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It's All Relative

How to avoid problems if you borrow money from family

By Karen Bannan

As founder of an Orlando, Fla.-based provider of turnaround services for small businesses, George Cloutier works with 70 to 100 small businesses each year. One of the most common problems he sees is lack of funding. Companies don't have the ability to get financing from a bank, and panic sets in. Many turn to friends and family to help them through a rough patch, says Cloutier, CEO of American Management Services.

"The primary benefit is that if the situation doesn't improve and you continue to bleed, a family member is much less likely to call the loan," Cloutier explains. "A bank, by law, is going to be less sympathetic." There are other benefits, too. Private loans often materialize more quickly, and most family members won't request equity in your company. Plus, interest may not come into play, which saves you money.

But there are drawbacks, says Joy Butler, a Washington D.C.-based attorney who specializes in small-business law. "People don't realize that when they get investments from friends or family, they are selling a security," Butler says. "They don't know that they still need to comply with federal and state security laws." Other problems may arise as well. Disagreements and misunderstandings are common when you borrow from people you know. And then there's the guilt, both real and imagined.

"Business owners can definitely pay a psychological price," Cloutier says. "Sometimes it's a loss of control; they may feel like they have a partner. And if you can't pay family members back, it can irreversibly damage a relationship." Another wrinkle: If you end up going public, you will be forced to explain where you got your previous funding and whether that funding complied with security regulations.

"You may end up having to go back and rescind what are in effect private offerings," Butler says. "This gets more expensive as time goes on. You'll have an easier time if you sit down and figure out the best way to structure a transaction from the beginning."

Keeping the Peace

Borrowing from relatives? Avoid problems by sticking to the rules:

Lay out the basics in writing. Set loan parameters-how much you're borrowing, repayment schedule and what you're giving up-to minimize miscommunication.

Explain the risks. The average person may not understand that businesses fail.

Ask family members to guarantee a bank loan instead, which can take feelings out of the equation.