The People's Bank

How to borrow from the people who love you without making them hate you.

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Restaurateur Artie Bucco asked a friend to loan him $50,000 so he could go into business with an importer of French liquor. The friend said no, explaining that he'd have no recourse if Bucco didn't pay him back. The problem was that Bucco just happened to have another friend—mob boss Tony Soprano. The friend's worry: "If you don't pay me back, I ain't gonna be able to hurt you."

You don't have to be a character on *The Sopranos* to know that going to family and friends for business capital can be a dicey proposition. Admonitions against mixing love and money may be as old as currency itself. "Neither a borrower nor a lender be," warned Shakespeare. "For loan oft loses both itself and friend." And a Punjabi proverb cautions: "When there is affection, never go into business together." But when your savings well runs dry and you can't snag a bank loan or are horrified by the rate you're offered, who better to turn to than the friends and family who believe in you and your dreams? Informal investment—money from friends, family, neighbors, colleagues, and the like—totaled $92.7 billion in 2005, according to the Global Entrepreneurship Monitor, an annual survey of entrepreneurial activity around the world.

That's not surprising, considering the many advantages of raising capital close to home. Friends and family often give you more favorable terms than a bank or a professional investor will, such as a higher estimate of your company's value or a lower interest rate on a loan. They are predisposed to trust you, so you likely won't have to jump through as many hoops to win their investment. And they may be more forgiving if your company goes south.

But Shakespeare knew a thing or two about human nature, and entrepreneurs would be wise to keep his words in mind. Your investors may feel entitled to a say in how you run your company, whether or not you want their opinions. If they don't reap the return they expected or you can't make payments on a loan, holiday get-togethers could be mighty awkward. "The fallout can be pretty ugly if you don't turn out to be the star you thought you were or the market isn't right for what you want to do," says Susan Newman, a social psychologist in Metuchen, N.J.

The key, Newman says, is to tread carefully. Your investors may have known you since you were in diapers, but this is business. From the start, give the process of raising money the attention it deserves. Figure out how much you really need, and whether debt or equity would be better for your company (though investors may get a bigger say in that than you'd like). Terms, of course, have to be fair to both parties. Perhaps most important, you'll need to take great care with the emotional aspects of the financial relationship: How will Aunt Jane feel if you go bankrupt and can't pay her back? Does Mom want a seat on the board? Talk it all through, and then write it down, in detail. Says Newman: "If family members keep focused on what's important—important being the relationship—it can work."

For most startups, debt makes more sense than equity, says Asheesh Advani, chief executive officer and founder of CircleLending, a Waltham (Mass.) company that administers loans between friends and family online. With equity, it can be difficult to get your investors' money out of the company unless you sell or go public. Equity deals are also more complicated to set up, and having a lawyer to guide you is essential. You'll first need to put a value on your company, taking into account its assets and potential to generate revenue and profits, and then multiplying that total by an amount common for companies in your industry. You probably will also want to structure the company as an S-Corporation or a limited liability company, both of which allow your investors to deduct corporate losses on their personal income taxes. Above all, you'll want to make sure you're complying with federal and state securities laws. A common mistake is not properly disclosing risks to nonaccredited investors, defined by the Securities & Exchange Commission as those having a net worth of less than $1 million or an annual income of less than $200,000. The amount you're raising might be small enough to fall under de minimis exemptions, which the federal government caps at $1 million (state exemptions vary), but ask your lawyer to check.

If you plan to go to angel investors or venture capitalists for additional rounds of financing, be aware that they will look closely at how you valued the equity you gave your friends and family. Likewise, professional investors might shy away if your so-called friends and family round hasn't been handled properly—if you've failed to document investments or have investors who could pose a legal liability by claiming they weren't informed of risks or were promised special rights. "It's much more cumbersome having a lot of small shareholders," says Jeff Harder, managing shareholder of business law firm Winstead in The Woodlands, Tex.

Equity investors often expect more of a say in how you run the company. In 2003, Heather Battey wanted to expand Spiritual Fitness Wear, her Mission Viejo (Calif.) workout apparel company. She brought in an investor who got a 5% stake. Although the investment agreement spelled out that Battey retained control of the company, the investor fought to have her way. After seven months, and with the woman threatening to sue, Battey bought her out. "It is hard to find people to invest without having to give up a huge percentage of your company or the rights, especially being small," says Battey. "You want the money, but you don't want to give up control." Battey has since turned down other friends who asked about an equity stake. She eventually took $30,000 from a friend—as a loan.

Still, entrepreneurs optimistic enough to foresee a relatively quick exit from their company may still prefer equity. When Shawn Harris started SkyWire Media in November, 2005, he eschewed loans. "I didn't want to consider debt," says Harris. After all, he anticipated an initial public offering or acquisition within a few years. To help finance the Las Vegas-based startup, which provides cell-phone ads and other mobile marketing services to businesses, Harris had planned to keep his job as a sales and business development executive at InfoGenesis, a technology company. But over Thanksgiving dinner at Harris' house, his father-in-law, Gerald Cunningham, a serial entrepreneur himself, grilled him about the company. Harris explained that he'd spoken with a potential customer whose enthusiasm for SkyWire's technology made him realize the company could be bigger than he initially thought. On the spot, Cunningham offered to invest. "I was just talking," says Harris. "I didn't ask him. I didn't volunteer anything. He saw the potential." Cunningham put in $44,000 and received less than 1% of SkyWire's common stock. Harris brought in 10 other investors, raising $250,000. He left his job to become CEO of the company, now with 11 employees, in March, 2006.

Rifling the Rolodex

Once you have some idea of which type of financing you're looking for and how much you might need, finding the right investors is all about who you know. Start by pulling out your address book or BlackBerry and listing potential investors. Include Mom and Dad, of course, but don't overlook the cousins you haven't visited in years or friends you see only in church on Sundays. Ask friends and neighbors if they know anyone who might be interested. But skip anyone with whom you have a shaky relationship or unresolved emotional issues, or for whom making an investment might be too risky, such as a grandparent on a fixed income or a friend who says he will tap his 401(k) for you.

No matter what form of financing you're seeking, be clear with potential investors about your expectations for the business, the risks of investing in it, what will happen if you can't repay them, and what role, if any, they are to play in operating the company. "The most common mistake is thinking that friends and family are easy targets, so you don't need a great pitch for a great business idea," says Guy Kawasaki, managing director of Garage Technology Ventures in Palo Alto, Calif. "The best model is to pretend you are meeting with [venture capital firms] Kleiner Perkins or Sequoia and give a great presentation." Go ahead and ditch the PowerPoint, but be prepared with a business plan and financial projections. Be direct and be passionate about your business. Better yet, show potential investors a tangible representation of your company, such as a prototype of your invention or the blueprint for your restaurant. "You want to bring the business to life," says Advani. "When family and friends feel they're helping you build something, they feel much happier about getting involved."

But every investment has its risks, and leavening your confidence with a bit of realism might prevent discord down the road. For Lisa and James Clunie, being frank made it easier to borrow from relatives to launch Rhombus Wear, which makes "studious but not stuffy," casual clothes. At first the Clunies worried borrowing might damage their relationships, and they didn't want any help. Says Lisa, the company's president: "We've really wanted to do things on our own terms and in our own way and show up at Thanksgiving and say 'Look what we've done!'" But as family members got wind of their plans, some asked if they could help. The Clunies gave potential investors a formal request for a five-year loan that included a business plan and three years of financial projections. They were careful to explain that they needed money to manufacture the clothes even before they knew if they would sell. Then it came time to negotiate terms. Clunie asked the relative who would likely make the largest loan what it would take to get him involved. She then worked with an accountant and determined, based on Rhombus' projected cash flow, that the company could handle payments at his requested rate of 8%. Two other family members then made loans under similar terms, and the Clunies had the $200,000 they expect to need to fill their first orders this spring. "It turns out that raising money from friends and family was a lot harder than we thought," says Lisa. "The lenders are so generous and so considerate. This was kind of a test to see if you can handle something like this, see if you can negotiate with somebody you care about."

To prepare for negotiations, first consult the Internal Revenue Service's applicable federal rates, which are the minimum rates Uncle Sam will allow you to charge to avoid classifying a loan as a gift. Then check the average rates your investors could get elsewhere, such as in a certificate of deposit, stock, or bond. Often, you'll have to match those rates, but some investors, particularly relatives, will give you a break. CircleLending's Advani says the current average interest for loans from a family member is 6.1%, compared with 8.2% for those from nonfamily members.

Consider asking investors for a grace period, perhaps six months or a year, to give you some breathing room. Clunie negotiated that first-year payments would be interest-only. Another option: a graduated repayment schedule that allows you to start with smaller payments. Balloon repayments also keep payments low but require a lump-sum payment at the end of the loan period.

Share the Wealth

Profit sharing is another way to reward your investors if your business is successful, with no risk to you if it is not. The Clunies promised their largest investor a bonus equal to 2% of net sales in the year that the loan is paid off, provided that the company's gross margin that year is at least 40%. Says Advani: "It is a great idea. It aligns everyone's interests and could also influence the behavior of your investors to really help you." Still, creating a profit-sharing plan can be tricky. The definition of profit varies, and it is difficult for a startup to project profits five or ten years down the line. A simpler option is to set a milestone, such as reaching $1 million in sales, and give your lenders a bonus payment or increase the interest rate on their loans when you reach the goal.

Once final terms have been nailed down, be sure to document them. "Far and away the biggest error entrepreneurs make is not stipulating the form of financing," says Bill Payne, entrepreneur-in-residence at the Kauffman Foundation and an angel investor. "They tend to be so grateful for Grandma's ten grand to get their business started that neither Grandma nor the entrepreneur document it." A promissory note is all that is needed for an unsecured loan. A secured loan requires a security agreement stating that, in the event of default, the lender has a claim on some property belonging to the borrower. For equity deals, your attorney will draw up term sheets and stock purchase agreements that indicate the number of shares an investor receives and the rights they carry.

Plan on being just as diligent about managing your investors once their money is in the bank. Whether they're lenders or shareholders, your investors will likely expect you to keep them informed about your progress. A quarterly letter or annual report can do this. Better yet, create a section of your company's Web site exclusively for investors, where they can get updates—and you can trumpet your successes—at any time.