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By Sabina Menschel

‘Everyone Has to Give Blood Sometime’: Lessons for Theranos Investors

Chief among the questions raised by the criminal fraud conviction of Elizabeth Holmes, at least among investigators who assess risk for a living, is: “What steps could investors have taken to avoid being victimized by the Theranos fraud?”

In a recent article, the *New York Times* explained why too many investors fail to see, or even ignore, ‘red flags’ — indications of potential regulatory, reputational, or compliance concern — in a potential deal or investment. Chief among them is FOMO, or “Fear of Missing Out.” Investors are reluctant to ask probing questions — or demand the information needed to fully evaluate an opportunity — because they do not want to be viewed as difficult and possibly cut out of a “hot” investment. Another roadblock, as we have discussed, is over-reliance on personal relationships and professional connections when evaluating opportunities. Both factors were clearly at play at Theranos, an extreme example of FOMO.

It may be, as the prosecution and some investors convincingly argued, that the real problem with Theranos was not a lack of due diligence but rather that the claims made by Holmes and company were lies, so that no due diligence exercise, no matter how comprehensive, would have been enough to detect the subterfuge. But even when assessing a company built on lies, there are many things investors could have done to evaluate the entity, including hiring trained investigators, researchers who are expert at conducting due diligence.

A basic, but often revealing, first step in assessing an investment opportunity is to conduct an open source background investigation. In the case of Theranos, such an investigation should have been conducted on Holmes and her executive leadership team. While nothing as obvious as a criminal record, history of litigation, or a failed business venture would have been found in her background, Holmes’ striking lack of professional and industry-relevant experience alone should have caused investors to want to know more about her and the company.

Additional digging would invariably require speaking with others about the company and its executives. In Theranos’ case, this could have taken a couple of different forms.

The first would have been to speak with industry experts to obtain their views on the concept, the technology, the product, and the firm itself. These subject matter experts might include individuals at investment banks or venture capital firms who specialize in healthcare investing, academics focused on biological assessment, and/or individuals at competing companies who know the landscape and may even be trying to develop something similar.

Reporting on the case has suggested that many healthcare-focused venture capital firms as well as some large corporations, including Schering-Plough and Pfizer, steered clear of investing in Theranos because they were not comfortable with what they learned about it. Their experience clearly helped them evaluate the opportunity. Without speaking to these types of people, investors with no relevant industry experience were clearly at a significant disadvantage.

"Former employees" — that is, people who had left positions at Theranos — are another group that had valuable information. Identifying and speaking to former company personnel is invaluable, especially when assessing a company's culture, operations, and management style. Public reports suggest employee turnover at Theranos was high, therefore there were a good number of potential interview subjects for an intrepid investigator. Relevant questions would have addressed the efficacy and viability of the company's product as well as its internal culture and the management style of its executives.

In his reporting and book about the company, *Wall Street Journal* reporter John Carreyrou recalled that in the early stages of his investigation, he had a difficult time speaking to former employees because of the company's use of non-disclosure agreements coupled with an intimidation campaign it waged against those who had left. While this undoubtedly made speaking to former employees more difficult, trained investigators are accustomed to this challenge. Further, any sign the company was intimidating former employees from speaking would have been a clear signal something was amiss.

Theranos provides yet another example of how the lack of any rigorous due diligence left investors high and dry. Even when a company moves past puffery to engage in chicanery, investors are not powerless — they can and should critically evaluate what they are being told. Investors would benefit from working with a reputable independent investigator — one who is not influenced by a desire to close a deal — in evaluating opportunities comprehensively. FOMO can have serious consequences and there is nothing as feared as a total loss of investment capital.

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