Private credit transactions – your nose knows

Before you invest your fee from a large award, give the deal a smell test

By David Cook

Clients ask their CPAs "Is this a good deal?" "Should I do this deal?" "What do you think?" "What can go wrong?" "Can you protect me?"

Responding to those innocuous questions conjures up the image of lion tamer putting his head in the mouth of liability. This article serves as a common sense guide in answering these questions.

The bouquet of success has thorns

An interviewer asked a famous actor who won the Academy® Award to describe the pay-off from his achievement. His answer: Better scripts, financial terms, and creative control. He mused that his Oscar® financed dinner for four at Masa, the famous New York Japanese restaurant ($300 to $500 *per person*) and let him bid farewell to the buffet at Circus Circus.

Like the famous actor and successful entrepreneurs, trial attorneys relish a banquet of opportunities, both the very good and the very bad.

Here is a quick guide to sifting the wheat from the chaff. Call it the "smell test" of deals. Breathe deeply and exhale.

Routine deals are seed, mezzanine, or bridge loans, tied to equity to enable a fledging entrepreneur to finance a start-up. Advisors, accountants and business associates shop these opportunities, but infrequently provide realistic financials to justify the risk inherent in the credit. These deals can be straight loans of money, but more commonly the borrower asks the private lender to guaranty a bank loan, line of credit, or letter of credit enabling the borrower to have direct access to the credit without the draconian constraints imposed by the private party as a direct lender. All too typically, the borrower exhausts the credit, rebuffs requests for financial statements and assuredly defaults in the loan. The bank calls on the guaranty and the private lender, as the guarantor, pays off the debt. Payment to the bank converts the guarantor, formerly the investor, into the angry creditor pondering the collection of the credit owed by a teetering start-up with miniscule assets, many bills and no future. Pre-ordained, Chapter 7 peeks around the corner. Any investment that just requires the investor to guaranty the bank loan is an investment that craters.

What can you do to better understand these transactions and make great decisions in proceeding or declining these deals? Is your next deal like a Jack-in-the-Box?

Basic, simple questions

• ***You talkin' to me?*** This is the best question. The answer is that the traditional lenders, such as banks, venture capitalists, hedge funds, commercial and industrial lenders, finance companies, factors, "hard money lenders," and even family members rejected this deal. Why? This deal represented a toxic brew of awful credit, the shady background of the key players, maxed out lines owed to others, insufficient collateral, or an undecipherable business plan.

No deal is perfect, every deal has risks, and financial gravity brings every deal to earth. Always ask, if this deal is so good, why are you offering this deal to me? And, always, is this deal too good to be true? Even the U.S. Patent and Trademark Office (USPTO) declined to award a patent to a perpetual motion machine.

Upon being asked to invest in a fuzzy deal, a very successful cosmetic dentist told the borrower, "So, the doctors turned you down, and why are you asking me? Did the podiatrist turn you down? How about the chiropractor? Am I your next guy on your speed dial?" If the deal smelled bad to the banker, the deal smells bad to you.

Moreover, financial institutions sell off their loans, or participations, to private lenders. You would think the bank that vetted the loan, ran the credit through the gauntlet of credit approvals, loan committees and senior management would hold it in its own portfolio; that these loans bear the earmarks of financial rigor and are all but free of risk or default. No? No, is right. Absent a need to raise capital, the banks retain the flawless, but peddle the flawed loans [buzzword: "non-conforming loans]. Consider these loans Rosemary's Baby.

• ***What do I know about the opportunity?*** Would you buy a $100,000 car without taking a spin, perusing Consumer Reports, studying the Kelly Blue Book and Edwards, and chatting with close friends? Not too likely. How about the eight-figure home? Many personal inspections accompany that capital purchase along with the bevy of contractors, architects and advisors. Surprisingly, private lenders lend big dollars, or guaranty mid-to-million dollar figures absent a clear understanding of the deal. This is precisely the weakness exploited by the dishonest borrower.

The answer to this issue is a famous statement attributed to Warren Buffet, when asked whether he would invest in a dot-com company. His answer: "I do not invest in anything that I do not understand."

Be your own best lawyer: Ask the tough questions. The common refrain is "I hate to ask a stupid question," This is plain wrong. The only stupid question is the question never asked. Stupid questions extract startling answers.

• ***What do I know about my new erstwhile partner?*** Banks, finance companies, venture capitalists and hedge funds have at their disposal: credit reports, maintain credit departments to evaluate financials, personal histories, audited financial statements, including tax returns, and employ highly trained professionals to advise on a credit. Private lenders lack these resources and rarely, if ever, receive the borrower's personal financial statement, tax returns or a credit report. As the potential private lender considering a deal, you should demand and receive every scratch of paper that a hard-nosed banker would demand and nothing less. If these documents, accompanied with the right of verification, are not forthcoming, consider the next deal.

The digital world is your BFF. Start here: (1) The grantor/grantee index of the county recorder for the county where your "partner" lives or the project is located. Why? You will find the tax liens, judgments and support orders and confirm ownership. (2) The local courts. Why? The docket for every lawsuit revealing your partners as defendant. (3) The U.S. courts (including bankruptcy) (PACER). Why? Every federal lawsuit against the new friend or bankruptcy filing. (4) The USPTO. Why? Does this person own the patent or trademarks upon which the deal rests? (5) EDGAR. Why? If your new friend is associated with a publicly traded company, what is the status? Penny stock or stock fraud? (6) Professional Licensing. Why? Disbarred attorney, perhaps. (7) UCC search. This search will reveal liens and, potentially, hard money financiers.

Cost for this information: Near zero. Westlaw and LexisNexis also offer this information. A very famous movie line is, "Trust no one." This is your investment strategy. Reagan had it right: Trust but verify.

Let us remember that today's singles prospecting for romance through the dating sites learn more about their romantic prospects than private lenders pondering a six-figure credit. We all wish that Zagat's would rate deals, and in the age of eHarmony, even dates.

• ***What are the other opportunities available to me?*** True, passing on historic companies, such as Google, Cisco (in its day), 3Com (in its day which was a long time ago), Amazon, Priceline, and Microsoft is painful, but just because some deals are missed does not justify grabbing every deal down the pike. Borrowers frequently label their deals as the next "Facebook." That might or more likely might not be true.

As former MPAA president, Dan Glickman, stated when he was ousted as Congressman from Kansas, "When one door closes, another door opens." Patience is more than a virtue. Patience is an investment strategy.

Keep your powder dry and wait for the next deal. Didn't we all think that Google stock was the Holy and last Grail?

• ***How can I manage my investment without an undue investment of time?*** This question is a little bit of "having your cake and eating it, too." Dishonest borrowers seek private lenders who are busy, harried, and ostensibly decline to invest time and effort in protecting their investment. You need to invest time and effort to manage the investment, or admit that you do not have time and effort, and find alternative investments bearing less risk, but less attention.

Starting at a bank statement requires no effort and, absent another bank meltdown, offers virtually no risk.

Rate investment as pets. Stocks, commodities, options, and equities are like toy poodles. Mutual funds: A cat. Bond funds, T-Bills, and government fund: Fish. Bank accounts: The turtle. Money under the mattress: bonsai tree. Real estate: ranges from the pet boa to the pet rock.

• ***What can I do to avoid a dud?*** Other than passing on bad deals, the answer is up-front diligence answering the first five questions here. Assuming that you're going to invest funds as capital or debt, the starting points are hiring a competent attorney (not the person who recommended the deal) to draft up documents, demanding security, receiving a full credit package, and retaining the services of a CPA (again not the broker) to advise of the credit and business risks. Even with a powerful team at your disposal, insure complete electronic access to all financials, a perfected security interest in all assets including the all important intellectual property, a control agreement in the bank account, economic and non-economic covenants in the loan documents. The covenants entitle you to call the loan should you sense risk. Finally, get personal guaranties from the principals.

Sadly, even these remedies go kaput.

• ***What loans should I always avoid?*** Loans to friends; any significant others (boyfriends who want the money for cameras); small businesses, and payment of their bills, child or spousal support; bail or the criminal defense attorney, or any family member. Loans to start-ups without a concurrent guaranty. Loans to offshore entities. Loans arranged by third parties who have a financial interest. Loans to finance new technologies that are obscure, difficult to understand, or lack clear potential to bring to market. Loans in which the lender is a participant with other lenders. Loans that don't make sense. Loans to entities whose addresses are Post Box Etc.® Loans to "cash-in" on the economy of any foreign country. Loans to any shell company. Loans to someone you do not know. Loans to someone that you do know. Loans to someone that your bank would decline. Loans without control of the credit facility. Silly loans. Loans that don't survive the smell test even for those who cannot

smell. Loans to finance the "future" of China (or any country). Loans to finance account receivables. Loans to purchase "debt instruments," offered on the Internet. Participation loans. Loans offering interest that is stratospheric. Loans without collateral. Loans with collateral, but no title report, escrow or appraisal. Loans secured by personal property without a UCC search, escrow or appraisal. Loans secured by a car without appearing as legal owner on the title. Loans that glow in the dark.

Sometimes greed, misplaced trust, love, personal friendships or family bonds motivate these loans, all of which lack any financial statements, security or credit references. These deals aren't loans. These loans are virtual gifts accompanied by mere moral commitment substituting as repayment. Love and kisses make lousy collateral, and collecting from the fellow whose address is a P.O. box is ephemeral.

• ***What is your strategy to minimize this catastrophic default?*** This answer comes from the securities business in the face of cascading losses. The answer is: "Your first loss is your best loss," that means when the borrower's business begins to teeter, shut it down, salvage your loss and walk away with at least something in hand.

• ***Should I walk from every private deal?*** No. Some private deals are winners. Facebook might stare you in the face.

In approaching every private deal, be your own credit officer. Be your own analyst. Be your own attorney. Be clairvoyant. Be cautious. Be prudent. Be careful.

Don't be a pioneer. What is a pioneer? A pioneer is the fellow with the arrow between the shoulder blades and face down in a puddle of water. The eulogy? He was a brave pioneer. Note the past tense.

Most important, be paranoid. As Golda Meier said to Henry Kissinger, "Even we paranoids have enemies."

If you avoid the bad deals, and pick the good deals, you will be happy.


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