsely claimed to have received an MBA degree from **Stanford University**.

Many other similar examples could be listed, and resume fraud is only one of many risks that should be addressed. For instance, **Ryan Petersen**, the former CEO of Silicon Valley company **OCZ Technology Group**, recently resigned after reports that he had failed to disclose a prior criminal history that was euphemistically described in one company filing as "youthful indiscretions" before the company finally acknowledged that Petersen had a prior felony conviction related to conduct involving "the possession and sale of marijuana, theft, selling stolen property and forging a check."^[1] Accordingly, it is incumbent upon an institutional investor when evaluating a prospective investment in a target company to delve beneath the surface, and not to fall victim to the type of "groupthink" that can sometimes infect the deal-making process when everyone is anxious to close a transaction in a compressed timeframe.

Some of these inquiries can reveal character, while others can reveal capability, and both types of inquiries are necessary in order to perform the kind of due diligence that will provide the desired "quality control" in a contemplated investment.

On the "character" side of the ledger, some inquiries are rather obvious:

- Does anyone have a criminal record?
- Is anyone included on a watch list, sanctions list, politically exposed person ("PEP") list or other list maintained by federal and international agencies charged with monitoring security-related issues (e.g., **Interpol**, **United Nations**, **Office of Foreign Assets Control**)?
- Is anyone included in a state or federal regulatory agency's database cataloguing individuals who have been subject to disciplinary action (e.g., **Securities and Exchange Commission**, **Financial Industry Regulatory Authority**, state licensing boards)?
- Does a search of media and internet outlets raise any ethical concerns or unflattering depictions that could create a future risk of misconduct or cause reputational harm to the company?

[+]

Feedback

- Has anyone misrepresented educational or professional credentials, or otherwise made false statements on an employment application or official document submitted to a government agency?

On the “capability” side of the ledger, the required inquiries may be somewhat less obvious, but no less important:

- Is there anything in a person's background indicating an existing or potential conflict of interest that could impair one's ability to carry out job responsibilities objectively and cause him or her to act out of self-interest at the expense of the company's best interests?
- Does a search of media and internet outlets raise any concerns over professional competence, either in connection with job performance at the target company or in past positions with other companies?
- Are there any concerns about external distractions that could compromise job performance such as involvement in outside legal proceedings or an excessive number of outside directorships by board members that could undermine effective corporate governance?
- Are there an adequate number of independent board members or does an investigation of historical corporate affiliations reveal extensive overlapping prior professional relationships between directors who are supposed to be “independent”?
- Do the educational and professional credentials of the people in leadership positions reasonably match their job responsibilities?

Answering these inquiries is not always a simple proposition of entering a name into a search engine. While having access to a robust set of online databases is an indispensable tool, it still takes a trained professional to understand what to look for, how to formulate the query and how to interpret the results. In some instances, witness interviews may be required to supplement the online findings and ensure a thorough risk analysis. When one is researching an individual's involvement in legal proceedings, either as a litigant or a witness, it is sometimes necessary to conduct on-site record searches, depending on whether the relevant documents are available online.

It bears emphasis that when the investment under consideration is a friendly one—e .g., when the target company has solicited the investment in order to generate additional operating capital—the investor may request that the senior managers and directors supply signed authorizations, as well as additional personal biographical information, that can be used to facilitate the background investigation being performed. Having a signed consent form authorizing prior employers, educational institutions, credit bureaus and others to release information, simplifies the process significantly and helps to ensure that all risk areas are thoroughly scrutinized.

As the above discussion reflects, the well-worn bromide “look before you leap” has special relevance when it comes to major capital investments in ongoing business concerns. It is imperative that before committing substantial investment capital, an institutional investor take a long, hard look “under the hood” of a target company by vetting its senior managers and directors and satisfying itself that the merits of the investment are not adversely impacted, and perhaps outweighed, by other significant risks surrounding the human assets running the company.



Geoffrey R. Kaiser is the founder of **Kaiser Law Firm** and a former federal prosecutor in the **U.S. Attorney's Offices** for the Southern District and the Eastern District of New York, where he was deputy chief of public integrity and chief of health care fraud prosecutions. His practice concentrates in internal investigations and business intelligence, white-collar crime and business frauds.

[1] OCZ Technology Group, Inc., Prospectus Supplement filed Sept. 2, 2012, at S-31 and Prospectus Supplement filed April 8, 2011, at S-31.

Geoffrey Kaiser



© 2012 Institutional Investor, Inc. All material subject to strictly enforced copyright laws.
Please read our [Terms and Conditions](#) and [Privacy Policy](#) before using the site.