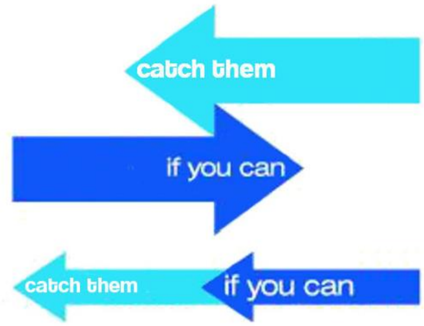

Catch Them If You Can:

Mitigating Risks When Hiring Executives

You may have heard the story, read the book, or watched the 2002 movie, “Catch Me If You Can” starring Leonardo DiCaprio and Tom Hanks based on the life of Frank Abagnale, who, before turning 19, had successfully performed millions of dollars’ worth of cons. He posed as an airline pilot, a doctor, and even a parish prosecutor. But Frank never went to flight school. Frank never went to medical school. And Frank never went to law school. Frank was still in high school. Eventually, Frank was also caught. Frank’s criminal penalty was 12 months in a French prison (about 6 months served), 6 months in a Swedish prison, and 12 years in a US prison (4 years served). Frank’s story ends on a positive note for him. Later he started his own business advising companies on fraud issues, taught at the FBI Academy and lectured at FBI field offices. Of course, while Frank Abagnale might have ultimately fared well and turned his life around, there was a substantial loss for the institutes that were subject to his cons.

The Cost of Bad Hires

While Frank Abagnale’s cons were committed in the 1950’s and 60’s, people are still hired today that are not exactly what they represent themselves to be, and the cost can be high.

In 2002, it came to light that executive vice president and CEO, Kenneth Lochar’s accounting degree from Arizona State University and MBA from Stanford were fabricated. He was forced to resign, but the damage had been done; Veritas’ stock fell 16% (nearly $20 million), and their business reputation was tarnished.

Hidden and undisclosed information cannot be found during routine background checks. In fact, routine employment screening typically only finds 1% of the adverse issues in executive backgrounds.

Zappos CEO, Tony Hsieh has said his past bad hires have cost the company “well over $100 million.”

Bad hires are not an infrequent occurance. According to a new survey by Career Builder reported in November, 2016, 75% of employers have employed a bad hire in the last year. The average loss, per bad hire, is estimated at $17,000. The cost for a bad executive hire can be substantially higher, frequently costing companies over $2 million for a bad executive hire.

A study by Oxford Economics and income protection firm Unum’s 2014 research shows for the UK 48% of new hires fail within 18 months with an estimated cost to UK businesses of over £4 billion a year.

And multiple bad hires keep the numbers adding up.

General reported negative impact on companies include: reduced productivity, inferior work quality, negative effects on morale, time lost to recruit and train another worker, time wasted by managers or coworkers to assist the negative hire—which all adds up to big dollar losses. Which in turn negatively impact bottom line results for many companies.

Now apply these numbers to the cost of an executive bad hire and the money lost soars. Not only that, there are greater potential company risks and dangers.

A bad executive hire can cost a company even more. Its financial costs in day-to-day operations easily can quadruple that of a regular employee, but it can also impact the company's corporate governance and Board of Directors if that executive hire was found to be involved with unethical and illegal activities. Not even a signed contract can protect a company if an executive hire's unethical actions come to the attention of the national media. Fiduciary risk and exposure for the board of directors cannot be overlooked.

Yahoo! Experienced this in 2012 with the hire of CEO, Scott Thompson, who had incorrect information listed in his online biography stating that he had a computer science degree in addition to an accounting degree.. While he had the accounting degree, he did not have the computer science degree claimed. The implications went beyond the activist shareholder accusations to reflect on the board of directors for not vetting his background more carefully. The company may have been exposed to claims of providing false information to the SEC and potential stockholder law suits. Thompson's 120 day tenure at Yahoo! cost the company over $7 million and seriously tarnished the company's reputation in the business community. Shortly after the resulting media scandal, Thompson stepped down.

Executive Due Diligence vs. Executive Background Checks – There is a Difference

Checking a potential executive's background, can go a long way in preventing a bad hire and saving the company financial losses both in terms of direct costs and indirect costs—such as reputation and negative news headlines, but there is a substantial difference in what you get for your investment in doing a background check versus a due diligence report on perspective hires.

The same concern holds for prospective new board members. Adverse media attention can create PR nightmares for boards and extensive reputational damage that can last years.

Surprisingly, non-profit organizations are also at risk for these types of issues and negative media exposure can result in losing the organizations' donor base for many years.

When evaluating a prospective company for business mergers and/or acquisitions (M&A), it is even more important to conduct through executive screening as the overall deal price may be affected if there are serious issues with the executive team, or if it later comes to light that there were serious issues such as bribery or corruption in the target company's business transactions. The final purchase price and even the entire basis of the acquisition could be changed by several million dollars. Additionally, the acquiring company, or purchaser, may face additional liabilities under the U.S Foreign Corrupt Practices Act.

Routine Background Checks

Most companies screen their executives using basic or routine background checks. These routine backgrounds are conducted for all other levels of employee and typically consist of basic public records searches. These searches are usually conducted by companies through one or multiple multi-jurisdictional data bases containing aggregated collections of data gathered from various entities. These checks are typically limited to a 5 component review of: criminal records, employment verification, degree or education verification, social security validation, address verification and sometimes credit history. These are very limited searches.

There is no one database that contains all information and in some cases, records still need to be accessed in person to ensure that the correct information is reported about that specific person, not someone else of the same name. Criminal records must be searched using date of birth, since the person's social security number does not typically appear in criminal files. Additionally, "statewide" and "nationwide" criminal searches typically miss as much as 75% of all criminal convictions.

While routine background checks are often cheap to conduct and quick to turn around, there are many issues with using them as a sole investigative tool. These issues include: greatly varying quality and availability of data, no results being returned even though a record exists due to search criteria, and data returned on persons with the same or similar name and mistaken for the searched candidate. Moreover, the use of national databases as a standalone product may not be in compliance with the FCRA. These backgrounds provide very limited “snapshots” regarding a prospective employee’s data in the public records domain. Executive due diligence, in contrast, looks at over 30 components of public record data combined with in-depth review of media and news sources plus a deep internet search.

Routine background checks are still important, but are not sufficient to find all of the important information necessary to protect a company’s board of directors from fiduciary exposure, and potential shareholder law suits if adverse information is later discovered post-hire.

Executive Due Diligence

Executive due diligence looks in-depth at all available public records sources: criminal history, civil litigation issues, financial and legal issues, relationships with other companies and board advisory positions, reputation, misrepresented education and overstated work history, behavioral history (for example litigiousness), and, in particular, undisclosed or adverse issues.

Executive due diligence is more costly than executive background checks and take more time, but the information gathered is extremely valuable and can save a company substantially more. A high quality due diligence review can find important information which would not be returned in a routine executive background check.

Some examples include: IP theft, hidden aliases, interstate bankruptcy, litigious behavior, signs of malfeasance misconduct (with or without criminal conviction), media negatives, social media negatives, undisclosed business and board level involvement, undisclosed business ownership, signs of misconduct, significant numbers of names changes, murder, manslaughter, embezzlement, bribery and racketeering, financial pressures, money-laundering, con-artists, and other negative issues.

When Do You Need Executive Due Diligence?

Infortal Worldwide has found consistently that 20% of executives fail a deep-level due diligence check and have issues which may cause risk exposures to corporations of any size from Fortune 100 to Fortune 5000.

You need to conduct executive due diligence when:

- Hiring a new executive
- Acquiring a new business subsidiary (Mergers & Acquisitions due diligence)
- Contracting with third party business parties and agents globally
- Selecting New board members
- Screening corporate board of directors

Deep-level due diligence minimizes FCPA/UKBA risks and non-compliance liability exposures, as well as reducing transactional risks associated with international business partners and their executives.

Not checking or relying only on an executive background check can cost a company substantially. FCPA fines, for one, averaged $80 million last year.

Finding out, after the fact, that the new CFO has undisclosed SEC violations or was/is involved in a company where kickbacks could be a real or perceived issue would be too late. A routine background check would not have been enough and would be considered a subpar due diligence. Deep-level executive due diligence could, however, have prevented the havoc such revelations would cause a company.

To Catch a Con or Protecting Yourself from a Costly Executive Mis-Hire

Cutting costs by selecting to disregard doing research on an executive hire or saving by doing a simple (routine) executive background check is a dangerous prospect. Best practices should include doing an in depth executive due diligence as standard procedure. When it comes to hiring executives, doing a routine background check is not enough to "catch them" before the issue becomes a liability.

More information on deep-level executive due diligence can be found at Infortal Worldwide.

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