

The Importance of Civil Litigation in Due Diligence Inquiries



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In the fallout from the infamous collapse of Enron, former company executives, including Kenneth Lay, Jeffrey Skilling, and Andrew Fastow, were criminally indicted for a broad range of financial crimes, including bank fraud, securities fraud, wire fraud, money laundering, conspiracy, and insider trading. All were convicted. Fastow and Skilling are currently serving time in federal prison for their crimes.

While these high-profile criminal cases captured media and public attention for months, the Enron bankruptcy also generated manifold civil court matters, aimed at recovering monetary damages for civil plaintiffs, the Securities and Exchange Commission, and the Department of Justice. In fact, as of 2007, US\$7.3 billion in settlements had been collected by one set of plaintiffs led by the Regents of the University of California—at the time the largest monetary settlement ever reached in civil securities litigation. To date, creditors of Enron have recovered more than US\$20 billion via civil settlements.

In conducting due diligence inquiries, recognition and analysis of civil litigation is vital to the development of a complete profile of a company or individual. While criminal litigation is often the focus of background and due diligence checks, civil litigation is commonly used, at both a state and federal level, to settle disputes between individuals and organizations and/or to recover monetary settlements. If a company or individual appears frequently as a defendant in these types of cases, this can be a red flag for risky and potentially illegal behaviors. Large, publicly traded companies (and their executives), for example, are frequently the subjects of class action securities/commodities and shareholder lawsuits. While many of these matters can often be attributed to the course of normal business activities, a thorough review of the nature and frequency of these types of cases is crucial to the completion of a proper risk assessment. Was a company accused of misleading shareholders by knowingly making false statements regarding a company's anticipated sales performance? (This was the case with Apple, Inc. in 2001 after the company purportedly touted new computers that were, according to the lawsuit, "late to market, had defects, and lacked features essential for market success.") Did the lawsuit achieve class action status? What was the outcome? Was the company or its management required to pay civil penalties to the plaintiffs? These are the types of questions a proper review of civil litigation can answer and that are key to understanding the general pattern of a company's business practices.

An analysis of civil litigation can also uncover major red flags in an entity's operations. As noted above, class action litigation frequently affects publicly traded companies and can be triggered when the nature of a given claim exceeds US\$5 million. Thus, when suits of this nature are settled, the financial burden on the defendants can often be significant. As a caveat, class action litigation is not always indicative of poor performance or crooked behavior by a company or individual. In fact, on June 2, 2008, Mel Weiss, co-founder of the major securities law firm Milberg Weiss (now called Milberg LLP), was sentenced to two and a half years in prison for "illegally paying clients to file shareholder suits that prosecutors said earned US\$251 million in legal fees." According to court documents, the kickback scheme enabled Milberg Weiss to become a successful and lucrative securities law firm. A complete due diligence review can even be as thorough as to include checks into the plaintiffs and law firms responsible for major litigation, separating legitimate claims from possible enrichment schemes.

Securities/commodities and shareholder litigation are only a few of the many types of cases brought before civil courts. Personal injury/product liability, patent/trademark litigation, contractual, civil rights, and employment matters all fall under the umbrella of civil lawsuits. Specific industry types are also more prone to some types of civil suits than others. Pharmaceutical and biotechnology companies tend to be easily involved in personal injury and patent litigation. Entities involved in heavy industry are often susceptible to environmental, personal injury, and asbestos-related suits. A proper due diligence review of civil litigation can help to analyze the types of suits involving entities or individuals and determine whether these suits are simply the consequence of "normal business operations" and general industry activity or if they reveal a lack of adherence to patent law, a disregard for consumer safety, or a pattern of environmental law violations, for example.

Anti-trust and Racketeer Influenced and Corrupt Organizations (RICO) lawsuits are additional red flag litigation that a complete civil litigation review can recognize. RICO laws were originally enacted to prosecute organized crime and have since evolved to cover a wide range of litigation. RICO lawsuits can be brought against an entity for various reasons, including to prosecute individuals or corporations that attempt to use the courts to retaliate against whistleblowers and victims. These lawsuits can also be filed if plaintiffs can prove that lawyers and their clients conspired to create false legal complaints solely for purposes of retaliation and retribution. For example, in 2002, a RICO lawsuit was filed against Major League Baseball Commissioner Bud Selig and former Montreal Expos owner Jeffrey Loria by the team's minority owners, claiming that the two purposely plotted to devalue the team for personal gain prior to the Expos' planned move to Washington. The case eventually went to arbitration and settled for an unnamed amount.

Also important to recognize in civil litigation reviews are anti-trust matters. In addition to being more "high-profile" cases, these matters also highlight another important aspect of civil courts: that civil litigation can be filed by the U.S. government to prosecute alleged violations of federal law. On May 18, 1998, the U.S. Department of Justice, along with 20 U.S. states, filed a lawsuit against Microsoft Corporation alleging violations of anti-trust law. After four years of litigation in various civil and appeals courts, the DOJ and Microsoft settled the case. As was the case with Microsoft, anti-trust laws are intended to prevent companies from restricting free trade and competition, ban behaviors including predatory pricing and price gouging, and supervise mergers and acquisitions. As such, perceived violations of these regulations are serious matters, often followed closely by the global business community. A preponderance of anti-trust litigation, similar to the other types of civil cases described above, can indicate deep problems in a company's business practices as well as present significant financial penalties to companies involved.

In addition to analysis of case type and frequency, a comprehensive due diligence review can also provide analysis of a civil case's docket report—a court record which displays a history of court proceedings for a given matter. The details provided in this document often offer valuable insight into a courtroom. How was the case resolved? Was an appeal filed? Was the subject of interest terminated from the case prior to its resolution? Is the case pending? These are only a few of the important questions analysis of the docket report can effectively answer. Even if a subject individual or company is listed as a defendant in several civil matters, "involuntary dismissal" of the cases (as indicated in a docket report) would mean that a judge terminated the proceedings on a failure by the plaintiff to prosecute or a failure by the plaintiff to comply with a court order or Federal Rules of Civil Procedure. This information alone can shed new light on civil litigation against an individual or entity, allowing for an understanding not only of the types of cases affecting a subject, but also of the way in which they are resolved.

Alone or combined with the full suite of due diligence checks, a thorough review of applicable civil litigation is crucial to understanding potential risks and liabilities affiliated with an entity or individual. As described in the cases above, civil litigation can be a valuable indicator of past problems and future performance. While understanding civil litigation may seem overwhelming, an inclusive due diligence investigation can provide the kinds of civil litigation research necessary for making informed and sound business and financial decisions.



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