



## BEYOND MADOFF

Eight Lessons from  
Recent Due-Diligence  
Background-Checking  
Gone Wrong

The unmasking of Bernard Madoff has made many business people uneasy about the ventures they invest in, and the new partners and new hires they take on. This mega-scandal is certainly instructive about the need for proper and timely due diligence about those with whom we do business. ¶ The missed opportunities to recognize Madoff's criminality have been discussed ad infinitum over the last year. At this point anyone who invests in a seeming Wall Street powerhouse that uses a tiny, unknown and underqualified accounting firm to audit its books needs to have his head examined. ¶ But more obscure recent cases provide other lessons about due-diligence checking that you might want to do as a matter of routine. The war stories below are real and scary, but the lessons they teach us can reduce the chances of deception, and the risks to reputation and investment.

**These cautionary tales, incidentally, are based entirely on the public record, and not on any work we did on client matters. Because we want to focus on the lessons, not the individuals involved, we have not used the real names of the people and companies involved in these events.**

**We're not saying whom you should and should not do business with; we're just saying, look before you leap.**

**In this special issue of *Global Fact Gathering*, we describe eight due-diligence disasters, and the best practices they offer about protecting oneself in this risky world. >**



## Lesson 1

**Before giving someone your money, you need to dig into his background even if he:** (a) is a member of your country club; (b) has a friend on the police force; or (c) was profiled in a glossy magazine.

When reporters asked New York businessman Subject A about allegations he was misappropriating investors' money, he replied that his investors included police officers and FBI agents. "How could we not be legit?" a news service quoted him as saying just over a year ago. He handed out copies of a glossy business magazine listing his company in its "HOT 100" fastest-growing businesses.

That was three months before federal agents shut down his company, and accused him of defrauding thousands of investors of \$370 million.

Between 2003 and 2009, he allegedly told investors that if they put money into his supposedly hyper-profitable business (that he said made high-interest bridge loans to companies), they would enjoy returns well above the rates of those loans, according to government court filings. The government's filings allege he was loaning out only a

U.S. District Court CRIMINAL DOCKET FOR CASE #:	
Case title: USA v. [REDACTED] Magistrate judge case number: 1:97-mj-01936	Date Filed: 01/27/1998 Date Terminated: 01/15/1999
<b>Pending Counts</b>	<b>Disposition</b>
18:1341.F, 3551 et seq. FRAUDS AND SWINDLES (1)	JUDGMENT (1 count) (s) I. Imprisonment: 21 months. Supervised Release: 3 years. Restitution: \$135,000.00. Special Assessment: \$100.00. AMENDED JUDGMENT: Imprisonment: 21 months. Supervised Release: 3 years. Restitution: \$ 177,000.00. Special Assessment: \$100.00.
<b>Highest Offense Level (Opening)</b>	
Felony	
<b>Terminated Counts</b>	<b>Disposition</b>
18:1341.F, 3551 et seq. FRAUDS AND SWINDLES (2)	

Above: US District Court Criminal Docket.

tiny percentage of the money he took in, and quickly lost much of the money on big commodities bets he never revealed to investors. After his arrest by federal agents 10 months ago, his company collapsed.

A skeptical, research-savvy investor might have been able to spot that Subject A was trouble. In 1999, Subject A had pled

guilty to mail fraud involving his handling of client funds as a stockbroker, court records show. He was sentenced to spend 21 months in prison, to undergo gambling therapy and to pay \$177,000 in restitution. A financial-regulation body barred him from association with its members.

He was released from prison in

August 2000, and that same month set up the company that became his latest investment vehicle, state records show. He has pleaded not guilty to his pending federal charges of mail fraud and wire fraud. His attorneys have said that his company was legitimate, and that prosecutors overstate the sums that investors might have lost. ■



## Lesson 2

**The further away from home you travel, the deeper you should investigate the prospective relationships you find there.**

Roberta L. Alexis, a veteran investor, had high hopes for her company China 101Electric. She had bought the company as a vehicle to acquire other Chinese utilities, and the CEO

hired by Alexis, a utility industry veteran who we will call Subject B, had started buying other utility firms there.

But last spring, when the Alexis company's accountant visited to check up on Subject B's latest acquisition, he found that almost \$10 million of the money Alexis had set aside for that deal had

disappeared, according to court filings. Some documents relating to the deal had been forged, too, the accountant found.

It was then that Alexis's team undertook a new due-diligence review of Subject B, who had run China 101Electric since its formation. Investigators soon found that Subject B was not who he said he was, according to a filing by the Alexis side in an ongoing court case.

In response to a lawsuit brought by Subject B last June, the Alexis side said in a court filing that "it appears that some

years ago, plaintiff was arrested in Macao under a different name and sentenced to prison." Subject B had told Alexis he had a college degree and used to work for a transportation company, but neither the college nor the transportation company exist, according to the court document, which added, "on information and belief, [Subject B] still retains ties to Chinese criminal organizations." One person who had disclosed information about Subject B's activities was beaten in retribution, said the court filing, which also asserted that Subject

B had absconded with millions of dollars.

"China has no central data bank," the filing said. "[Subject B]'s fraudulent accounting scheme was so well concealed that it eluded two respected investment banking firms, two major shareholders of [China 101Electric], and [China 101Electric]'s independent auditor."

In his court filings, Subject B has denied Alexis's assertions, saying he is who he said he is, he committed no crimes and he was financially injured by China 101Electric's cancellation of his shares. ■



## Lesson 3

### Relying on only checking references can give you false comfort about a person.

**A 2008 decision by a New York judge could serve as a clarion call for corporate officers and board members everywhere to vet new high-level hires. A judge found that a pharmacy benefit management company had no right to fire human resources executive Subject C, even though the judge agreed Subject C had made "fraudulent misstatements" in his resumé.**

The court case file tells the following story: In 2004, the company became interested in hiring Subject C as head of Human Resources and Employee Development based on an executive recruiter's advice.

The company asked the recruiter to check Subject C's references listed on his resumé. The recruiter contacted an official at a leading food manufacturer, who described Subject C as one of the best executives he ever had. The recruiter did not contact anyone else because of the strength of that recommendation, according to court filings. Subject C was hired at an annual salary of \$150,000.

*The company "had ample opportunity to conduct a full investigation and background check prior to its hiring of [Subject C]. It did not."*

According to court documents, nine months later, two female subordinates complained that Subject C had sexually harassed them or made them uncomfortable with questions about sex. Subject C allegedly responded that he had intended to fire them for poor work ethic. Instead, he was fired in 2005 for "allegations of sexual harassment."

It was only later that executives at the company came upon the food manufacturer's SEC filings from several years before containing a biography of Subject C, and learned he misstated major portions of the resumé he had given them. For example, according to court records, he had omitted mention of two firms for which he had worked in the mid-1990s, and misstated the dates of his work at another

company to cover the two years he spent at the omitted firms.

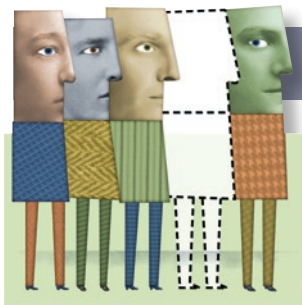
In 2005, after the company and Subject C argued about his severance, the company filed suit against him, alleging fraud and seeking to rescind his employment contract.

At trial, Subject C testified that he had changed details in his resumé to get a "foot in the door," court documents said. The state-court judge found that the sexual harassment allegations against Subject C were weak, and that the company could not later cite the resumé lies as justification for firing him. Last December, the judge ordered the company to pay Subject C \$128,790.

In his decision, the judge wrote that courts have no sympathy for sophisticated companies with access to key information that fail to use it.

"While it is unfathomable for a publicly traded company to be so lax in its protocol for hiring senior management, it is clear that [Subject C's] background was never the subject of a complete and thorough background check and reasonable due diligence," the judge wrote. The company "had ample opportunity to conduct a full investigation and background check prior to its hiring of [Subject C.] It did not." ■





## Lesson 4

**If you fail to check for fraud convictions and fake names in a partner’s past, you might be in for wrongdoing in the future — leopards generally don’t change their spots.**

**Upstart commodities broker OptEXT Inc. was brimming with business in 2007, when a blue-chip commodities exchange announced it would buy a 19-percent share in the company. A news release put out by the commodities exchange said the deal, to be closed a few months later, was “subject to (its) board of directors’ satisfaction with its reasonable due diligence review.”**

It was only weeks later that trouble descended: OptEXT’s biggest customer, a large Canadian bank, announced a bizarre \$396-million loss on natural-gas options trades that had been executed by OptEXT, according to news accounts. Soon the estimates of the Canadian bank’s losses grew to \$895 million. Authorities alleged in court documents that the bank’s natural gas traders had been lying about the size of the trades they did, and that OptEXT officials were in on their lies.

In late 2008, a former top commodities trader for the Canadian bank pleaded guilty to wire fraud and falsifying trading records for inflating the value of his trades. Prosecutors said he sent his false trading numbers to OptEXT officials, who would validate them even while knowing they were fabricated and would send the numbers on to the bank’s compliance office.

That same month, OptEXT’s CEO and co-founder, Subject D, was indicted on criminal counts of wire fraud, making false statements to the bank and to the SEC, and securities fraud.

It didn’t need to happen that way.

With basic due-diligence research, investors and customers might have found that Subject D was hiding details of his life.

In 1987, Subject D had been charged with wire fraud and sentenced to one year’s probation, according to the Commodities Futures Trading Commission. In 1993, Subject D was convicted of tax evasion and sentenced to six months in prison, the CFTC said. According to the CFTC, Subject D also was charged that year with credit card fraud and money laundering, and later pled guilty to two felony counts. He was sentenced to 30 months in prison and was released in 1999, two years before becoming OptEXT’s CEO, the CFTC said.

One way he avoided scrutiny, the CFTC said, is that, while he started as OptEXT’s CEO in 2001, he resigned in 2004 — a few

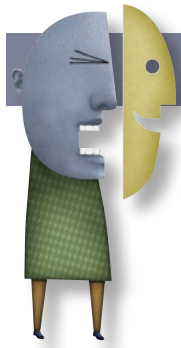
months before the company offered shares to the public — before retaking the helm a few weeks after the initial public offering in 2005. The government also accused Subject D of giving a fake name and Social Security number to hide his past during negotiations with a potential investor in OptEXT.

OptEXT has denied wrongdoing and said in court filings that as far as it knew at the time, the trading valuations it passed on were accurate.

Subject D has pled not guilty to the pending charges against him, and has denied all wrongdoing. His lawyers have said that the commodities deals between OptEXT and the bank were proper but complex, and that the government misunderstood them. ■

		08/20/1997)
08/19/1997	155	Minute of sentencing held on 8/12/97 before _____ as to _____; Court Reporter Name or Tape #: Reeves (lh, Deputy Clerk) (Entered: 08/21/1997)
08/22/1997	157	JUDGMENT as to _____ (1) count(s) 1ss, 46ss . Special assessment of \$100.00; Imprisoned for a term of 30 months as to each count, to run concurrently with each other. Defendant to receive credit for time served. Supervised release for a term of 3 years. Restitution in the sum of \$61,772.57. (1) count(s) 1-2, 1s -5s , 2ss , 3ss -37ss , 38ss -41ss , 45ss . Dismissed on the motion of the United States. ( Signed by Judge _____ on 8/20/97) CCAP (lh, Deputy Clerk) (Entered: 08/26/1997)
09/29/1997	158	MOTION by _____ to extend time of surrender date for seven days (lh, Deputy Clerk) (Entered: 09/30/1997)
09/29/1997	162	ORDER as to _____ granting [158-1] motion to extend time of surrender date for seven days until 12:00 noon 10/7/97 as to _____ (1) ( Signed by Judge _____ on 9/29/97) CCAP (lh, Deputy Clerk) (Entered: 09/30/1997)

Above: U.S. District Courts Docket Report.



## Lesson 5

## Some raves offered by prior employers continue old entanglements.

**When a public hospital hired Subject E as its CEO in 2002, it didn't know about his criminal record from the mid-1990s. The same thing happened in 2008 when a large private hospital hired him as COO. Neither one knew that as a military dental technician in the mid-1990s, he spent nine months in jail following a guilty plea. Subject E had stolen a colleague's credit card, gone on a spending spree, then tried to cover up his actions before being court-martialed, news accounts said.**

Both hospitals could be excused for that oversight. While both did pre-hire due-diligence reviews, military justice records are rarely checked in such investigations; they are obtainable only with Freedom of Information Act requests. But the second hospital's checks on Subject E had other problems.

The CEO of the second hospital was later quoted by a newspaper as saying that besides using an executive search firm and doing its own criminal and credit check on Subject E, the second hospital's top officials "talked to probably at least half of the board members (of the first hospital) before we hired him."

That turned out to be a less effective check than it seemed.

One thing the second hospital's officials didn't know is that when Subject E joined them, the federal Inspector General in the jurisdiction where the first hospital is located had finished, but not yet released, an investigation of alleged mismanagement

*Top officials "talked to probably at least half of the board members [of the first hospital] before we hired him."*

and fraud at the public hospital under Subject E's watch, news reports said.

Shortly after Subject E joined the second hospital, the Inspector General released a scathing report describing the public hospital's "egregious" and "fiscally irresponsible" overpayment of hospital funds to Subject E, "fraud and mismanagement" by top hospital officials, and "an alarming depth of mismanagement of Medical Center funds and a complete lack of oversight" by the public hospital's governing board. The board "colluded with the Medical Center's senior

executives...to divert Medical Center funds for personal gain," it added.

Days after the audit, the jurisdiction's governor fired four of the public hospital's board members, saying they had "failed to live up to their fiduciary responsibility," news accounts said. Later, one of those fired, the board chairwoman, was charged with lying under oath for denying she had signed unauthorized approvals for payment of large sums of hospital money to Subject E and two other hospital executives, news reports said.

In late 2008 Subject E and the two other public hospital executives were charged in a 144-count indictment with embezzlement for allegedly looting the hospital of \$5.4 million, according to court documents, news accounts and the inspector general's reports.

According to an affidavit by an investigator for the Inspector General, the public hospital's board had not even read resolutions they approved for Subject E's alleged overcompensation, news accounts said.

Subject E denied all the pending charges, including one for lying to get the public hospital job. Subject E's lawyers say that he committed no wrongdoing, and that he simply received money to which he was entitled under lawful agreements and contracts with the public hospital. ■



## Lesson 6

**Don't be bashful about doing a due-diligence check** of a prospective hire or business partner; be suspicious if he or she seems offended that you're doing one.

**It seemed to be excellent news for an economically down-and-out Indian tribe in 2003 when businessman Subject F approached the tribe offering to build a defense plant on its land. Subject F said he would employ 60 or so tribe workers at the plant that would fabricate metal parts for U.S. military equipment.**

Years later, the director of a key tribal government office recalled to tribal investigators looking into the joint venture that his office did not conduct a thorough due-diligence probe of Subject F because top tribal officials "did not want to offend a potential corporation that wanted to bring business and jobs" to the tribe, according to news accounts.

The tribe came to regret that decision.

In 2006 top tribal officials had agreed that the tribe would become majority owner of Subject F's Circle BTTB Inc., and would guarantee a \$2-million bank loan for the business. The plant got up and running for awhile, and made some military gear, but soon employees complained that Subject F told them to wait before cashing their paychecks, news reports said.

Then local newspapers made a discovery that had eluded tribal officials: Subject F had served three years in prison in the late 1980s after being convicted on charges of fraud and perjury. Federal prosecutors said at the

time that he and his partners used high-pressure sales tactics and false guarantees of large profits to bilk 1,200 investors out of \$11 million, news accounts said.

After the revelations of his past life were disclosed, work at the factory tailed

off, and Subject F left town, news reports said. In 2008 the tribe's Auditor General wrote a critical report about the tribe's role in the episode, saying it "did not conduct (a) due-diligence investigation on [Circle BTTB] before investing into the company."

It also found that Subject F had used \$3 million of the joint venture's funds for personal spending, including \$517,000 spent at casinos and \$433,000 to repay personal loans, news reports said.

Subject F has told the investigators that the sums he supposedly used for personal use were overstated, saying he was entitled to much of the money as legitimate consulting fees, news accounts said. ■

Federal Bureau of Prisons

**Inmate Locator** - Locate Federal inmates from 1982 to present

Name	Register #	Age-Race-Sex	Release Date Actual or Projected	Location
1. [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	RELEASED

Results 1 - 1 of 1

[New Search](#) [FAQs](#) [Privacy](#)

## The New York Times

**Fraud Charge On Futures**

By The Associated Press

Seven businessmen were charged yesterday with bilking 1,200 investors out of \$11 million by promising big profits on commodity futures traded by the Wall Street firm of [REDACTED].

A Federal grand jury in Manhattan charged the defendants with using high-pressure sales pitches and false claims to persuade "unsuspecting victims to part with their funds."

Federal prosecutors said that investors across the country had been misled with the untrue assertion that "computerized stop-loss trading techniques" protected [REDACTED] trading programs.

The defendants all were charged in a 46-count indictment with mail fraud and wire fraud, punishable by up to five years in prison and a \$1,000 fine. The co-owners - [REDACTED], of Manhattan, and [REDACTED] - were also charged with commodity fraud and perjury.

Top left: Federal Bureau of Prisons Inmate Locator

Bottom right: New York Times article, May, 1984



## Lesson 7

## Fake due diligence can be worse than no due diligence at all.

**Consider the case of stockbroker Subject G. In September 2009 the SEC filed suit against him alleging fraud, saying he persuaded 800 retired and elderly people to put in \$74 million toward what the government called a “massive Ponzi scheme,” according to SEC documents filed in court. Many investors had refinanced their homes to put up money.**

Subject G was the biggest independent salesman for EE-K Management Co. LLC, which the SEC said was at the center of the alleged fraud. It raised a total of \$250 million before the scheme collapsed in 2007, the agency said. Subject G and EE-K said the company had lucrative contracts servicing telecommunications equipment for Las Vegas casinos, most of which it

*Subject G “lied about the due diligence he supposedly conducted.”*

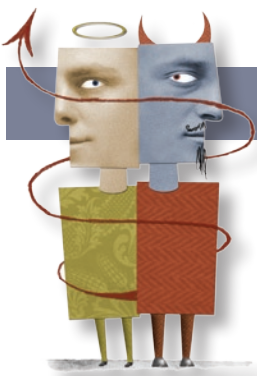
in fact did not have, the SEC said. Subject G held “investment seminars” to attract investors, and “lied about the due diligence he supposedly conducted regarding the [EE-K] offerings,” the SEC said in its complaint. “[Subject G] was aware of serious red flags regarding the existence of some of the purported hotel transactions underlying the [EE-K] offerings,” the SEC said.

Subject G told investors that his due diligence included traveling to Las Vegas to perform an “audit,” and reviewing the supposed casino contracts, SEC court filings said. He testified he met with an MGM-

Mirage executive named “Randal Wolf” and Tropicana Resorts’ “Reed Stewart.” But no one by those names ever worked for those casinos, the SEC said. Investors received distributions purportedly for a contract with the Stardust Hotel, even though, Subject G later testified, he knew it had been demolished years before, the SEC said.

“His lies, false assurances, and unscrupulous tactics,” Merri Jo Gillette, director of the SEC’s Chicago office, said in a statement, “put many investors at risk of losing not only their life savings, but also their homes.”

Subject G’s lawyers say that Subject G had no intent to defraud the investors, that he lost money along with other victims and that he is now cooperating with the SEC, giving investigators thousands of pages of documents. ■



## Lesson 8

## Don’t be naïve — many people with things to cover up in their pasts lie when asked about themselves.

**Let’s turn now from the recent examples of due diligence gone wrong, cited above, to the mechanics of how one performs a due-diligence investigation. For example, what is adequate due diligence when you are doing a business deal overseas, and don’t want to be accused**

**of turning a blind eye to foreign bribery?**

Some due-diligence firms, including some purporting to act in the public interest, advise that when it comes to third-party agents in foreign countries — the very people whom U.S. companies

should vet most carefully — it is enough simply to give them a questionnaire about themselves, and then perhaps follow up with cursory additional checks to “verify” their information. Surely these chaps will tip us off if they have trouble in their pasts, right?

Of course, asking a third-party

*continued on p.8*



We connect the dots  
and prove the connections

The Mintz Group is an investigative services firm that gathers hidden business facts all over the world for corporations, law firms, financial institutions and non-profits. We connect the dots by finding the critical facts our clients need **before relationships, during disputes, and after frauds.**

Telephone: 1-800-366-2503 Email: [contact@mintzgroup.com](mailto:contact@mintzgroup.com)  
[www.mintzgroup.com](http://www.mintzgroup.com)

New York • Washington, DC • Chicago • Miami • San Francisco • London • Zürich • Los Angeles

## Don't be naïve *(continued from page 7)*

contractor to fill out a questionnaire can be useful. But it is naïve to imagine that third-party agents will as a rule admit to any past missteps, bad acts, corrupt ties and under-the-table deals — or that their information can be easily validated by a few quick checks.

Human nature being what it is, we are skeptical about any assumption that bad people no longer lie to protect their interests. To think that they have stopped is to engage in what we call “due diligence for a sunny day.”

An investigative due-diligence firm’s approach should be hard-headed enough to spot a liar, and relying on questionnaires-with-spot-checks will rarely succeed at that.

FCPA compliance professionals should have high standards for any investigative firm helping them out. Is the firm a small shop using part-time employees doing

Google checks, or does it have experienced forensic data analysts using sophisticated

*It is naïve to imagine that third-party agents will as a rule admit to any past missteps, bad acts, corrupt ties and under-the-table deals.*

search methods? Does the due-diligence company make the investment for access to the leading intelligence databases? Does it deploy a network of global information sources and, when necessary, have forensic expertise to dive into the records?

Given the stakes, and the trend-lines in FCPA prosecution, we think it’s irresponsible to advise companies that they can rely on foreign fixers to self-report their questionable acts. ■

**To recap, these recent examples reiterate what Bernie Madoff showed us — that investors, employers and businesspeople generally need the discipline and skill to do due-diligence investigations before betting their money and reputations on new relationships.**