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Due Diligence: Robust v Fragile

By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc\* (01/03/2012)

If you mail a package to your office in Cayman and it has a computer in it, you write on the outside of the package 'Fragile'. The fragile computer package can arrive on a sliding scale from at best, unharmed, to at worst, completely destroyed.

If you mail a package to your office in Cayman that is robust, you don't write on the package: 'I don't care, do whatever you want to this package'. The robust has a sliding scale from unharmed and a lower boundary of unharmed.

Or as an experiment on the fragile computer package one could write: 'Please mishandle.' Because a lower bound would be unharmed. And the upper bound would be improved - you'd get, instead of one computer, two computers with all of your work prepared and done for the week. Just like in mythology expect the computer would be bigger and somehow faster, stronger.

Ok while this is all fine what does this have to do with offshore and due diligence?

The service providers are the package and the package handlers are the media, the regulators and the clients.

I have described due diligence as the process that helps the business person to be able to correctly and reliably differentiate the hound from the hare - the result is often a surprise to both hound and hare. While that is a cute remark, modern due diligence is a structured, systematic, consistent and efficient methodology of choice making. It is both an outward and inward looking managerial process.

For the offshore financial community due diligence mostly appears as a disembodied phantasm of checklists of tasks for KYC and AML - nothing more.

But there is so much more we must know about the handlers of our package, KYC and AML is just the surface, what about, SDNs, OFAC complications, companies dealing in conflict minerals, environmental crimes, smuggling, kidnapping and ransom, extortion, corruption, and drug dealing. What about the regulator that would rather see a firm that has caused a jurisdiction a 'red faced moment' gone and closed as opposed to actually exploring the validity of a given matter.

It is these types of regulators that are going to mishandle your fragile package - your law firm, your trust company, your bank. The client may have the specific intent of mishandling your reputation just long enough to get what they need. This type of regulator will mishandle your package for their internal reasons and to show the world they are tough on crime.

I watched a US citizen who, in the past had been in the offshore business himself; shop his needs to many different service providers. He had a significant 'legacy issue'; he was a defendant in a civil case with the SEC on a US\$10 million matter, alleging fraud. He shopped his needs and wants and in a show of bravado was very aggressive in negotiating price since in his words: "he was in settlement discussions" with the SEC. Many were eager to have this man as a client, it was a large sum of money, and the federal docket on his case did show several settlement conferences. All seemed real - if even a bit on the edge. However, a bit more research would have shown that he had filed for each of the settlement conferences. Reading the documents, the SEC accused him of using these settlement proposals as a way of stalling the matters at hand. He used the settlement conferences in the docket as a way to downplay the legal matter and as leverage to get an offshore service provider to help him.

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I was part of a firm that this man came to see and it all looked plausible. This man had already signed our client intake forms. The firm was going to move forward until I asked the right questions and discovered the 'rest of the story'. We did turn him down but it was that close.

Ultimately, he did get a well known and reputable service provider to help him. The service provider was staffed by skilled and seasoned professionals. In the end this reputable service provider was driven into insolvency from a combination of the cost of defending themselves and the loss of revenue from a departing client base after both the regulators and the newspapers learned of the service provider / client relationship.

Our little firm too was questioned both by the regulators and the papers. The SEC in a raid on this man's home found a copy of our client intake forms. We were forthright with the regulators as the story he presented and the evidence he provided at that time seemed plausible. However, after further research - as required by our little firm's due diligence guidelines, it became obvious to us that the evidence supplied by the prospective client was faulty and we refused him as a client.

Our little firm has been tested again and again by clients, governments and general economic circumstances. We continually test this firm with thought experiments or 'what if's' and measuring our firm's ability to avoid those who would mishandle us. The firm that took the man as a client was easily 20 times our size and is now gone. Our little firm, though not much larger today as it was back then, is still around.

The larger firm was vulnerable to the perturbations suffered by being mishandled. Their frailty in this case was a technically compliant, but ultimately an insufficient due diligence process.

For more information on Due Diligence visit the Association for Due Diligence Professionals at [duediligenceassociation.org/](http://duediligenceassociation.org/) or email me from [feinc.com](mailto:feinc.com)

\*Author of 'Due Diligence For The Financial Professional 2<sup>nd</sup>'

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