

Families in Business - External risks and fault lines within

June 2014

Introduction

1. There is a strange paradox associated with Middle Eastern businesses. On the one hand, family businesses are the real strength and spine of the GCC economies. Alongside sovereign enterprises, family businesses dominate the business landscape. On the other hand, close examination of particular GCC family businesses, even very large ones, frequently reveals frailties and fault lines which expose them to external business risks; and to far less visible threats from the inside.
2. In many cases these weaknesses will not be obvious to the outside observer, or even to the families themselves. Lawyers can help [family businesses](#) counter these threats, but often the very first order of business is to educate and alert families to the risks, as it can be truly disastrous if the risks crystallise.

External Business and Legal Risks

1. Typically, [GCC family businesses](#) are highly diversified and have many compartments. Unfortunately, the famous 1912 shipwreck the *RMS Titanic* also had many compartments - but because those compartments were not totally sealed and separated the *Titanic* sank to the bottom of the ocean when the ship tilted and the rushing waters flooded over the dividing walls into every compartment.
2. The typical GCC family business is completely exposed to a disaster in one compartment of the business spreading to the other compartments. Why? The answer is that there are serious weaknesses evident in the most commonly used family business structures, e.g:
 - businesses are often set up as sole establishments owned by an individual within the family (often the founder) therefore one catastrophe (e.g. a fire in a large building owned by the founder himself) carries financial consequences and exposures directly to the core of the family's asset base;
 - many families operate an array of businesses through registering multiple branches of a family "mother company", a shoddy structure design. Taking this cheap and convenient shortcut means that every liability of every branch is a direct liability of the core mother company (usually the company which owns all the major assets); and
 - failure to have a coherent corporate structure often leads to the twin evils of reliance on borrowings secured by personal guarantees and a failure to track and identify adequately the performance or losses of individual businesses within the family's portfolio.
1. For the above reasons, many family businesses in the GCC inhabit glass villas - and any major hailstorm will prove calamitous.

The Fault Lines Within

1. The dangers from within the family are more subtle and these problems are often more difficult for the founder or other family members to perceive or acknowledge, let alone tackle in an effective manner. But even hairline cracks in the family can widen and invite disaster, particularly where the cracks are disagreements between siblings, the family's bridge to the next generation.
2. In 1967 fine corrosion cracking triggered a catastrophic collapse of the Silver Suspension Bridge across the Ohio River in West Virginia, under the twin stresses of low temperatures and high bridge loading. A total of 46 people in motor vehicles died when they fell into the river with the bridge. Likewise, in

families, the twin stresses of leadership transition and business pressures can open up differences between siblings or cousins and can lead to the disintegration of the fabric of the family and the business.

3. Most GCC family businesses were started by one or two founders who retain ownership of the equity. In the wings awaits a fresh generation of owners, and the number of heirs in the wings is often large, because the culture in the Gulf region favours large families. It is one thing to build a successful business, it is quite another task to imbue every stakeholder with a culture promoting the cohesion and continuity of the family in nurturing and growing successful business enterprises over generations.
4. Regardless of whether or not a particular sibling understands the family business or embraces the culture, the GCC inheritance laws guarantee that this sibling will receive an inheritance share commensurate with each other sibling of the same gender, and the GCC companies laws guarantee that any heir inheriting shares will have one vote for one share inherited. This combined force of inheritance laws and companies laws means that for most families in business there is absolutely no guarantee that equity and the voting power will be vested in those heirs with the knowledge, ability, character and commitment to lead the family enterprise. Those heirs who do have the training and experience are commonly outnumbered and outvoted by other heirs without these qualities.
5. The control of family business assets is a key which may unlock a vast reservoir of financial power, social prestige and an enviable lifestyle, so it is natural that there should be rivalry amongst heirs to lead the business. Add the element of sibling rivalry as an overlay and it can be seen that there is real potential for family business disagreements to escalate, particularly at the time when the founder ceases to play an active role.
6. For these reasons, the inevitable transition associated with generational change and the inheritance process carries with it the potential to develop into an existential threat to the continuity of many GCC business enterprises. Even where the family business does not break apart, the paralysis of decision-making and the need for complete unanimity in the post-founder era may cause a gradual erosion of the business and asset base.

What Can Families Do?

1. The first and the most important thing is to realise that in many cases the past history of the family and its enterprises may not be a reliable guide to what will happen in the future, so something must be done to secure the future.
2. A family which has a desire to sustain and grow a business together must:
 - develop a vision;
 - generate a consensus to embrace the vision;
 - formulate a plan to take the practical steps to ensure the vision continues (including a succession or stewardship plan); and
 - implement that plan in an effective way with the best advice.

What Can Families' Legal Counsel Do?

1. There are clearly limitations as to what any external or in house legal counsel can achieve in managing close familial relationships. However, a family's legal counsel can do a lot to help, particularly where the atmosphere in the family remains positive. For example:
 - create a corporate legal structure for the family which has watertight compartments;
 - isolate "*blue chip*" investment assets from entities carrying on trading enterprises with business risks and borrowings;
 - create a corporate legal structure which is both bankable and "*deal friendly*";
 - suggest that the family needs to work together to develop the right succession plan and framework of arrangements to promote stewardship, continuity and an orderly transition when generational change occurs;
 - make sure the right questions are asked and addressed even though the questions may be tough (e.g. should present or future in-laws have a role in the business?);

- encourage the creation of safety valves, because if a minority of family members becomes locked into a structure which others control they may feel they have no choice but to fight to break up the business, unless the minority is provided with a fair exit option.

Conclusion

1. Family businesses are vital to the lifeblood of the Gulf economies and societies but there is a great need to educate families on the need to put in place the structures and governance platforms necessary for future continuity, harmony and growth in the business enterprise. The hidden economic and social costs of families in business which are dysfunctional are very high, measured in lost business revenues and missed growth opportunities. The family must put in place a leader or a leadership group which can act decisively to move the business forward. Well structured arrangements are needed to head off the ultimately destructive process of open conflict and litigation within families.
2. The challenge for the family's legal counsel is to win the trust of the families and apply the right guiding principles for good corporate governance to give the families the tools they needs to build a cohesive family and business dynamic for the good of future generations.

First published in The Oath Magazine, May edition.