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Investigative Due Diligence in LIHTC Transactions

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Financial due diligence is nothing new in the context of business transactions. Investigative due diligence (IDD), although not new, is however, developing into an increasingly important tool in the risk mitigation. For some, IDD may be more of an afterthought or given less weight than the “standard” platform of risk mitigation steps. Thorough background checks conducted in concert with the more traditional due diligence is a powerful tool to help ensure the selection successful partnerships with high-quality partners and in minimizing the risks in low-income housing tax credit (LIHTC) investments.

Why Conduct IDD in LIHTC Transactions

Outside what’s mentioned above, affordable housing professionals don’t just conduct business with Joe down the street anymore. In fact, most LIHTC transactions are conducted among investors, syndicators and developers many states apart. Often, these transactions involve potential partners that are not well-known to the syndicator or investor. Those developers, key principals and guarantors (the developer) may have lived or have spent significant time in other countries. Even for those we know well, or think we do, events in one’s personal or business life can create stressors or can significantly change an individual’s or business’ situation over time.

It’s certainly true that what you don’t know can hurt you ... and, potentially, your investor(s) and other stakeholders. It has also been proven that one of the best predictors of future behavior is past behavior. IDD, aka comprehensive background checks, capture off-balance-sheet risks that traditional due diligence does not. These include: reputation issues, undisclosed business interests, recent arrests,

criminal records, civil suits, liens, judgments, bankruptcies, ties to organized crime, troubling patterns of behavior, and information or situations that might be detrimental or embarrassing to the syndicator and investors. The lengthy compliance period in LIHTC transactions further increases the importance of background investigations, as these are long-term investments and there are enormous direct and indirect costs associated with the removal of general partners. The bottom line is that you’re simply not being a good fiduciary if IDD isn’t part of your risk-mitigation platform.

Trouble Triangle

Fraud examiners know of the fraud triangle, which provides a framework to explain the reason behind fraud in the workplace. I like to think of it as the “Trouble Triangle,” as it helps show the interaction among pressure, opportunity and rationalization and how those three elements, when present together, increase the possibility an individual will conduct a bad act.

When pressure (usually financial pressure perceived to be unshareable), opportunity and rationalization are present in any scenarios, there exists an elevated chance for trouble. Imagine a developer who has financial difficulties at a property that for whatever reason they feel they can’t share; has the opportunity to extract money from another property and; rationalizes it as a temporary loan. All three elements of the Trouble Triangle are present in this example. While not common, this scenario or something like it is certainly not an anomaly. With the Trouble Triangle in mind, it’s important to not only look into the developer, but also to conduct at least some investigation

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into other business interests that the individual developer might have. Looking into other business interests that an investigation finds to be exhibiting signs of trouble should be evaluated as they could eventually negatively affect the transaction at hand.

Critical Investigative Steps

For some, background checks might consist of little more than a Google search and obtaining credit reports. While a good start, these steps are unlikely to uncover all potential risks that might require further evaluation. Comprehensive background checks require the use of proprietary databases, as well as in-person searches of public record repositories, interviews with references and yes, the use of Google and other search engines and social media sites. Sometimes the use of confidential sources is also necessary.

The Foundation-Building Steps

There are number of powerful, foundation-building investigative databases (FBD) that are quite proficient at providing key initial information on a person or entity. This information includes: birthdates, where they live, where they have previously lived, Social Security numbers, links to businesses interests and more. FBDs sometimes identify criminal records, civil records, liens, judgments, professional licensing data, names of business associates and relatives. FBDs also provide a fair amount of information on entities. Regretfully, unlike what we see on weekly crime television programs, there is not a single button to push or search to run that assimilates all relevant information about an individual or business. FBDs such as LexisNexis's Accurant, Thomson Reuters' Clear and TransUnion's TLO do a good job assimilating quite a bit of data. Each is stronger in some areas than the other and thus, the use of at least two or three FBDs gets an investigation off to a very good start.

With the help of multiple FBDs, investigators can determine with a reasonable degree of certainty in which jurisdictions to conduct database searches, target field research and thus where to send research and records retrievers in the field. In addition to information the FBDs provide, a review of the developer's resume, professional bio and review of their real-estate-owned schedule often provides information on additional jurisdictions in which searches should be conducted.

Next Steps

Once relevant jurisdictions have been identified, jurisdictional-specific checks should encompass at least searches of the indices of upper and lower criminal and civil state courts (including both pending and closed matters), divorce courts, probate courts, recorder of deeds (for both pending and closed liens judgments and lis pendens) and business courts (if applicable). Searches should also be conducted to look for property violations. The indices of the United States District Court, bankruptcy court and appellate courts should be checked in each jurisdiction as well. If the developer has professional licenses, checks should be conducted with professional regulators in the states in which they live or have lived and/or conduct businesses for any disciplinary actions associated with their professional license(s). One reported \$130 million disaster that might have been avoided with simple professional license checks is the case of Gary W. Lefkowitz and Citi-Equity Group. Lefkowitz was charged in 1994 with multiple counts of fraud and related charges involving low-income housing developments across the country. He was subsequently convicted and sentenced to prison. Had investors conducted a simple check with the California Bar, they would have found Lefkowitz's license was suspended for a year for, among other things, breaching his fiduciary duty to a client that involved real estate and forged documents. This example illustrates how past behavior can predict future behavior.

Less jurisdictional-specific checks that should be conducted include nationwide searches of the indices of federal courts to include the oftentimes overlooked Tax Court in Washington, D.C. Other than the Tax Court FBDs, all federal courts can be accessed through PACER, a low-cost gateway to the indices of the federal courts. The Tax Court can also be accessed through its website. FBDs also allow for multistate searches of the criminal and civil indices of state and local courts. While less-targeted than jurisdiction-specific checks of state courts, multistate searches can sometimes yield valuable information. Many of the major databases also allow for multistate checks for liens and judgments. Some also allow for multistate foreclosure checks and registered sex offender checks. In addition, searches for press or at least negative press should be conducted through the use of LexisNexis or the like. A check of relevant names should always be checked (as required by law) against OFAC's list of specially designated nationals and blocked

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persons. Names should also be checked against other watch lists, local and state offender lists and most-wanted lists. LexisNexis’s Financial Service Sanction database provides an easy way to check names against sanction lists maintained by the U.S. Department of Housing and Urban Development, the Financial Industry Regulatory Authority, the Securities and Exchange Commission, stock exchanges, state mortgage regulators and other federal and state agencies. Authorized credit reports should also be obtained and reviewed. All searches (wherever possible) should go back at least 10 years and preferably more.

Information obtained from IDD should be evaluated to include a comparison of the information identified against information reflected on questionnaires (a tool Boston Financial Investment Management LP (BFIM) uses in

its background investigations) as well as representations made on resumes, professional bios, company websites and LinkedIn. Any information deemed materially negative, including fact patters and inconsistencies in representations or lack thereof, should be summarized in easy-to-read and reference reports. All investigations and their associated steps should always be conducted in accordance with state and federal laws and should meet, at the very least, the minimum requirements set forth by investor(s) involved in the transaction. ❖

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BFIM has a strong risk culture that includes a platform of in-house risk mitigation assessments that for almost nine year has included an in-house investigations department. Mr. Curtis has conducted more than 3,000 comprehensive pre-transaction background investigations over the course of his career that in the private sector dates back to 1987. Mr. Curtis is BFIM's director of investigations.

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