3 Ways to Bring On a Silent Partner

Before you accept financing or sign an investing agreement, be sure you know how to protect your company and get what you want out of the deal.

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The following excerpt is from Mark J. Kohler's book The Tax and Legal Playbook. *Buy it now from* Amazon | Barnes & Noble | IndieBound | Entrepreneur Books

Your first step? Understanding the difference between investors and silent partners. Silent partners generally want to "set it and forget it" when it comes to their investments. They want to invest money in an enterprise, not worry about or spend time and effort helping the business make decisions, and still see a significant return on their investment.

The scary part here is the term "significant return." Silent partners are taking a risk investing with you, so they usually want a bigger bang for their buck than stocks, bonds, and mutual funds can offer. But you may simply want someone who gives you money, sits back, doesn't get involved, and doesn't have a say in what you do or how you do it.

Based on the two perspectives above, the person I just described is actually an investor. Silent partners are investors. The SEC sometimes agrees: The SEC calls a money partner an investor if they're investing in what the SEC terms a "security." To meet those requirements, the investor has to have:

1. Been given a promise or an expectation for a return,
2. Invested money
3. Rely wholly on someone else’s efforts in the business.

They don’t have a say in the business, and thus while you might call them a silent partner, they qualify as an investor to the SEC. This distinction is extremely important, and misunderstanding it could land you in jail if you lose their money.

There are three primary ways to bring an investor into your business without incurring the wrath of the SEC:

1. Bring them on as a partner,
2. Treat the silent partner as a lender
3. Register your company with the SEC under “Regulation D offerings” to offer a security to your investor

1. Bringing on a money partner as a true business partner.

Bringing on a money partner as a business partner has several pros and cons. First, you can avoid the SEC registration issue, and your partner can now share in the profits. It saves you extra legal work, and you may even get the help and advice of an excellent partner.

However, by bringing them on as a partner, you must involve them in voting and decision-making. The words “silent partner” should never escape your lips, and they should never be treated in that manner. The reasoning is this: By not treating them as a silent partner, they can’t complain later that they didn’t know what was going on or didn’t have any say in the operations if the business fails.

The potential drawback in this situation is that you legitimately have to address their concerns on a regular basis. In fact, the documentation from the beginning of the

relationship needs to reflect that they're a business partner. There isn't a loan or interest rate, and they have actual ownership in the underlying entity.

2. Treating Your Money Partner as a Lender

A lender relationship could be a great fit for you and your money partner. The positives include a fixed rate of return for your lender, which leaves them with much less risk in the venture. Moreover, if they're considered a lender, you don't have to listen to their complaints on how you run the business or follow through with their recommendations or advice. If you're looking for a silent partner and don't want to deal with the SEC, the lender classification may be the perfect fit. But they must be willing to live with a fixed rate of return.

As lenders, they cannot share in the profits of the business through some sort of percentage of ownership or back-door payment. This will drag you back into a potential SEC claim from them if you lose their money. They could also be unwittingly transformed into a partner, and now they're personally and vicariously liable for the operations of the business. They could even be targeted by your creditors if a creditor gets wind of your relationship.

Having a solid promissory note is great start. At a bare minimum, the promissory note and terms should include the following information:

- The party making the loan, and the party responsible to pay it back
- The amount loaned and interest rate
- How and when payments are to be made
- Whether there is a penalty for repaying the loan early
- The consequences of a default in the repayment of the

loan

3. Documenting an Investor Deal with the SEC

While bringing on a lender can be a great option, some silent partners want more than just an interest rate return on their money. They want to share in the profits of the business without worrying about how to run the business; in other words, they want an equity position in the enterprise. This is our investor classification and needs to be documented as such.

Here’s a short checklist for bringing on a silent partner as an investor:

- Consult with an experienced securities attorney to make sure a Regulation D offering (the format most applicable to small businesses) makes sense, and to choose the specific option that’s best for you.
- Make sure your attorney files Form D with the SEC within the allotted time frame.
- Don’t forget to make the necessary filings in each state where you will offer securities for sale.

The path of any Regulation D offering must be followed carefully to make sure that all parts and subparts of the rules and regulations are being satisfied. This is a path that a small-business owner would be foolish to follow without the guidance of an experienced and knowledgeable securities attorney. For this reason, bringing on a silent partner as an investor isn’t cheap; expect to spend at least $15,000 in fees if you wish to raise capital in this manner.

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