Family-Owned Businesses in Saudi Arabia: Challenges and Solutions from a Legal Perspective

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Abstract
Performance of family-owned businesses has been widely addressed in the context of developed countries. However, limited studies have been conducted in emerging economies. The purposes of this paper were to analyse the significant challenges facing the family businesses in Saudi Arabian marketplace and to look at corporate governance as one of the solutions to reform their issues and ensure their continuous for the following generations. To achieve this end, the research based on a critical analysis method that starts by discussing the definition of family-owned companies, then analysing their characteristics. A succession planning issue, management problems, protection of shareholders' rights, and transparency requirements would be addressed. The key findings were that limited studies have been conducted in the context of emerging market economies although family ownership in emerging countries is common. Hence, any current evidence provides an insight into family businesses in the emerging economies, and Saudi Arabia is valuable.

Keywords: Corporate governance, Family business, Shareholders, Firms, Transparency

1. Introduction
Since ancient times, family-owned Businesses (FOBs) constitute one of the most significant pillars of the global economy [1]. The presence of the family-ownership structure on the stock markets is common and familiar form over the globe [2]. It has been mentioned that the majority of the 3740 publicly traded companies worldwide were owned by families, almost 72% in Germany, 70% in France, 65% in Italy, 67% of Spanish public companies [3], and 60% in East Asian countries [4].

The importance of the family businesses clearly shows by the fact that the largest contemporary enterprises were started as family-owned businesses, such as Wal-Mart Stores, Ford Motor Company, Hyundai Motor, Acer Computers, Cadbury, SC Johnson Company, BMW, Samsung, Michelin, Carrefour Group, Fiat Group, William Grant and Sons, LG Group, etc [5].

In the Gulf Co-operation Council (GCC) member states, including Saudi Arabia, family-owned businesses account for almost 95% of the total number of listed companies. According to research conducted by the Dubai International Finance Centre (the “DIFC”), family-owned businesses in the GCC hold an estimated $1 trillion. The local investments of family-controlled companies in the Gulf area alone exceed $500 billion, and their international investments are estimated at over $2 trillion [6].

Nonetheless, the FOBs have recently faced many challenges threatening its continuity and survival. As a result, there has been a significant focus on the case of reformatting the types of these companies. Corporate governance has become one of the significant solutions which may ensure at least the sustainability of these companies for a long-term and protect the financial system in any country from the financial crisis and collapse. It concentrated on enhancing responsibility, fairness, accountability, transparency, and disclosure in financial institutions [7].

This paper purposes are to examine the pivotal role of family businesses in Saudi Arabian marketplace, as well as to analyses the significant challenges facing these corporations in the future. To achieve this end, the research based on a critical analysis method that starts by discussing the definition of family-owned companies, then analysing their characteristics. A succession planning issue, management problems, protection of shareholders' rights, and transparency requirements would be addressed. In addition, the paper looks at corporate governance and its application on Saudi family businesses as one of the best solutions to reform their issues and ensure their continuous for the following generations.
2. Methodology

An online searching process was used to obtain scientific articles related to our current subjects. The searching process involved searching through different websites such as Google Scholar, pubmed, and online articles. We obtained 40 articles related to the current subject, of them 8 were excluded as they duplicate articles, may not focusing on the current subject, so only 32 articles were included, and they were published till 2020.

The research methodology would be constructed based on “The Research Onion” from the work of Saunders. The research onion represents various steps that can be used during the process of writing the methodology; it is an effective way for and organizing the ideas and helps in choosing between the strategies or approaches. The steps included are the philosophies, approaches, strategies, choices, time horizons, techniques and procedures [8].

3. The Definition of Family-Owned Businesses and its Forms

Family businesses (FB) are an important segment of any economy and the way they manage their capabilities in order to adapt to changes and to create competitive advantage represents a challenge [9]. A family business can be defined as “a business where its ownership controlled by a single family, in which the family members control the direction of the business through their ownership rights and management roles” [10]. A family business is considered as the backbone of the economy as they have vast potential for generating wealth, employment and welfare to the country and its citizens, and can be described as an interaction between separate and connected systems at the same time which are the family and the business, in which both are governed with uncertain boundaries and different rules [11].

In Saudi Arabia, the FOBs are defined as “a company which is fully owned or controlled by a certain family [12] The Saudi Company Law has determined the types of companies that are permitted to operate within the Saudi economy [13]. Yet, practice shows that many the Saudi family businesses prefer the form of Limited Liability Company, and others intend to take the shape of the Joint Stock Company [14].

4. Characteristics of Family-Owned Businesses

FOBs contribute significantly to the global economy. It plays a vital role in developing wealth, creating job opportunities, attracting foreign investment. Six common aspects within family business have been used to distinguish family from non-family firms: financial performance, financial composition, risk preference, firm age, firm size, and internationalization. The characteristics of family and private non-family firms are generally converging with greater firm size, apart from firm size and profitability, family firms have lesser amounts of total assets, employment, and sales than private non-family firms, even within the same size class. Family firms have higher solidity and are more profitable. Moreover, the term “family firm” includes a wide variety of entities from small firms to large traded companies. Family firms are active in all industries except when crowded out by government actors [15].

5. Major Challenges facing Family-Owned Businesses

Family-owned companies face a bundle of challenges that need to appropriate remedy to gain the confidence of investors and to ensure stability for these companies for the long-term. Challenges of family business including the dilemma of the owners about what should come first, family or business recruiting staff, retaining valuable employees and professionalization of company for sustainable business [16].

Sustainability is the key challenge for a family business, the family involvement in a company brings mostly done through ownership and management. Oudah conducted an analytic hierarchy process model created on the basis of factors influencing the survival of family businesses in the United Arab Emirates (UAE) and found that “they need to create and give more importance to succession planning, strategic planning and corporate governance to ensure their business longevity” [17]. In order to grasp the significant issues facing family businesses, this section divides into the following sub-titles.

5.1 Succession Planning Issue

Succession planning refers to the process that facilitates the transfer of management control from one family member to another, and entails the degree to which the family business is engaged in selecting and training the successor, communicating succession decisions to family members, and deciding on the post-succession strategy and the post succession role of the incumbent CEO [18]. Most family firm owners express a strong preference for the renewal of family bonds through dynastic succession company [19].

Although the case of succession is growing in many countries, however, it seems more badly within Saudi Arabia, with surrender the business to the next generation. According to the Islamic Law (Shariah principles), the owner's wealth must be divided between his/her family after he died. Hence, in Saudi Arabia, the conflicts of interest among family members usually start-up when the ownership transfers to the third generation, which runs at least 15% of Saudi family companies
Generally, 90% of the businesses in Saudi are family-owned while only 5% were surviving the third generation and most of the companies which were successful were less than 65 years old, succession issues, which must be shared among old members of the family and secondly, the challenge of having to pass the business to someone who may not be able to run the same [21].

5.2 Management’s Issue

In family businesses, decision-makers are often from the family, and many of family members joined the company at an early age, and quickly learn the mechanism of the work, their responsibilities, and how to manage the company and understand the nature of the market that it operates in. Family businesses face many legal challenges, including the overlap between ownership and business interests, which can threaten the company’s sustainability. It is important to emphasize professionalism in the management of a family business, especially at that potentially tricky time when the reins of power are being passed from the founding generation to its successors.

To address this challenge, and in the understanding that company owners do not necessarily possess the skills and experience to manage, many family businesses have separated ownership from management and have appointed an independent professional board of directors. Another potential challenge is that traditional management methods may be viewed by succeeding generations as out of date, while the founding generation may be reluctant to take younger family members’ opinions into account when making decisions. It is a fact that in such businesses personal family issues can affect management matters, and vice versa [22]. Additionally, it was reported that family-business managers show less reliance on formal written policies; have a more personal orientation; and trust their employees to a greater extent [23].

5.3 Concentrated Ownership and Control

A dilution of the ownership structure is prevalent in some countries and absent in others. The common law countries, for example, the United Kingdom is characterized by a separation of ownership and control, whereas the concentration of the ownership structure is still high in many countries, especially in continental European countries, Latin American countries, East Asia, and Arab countries [24]. In Saudi Arabia, applying corporate governance principles in the listed corporations, including banks has increased dramatically, particularly in the wake of the economic crisis of 2006. Specifically, this awful financial crisis hit the Saudi stock market and made the price index plummet by approximately 13,000 points within one month [25].

For instance, Al-Mojil Group Company and others revealed that despite turning the family company into the form of a joint-stock corporation form in Saudi Arabia. However, the management and the board of directors are still working under the dominance of the family members because they think that is the company is deemed as private property.

5.4 Minority Shareholders’ Rights

A minority shareholder owns less than half of a company. As a result, if a dispute arises over the sale or distribution of assets, or another issue requiring shareholder votes, a minority shareholder doesn’t have voting strength on his own. This type of shareholder relationship is typically established in a small business, where initial funding comes from a group of friends or family. In exchange for the investment, a business owner gives you a percentage of ownership through stock [26].

A minority shareholder falls under the term ‘investor’ and thus must be afforded interests and rights by law, which the legal system safeguards. In Saudi Arabia, shareholders may legally include whatever clauses and terms they wish in shareholder agreements provided that these clauses or terms do not conflict with the relevant company statutes. Shareholder agreements allow shareholders to protect themselves when dealing with especially disputatious issues. Serious problems can arise without a well-crafted, written agreement. An agreement can also establish exit processes in case an impasse is reached. This allows a minority shareholder to leave a firm without causing serious disturbance to its operations. In addition, express terms to prevent conflict during the removal or cancellation of the directorship of a minority shareholder can be included in shareholder agreements [27].

6. Corporate Governance as an Ideal Solution

6.1 Its Definition

It was the collapse of some of the prominent companies in the early 90s in the UK that triggered the need for corporate governance. According to the revised principles of corporate governance of OECD, corporate governance may be defined as “Procedures and processes according to which an organization is directed and controlled [28].

The Saudi Corporate Governance Regulations (SCGRs) has identified the interests of stakeholders combined with the interests of shareholders [29]. These regulations intend at the outset to provide the same protections for all the groups of people who have relationships with the company [30].

6.2 It’s Objective

The bigger reason for concern was that none of the Annual Reports of these companies, before the crash gave any indication of the poor financial status of these businesses. The weaknesses in accounting standards were being exploited
by the company decision makers to paint a better picture of growth and profitability to various stakeholders. In many of the companies, it had happened that the Boards had been shrunk and the roles of the Chairman and Chief Executive were combined to enable one individual to run the company. The collapse during the 90s made a realization that irrespective of how brilliant the person was, no one individual could be 'right' all the time and needed guidance from independent Board members and thus came the requirement of implementation and monitoring of Corporate Governance [31].

6.3 Its Role

The practical application of corporate governance in the FOBs is crucial to make it more sustainable and growth [32]. Although these regulations aim to regulate the joint-stock companies, however, there is a general trend towards stimulating the FOBs to adopt these regulations to address its challenges and ensure its stability. Consequently, the Ministry of Commerce and Investment has issued new guidance for enhancing and encouraging the FOBs to move toward the sound practice of corporate governance [33].

The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization—such as the board, managers, shareholders and other stakeholders—and lays down the rules and procedures for decision making. Or simply it may be explained as a blend of internal and external company governance mechanisms. External mechanisms may include the managerial labour market, the capital market, takeover and legal protections/systems whereas the internal governance mechanisms would include a board of directors and most important is ownership. Across the world, Family businesses are probably one of the most important contributors to wealth and employment creation. Family Businesses are the main source of economic wealth creation in most economies [34].

In line with the OECD Principles, the Saudi government has issued the Corporate Governance Regulations (CGRs) in order to reform the listed companies and enhance market integrity. The CGRs stipulated that; "These Regulations include the rules and standards that regulate the management of companies to ensure their compliance with the best governance practices that would ensure the protection of shareholders’ rights as well as the rights of stakeholders [35].

6.4 Required Remedies

There are some remedies that should be taken under consideration by family business owners to ensure their businesses continue successively through successive generations.

6.4.1 Legal Restructuring:

The legal status of the company is considered as one of the leading causes for the continuity of the company and its survival. Turning the FOBs into a closed joint-stock company or transferring its form to a public joint-stock company, with putting its shares for a public offering, is essential [36].

Given the importance of corporate governance, Abdullah M. Al-Zamil, chief executive officer of Zamil Industrial, which is one of the largest family-managed and owned diversified groups in Saudi Arabia, said that “More family-owned businesses are focusing their attention on the implementation of more proficient corporate governance.” Despite that, but he also added that “Saudi family-owned businesses are slowly moving towards the implementation of a truly professional corporate governance regime, a business reality not known some thirty to forty years ago [37].

6.4.2 Mitigating Concentrated Ownership and Control

In the FOBs, for a good performance of family businesses and to ensure the survivability of the family businesses, ownership should be integrally separated from the other dimensions in the governance within the business. In addition to this family relationships must be managed, picking and promoting the right members of the family, providing attractive opportunities to managers from outside the family and demonstrating even-handedness in training, promoting, compensation and benefits [38].

The separation of ownership and management aims to establish an institutional framework for the family company. Hence, the owners and their family can exercise their competences according to the company system. This procedure prevents family members from surpassing his/her specializations into the company, either this member was the owner, manager, or even if he/she is chief executive [39]. The culture of separated ownership is still underdeveloped in Saudi Arabia. The concentration of ownership and control in the hands of controlling wealthy families is still prominent, whether in the private or in the public corporations. Consequently, the ownership structure is one of the most obstacles that may hinder the practical application of sound corporate governance in the Saudi marketplace.

6.4.3 Family-Owned Businesses Constitution

The family constitution known as family rules, regulations, doctrine, and charter, which must be respected by all the family members, the form of family constitution varies from one family company to another depending on the needs, goals, size, and structures of the company [40]. However, it is essential that the family constitution should demonstrate family values, mission, and vision. Defines shares ownership's rights, shareholding policies, and family member's employment policies, [41] a family constitution can involve a set of provisions dealing with crucial issues facing business growth and stability, for example, the demise of founder or any member, succession planning issue, risk management, and tax payment issue [42].
6.4.4 Family-Owned Businesses Institutions

6.4.4.1 Family council
The family council is a forum to consider the complex issues facing the family in business. Like the board of directors on the business side, the family council is concerned with policy and planning issues for family business, but it looks at these issues from the family's perspective. For example, the question of whether to reinvest profits or distribute dividends is a relevant issue for the family council because the business is operated in substantial part to benefit the family. Input from the family council on this issue can help the board make a decision that is good for both the family and the business. The challenges facing the family in business are immense, especially as both the business and the family grow. The family council, like the board of directors, can assist the family in finding workable solutions to the complex problems that arise when the family is in business together [43].

6.4.5 Board Structure and Its Members
A Board of Directors is a group of individuals who are either elected or appointed to oversee the operations of a business. The role of the Board of Directors is to understand the goals of the business and to make important decisions on behalf of business, always keeping the best interests of the business in mind. A family-owned business is not always required to have a Board of Directors, but many family businesses are large enough to warrant a Board of Directors. The benefits of having a Board of Directors are numerous. A Board of Directors allows a family-owned business to establish boundaries and to create a defined line separating the family dynamic from business operations. The Board of Directors should include individuals other than the company’s majority shareholders, President, Chief Executive Officer, or people who are in any other prominent position in the business [44].

6.4.6 Disclosure and Transparency
Transparency being the heart of corporate governance will minimize any information-gap and would promote greater efficiency and lead to higher economic growth of the business. The application of corporate governance transparency by family businesses would help reduce corruption and misuse of resources. Transparency would be achieved in family businesses by adhering to the family constitution, its policies, regular disclosure of liabilities and assets to all the stakeholders etc. In short, principles of corporate governance will have to be followed in letter and spirit to ensure transparency within the business. In case the family business can achieve transparency to an extent, the business will continue to grow [45]. The disclosure requirements in Saudi Arabia associated with stakeholders could not be suitably analysed, there were substantial weaknesses identified, particularly in relation to non-financial disclosure, and issues such as conflict of interest by brokers and rating agencies have not been implemented at all.

7. Conclusion
Although the performance of family-owned businesses has been widely addressed by many researchers, prior studies have mainly focused on the context of developed countries that have many institutional similarities to the U.S., the U.K., Canada, Germany, and Japan. Limited studies have been conducted in the context of emerging market economies although family ownership in emerging countries is common. Hence, any current evidence provides an insight into family businesses in the emerging economies, and Saudi Arabia is valuable.

Furthermore, numerous studies revealed that family firm performance is substantially influenced by the decision of whether to have family or non-family members in the company ownership structure, supervisory boards, management positions, and the identity of their potential successor and other block holders. Surprisingly, there is an apparent lack of research addressing issues relating to such decisions in the context of the Arab World and particularly Saudi Arabia. Hence, a gap in the empirical perspective regarding the family impact on firm performance has existed, and more studies are called for to investigate the factors that may affect Saudi family-owned businesses’ performance and their long-term survivability.

References


[29] Article (2) of Saudi Corporate Governance Regulations, 2016.

[30] Article (1-a) of the SCGRs which states that "these Regulations include the rules and standards that regulate the management of joint-stock companies listed in the Exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders rights as well as the rights of stakeholders." It is available at http://www.cma.org.sa.


