Can Family Companies survive the winds of change? A cry for legislative help

Mariam Sabet - Senior Counsel - Intellectual Property / Competition
m.sabet@tamimi.com - Dubai International Financial Centre

Three factors are mainly to blame. First, the natural stresses of family dynamics, sibling rivalry and a failure to educate and inspire the new generation to become stewards of the family legacy is a factor. Second, the dilution of ownership naturally occurring as part of the estate devolution rules often results in the business being run by a bickering committee of family heirs and not all businesses survive being governed in this way.

Without a properly pre-framed family rule book, no business can prosper in the face of unresolved family conflicts, deferred decision making and general bad management. This pushes the family into going their separate ways by breaking up or dividing the business thus undermining a once successful economic force. Family businesses are often better off staying together, their market strength and staying power stems from this unity. This divide may ultimately end the business and deprive the coming generations of the family legacy.

Third, the main UAE legal platform, the UAE Commercial Companies Law ("CCL") lends no assistance to generational transition and the preservation of family legacy because it does not provide any adequate framework for central and strong stewardship after the fragmentation of holdings through the inheritance rules. The CCL is not adapted to handle the unique features of family companies (particularly large ones) and is not flexible enough to deal with the evolution of the families from one generation to another.

Family businesses are not ordinary companies and it is about time they received special treatment. Without a legislative recognition for family companies, family 'rule books' will have no teeth.

This article will highlight some of the main impediments entrenched in the CCL which hinder the successful implementation of the two main pillars of family success. Those pillars as usually mandated in a family book are mainly (i) family corporate governance; and (ii) Keeping the family business together.

I. Family Corporate Governance:

This first part will focus on those impediments in the CCL in relation to implementing a successful family governance program.

Restrictions in Number of Shareholders:

Let's take this example; a family business with a significant number of potential heirs operates under a limited liability company ("LLC"). When transitioning from one generation to another, the large numbers of potential family heirs become owners, and exceed the fifty partners' limitation imposed by Article 218 of the CCL.

The family company considers its options and switches to a joint stock company to accommodate its ever-expanding family (where no so such legal limit exists) only to face other legal road blocks. The joint stock company requires hands-on procedural governmental involvement and red tape involving the Ministry of Economy if the company wishes to amend its Articles of Association to adapt to changes in their structure and family arrangements. So it is an unsuitable platform for family companies where flexibility is a welcome feature to its ever expanding shareholder registry.

There is no obvious "go-to" option in such a situation. Large family companies should not be faced with hurdles on the number of shareholders allowed. They should be able to operate under their choice of corporate legal platform (an LLC is the most common type found in the UAE) so they can set their own rule book regardless of the number of family shareholders.

Family companies need special exemptions to enable them to operate as LLCs.

The case of the accidental shareholders

"Accidental" shareholders are best described as those family heirs who become shareholders by operation of the inheritance rules and not as the result of any conscious decision. If you take the literal meaning, by no means is "inheritance" considered an accident, the business should be well prepared for the possibility of the heirs becoming potential partners. Yet, many proprietors by inheritance do not prepare for their role and most companies fail to plan for their arrival.

The term "accidental" is more of an analogy for the element of surprise that comes along with it. Will they act for the best interest of the business, or will they treat the business as their personal ATM machine and cast their shareholder votes accordingly?

Reform is required to protect the legacy and prosperity of the business from the business equivalent of "mob rule" and the scramble for cash.

I am a partner and have strategic powers!

An outburst like that from an "ATM only" partner can have a chilling effect on committed partners (here, our "good guys"). Even with management powers delegated largely to the board, there are still some strategic decisions that fall into the hands of shareholders and that could be an issue if the "ATM only" faction has power.

Those decisions, which are mandated by the CCL, cannot be contracted out in either the company's by-laws or separate shareholder agreements. Examples of some of those decisions are set forth below:

(i) Powers to dismiss members of the board:

Article 116 of the CCL mandates the General Assembly has the power to dismiss any or all members of the board of directors:
Those powers explicitly override any conflicting article in the company's by-laws.

(ii) Powers to amend the by-Laws & crucial decisions:

Article 137 of the CCL mandates the Extraordinary General Assembly with the powers to amend the company's by-Laws and incorporation contract (all amendments permissible except for certain restricted events) and additionally shall have the following powers:
– To increase or to reduce the company's capital;

– to dissolve the company or amalgamate it with another company;
– to sell or otherwise dispose of the project undertaken by the company; and
– to extend the duration of the company.

The dangers of the decisions being in the hands of "ATM only" partners are obvious. They could disrupt the growth of the business should they (unrightfully) decide to veto some strategic decisions or fail to respond in timely manner thus compromising important deals for the business.
The CCL should create different classes of shares with different voting rights. Not every partner must be warranted voting rights! For example, the business can implement rules where it grants the voting rights to certain individuals answering to certain specific criteria.. This will require major legislation reform but it can be a useful tool in keeping at bay undesired partners from the decision making process.

Notes:

- The reference to the articles above applied to joint stock companies given that they have the most hurdles and require most reforms. However, LLC's do not fair any better, they share similar restrictions (if more flexible) with regards to governance and have a similar effect on hindering family transition.
- Furthermore, we have not addressed the importance of board management, its selection process and eligibility criteria and how it should be dealt with under the CCL. These should be addressed in depth and in a separate article given their significance in proper family governance.
  Next we tackle the second pillar of a family success which is keeping the family together.

II. Keeping the Family Together

Exit mismanagement is one of the main culprits in family conflicts. This almost certainly creates imbalance in ownership, triggering a chain of reaction of resentment, unfairness and ultimately leading to the break up of the business and the loss of family control.
A good exit management (i.e. share exchanges) allows the following:

- Fair treatment of family members by preserving their exit rights;
- Meeting the liquidity needs (to the extent possible) of family shareholders; and
- Sustaining the business by protecting against breakup of ownership.

So how do we face exit mismanagement and preserve the sustainability of the business?

You cannot rely solely on family ties as an incentive to resolve conflicts. There needs to be a more tangible and foreign force to which those family shareholders can rely on to resolve the much hyped conflicts tagged to unruly exits.

What better force than tailored statutory rules! The current system under the CCL (or the lack of it) regulating share exchanges does not have a good track record in securing smooth exits between family members. We emphasize below on the buy backs and how they are dealt with under the CCL.

Buy backs:

Let's take the example of a family shareholder who, in need of liquidity, offers part or all of his shares for sale. Ideally, the business should have the flexibility and discretion (depending on the terms of family book) to offer to buy those shares This will help the business control any off the record dealings between the shareholders (which could result in some members obtaining a majority control of shares) and fairly meet (depending on its cash availability) the liquidity needs of a shareholder. For this process to run smoothly, the business needs enough flexibility to allow it to dictate (and enforce) in the family book and its by-laws the exit mechanics from transfer window to payment mode and the like. This helps the business control the exits and possibly mitigate potential family conflicts.

Now compare this ideal level of flexibility to the current situation under the CCL.

Under the CCL, buy backs are heavily regulated for joint stock companies and are only allowed in two stipulated circumstances. Article 168 of the CCL sets forth lengthy and procedural conditions governing buy backs and requiring the involvement of the competent ministry. Additionally, the business needs to comply as well with Article 209 of the CCL which limits the option to reduce capital (i.e. as a result of buy back) only in two stipulated circumstances (capital exceeding a company's requirements and the business sustaining a loss which is not recoverable from future profits).
As such, under the CCL, the business will not be able to implement a selective buy back and hence accommodate an exiting shareholder outside those two cases.

Effective family management and uniting the family is one of the main facets of survivability of family businesses. Yet, they are often poorly served by the CCL. What we need for preserving family businesses and legacy is a clear legislation reform that recognizes family companies and exempts them from the many legal hurdles awaiting them upon transition. Families businesses are a special breed and so should be their legal platforms!