Legal Structuring for Families in Business

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Family-owned businesses contribute significantly to the economies in the Arabian Gulf and wider Middle East. Family-owned businesses are important to the economy of the United Arab Emirates and are the backbone of the UAE business community. They vary in size from small and mid-sized enterprises ('SMEs') to international corporations. Whatever their size they have their own unique attributes and challenges. These affect not only the families operating the business but also third parties dealing with such businesses.

Succession planning and governance is the key to maintaining and growing successful family businesses. Recently, founders in the region have become more aware of the importance of succession planning and the risks associated with transition from one generation to another if the binding arrangements governing the family and its business are not in place.

An essential pre-condition to effective succession planning is corporatisation of the family business. In order to corporatise the family business, an appropriate corporate structure must be put together. There is no one-size-fits-all structure. Each family is unique in its own way. The dynamics of the family and its business differ from one family to another depending on several factors.

Selection of the optimal corporate structure usually depends on several factors that are different from one family to another and from one business to another. Such factors include: the nature and type of assets and business activities; its geographic location; the complexity of the family arrangements; and many others.

In some cases, the optimal corporate structure may be impossible to achieve due to certain limitations such as restructuring constraints in light of certain regulated activities that impose certain requirements or local ownership restrictions. However, even under severe regulatory restraints there is usually considerable scope for improvement in the equity holding and governance arrangements affecting the family.

A Prevalence of Poor Legal Structures

The most common family ownership structures entail an array of businesses and assets owned by one person i.e. the founder. Founders often own the businesses in their personal capacities with full management control and authority. Insufficient heed is paid to the risks arising out of the assets and businesses, the consequences of forced heirship under Sharia Laws and the contingencies of managing businesses and assets in the event the founder suffers a disability or passes away.
In other scenarios, ownership of family assets is not restricted to the founder but is distributed amongst the family stakeholders under which all assets are owned by the family stakeholders directly according to their respective proportions under Sharia or otherwise as agreed.

Branches and sole establishments are very common in the Middle East because they are easy and cheap to establish in comparison to other structures. However, they provide no limitation of liability for any owner of an establishment or to the parent company of the branch.

Problems Associated with Poor Legal Structures

What happens if the founder passes away? Inheritance rules will apply and this usually results in fragmentation of ownership and control, and too often shareholder fractionalisation. These problems can be exacerbated in the case of large families. Added complications occur where there are minors amongst the heirs and the inheritance courts become involved. Business and decision-making ability is frozen until the inheritance procedures are completed and can be impacted and slowed until minors attain full legal age.

Risks are not limited to after the death of a founder i.e. at transition. There are also dangers that can arise during the lifetime of the founder.

Where a founder owns businesses through sole establishments that are engaged in high-risk businesses, all liabilities of the business are the personal liabilities of the founder being the owner and the manager of the sole establishment.

Buildings registered in the personal name of a founder can give rise to civil or even criminal liability (e.g. fires).

Poor legal structure models also intermingle passive assets that are risk free assets with operating risks in particular types of business (e.g. oilfield services). Furthermore, poor structures are prone to lack of proper governance, management and/or reporting lines. Such models do not offer an attractive structure for future sell-downs, joint ventures, introduction of a strategic investor or even a public offering. Significant preparation would be required which may be costly and time consuming.

A further disadvantage when there is no proper structure in place is that financing cannot be obtained on a stand-alone basis meaning significant dependence on personal guarantees from the founder or individual family stakeholders might be required.

A Well Designed Structure

What is a Good Legal Structure?

Ideally, a business structure should have a holding company in the form of a limited liability company (regardless of the jurisdiction of the holding company) which consolidates the collective family assets and business under a holding structure which facilitates management, accountability and reporting. Such a structure should limit the liability of the founder and/or family stakeholders against any business or financial risks.

Further, subsidiaries should be separated into focused business units also in the form of limited liability companies.

Ideally, the structure should minimise the use of branches or sole establishments except in exceptional cases (e.g. fast food outlets).

A well designed structure would limit the liability of the holding company i.e. against any possible business and financial risks resulting from any of the businesses downstream i.e. corporate guarantees. Such a structure would also separate and insulate core fixed assets from operating risks and liabilities within the businesses on an ongoing basis as well as facilitate financing on a ’stand-alone’ basis.

A structure comprised of a holding company consolidates the management of a business and other assets of the family under one group umbrella and provides the flexibility to facilitate sell-downs of, or disposals of equity.

Real Estate constitutes a significant stake in family wealth in this region. Accordingly, any proposed structure should take into account risks associated with real estate ownership. Generally, it is recommended to place ownership of the collective family real estate assets under a holding company or several corporate entities as opposed to individual ownership. This, together with other advantages, protects owners against civil or criminal liability arising out of real estate assets. In addition it removes the land from direct involvement in any inheritance law procedures and avoids large commercial properties having numerous co-owners, all of whom must agree on every decision.

Al Tamimi & Company’s Family Business practice regularly advises on Family Business Structuring. For further information, please contact Nawal Abdel Hadi (n.abdelhadi@tamimi.com), Gary Watts (g.watts@tamimi.com), or Richard Catling (r.catling@tammi.com).