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Blurred Boundaries: The Complex World of Embedded Family Offices

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Image by Cassidy Reed

Most families start their family office journey by using the resources and staff of the family business to manage their wealth issues.

"Embedded family offices are the most common type of family office globally. It all happens organically and naturally," says Richard J. Wolkowitz, founder of Xylogenesis Family Office Advisory. "Families start to use business resources like it's an extension of themselves: For example, they may want to use the business's marketing services to support their children's school."

Wolkowitz brings more than 30 years of legal experience and experience managing family offices — for his own family and others — to his work. He doesn't believe an embedded family office is necessarily a bad thing — but notes that it's critical to set up this type of family office carefully.

"There are plenty of very, very successful, properly run embedded family offices," Wolkowitz says. "The problem is that most aren't."

One reason, he says, is that the goals of a family office are likely very different than the goals of a business: "The mandate of a family office is dynastic. That's a different kind of animal than a business that might be looking at a 10-year plan."
In structuring their family office — and considering which functions could be outsourced to experts in that area — Wolkowitz advises families to consider the risks that can stem from embedded family offices:

What types of risks are run by embedded family offices?

The risks fall into three broad categories:

** Mixing of business and personal affairs*

The very definition of an embedded family office is one that includes commingling of the business and the family's personal affairs. The word 'comingling' is much more concerning than the word 'integrated.' Integrating means setting up clear processes and boundaries – more like creating a separate division within the company for the family's personal affairs.

You don't want to commingle your personal and business affairs because it can pierce the corporate veil, which provides limited liability protections for the owners of the business. One way to pierce the corporate veil that plaintiffs will look at is, did you comingle business and personal affairs, therefore making the business – the corporation or the LLC – actually an instrumentality of yourself? If the court finds that, the liabilities and actions of the business can become a personal obligation to owners, managers, board members and sometimes employees.

The next big issue is audits. Businesses are audited in many different ways: by the federal IRS, state tax authorities, banks if they've got debt facilities, and government agencies if they're in heavily regulated industries. When the auditor comes in, they're going to be looking for certain things, such as the list of assets for the company and payroll records. If they look at the assets and say, 'Why does this business have jet skis on the books when they're not in the jet ski business?' they'll ask an employee. The employee might say, 'Those are the assets of the owners, and they're down at their lake house.' Or the auditor will look at the payroll records and ask, 'Who are these employees and what are their responsibilities?" An employee might say, ‘Those employees work at the family farm – they really don’t work here in the business.’ Once an auditor hears that, they’re going to begin investigating the entire company for issues. And once an auditor gets in, all bets are off.

Image by Cassidy Reed

If it’s a bank auditor, they’re going to be concerned that bank proceeds are not being used for the business but are being used for personal things. It could be a breach of covenant or even potential fraud. In regulated industries, it could mean the revocation of a business license.

There is also insurance exposure and risk. The business is buying insurance for business purposes. If those employees or assets are not business related, that’s probably outside of those policies. If something happens to those assets or people – or if the people commit certain acts that cause liability – the owners could be personally liable.

Commingling can add to cyber security risks, as well. Cyber security may be developed to protect the business, but if people going outside the business system to do tasks on their personal devices, that could cause a breakdown of the system.

Finally, there are confidentiality and business morale issues. If people in the accounting department for the business see that they’re making payments for family members’ cars, trips, college educations, that could become a morale issue that bleeds into the company. This is particularly true if the company says, ‘We’re giving small bonuses and raises because we’ve got high inflation and supply chain challenges.’ That becomes a morale issue and a confidentiality issue, because employees talk to other employees.

* *Execution and implementation*

Usually in an embedded family office, the family first looks to its trusted advisors for help. For example, the family may come to the business’s CFO and ask them to handle personal matters because they trust that CFO. The question is, does the CFO have the expertise to do that type of work? Do they have the capacity to do that work, in terms of time? And how do you measure performance?

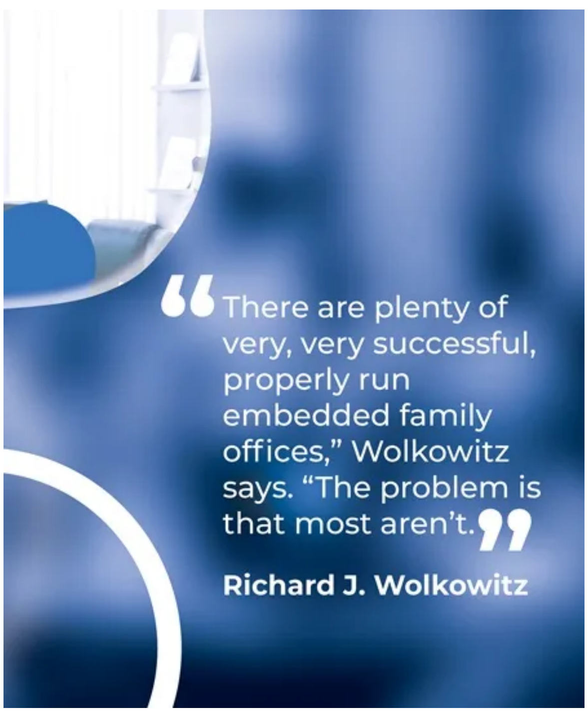
A CFO for a manufacturing company could be the best CFO for manufacturing but may not understand personal tax planning and investment management. And the CFO of that manufacturing company has a lot of demands on his or her time. The CFO will likely not be able to keep up with both the business affairs and the personal affairs.

And how can you measure how someone is doing managing the personal affairs? It's likely that performance for both the business affairs and the personal affairs will be lacking if the CFO doesn't have the expertise or the time.

** Selling or refinancing the business*

If you have embedded employees providing services, you also have greater overhead. When the business goes to refinance or you want to sell, the performance is not going to be as high as it would have been. That impacts the profitability of the company and will ultimately impact the purchase price. It's important to keep personal expenses separate so that you can show the bank or a potential buyer that these expenses are not really coming along with the business, and they should be kept out of the borrowing base or profitability calculations.

When a buyer looks at this scenario, they're also thinking about the human capital. If they were going to buy the business, are some of the employees – the CFO, certain individuals in the accounting department – going to want to go with the seller, or stay with the company? That can impact the purchase price or the refinancing because it brings instability to the company.



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What can businesses do from a practical perspective to make an embedded family office work?

- Keep detailed records that segregate business from personal expenses.
- Make sure that employees who are asked to serve dual purposes have enough time and space to really serve both purposes. If some employees are expected to spend 80% of their time on the business and 20% on the family, the family needs to have a separate department that is run like an independent division, with a real budget and a real time allocation.
- Look at setting up some sort of management services agreement, where the family is paying back the company for the use of business employees for personal purposes. There needs to be documentation, and there need to be real payments from the family on a commercially reasonable basis. But it needs to be a real shared services agreement that is actually followed. Too many families put together a shared services agreement but then never make a payment – which can be even worse when the auditor shows up.
- Always consult your own lawyers, tax providers and other advisors. This is not legal advice.