



# Briefing Paper

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*Extracts of Legal White Paper*

## **Succession Planning for GCC Family Businesses: The Future is Now**

Prepared by

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We would also like to thank and recognize the contribution of the law firms and FBCG members who assigned their lawyers and legal counsel to respond to our legal survey and share their insights with our team.

<b>Law Firms in the GCC</b>	<b>FBCG Members</b>
Hadeef & Partners Jihad Al Taie Law Office ASAR - Al Ruwayeh & Partners Law Office Law Offices of Dr. Mujahid M. Al-Sawwaf	Al Ghurair Investments LLC Al-Futtaim group Alfardan Group Holding Alghanim Industries Al Muhaidib & Sons Al Rajhi Holding Alsayer Group M.H. Alshaya & Co. SEDCO Holding The Zubair Corporation WJ Towell

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## INTRODUCTION

### *“Failing to plan is planning to fail.” – Alan Lakein*

It is well known that many private businesses in the Arab Gulf are family owned and these businesses contribute significantly towards the economy of their respective countries. Many of these family owned businesses are approaching the critical stage of transition from one generation to another. It is estimated that US\$ 1 trillion of assets are set to be transferred to the third generation over the next 10 years.<sup>1</sup> However, what is not common knowledge is that only approximately 30% of all family businesses make it to the second generation with even fewer making it to the third and fourth generation (some estimates as low as 12% and 3%, respectively).<sup>2</sup>

One of the main contributing factors for this phenomenon is the lack of proper succession planning and governance mechanisms to support the process.

In regard to succession planning, the Arabian Gulf has a unique dynamic at play when compared to other jurisdictions in the world. The key differences lie in the fact that across the GCC, apart from federal law as passed down in the form of Ministerial Decisions or Royal Decrees, businesses and individuals are also required to comply with Islamic law principles (Sharia law). This is particularly the case in inheritance related matters. Families are also often larger in this region resulting in more heirs to the business than elsewhere in the world. This is in addition to the fact that none of the GCC countries have any dedicated statutory laws addressing the concept of family business.

In the past, there has also been some cultural reluctance to discuss the concept of succession planning within the family as it is a difficult subject. Family members are often not prepared to consider the possibility of the passing away of relations and relinquishing control to the next generation. Given these distinctive circumstances, legal practitioners and advisors face sizable challenges in devising effective succession planning mechanisms that meet the needs of each family.

In recent years, the climate for family business in the GCC is shifting towards greater awareness of the importance of succession planning and a greater desire to preserve the family legacy. Many founders of family businesses are now actively seeking flexibility in determining the entitlements of their beneficiaries and shareholders among family members. They are also looking for legitimate and innovative means to transfer the ownership and management of their business to suitable custodians to ensure their businesses, vision, objectives and legacy are sustained and carried forward in the future.

In order to assist our members in preparing for the future, FBCG has developed this White Paper Report entitled **“Succession Planning for GCC Family Businesses: The Future is Now”**.

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<sup>1</sup> World Economic Forum on the Middle East and North Africa, 2013, Session titled “Family Businesses as an Engine for Growth”

<sup>2</sup> Family Business Institute

## OBJECTIVE

One of our objectives at FBCG is to assist our members in ensuring that their business and its legacy is built to last across several generations. Accordingly, this Report is aimed to provide the readers with an understanding of the potential legal structures that can be applied for succession planning whilst taking into account the unique requirements of the GCC region.

## METHODOLOGY

We have prepared a detailed survey asking key questions currently concerning succession planning in the region. We have shared it with several law firms and other stakeholders, including the legal counsel of some of our FBCG members.

Based on the responses received for the survey, we have rationalised and collated our findings into one consolidated set of responses for each country in the region. These are set out under Annexure A of this Report.

We have researched and set out the concept and basic mechanics of each of the legal structures that can be used for succession planning together with their strengths and drawbacks. We have also highlighted the applicability of each of these structures country-wise across the GCC.

Based on the findings of the survey, we have also created an index ranking each of the six countries in the region according to their 'Ease of Managing Succession'. The methodology for the index was developed by FBCG. Information on the ranking methodology is set out under Annexure B of this Report.

We have also briefly set out our general recommendations on improving and facilitating succession planning in the GCC.

## SUCCESSION AND TRANSITION CONCERNS IN THE GCC

Our analysis indicates that roughly 80% of GCC family businesses are in the critical transition stage of first to second or second to third generation.<sup>3</sup> If the FBCG community serves as a representative sample of the GCC, it implies that majority of GCC family businesses will need to consider succession, in terms of transfer of leadership across the three vulnerable cycles of first to third generation over the next 5 to 10 years.

In regard to succession planning, the Arabian Gulf has a unique dynamic at play. GCC family businesses are large families which presents them at an earlier stage in their evolution with complexities typical of families in their third and fourth generation cycles with large number of family shareholders. The likelihood of conflict and disputes increases with more family members who may have different views about the management of the family business, such as its future direction, investment decisions, and who should and can run the company. There might also be competing views and interests for the leadership and management positions available to the family members in the company.

The large family size also puts significant pressure on the family business to grow exponentially fast in order to maintain the same level of wealth for each family member across generations. A study estimated that the typical GCC family business had to grow at 18% year on year to maintain the same level of wealth.<sup>4</sup> In the GCC, this is compounded by the fact that there is a greater overlap between the “family” and “business”.<sup>5</sup> Therefore the likelihood that decisions strictly related to the management of the business, may be rooted in overlapping objectives such as impact on personal wealth, emotional attachment to businesses and assets, or personal employment opportunities.

As the size of family members grows, with possibility of more female shareholders, it also raises the question about the role of women in the GCC family business. Many family businesses are aware of the need to address this and are increasingly engaging women as leaders, managers and Board members.

Despite their relatively young age and provenance, some GCC family businesses have gained stature as large diversified conglomerates with presence in retail, finance, real estate, hospitality and many other sectors. So they are also confronted with external commercial pressures, such as the need for scaling and internationalizing, in the presence of increasing competition within the region and globally.

These challenges related to management succession and sustainability of the family business, are coupled, and at times complicated further, by challenges of ownership succession in the context of GCC regulatory challenges and unique dynamics compared to jurisdictions elsewhere.

In the GCC, succession planning must be done in the context of Sharia principles and inheritance laws that dictate a different approach to several issues including the separation of voting rights and ownership, and consolidation of the family members’ voting power.<sup>6</sup> For example, for LLCs in the GCC, except in the DIFC jurisdiction within the UAE, differential rights for different classes of shares, such as non-voting preferred shares, are not possible. Laws require that each shareholder has votes equal to their number of shares owned in the family business. To accommodate these regulatory limitations, family businesses may opt for the concept of “blocking-state” or a “cascading ownership” structure, whereby the founder sells

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<sup>3</sup> Family Business Council - Gulf Analysis 2015

<sup>4</sup> “GCC Family Businesses Face New Challenges” Booz & Co Perspective by Joe Saddi, Per-Ola Karlsson, Ahmed Youssef and Karim Abdallah, 2009

<sup>5</sup> “Family Matters: Governance Practices in GCC Family Firms” Pearl Initiative and PriceWaterhouseCoopers, 2012

<sup>6</sup> Ibid

49.9% of a holding company and corresponding 49.9% of shares in each business entity within the holding company, thus maintaining a majority share.<sup>7</sup>

Access, applicability and enforceability of a “vehicle of choice” or legal structure that best fits their unique succession needs is limited in the GCC, compared to their Western counterparts. This presents many hurdles when families consider the transfer of company control and ownership to the next generation. For example, only three of the six countries, Bahrain, Qatar and UAE, provide regulations and mechanisms to establish a family trust, which is a popular legal structure typically used for preservation of the family wealth, stake and consolidated control of a business. In addition to the limited usability of family trusts, the indigenous vehicle, Waqf Al Ahli, also have challenges. Not all the GCC jurisdictions have the presence of dedicated Waqf laws or a clear precedence of Waqf used as succession vehicle. Furthermore, the ability to contract out of Sharia Court to arbitration or special courts for Waqf is not possible across all countries, should an imminent and serious family conflict arise.

Large and growing families in the GCC require pre-emptive measures and mechanisms to resolve conflict, before it escalates to the courts. Families are not offered nor legally required to follow a stage-gate process of mediation, arbitration and litigation. Confidential mediation and arbitration can help the family settle disputes collaboratively and discreetly, whereas litigation can result in public disclosure of a family conflict.

Even if family businesses do create internal guidelines and mechanisms to resolve conflict and address issues related to transfer of ownership, by way of a protocol or constitution, they are voluntary agreements, not enforceable in GCC jurisdictions and easily challenged by family members, if not in line with Sharia principles.

Finally, as family businesses gain regional stature, it becomes increasingly critical that their legal entities and agreements are binding across the GCC. However, many legal entities have limited applicability in the GCC and global context. For example, in the case of a family trust established under Qatar Financial Centre (QFC) Trust Regulation 2007, the QFC has no jurisdiction over real property, shares of entities established outside the QFC, or stock in public companies, and exclusive commercial agencies established in Qatar. Therefore the trust provisions of QFC laws would not be recognised in relation to the same nor would any foreign trust relationship be recognised.

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<sup>7</sup> “GCC Family Businesses Face New Challenges” Booz & Co Perspective by Joe Saddi, Per-Ola Karlsson, Ahmed Youssef and Karim Abdallah, 2009

## RECOMMENDATIONS

This section aims to outline briefly certain remedial measures that can help to eliminate or reduce some of the issues faced in succession planning across the GCC.

### A. Family Charter to be a legally enforceable document

To avoid disputes and challenges to the authority and vision of the founders and management of a family business, it would be useful to have the 'Family Charter' or 'Family Constitution' deemed a legally enforceable document, so long as it addresses appropriate and designated topics. This is currently not the case across the GCC. If such a document were legally enforceable, it would enable founders and management to enforce the provisions of this charter against family members reneging on their commitments under it and causing disruption and damage to the smooth running of the business.

### B. Approval Requirements for Share Sales

To prevent disgruntled family members from selling their shares and diluting the family ownership or alternatively using their power to exit the company as a threat to influence management decisions, it would be helpful if share sales required pre-approval from the other partners in the company before they can be sold. This measure would work on the same lines as a pre-emption right except in this instance, if a shareholder wants to sell his shares, he will need the approval of a special majority (i.e. 75%) of the partners before he can sell them off. The existing shareholders (if not in a position to purchase the sale shares at this stage), in the face of a request to sell shares, can impose a specified period of time wherein the shareholder cannot sell his shares (whilst the existing shareholders can collect the requisite funds). On the expiry of that time period, if the existing shareholders have not offered to buy the shares, the selling shareholder can sell them to a third party. Another version of this restriction could also be that the third party buyer has to be approved by a simple majority (i.e. 50%) of the other shareholders (the selling shareholder would not be able to participate in this vote).

### C. Buy-Back of Shares

It would be useful if a buy-back of shares by the company itself was permissible. In situations where existing shareholders cannot buy all the shares being offered by the selling shareholder, the company could step in and purchase the balance shares or alternatively, all the shares, if necessary. The buy-back of shares is permitted in Oman in limited circumstances. Therefore there is a precedent of such a practice in the region. This could be further developed and made a GCC wide practice. This can also be achieved via reduction of capital.

### D. Lock-In Period

Another useful measure could be to permit the incorporation of a 'lock-in period' in the constitutional documents of an entity. This would entail restricting shareholders from selling their shares outside the existing shareholders for a specified period of time, perhaps for 3 to 5 years. This would be useful in ensuring stability is maintained particularly where the leadership of the companies is in transition from one generation to the next.

### E. Increasing the Ceiling on the Number of Partners in an LLC

Currently in most countries across the GCC, there is an upper limit on the number of partners (i.e. shareholders) for an LLC. For instance, in the UAE, the maximum number of partners an LLC can have is 50. Especially given the large sizes of families in the region, it would be useful, for family companies, to increase this number to 200.



## **F. Differential Voting Rights**

Generally, across the GCC, every issued share in a company is a voting share and carries the same voting rights. In most GCC countries, there is no concept of carrying different voting rights for an LLC which means every shareholder has the same voting power. This is problematic for family businesses with large numbers of shareholders of all ages. Having shares with differential voting rights should be made permissible to enable key stakeholders in the family business to have more say. This would help to avoid deadlock and facilitate smoother decision making which is beneficial for the company.

## **G. Non-Compete Provisions should be imposed on Partners in a Family Company**

It would be useful to introduce a restriction on partners in a family company preventing them from competing with the business of the company. This would mean partners cannot invest or participate in other businesses engaged in the provision of the same services as the family company. This is particularly significant seeing as each shareholder carries the same voting power. It is possible that if a partner has interests in other competing businesses, their interests would be conflicted and their vote on a key matter would not be in the interests of the family business.

## **H. Introducing a dedicated law for Family Business**

Given that family businesses account for the majority of businesses in the GCC, it may merit the creation of a law dedicated to their regulation. Whilst family businesses share many similarities with ordinary commercial enterprises, the dynamics and concerns of a family company are considerably different from an ordinary commercial entity with partners acting at arms-length. In light of these differences and given the economic importance of these businesses to economies in the region, it is recommended that a dedicated family business law be developed in each of the GCC countries. This law could address some of recommended measures in this Report. However, compatibility with existing corporate laws should be taken into consideration when introducing such laws.

Based on a private initiative by FBCG, a draft family business law has been presented to the Government of Dubai for further discussion. If approved, this draft may also be presented for discussion at the Federal level. Furthermore, we understand that a draft 'family ownership' law has been drafted in Dubai and is being discussed with competent authorities there. The draft law uses and builds on the concept of family ownership in the UAE federal laws.

## **I. Ability to Contract Out of Sharia Courts in the case of Waqf Ahlis (Family Waqfs)**

Where a family Waqf structure has been implemented, it would be useful if local laws across the GCC permitted family members to contract out of the jurisdiction of Sharia courts in favour of arbitration or a special court, if it is specified in the Waqf deed.

## **J. Freedom to apportion Beneficiaries under a Waqf**

It would be useful if under a Waqf, local laws permitted the founders to apportion the Waqf assets (even if greater than 1/3 of the founders' total assets) to beneficiaries in the size and manner they deem fit. If local law legitimised such flexibility, beneficiaries would be unable to successfully challenge the validity of the Waqf on the basis that it is a 'Will'. It enables the Waqf to serve as an effective and culturally acceptable solution for succession planning.

## **K. Temporary Waqfs**

Some countries across the GCC, such as UAE, Bahrain and Kuwait, may permit temporary Waqfs. It would be beneficial to issue decrees with the appropriate legal backing to make this a consistent practice across the GCC. This way, beneficiaries will more amenable to accept the Waqf and see life beyond it.

## **L. Introducing a Legal Framework for Private Foundations**

Private Foundations, if legally permissible, would provide families in the GCC an independent succession structure that does not rely or seek support from the local commercial company laws. Since setting up a private foundation does not involve incorporating a company, introducing a law on it would not require changes to be made to existing company law. This is helpful particularly since many of the recommendations mentioned above may require changes to be made to the company laws and practices across the GCC. In the UAE, for instance, a Government of Dubai decree could be passed establishing a framework for setting up and operating private foundations in Dubai. Some practitioners believe this would be easier to achieve than to seek to amend the UAE company law at the Federal Level.

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