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Forensic/leadership due diligence in private equity deals, mergers and acquisitions

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Lawyers working on deals run two major kinds of risk when they hire an investigator: That their agents will end up not being aggressive enough when searching the public record, or too aggressive when interviewing and gathering non-public information.

The risks of a too-soft or too-hard investigation are easy to envision. A critical piece of information about a target person or that person's fund or company may get overlooked. If the merger turns hostile or the matter ends up in court and the investigator has talked to the wrong people, perhaps violating the attorney no-contact rule,¹ critical evidence could get excluded.

Even if the merger proceeds in a friendly way, it is a lot harder to make money when the people you paid for are about to rush for the exits because of a major issue you didn't find out about during due diligence.

Let's address the too-passive investigator problem first. Proper due diligence approaches a sweep on all available public-record documents as a forensic audit of a person's life. Instead of a sampling of data about a person, a forensic investigation turns over every piece of paper publicly filed about the key actors in a target company — the fund managers, the C-Level executives, and sometimes the Board too. Every lawsuit they've ever been involved in, every securities filing, every side company they operate, as well as UCC security agreements, real estate transactions, and undisclosed business partners.

You also need to look at arrests, regulatory and licensing infractions, and perhaps even customs records if the person is involved in the trading of tangible goods.

Regular due diligence requires the checking of references and education degrees. Forensic due diligence does all this, but looks for the places the person worked that are NOT on the resume (Fired? Quit to avoid being fired?). It also necessitates looking for side businesses that person maintains, whether at an office or out of his (first or second or third) residence. It also looks at the people not listed as references — colleagues and employees at various jobs (disclosed or otherwise), as well as litigation opponents. If things got so bad that somebody went to court over it, we need to know what happened.

How might this approach work for an investor thinking of putting money into a hedge fund? Two years ago, we were asked by a fund-of-funds to look at a hedge fund run by two New York individuals. The hedge fund had been running for two years and had pretty good returns. We saw no problem with its financials. Our client gave us the fund's name and the Delaware company he thought he would be looking at. It turned out that since the prospectus had gone out to our client, the New Yorkers had formed eight other companies. Our job turned from looking at one fund run by the pair to

looking at a universe of firms they may have been running.

Where was this information? Most public records are not on the Internet, so this information is not on Google. Instead, it is in a document registry that had to be accessed by hand. Certainly the abstracts were on line, but the documents themselves, with names of incorporators and shareholders, were nowhere to be found in an Internet search engine.

In fact, some of the best information about a person will not be written down anywhere. It will be in the head of a person you have to find, and then persuade to talk to you about the people you are investigating.

Take a person's litigation history. A forensic due diligence procedure does not simply dump abstracts of cases off the Internet with a cover letter that says, "We found five cases in Philadelphia, but all were settled." Instead, we want to know what was in the papers filed in court. What were the allegations against the person? Who is behind the company on the other side of the case? What kind of evidence was on the public record? And since settlement terms are not published, we would arrange interviews with the venerable telephone, and try and uncover the terms of the settlement, as long as they were not confidential. Nearly all of this information will be found not in electronic form, but first on paper that would lead directly to the people involved in the matter.

Another investigative tool to remember is books. If you want to know what someone was like to work with in 1999, a book published in 2001 may be just the thing to look for. If it's no longer for sale, you may need to go to a library to get it. One thing that is true today and will be true tomorrow: librarians are lonely people while at work. If you ask them how to find a book, they will talk to you as long as you will let them. That goes double for reference librarians.

But as important as take-no-prisoners document research is, it is equally important to know when an investigator has to stop talking to a person, refrain from contacting that person entirely, and avoid getting into private records he has no business looking at. Sometimes it's a matter of not violating a statute, and sometimes it's a matter of professional ethics that could get the supervising lawyer disciplined and any evidence excluded in the event of litigation.

One of the fastest-changing areas right now in the issuance of professional ethics opinions involves the use of pretexting in social media. By pretexting, lawyers usually mean the use of impersonation or fraud to trick another person into releasing personal information.

Assume you want to contact someone on Facebook (say the CEO's executive assistant) to get her to talk about her company and her boss. Your investigator decides to make up a person on Facebook with similar interests to the person you wish to contact. The fake persona "friends" the CEO's assistant, who accepts the friend request. You now have a window into the company.

This is done all the time, though not by us or any investigator concerned about crossing an ethical line. In addition to being against Facebook's Terms of Service, the attorney Rules of Professional Conduct are very clear: it is unethical for any lawyer to pretend to be someone they are not. If your investigator is not a lawyer, that's no excuse. A lawyer has a non-delegable duty² to make sure his agent does not violate the rule as well.

Not that Facebook is off-limits entirely. In 2010, the New York State Bar Association opined that it is permissible to look at the public pages of even an adverse party's social networking site for "the purpose of impeachment materials for use in the litigation."³ That's no different from looking at a company website that's not password protected or advertising materials intended for the general public.

It gets trickier if you get someone else to use his real name to "friend" that executive assistant. If the person working for you and using his real name conceals the purpose of his contact over social media, that may be seen to be unethical depending on your jurisdiction. The Philadelphia Bar was the first to declare this kind of agent use unethical, and other jurisdictions have followed it.

Even trickier is the no-contact rule – the prohibition from contacting a person a lawyer knows is represented in the matter without the consent of the other lawyer.⁴ All lawyers learn the rule about not contacting represented people, but sometimes forget about all the tough calls there are to make in determining whether or not a particular contact violates the rule. For instance, the no-contact rule applies even in pre-deal due diligence. When calling a corporation's employees when a corporation is represented "in the matter," most jurisdictions, including New York,⁵ allow lawyers to contact people whose actions are not "binding" on the corporation. In practice, that's a tough test for an investigator to wade through: without an organization chart you go into an interview with little or no idea about the person's responsibilities and whether they can in fact bind the company with their actions.

Assume the person worked in "equities." Does that mean equity sales? Equity derivatives? And if they could enter the

company into even small contracts, was that the kind of "binding" that puts them off-limits? Checking the ABA's comment on this issue does little to clarify matters.⁶

Even if there is no legal case filed, your investigator may still be talking to someone who is "represented." Suppose you are looking at regulated financial institution in the middle of a LIBOR-scandal inquiry. No case or regulatory action has begun, but many ethics experts would tell you that talking to key people in that company would be talking to "represented" people and could violate the no-contact rule.

The same could be true if you are doing due diligence on a company prior to making what will probably turn out to be a hostile bid. If it's reasonably foreseeable that you will be in a tussle with that company, talking to some or all of the employees could land a lawyer in hot water with his ethics board.

A cautious person may therefore wish to stay clear of anyone currently employed at the company until receiving permission from the company's general counsel or outside firm.

Our recommendation in most cases is that we begin by interviewing former employees of the firm in question or former colleagues and litigation opponents of the person in question. The propriety of this technique is widely accepted,⁷ but there are still important ethical considerations.

If someone who used to work at Company X has confidential or proprietary information, you are not entitled to get that information simply because the employee is gone from the company. Further, an investigator needs to terminate contact if given information he has no right to get. We always recommend that investigators make certain to tell those they interview that they do not want any information that is off-limits. Investigators should note that their interview subjects acknowledged these instructions and keep their working notes as backup in the event the interview results in an allegation of improper contact.

One final tip when hiring an investigator: give your fact finder as full a briefing as you can. Sometimes there is no smoking gun that leaps off the page at you when doing due diligence, but a good briefing from the client helps to sniff out something that just doesn't seem right.

One client asked us to look at an asset manager who, in addition to his company, maintained a foundation. The manager had boasted several times to our client that this foundation did a lot of wonderful work. The foundation turned out to do some good work, but after we found its Form 990 tax returns (required and publicly available for charities of any decent size and which a forensic public records search would uncover) we found out that the foundation was tiny in comparison to the sales pitch our client had been given.

A good briefing gave us proper context, and an otherwise innocuous fact (a small foundation) turned into something much more significant (misrepresentation). The client passed on the manager.

Notes

1 [ABA Model Rule of Professional Conduct 4.2.](#)

2 [ABA Model Rule of Professional Conduct 8.4 \(a\).](#)

3 [New York State Bar Association Committee on Professional Ethics, Opinion #843 \(09/10/2010\).](#)

4 In New York, the rule is to refrain from contacting an unrepresented "party," whereas in most other jurisdictions it's an unrepresented "person."

5 [Niesig v. Team I, 559 N.Y.S.2d 493 \(1990\).](#) "The test that best balances the competing interests, and incorporates the most desirable elements of the other approaches, is one that defines "party" to include corporate employees whose acts or omissions in the matter under inquiry are binding on the corporation (in effect, the corporation's "alter egos") or imputed to the corporation for purposes of its liability, or employees implementing the advice of counsel. All other employees may be interviewed informally."

6 [ABA Model Rule of Professional Conduct 4.2, Comment 7:](#) "In the case of a represented organization, this Rule prohibits communications with a constituent of the organization who supervises, directs or regularly consults with the organization's lawyer concerning the matter or has authority to obligate the organization with respect to the matter or whose act or omission in connection with the matter may be imputed to the organization for purposes of civil or criminal liability.

7 See for instance, [Muriel Siebert & Co. v. Intuit Inc. 836 N.Y.S.2d 527 \(2007\).](#)