SHARK OR BAIT?

AT RISK IN THE SHARK TANK

BY JACK GARSON

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So, you're going to be the next Shark in the Tank.

You're sitting on a pile of cash and you know that if you're smart—and your spouse doesn't find out—you can put that money to work and next thing you know, you'll be able to tell your boss to take that job and…uh…find someone else.

But, you don't trust the stock market. And does anybody want bonds or CDs that pay .000001%?

So, move over Mark Cuban. There's a new Shark in town. You'll invest here, lend there, dole out wisdom and, of course, cash big fat checks. In fact, you're beginning to wonder: "Why didn't I do this sooner?"

Here's why.

People who have money usually made it at their job or in their own business. The problem arises when they think they have the Midas touch—that they will multiply their savings by investing it with others. But, for every Warren Buffett, there are thousands of investors licking their wounds and trying to hide their losses from their spouses. The only good things they get are tax deductions. They also feel cheated. Regularly, some angry investor comes to my office, holds a stack of papers up in the air and says, "These crooks stole my money." A bloody Shark with a hook in his mouth is not a pleasant thing to see—or be.

Avoid the bait and you, too, can swim with the big fish.

Due Diligence

One client was ready to pounce on a "sure thing" deal. He was going to lend money to a business and haul in 20-30% in interest annually. Plus, he'd get an equity kicker that would give him an option to buy stock in the company. Here's the clincher. The business was "woman-owned" and did all of its work for the government. So the loans weren't supposed to be risky at all—the money would be coming directly

from the U.S. Government. It seemed as secure as owning government bonds and, with the stock option, had the potential to skyrocket like Google.

Still, to be safe, I suggested we do our due diligence. One visit to the business' headquarters and it was clear there was a problem. The key to this deal was the fact that we were working with a bona fide woman-owned business—that's why the company was getting all that government money.

So, we began our search for the "woman" in "woman-owned." No such luck. No office for that key woman. No parking space. No name on a door. After some very persistent questioning, we learned she was the wife of the guy actually running the business. He admitted she had another job altogether and couldn't find the company even with GPS.

So, what was my client really buying into? Hmmm…FRAUD. Yeah, that's it. FYI, 8 out of 10 advisors recommend that their clients avoid fraudulent schemes.

Do your due diligence. Every situation is different. Sometimes, you read the contracts and financial statements. Other times, you talk to the customers, employees or competition. You may even try out the company's products or services.

Don't trust. Verify.

Personalities: Meet Your New Partner, Dr. Jekyll

Everything had been going fine with another client's investment in real estate—her check had been cashed and was already producing a good return. Then, she called her new partner on a day that he missed his meds. Yes, everybody has issues. But, not everybody turns into a raging, cursing crazy man—who happens to be in charge of your multi-million dollar real estate investment. That'll put a scare into you—and jeopardize your retirement plans. From then on, it was a delicate egg-shell walk. Fortunately, I had negotiated the deal so she had the right to put the property up for sale. So, she forced a sale—and fortunately got out when the market was strong. The lesson here—more than a good contract and lucky timing—is that you really need to know who you're partnering with. Preferably, you should be around someone for at least one year—see them through all four seasons and how they react to good times and bad—before you make a significant investment with them. If you can't, then at least spend time with them in a variety of situations—especially difficult ones. It's a lot easier for someone to seem charming and reasonable when it's all champagne and celebrations. How they handle bad news and stress is much more revealing.

The "wait and watch" rule works.

Risky Business

In every investment, consider the risks. Plenty of companies are out there, figuratively speeding on highways, thinking it's legal just because the road is empty. Take Aereo. The company had a revolutionary idea to avoid paying broadcast fees by using millions of little antennas to capture the broadcasts of network shows. They didn't pay license fees, but they still sold the service to their customers. Good business, if you can get it—or in this case, get away with it. That was the hang-up. In 2014, the U.S. Supreme Court found that the operation was illegal. Aereo is liquidating now—so that probably takes them off most everyone's list of "Top 10 Best Investments."

On the other hand, Uber and Airbnb don't seem to care if someone tramples on a law here or there. But, they've got an army of lawyers and lobbyists to fight for them. And they've won over a lot of customers with some compelling services. So, they're winning converts. As they do, every week another city, state or country adopts rules that make it easier for them to do business. So, these risks don't seem so bad.

Evaluate every investment: Will the risks crash the company or just be a speed bump on the road to success?

Documents

I understand. You're not going to read the documents. But, someone needs to on your behalf.

All too often, people think that these documents are irrelevant—just "boilerplate" that has little real-life consequences. But, savvy investors know that the details in those documents are critical. Consider the following:

- Your investment can make a profit, requiring you to pay taxes on your share of that income. But, the person in charge of the investment can financially strangle the investors by refusing to make any distributions of that income. That leaves you paying the taxes out of your pocket. It's so common it has the nickname "phantom income"—income that the IRS taxes, but that you haven't received. As a result, control of the distribution of money to pay these taxes is so powerful that the person in charge can use it to extract concessions and even force an investor to sell out cheap. Savvy investors (a/k/a burned, but wiser, investors) insist—from the outset that they get mandatory distributions of enough funds to pay the tax bills.
- Another tricky provision can be used to withhold all distributions of the company's profits. The person in charge of the company's finances is typically entitled to establish a seemingly innocuous "reserve" to pay for unanticipated expenses. Seems fair enough. But, if the person in charge sets this reserve high enough, there is never any money left to be distributed. Once again, you could be holding on to an investment that is making a lot of money—and you don't get any of it. Set a limit on reserves.
- Understand, though, that even the best documents aren't always enough to protect you. Because the Sharks write the checks, they usually insist on documents that give them control. They think they get it. Sure, they can make certain decisions, but that doesn't always mean they have real control. Take the restaurant named after a particular chef. The success of that

business depends on that chef's involvement. Without him or her, all you've got is a full-time staff and a bunch of tables, chairs and fancy Panini machines you haven't paid for. So, you can have the best contract in the world. But, if a key person can threaten to walk and trump those carefully worded documents, that ain't control.

Don't end up like the bait. If you're in the investment tank, be the Shark.

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