Five Tips on Raising Start-Up Money from Family and Friends

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Many owners of broadcast stations received start-up capital from close friends, relatives or business associates who lent them money, invested in their stations or made no-strings attached gifts. There are lots of advantages of tapping individuals you know for money, including the elimination of extra paperwork and bureaucratic delays. Of course, there is a big downside. If your business venture turns sour, you risk burning the relationship that you have with members of your family, business colleagues and friends. William Shakespeare, in Hamlet, tells about the advice that Polonius gave to his son Laertes: “Neither a borrower nor a lender be; For loan oft loses both itself and friend.” Polonius should have said that loaning money to friends and relatives and accepting such funds can be a perilous proposition. Facing down an institutional investor or lender staring at a write-off on their ledger is not nearly as painful as telling your childhood friend or aging parent who raided their 401k or home equity line that their money is gone. Then it becomes personal.

Assuming that you have thought through the pros and cons of tapping money from those individuals who know you best, here are words of advice that Polonious, if he were alive today, might dispense:

Tip One: Be Honest about the Risks. In dealing with friends, family and business associates, be extra careful to explain the risks. Explain in detail your business plan in much the same way that you would to a banker. Or as Polonious might say, treat them as if they were strangers. Avoid the temptation to give an unduly rosy forecast of expected revenues and lay out all of the pitfalls. Don’t place undue pressure — especially on those individuals who are on fixed incomes or otherwise can’t afford to be out of pocket on an investment. Don’t be shy about asking your friends or family member what they expect in return for parting with their money. Be specific on how much money your company will need and your plans for the money that is invested. For family and friends on the other side of the deal, they need to ask themselves how much damage they can tolerate if they lose everything, because there is at least a 50/50 chance that they might. If they have a $500,000 net worth, is a $100,000 bet too much? What if 90% of that net worth is tied up in their home, as it is for many people? In some cases, it may be wise to bring in a trusted, independent third party to give an opinion on the business plan.

Tip Two: Select the “Right” Investment Vehicle. Give very careful consideration to whether the funds will be in the form of an outright gift, a loan or an equity interest. Debt is generally preferable to equity; one of the advantages of debt is that your only obligation is to pay it back pursuant to the terms of your loan agreement. Also, you might be able to secure a much lower interest rate than would be charged by conventional lenders and may be able to tie payments to your cash flow. In a worst case scenario, a properly structured business loan from an individual, if deemed uncollectible, can be written off as a deduction on your "investors'" tax returns, provided they follow IRS guidelines carefully. If you give some form of equity interest in exchange for the funds, consider giving non-voting stock so that the stockholder doesn't have the right to second-guess your business decisions. Another alternative you might consider is convertible debt (a combination of a loan and a future equity interest). For the uninitiated investors (and for all concerned in the deal), it's always better to have some protection or cushion of capital behind them. A subordinated loan that ranks behind the senior secured debt but ahead of common stock (especially if the stockholders are experienced) should provide some measure of comfort over being the one at the very bottom of the pile. For the "investor," it's always wise to make sure that the person asking for funds has something at risk as well – a personal guaranty with some teeth in it, for example. But once again, potential "investors" need to ask themselves if they'd be willing to enforce a personal guarantee by foreclosing on the house of their friend or family member.

Tip Three: Get The Terms in Writing. It should go without saying — but we will say it — it is essential that any loan of money to you be accompanied by a written agreement that spells out what the payments will be, when they are due, the interest rate, what happens if there is a default and whether there will be any security for the loan. It is to your advantage to work out a repayment plan that lines up with your most conservative business projections. A document that spells out the terms of the loan will be needed in case of an IRS audit. To use the words of a popular American Express ad, don't leave home without it, namely, a carefully drafted loan agreement.

Tip Four: Comply with the Securities Laws. Beware: there is no "friends and family" exception for U.S. and state securities registration requirements. If you decide to sell stock or membership shares in your company, you will have to register with the SEC and applicable state regulatory authorities or rely on the exemption from securities requirements pursuant to the "accredited investor" exemption under Rule 506 of Regulation D. Among the advantages of accredited investors (individuals who have at least $1 million in net worth or an annual income of $200,000) are your dealing with individuals who are more likely to understand the risks of the investment and because of their high net worth, and your having to raise less money from other sources. The applicable securities requirements will be determined in part by the number of investors, which state or states you are in and whether you limit your solicitation of funds to "accredited investors." If you pardon the program-length commercial, you would be wise to consult with counsel.

Tip Five: Keep Open the Lines of Communication. No one likes surprises. Keep your sources of money current on how your business is faring, and remember, *if you're dealing with unsophisticated investors, they may be more prone to panic than an experienced investor*. Consider sending monthly or quarterly progress reports (they do not have to be lengthy) along with detailed financial statements, preferably prepared by an outside CPA rather than your spouse or significant other. If loan payments are made by check, you might send a written receipt and, on occasion, a note expressing your continuing appreciation for that person's generosity and faith in your abilities. Also, post closing, don't be shy about continuing to solicit business advice from trusted members of the family and business colleagues most likely to be of

assistance.
Hitting up family and friends for a business investment is very dicey, but may be your only choice when the investment window is closed. Decision making on both sides can be easily skewed when emotions like guilt and desperation come into play. All too often, there is a desire by the “investor” to want to help a friend or family member, especially if that person appears to be in dire straits. Sometimes saying “no” may be best for both sides. But not always. Remember, the college roommates who pooled their allowances and bankrolled Facebook are now billionaires.

So with that, we wish you, your friends and family members well.

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