SQUIRE PATTON BOGGS

Family Office Insights
Beware: Fraud Prevention in the Family Office

The transition from a family business to a family office can be treacherous. In a family business, the family is still involved in the day-to-day operations of the business and is literally "watching the store." In a family office, the day-to-day operation of the family business and other financial investments and endeavors of the family may be delegated to experts outside of the family. This should create an enhanced level of professionalism and provide institutional safeguards and protections for the family, but can backfire.

I will tell you an apocryphal story that is based on real events. A family engaged in the energy business hired a professional CEO/CFO to help run the business for a decade. The third generation of family members still worked and had titles in the business, but devoted more and more time to personal interests. The family business appeared to be steadily prospering and money was plentiful. Gross sales exceeded US$1 billion, with a healthy margin. The family had acquired real estate and synergistic businesses to help expand and diversify the pie. The most prominent local bank in the area provided over US$100,000,000 in revolving and fixed financing for many years.

The family enjoyed benefits of wealth such as estates, yachts and high-end travel. While the family still held a puritan ethic, particularly in the retired second generation, it was generally understood that there was plenty of money for all of the family members to be able to enjoy themselves. There was also a focus on giving back to the community, and the family had a high profile as a major local employer and sponsor of charitable events.

Then it all came tumbling down. The hiring of new management consultants to help modernize/streamline the business led to a more careful examination of the financial status of the operations. On their face, the reported numbers were solid, but there had been no formal audits and the back-up supporting materials were not well maintained. Upon closer examination of the books, there were questions, but answers were not readily available. Soon, a major fraud that had gone on for several years involving the CEO/CFO and the accounting department was discovered. The numbers did not reconcile and false sales had been booked. The biggest customer of the business was not purchasing products, but was, in fact, merely having them delivered. The lock box accounts at the bank had only been receiving a few hundred million dollars a year, not the billion dollars of revenue that had been reported.

As a result, there was an US$80 million hole owed to the bank, which opted for a liquidation instead of a restructuring. There were massive lay-offs. The CEO/CFO fled. The FBI became involved. The business was lost and the bank started to pursue the proceeds that had been used to fund the family and try to seize assets.

Litigation ensued and the family was forced, in effect, to start over with a tarnished reputation. Generations of hard work and contributions to the community were undone.

What could have been done to prevent this catastrophe? Would best practices have uncovered or mitigated the fraud? What lessons can be learned?

Well, of course, closer involvement in and scrutiny of the business would have helped. Audits can be expensive and viewed as a waste of money in a successful privately owned business, but they are invaluable in uncovering fraud. In hindsight, the CEO/CFO clearly had too much authority. Perhaps the positions should have been split or a group of family members could have functioned as an audit committee, similar to those in a public company.

The protections of having a bank credit committee review, periodic reporting and lock box did not help either. The bank became too comfortable and did not adequately ask for or review the necessary information. Since the bank was out US$80 million, the fact that the bank was negligent did not help the family.

Sufficient insurance against fraud or malfeasance would have helped, too. Although there are costs involved, the discipline of obtaining and maintaining insurance can both protect the beneficiaries and help uncover fraud.

Best practices might have uncovered the fraud much earlier as well. If the CEO/CFO had been forced to observe all corporate formalities with respect to contracts and transactions, and provide regular detailed reports to the family, then questions would have likely arisen. The formalities of corporate governance (e.g., double signature authority, maintaining complete and accurate records, frequent reports to and board of directors and shareholders meetings) provide a useful discipline and interaction between professional management and the family members. But in this case, because the news was all good, this was not viewed as a priority.

Further diversification would have prevented the loss from being so devastating. There is a tendency for a family to seek to invest in what it knows best and make it successful, but a series of interrelated businesses and real estate become more vulnerable. A nice cache of publicly traded securities, private equity investments or other non-correlated assets might have given the family sufficient liquidity to weather the loss.

In summary, it is best not to cut corners in establishing and implementing the structure of a family office. Without proper attention, the risks can be high and the transition process hazardous.

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