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Due Diligence

Petters' Fraud Underlines Need for Vigilant Due Diligence

By Jennifer Banzaca

Several hedge funds have been caught in a large-scale fraud alleged against Tom Petters, former CEO of Petters Companies Inc., a Minnetonka, Minnesota-based company. Attorneys who spoke to The Hedge Fund Law Report suggested that the Petters situation serves as a reminder of the need for hedge funds managers to conduct vigorous due diligence, both prior to making an investment and at regular intervals after an investment is made.

"I think it's a matter of practical advice that due diligence should be done on a periodic basis," said Gary Mennitt, a partner at Dechert. "Even if the initial due diligence finds nothing of concern, later checks might turn up some activities that could raise red flags for investors, such as changes in service providers or recent litigation against executives in a company. As an investor, you should be constantly monitoring your investments, which includes continued research and investigation."

Alleged Petters Fraud

According to documents filed in court by federal prosecutors and civil plaintiffs, Petters Companies Inc. and Tom Petters allegedly engaged in large-scale Ponzi scheme whereby new investor money (ostensibly intended for the purchase of merchandize that would be sold at a profit to big box retailers) was used to pay a "return" to older investors. To entice new investors to make short term loans to his companies, Petters allegedly used falsified documents and fake entities.

Petters was arrested October 3 on federal charges of mail and wire fraud, money laundering and obstruction of justice. Also arrested in connection with the alleged fraud were: Petters Vice President of Operations Deanna Coleman; former Petters executive Robert White; Michael Catain, owner of certain alleged sham companies; and Larry Reynolds, a Petters associate.

According to court documents, Petters directed Coleman and White to fabricate documents used to obtain billions of dollars in loans from various investors, including some hedge funds. The phony records included fake purchase orders relating to non-existent purchases of merchandise by Petters Co. from two suppliers. As new lenders provided loans to Petters Co., outstanding loans would be paid off or rolled into new loans from the same lender. Proceeds allegedly were funneled to other Petters-owned companies and to Petters himself, to subsidize his lavish lifestyle.

On October 11, 2008, Petters Co. and affiliate Petters Group Worldwide filed a voluntary petition for Chapter 11 bankruptcy in the Bankruptcy Court for the District of Minnesota.

Hedge Funds Caught in the Middle

Several notable hedge funds had invested in Petters Co., including Interlachen Harriet Investments, Swiss money manager Gottex Fund Management Holdings, Acorn Capital Group, Lancelot Investment Management and Ritchie Capital.

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On September 30, Interlachen filed a lawsuit against Petters Co. seeking the repayment of a $60 million loan it made to the company to buy high-end electronics, plus interest, costs and attorney's fees. In court filings, Interlachen charged that Petters Co. had approached the fund several times since 2005 to invest in other potential deals, each of which Interlachen declined. Then, in April 2008, Interlachen agreed to invest in Petters Co. According to Interlachen, Petters Co. claims to have used its investment to purchase merchandise and sell it at a profit – which profit Peters Co. was obligated by the terms of the investment to distribute, but never did.

Acorn Capital filed suit against Tom Petters on August 14 after Petters Co. defaulted on $273 million in loans provided by Acorn. Tom Petters personally guaranteed the Acorn loans up to $50 million.

Five investment funds run by Lancelot Investment Management invested nearly $1.5 billion in Petters Co. Following the criminal investigations into Petters Co. and its subsequent bankruptcy, on October 20, the five Lancelot funds filed for Chapter 7 liquidation in Bankruptcy Court in Chicago. Lancelot attributed the insolvencies to actions by Petters and Petters Co.

Ritchie Capital has a claim for more than $275 million against Petters Co.

A Bullet Dodged

However, not all hedge funds approached by Petters were willing to loan money to the company or make any other type of investment. The president of one hedge fund manager who was approached to make a loan to Petters Co. said that in conducting its due diligence, his firm discovered too many red flags to proceed.

"We just didn't feel comfortable with them," he said. "Something just didn't jibe with us. Just in some of our cursory investigation we found things that did not seem right."

This hedge fund president said his firm did a Google Earth search of the warehouse listed on invoices they were shown and discovered that the property was a vacant lot. He also said Petters Co. executives pushed his firm hard to make an investment, and their sense of urgency dissuaded his investment team from proceeding.

A lawyer for another hedge fund that declined to invest in Petters Co. said that in the course of due diligence, his client discovered a number of indications that the company was not operating as claimed. The lawyer stated that his client was wary of the high returns promised by Tom Petters, and that a background check on the executive found previous litigations that raised a major red flag. "They walked away without a second thought," the lawyer explained. "There were too many things wrong with that picture for my client to consider an investment."

Due Diligence is Key

Eric Sleeper, a partner at law firm Barton Barton & Plotkin LLP, suggested that thoughtfully conducted due diligence remains key to avoiding fraudulent situations like Petters Co. For example, Sleeper noted that while routine due diligence might fail to uncover fraud at companies where the perpetrators have taken pains to cover their tracks (for example, by creating false documents), even in such situations, a simple phone call or check on the other entities purportedly involved with the company could confirm or deny the existence of claimed transactions. Sleeper also noted

that an investigation into Tom Petters' background turned up prior litigations – an important red flag.

Call Suppliers, Customers and State Securities Boards

"What it comes down to is effective due diligence and not ignoring the warning signs," Sleeper said. "You can verify the contracts and relationships, you closely analyze the financial information and check out those that are running things. You get on the phone and you call the suppliers and customers. If you want to get way out there, you can contact state securities boards to see if the investments are in fact appropriate investments. You can't take things at face value."

Talk to Outside Service Providers

Mennitt, the Dechert partner, added that hedge funds should also talk to the watchdogs tasked with monitoring the companies in which they consider investing, such as outside legal counsel and accountants. In addition, financial statements can also be enlightening from a legal and operational due diligence point of view (in addition to their more traditional utility in the course of financial due diligence). Financial statements can show – or conspicuously fail to show – the source of a company's profits or losses.

Criminal Background Checks

"It may also be helpful to do criminal background checks on key executives," Mennitt noted. "If there are questionable activities, lawsuit or criminal charges, depending on the nature of the allegations, it may be best not to be involved in that particular deal. And, if anything looks unusual, you have to follow up on that." It is also prudent for hedge funds to ask for references for the executives of companies in which they may invest, and actually call the references and listen closely to what they say (i.e., the ability to produce a list of references is not, by itself, sufficient).

Affiliated Service Providers

Mennitt added that it is important to check on a company's service providers and business affiliates to make sure they are not shell companies or owned or operated by company executives. If there is overlap between the company targeted for investment and any of its service providers, that is a big red flag, Mennitt said. Notably, that was the case in the Bayou fraud, where one of the principals was also a key person in the fraudulent accounting firm used to create the illusion of positive investment performance.

Financial and Accounting Diligence and Loan Terms

Craig Lilly, partner Squire, Sanders & Dempsey, suggested that for hedge funds making loans, the terms of those loans should be very clear and that penalties for defaults and other events of default are clearly outlined. Lilly said funds should do extensive due diligence on the legal structure and organizational documents of the company and make sure that the loan documents – the documents governing the investment – provide adequate remedies, as well as for control and valuation of collateral.

"Funds should also do financial and accounting due diligence to see how the cash flow is working and that their assets and liabilities are as claimed," Lilly noted. "The loan documents should have restrictive positive and negative financial covenants so the fund can monitor the company on a monthly, quarterly and annual basis to make sure their financial performance is what they say. If possible, it would

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be a good idea to have negative covenants to prevent a company from incurring more debt or making dividends that aren't allowed or making certain capital expenditures that are way and above what they need."

Warning Signs of Fraud

Badges of corporate fraud can be numerous and varied, and, according to Sleeper, the old adage – "if it's too good to be true, it probably is" – often holds true in situations like the Petters case.

"Whenever you see a business that seems to have out of normal returns compared to their competitors, it should give you pause to consider what makes them so much better than everyone else in that business," Sleeper noted.

Hedge funds should consider what kind of returns the company is promising investors, and whether such returns are materially different from the returns being offered by similar companies to other market participants. Hedge funds should also keep a close eye on operations and inventory, to make sure they accord with reported sales figures.

Another warning sign noted by Mennitt is a change by a company of its service providers, such as its accountants or outside counsel. If such changes occur, funds should ask both parties why the change was made. (As an aside, changes in service providers, if inadequately justified, also often serve as a red flag to potential investors in hedge funds.) Other things to look at, Mennitt added, include wide swings in assets or inventory, and sudden unexplained financial losses.

Responsiveness to questions is another gauge of a company's transparency: when issues arise and executives stop being responsive to reasonable inquiries, that should cause concern, Mennitt noted.

"There is a litany of things that should be done to make sure a business is on the up and up," Sleeper summed up. "Even then, investors will sometimes not recognize the danger and still get pulled into a scheme. The main thing is to first do your homework and make an informed decision. If something goes wrong, it's important to know what your rights are as an investor and what avenues are available to you to recover your investment."