

Exploring the Interplay of Corporate Governance, inter-generational Inheritance, and Innovation Strategy Driven by Socio-Emotional Wealth

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Abstract:

As an important part of the global economy, family firms, with their unique dual logic (family logic and corporate logic), exhibit significant features in their organizational forms and development paths. This study takes family firms as the research object, focusing on the interaction of its dual logic and their impact on the relationships between corporate governance, inter-generational inheritance, and innovation strategy. Through literature analysis, case studies, combined with domestic and international classic literature such as socio-emotional wealth theory and incomplete contract theory, this study reveals the characteristics of family firms in terms of concentration of ownership, closure of inter-generational inheritance, and innovation decision-making. It is found that socio-emotional wealth (SEW) is a core driver of family firms' decision-making, but it may also inhibit innovation and external resource integration; balancing this tension is therefore critical. The conclusion suggests that family firms need to optimize their shareholding structure, establish a compensation mechanism for SEW, and progressively open up their operating rights to achieve sustainable development.

Keywords: family business, dual logic, socio-emotional wealth (SEW), inter-generational transmission, corporate innovation

1. Introduction

As one of the important subjects of global economic development, the unique organizational form of family firms has long received academic attention.

Existing studies have revealed the basic features of the dual logic (family logic and corporate logic) of family firms from several dimensions, such as the family-firm system interaction theory proposed by Kepner and the socio-emotional wealth (SEW) theo-

ry developed by scholars such as Gómez-Mejía. However, there are still three notable gaps in current research: first, insufficient exploration of the peculiarities of family firm governance in the context of emerging markets; second, a lack of systematic analysis of financial constraints in inter-generational inheritance; and third, inadequate in-depth research on the mechanisms through which dual logic dynamically affect firm innovation. This paper focuses on the duality of family firms' organizational form and addresses the following specific directions: (1) the characteristics of dual logic in governance; (2) the current status of high concentration of the 'three powers' (ownership, control, and management) under family logic; and (3) the impact of family logic on corporate innovation. In terms of research methodology, the literature analysis method is used to sort out the theoretical lineage, combined with case study method (e.g., Samsung Group shareholding structure) to support it, and the institutional theory is used to analyze the impact of different market environments. This study has theoretical value and practical significance. Theoretically, it deepens understanding of the unique characteristics of family firm governance by integrating resource dependence theory and incomplete contract theory. Practically, it offers recommendations on inter-generational inheritance and innovation management for family firms in emerging markets and provides a basis to develop targeted service programs. The findings will help predict the transformation path of family firms in the digital era and provide new ideas for the design of hybrid governance models.

2. The Duality of Organizational Forms in Family Firms

2.1 An Understanding of the Dual Logic

Organizational Dynamics, for the first time, explicitly regarded the family and the firm as two independent but interacting systems, proposing that the family system emphasizes emotion, loyalty, and long-term relationships (family logic). In contrast, the firm system pursues efficiency and competition (firm logic). Families are bound by blood, emphasizing emotional ties, inter-generational inheritance, and the allocation of resources according to proximity. The *Bind that Ties: Socioemotional Wealth Preservation in Family Firms* [2] elaborates more deeply on how emotional and reputational elements of family logic influence corporate behavior from five dimensions, causing firms to deviate from the dominance of economic goals. Corporate logic is rooted in market efficiency: it pursues the 'performance' doctrine, emphasizes the separation of powers and checks and balances, and realizes power distribution through institutions such as the board

of directors, the supervisory board, and other governance bodies.

Adam Smith, in his 1776 work *The Wealth of Nations*, argued that corporations are profit-seeking 'economic beings'. The logic of business was initially equated with the logic of economic efficiency, driven purely by market demand. With market evolution and the advancement of market-related theories, corporate logic has become institutionally embedded. As Thornton, P. H., & Ocasio, W. argued in their 1999 work *Institutional logic and the Historical Contingency of Power in Organizations* [3], corporate logic are shaped by institutional logic embedded in industry, history, and culture.

2.2 Interaction between family logic and corporate logic

A family firm integrates family logic and firm logic: the former encompasses blood ties, emotion, and inheritance, while the latter includes competition, efficiency, and profit maximization, with the two influencing each other.

To cope with market competition, when the founder or their second and third generations cannot meet the demands of enterprise expansion, many family firms choose to hire professional managers. In strategic decision-making, family members may not be able to make actual decisions due to emotional distrust, etc. In a quantitative study on family trust and agency costs, Verbeke & Kano analyzed 389 family firms and found that family members' distrust of professional managers increased agency costs by 28% [4].

Family firms are prone to the phenomenon of "privileged positions". The relative skewing of resources and the possession of super-position descriptions of authority lead to higher management costs and lower efficiency for professional managers. Bennedsen, M., et al. analyzed privileged positions in Chinese family firms in 2015, and concluded that the average management efficiency decreased by 29%. [5]

Family logic pays more attention to inter-generational inheritance, protection of social sentiment, adoption of long-term strategic choices, and extreme risk aversion. When professional managers are introduced, they may diversify their investments for the sake of performance during their tenure, with the risk of short-sightedness.

China's financial and corporate governance system is characterized by a "hybrid system" that is different from the bank-dominated system in Germany and Japan, as well as the fully market-oriented system in the UK and the US. It can be categorized into a legally guaranteed basis for market competition and the actual dominance of the banking system. The logic of such system-embedded enterprises has a profound impact on family businesses. In the inter-generational inheritance of family firms, banks'

trust in the founder cannot be transferred to the second generation, who have not yet established a strong business track record. Consequently, banks reduce the firm's credit limit, leading to higher financing costs and stricter guarantee requirements.

3. Status of the high concentration of the three powers of the family business under the family logic

3.1 Familialization of ownership

3.1.1 Ownership

Business ownership is the attribution of residual control and residual claim rights over the assets of a business-. Its essence is the two elements of key decision making and earnings distribution rights. Alchian, A. A., & Demsetz, H. argued in their 1972 work *Production, Information Costs, and Economic Organization* [6] that residual control is the core of business ownership. On the other hand, residual claims exist in relation to residual control. Alchian & Demsetz, meanwhile, suggest in *Production, Information Costs, and Economic Organization* that firms are products of team production, and that supervisors need incentives to supervise effectively—linking residual claims to organizational efficiency [6].

3.1.2 Familialization of Ownership

In the early stages of the creation of family firms, which tend to be small and monopolized at the top of the company by the founder's immediate family, the residual control and residual claim rights of the company are absolutely controlled in the family. When the enterprise progresses and expands, some enterprises refuse to go public to ensure that the family's interests do not flow out of the company, and at the same time to ensure that the residual control and residual claims are centralized; while others choose to go public, adopting the model of centralized residual control and decentralized residual claims.

Listed family firms generally keep residual control within the family through equity design.

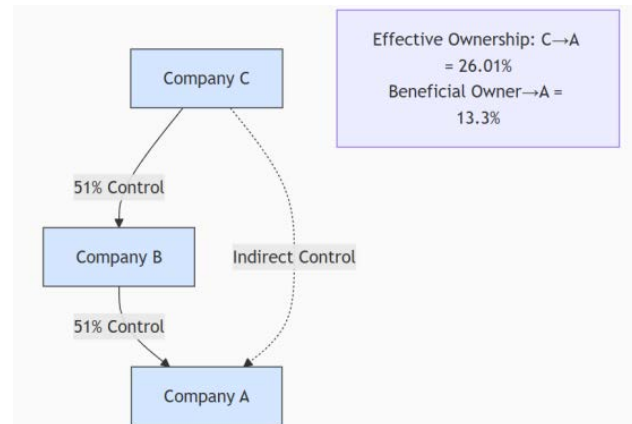


Figure 1. Shareholding Structure of Companies A, B and C

The beneficial owner's 51% stake in Company C passes the relative control threshold for Company C, which generally allows it to have decision-making power born in Company C as shown in figure 1. Company C owns 51% of Company B, which generally gives Company C effective control over Company B. Company B in turn owns 51% of Company A, which gives Company B 51% of the voting power in Company A. The beneficial owner's 51% stake in Company A gives Company B absolute control over Company A. Company B owns 51% of the voting power in Company A. The beneficial owner, through the chain, obtains absolute control of Company A with $51\% \times 51\% \times 51\% = 13.3\%$ of the effective shareholding in Company A.

Different family members have shareholding control of the business branch (generally $>50\%$), and the rest of the family members are involved in shareholding in that business, ensuring both independent control of the members and control within the family. Each family member may set up their own holding companies, and the holding companies of different family members hold shares in each other, which to some extent solves the problem of equity dispersion in inter-generational inheritance, and is always in the hands of the core controllers.

Under the pyramid structure, although the actual controller of Company C obtains the absolute control of Company A, the actual dividend right for Company A is only $51\% \times 51\% \times 51\% = 13.3\%$, and more risks are borne by external shareholders. In the process of preparing for the listing of the family business, venture capital, private equity and other strategies may be introduced to actively dilute the equity in exchange for capital injection, and the remaining ownership is decentralized. Because start-ups possess greater risk, investors may demand preferential dividend rights on top of a certain amount of stock, with priority dividends after the business becomes profitable. However, the founding family can still take control through special equity structures such as AB shares.

Listed family firms may achieve a win-win situation at the expense of dispersing residual ownership through a system of equity incentives that exchanges residual claim rights for talent motivation. A technology company has distributed virtual shares (with dividend rights but no voting rights) to 100,000 employees, with an annual dividend rate exceeding 20%. The company generates hundreds of billions of RMB in revenue, and the founder—who holds less than 1% of the company’s shares—has received hundreds of millions of RMB in dividends.

Among the listed family businesses, the trend is to firmly grasp control and decentralize claiming rights. South Korea’s Samsung holds on to its subsidiaries, such as Samsung Electronics, through a pyramid chain. The Lee family, led by Lee Jae-yong, holds only 17.3% of Samsung Physical Products, but relies on voting proxies from the National Pension Service (NPS), and a unanimous agreement on table resolutions with Samsung Fire & Marine Insurance through a cycle of shareholdings to keep about 34.5% of the actual voting rights under control. At the same time, through a cross-shareholding, Samsung Property & Casualty directly holds 19.3% of Samsung Life’s shares as the largest shareholder. Samsung Industrial receives 4.5% of the voting rights from the National Pension Fund and proxy parties such as small and medium-sized shareholders, 2.1% of the voting rights through a concerted action agreement, 0.6% of the voting rights from convertible bonds, and 2.6% of the voting rights from hidden coercion relying on commercial hegemony (e.g., in the case of Naver, a supplier to Samsung Life, if Naver refuses to pay the price of the bonds, Samsung Life will be able to control the voting rights of Samsung Life’s shareholders. supplier Naver, if Naver refuses to entrust its voting rights to Samsung Property, it may lose 7% of its annual revenue), which together constitute Samsung Property’s control over 29.1% of Samsung’s life. In actuality, Samsung’s dividend rights over Samsung Life amount to only 19.3% of its direct shareholding. Samsung Life directly holds 8.5% of the shares of Samsung Electronics, and through the escrow account of small and medium-sized shareholders to get 2.1% of the proxy voting rights, the potential control of convertible bonds “coercion” 1.3%, at the same time, Samsung Life will be part of the premiums invested in the Hong Kong SPV, which holds preferred shares of Samsung Electronics, through the offshore structure. Samsung Life holds 0.8% of the voting rights of Samsung Electronics. In addition, Samsung Life also got 17.3% of the voting rights by signing an agreement with Samsung Fire to control the voting rights and receiving NPS to hold the voting rights of Samsung Electronics. And the Lee family also directly holds about 0.7% of Samsung Electronics. Adding up, Samsung Life owns $8.5\% + 2.1\% + 1.3\% + 0.8\% + 0.7\% = 12.7\%$ of the voting rights through leverage, while actually own-

ing only 9.2% of the dividend rights of the directly held portion of the shares. Thus, the family controls $17.3\% + 12.7\% + 0.7\% = 30.7\%$ of the actual voting rights with $17.3\% * 19.3\% * 8.5\% + 0.7\% = 1\%$ of the actual holdings in this single holding chain.

3.2 Inter-generational transmission and closure of the right to operate

3.2.1 Right to operate

In the direction of economics, the right to operate is considered to be the same as the right to residual control, which is essentially the right to make decisions on pending matters. In classical enterprises and some family businesses, the owner and the operator are the same person, with the two powers highly unified. With the development of the modern enterprise, the separation of ownership and operation was first proposed by Berle, A. A., & Means, G. C. in 1932 in *The Modern Corporation and Private Property*. [7] This separation established the concept of “the right to operate”, which refers to “the actual power to make decisions on pending matters”. The operating right is defined as “the actual power to select the members of the board of directors or a majority of them”. In the jurisprudence, the management right is a “transferred power”, which is written in the rules and regulations, and there is a gray area of the right to transgress the boundaries of the pending matters. In the managerial field, the right to operate is more of a dynamic game, and the one who has more resources actually has the right to operate. In 1978, Pfeffer & Salancik proposed the Resource Dependence Theory in *The External Control of Organizations: A Resource Dependence Perspective*. This theory breaks with the traditional view that power resides in positions and suggests that “an insider’s ability to control the flow of key resources determines their actual operational power [8].

3.2.2 Inter-generational Inheritance of Family Business Management

inter-generational inheritance is not only the alternation of power and resources, but also the transmission of family culture, and its smooth inheritance is directly related to the survival of the enterprise. Gómez-Mejía and other scholars proposed the Social Emotional Wealth (SEW) theory in 2007, which departs from the traditional economic perspective. SEW analyzes family business decision-making from more diversified aspects [9]. For inter-generational inheritance, SEW theory suggests that the inheritance of family business is essentially a rebalancing of the family’s emotional utility and the economic value of the enterprise. In the process of inheritance, family firms tend to give primary consideration to blood relationship rather than the management ability of the second generation of succes-

sors.

According to the way of inter-generational inheritance, it can be roughly divided into the following types:

Vertical inheritance: In traditional family businesses, which generally follow the principle of “the son inherits the father’s business”, direct descendants directly inherit the right to operate, with the right to operate and ownership transferred simultaneously. This model refuses to introduce high-level talents, features higher decision-making efficiency, but places great demands on the management ability of the second generation and easily ignores the development opportunities of non-family members. Generally, the founder will use the relationship network to escort the second generation in the early stage of succession and realize the external invisible resource alternation.

Introducing professional managers for transition: In order to solve the challenge of ensuring both emotional wealth priority and efficient management in inter-generational succession, the choice is made to introduce professional managers to temporarily take up core positions such as CEO during the growth period of the family heirs. Mao Lixiang, founder of Fotile Group, realized that his heir Mao Zhongqun lacked management experience and thus first chose to introduce professional managers as general managers. This allowed Mao Zhongqun to eventually take over the CEO position after six years of training, which included further study abroad and internal rotation within the group

Full externalization mode: family members only act as shareholders, control the board of directors, or through the design of the equity structure, the actual control, the remaining control is held within the family, the right to operate to the professional managers. Stephen Ross in 1973 for the first time to put forward the “principal-agent” term, and define the relationship between the two sides. Stephen Ross first introduced the term “principal-agent” in 1973 and defined the relationship between the two parties [10]. In traditional family firms, economic efficiency is not the primary purpose and the SEW goal is to maximize non-economic benefits, while the agency theory produces the goal of maximizing firm value and achieving economic benefits, and the two play with each other. In 2012, Berrone et al. surveyed 348 European and American firms and found that 74% of family firms still refused to bring in professional managers even when their performance was declining, due to concerns about SEW loss. Externalization mode is a major feature of traditional family firms towards modernization. Under the conditions of low SEW sensitivity and high institutional constraints (e.g., listed companies’ regulatory requirements on information disclosure, independent directors, etc.), the introduction of external professional managers can better enhance business operations.

4. The impact of family logic on corporate innovation

4.1 Positive impact

In the theory proposed by Gómez-Mejía et al. in 2014, it is described that families focus on inter-generational continuity and are willing to suffer short-term losses to invest in innovation. [11] Unlike professional managers who view their tenure as a fixed work period, family members are more likely to see the business as part of family continuity, reducing the risk of sacrificing long-term development for short-term gains during their tenure.

The overlap of ownership and operation rights reduces trust issues caused by cumbersome decision-making and complex approval processes, enabling more timely and innovative decisions aligned with development trends. (Compared with external personnel, family members are less likely to consider how innovative decisions will affect future profitability assessments of their own performance and abilities, thus making bolder decisions.)

Domestic family businesses have a tradition of passing on hidden formulas and process parameters, which are only passed on within the family business. In the Fujian Anxi Tieguanyin tea-making family, the secret of roasting fire is only passed on to the children, and the core fermentation technology is mastered by the son-in-law (and requires a three-year inspection period). Through the family internal records, it is more likely to ensure innovation on the basis of the unique formula and strong competitiveness.

4.2 Negative Impact

The right to operate a family business is closed, and the deployment of family members in important positions is an important means of actually mastering resources. However, it may lead to the exclusion of external talents and reduce the entry of innovative technology into the enterprise; at the same time, this initiative also produces a huge test of the innovation ability of the family successor. A jewelry company in Hong Kong has a R&D director who is a second-generation family member, and no new product has been launched in five years.

The non-economic rationality of family business SEW is prioritized. Family enterprises to protect the right to operate and control, may refuse external financing, resulting in insufficient funds, missing the transition wind. At the same time, in the original handicraft family enterprises, retaining backward production capacity and refusing technological change may be a symbol of “maintaining the ancestral business”, deliberately avoiding innovation. The SEW loss aversion of family firms is magnified by the possibility of innovation failure, and they are more conservative in terms of the family’s core information and

reputation.

5. Conclusion

The family characteristics of family enterprises are their unique identity, but also have relatively negative effects on the development of the enterprise. Among these, SEW is the core element shaping family characteristics, and balancing SEW and economic goals is the key to breaking the dilemma. In the face of this dilemma, the establishment of a SEW compensation mechanism is a solution to the problem.

Family enterprises can be financed by issuing shares and other behaviors, and at the same time, they can grasp the core control and ensure family influence by means of equity structure design, family trust or golden shares. In terms of introducing external talent, external executives such as professional managers may have stronger professional backgrounds than the family's second generation. However, to safeguard the family's core SEW, the board of directors can adopt seat-lock mechanisms and stipulate a minimum percentage of family members.

Family firms should appropriately bring in external talent to adapt to changes in market competition and set up systems to integrate and maintain family values with external talent. A commitment to upholding these values can be included in executives' employment contracts, and executives can receive ongoing education through daily values training. Additionally, values-aligned work behaviors should be incorporated into performance appraisal standards, with compensation linked to SEW indicators.

An early warning threshold for equity should be set; for example, if external shareholders hold more than 30%, an early warning is triggered, and part of the equity should be recovered. In terms of innovation sensitivity, specify the SEW loss threshold that can be borne each year, such as brand value fluctuation $\geq 20\%$, stop innovation programs. The realization of "patent moat" not only recovers the loss for innovation failure and obtains long-term income, but also lays out the market and interrupts competitors' innovation strategies.

This paper mainly adopts literature analysis and case study methods. While it can conduct in-depth analysis of typical phenomena, it lacks support from large-sample empirical data. Meanwhile, the samples in this paper have limitations: they are mainly drawn from cases in mature European and American markets and large East Asian enterprises, with insufficient coverage of small and medium-sized family firms and the specific characteristics of emerging markets. The research structure can be improved by expanding the research dimensions (e.g., increasing the comparative study of emerging markets, introducing digitized variables, etc.) or selecting the breakthroughs of empirical analyses (e.g., the test of the nonlinear relation-

ship between the family control ratio and enterprise value, and the construction of the SEW index). In the future, we can establish a three-dimensional analysis framework of "system-culture-generation", and focus on quantitative research in emerging areas such as digital transformation of family-owned enterprises and ESG practices, so as to deepen our understanding of family-owned enterprise innovation.

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