

# How to Make Due Diligence Pay Off



by Larry Scherzer

**S**ecured lenders are making sophisticated background investigations a routine element of their due diligence these days — and no wonder. The times are uncertain, and that makes it imperative for lenders to gather far more information about their borrowers than they can glean from the sources usually used in the past, including the borrowers themselves.

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This new caution gives new meaning to the phrase “risk management,” and it is a trend likely to bring important change to the industry, with substantial benefits to lenders’ own bottom lines.

Why are lenders commissioning these investigations? What kind of information do they gather about their borrowers? Where do they get this data, and what do they do with it?

The answer to the first question is simple: It pays to know your borrower. Secured lenders already know this, but in the past they took the truism to mean that they needed to know everything possible about the assets securing the loan and the business to which those assets accrued. Thus, lenders analyzed and tracked such assets as receivables and inventory, studied financial statements, checked business and banking references, pored over their own files, and studied credit information gathered from such sources as Dun & Bradstreet.

But given human nature, collateral is sometimes only as good as the character of your borrower. When it comes to the lender’s bottom line, there is a difference between the borrower who feels the obligation to pay a debt in good and bad times alike and the borrower who, having offered inventory or receivables as security, considers it the lender’s problem if things go south. When dealing with people in the former category, you gain security from two elements: the collateral for your loan and the character of your borrower. When dealing with people in the latter category, you have only the collateral, and it can disappear.

The genesis of the trend toward background investigations

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lies largely in the rise of the Internet: the electronic age makes it possible to gather information about business borrowers from vast databases that did not exist a few years ago.

These databases contain detailed information on borrowers and their businesses that can enable lenders to make solid judgments not only about the value of the assets securing their loans, but also about the willingness of business borrowers to make good on their obligations. In short, the information illuminates character.

Also at work here is the nature of the competition among secured lenders. In recent years, the lure of profit has drawn many commercial banks into offering asset-based loans. Given the financial muscle of many commercial banks, this creates a fierce competition for the best business borrowers, driving every lender in the marketplace to limit risk and push costs down — all in the midst of an economy whose uncertainties make it hard to come by good business borrowers under any circumstances.

“Banks have the ability to be very competitive in this marketplace, although you have to remember that GE Capital is the biggest asset-based lender there is,” says Keith Leggett, a senior economist at the American Bankers Association. “Talk about financial muscle — GE is the 800-pound gorilla. But asset-based lending has been good to the banking industry. It has allowed banks to continue to lend, earn fees associated with loan origination, maintain relationships and offer other products.”

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A study by the NFIB Research Foundation, an arm of the National Federation of Independent Business, throws some light on the question. Published last January, the study, "Credit, Banks, and Small Business — The New Century," found that commercial banks continue to serve as the primary source of fixed-asset and working-capital financing for small- and mid-size businesses; about 70 percent of the companies surveyed obtained financing from commercial banks and only four percent from finance companies. The numbers are consistent with those of a similar NFIB study in 1995.

But because lenders of all kinds must put good loans on the books and avoid bad ones, it comes as no surprise that they now go to greater lengths to gather and study detailed background information.

In fact, it's a new world out there when it comes to lender due diligence, and those lenders that make routine use of detailed background investigations know they're better off. You can't secure any loan by weighing only financial and credit data on your borrower. You must also investigate the borrower personally.

How? If not required to give a personal guarantee on the loan, most borrowers commonly won't offer much personal information, much less damaging information. What personal information lenders get from a borrower is usually cursory: the borrower's representation that he or she owns a house worth so much money, drives a car costing so much, has never declared bankruptcy, has no criminal record, has never been sued, faces no tax liens or regulatory action, and the like.

The first step in any background investigation is to verify this information by checking the applicant's address and Social Security number and inspecting motor vehicle and court records for misdemeanor and felony criminal proceedings, along with personal and business credit and banking references.

But you also want to know whether your borrower is shading the truth, and here's an example. In one recent case, the borrower, a long-standing customer of the lender, told the lender he had one arrest on his record for drunk driving. In consideration of the long-

standing relationship, the lender judged the arrest to have been an isolated incident and made the loan without further investigation.

The borrower came back a short time later seeking a larger loan, and this time the lender called in a background investigation firm to conduct a thorough check. The investigation firm learned that the borrower had indeed been arrested for drunk driving, but that the sobriety test had registered his blood alcohol level at three times the legal limit. It was also discovered that a previous conviction for drunk driving was no longer on his record because the statutory limit for reporting it had expired some years before.

The lender, of course, had good reason to worry about a borrower who was less than forthcoming about his drinking — and who might kill himself or somebody else should he get behind the wheel again with his blood alcohol level at three times the legal limit.

But let's be careful here. Notwithstanding the human tragedy that might ensue, the lender faced a practical problem in this case from a purely business standpoint. What would happen to the borrower's business and the assets securing the loan if the man died behind the wheel of his car? What good would even a personal guarantee do if that happened?

To bring about a happy ending, the lender made it a condition of the loan that the borrower take out a life insurance policy equal to the value of the loan, with the lender as beneficiary — a simple and relatively inexpensive solution to a serious problem.

Note the dynamic here: It was only by obtaining the information turned up by a background investigation that the lender could come to a fair judgment as to the specific risk involved in making this loan. The information did not prevent the lender from doing the deal, but instead enabled it to fashion terms that made the risk acceptable. Indeed, the information enabled the lender to manage a very real risk and still put a profitable loan on the books.

Here are two more examples with less-happy endings, both showing how a background investigation can limit risk.

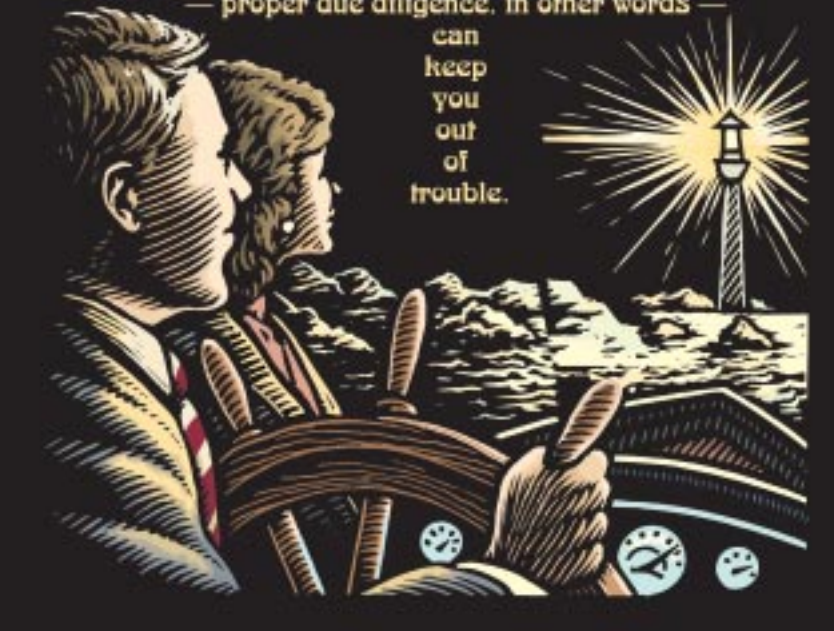
The lender in the first case closed a deal, funding a \$1-million loan on one day only to see a business creditor of the borrower enforce a \$1-million legal judgment against the borrower the very next day, seizing the cash generated by the loan. The lender called an investigation firm, but by then it was too late to save the day. The judgment was, of course, a matter of public record and the creditor had every right to seize the cash.

In the second case, the lender closed a \$5-million loan to a man representing himself as the scion of a wealthy Asian family. Conducting a cursory check using its own resources, the lender found state records listing the borrower as president of a U.S. corporation whose name resembled that of a holding company controlled by the



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Asian family. A Dun & Bradstreet report yielded similar information, noting that the logo of the U.S. company resembled that of the Asian family's holding company.

There was only one problem: The connection to the Asian family was fiction. When the borrower came back for another loan, this time for \$10 million, the lender commissioned a background check. The fraud was discovered, enabling the lender to avoid compounding its error with another \$10 million, but meanwhile the borrower absconded with the original \$5 million.

These last two examples are cautionary tales, of course; in each case the lender learned the bitter lesson that good information obtained in timely fashion — proper due diligence, in other words — can keep you out of trouble.

It is usually not enough, however, to conduct a basic background investigation verifying the address and Social Security number of the individual in question and inspecting motor vehicle and local court records for misdemeanor and felony criminal proceedings, along with personal and business credit and banking references. A thorough investigation should go back five, and possibly ten, years to cover:

- Federal and state court records for personal or business bankruptcy proceedings, employment practices litigation, civil litigation, Uniform Business Code filings, securities law proceedings, officer and director records, and other business-related matters; and
- Media mentions in local and national newspapers and magazines and on the Internet.

A thorough investigation should also include interviews with previous employers or business associates and, if the subject of the investigation has lived elsewhere over that time span, the court search should extend to both local and nearby venues — that is, the courts in all counties of residence along with those in adjoining counties. In the case of a foreign national, the investigation should have international reach, verifying immigration and naturalization status and exploring business connections both domestically and overseas.

As you may surmise, any thorough investigation can involve massive quantities of data, but it is not enough just to dig it up. To prove fruitful, the investigation must sift the data to determine, for example, whether the subject of the inquiry is the same individual named in a consumer-fraud proceeding brought in a courthouse one county away from the city where the subject lived five years ago. It is equally important to know what the litigation involved and what came of it. Did the subject of the inquiry settle out of court or contest the suit all the way to a trial? If the latter, did he or she win or lose? Clearly, it takes judgment to weigh the data gathered in any thorough background investigation because the investigation should answer questions, not raise them.

As to the costs, secured lenders commonly require that their borrowers finance the costs of the lender's due diligence, but because of competitive pressures — not to mention the pressure to put loans on the books — they tend to limit costs wherever they can. Even so, it is not unusual for due diligence costs to start between \$5,000 and \$10,000 and range upward for loans of substantial size. A thorough background investigation will add \$2,000 and possibly \$5,000 to these costs, more if the investigation is complex or requires checking foreign sources of information.

Is that a good deal? Yes. Studies show that a thorough investigation will turn up information damaging enough to halt a business transaction seven percent of the time, on average. This does not mean that in the absence of a thorough background check each transaction will go south; after all, lenders decide to lend based on many factors, not just the information produced by a thorough background investigation.

But good due diligence, including a thorough background investigation of the principals involved, can make a difference. In a competitive marketplace, that alone is enough to explain why so many lenders now commission background investigations as a matter of routine. ▲



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