SMALL BUSINESS: Asking kith and kin for capital is tricky

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Thinking of tapping your Great-Aunt Millie or your best friend Bud for some business start-up cash?

More than half of start-up capital is raised from family, friends and informal investors, according to Waltham, Mass.- based CircleLending.com, which manages loans between such groups.

It can be a good source of bootstrap financing, but it also can lead to bad blood quickly if you're not careful, say experts.

"I've seen relationships and families destroyed over money," says Neil Seiden, managing director of Asset Enhancement Solutions Llc, a financial consulting firm in Port Washington.

So it's important to structure the deal right from the get-go, he says. "You should approach friends and family in the same fashion you would approach a third party like a professional investor," Seiden notes.

That means you should lay out the terms, risks and rewards in a formal document.

"Any loan with a family member or friend should be in writing," notes Bruce Phillips, senior economist with the National Federation of Independent Business Research Foundation in Washington. "It should be looked over by an attorney, and it should be a legal, binding contract." Leaving terms ambiguous can often lead to problems down the road, he warns, especially if a family member decides he wants his money back sooner than expected.

Lay out the amount of the loan and terms of repayment, including interest, if any will be charged, advises Roslyn Goldmacher, president of the Long Island Development Corp. in Bethpage.

Yes, even family members charge interest because typically they are drawing from their savings and are losing interest they would have otherwise accrued, notes Goldmacher. The going family/friend interest rate is about 5 percent on average - at least 3 percentage points less than a traditional bank loan, says Asheesh Advani, president of CircleLending.com, which structures such loans and manages payments.

He's seen all types of payment arrangements made between family and friends. One size doesn't necessarily fit all; some people may need to come up with more creative payment options, he notes.

"We have entrepreneurs that create seasonal repayment plans," says Advani, author of "Investors in Your Backyard." So they only make payments in the months they make money.

It's possible family or friends will be more flexible on repayment than a bank. But be sure before agreeing upon any specific terms that lenders understand all the risks involved. That's what Jason Bishara of SLM Holdings in Woodbury did.

"I told them, 'There's a very good chance you're going to lose every nickel,'' says Bishara, whose 6-year-old company provides Web-based and desktop data management software to financial professionals. Still, his friends and family were willing to bet on him and invested about $500,000 in initial seed money. And so far, no complaints, he notes.

"They're all long-term players and haven't cashed out even though the company recently went public," says Bishara, who gave friends and family an equity stake in the company in lieu of a repayment plan.

David Cuccia of Advanced Back Technologies in Hauppauge did something similar. He raised more than $500,000 from family, friends and patients through a private stock offering.

"I gave them shares in my company," says Cuccia, whose firm manufactures a nonsurgical therapeutic device for lower back and neck pain.

He says it helped his fund-raising that he had a prototype he was using in his chiropractic office when he first approached family and friends for cash. "They saw me using it and helping people," he notes.

It can be a lot trickier to fund a concept, says Jacqueline Peiffer, owner of Drinxology in Bethpage, which will soon test its interactive information kiosks in wine and liquor stores.

"People want to see you up and running, even if it's just barely," says Peiffer, who had to take out a second mortgage to get her business off the ground.

She tried tapping a friend for cash early on but found out it was more of a headache than she bargained for. The friend originally offered to give her $150,000 to get the business going, then scaled back to $50,000 and ended up sending her only $5,000.

"The checks suddenly got lost in the mail," says Peiffer, who didn't end the friendship over it.

That's why it pays to get a friend's commitment in writing. This way if she gets cold feet, you're not left holding the bag.

Some borrowing boo-boos

Don't tap a friend or family member if he or she really can't afford to loan you money.

Don't leave borrowing terms ambiguous. Get it all in writing.

Don't push it if a friend or family member says he or she can't lend you money.

Don't minimize the risk factors.

Avoid structuring repayment in a lump sum. A payment plan is much more doable.