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## HAZARDS TO EFFECTIVE DUE DILIGENCE

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### Abstract

It is not surprising that many business deals fail to realize their expected future value because some deal makers fail to perform effective due diligence. Successful deal makers, however, know that due diligence is one of the most important tasks in successful deal making. Thus, they avoid the psychological and contextual traps that cause poor due diligence. In this article, I describe the hazards – the psychological biases and contextual factors – that might affect the due diligence task. These hazards include information availability bias; confirmation bias; over-confidence bias; time pressure; self-interested agents; deal fever; narrow focus; and complexity. Following this review, I provide a number of suggestions to help deal makers and organizations overcome these hazards.

**Keywords:** Deal Making, Due Diligence, Decisions, Biases, Hazards, Negotiation

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### 1. Introduction

While there are multiple factors that explain why many deals fail to realize their expected value, this failure is largely attributed to poor due diligence than to other lapses in the other elements of the deal making process (Aiello and Watkins, 2000). In a recent survey, two hundred and fifty global executives, involved in mergers and acquisitions, admitted that there were breakdowns in their due-diligence processes where important deal-related issues were not detected (Harding and Rovit, 2004a). In the \$5.8 billion acquisition of Rubbermaid by Newell, for example, Newell failed to discover that Rubbermaid “perfumed” itself to smell better than it actually did: it stuffed its distribution channels through heavy promotions and offered deep discounts. In 2002, Newell wrote off \$500 million in good will leading its former CEO and chairman to admit: “We paid too much” (Harding and Rovit, 2004b, p.121).

Conducting an effective due diligence process plays a major role in successful deal making. A study of 1,700 mergers and interviews with deal makers shows that executives who led high performing mergers conducted effective due diligence (Harding and Yale, 2002). Successful deal makers such as, Bain & Company, a top-tier private equity firm; Cinven, a leading European private equity firm; and Nestle, a Swiss conglomerate, avoided the traps of poor due diligence by using a disciplined process.

Due diligence is broadly defined as a data collection and analysis process designed to help negotiators to effectively assess potential deals. In this paper, I identify some of the hazards to effective due diligence and suggest how to overcome them.

## 2. Information Availability Bias

Deal makers tend to distinguish between information that is easily available, usually collected from secondary sources (e.g., corporate annual reports or industry outlook studies) and information that is not easily available usually collected from primary sources (e.g., direct information from customers, suppliers, lenders, or employees). Deal makers who are susceptible to information availability bias, limit the data collection effort to secondary sources of information that are easily available, and consequently make decisions that are based on a limited set of data.

John Connaughton, the former managing director with Bain Capital, had observed that often managers rely on secondary sources of information, such as industry studies. At Bain capital, he said, “We throw out the secondary research associated with the outlook for the business and build our point of view from the bottom up” (Harding and Rovit, 2004a, p.65). A bottom up process means collecting information from primary sources, including data from the field. This is what Cinven, a leading European private equity firm, did prior to acquiring Odeon Cinemas, a United Kingdom theater chain. Cinven sent its own teams of analysts to the field – to “hang out at the movies” –and to collect information on each theater site. With the feet on the ground, Cinven was better able to analyze Odeon and assess its financial value (Harding and Rovit, 2004a, p.78).

Effective deal makers act like detectives. They understand the power of primary data and do not assume that it is not available. This was the case with Sumner Redstone before he competed successfully to acquire Viacom. The CEO of Viacom at that time, Terrance A. Elkes and his management group wanted to takeover Viacom. As insiders, they had a significant information advantage over Redstone, just an outsider stockholder. Redstone, recognizing his information disadvantage, acted like a detective and went to collect data from primary sources. He wrote:

I decided to go around them [Elkes and his management group]. I met with Bob Pittman [an insider], who had helped to create MTV [a business unit of Viacom]... and picked his brain. He told me MTV had become a very unpopular place to work in the year since Viacom had bought it. Morale was extremely low and people were leaving in droves (Redstone, 2001, p.125).

Redstone, through Pittman’s connections, met other insiders, Tom Freston, the co-president of MTV [after Pittman left MTV] and Geraldine Laybourne, the president of Nickelodeon [also a business unit of Viacom]. In a dinner with them, Redstone got important financial information such as, “MTV business was just getting started and was making \$15 million on \$80 million in revenues” (Redstone, 2001, p.126).

## 3. Confirmation Bias

Deal makers, as most humans, are naturally motivated by their need to confirm their own preconceived ideas, values, and preferences. Thus, they tend to exclude non-confirming information. When deal makers believe that certain businesses are attractive and fall in love with them before they analyze them, they are susceptible to compromising the integrity of the due diligence process. This tendency is reinforced when someone at the top of the organization falls in love with a deal and signals to the deal team that “we are going to do this deal.” In this kind of a situation, Aiello and Watkins (2000, p.102) observed, the deal team will stretch the operating assumptions in order to justify the deal and the rigor of the risk analysis will be compromised, particularly the downside analysis by using optimistic assumptions (Eccles *et al.* 1999). This, it seems, was the case in the failed acquisition of a leasing company by Fidelity National Financial. The due diligence process, according to Brent Bickett, a veteran investment banker, broke down because “The desire to get into the industry overrode the attractiveness of the company” (Harding and Rovit, 2004a, p.168).

Benoit Bassi, the managing director of Bridgepoint Capital in Paris, is different. He is aware of the hazard of the confirmation bias and the affect heuristic – the tendency to minimize

the risks and costs of something that we like and exaggerate its benefits (Kahneman *et al.* 2011). Bassi did not fall in love with the companies that he targeted for acquisition. For instance, after courting Fruit Co, a European company for months and later subjecting it to a rigorous due diligence for several weeks, he found many worms. He himself killed the deal. "When we got in there to do our due diligence," he said, "what we thought we knew turned out to be wrong" (Harding and Rovit, 2004a, p.61).

#### **4. Overconfidence Bias**

Hubris or overconfidence is a cognitive bias that can influence decisions (Kahneman *et al.* 1982). It is generally defined as exaggerated self-confidence (Hayward and Hambrick, 1997) in regard to one's judgment. Prior studies found that overconfident CEOs are prone to information judgment error because they believe that "they hold more information than they actually have" (Li and Tang, 2010, p.4), consider their own information more valuable than external information (Bernardo and Welch, 2001), and make decisions based more on subjective judgment than on objective information (March and Shapira, 1992). They also tend to underestimate the resources that are required to embark successfully on strategic initiatives (Hayward and Hambrick, 1997; Malmendier and Tate, 2006). Thus, it is not surprising that in making deals, overconfident CEOs pay higher premiums and end up with more value-destroying deals.

The former President of Israel, Shimon Peres, has been negotiating diplomatic and political deals for more than 60 years. He believes that deal makers are prone to making two types of mistakes: overestimating or underestimating their counterparts and the situation (personal communication). Overconfident deal makers would underestimate their counterparts and the situation. Terrance A. Elkes, the former CEO of Viacom was overconfident and he underestimated Sumner Redstone, his competitor. When Elkes and his management group attempted to privately take over the company, Redstone, a small shareholder, was outraged! Although just a small investor and largely unknown, he decided to compete for Viacom which he did successfully. Later in his book he wrote: "I was unknown, just some theatre owner who had struck it rich with a couple of stock purchases. Elkes and his group didn't know me and they never took the time to find out who I was. I believe they underestimated me, never for a minute took me seriously" (Redstone, 2001, pp.121-122).

#### **5. Time Pressure**

The more time a party has to research the other party, the better the discovery would be. Sellers, aware of the time-discovery disadvantage, sometimes use time pressure tactics to limit the discovery of information. In the case of Newell and Rubbermaid, the executives of Rubbermaid, the acquired company, gave Newell, the acquiring company, an exclusive right to close the deal quickly and only three weeks to do the due diligence. Newell, under enormous time pressure "raced through the due-diligence process" (Harding and Rovit, 2004a, p.73) and failed to discover that Rubbermaid "perfumed" itself. As was discovered later, Rubbermaid stuffed its distribution channels by offering deep discounts, had a poor customer service record, and weak management.

In another case, Kirk Kerkorian, an experienced deal maker, also used a time pressure tactic when he was ready to sell Metro-Goldwyn-Mayer and United Artists (MGM/UA). He called Ted Turner, the founder of CNN, telling him that he is planning to put MGM/UA up for auction in two weeks, and would give him the first right to buy the asset for \$1.5 billion, provided Turner would submit an offer in ten days. Turner, eager to make the deal, rushed to meet the deadline and signed a purchase agreement at full price of \$1.5 billion. Not only that Turner, according to industry analysts, overpaid by 200 to 300 million dollars, his team failed to uncover important issues such as: the deal between Rainbow Services and MGM/UA that already locked up all cable rights; and the deal between HBO and MGM/UA to buy several movies at a very advantageous rate (Goldberg and Goldberg, 1995, p.355).

## **6. Self-Interested Agents**

Due diligence in complex transactions is particularly challenging because the parties do not have the necessary knowledge and expertise to conduct sophisticated financial, legal, or technical, due diligence. For example, in most complex mergers or acquisitions, the parties are dependent on the services of expert-agents such as investment bankers and lawyers. Another problem is the compensation structure. Agents, such as investment bankers or real estate professionals, typically get paid only if deals close, regardless of the future value of the deals. In a number of cases, self-interested agents “pushed” questionable deals. For example, Rawson Food Services, on the advice of Prudential-Bache, its financial advisor, paid about \$40 million to acquire 43 supermarkets from Pantry Pride Enterprises, Inc. As it turned out, shortly after the deal was done, Rawson Food Services filed for bankruptcy reorganization and sued Prudential-Bache for negligence. Rawson argued in the Florida state court that Pantry Pride was worth substantially less than what it had paid for. The court found Prudential-Bache guilty of negligence and awarded Rawson \$26.3 million in punitive and compensatory damages (Kosnik and Shapiro, 1997).

In another case, First Boston, the financial advisor of Campeau, a Canadian investor, received \$12 million in agency fee for advising Campeau on the acquisition of Federated Department Stores (Kosnik and Shapiro, 1997) and in less than two years after the deal closed, Campeau declared bankruptcy (Bazerman and Neale, 1992).

The rating agencies, Standard and Poor, and Moody's, are perceived as independent and trusted agents of the investing public. Many private and institutional investors trust the due-diligence of the rating agencies and make investment decisions based on their ratings. In 2008, however, the public discovered that the rating agencies rated risky bonds as triple A (“AAA”) because they were not independent. They are financially dependent on Wall Street. For rating each deal, the rating agencies received fat fees from Goldman Sacks and other Wall Street firms (Lewis, 2010, p.73). The “independent” rating agencies did not even have their own model of rating bonds; they relied on Wall Street firms that packaged the bonds to “send over their own model...[and] somehow, roughly 80 percent of what had been risky triple-B- rated bonds now looked like triple-A-rated bonds” (Lewis, 2010, p.76).

## **7. Deal Fever**

Not only may external agents be driven by self-interested motivations, internal negotiators may as well. Robert Kohlhepp, the vice chairman and former CEO of Cintas, highlights the hazard of deal fever – the tendency to get deals done – because the internal merger and acquisition units, for example, are evaluated on the basis of the number of deals that get done. The internal operation units also like to do many deals because they want to grow their areas of operation and increase their potential income.

Deal fever is promoted by parties who stand to benefit immediately from the deals as they close, regardless of the future consequences. In fact, the entire American financial sector was driven by unchecked frenzy of deal fever leading to the global financial crises in 2008. The race for immediate financial rewards, regardless of the consequences, was indeed relentless. Wall Street firms, standing to benefit immediately as deals close, raced to purchase mortgages, bundled them into highly complex securities, and sold them as securitized bonds to investors who were unable to assess their risks. The quality of the countless deals in terms of creating future value was not considered. Unfortunately, the investors themselves, unable to do due diligence on the purposely bundled and complex securitized mortgages, were also caught in deal fever frenzy.

## 8. Narrow Focus

The due diligence task is sometimes narrowly focused on a few issues like financial and legal matters, ignoring important issues such as, cultural values and practices.

A study of 125 mergers and acquisitions that were greater than \$1 billion between 1996 and 2000 by Bain & Company, found that “cultural-integration issues can make or break deals” (Harding and Rovit, 2004a, p.112). In the joint venture between a French company and a Swedish company, for example, an important cultural practice went undetected. The agreement between the French and Swedish companies stipulated that the French company would own 50.01 percent equity, and the chairman of the newly formed joint venture would come from the French company. The Swedish company, on the other hand, would own 49.99 percent equity and the CEO of the joint venture would come from the Swedish company. What the Swedish deal makers failed to realize and investigate was that in France a chairman of a company, known as President Directeur General (PDG) usually acts as both, as chairman and as CEO, getting deeply involved in strategic issues as well as in the daily operations of the business. The designated French PDG of the joint venture indeed got very involved in the strategic and in the tactical issues of the joint venture. Eventually, conflicts over roles and responsibilities of the French PDG and the Swedish formal CEO, who was relegated to a non-CEO role, erupted. Later the management of the Swedish firm admitted that “it did not do its homework” and had they understood how powerful the role of the French PGD was, it would never have agreed that the chairman would come from the French firm (Inkpen and Li, 1999, p.40).

## 9. Complexity

In some cases, the due diligence task is nearly impossible because of the complex nature of the asset that is involved in the deal, for example, a Collateralized Debt Obligation (CDO). A CDO is a tower like structure of assembled debt obligations of mortgage bonds. Each mortgage bond is a bundle of thousands of mortgage loans and one hundred bonds create a CDO. The CDO tower like structure is based on the bonds ratings and yield. The riskiest bonds that are rated triple-B (“BBB”) are placed in the lower floors of the CDO tower. This system of bundling thousands of mortgage loans together makes it extremely difficult to do due diligence because the CDO tower simply cannot be unbundled. Commenting on this complexity, Alan Greenspan, the former Chairman of the U.S. Federal Reserve, said:

I have got some fairly heavy background in mathematics...But some of the complexities of the instruments that were going into CDOs bewildered me. I did not understand what they [Wall Street bankers] were doing or how they actually got the types of returns out of the mezzanines [the risky subprime mortgage bonds at the floor level of a CDO tower] and the various tranches [floors] of the CDO that they did. And I figured if I didn't understand it and I had access to a couple hundred PhDs, how the rest of the world is going to understand it, sort of bewildered me (Sorkin, 2010, p.90).

To make matters more complex, Wall Street firms created and used opaque terminology which was designed “less to convey meaning than to bewilder outsiders [investors outside of Wall Street]” (Lewis, 2010, p.126). For example, a bond backed entirely by risky subprime mortgages was not called a subprime mortgage bond. Instead, it was called an asset-backed security. The low level floor in a CDO was made of risky low rated subprime mortgage bonds. However, it was called differently -- mezzanine. In order not to mention the word *subprime*, the mezzanine layer of the subprime mortgages was not called subprime-backed CDO. It had a different name -- a structured finance CDO (Lewis, 2010, p.127). Such terminology was designed to obscure and not to clarify.

Bundling thousands of mortgages into a single and complex CDO which couldn't be unbundled made it difficult for investors to find out what was in each CDO. This complexity “suggested that most investors were simply skipping this stage of their due diligence” (Lewis, 2010, p.130). Sophisticated deal makers, like Warren Buffet, never got into the CDOs business.

## **10. Successful Due Diligence**

Successful deal makers are aware of the hazards to ineffective due diligence and thus develop a disciplined due diligence mindset and process. Here are some suggestions:

- Collect information from primary and secondary sources of information and act like a detective; do not assume that information from primary sources is not available.
- Create a diverse deal team, including an internal or external devil's advocate in order to challenge assumptions and preconceived beliefs.
- Restrain hubris by focusing on objective data and by involving independent and trustworthy experts.
- Negotiate realistic and favorable time frames for thorough due diligence and challenge arbitrarily set deadlines.
- Select carefully trustworthy agents who act strategically by focusing on creating present and future value for their principals.
- Restrain deal fever by using contingent contracts that reward deal makers for closing deals as well as for creating future value. Furthermore, separate between deal negotiation and deal approval.
- Broaden the scope of the due diligence task and include diverse "hard" and "soft" relevant issues (e.g., financial, legal, technical, cultural, and human resources).
- Be aware of highly complex deals that are more confusing than clarifying and use well qualified and trusted experts to help perform the due diligence task.

## **10. Conclusions**

Successful deal makers know that effective due diligence is perhaps one of the most important tasks in creating successful deals. Some deal makers, however, fail to recognize the psychological and contextual hazards to effective due diligence because they are prone to psychological biases and contextual traps. For example, they fail to collect information from primary and reliable sources of information, tend to collect selective information that confirms their pre-conceived beliefs, and value their subjective information more than external information. In these cases, deal makers should: (1) recognize that critical information is to be found in primary sources; (2) promote a strong culture of devil's advocacy in order to challenge assumptions and preconceived beliefs; and (3) learn how to restrain their hubris and appreciate humility.

It takes time to perform well the due diligence task. At times, however, some negotiators purposely set arbitrary and short time frames for their counterparts in order to prevent a full discovery. Successful deal makers know that it takes time to discover potential "perfumed pigs" and thus negotiate enough time for discovery, never rushing this process.

Short and arbitrary deadlines are perhaps more risky when self-interested agents are involved in the negotiations. In many cases, it is not possible to dispense with the services of an agent. In such cases, they must be selected carefully to ensure that they are trustworthy and committed to pursuing the interests of their principals.

Not only may external agents be possessed by deal fever and self-interest motivations, principals may be possessed by these as well. Organizations, therefore, should create a reward system that is based on future value creation, and also separate deal negotiation from deal approval.

Lastly, due diligence has been limited to legal and financial discovery and analysis, often excluding other areas like cultural values and practices. The due diligence task should be comprehensive and include all the relevant issues that might affect the future value of a deal

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