

What to expect when friends become investors

You've dug into your savings account and maxed out your credit cards, but your growing business still needs cash. What do you do? High interest rates, lack of collateral and a skimpy resume can doom conventional approaches to early financing.

If you are like most entrepreneurs, the next most common and seemingly simple form of raising capital is through friends and family. Raising money this way seems attractive: potentially good rates, lenient credit standards, and a chance for your friends and family to share in the wealth you create.

Just make sure to manage the downside, and find any way you can to keep the love and affection firmly separated from the business transactions.

Asking friends and family for loans or investments carries a potentially high cost in hurt feelings and spoiled relationships. A seasoned attorney can help you craft an arrangement that minimizes the potential damage if business goes south and maximizes the rewards when things go right.

Here are some universal issues, supported by legal precedent, which should be addressed when dealing with financial relationships that transcend personal ones.

1. When raising capital, specify in writing all terms and details of the transaction.

To minimize hard feelings later and as good legal practice for any contract, all activities and understandings among parties should be put in writing. A lender may make oral promises and agreements, but borrowers should rely only upon written documentation. The legal doctrine "parol evidence rule" disallows any evidence of oral agreements in court if they conflict with the written loan documents. Borrowers have the added burden, but written documentation makes the burden more manageable.

Depending on your chosen investment vehicle, raising capital can span from a family loan to a highly regulated activity requiring volumes of paperwork. An attorney can help determine whether the Securities Exchange Commission and the Securities Act of 1933 regulate your private fund raising, but even if you're not initially subject to regulations, it is essential that you document every aspect of the transaction. As your business grows, so will the sophistication of your fundraising, and a clear understanding of your obligations is crucial in weighing future investment opportunities.

2. Entrepreneurs must decide whether investment money will be debt or equity.

Many entrepreneurs now are trading equity for startup capital. Equity is an ownership interest in your company. While equity deals are in vogue, an equity deal with a relative may not be a good idea, because it exposes them to more

risk and it can blur the distinction between ownership and control of operations.

According to U.S. Bankruptcy Code Section 507, if the venture goes into bankruptcy, debt holders go to the front of the line in a settlement or liquidation, while equity holders go to the back.

There are advantages to debt when compared to equity.

- Because the lender does not have a claim to equity in the business, debt does not dilute the owner's ownership interest in the company.

- A lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, and the lender has no direct claim on future profits of the business.

- Except in the case of variable rate loans, principal and interest obligations are known amounts that can be forecasted.

- Interest on the debt can be deducted on the company's tax return, lowering the actual cost of the loan to the company.

- Raising debt capital is less complicated because the company is not required to comply with state and federal securities laws and regulations.

Yet, there also are disadvantages of debt when compared to equity.

- Unlike equity, debt must be repaid at some point.

- Cash flow is required for both principal and interest payments and must be budgeted. Most loans are not repayable in varying amounts over time based on the business cycles of the company.

- The larger a company's debt-equity ratio, the more risky the company is considered by lenders and investors. Accordingly, a business is limited as to the amount of debt it can carry.

- The company usually is required to pledge assets of the company to the lender as collateral, and owners of the company are in some cases required to guarantee repayment of the loan personally.

One possible solution is to obtain a loan that can be converted into equity once it is evident that the venture is going to prosper. This can be the best of both worlds, but it requires a carefully drawn convertible loan agreement. Also, whether you choose debt or equity, it is imperative that you weigh the potential tax ramifications of your choice, identifying those outcomes that are benefits versus obligations.

3. Clearly identify and document all terms of the investment.

Traditional legal issues, like Usury, the Uniform Commercial Code, and the Securities Acts of 1933 and 1934 [including Regulation D exemptions], regulate the documentation of investment capital.

Such laws dictate that the terms of the investment should be vetted and embodied clearly in a set of documents that may include a loan agreement, promissory note, personal guarantee, security agreement and financing statement.

To minimize hard feelings later and as good legal practice for any contract, all activities and understandings among parties should be put in writing.

If you choose debt over equity, a well-drawn loan agreement will provide that financial and operating reports be given to the lender on a monthly or quarterly basis.

This is a good idea because it clearly sets out the limits of the involvement of your friend or family member in your business. Otherwise, you risk confrontation as they erroneously may think they're now equity owners in the business and thus have a say in the decision-making process.

Use of a promissory note is especially important. A traditional lender will almost always want you to sign a written promissory note, a paper that says, in effect, "I promise to pay you X amount plus interest of X percent." It then describes how and when payments are to be made.

Under contract law, for a promissory note to be enforceable it must state the amount of the loan and the maturity date. Other terms that should be included in the note are the interest rate, the place of payment and what happens if the note goes into default. Will the lender be able to collect attorney's fees and in what jurisdiction will any actions be taken?

It's smart to sign a promissory note even if the friend or relative from whom you're borrowing assures you that such formality isn't necessary.

Legal instruments are only a piece of a company's infrastructure. However, giving legal issues priority at the onset not only saves heartache, but it also reveals to investors your level of sophistication and your ability to address the complex issues that will affect the success of your business.

If you rely on friends and family, you should want someone to lend you money because they think the idea is solid and the documentation has been properly handled, not simply because they bounced you on their knees years ago.

When raising capital, make full disclosure, even if it's not asked. Don't sell investors with business plan pie-in-the-sky goals to secure financing. Don't borrow more than the lender can afford to lose. Put all loan agreements in writing.

Formal contracts upfront may eliminate the need for painful discussions later, and it reminds the borrower that this is a loan, not a gift.

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