Want to Ruin Your Relationships? Ask Family and Friends to Fund Your Startup

Xconomy, Boston (January 19, 2017) –

When you need cash to fuel your startup, it's tempting to "think local." The people with the strongest ties to you—relatives, friends, college roommates, running buddies, and co-workers—are the ones who believe in you. You'd probably turn first to them for financial support.

Gary Schall

Capital fronted by these folks might be the quickest, easiest cash you'll ever collect—but you could end up paying a crippling price for it.

Obtaining capital from friends and family can be a lose-lose proposition for entrepreneurs. If the company founders, those investors will kiss every penny goodbye. Even if the startup thrives, they might never see a return. Beyond relationships ruptured by feelings of betrayal, potential pitfalls include violations of securities law and destruction of your startup's credibility with institutional investors.

Unrealistic expectations

It's no secret that startups are **more likely to fail** than succeed. You know it. I know it. Your poker buddies may not know it. Or they may not want to believe it. In the worst-case (and most likely) scenario, your investors will lose their entire investment. Do your backers understand that risk—and are they willing to take it? If they claim they're willing to take that risk, can they really bear that loss?

Even if your startup defies the odds, your early investors might suspect they've been shortchanged. These small investors are typically at the bottom of the liquidation preference stack, queuing up behind holders of more senior preferred stock as well as creditors. Later-stage investors, who often reap sizeable rewards for taking on great risk and providing a substantial infusion of capital, may leave nothing for others.

Your novice investors can also become queasy on your startup's years-long rollercoaster ride of financial instability. They may demand to get off, not understanding that their investment is illiquid. If you have a month's payroll in the bank and your fraternity brother insists that he needs his $10,000 back now, you both have a problem.

Financing and family fiascoes

Even assuming your startup's financial picture is rosy, other challenges loom. One of my clients was courting a large investor that pressed the founders to buy back shares from their many small, early investors. But those investors refused to sell. They knew that a significant infusion of capital was coming, and they didn't want to miss the upside. The prospective investor walked, and the company is still struggling to attract capital.

Another founder I know was raising his first institutional round after funding his startup with investments of $10,000 to $15,000 from nearly two dozen people. That early funding pattern was a red flag to the VCs: The shortsighted founder hadn't considered that later-stage institutional investors would be leery of taking a raft of unsophisticated stockholders with them. The VCs did fund the startup, but they ruled with an iron fist, granting only very limited rights to the early investors.

Violation of law

VCs are justifiably wary of novice investors, who have little experience with the high risk and long-term commitment involved in funding startups. The Securities and Exchange Commission (SEC) tries to protect these folks from making investments that can wipe them out.

There are two ways to sell securities in the U.S.: Register with the SEC—a complex and costly process that startups cannot afford—or rely on federal and state exemptions to sell those securities. The most common federal exemption involves selling securities only to **accredited investors**, who are people who have earned at least $200,000 each year for the last two years (or $300,000 combined income if married) and expect to make the same amount this year or have a net worth of at least $1 million, not including the value of their home.

The SEC considers accredited investors to be sophisticated enough to understand the risks of their financial decisions. These investors don't require the disclosures mandated for registered securities, and they presumably wouldn't be ruined if their investment tanks. When your potential investors are accredited, you've cleared a big hurdle. If you're uncomfortable asking friends and family whether they qualify as accredited investors, you need to seek capital elsewhere.

Look here instead

Founders all solemnly nod their heads when I warn them about these downsides. Then they tell me that if they have to decide between abandoning their plans for lack of capital and taking risks to get critical funds, they're willing to gamble. That's how entrepreneurs think. They are, almost by definition, people willing to take risks.

Fortunately, another trait entrepreneurs share is their doggedness. So if you need cash, look to **AngelList** and other crowdfunding websites for accredited investors. Tap accelerator programs and the **U.S. Small Business Administration** for grants and early-stage seed financing.

Ask Mom and Dad to give you cash; the IRS exempts up to $14,000 per person per year from the gift tax. (Loans are trickier; even no-interest agreements can trigger tax and accounting headaches if the startup fails and the loan isn't repaid.) Reach out to your connections for introductions to accredited investors.

Your family and friends are your support system through the ups and downs of your life and your business. They're going to love you whether your startup tanks or soars. Take their support. Take their unshakable belief in your impending success. But be very, very careful about taking their money.

—By Gary Schall, WilmerHale

Gary Schall is a partner in WilmerHale's Boston office who advises entrepreneurs, start-up founders and innovators with great ideas. Contact him at gary.schall@wilmerhale.com.