



**CRITICAL DUE  
DILIGENCE IN  
INTERNATIONAL JOINT  
VENTURES**



## A DAVID AND GOLIATH JOINT VENTURE PROPOSAL

A large international manufacturing company (international manufacturer) which makes components used in a wide range of product categories including vehicles, machinery, industrial equipment, electronics, and consumer products was approached by a small Asian component design and manufacturing company (Asian designer) with a proposal to establish a joint venture (JV). The proposed JV could best be described as a partnership between David and Goliath.

The Asian designer brought to the negotiating table a longstanding relationship with an important Chaebol, a family led industrial conglomerate in South Korea. Its relationship with the Chaebol provided it with a nearly captive market for its components in several categories of high value products manufactured by the Chaebol's companies. This relationship was an attractive feature to the international manufacturer who hoped to further grow its industry leading position by consistently exceeding 50% market share with the Chaebol-owned companies.

The proposed scope of the JV offered the international manufacturer several different corporate structure models to choose from and planned to utilize existing intellectual property (IP) and product families it already

manufactured. The JV also proposed that the Asian designer would provide research & development services to broaden the applicability of the international manufacturer's current product offerings to expand into new product lines among the Chaebol-owned companies and to co-develop new product lines for planned future products under development. The international manufacturer also sought to leverage the IP and products developed by the JV by selling them to markets and companies outside of South Korea and the Chaebol-owned companies.

The international manufacturer carefully deliberated over the relative strength of the existing commitments, supply agreements and contracts in place between the Asian designer and the Chaebol-owned companies which would form the JV's customer backbone. They sought to develop measures to expand upon and strengthen these relationships and agreements to ensure obligated captive buyers for its existing product lines and those planned for future development. The JV financial forecast projected consistent revenue growth from the partnership, eventually exceeding \$1 billion USD in four years.

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*This due diligence investigation was conducted by Banyan Risk Group's Director of Special Projects. He is Banyan Risk Group's subject matter expert on corporate security investigations and due diligence matters.*

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## STORM CLOUDS ON THE HORIZON?

Despite the many attractive benefits of the prospective JV between the two companies, there were some serious potential vulnerabilities that prevented the JV from being an obvious no-brainer.

The financial soundness of the Asian designer was very weak and had significant encumbrances. Initial capital for its creation was provided by one of the Chaebol-owned companies and several large banks in the form of convertible bonds. The company sought to convert bonds held by its creditors into equity shares and planned to pay off other existing loans by selling the building which housed the company. Two Chaebol-owned companies also held pledges on certain patents owned by the company with a combined maximum secured amount of approximately \$24 million USD at the time.

During the Asian designer's 12 years of operation, its total revenue grew for its first four years, then remained steady for three years, followed by five years alternating between large swings of growth and decline. The designer's gross profits fluctuated mildly in its early years, then spiked dramatically in the middle years, finally falling off sharply over the last three years. Negative EBITDA amounts grew in the designer's early years, spiked and turned positive one year, then turned negative again for the final three years possibly pointing to significant operating challenges and poor

management. The designer never turned a profit and its net income losses were relatively flat for all but the last three years when the losses grew substantially.

Despite the Asian designer's weak financial position, the international manufacturer was still very much interested in pursuing the JV. Relying on its long-established track record as an industry leader in the field and taking into account its own solid financial performance, the international manufacturer believed the JV could be very successful and lucrative.

## THE DEVIL IS IN THE DETAILS

Before moving into serious negotiations, the international manufacturer conducted due diligence on its potential JV partner and its leadership team to determine if its poor financial performance had been due to operating challenges, poor management or some combination of both. Due diligence was jointly conducted by the company's legal department and global security investigations team. Due diligence efforts were aided by utilizing local resources in South Korea to obtain documentation and to analyze reports written in Korean. The global security investigator (investigator) was responsible for due diligence investigations into the backgrounds of the Asian designer's former and current management team.

Prior to the JV proposal, the Asian designer's leadership structure had consisted of two Representative Directors (RD), who had more recently been replaced by one Chief

Executive Officer (CEO). The first former RD who was investigated had also been an RD of two separate Chaebol-owned companies. The investigator uncovered information that the leader of the Chaebol and chairman of its most prestigious company, for whom the first RD had been an executive at the time, had been sentenced to three years in prison for embezzling funds that were used for illegal political donations. The Chairman and his employees set aside approximately \$110.5 million USD without proper accounting and used approximately \$74.3 million USD for illegal political donations, undeclared employee bonuses, and to attract an international exposition to South Korea. The Chairman was also found guilty of breaching his fiduciary duties. He admitted to knowing that funds were being diverted without proper accounting, however, he claimed he was unaware of the funds' purpose.

The investigator discovered that the first RD, who was a Vice Chairman of the Chaebol's most prestigious company at the time, and two other executives were separately found guilty of embezzlement and received suspended sentences. The three former executives used some of the embezzled funds for personal use and the remainder for company uses and for national events. The first RD was fined approximately \$47 million USD for his part in the embezzlement scheme.

The investigator's due diligence investigation into the Asian designer's second former

RD uncovered that during the year prior to the proposed JV, the second RD was found guilty of embezzling approximately \$9 million USD from the company and sentenced to three years in prison. The verdict was appealed and was still pending a decision by the Supreme Court at the time of the proposed JV. The second RD embezzled the fund by falsifying revenue in the company's financial and accounting records. Of the embezzled \$9 million USD, the company disclosed that \$3.1 million USD were pending in various civil lawsuits and that the company won a judgment against its former RD for the remaining \$5.9 million USD.

The ramifications of the Asian designer's second RD embezzling company funds and falsifying financial records didn't end there. South Korean financial regulatory authorities conducted a review of the company's eligibility to continue to be listed as a publicly traded company on the KOSDAQ stock exchange. Ultimately, the South Korean financial regulators allowed the company to continue to be listed on the KOSDAQ stock exchange, however, they imposed a fine of approximately \$990,000 USD on the company and required it to take on an external auditor for a period of two years.

As a result of the significant criminal activities and financial improprieties of its first two RDs, the Asian designer removed both from their positions and appointed a new Chief Executive Officer (CEO) in an apparent effort to right the ship and restore the reputation of the company.

## A CASE OF MISREPRESENTED IDENTITY

During the first meeting with the legal team of the international manufacturer, the Asian designer's CEO did little to instill confidence in his leadership and management of the company. He brought an unidentified business associate with him to the meeting. At the outset of the meeting, the CEO and his associate did not make any effort to greet the legal representatives, offer their business cards or even identify themselves. The legal team reported that not only was such behavior rude and completely at odds with South Korean business etiquette, it raised serious doubts about the two individuals' identities and roles in the proposed JV.

Based on the results of the legal team's first meeting with the CEO and his associate, the international manufacturer broadened its intensive due diligence investigation. Efforts focused on obtaining information on the CEO's background, experience and qualifications to be named one of two RDs who were to manage the JV. Investigation into the backgrounds of the CEO and his associate were assigned to the investigator.

The CEO made the following representations regarding his background, military service, and education:

- He was born in the United States to South Korean immigrant parents;
- He graduated from the U.S. Military Academy (USMA) at West Point;

- He served several tours of duty in Iraq as an officer of the Korean Marine Corps;
- He earned a Master's Degree in Business Administration (MBA) from Stanford;
- He was formerly an investment banker.

Despite repeated requests for biographical information such as date and place of birth, social security number, dates of attendance at the USMA and Stanford, and dates of military service, the CEO did not provide the investigator with any information. The CEO's repeated unwillingness to provide such biographic information was a furiously waving red flag. He should have understood that such information would be required and was routinely provided to facilitate verification of one's background, education, employment and claimed achievements, especially for someone who claimed to have been born and educated in the U.S. and served in Korean military.

Though significantly hampered by the dearth of biographical information, the investigator set about to conduct his due diligence investigation, using what little information he had: the CEO's name and approximate age.

The first glaring error that came to light during the due diligence investigation was the incongruous nature of his claim to have graduated from the USMA and served as an officer in the South Korean Marine Corps (ROKMC). If he had, in fact, graduated from the USMA, he would have been commissioned as an officer in the South Korean

Army, not the ROKMC. If he was an officer in the ROKMC and had graduated from one of the three major military academies in the U.S., he would have attended the U.S. Naval Academy in Annapolis, not the USMA.

The investigator contacted the registrar at the USMA and simultaneously made use of a personal contact who was a West Point graduate to verify the CEO's attendance. The USMA registrar was unable to find any West Point graduate or cadet (USMA attendees who did not graduate) with the CEO's name or using any of the logical name variants. The investigator's personal contact provided a printout of all 120 USMA graduates with the same surname as the CEO and the names of five former USMA cadets who did not graduate. No match was found among either USMA graduates or cadets. The investigator also searched the rolls of the West Point Association of Graduates but did not find any matches there either.

The USMA registrar suggested that it was possible that the CEO attended the US Military Academy Preparatory School, an institution which offers a one-year program to students who want to attend the USMA but need to improve their education with specific courses or to improve their academic standing in order to be eligible for acceptance to the USMA.

The investigator next contacted the US Military Preparatory School registrar who was able to confirm that the CEO had attended the institution. However, he did

not complete the curriculum and withdrew from the institution ten days before completing the course of study. The registrar acknowledged this was unusual, but not unheard of. The registrar also commented that the CEO had prior military experience before enrolling, which too, was atypical. The registrar did not have information regarding the nature of the CEO's prior military service.

The CEO's claim of being a graduate was spurious on two accounts. First, he did not complete the one-year curriculum of the US Military Preparatory School, and therefore did not graduate. Second, he did not even attend, much less graduate from, the USMA.

The investigator's query into the CEO's claim of having matriculated and graduated from the Stanford Graduate School of Business were inconclusive. The Stanford registrar was forbidden from sharing any information regarding former students. The registrar stated that Stanford used the National Student Clearinghouse (NSC) for degree certification of its graduates. The investigator ran into a dead end at the NSC. Searches of NSC records require a date of birth and social security number which the CEO had been unwilling to provide. Furthermore, if the CEO had provided his biographical information and had in fact earned an MBA from Stanford but had placed a privacy block on his records, a search of NSC records could have produced a false negative.

## BALANCING RISK VERSUS REWARD

While the due diligence investigation was being conducted in the background, the international manufacturer's legal team and executives continued negotiations apace with the executives of the Asian designer, who were pushing hard to wrap up the process in the next two weeks prior to a planned meeting with the Vice-Chairman of the Chaebol's flagship company who would authorize the JV on behalf of the Chaebol.

The international manufacturer's executives faced a risk assessment inflection point. Should they ignore the significant warning signs regarding the Asian designer's weak financial condition, the uncertainties regarding the strength of the supply agreements with the Chaebol-owned companies, and the encumbrances of pledges against their patents held by other Chaebol-owned companies in exchange for a chance to generate its share of an estimated \$1 billion USD in revenue over four years, and to grow its market share above 50% with the Chaebol-owned companies, all for a minimal financial investment?

Furthermore, should the executives ignore the very strong red flags produced by the due diligence investigation which uncovered the past criminal activities and massive embezzlements of the key Chaebol executives and the first two RDs of the Asian designer, the designer's uncertain future as a publicly traded company, and finally, the gross misrepresentations concerning the

background of the Asian designer's newly appointed CEO who was designated to be an RD for the joint venture?

The international manufacturer had to carefully weigh these risks, as well as the potential for severe brand reputational damage, the potential loss of other key customers, and finally, the prospect of diminished market capitalization if the manufacturer's stock should suffer due to executives of the JV becoming enmeshed in another scandal be it related to criminal activity or financial impropriety.

The international manufacturer's storied tradition and history of being the perennial recipient of multiple national and regional awards for its robust and effective Ethics programs underpinned the internal deliberations by the company's C-suite executives.

After carefully conducting a cost-benefit analysis of the risk factors against the potentially significant financial reward, the executives chose to walk away from the proposed JV deal.

Though purely conjecture, the international manufacturer would probably have agreed to participate in the nascent JV venture if the only impediments to it were the Asian designer's weak financial footing, patent pledge encumbrances, and the less than iron-clad agreements with its Chaebol-owned customers. They stood to lose little in terms of financial cost while being in a good position to reap large financial rewards if the JV proved to be successful.

The potential massively deleterious consequences to the international manufacturer's brand reputation, customer base, and market capitalization, all of which could have been severely damaged by any future repetition of the of criminal activities and financial improprieties of the Asian designer's executives

uncovered during the rigorous due diligence investigation probably led the international manufacturer's executives to walk away from the JV. In short, the due diligence findings tipped the scales to the point where the risks outweighed the benefits.

**BANYAN RISK GROUP CAN HELP YOUR COMPANY EFFECTIVELY  
EVALUATE THE MANY BUSINESS RISKS OF JOINT VENTURES,  
PARTNERSHIPS, AND MERGERS & ACQUISITIONS**

- Working with your legal staff, Banyan Risk Group's skilled investigators can uncover hidden landmines awaiting you when considering joint ventures, partnerships and mergers & acquisitions with unknown persons and companies.
- If your company lacks in-house due diligence capabilities, Banyan Risk Group can help you develop and build out a robust due diligence program.
- Banyan Risk Group's experienced experts have successfully helped many large international companies and clients by providing them with these services and others to effectively protect their clients from unnecessary business risks while tipping the risk versus reward balance in your favor.

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