# Transcript - 2022-05-10 TENFL Friends and Family Funding Q&A

## Section 1 -- Friends and Family funding

**Hall Martin:**Today, we're going to talk about friends and family funding, and looking forward to your questions as we go through. So with that, let's go and kick it off, and talk about how you raise money from family and friends.So we always think that when you start, you start with your network and your family and friends, because that shows support for your business and gives validation that people that know you believe in you, and that makes a big difference. So always believe in funding from family and friends, but there's certain things we should and shouldn't do when we take money from family and friends. number one is you want to look for family and friends that are appropriate for startup funding, not everybody is appropriate. You're looking for people that can help you as well as invest in your deal; and you're looking at people that are connected, they know others that can help you, other investors, people that can work in the business, people that might be potential customers. So you're looking at seeing what connections they might bring, and then you're looking to make sure that they have enough money that it's not going to hurt their lifestyle, if it doesn't come back anytime soon, because startups, you're invested for a long period of time. So you want to choose your family and friends carefully for sure.

And then, some startups are very reluctant to take money from family and friends, because if it doesn't go well, it can change the nature of the family dynamic there. But I will say that outside investors are going to look very closely at, if you can raise money from family and friends, it doesn't have to be a lot, but it shows that the family believes in you. And if the family and friends don't invest, well, why should outside investors invest is what crosses their mind. So something to consider when you put in there, I think anybody that's starting a business should take some amount of their own money, put into the company's bank account and declare yourself an investor – I have skin in the game, I have put money in; and then that will tell a lot to your family and friends – if you're putting your money in, they're going to be more likely to put their money in as well.

So one of the mistakes I see people do with the family and friends round is they want to give their family and friends special valuation, so they give them a very special rate and so forth. The problem is that you're going to have other investors coming along, and they're going to want to look at what rate you gave them, and, in some cases, they're going to want the same rate, because the business is still pretty much at that same level, it hasn't moved forward. So if you set a valuation very low for your family and friends, other investors are going to want to come in and now you're up for dilution – you're giving away a lot more ownership because you set that. So, in general, you always want to just set market rates, whatever the appropriate rate is for the business, just set that, and family and friends will get a decent return in most cases. Next thing is I believe that if you're raising money from family and friends, and you're concerned about not being able to pay it back, then just limit how much you take from each person, no more than $10,000; and when the time comes for them to start a business, well, you're going to be putting money into their business the way they were putting money into yours. So if you keep the rates low, this process works, and you can check mark the box that family and friends did come in, and they did help you with your business, how much is usually not a number that people care about as long as they actually get it, that's what matters.

So in launching a business and family your friends' money is there, usually at the same time, you're figuring out who the cofounders are, who's working with you on the business. I'm a big believer that you need a complete team at all stages of the business and a complete team at this stage is someone is building it and someone is selling it. And so, if you're a founder and you’re selling it, well, then you need a cofounder that can build it, find someone that's complementary for you. And the next one is make sure that any intellectual property that anyone does, you, your cofounder, or anybody related to the business, all that intellectual property is assigned to the startup, have them sign agreements saying anything I do while working here is part of the business – code, product designs, trademarks, domain names, all of that goes into the business as well. And if you're hiring employees, then you can start thinking about stock incentive programs; and you're going to need an entity filing, LLC or a C Corporation; investors want to know if they're investing that is going into a fully established legal entity. I believe you start with an LLC and you move to a Delaware C Corporation later, LLCs are very low cost and simple to run. And finally, you're going to need a business bank account, so once you've filed an LLC or a C Corp, you can get an EIN number, Entity Identification Number that the IRS uses, and with that, you can set up a bank account, and now you have the elements to start working on building a business, because you got a bank account, you have an entity, you have a cofounder and at heart you've got some intellectual property that you're going to be leveraging for this business as well.

So oftentimes, instead of taking – giving out equity, you start taking loans from family and friends. And if you do that, that's a good way – some people don't want to be in the business for a very long time, and maybe you don't want to make them an equity owner for dilution or other reasons, and you just want to do a loan with family and friends. So what you might want to do is set up a loan and then pay it back based on time, that's how many loans are working, I pay a certain amount every month, no matter what. Or you can also make what are called milestone based disbursements, which means I’m going to pay when I get to different milestones, when I get to my first product, then I'll pay the first payment; when I get to my first $10,000 of revenue, I'll make my next payment as well. And this gives you a little bit of flexibility to change the date on it, but yet, you're still keeping track of, as you grow the business, you're paying people back for the money that they put in. Make sure that the loan goes is made to the startup and not the founder. You want a clear division line between what is assets of the founder and what's assets of the business, because you're setting up a legal entity, it really needs to be inside and part of that legal structure that you set up.

So one thing to avoid is no interest rate loans, you need to put some interest rate on it, it can be very low, 1, 2, 3, 4, 5%, something like that. The IRS will have certain rules if there's a no interest loan, and you want to avoid those, you want just to be a business transaction and not a gift or anything like that. And then, if you want to sign a personal guarantee, you can think about doing that if you are being asked for a collateral, that's the other thing that some people will do is they'll want to structure the loans, and they'll get paid back. And so, typically, collateral on the business is very limited, so a lot of people put their IP up as collateral, just to show that we're serious about this. So a personal guarantee means you're personally guaranteeing that you're going to pay back the loan if the business does not, and you have to think hard about that. One of the loans that people take a lot of is the SBA loan, and the SBA does have a personal guarantee on it, so you have to think very carefully about that, because if the business doesn't succeed, you still have to pay it back.

So after you get the business up and running, you want to keep your family and friends updated about the progress of the business, and so, you want to give them reports on a regular basis; in the startup world, typically, every quarter, you send out an email that describes the status of the business, but the financial statements in their income statement balance sheet, and you give a few updates about the milestones you've achieved and what's coming up next, and what products you're developing and what you might be working on in the future. So it's important to keep the family and friends up to date, just like you keep other investors up to date as well; it's no more than just a well thought out email that comes out once every three months.

And then in there, you want to put some things, maybe some key financial metrics are good. If you're raising additional rounds of funding, you want to put that out there in case they know someone who else might want to come in. And then, you always want to outline the team, who have you hired, who you're planning to hire, who you're bringing on. And then you want to put key product updates out there as well, how's the product doing, because this shows what you guys are doing, it shows what your business is accomplishing, and that's what the investors want to know is what progress are you making, and these are the key things, hiring team members, building product and closing sales, that's pretty much what you're doing all day every day.

And then, next one is funding as a gift. You can take, in some cases, instead of taking a loan, you can take a gift and put the money in yourself. The tax laws let people put money into, give gift money up to 15k without any tax implications, and so, you can, if you want to raise 10k as a gift from family and friends, they insist it's going to be a gift, you can then take the gift and invest that in the business under your own name. It's not a good idea to gift the funds directly to the startup, you really have to gift it to an individual; so, in this case, it would go through the founder into the business as well. And there are some people that will just do that – I'm just going to give you a 10k, but I don't want loans, I don't want equity, I just want to gift you the money and that can be done as well.

~~S~~o those are the key issues that come up with family and friends funding.

## Section 2 -- Bootstrapping a company

**Mark**: So we are bootstrapping a company where we have a $300,000 round open, a 100,000 of which is, I guess, you'd say committed from family and friends, when should we take that in? Should we actually take it in prior to the outside, folks, or should we just get a commitment for it and share that with them, does it matter?

**Hall Martin:** Well, there's three levels of investment. There's interest, if I think I'm going to give you, I'm thinking about giving you 50k, that's interest; if I say, I'm going to give you 50k, that's committed; and if 50k is in your bank account, that's invested. I like to show all three numbers to investors to show the funnel into the fundraise, to show the traction, because quite often, you'll have a very large interest number of smaller committed and then a smaller invested. And most people only put the invested out there, they only put what's actually hit their bank account, but they haven't communicated the other numbers. So, in your case, it really doesn't matter if you're communicating all three numbers, the family and friends round is either at the interest committed or invested stage, and that's always a great thing to drop in the conversation, we're raising funding, we have 100k committed already, if you, at some point, think I really need to have the money in the bank account, we're going to take it and collect it, put it in the bank account and then announce we now have a 100k invested in the deal. So terminology is a little bit different, but I think it shows that you're streaming money through that pipeline into the business, and, at some point, people will want to see that. The thing you want to think about is terms, if family and friends will probably accept any terms you've put in front of them, when you go out to the market, what you'll find is that outside investors may not accept just any terms, they may want to have a better valuation cap or a different interest rate or whatever. So there is that aspect of not taking the money until you figure out what the right terms are, because once you take money, those terms are kind of set in stone, you really can't change them for the invested at this point.

## Section 3 -- Convertible Note vs Preferred Equity

**Mark:** Okay, and is there a preferred, forgetting about the loan for a minute and a gift, is there a preferred structure, if it is an equity infusion that you think is ideal from the next investor standpoint, is it note or pure equity, what's their preferred way to see friends' round, let's call it, if it's not family?

**Hall Martin:** At this stage, people are using safe notes and convertible notes for several reasons, one is you really don't have to have an attorney go check that out, if you want to, they can, but the idea is that the note is a debt instrument that converts to equity later, and some people raise a 500k convertible round note and what you're doing is like the credit card, you go out, you could raise a couple 100k, put in the drawer, come back and raise another couple 100k. It's a rolling close, the investor signs the check, you sign the note, the money goes into the business the next day, there's no escrows, there's no setting board seats or any of that sort of thing. In fact, most people push off equity until they get to the series A round where you do set board seats and you do set all those other terms and you do get in, and at that point you really do need to have attorneys involved. But at the pre-seed and seed stage, we're just signing convertible notes, I have one-page, two-page, eight-page versions of those notes that you can use, and so it just depends on how much detail you want to put into it as well. And some people use safe notes in the very same manner, they just have the thing that people want – later stage investors will want if they're signing convertible note is a valuation cap on it, very few – many investors will not sign a convertible note unless the valuation cap is there. Otherwise you could put any valuation you want on the next round, next round's $200 million, so that's something you have to think about, family and friends don't care about that, but you have to think about the next round of outside investors, because if they're not family and friends, you'll find, you'll be getting a lot harder questions. I get that a lot – when I raised money from family and friends, they just gave me money, they didn't ask anything; when I went outside my family and friends, they started asking about how they're going to get their money back, and why this valuation cap and not that valuation cap. And so, there is a big transition from family and friends to that next group of investors.

## Section 4 -- Tracking cap table before fundraising

**Mark:** And as far as the business bank account, what's kind of the expectation for tracking capital in over the prior years, leading up to the first institutional round, is it somewhat of an informal audit, because I have records of everything, I don't have a formal ledger for the business, but, of course, when I do taxes, I have it itemized for my accountant, what's the expectation for getting to that first level?

**Hall Martin:** Well, some people just keep a spreadsheet, and they just put everybody's name and percent ownership. I think the real key is any documents, convertible notes, safe notes, equity agreements, then, if you ever give out equity for other reasons, like employee work or whatever, you really need that supporting documentation. What I see a lot of groups do today is they go to Carta, and at the stage you're at, you can get them to put a cap table together online with all the documentation for free, they won't charge you anything for that. And that's probably a good thing, because you can upload all the supporting documents, they keep track of the cap table; when you go to outside investors, your cap table is already on Carta, so they know everything is complete or accurate based on what you've given it. And that's the challenge is these cap tables last for the entire life of the company, and so, four or five years from now, where you remember what was on that convertible note that was in the drawer, and so, I always recommend go and get it up on a system someplace, find a low cost, no cost system like Carta, there's other ones out there, and just get everything in one place online, and then, you can just give the link to investors, and they can check it out when they need to.

## Section 5 -- Tracking expenses and revenue before funding

**Mark:** Okay. What about just like the P&L, the bank ledger itself, is that something they want to see you're tracking, like, for example, we've got just over 100,000, we've already put in and spent practically, do we need to document for the investors what that track was, or not so much?

**Hall Martin:** Yeah, in a data room or diligence box, you're going to want to put in an income statement, and a balance sheet, well, you need to have some accounting system that does that, and you either put it in QuickBooks that you run yourself, or you go get a bookkeeping service that charges 250 a month, and they'll keep the QuickBooks for you. Either way works, if you ask somebody that's good with QuickBooks, you can do it yourself, if you don't, I just get a bookkeeper and have them run it, because what you have to put into the data room is that the investor is going to wait and see financials. And, in fact, every time you do an investor update each quarter, you want to print out the quarter and year to date financials, which is the income statement and the balance sheet. And then what investors are looking for is at what point are we, what kind of revenue are we actually booking into the system, if it's recurring, are we booking it appropriately in the right month that it is recognized. And on the balance sheet, they're looking for evidence of debt, do we have debt, if so, how much debt, and that's why people want to look at those statements, and we just need to have a system that generates those, whether it's internal to you or external, you have to come up with those on a regular basis. And then, you have to file taxes at some point, and you'll be pulling out information from that system for your tax payments later or franchise tax in Texas, but that's when you hit a million dollars, so that's ways out. But you do need to have all this stuff and a proper system, where you're doing things. When you bring on employees, you have to start filing with the Texas Workforce Commission for payroll taxes, that’s a big issue, I see a lot of startups miss that. If they're contractors, true 1099 contractors, well, then you have to be giving them 1099 forms from your system. So you start to get into some of those issues, and it's best to start off with a proper accounting system that generates all that stuff, and it has all of it in one place.

## Section 6 -- Filing patents before funding

**Hall Martin:** Right. What about intellectual property, are you filing any patents in this case or have filed them?

**Mark:** Yeah, we have. We filed, initially, in 2017-18, and then, we filed some continuations last year.

**Hall Martin:** Have you had office actions on those filings yet, are they design or utility patents, or what exactly are they?

**Mark:** They are utility, and then we have, as is typical, we've had, I think we have two of the initial 21 claims still alive in the initial, and then our continuations haven't had any action on yet. But that's okay, because as we're developing, we know we'll add some more. But yeah, for now, it's nothing's issue.

**Hall Martin:** That's fine. Half the value of patents is with investors, so we're coaching, make sure you do the filing before you go out to raise funding, not after, which is what a lot of people do, and if nothing else, file provisional patents. And you can do some strategy work where you file five-six provisionals, and then, a year later, it gives you a year to figure out which ones are going to do something, which ones are not. Those which are going to do something you turn into full patents, those that don't, you just let go. But you'll spend a lot of time building your patent strategy in the first year, so it sounds like you may have already done that, but just want to make sure you bring that up to investors, because they will appreciate the fact that you've got intellectual property, even if it's not truly filed. Typically, it takes three and a half years for something to go all the way through the system, so it won't look good. What they'll ask you is what was filed and when, so I filed a utility patent in January of 2018, and they started doing the math on that, three and a half years. We had two years of COVID in there, which set the system back a fair amount, and I don't know exactly how much, but there was that factor in it, but they will still give you credit for having filed that patent, even if it's not fully issued at this point.

**Hall Martin:** thank you for joining us today,

**Mark:** No, thank you very much again, I appreciate it.