“Winter is Coming” How Family Businesses can survive Generational Transitions

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For this reason the motto of the House of Stark is “Winter is Coming” – words which send a warning and remind of the need for planning and vigilance.

For every family in business, the transition between generations can be winter of despair and if not handled properly can lead to the paralysis and death of the business.

How Can Family Businesses Survive?

Family businesses are the cornerstone of most economies in the Middle East. Research by the Family Business Institute shows that only 30% of family businesses survive to the second generation, 12% to the third generation whilst only 3% continue through the fourth generation and beyond.

Succession planning and good governance are the keys to keeping successful families together. The absence of these key elements has driven many families to legal and financial problems and ultimately opens family conflict. Disruption of business operations, failure of business continuity and, worst of all, the decay of family ties, represent the sad legacy.

Succession planning and robust governance arrangements may be viewed as unnecessary by founders, especially where founders command complete control of both the family and the business. However, in time, the number of stakeholders will proliferate due to inheritance processes. Often, consensus amongst the stakeholders becomes difficult.

Awareness of the importance of succession planning and governance amongst Arabian Gulf families has come a long way in the past few years. Many families are initiating the building of the machinery to enable the second generation to step in and go forward.

Why are Succession Planning and Governance Urgent?

Threats in the absence of succession planning appear mainly at the transition, the time when the founder and patriarch of the family and the business passes or can no longer be involved. Under Middle Eastern legal systems, the lack of preparation for such a scenario usually results in a temporary freeze on dealings with the assets of the founder and the business.

Lack of succession planning will also result in splintered real estate ownership at the death of the founder which usually leads to cumbersome selling, development and management of property. Furthermore, it exposes the heirs, as the new owners, to liability against any risks arising out of real estate occupation (e.g. liability for fires or serious accidents in buildings).

Another significant risk is the lack of unanimous agreement on business leadership amongst the heirs resulting to a decision-making void. This scenario degrades business decisions and encourages shifting alliances and power struggles between family members. Many family businesses are challenging to run. Not all family members are interested in maintaining the business and not all family members possess the skills, aptitude and experience to do so successfully.

Forced Heirship Challenges

Sharia Law forms the basis of Islamic jurisprudence. Islamic jurisprudence includes both laws and regulations relating to the practices of the religion of Islam as well as laws and regulations relating to possession, inheritance, finance and other aspects of life.

In the UAE for example, the UAE Personal Affairs Law contains a formula for division of assets which reflect Sharia principles.

Family owned businesses in the Gulf region face additional challenges because they must take the inheritance rules into account when considering succession planning. Sharia inheritance rules aim to conserve and distribute wealth fairly across the generations; and to protect the rights of minors, family members, and orphans.

These rules are mostly concerned with fairness in inheritance but if stewardship arrangements are not put in place for complex businesses, fairness of distribution can also lead to fragmentation of ownership and decision making. Furthermore, whilst the Courts have a system in place for protection of minors, the process itself may neglect the needs of the business as a result of the requirement to comply with meticulous court procedures in relation to decision-making process affecting minors’ interests.

These challenges may be mitigated by designing a Sharia compliant structure which accommodates large and complex business holdings yet respect and implement the principles and spirit of Sharia. These structures can also be reviewed and approved by an Islamic scholar.

Corporatizing Family Arrangements

An essential part of succession planning is the corporatization of family arrangements. In order to corporatize the family arrangements, a suitable corporate structure must be selected. Which corporate structure is viable will depend on a number of factors such as the nature of the business and type of business activities involved, its geographic location, the presence of real property assets and their locations, the complexity of the family arrangements required and many more elements.

All family assets must be quarantined within the collective family corporate structure selected and the shareholding must be distributed appropriately amongst the founder, family members, and others as the case may be. This should be followed by a binding document, i.e. family constitution, shareholder’s agreement or trust deed supported by the relevant Memorandum and Articles of Association (where applicable) to reflect and detail stewardship arrangements and reflect and impose the family governance arrangements.

It is evident that some structures, such as corporate structures established in “onshore” GCC areas (i.e. areas not confined to free zone) are not suited at all for succession planning purposes in comparison to other legal structures. This is due to their inflexible nature and the significant involvement of governmental authorities. Other legal structures are superior vehicles for succession planning, such as legal structures involving common-law trusts.

Selecting Legal Structures for Families

Amongst the obstacles family businesses in the GCC face when considering onshore structures arise from limitations embedded in commercial companies laws. Comprehensive family arrangements may be difficult to implement through a corporate structure governed by the respective local onshore companies’ law.

Corporate structures, specifically those in the UAE and the other GCC countries, are relatively rigid. Even where a family constitution is put in place to reflect and impose the family governance arrangements which cannot be included in the Memorandum and Articles of Association of a company, the establishment of a practical and enforceable link between a set of Memorandum and Articles of Association in a form consistent with the companies law and a “non-standard” family constitution (operating as a binding shareholders’ agreement) may be challenging due to prescriptive legal requirements (e.g. mandatory statutory rights of pre-emption).

In contrast, trust structures can be designed to preserve the wealth of the family as a unit and are well suited to an enduring family structure.

Common-law trusts can be administered according to the wishes of the founders. Where a corporate trustee is utilised, the benefits of these arrangements can be reinforced by the trustee’s perpetual succession and limited liability.

However, common-law trusts are often unviable for GCC family owned businesses. A foreign trustee would be deemed “foreign” for the purpose of business licensing rules and land ownership in GCC countries, and the trust deed itself would not be recognised or enforced in GCC’s onshore courts.

One avenue which may be available for certain families is the Dubai International Financial Centre (“DIFC”), a financial free zone which is a “stand-alone” jurisdiction, governed by a separate set of laws, rules and regulations informed by the common law of England.

DIFC laws allow trust structures to be the basis for company and asset holding arrangements of the type available in common-law jurisdictions such as the UK, Cayman, and BVI, making the DIFC a recognized platform for wealthy families to set up holding companies to manage private family wealth and family structures in most of the GCC.

Amongst the many advantages the DIFC offers, a company established in the DIFC and wholly owned by GCC nationals is considered to have GCC status in Dubai and in a number of countries around the GCC. Hence, the DIFC trust structure can work for GCC nationals with GCC assets.

Given the diversity of families in business in the region, there will never be a “one-size fits all” solution. Each family business succession plan must be considered and developed independently taking into consideration many factors such as the founder’s vision for both the family and the business, the relationship between the founder and family members, the relationship amongst the family members themselves, the nature of the business, the corporate strategy desired, the business assets and their geographic locations and many more.

Signing a Binding Arrangement

Legally binding arrangements should be put in place to govern the affairs of the family stakeholders and record the rights and duties of the stakeholders and detail stewardship arrangements. Where applicable, the document recording these arrangements should be, to the extent possible, supported by the relevant Memorandum and Articles of Association. This binding document may be a family constitution, a shareholder’s agreement or a trust deed.

This binding document in most cases is a comprehensive document that covers and regulates many aspects of the family and its business.

The binding document determines, amongst other matters, who from the family is eligible to own a stake in the business, restrictions on dealing with such stake, board membership eligibility and the mechanism of its election, the ultimate controlling body, dividends policy, reserved matters, exit policy and valuation of shares, conflicts of interest, competition and many other matters.

In trust structures, the family arrangements are usually embedded in the trust deed and not Articles of Association or shareholders' agreements. Family members enjoy almost unlimited flexibility in designing their family arrangements under the trust deed. Also, the trust deed is a confidential document that is not publicly available. In most jurisdictions which have trust laws such deeds are not subject to any filing with any authorities. Hence, the family can ensure total confidentiality of their arrangements.

The Importance of Taking Action Now

Family businesses may face many challenges both on the business side and the family side. Therefore, it is important to put in place a coherent structure that will protect the family legacy and wealth, preserve the legal rights of the family members and at the same time ensure that the business grows and succeeds.

Now is always the right time for families to take the necessary actions to avoid falling into the pitfalls other families have endured due to the lack of proper succession planning. Examples and cases from the real world have proven that preservation of family wealth, continuation of the legacy of the founder's business and the seamless transition into next generations is a result of taking appropriate action long before the transition occurs.

Every family business must face generational change – so for every family in business "Winter is Coming" and they must be prepared for it.