Article

Legal Recognition of Family Companies

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December 20, 2012

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This article basically deals with the various aspects of family companies especially emphasizing on the lifting of the veil of incorporation in case of such companies. It also highlights the pros and cons faced in the operation of a family company.

1. DEFINITION

Though a clear definition has not been devised for describing a family company, based on studies it can be identified as a corporate entity that was founded by several members of one or more families, where the members or their descendants maintain significant ownership interest and commitment towards the overall welfare and continuity of the business[1]. It is a company where one or more families having family ties, relationships and solid alliances own the majority of the capital and are responsible for the governance and management of the business.

A firm is said to be family-owned if a person is the controlling shareholder; that is, a person (rather than a state, corporation, management trust, or mutual fund) can garner enough shares to assure at least 20% of the voting rights and the highest percentage of voting rights in comparison to other shareholders[2].

In a family owned business, the family members are economically dependent on each other and the success of the business is directly related to the quality of relationship existing between the family members. Moreover, the family members also intend to keep the business continuing by handing over the ownership, control and management to the second generation subsequently.

However, a family company is not limited to engaging family members only and non-family members can also be employed for the effective control and management of the affairs of the company. In fact it is in the interest of the company that non-family members be employed so that they can contribute in the decision-making process in a rational, unbiased and practical manner keeping only the company's welfare as their foremost objective and preventing individual interests to take priority over the company's interest.

2. CHARACTERISTICS AND FEATURES OF A FAMILY COMPANY

[1] Legal Aspect of Acquiring Family Companies-Part I

[2] Chakrabarty, S (2009) The Influence of National Culture and Institutional Voids on Family Ownership of Large Firms: A Country Level Empirical Study ,Journal of International Management

A family owned business being controlled and managed by the family members themselves, is characterized by the added advantages of trust, loyalty, common values, mutual understanding among all the members, need for development of the business for the welfare of future generations as well for the continuity of the business and lastly either no or minimal interference from external sources[3]. Moreover, a kind of 'familiness', i.e. presence of unique capabilities, persists among the family members which is reflected in their manner of conducting business.

Fiduciary Duty

In the case of *Sangramsinh P. Gaekwad & Ors v. Shantadevi P. Gaekwad*[4], one of the issues which came for consideration was the fiduciary duty owed by the directors towards the company and the individual shareholders thereof. In this regard, several decisions were relied on by the learned counsel, one of them being *Peskin and Anr. v. Anderson and Ors.*[5], where in the Court of Appeal placed further reliance on the judgements delivered in *Coleman v. Myers*[6] and *Brunninghausen v. Glavnics*[7] respectively where the following observations were made stating that:

> *"though the directors do not have any fiduciary duty towards the shareholders as per the facts and circumstances of the matter, however such duties may arise in special circumstances demonstrating the salient features and well-established categories of fiduciary relationship such as agency which involves duties of trust, confidence and loyalty."*

In both the cases of *Coleman*[8] as well as *Brunninghausen*[9], it was held that the fiduciary duties of directors to the shareholders exist in the especially strong context of the familial relationships having regard to their personal position of influence in the company concerned.

Thus one of the aspect in which a distinction arises between a normal company and a family company is the fiduciary duty owed by the directors to the company as well as the individual shareholders due to the close association existing amongst them.

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[3] The Cultural Determinants of Success in Family Owned Business
[4] *Sangramsinh P. Gaekwad & Ors v. Shantadevi P. Gaekwad,* http://www.indiankanoon.org/doc/1740339/
[5] [2001] 1 BCLC 372
[6] [1977] 2 NZLR 255,
[7] (1999) 46 NSWLR
[8] See *supra* Note 6
[9] See *supra* Note 7

3. LIFTING OF CORPORATE VEIL: QUASI-PARTNERSHIPS AND FAMILY COMPANIES

In India, a company incorporated under the Companies Act is essentially a body corporate. However, it is also a well-established fact that nowadays more companies are being formed which are in the nature of a quasi-partnership i.e. they are formed as a company consisting essentially the characteristics of a partnership concern to avail especially the benefit of limited liability.

Defining the term 'quasi-partnership', it has been accepted judicially in Ireland in the matter of *Re Murphs' Restaurant*[10] that, where there exists between the participants such *"a relationship of equality, mutuality, trust and confidence between them which constitutes the very essence of the company" on the basis of which the participants constitute a joint venture, they may regard themselves by reason of this relationship "as equal partners in a joint venture, and that the company was no more than a vehicle to secure a limited liability for possible losses and to provide a means of earning and distributing profits to their best advantage with minimum disclosure".*

Similarly, a company can be a family company and the principles applicable to it have to be differentiated from that governing a normal company. The Court has made a clear distinction between a family company, a private company and a public limited company[11]. It was observed by the Apex Court that the true character of the company, the business realities of the situation should not be confined to a narrow legalistic view[12].

There are certain situations where the courts have to adopt the doctrine of 'lifting of corporate veil' to determine the true nature and character of a concern. The various grounds on which the doctrine can be adopted may be 'evasion of obligations', 'protection of public interest', 'abuse of corporate form', 'countering fraud, sharp practice and oppression', 'disguise of the controlling hand' and 'substance over form doctrines'. Applying the doctrine of *'substance over form'* the court may adopt the approach of 'lifting the corporate veil' when it is under an apprehension that a company is actually a quasi-partnership or a family company. In case of a company being a quasi-partnership, it is directed to follow the principles of a partnership firm only. Depending on the nature of the case, the principles

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[10] [1979] I.L.R.M. 141 (H.C.)
[11] See *supra* Note 4
[12] *Needle Industries (India) Ltd. and Ors. v. Needle Industries Newey (India) Holding Ltd. and Ors.* (1981) 3 SCC 333

of dissolution of partnership may apply if the apparent structure of the company is not the real structure and on piercing the veil it is found that in reality it is a partnership[13].

In the same matter[14], Ray J. rightly summarized the entire legal position with regard to the application of the partnership principle to quasi-partnership concerns as under:

> *"The dissolution of partnership principle has been applied to companies either on the ground of complete deadlock or on the ground of domestic or family companies. In the domestic or family companies courts have applied the dissolution of partnership principle where shareholdings are more or less equal and there is ousting not only from management but from benefits as shareholders."*

However, it was further observed in the same that when more than one family or several friends and relatives together form a company and there is no right as such agreed upon for active participation of members were sought to be excluded from management, the principles of dissolution of partnership cannot be liberally invoked.

The observations in the above case was based on the landmark decision in Ebrahimi's case[15] where the company which was first formed by the two erstwhile partners, Ebrahimi and Nazar, was joined by Nazar's son, George Nazar, as the third director and each of the two original shareholders transferred to him shares so that the Nazars i.e. father and son had a majority of the votes in general meeting. Until the dispute all the three remained directors. Later on an ordinary resolution was passed by the company in general meeting by the votes of Nazar and George Nazar removing Ebrahimi from the office of director. That led to the petition for winding up before the court. The House of Lords in this case allowed the petition applying the principles of partnership. The basis of such decision was that there was a prior partnership between the only two members who later on formed the company.

Apart from quasi-partnerships, the principles of partnership was also sought to be applied to concerns in the nature of family companies. For instance in *Atul Drug House Ltd. v. Unknown*[16], a petition was filed for the winding up of the company under section 433(f) of the Companies Act, 1956. It was contended by the petitioner that the concern being in the nature of a small family concern should be

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[13] *In Re Hind Overseas (Private) Ltd. v. Raghunath Prasad Jhunjhunwalla and Anr.* AIR 1976 SC 565;
[14] Ibid.
[15] *Ebrahimi v. Westbourne Galleries Ltd.* [1972] 2 All E.R. 492 (H.L.), see also *Loch and Another v. John Blackwood Ltd.* [1924] AC 783
[16] 1971 41 Comp Cas 352 Guj.

treated as a quasi-partnership and the principles of dissolution of partnership should be applicable for the winding up of the same. However, the Hon'ble Court stated that the concern was not formed on the usual partnership pattern since the small family concern ceased to be so due to subsequent capital participation by a public limited company. Thus, it refrained from applying the principles of partnership and held that even assuming that this is a small, domestic, family concern which can be treated as a quasi-partnership; the partnership principle could never be invoked for dissolution because this is not a case where any irresoluble deadlock is suggested. Therefore, the petitioners would have ample remedies under section 397 and 398 on the very facts which are sought to be alleged in this petition to get adequate relief.

Thus, on the basis of the above judgment, it can be rightly interpreted that apart from being a family concern; there should be an irresoluble deadlock to apply the principles of partnership for the dissolution of a family company. Moreover, in situations where alternative remedy for obtaining relief is available, the court will not resort to winding up of a company especially when the company is still a solvent and going concern[17].

The doctrine of lifting the corporate veil can be applied only when proper grounds for doing so are established. To elaborate, in the case of *Hashem v. Shayif & Anr.*[18], several cases were relied on to support the "no lifting unless façade" approach.In his lengthy and detailed judgment, Munby J. in this case considered the issue of whether the wife can pierce the corporate veil to make good the claim that the entire company and its assets are in reality part of the available pool of assets for financial provision. The claim was rejected partly on the grounds that the other shareholders, although submissive, were not merely ciphers for the husband and the wife could not demonstrate any impropriety that required incorporation to be ignored. The only way in which the veil can be lifted is by proving the existence of a facade. Agency-type arguments (such as "the company so habitually acts according to the wishes of the defendant that it is should be treated as an alter-ego") are not sufficient to lift the veil because of the element of "impropriety".

4. ADVANTAGES AND DISADVANTAGES

4.1 Advantages

[17] *Atul Drug House Ltd. v. Unknown, supra* Note 16.
[18] [2008] EWHC 2380 (Fam)

The involvement of close family relations in a business has various advantages attached to it for the growth and success of the business. The advantages of running a family business are listed below:

i. A strong support from the family due to a common goal shared by them for the success of the business and the maintenance of their legacy through the family company;
ii. A better understanding leading to quick decision-making and effective utilisation of the resources;
iii. The ability to think long term with a view to stabilize the future generations;
iv. High levels of trust at all levels of the organization.

4.2 Disadvantages

All kinds of businesses have to face certain challenges during their lifetime. Similarly, a family owned business is not an exception and does face challenges. The following challenges faced by a family company are listed below:

i. The assumption by the family members that the past success of the business will also guarantee the future success;
ii. Decision-making is based more on emotional and subjective basis rather than on an objective basis;
iii. Initially there is a lack of professionalization among the family members in conducting the affairs of the business;
iv. The families find it difficult to dispose off unproductive assets which might be due to personal attachment with the same;
v. There are greater chances of conflicts arising among the family members on various grounds which have an adverse effect on the personal as well as professional front;
vi. The lack of opinions from outside limits for the operations of the business;
vii. Lack of proper succession planning and absence of professional training to the future generations can hinder the growth of family business in the long term.

5. CONCLUSION

Family companies form an important part of the economy in all the countries. The only difference that can be felt through the countries is the diversity in culture which influences the operation of family

companies. For example, the culture of the western countries being different from the Asian countries can be felt in the management of companies. Also, it has been observed that the success achieved initially by the family companies sometimes tends to deteriorate with the successive generations due to inter-generational differences and the different methods of working. The legal issues involved in the governance of family companies and the principles to be adopted by them differ significantly and cannot be avoided for the sake of convenience. To ensure the same, the courts have also played an important role by adopting a strict approach towards family companies and shall continue to do the same in all fairness.