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Self-Disclosures: Powerful Tools for Mitigating Risk

Doug Chisholm and Craig Kelbus

The grey-haired former GC of a technology business appeared to become increasingly nervous the more we asked him about his role in a criminal probe into a key executive at the company. Although he stated, repeatedly, that he had "nothing to do" with the scheme, he wasn't answering our questions directly and seemed to want to talk about literally anything else. The court records told a different story, as did some former employees with whom we spoke, and our client couldn't get comfortable moving forward with him any longer. Although the role he played in the scheme could best be described as minimal or passive, our client simply couldn't trust him any longer after our findings directly contradicted several of his representations. There is perhaps no component of the relationship between investors and the companies/ management teams in which they invest that is more critical than trust.

While there are many tools that investigators use to help investors make sound decisions before their investment —including quiet public record checks under IOI, in-depth background checks with management's consent under LOI, and reputational inquiries—sometimes a background check won't tell you as much as you'd like to know about someone's character and integrity. Either good or bad. Occasionally, after an investment, character and integrity concerns can develop quickly and leave an unsuspecting investor with the task of replacing a CEO or other management members, which can set back a growth plan six months or longer and potentially create morale issues throughout the company.

One of the key tools that we use is something we call "Self-Disclosures." At the outset of our investigation, we have management members either fill out a questionnaire or we conduct an integrity interview, typically over video call, with them, which usually lasts about 20 to 30 minutes. We ask them to disclose issues in their backgrounds – civil lawsuits, criminal cases, regulatory issues, financial problems, controversies, etc. – through either the questionnaire or interview and then compare their answers to our findings. This allows us to add another layer of context to our findings: what did/ didn't they disclose, and how does that compare to what we found?

Following are a few of the reasons why Self-Disclosures are such a growing part of our transaction diligence practice:

Testing Transparency and Trustworthiness

Bad information can have a way of reaching investors slowly and knowing whether a management team might be more inclined to try and avoid reporting bad news can be extremely informative for investors.

Particularly for operations professionals, who will be dealing closely with management. Alternatively, if management disclosed all issues, acted transparently, and was helpful in explaining the issues, that can also be information that investors and ops professionals can use to their advantage in the post-investment relationship. Self- Disclosures allow us to test what the culture of accountability looks like within that management team and, by extension, the organization.

Discovery of Information

It's not uncommon for individuals to tell us information that we wouldn't otherwise find. Because of the way online data sources and public records work, people sometimes tell us about issues that were litigated in courts/jurisdictions that we wouldn't otherwise have known to search. And sometimes people tell us about adverse events in their background that do not show up anywhere on the public record – often times it was a dispute that never ended up being litigated. People don't always know or appreciate what gets captured on the public record and what doesn't.

Deeper Dives on Disclosures

We specifically conduct research into relevant issues that are disclosed, to independently verify that the representations are accurate, as often times management can present issues in their backgrounds in a more benign nature than the public record shows. Also, the use of Self-Disclosures can provide a real forum for management members to explain adverse issues in their background and lend their voice to our findings. For example, personal financial troubles in the background of a CFO are typically concerning to us and our clients, but sometimes CFO's explain that they're overextended trying to care for elderly parents or loved ones, which can put the issue into a different context.

Finally, we understand there can certainly be risks associated with inserting outside investigators into the deal process, particularly when investors are under LOI and possibly in a beauty contest. We understand the unique role we play and we're careful to be unassuming, keep the temperature down, friendly, and good listeners. We're agents of our clients and want to be seen as an extension

DOUG CHISHOLM
Partner and Practice
Head of Pre-Deal
New York
dchisholm@mintzgroup.com

CRAIG KELBUS
Managing Director
Chicago
ckelbus@mintzgroup.com

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