Family Wealth Report
North American Family Office Intelligence

Embedded Family Offices: Inherent Risks And Practical Solutions To Mitigate Those Risks

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July 7, 2023

Embedded family offices are the most common type of family office across the globe, but often the most ignored and the least discussed. This article attempts to help change this.

We like to add to the vocabulary of this business, and here's another for those unfamiliar with this one: "Embedded Family Offices." Okay, what are they, how do they fit into the family offices ecosphere, and what's distinctive about them? Richard J Wolkowitz, founder and chief executive of ***Xylogenesis****, explains all. We are grateful for this incisive and valuable article, and invite readers to reply. The usual disclaimers, as ever, apply.*
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Embedded Family Offices ("EFOs") are the most common type of family office across the globe, but often the most ignored and the least discussed. Most families and their employees do not even realize that they are operating an EFO.

So, what is an EFO?

EFOs exist within a family's operating business, or overall family enterprise, when some of its employees share the dual function of serving both the business and the family.

EFOs evolve in a natural, non-assuming manner over a period of years, decades…or even generations. It just becomes part of the "company culture," or known as a family "company perk."

EFOs serve an important function to support the family system efficiently, while the family focuses on managing and driving the business.

EFOs are neither inherently good nor bad; an EFO is simply a support system, structure, and business model with the potential to be high-functioning when structured and operated properly. Conversely, there are heightened risks and liabilities, some of which may have catastrophic consequences and outcomes, if the EFO is not properly structured and operating poorly.

Possible risks and liabilities

Overlooked liabilities and risks for those with EFOs:

1. ***Legal exposure.*** One of the key reasons for forming an entity of any type is to avoid personal liability and to establish creditor protection. This is called, the "corporate veil." Co-mingling the business with personal matters can "pierce the corporate veil," which can lead to personal and individual liability for the company's debts and the possibility of losing company assets. Personal liability may also be attributed to the company's individual owners, as well as to its directors, officers, and company employees (please see your attorney for legal advice and counsel). An EFO is ripe for having its "corporate veil" challenged and pierced.

2. ***Audit exposure.*** State and Federal tax auditors often focus their time and attention on the co-mingling of personal matters within a closely-held or family-owned business. Attention is drawn to overhead, payroll, A/P, and "borrowing" company assets used for purchasing personal items. Once a government auditor finds one misstep, a Pandora's Box is opened for a deeper audit. Not only is this a distraction to the business and employees, but an unsuccessful audit defense for an EFO can lead to business and personal penalties. In addition to tax auditors, consider other audits led by your lender or government regulators (please read further below and see your attorney, CPA, accountant, or auditor).

3. ***Banking exposure.*** Bankers expect their loan proceeds or "use of funds" to go to the business and not the family. Working capital used to support the family and its personal affairs would not only be a breach of trust and loss of credibility, but likely a breach of your loan covenants, causing a possible default. Once a bank or its credit committee is aware of this co-mingling, the lender (and lending community) looks differently upon this borrower – with less favorable terms, higher costs, more internal bank audits (at the expense of the borrower), possibly calling off the loan, expectation for repayment of the improper use of funds with penalties, no renewal of the loan, causing the difficult possibility of finding a new lender.

4. ***Business licensure exposure.*** Many family-owned businesses are in heavily regulated industries (i.e., nursing homes, medicare, medicaid, defense, wine, beer and spirits, government contracts, etc.). Co-mingling business assets with family can create legal and regulatory exposure and jeopardize licensure – anything from suspension, to penalties, to forfeiture of contracts, to license revocation/termination.

5. ***Operational exposure.*** Managing an EFO must be done thoughtfully and methodically. Some examples of improper management of an EFO are:

a. harms the family and the operating company, both in terms of performance and a lack of quality services by ill-equipped or non-focused internal employees;

b. affects the family's privacy of otherwise confidential, personal, and family financial information;

c. distracts the operating company personnel from their focus on business operations and performance;

d. harms the employee morale, as they learn of family wealth in comparison with their own compensation and lack of increased compensation/bonuses during both good and bad economic periods; and

e. increases the operating company's overhead and expense, while decreasing the company's performance in comparison with other competitors in the industry, which can hurt refinancing terms/ability and/or optimization of sale price in an exit (see below).

6. ***Exit or sale of the business limitations and considerations.*** EFOs raise two primary considerations from a pre-sale and post-sale perspective:

a. Pre-sale – optimization of the purchase price. The embedded costs/overhead and performance distraction inherent in poorly-implemented EFOs can and will impact the purchase price; and

b. Post-sale – understanding who will be providing and delivering the services to the family once the operating business has been sold is critical. Key employees and support staff are part of the value and sale of the business. The buyer might be expecting those employees to remain with the business and no longer permit them to provide services to the family. Often, the employees themselves will want to remain with the buyer for a variety of reasons as well.

7. ***Professional malpractice*** – while the risks and consequences primarily impact the family, the family's trusted professional advisors should also be beware. Trusted advisors (particularly, attorneys and accountants) could face malpractice ongoing, from their clients if the advisors know, or should have known, that the co-mingling of personal-business matters has been ongoing and they fail to provide advice to the contrary for a client who is ultimately pierced in a lawsuit or unsuccessful in defending a government audit. Just as many families do not recognize this EFO "trap," many professional advisors have missed this issue as well.

Possible solutions. Consulting with your team of professional advisors is critical to ensuring a proper structure. Some considerations:

1. With your internal and external teams, identify "who" is doing "what" within your organization, and at what "cost";

2. What is complete or proper AND timely reimbursement for those personal services provided by the business (i.e., hard costs and soft costs, including salaries and benefits)?;

3. Do you have support, documentation, and evidence of payment for those personal services?;

4. Is there a better way to operate, in terms of design or structure?;

5. What other alternative designs or structures would support your needs and achieve compliance?;

6. What type of documentation would be helpful – or harmful – in defending a piercing claim or audit?; and

7. Have you fully considered optimizing bank refinancing and/or positioning your business for sale and sale price?

A well-structured, well-defined, and professionally executed EFO manages these risks and integrates personal services in a compliant, secure, and high-performing manner.

The risk of co-mingling personal with business affairs is serious and actions should be taken promptly.