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Friends and Family

Doug Green

Many aspiring entrepreneurs turn to friends and family to raise money for their early stage new ventures. It seems a natural fit to ask those who believe in you most to invest when you need it the most. In my experience I have seen many cases where investment from friends and family can be problematic and even turn into a disaster. There are also some preemptive actions to avoid common pitfalls that one can take if raising money from friends and family becomes necessary.

Why Friends and Family are Different

Professional venture capitalists and sophisticated angel investors understand the nature of the risk involved in a startup. They try to invest wisely, but they expect that some of the businesses that they invest in will fail. They understand that a failed business is not always a result of mismanagement, and they don't take failures personally unless there is a reason to. Friends and family, however, are usually investing less in a business that they believe in and more in the person. They are likely to view a failed business as a personal failure by the entrepreneur at best and a personal betrayal at worst.

The pros don't invest money that they can't afford to lose and they don't invest emotionally. They have their risk spread and play the odds. Losses by one company can be made up by a big exit. In most cases the amateurs aren't looking at an investment in a friend or family member in the context of a portfolio of investments. They really haven't thought through what changes they might make in the rest of their investment to account for it. To them a failed investment in something like a publicly traded stock means the loss of 10-20% of the investment, not 100%. They may end up financially damaged by a loss taken in such an investment.

A lost investment by friends and family can lead to financial hardships to those close to the entrepreneur and often severely damage relationships, but problems sometimes arise even when the business has potential for success. If the business progresses to the point that it is time to raise money from the pros, most amateurs are completely unprepared for the dilution in their investment that will inevitably occur. While they may not suffer financial hardship, they can still resent the fact that their ownership in the company is a fraction of what they expected (so can the neophyte entrepreneur, but that is another subject).

Finally, professional investors don't panic when things don't go exactly as planned. They evaluate the situation and determine the best way forward. Sometimes that means shutting the business down, sometimes a redirection, and sometimes the need to put in even more money. Amateurs often can't emotionally stand the bumps in the road that inevitably occur. The result is often a demand to "get involved" and micromanage the business to protect their investment, or even worse threats to pull money out unless they see instant and unachievable results.

How To Avoid Pitfalls

There are some ways to avoid these pitfalls. The first is to avoid investment from friends and family altogether and seek money from more sophisticated angel investors, but that may not be realistic. If it becomes necessary to ask for money from close friends and family, here are a few suggestions:

1. To the extent that you can get enough information, try to avoid taking money above the amount that would lead to financial hardship or resentment if it were lost. One question I like to ask is how the size of their investment compares to other individual investments they have made both past and present. I am especially interested in their taste for more traditional investment risk, especially uncertain IPOs. If they are willing to invest $100,000 out of their $2 million portfolio in a Facebook or Groupon IPO then I would be more comfortable taking $25,000 from them for a new venture. If they were taking $50,000 out of their $500,000 bond fund that they expect to use for retirement I would think seriously about the potential damage that could result to them and to our relationship if that money is lost.
2. Be specific with your friends and family about possible outcomes. Don't just tell them that it is a risky investment. They have no context for understanding venture capital risk. Explain to them clearly that while you believe strongly in the business and will do everything in your power to make them money, there is a possibility that all the money could be lost. Ask them specifically how they would feel if their investment was lost.
3. Be specific about the dilution possible. Once again it is not good enough to just say "your percentage may go down as we raise more money." They think that this means their 10% could go down 8%. Explain several likely scenarios going forward and exactly what it would mean for their ownership. If you don't have any idea what this means, you should not be taking their money before getting help.
4. To the extent possible, put in writing what the limits of their involvement in the strategy and operation of the company will be.
5. Include in your written agreements what conditions will warrant them requesting a return of funds. If they want to be able to pull money at will then you should limit the percentage of funding that you will take from any individual.

This might sound like you are trying to talk them out of investing, and that is not far from the truth. Given the potential damage both to your relationships and to their financial health, not to mention the risk to your company, you want them to invest with their eyes wide open.

Doug Green is the founder and principal of the Bradam Group, a consulting firm specializing in marketing, strategy, and early stage execution with a focus on new ventures. He is also teaches entrepreneurship and marketing at Duke University. For more information on Doug and The Bradam Group visit www.thebradamgroup,com.