

Do It Diligently: How a New Best Practices Process Can Slash Expenses

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In the post Sarbanes-Oxley world of good governance and corporate social responsibility, successful companies place a premium on ethics, risk management, due diligence and compliance. Though they are fond of saying how important their reputations are, however, many companies have not taken the steps necessary to design and implement a comprehensive mandatory company-wide reputation risk due diligence (RRDD) program. Good compliance and due diligence programs not only provide protection from potential legal liability and financial hardship, but also safeguard a company's reputation.

The stakes are especially high for companies that conduct business overseas in emerging markets, in large part because of a global increase in compliance-related enforcement actions and the inherent difficulties in managing third party and partner risk in these markets. Recent fraud cases and Foreign Corrupt Practices Act (FCPA) investigations have renewed the focus on due diligence. Board members are no longer willing to take a company's RRDD process for granted and are asking for assurances that their company is using best practices. General counsel and compliance officers should take personal responsibility for being well-versed in performing RRDD, as it is likely that they will be held responsible for due diligence failures —especially those that result in corporate “crisis.”

An effective RRDD program provides a company with a variety of background due diligence information on intermediaries, prospective business partners and other key parties in potential business transactions. Supporting the program is a top-down ethical culture and written policies and procedures that will insure relevant information is transmitted (and recorded) in an appropriate format to the company's decision-makers. The terms “character risk” or “integrity risk” are often substituted for “reputation risk” in describing this type of due diligence. RRDD is a key component of anti-corruption and other compliance ACC Docket 80 November 2009 and risk management programs, and not only will identify entities and individuals that have been sanctioned, debarred or convicted, but will also pinpoint red flag areas such as negative allegations and the involvement of politically exposed persons in a deal. Companies that fail to take adequate measures to perform effective RRDD not only risk financial hardship and damage to their reputation, but may not be able to mitigate liability pursuant to the Federal Sentencing Guidelines. See www.ussc.gov/guidelin.htm.

The Due Diligence Services Industry

Designing a best practices process involves understanding the capabilities and limitations of the due diligence services industry and how the market is segmented. The relative costs and benefits of outsourcing services must then be carefully compared to the cost of performing some or all of these services in-house. Only then can a program be designed that takes into consideration the company's business model, its existing capabilities and the intensity of its due diligence needs. There is no one formula that will work for all companies.

There are only a handful of due diligence database providers that license the use of their search tool products to companies performing searches for themselves and others. Benchmarking makes it clear that complete data coverage is possible only through some combination of these companies' products. Their publicly available data collectively includes voluminous information in the following main categories:

1. worldwide sanction, violation, conviction and debarment lists from multilateral and international organizations and foreign governments;
2. worldwide news reports and articles dating back many years;
3. personal and company information on assets, liens, litigation, bankruptcies, addresses and other similar information; and
4. worldwide politically exposed persons.

RDC also provides non-public data that its bank founders have gathered on clients over a decade. Data is updated on a daily basis.

What the industry calls a "Level 1" search/report will encompass information gleaned from these categories using data from a number of different database providers. Although sales representatives may claim otherwise, none of these companies have the best data in all categories. It is only by integrating a number of database products from different companies that you can put together complete coverage. Moreover, because of different filtering requirements and search term settings, some redundancy in data is highly recommended.

A variety of RRDD contractors are used by investors and international companies that outsource all or most of their international due diligence reports and investigations. These companies, often staffed by former intelligence community analysts, search database provider products to supply Level 1 reports to clients on individuals and entities that range in cost from \$1,500 to \$3,000 and can take up to a week to be completed. Level 1 reports generally do not include information that cannot be obtained online. RDD contractors also provide more extensive searches and investigations with a "feet-on-the-ground" in-country component. The cost of "Level 2" or "Level 3" searches and reports ranges between \$5,000 to \$50,000, involve discreet inquiries and interviews, as well as searches of local records that are not on the internet. Level 2 and 3 reports take at least a week, and generally more, to prepare and deliver to clients.

Larger RRDD contractors, enterprise risk management and accounting firms also provide security, forensic and risk management, as well as other consulting services. Other firms in this market segment are more specialized and focus on serving the needs of particular industries, such as private equity funds or exporters.

Many RRDD contractors use the same foreign investigators as subcontractors. Finally, there are also dozens of consultants that provide international due diligence and security, risk management, merger and acquisition and compliance consulting services but don't generally perform searches themselves. These firms are typically small and their capabilities are limited. Not discussed here are those firms that specialize in checking backgrounds for employment purposes. Keep in mind that the due diligence services industry is rapidly maturing. Acquisitions and partnering results in a constant stream of new

due diligence products, and there are currently flaws and gaps in the services and products offered. Options for implementing best practices will vary depending on the size of your company and the amount of overseas business you transact. A key consideration is how much of your process should be outsourced and to whom. Large- and medium-sized enterprises may be in a position to hire full-service RRDD contractors, but the cost of such services can be extremely expensive. Smaller firms that do minimal or sporadic business overseas have fewer cost-effective options, but because of the high level of fines and the cost of legal representation shoulder more devastating consequences in the event of failure.

Consider Bringing More Due Diligence Functions In-house

If your company is a party in even one or two sizable overseas business transactions in a given year — especially in emerging markets — consider bringing the majority of your due diligence functions in-house. Begin with a comprehensive audit of your current due diligence and business intelligence practices, followed by a benchmarking or comparison of those practices and procedures alongside those of other companies and institutions in your industry. In many cases, with the addition of minimal resources, a company can simply improve and build upon existing practices and procedures. Depending on the number of background information searches needed per year, a company doing business overseas can easily save a significant sum by doing its own Level 1 background information due diligence reports on potential business partners, project parties and business intermediaries. The most efficient option is to create a company background information and research center that is manned by trained specialists. Mandatory, enterprise-wide and comprehensively written rules and procedures should govern the use of the center, and how the information it provides to management is requested, reviewed and stored. Subsidiaries and intra-company divisions should follow the same practices and preferably use the same information center resources.

The information center should negotiate a number of database provider product licenses within budget and continue to evaluate and benchmark new product offerings. The legal and compliance departments should work closely with information center staff and insure that all procedures are being implemented. They should also be reviewing the due diligence information reports and making determinations as to when additional due diligence should be performed — in addition to when RRDD contractors should be engaged to provide more detailed reports and investigations. The legal and compliance departments should insure that the information center function is integrated with all of the company's general risk mitigation efforts, such as its anti-corruption compliance program.

The cost savings of setting up an in-house information center should be evaluated without consideration of the need for Level 2 reports because this need is a constant and most companies must outsource these when necessary. By way of example, let's consider the Level 1 due diligence that should be performed on a hypothetical overseas joint venture partnership with two foreign entities, one of which is a local partner. Level 1 background information searches should be done on the key officers, directors and equity holders (The Overseas Private Investment Corporation (OPIC), for example, performs background information searches on equity holders of five percent or more) of each of these entities. If a potential partner controls a subsidiary or has a parent company, the same level of due diligence should be done on those entities.

Moreover, best practices would require that due diligence be performed on other parties that are material to the potential transaction, including intermediaries and consultants, local investors, construction contractors, manufacturers, suppliers and sales representatives. Evaluation of this hypothetical transaction

could easily require as many as 50 Level 1 background information searches. If outsourced at \$2,000 each, the cost of Level 1 reports alone will be approximately \$100,000. A company that does a significant amount of overseas business could easily need to perform 1,000 background checks per year at a cost of approximately \$2 million before volume discounts. At a discount of 50 percent, the cost of obtaining 1,000 reports would still be approximately \$1 million. Financial institutions and banks, for instance, are known to perform thousands of background checks each week.

Contrast the cost of outsourcing 200 Level 1 reports in a given year (e.g., \$300,000 at \$1,500 per report), against a cost of only \$250,000 per year for maintaining an information center with the capacity to provide approximately 1,000 Level 1 reports per year in addition to other research and information services to the enterprise. The \$250,000 covers the cost of subscribing to several database provider products at approximately \$100,000 per year, including 24/7 access to LexisNexis databases, and employ two full-time information specialists with an estimated \$75,000 in salary and benefits per year for each.

There are also a number of ancillary benefits to consider. Because information center staff will have intimate knowledge of the company's business, they are in a better position to request additional search terms and identifying information, evaluate allegations and data and make secondary search inquiries. Reports can be generated on a same-day basis when necessary — and when information center staff is not fulfilling company search requests, they can efficiently perform company research and satisfy business intelligence requests. Benchmark Your Practices General counsel and compliance officers cannot honestly assure their boards that their companies engage in RRDD best practices unless they benchmark practices periodically. Benchmarking can be done internally or through the use of an independent consultant. Unless serious efforts are taken in this regard, auditors and/or enterprise risk management consultants may identify embarrassing internal control issues. Ideally, procedures should, at a minimum, require a yearly comparison/audit within the relevant industry. A good way to benchmark and improve practices is by sending law and compliance department Risk Due Diligence Resources Databases representatives to seminars and conferences addressing compliance, due diligence and risk management practices.

There are legitimate differences in best practices among industries and sectors. For example, the due diligence performed by private equity firms investing in emerging market countries typically differs from due diligence that should be performed by companies investing in early stage or green-fields companies. Private equity firms usually invest in established, closely held companies that are usually well-known in the market and are often traded on local stock exchanges. A personal survey of private equity firms indicates that they generally do not do Level 1 reports on target portfolio companies and their principals. Instead, they rely heavily on their in-country or regional staff for due diligence and only use RRDD providers for Level 2 background information reports on one or two key persons controlling or managing the target investment.

As a general rule, companies investing in green-fields projects, startups and emerging companies should be running Level 1 background information searches on partners and other key parties involved in the project. Companies investing in both startups and ongoing concerns also need to ensure themselves that the entity in which they invest uses best practices in due diligence and know-your-customer (KYC) procedures. Attorneys and project teams should review and approve such policies and procedures before commitment.

Small and midsize firms that venture overseas find their options are more limited. The sporadic nature of their needs may not justify the creation of an information center, but it is a struggle for them to find the resources to outsource comprehensive due diligence when they need to. Lack of working capital can put a natural pressure on smaller companies investing overseas to cut corners and perform less than through due diligence.³ Another common mistake made by deal teams is allowing an executive's personal judgment of a potential business partner's character or reputation to substitute for a thorough background check. Personal and company information needed for background checks should be requested as early as possible in the due diligence process, well before personal relationships are established between negotiating parties. In many cultures, it is considered an affront to ask for identifying information in order to perform a background check after a relationship is developed.

Does Outsourcing Provide Added Protection?

Hiring a contractor to investigate a potential partner's reputation and background and write an independent Level 2-3 report is often an essential part of the due diligence process, especially when a company does not have a real presence on the ground. Even when a company has an established deal team or staff living in the country, there will be times when you must turn to contractors for in-depth investigations.

General counsel and compliance officers may also like the idea of outsourcing their due diligence search needs, in part because they believe that relying on "experts" will help insulate them from liability and provide them with a culpable party to sue in the event that they rely on misleading or inaccurate data. Lawyers and business persons are used to relying on the work of experts. Take, for example, the common practice of relying on legal opinions related to a variety of legal and factual issues. Counsel carefully negotiates these opinions, as they can become a basis for a malpractice lawsuit if a business transaction goes sour. Yet any application of this logic to outsourcing Level 1 due diligence provides a false sense of security.

In reality, outsourcing Level 1 background information reports does not give a company any added protection. RRDD contractors that perform background checks and other due diligence for corporate clients license commercial database products from the same database providers that will license their products directly to you. Providers' licenses always contain explicit disclaimers of warranties and limitations of liability in regard to the information and its usage in their databases. In turn, the RRDD contractors themselves go to great lengths in their contracts with client companies to protect themselves from potential liability based on the information contained or not contained in reports they provide to clients. Contracts generally state that all information provided is 'as is' without any warranty and with no guarantees of completeness, accuracy or timeliness.

It is doubtful that a lawsuit against a due diligence information provider for merely failing to locate relevant information — or for providing unclear or misleading information — would ever succeed. A successful case would need to involve gross negligence on the part of a database provider or RRDD contractor. Even if it did, any damages for lost profits would be speculative and hard to prove. In any event, reliance on outside RRDD information providers for due diligence reports, without a full understanding of their procedures, is a risky practice. What search tools are they using? How are they filtering negative information? Is there going to be a human intelligence element in the review of the data provided to the client? If so, what training do these information analysts have? Ask yourself whether it

would be better to make decisions internally about the relative importance of allegations and other historical information rather than allow your contractor staff to make such decisions. Finally, when outsourced information is transmitted and received by your company, how that information is reviewed, stored, evaluated and used internally in regard to any decision-making process is not the responsibility of the information provider. Management and company employees with an in-depth knowledge of business operations are in the best position to judge the relative importance of — and risks to — the company presented by due diligence information.

Other Cost-Effective Resources

One of the most cost-effective ways to supplement your Level 1 due diligence in overseas transactions, short of hiring in-country private investigators, is to utilize your local/foreign counsel. They may, for example, request to search local databases and court records and include a reference to the results in their opinion letters.

There are many other excellent due diligence resources that are free of charge and should be used to supplement due diligence on a routine basis. In the United States, investors should consult with country desk officers at the Department of State, and country specialists at the Department of Commerce's Advocacy Center about prospective partners and potential projects. In-country due diligence should include taking advantage of opportunities to speak with Foreign Commercial Service and the US Agency for International Development (USAID) representatives, ambassadors and US embassy economic counselors in addition to Am Cham businessmen about potential projects and the reputations of local companies and business persons. Finally, a good deal of valuable information can be learned from meetings with foreign ministers and local government officials.

A Proactive Approach Yields Advantages Companies that need to perform several hundred or more background information searches each year should consider building an in-house information center. This approach can be particularly cost-effective, especially if the information center staff also provides general business intelligence research utilizing information center resources. Under such a scenario, If your company is a party in even one or two sizable overseas business transactions in a given year — especially in emerging markets — consider bringing the majority of your due diligence functions in-house.

A company would perform its own Level 1 background information searches and would only enter into contracts with RRDD consultants when more detailed Level 2 and 3 reports are requested by managers or by company policy.

Key elements of an effective RRDD program include:

- integration of multiple due diligence database services and products, providing redundancy and complete coverage;
- same-day customized report generation capability;
- enterprise-wide mandatory internal procedures and guidelines covering all aspects of the RRDD process;
- blanket contracts in place with RRDD consultants for outsourcing of secondary-level due diligence;

- incorporation of United States Government and other free in-country RRDD resources;
- periodic benchmarking and best practices reviews; and
- integration with more general risk mitigation and compliance efforts.

Accept that your deal teams will naturally develop a “close the deal” bias when evaluating negative due diligence information. Obtained as a result of due diligence, negative information is not always going to be fatal to the deal. But make sure that there are controls that assure that final decisions which take this information into consideration are made independent of the deal team at the appropriate level. It is incumbent upon companies to adopt the necessary internal control processes and procedures to insure a documented and consistent company-wide approach — whether or not they outsource all or most of the process. Finally, a top-down ethical culture is essential to support your RRDD program.

A proactive approach provides many advantages. It may not be long before international standards are developed in this area. General counsel and chief compliance officers should understand the nuances of a best practices reputation risk due diligence program and continually benchmark their search tools and internal procedures. The foundation of any successful risk mitigation plan or compliance program is an effective reputation risk due diligence process.

Notes

1 Politically exposed person or PEP is a term that describes a person who may be or recently acted in the political arena of a country or has held a position in the recent past. Such an individual must be tracked by financial institutions and multinationals as they pose potential reputational risk to regulated entities. For example, The participation of a PEP in a business deal is generally seen as a red flag in regard to corruption. While there are a number of due diligence database providers that track such individuals, some lists are more complete than others in terms of the types of positions tracked and the degree to which “local” governmental entities are tracked.

2 Reputation risk due diligence is one of the most important elements of any enterprise risk mitigation plan, especially one designed for investments in emerging markets. Overseas investors should carefully evaluate country, political and legal risks; adopt strong anticorruption and other compliance programs; implement proactive corporate social responsibility and crisis management plans; and learn how to obtain USG advocacy before it is needed. Studies have shown that US companies lag behind their foreign counterparts in developing risk mitigation plans especially in emerging markets.

3 For example, a company looking to partner with or invest in a foreign enterprise may perform background information checks on the entity itself and its top officer, but fail to look at all company officers, its board of directors, major shareholders, subsidiaries, agents and lenders. In an overseas project with multiple parties, the number of background information searches that should ideally be performed can be more than one hundred. While it may be unrealistic to perform these many background searches in every transaction, a company should prioritize its search targets and find ways to mitigate risk where searches are not performed on lower risk targets.