

Inquiries into Past and Current Corporate Affiliations: Providing Insight into the Business Background of Corporate Executives



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In September 2000, the online shopping site TheBigStore.com ceased business after only five months in operation. While the dot.com bubble may have contributed to the website's downfall, a closer look at TheBigStore's CEO, Robert J. McNulty, would have revealed a history of successes, but also several failures with previous online sites. Prior to launching TheBigStore, McNulty had established 11 other online shopping sites, some of which were also unsuccessful, leading to his own bankruptcy in the mid-1990s. Even some of the successful websites faced difficulties, including Shopping.com (sold to Compaq Computer Corporation for US\$220 million), which was the subject of an investigation by the U.S. Securities and Exchange Commission (SEC) into allegations of stock manipulation by the company and McNulty. As demonstrated in this example, a deeper review of McNulty's past business endeavors could have provided investors with valuable information to assist in their evaluation of the company.

When conducting due diligence inquiries into corporate affiliations, it is important to look beyond the biography or résumé disclosed by the individual. In some cases, an individual's biography or résumé will be deliberately vague, stating that an executive has experience in a certain industry (i.e., the finance industry) or with various-sized companies (i.e., a mid-sized public company). These omissions are often purposeful. Further media and database inquiries can usually reveal that an omitted company filed for bankruptcy or faced regulatory sanctions.

Investigating a person's past and current corporate affiliations is also important in order to uncover possible conflicts of interest. This is especially pertinent when reviewing independent directors. Since the collapse of Enron, the topic of independent directors and their responsibility to the company has become a central issue. During the Enron scandal and investigation, it was found that Andrew Fastow, Enron's former CFO, made various profits off the company's investment in partnerships that Fastow ran and partly owned, known as LJM1 and LJM2. The arrangements of these investments were made in such a manner to guarantee the LJM partnerships profited in return for helping Enron manipulate its earnings. While Enron alleged that it was forthright in its dealings with LJM and stated that the relationships were proper due to Fastow's familiarity with the company, it was found in investigations that LJM was crucial to Enron's fraudulent dealings because it would take money-losing investments off Enron's books.

Since the collapse of Enron, the New York Stock Exchange and the SEC have cracked down on the issue of independent directors. Their goal, post-Enron, is to regulate the short-term thinking and self-dealing of directors who are not wholly independent. Prior to Enron's collapse, many companies stipulated that directors were independent, even though they were affiliated with companies that had business dealings with the company on whose board they served. According to new regulations, independent directors should only have one financial tie to a company he or she oversees. If there is a conflict with these regulations, it must be reported as a "related-party transaction."

Even with these higher standards and additional reporting on the issue by companies, independent directors remain non-independent. According to media articles, in 2005, Sierra Health Services, Inc. paid US\$212,000 to a law firm where one of its directors was a stockholder. The company reportedly concluded that this was immaterial because the director was only a stockholder in the law firm because it had merged with Sierra's previous law firm at the end of 2004. It was alleged in media articles that some analysts believe companies

need some flexibility reviewing these issues, because not all relationships are “sufficiently” serious to cost directors their independence. However, it was alleged by others that changing rules when inconvenient to a company subverts the entire notion of independent oversight.

Another form of “related-party transaction” that has become more regulated, and all the while more skirted, involves familial relations. Prior to Enron, judgment on the independence of directors depended primarily on whether “family relations” existed. Today, the SEC and NYSE are scrutinizing these forms of relations more and more, leading to insider trading allegations against husband and wife teams (often referred to as “pillow talk”) in addition to deals with other family members. An example of related-party transactions due to family ties was cited in 2006 SEC filings published by Centennial Bank of Colorado. In these filings, Centennial Bank reported that it bought securities through Piper Jaffray, generating commissions for Chairman John Eggemeyer’s brother, a financial adviser at Piper. At the same time, Centennial Bank reported that it also used an interior design firm owned by the wife of William Farr, a Centennial director. According to reports, payments to Piper Jaffray were less than US\$5,000 and payments to Parr Interior Designs in 2005 were less than US\$120,000. While family relations did not lead to sanctions for Centennial Bank, executives of other companies have been accused of insider trading for arrangements such as the above. It is critical to ensure that family members’ companies that are being contracted are in good working order and free of adverse public filings (i.e., litigation, bankruptcy, etc.).

Please refer below for steps to follow when trying to compile a complete and thorough history of an executive’s corporate affiliations:

1. Identify the corporate affiliations of an executive by compiling biographies published for the executive. Professional networking sites may list former affiliations that are not listed in current biographies.
2. Conduct checks of federal litigation records to determine if any of the corporate affiliations has filed for bankruptcy or has been involved in any noteworthy civil litigation matter.
3. Evaluate the possible relationships between the corporate affiliations of an executive to determine possible conflicts of interest.
4. Conduct media inquiries on the various corporate affiliations for any adverse information that pertains to the time the executive was affiliated with the company.

Examples that were previously discussed demonstrate the paradox of independent directors today. While regulators continue to tighten the standards on the independence of directors, it appears that some companies are trying even harder to skirt the issue. By following the above outlined due diligence steps, one can ensure that a complete picture has been compiled for an executive so as to uncover any adverse affiliations (past or present) or any conflict of interest issues.



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