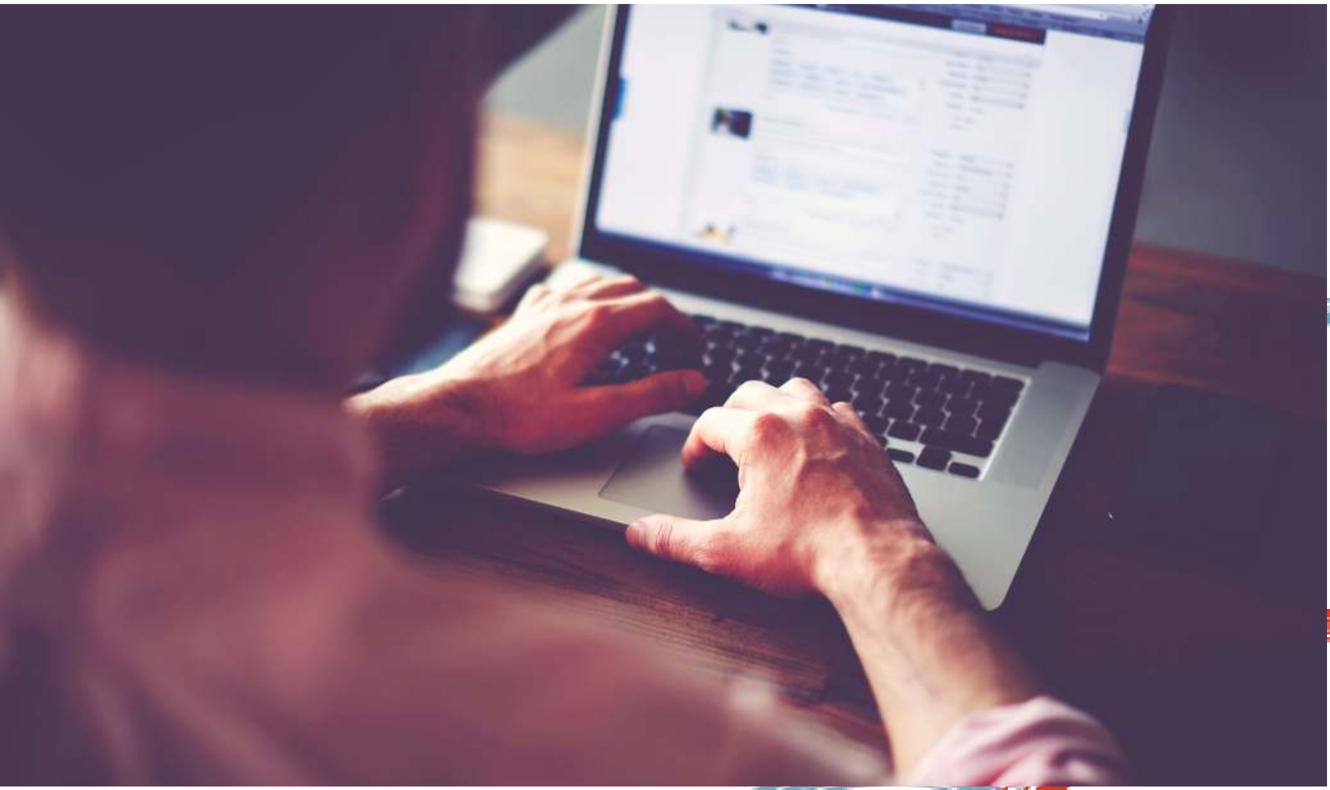
What Role Do Backgrounds Play in Private Equity Transactions?

A Guide to Gaining Improved Transparency and Validation During Due Diligence



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Introduction

When your private equity (PE) firm is looking to acquire or take a majority stake in a target company, the due diligence process is critical to reducing risk and ensuring you only move forward with the most viable investments. But sometimes, the due diligence process focuses primarily on the company and fails to sufficiently vet the executives who own and run the business. Even when the executive team is investigated, some firms rely on simple automated background checks and forego a more detailed, nuanced human analysis. Yet, as recent high-profile cases have underscored, such an oversight can prove costly and damaging.

This guide reviews the importance of properly investigating executives and what can go wrong if you don't, explains why artificial intelligence (AI) and other technology tools only skim the surface and don't provide a full and accurate picture of key executives, and details the most common red flags that only come to light through the skilled analysis of a human investigator.

This guide also reviews why the combination of technology tools and human insight yields better transparency and validation on background investigations and why a third-party investigative firm is the right choice to help your PE firm move forward on deals with greater confidence.

This guide is designed to help you avoid the risks of not sufficiently vetting the founders, CEOs, and other executives of your target companies before adding these businesses to your portfolio.

The Harsh Reality of Due Diligence Shortcuts

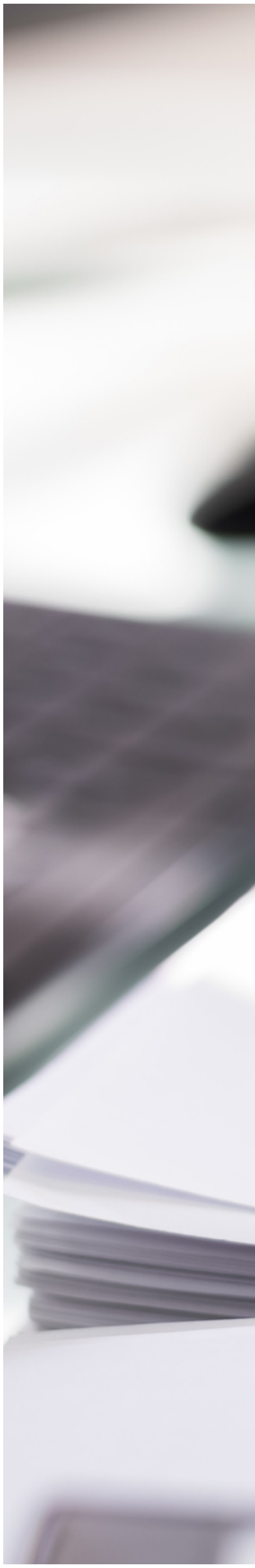
Investors need look no further than the fate of the cryptocurrency exchange FTX for evidence that failing to conduct sufficient due diligence on an investment and the key people involved can have devastating consequences.

The US Securities & Exchange Commission (SEC) has charged FTX founder Sam Bankman-Fried with allegedly defrauding the company's investors, who had infused an estimated $1.8 billion of capital into the crypto platform. The SEC is also investigating whether some investors in the now-bankrupt firm failed to engage in proper due diligence or fulfill their fiduciary responsibilities on behalf of their own investors, which could prove a regulatory blow to the very victims of the alleged scheme.

As investment consulting firm Fiducient Advisors has pointed out, a review of FTX executives should have set off alarm bells. The organization had no CFO and no board of directors. The COO had only two years of post-undergraduate work experience before joining the company, and the Chief Regulatory Officer was allegedly involved in a poker cheating scandal in his previous role at an online gambling site. A lack of corporate controls and governance also should have given investors pause before committing such large sums of capital.

Many more such examples abound. Consider the recent congressional scandal involving US Representative George Santos, who admitted to falsifying information on his resume and lying about his personal background. Or the civil fraud ruling against Autonomy founder and chief executive Mike Lynch, who faced allegations of fraudulently boosting the company's revenues and earnings.

> **These are just a few of the many incidents that underscore the risks of failing to properly investigate the key players involved in a major deal.**



Why It's Critical to Vet People, Not Just Companies

When you acquire or invest in a portfolio company, you need assurance that the business is exactly what it presents itself to be, in every respect. Of course, it's expected that you'll scrutinize the company's financial statements, review contracts and other legal documents, evaluate the viability of its products and services, assess the market opportunity, and examine its technology and security measures, among other key aspects of the business. Yet, even if the company scores well in all those categories, other land mines could be lurking. And as the old adage says, you don't know what you don't know.

Without a thorough understanding of the people involved in the transaction, you could end up moving forward with a deal that inadvertently exposes your firm to risks. If you fail to properly investigate the founder/owner, CEO, and other key executives, your PE firm could face consequences like these:

- You could become the victim of embezzlement after the deal closes.
- You might need to transition the founder or other executives out of the business post-closing, which typically involves a costly buyout.
- Your reputation in the PE world could be tarnished, creating an avalanche effect where other deals get derailed and new opportunities dry up.

The fact is, the owners and executives of the company you're evaluating could have exposed themselves to risks that you will now be exposed to if you complete the transaction. If you conduct a thorough background investigation on all the key players involved and no substantive red flags emerge, you'll **gain greater confidence in moving forward with the deal.** And if the investigation does uncover potential problems, you can **make an informed decision about whether the issue is a deal breaker or can be resolved easily and proactively, rather than waiting for the fallout.**

For example, misstating an academic degree on a LinkedIn profile or posting photos of questionable (but legal) behavior on Instagram are issues that don't create cause for alarm and are easily fixed. If a business owner seems to have genuinely forgotten about a $1,000 debt that resulted in a lien on an out-of-state property jointly owned with another party, that's easy to clear up.

But if a major infraction surfaces, and other issues are discovered in the financial or legal due diligence, then the personal issue might be the final straw that sways your PE firm to reconsider the investment.

Going Beyond Compliance

A basic background check is likely to be required as a condition of certain transactions, especially if there is a co-investor or you're financing a portion of the deal through a traditional lender. For purely compliance reasons, a basic background check will be required.

But the decision to go beyond public records vs. simply checking the box sometimes comes down to budget. And the reality is that most of the likely deal-breakers will involve other aspects of the company—whether it's spotty financials, poorly crafted contracts, pending litigation, or a sub-par service offering.

Yet, all it takes is one questionable finding about the company founder or CFO to potentially sink a deal, especially given today's 24/7 news cycle.

Relying on a quick Google search to satisfy a compliance requirement is no longer considered prudent for PE firms that want full transparency on the executives involved in a deal and complete confidence in the investment.

What You Hope You Don't Find

When you think about investigating the founder, CEO, or other executives at a target company, you might wonder, "Exactly what do we think we could find here?" The shorter answer is: Plenty. There are many potential risks that could lie beneath the surface of the key players involved in a transaction.

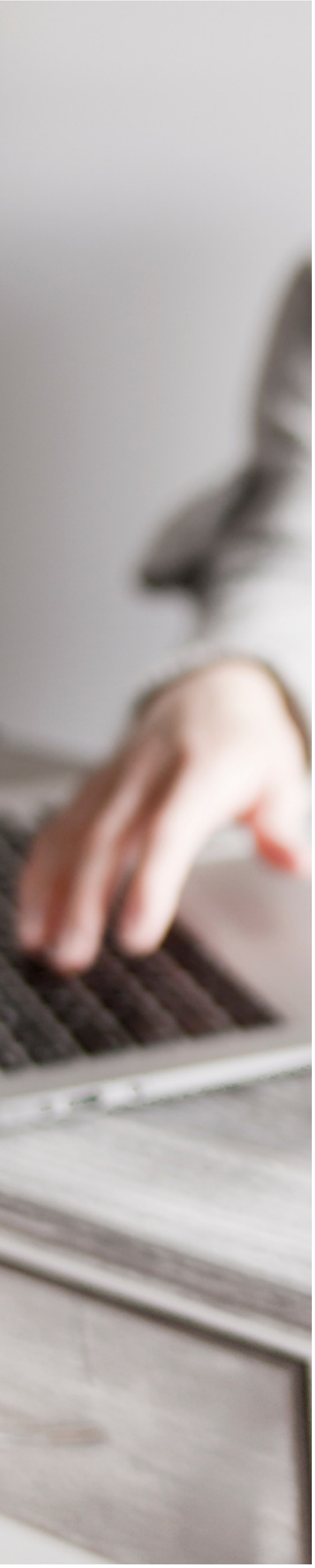
The most common include the following, which range greatly in importance and severity:

- False or unverified credentials
- Unethical or questionable behavior displayed on social media
- A history of past or pending civil litigation
- Past breaches of contract
- Conflicts of interest
- Bankruptcy filings (personal or business)
- Tax liens
- Fraud or corruption charges or allegations
- Criminal activity

Connecting the Dots

Sometimes when you connect two disparate facts, you get a picture that is more than the sum of the parts. That's what happened when a background investigation revealed that an executive involved in a potential deal was charged with vehicular manslaughter.

The initial investigation also revealed a one-year gap in his employment history. These findings allowed the client to have an informed discussion with the executive, who explained what happened and shared that he had taken a one-year sabbatical after the incident to undergo therapy and reevaluate his life priorities. This finding served to cast the subject in a much more positive light than either of the two facts alone.



Why Technology Isn't Enough

In today's digital age, there can be a tendency to rely too much on technology as the solution for almost any issue. Background investigations are a prime example.

AI and other technologies are well suited for distinct purposes in an investigation, such as filtering out the "noise" and identifying obvious problems like names or dates of birth that don't match up. These tools provide a useful starting point for a background investigation, but they should never be viewed as the only source of information on a subject because they have inherent limitations.

For example, different data sources will inevitably yield different information on a subject, and those sources rarely integrate with each other. And simply scanning a database doesn't enable you to make connections between the subject and any associates that may be involved in wrongdoing.

Consider too, that databases are driven by algorithms that continually change and are sometimes plagued with bugs. One county court had failed to update their records, but that fact wasn't apparent until a human investigator did some digging and figured it out. That meant the dated records couldn't be taken at face value.

Some records simply aren't available through an automated search because they aren't included in a court's online database, which is the case for hundreds of courts across the US. In those instances, the only way to obtain all the information available about the subject at the county level is to visit the courthouse in person and search additional databases only made available on site or review manual records.

Despite these limitations, some organizations rely on an automated search as the magic bullet for a background investigation—a task they can accomplish quickly and at a low cost. Because these technologies are pervasive and often inexpensive, there is a danger that the background investigation will start and end there, exposing the PE firm to significant risk.

Where an Automated Search Can Fall Short

These are just a few of the countless examples of background red flags that an automated search wouldn't find.

- Pharmacy boards don't always list board decisions online. Only through a detailed review of board meeting minutes would an investigator learn if a pharmacist was involved in a dispute about historical substance abuse.

- A reckless driving violation might not trigger a flag by an automated search—but an experienced investigator knows that such a violation often begins as a DUI (driving under the influence) charge and is pled down to the lesser charge.

- A divorce might not raise alarm bells in an automated search—but skilled investigators know that underneath any divorce agreement could lie an allegation of college funds taken to pay business debts, a drug testing mandate, business agreements tied to the ex-spouse, or a criminal activity allegation.

There's No Substitute for Human Insight

Given the limitations of AI and other technology tools, background investigations yield the greatest transparency, validation, and confidence when automation is paired with a human investigator. An experienced professional brings numerous capabilities that are critical to a background investigation, but which technology tools can't match—including problem-solving, analysis, and the ability to spot information gaps, follow leads, and make connections between seemingly disparate information.

Unlike a technology tool, a human investigator starts the process by getting to know the subject, their family members, associates, aliases, and affiliations. They learn where the subject lives, where they vacation, and their past schools and employers. They look up the subject's photo and develop a timeline of their activity. They seek to know the entirety of the subject's footprint before they even run a first-line automated screen.

Perhaps most importantly, technology can't duplicate the instincts of a human investigator who has done this type of work for years. Over time, investigators get to know what the results should look like—and when they don't, they instinctively dig deeper.

Let's say a media article points to the subject's involvement in a court case in a particular county, but an automated search of county records fails to generate any results. A technology tool might stop there. But an investigator would follow up on the lead and go beyond the obvious—checking to see if the court records have the name spelled wrong, if the record was unavailable in an online search, if the media article names a spouse (making it easier to find the subject), or if the subject is the fifth named party in the matter, in which case the name might not show up in an online search. Humans don't let leads go; they follow them until they find an explanation.

Human investigation also outperforms technology when it comes to customizing a background investigation to reflect the red flags most important to the particular client. Every PE firm's risk appetite is different, often varying with the size of the deal or the industry involved. For example, a large deal in the healthcare industry might have more room for risk than a much smaller deal in the manufacturing sector.

You can't easily program AI or other tools to account for heightened risk or unique red flags. But a human investigator can work closely with the PE firm, engaging in open and candid communication to learn the specifics of the deal, understand whether the firm has certain suspicions or concerns, and adjust their approach accordingly.

An open line of communication also proves vital when red flags surface, opening the door to early conversations that might avoid unnecessary time and money later in the process. And it paves the way for the investigator to provide guidance and advice about how the PE firm might approach a subject whose background check yields questionable results. When one investigation found that a subject defaulted on a loan, but he insisted that wasn't the case, the investigator equipped the client with probing questions to ask in resolving the issue. The client soon discovered that the loan was co-signed with an ex-spouse, bringing the matter to a satisfactory close.

The bottom line is that there is little about a background investigation that's straightforward. Going beyond automation enables an investigator to understand the nuances and complexities surrounding each subject, providing more thorough, reliable results that reveal the entire picture, reduce risk, and enable more informed decisions.

Common Red Flags an Experienced Investigator Can Spot

Perhaps the best way to illustrate the value of a human investigator in PE transaction background checks is through real-life examples. **The following five examples demonstrate red flags that automation could miss but an investigator would uncover.**

Same Name, Different People

When the subject has a relatively common name, relying solely on database records can lead the investigation astray. That's what happened when a data aggregator report for a man with the last name "Smith" returned a history of addresses across the U.S. At first glance, it seemed that the subject had moved often, defaulted on loans, incurred criminal charges, and filed for bankruptcy. In reality, he had attended a large university where he resided in the same dorm as another man with the same first name, middle initial, last name, and birth year. Because a computer mistakenly recognized the two men as the same person, the report was a combination of both of their histories.

Same Name, Different People, Part 2

A man with a relatively common name was fired from a large international company for suspected fraud, though criminal charges were never filed. A basic records search revealed two people with the same name had worked at the company, overlapping for several years, and resided in the same city. With no charges on file, there was no identifying information to sort out whether the subject was the person terminated for suspicion of defrauding his employer. By conducting deep media research, the investigator found articles referencing the names of both parties' spouses, helping to distinguish the two. Eventually, the investigator found a media article in which the subject, shared the headaches and hassles of being mistakenly identified as the person associated with the fraud case.

A Lien That Almost Went Overlooked

A background investigator discovered that the subject had a federal tax lien. While an automated search might have stopped there, the investigator reviewed the lien documents and found that the target company the PE firm was conducting due diligence on was also named in the lien. But the company name was misspelled in the court documents, with two letters transposed. By looking past the spelling error and making connections between two reports, the investigator uncovered a finding that proved meaningful and significant to the client's due diligence—something an automated search could not easily do.

The Case of the Missing PII

Personally identifying information (PII) is invaluable in investigations, but in more and more states this information is redacted from online court records, though not the physical records. So when an investigator searched online criminal records in California, the search returned names without a date of birth, address, or other personal identifiers. The investigator had to dig deeper—searching media reports and incarceration records, assessing the timeline of the crime, and taking a trip to the courthouse to view available records in hard copy form—to get an accurate picture of the subject.

When County Records Aren't Enough

During an investigation into a physician, an online search of the county's litigation records revealed only two inconsequential civil cases. But in this particular county, certain types of cases are handled by a different court and the records unavailable in standard online searches. By visiting the courthouse in person and searching a broader set of records, the investigator discovered the physician was named in three stalking/orders of protection cases.

Why a Third-Party Investigator Outperforms an In-House Search

Conducting thorough, rigorous background investigations into the executives involved in a pending transaction is essential, but it's not feasible for a PE firm's in-house staff to take on this vital task.

At a minimum, the databases required to conduct the first-level investigation are expensive to subscribe to and complicated to use. Third-party investigation firms like Subrosa Investigations **subscribe to the many databases** needed for the initial screens and are skilled in using them effectively.

Another key benefit of a third-party investigator is their **lack of bias**. An objective third party can take an arm's length view of the case because they have no stake or vested interest in the outcome. They're hired to simply uncover and report on the facts.

A third-party firm also brings the benefit of a proven investigative process, honed through years of experience, as well as a team of highly skilled and talented investigators with the **resources and capacity** to conduct thorough, effective background due diligence.

If your PE firm primarily invests in US-based target companies, it's best to partner with a domestic third-party firm that will have **ready access to US public records** (which other countries are often restricted from accessing).

You should also look for firms with a **rigorous quality control** process that ensures the greatest accuracy and a track record of meeting deadlines, since time is of the essence when completing a PE deal.

Strong communication is another important attribute of a third-party investigative firm, as well as no-surprise pricing that clearly outlines any optional services that would incur additional charges.

Why Subrosa is the Right Partner for PE Background Investigations

For PE firms in search of complete transparency in their background investigations and a high degree of confidence in the findings, Subrosa Investigations is the partner of choice. We bring decades of experience providing detailed investigations to support PE acquisitions and majority-stake investments, helping investors gain the insights to make the most informed decisions.

The Subrosa team forms strong relationships with each client, getting to know your organization, understanding what's important to you, and learning about the specific transaction you're working on. Our investigators go well beyond the basics, digging deep to follow up on leads, make connections, and identify issues that an automated search or an inexperienced investigator simply can't. While we use automated tools as a starting point, we augment those technologies with expert human analysis that provides more nuanced information and greater context for our findings—leveraging our unique combination of research strategies, experience, insight, and collaboration to deliver relevant, reliable results.

Most importantly, we've gained the trust of our clients—both in and outside the PE world—because they know they can rely on Subrosa as a valued partner. Our passionate team of professionals gets to know your firm, what keeps you up at night, and what will give you the confidence to close the deal. We believe in our work and recognize how important it is in ensuring you can invest in companies with confidence.

Schedule a call with Subrosa

to learn how our expert background investigations can help you better understand the principals involved in a deal before making a major investment.

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