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 - Europe
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Due Diligence: Investigating the Investor
By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/05/2013)

Due diligence is often thought of as a process to be used by the one with the money, to be applied to the representations of the party seeking the money. Thus, why does this need to be turned on its head? Why does the company seeking investors need to conduct a due diligence investigation on the investors? While there is concern for money laundering using small and medium sized entrepreneurial business, the concern is really deminimus. The hold times and uncertainty are ill suited to money laundering.

So let’s go back to the first assumption, and change it ever so slightly. A due diligence investigation is required by those who have assets to protect those assets from parties seeking to misappropriate the assets. Thus, an entrepreneurial company seeking investment is the entity with assets, often intangible assets, seeking to leverage their assets through additional funding. By a distance, the most dangerous investors are the dubious investors that are not seeking to invest in an entrepreneurial company, but seeking the company’s information.

All Fortune 500 companies have Competitive Intelligence departments. There is an association called the Society for Competitive Intelligence Professionals (SCIP). There are also less sophisticated home grown efforts at industrial espionage. All are trying to get the information from competing companies, new or established. So what better way to get a company’s information than by offering to invest money in a company? Naturally, the condition of any investment is a full and fair disclosure of the assets and opportunities possessed by a company. Investing is a marvelous pretext to pry all of the secrets out of a small company.

The following is a true story, with names changed to protect the writer and the small company from retribution.

Carlos Villanueva was often introduced to small companies as an investment opportunity. Mr Villanueva was an active participant in several of the Los Angeles - Angel Investors associations. Villanueva was known to spend a great deal of time with the target companies often providing very good advice as he conducted his due diligence investigations prior to investing. The CEO of a little company had made a presentation at one of these gatherings and Mr. Villanueva took an interest in this little company.

After an extended period of time, Mr Villanueva’s diligent research began to become a concern. The CEO of the little company found Villanueva looking into all of the little company’s particulars but always had more questions. Several rounds of research and questions had occurred, but all Villanueva came with was questions. No money, just questions.

The CEO of the little company called an investigator to find out more about this fellow Villanueva. After a short day of relentless researching, the investigator found that a Mr. Carlos Villanueva did not exist. Furthermore. others had asked

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the same question: “Who is Carlos Villanueva?” The guesses were that Villanueva was more likely than not an employee of either a larger law firm or a large company in the same sphere as the start-up company.

The CEO of the little company pondered the Villanueva issue for a while and found a great deal of fault with his own behaviour. He had disclosed too much information to Villanueva. Any one sophisticated in the industry of this little company would know both how to exploit his little company’s information and / or to be able to block the little company’s plans. The CEO of the little company chose to invite Villanueva back for one more meeting.

At the meeting the CEO confronted Villanueva. The CEO told Villanueva that according to an investigation - he, Villanueva, did not exist and before Villanueva would be allowed to leave he would need to show a valid ID. Villanueva became enraged and tried to storm out - the door was locked and blocked by three very big men. Villanueva turned with a clenched fist, and swung at the CEO.

Hold the moment in a freeze frame. When one is doing espionage on a little company and its CEO, it would be wise to check the hobbies and skills of the CEO. The CEO of the little company had earned several black belts in multiple martial arts disciplines.

The next two minutes went poorly for Villanueva, the three very large men watched the CEO smear the floor with Villanueva. Villanueva said he was going to call the police. “No matter,” said the CEO, “the police have been called.” What remained of Villanueva left.

The CEO of the little company reasoned that either Villanueva came clean and showed who he was or there was no down side to a punishment. Villanueva could stay for the cops and then the CEO would be able to figure out who Villanueva was, or Villanueva could take his punishment and run as no complaint would be filed. Villanueva’s clenched fist was a bonus.

Three to four weeks later the CEO was at a tradeshow for his industry and spotted the fellow called Villanueva - he was working for a large competitor. The CEO approached Villanueva, who was sporting a very different name on his name tag and said, “Well played Carlos”.

Smaller firms, especially those seeking investors, are more vulnerable to the disclosure and compromise of their Intellectual Property and Critical Information (IPCI). The concentration of these small companies’ value is almost all embodied by what they have invented. It is a very fragile position. Larger companies with more money and market access can trump the IPCI of a small company just by taking the IPCI. After all, if the start-up company barely has money for expansion and growth, they certainly have no money for litigation. The small company is effectively squashed.

Is it fair that the large and the well moneyed companies steal a start-up company’s IPCI? No it is not fair, but it is what happens. Due diligence is not just for the investor but also for the company looking for money. And while I have seen money laundered through a start-up company (only once), the dubious investor overtures are almost always from those who seek the IPCI.

Keeping your IPCI private is important, yet investors deserve a decent amount of disclosure to make an informed choice. Balancing the two is always difficult and the what, where, and how, to disclose what to whom is a case by case matter wholly dependent upon the facts of the time and place.

Do your due diligence on investors prior to disclosing information. Do also make tracking any IPCI you divulge traceable to the individual recipient.

None of this is ever black, white or gray; it is more like the weave of a fine herringbone jacket.

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