

# Tales from the fraudulent frontline

Timothy Mohr and Robert Weiner of BDO Consulting share cautionary tales of misdeeds and alarming facts unearthed just before deal closings.

By Jennifer Harris

Recently, a US-based real estate investment firm had been approached by a member of the Saudi Royal family regarding a potential real estate venture. The firm was introduced to a number of the Sheik's senior advisers – among them was an individual identified as a “Pakistani National.” Unknown to both the US investment firm and the Sheik, this man was actually a disbarred attorney from California, who had fled the United States in the late 1970's to avoid legal prosecution. Clearly, this person was not someone that the firm wanted to be in a position to make decisions regarding the investment.

The information about the Pakistani National's identity surfaced only during the pre-deal investigative due diligence, which included research into the backgrounds of the Sheik and his team of advisers. Although the deal moved forward, the Pakistani National was eliminated from the deal and dismissed from the Sheik's group of advisers.

As this example demonstrates, when acquiring a foreign company or investing in a US entity with international operations, private equity firms and their advisers need to obtain full disclosure with respect to the entity and the people involved in the deal. In particular, they should be concerned about the quality and reliability of information they receive and take additional steps to identify undisclosed legal and reputational issues in order to make an informed decision about the parties involved in their proposed investments. Reviewing financial information and identifying inconsistencies or barriers related to a transaction is a common practice, but when the deal involves an international partner or has an international component, conducting the proper investigative due diligence to identify less obvious risks is an equally important protective measure.

## In search of your prince

Many years ago, Warren Buffet shared his acquisition experience in a Berkshire Hathaway shareholder letter. In the note, he stated that companies are often populated by executives who regard themselves as “princesses looking for a frog of a company to kiss and turn into a prince” – but in his experience, “if you kiss frogs you end up with a bad taste in your mouth.”

In Rethinking the Career Value of Private Equity Ownership, Dean Ireland states that when acquiring a company, irrespective of the ownership model, it is often best to choose a prince. However, distinguishing between princes and frogs is a function of knowing their backgrounds and understanding the footprints they have left behind. It's certainly a case of “easier said than done.”

Especially important for international transactions is conducting the proper pre-deal investigative due diligence, which typically covers the company's business ethics and practices, including those of the principals. This includes looking into the

parties' economic and political standing in the local business community, relationships with the government and its various agencies, signs of financial or tax difficulties, past or current criminal or civil legal problems, and evidence of bribery or other forms of corruption. Additionally, effective due diligence procedures should include a variety of specific evaluations to determine if the risks of undisclosed corruption or Foreign Corrupt Practice Act violations are also present.

## For private equity investments, the prince is harder to find

While the negative impact of corrupt business practices on revenue is well known, the type of due diligence needed to identify fraud and corruption prior to deal consummation or an investment is highly specialised.

For businesses in any country, corruption is a central concern – especially for those in developing or emerging economies, but also those in industrialized nations. It affects multinationals in the United States and Europe; touches manufacturing in China; affects information technology service providers in India; reaches farmers in Latin America; and permeates numerous industries in Africa, Central Asia and the Middle East. According to Transparency International's Global Corruption Report 2009, in addition to direct financial consequences and lost business opportunities, there are substantial damages to brand, reputation, employee morale and business relationships that accompany corruption. As one lawyer in Asia commented, “nothing destroys value like a corruption case hitting the media.”

In order to help avoid liability for corrupt third-party payments, US companies are advised in the Lay Person's Guide to FCPA to take the necessary precautions that would increase the likelihood that they have formed a business relationship with reputable and qualified partners and representatives. This screening process requires due diligence to be tailored to address industry- and country-specific concerns. Questions regarding the use of agents, cross-border agreements, retainer and commission payments should be included and scrutinised – and the use of in-person interviews and site visits should be a part of the due diligence strategy.

## Fraud affects the bottom line

According to BDO Consulting's 2008 Anti Fraud Study, 37 percent of top executives at leading US private equity firms have been exposed to corporate fraud through their investments, and 40 percent of those investors felt its impact on their investment return was significant. Fifty-nine percent of those exposed have faced instances of fraud worth \$1 million or more, and 84 percent of private equity firms would consider fraud risk when making an investment.

For example, during pre-deal investigative due diligence

with respect to one potential investment in Nigeria, allegations of corruption and self-dealing surfaced regarding fraudulent practices committed by management of the target company at its Port Harcourt, Nigeria operations. A number of the target's management-level staff members, in conjunction with others, had been involved in dubious business practices, including:

- Misappropriated funds by recording payroll payments to individuals who had previously resigned from the company;
- Misappropriated petty cash funds by inaccurately recording the purpose of payments and by inappropriately issuing checks; and
- Diverted contracts to another Nigerian company, in which some of the target's management had an equity interest.

As a result of these findings; the deal was terminated.

### **Finding the information overseas – it's an art**

At the Summer 2009 Regional M&A and Private Equity Trends Symposium held in Dubai, Azmat Taufique of Investcorp described conducting due diligence in the Middle East and Africa as having "the challenge of inefficient information, as sometimes information that is provided to us by the vendors, or their advisers, is incomplete and very often unreliable." He went on to say, "it is often the case that you cannot trust the data that is provided to you... so you have to dig a lot deeper into the fundamentals of the company."

The availability of certain information is not always clear, and records that are accessible in one country may be nonexistent in another. To make matters worse, there are often certain cultural differences and legal impediments (e.g., privacy laws) that may also affect the quality and timeliness of the information sought. When conducting deals in foreign territories or with US businesses operating abroad, buyers may encounter regulations with which they are unfamiliar.

When public records are insufficient to provide the necessary information to decide whether to invest in a fund or enter into a relationship, the focus of due diligence efforts must involve a greater depth of investigation. This can include in-person interviews with the target's customers or representatives, as well as additional research into cultural, political and corruption climates.

One private equity firm was recently contemplating financing a US company looking to export its manufacturing requirements to China. The pre-deal due diligence focused on the Chinese manufacturer – looking into whether the manufacturer had undisclosed past criminal or substantial legal issues, and if there was a possibility that it would manufacture counterfeit copies of the product to sell in "off- markets."

While there were no records to indicate that the manufacturing company had been the subject of civil litigation pertaining to violations of foreign or domestic intellectual property laws, discreet interviews with its management and employees revealed that they had a history of reverse engineering and manufacturing their clients branded products without authorisation and selling them to other markets, such as Africa. As a result, the company did not enter into an agreement with the Chinese manufacturer.

In a separate deal, a financial institution was looking to conduct business in Saudi Arabia. Due diligence efforts included a detailed review of the current economic and business climate in Saudi Arabia, as well as a descriptive analysis of the current corruption climate and the measures and laws enacted in the Kingdom aimed at curbing corruption and terrorism. In addition, the financial institution was provided with research including English and Arabic language media, public record searches and reputation inquiries pertaining to the companies and affiliated individuals. As a result of this information, the financial institution had the necessary information about doing business in Saudi Arabia, sufficient to make an informed business decisions regarding the potential investment and joint venture agreement.

### **Deal making is glamorous - due diligence is not**

It is imperative not to accept at face value the information provided when entering a business venture with a foreign entity or a US company operating abroad.

When a potential joint venture partner, a "prominent Brazilian entrepreneur," failed to provide sufficient documentation regarding the source of his income, the potential private equity investor hired an outside adviser to conduct specific in-country pre-deal investigative due diligence. At first glance, this individual appeared to be involved with a myriad of legitimate commercial entities, including multiple real estate ventures and shopping malls. What was revealed during the background inquiries was that this alleged successful businessman's portfolio resulted from illicit activities including drug dealing and other activities in conjunction with various organized crime syndicates. In fact, it was determined that Brazilian and US law enforcement agencies were actively investigating the activities of this individual and his related business concerns. The ramifications of this deal moving forward could have been disastrous.

Do not take things at face value when looking at companies abroad. The excitement and potential upside of a deal should not dissuade businesses and individuals from understanding the entities and persons with whom they are dealing. And while the information is usually available, the art is in knowing where and how to look for it.

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