

NOTE

FAMILY BUSINESS SUCCESSION: APPROPRIATION RISK AND CHOICE OF SUCCESSOR

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Using a game theoretic approach and integrating research on managerial succession, family businesses, and transaction cost economics, we examine how the degree of idiosyncrasy of a family business and the ability of the family's offspring affect succession. Contrary to the popular belief that successors to family businesses are often offspring because of nepotism, we propose an economic rationale that this is due to the appropriation risk and the agency paradox that family businesses encounter in engaging agents.

Succession planning is crucial to the success and continuity of a business (Miller, 1993; Ocasio, 1999; Pitcher, Cherim, & Kisfalvi, 2000), particularly for family businesses, where few survive more than one generation (Birley, 1986; Kets de Vries, 1993). Nepotism is generally perceived to be the reason why families hand over their businesses to their offspring or close family members (Barach, Gantisky, Carlson, & Doochin, 1988; Beckhard & Dyer, 1983); however, "nepotism may prove a serious problem for the family firm" (Pollak, 1985: 215) and may not be in the interests of the firm's shareholders as a group (Barach et al., 1988).

Here we examine (1) the effects of specific human capital in the form of idiosyncratic knowledge and (2) the ability of prospective successors on families' successor choice for their businesses. We aim to provide an economic rationale based on transaction cost economics (TCE) to the succession phenomenon observed in family businesses. We formalize the arguments of TCE following the game theoretic approach to explicitly investigate the effect of specific human capital on the appropriable quasi rent (the difference between the value of an asset in its first best and next best alternative use [Klein, Crawford, & Alchian, 1978]) that arises when family businesses engage agents as successors for their businesses.

Our paper contributes to the literature in several ways. First, we propose an alternative explanation, based on asset specificity and appropriation risk (the risk associated with an incumbent agent's using the idiosyncratic knowledge of a business that he or she has acquired to demand a premium in compensation), to nepotism for the observation that families prefer to hand over their businesses to their offspring. Second, we identify that families may face an agency paradox when their businesses are highly idiosyncratic. Because of the paradox, families encounter a succession dilemma when their offspring are so poorly qualified that it will be detrimental to firm profitability and long-term survival to hand over the businesses to them. We establish the "seat warmer strategy" as a way for families to resolve the succession dilemma. Finally, we illustrate how the arguments of TCE can be formally analyzed by following a game theoretic approach to gain a more in-depth insight on the implications of transaction costs.

LITERATURE REVIEW AND MODEL DEVELOPMENT

Stylized Facts

Low survival rate of family businesses. The fact that very few family firms survive beyond

the first generation (Birley, 1986) is rather universal and independent of cultural context or economic/business environment (Lank et al., 1994). Research suggests that 30 percent of family firms in the United States survive into the second generation of family ownership (Birley, 1986; Kets de Vries, 1993) and approximately 15 percent to 16 percent survive into the third (Morris, Williams, Jeffrey, & Avila, 1997). The average life expectancy of family firms is estimated to be twenty-four years, which is also equivalent to the average tenure of their founders (Beckhard & Dyer, 1983). Most major overseas Chinese firms survive only as far as the second generation (Chu & MacMurray, 1993). There is even a popular Chinese saying that the third generation dissipates the family's fortune that the first creates and the second helps maintain (Weidenbaum, 1996). Similarly, there is also an English saying that most family businesses go from "clogs to clogs in three generations."

Family businesses often succeeded by families' offspring. Although the need to pass the reins of businesses to professional managers is generally recognized, especially when there is no suitably qualified family member, successors to most family businesses continue to be the families' offspring (Kirby & Lee, 1996). Sometimes, this takes place regardless of the ability of these successors to contribute to the businesses (Kets de Vries, 1993).

Family businesses often highly idiosyncratic. Family businesses are highly idiosyncratic (Williamson, 1979). Unlike in other firms, the institutionalization of the idiosyncratic knowledge of the business, which is a form of human-specific asset that arises from learning by doing (Klein, 1988; Williamson, 1979, 1981), tends to be lacking in family businesses. Hence, the idiosyncratic knowledge of family businesses is often individual specific rather than firm specific (Castanias & Helfat, 1991, 1992) and, indeed, may be accessible only to family members and trusted agents. The profitability of family businesses, therefore, often depends on the extent of idiosyncratic knowledge possessed by the heads of their businesses (Barach et al., 1988; Rosenzweig & Wolpin, 1985).

Such knowledge or assets include important personal business contacts and networks (Bruderl & Preisendorfer, 1998; Nooteboom, 1993b), the ability to garner the cooperation of the firm's workforce, and knowledge about the local con-

ditions (Pollack, 1985) and the internal operations of the family business (Nooteboom, 1993a)—all of which may be important for firm performance. For example, "Entrepreneurs often employ a personal network of long standing relations with trusted family, colleagues, accountants, customers, local politicians, suppliers or the bank" (Nooteboom, 1993b: 289), and such networks may be an entrepreneur's major asset (Bruderl & Preisendorfer, 1998). Therefore, it is important for a chosen successor to acquire such knowledge through exposure to the idiosyncrasies of the firm (Barach et al., 1988) and through working in all the major departments in the firm, just like other employees (Neubauer & Lank, 1998). Through these processes, a successor also will gain credibility and be accepted by key stakeholders of the family business (Osborne, 1991).

A Game Theoretic Model of Family Business Succession

In this section we describe the game theoretic model. The technical formulation and proofs for the propositions are available from the authors. We assume the following in deriving the equilibrium for our model.

1. *There is a competitive labor market.* There are competing outside agents (currently not in the employ of the family business) available to head the family business. Hence, there exists a competitive market rate in compensation for an outside agent. Thus, a newly recruited outside agent of uncertain ability and no idiosyncratic knowledge must be paid the competitive market rate. However, after being recruited, as he or she gains idiosyncratic knowledge of the business, the competitive labor situation is transformed into one of small numbers bargaining (Williamson, 1979) between the agent and the family. This implies that an agent who possesses idiosyncratic knowledge of the business and/or of known ability can therefore command a premium over the competitive market rate when engaged.
2. *Players are risk neutral.* For simplicity, we assume in our model that all the players are risk neutral and maximize their expected payoffs. However, we illustrate in our analysis that the essence of our results remains unchanged for players of varying risk preferences.
3. *Families are motivated to retain the ownership of their businesses.* Families are known to have gone to great lengths to keep their

businesses within their families (Kuratko, 1993; Numazaki, 2000; Weidenbaum, 1996). For this reason, and because our aim is to examine the phenomenon that a family business tends to be succeeded by the family's offspring, we focus on the case when the family does not consider the sale of the business.

4. *An offspring is less opportunistic compared to an agent.* Compared to an agent, a family's offspring is less opportunistic in general (Klein et al., 1978), because "both family loyalty and cultural norms limit opportunistic behavior" (Pollack, 1985: 590). Opportunistic acts against the family would be in violation of social customs and, hence, would result in sanctions by the family (Akerlof, 1980). Therefore, in our model we assume that an offspring is a price taker and needs only be paid the prevailing competitive market rate at any time.

We consider a four-stage sequential game played over two periods (Figure 1) to allow for intertemporal interactions. In Stage 1 of Period 1, an agent bargains with the family over the compensation or price level. In Stage 2 of Period 1, the family decides whether to appoint the agent or an offspring to head its business after assessing the agent's price demand. If the family decides to appoint the offspring, the game ends, with the offspring heading the business over the two periods. Otherwise, the agent is appointed for one period.

The incumbent agent then bargains with the family on the price in Period 2. Depending on the bargaining outcome, the agent decides whether to continue in his or her appointment in Period 2, while the family decides whether to extend or terminate the agent's appointment. In the latter event, the family employs an outside agent to head the business. Taking into account the exogenous bargaining power of the family vis-à-vis the agent, we apply the Nash bargaining solution concept to derive the bargaining outcome in price in Period 2. The agent maximizes the sum total of his or her compensation in both periods, while the family maximizes family wealth, which is the sum total of the business profit less the two-period compensation paid to the head of the business. Profit depends on the competency of the head of the business—that is, his or her ability and the extent of his or her idiosyncratic knowledge of the business.

According to the arguments of TCE, transaction costs vary, depending on the degree of asset specificity, uncertainty, and frequency of trans-

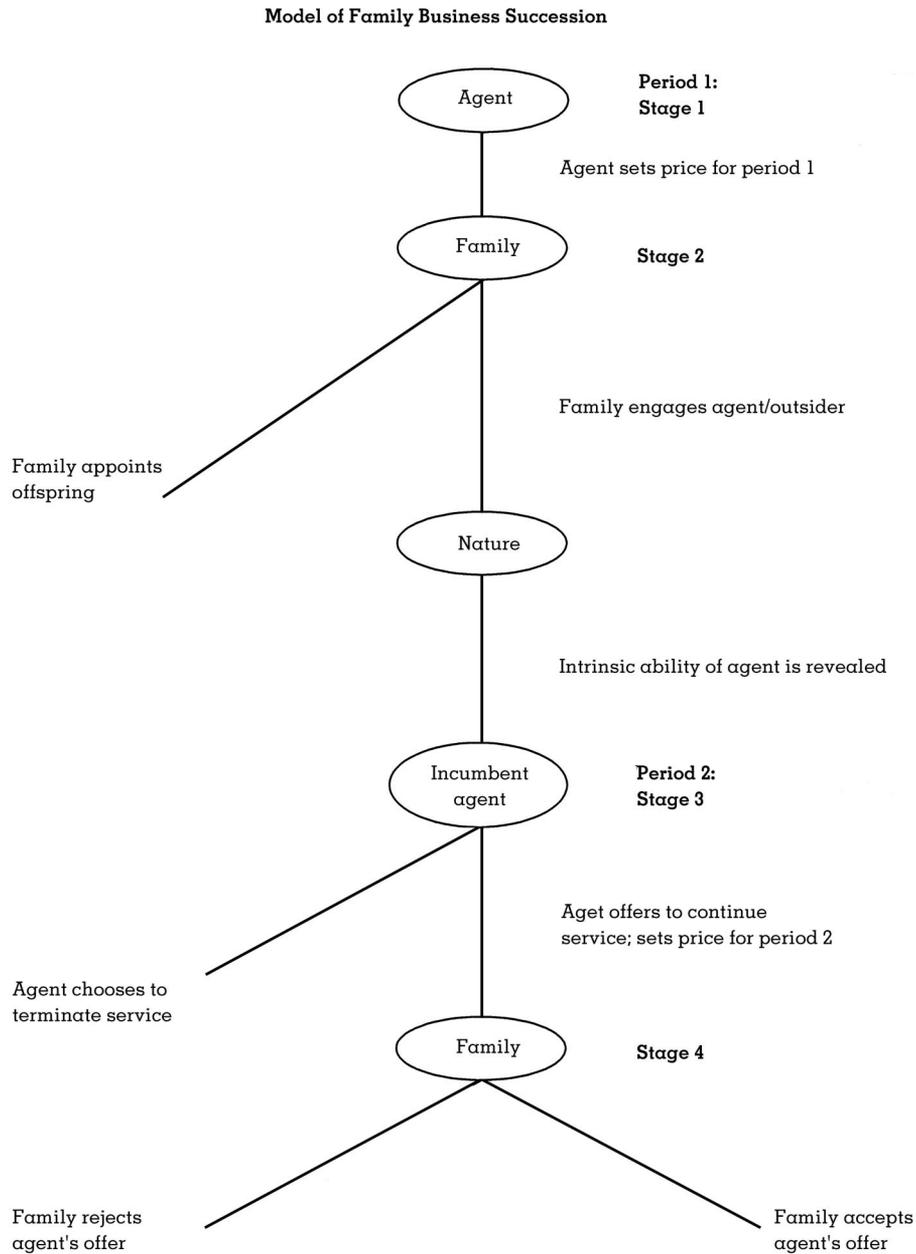
actions (Williamson, 1985). Because family businesses are highly idiosyncratic and the extent of a candidate's idiosyncratic knowledge depends on his or her accumulated business experience (Irwin & Klenow, 1994; Nooteboom, 1993a; Spence, 1981), we incorporate asset specificity in our model as a candidate's idiosyncratic knowledge of the business that is individual specific. This, plus a candidate's ability, which is exogenous, defines the individual's competency as head of the business. A candidate's idiosyncratic knowledge depends on whether he or she has been in the employ of the family business and the number of periods that he or she has been the head of the business (Pollak, 1985). As a candidate's idiosyncratic knowledge of the business increases, the candidate becomes more competent and business profitability increases. The firm's profit is therefore an increasing function of ability and idiosyncratic knowledge at a diminishing rate.

Uncertainty in our model arises because the ability of an outside agent is an intrinsic characteristic and, hence, may not be completely observable prior to recruitment (Spence, 1974). Compared to prior studies on successor choice (Osborne, 1991), here we examine how uncertainty in the ability of outside agents and idiosyncratic knowledge give rise to appropriation risk or transaction costs (Williamson, 1979, 1981) and, thus, affect succession in family businesses.

APPROPRIATION RISK

As with all sequential games, we apply backward induction to our analysis by examining Period 2 outcomes under all possible scenarios in Period 1. Since an offspring engaged in Period 1 will serve for two periods, we consider the consequences in Period 2—in terms of the appropriation risk to a family if an agent is engaged in Period 1—before examining the family's preferred choice of a successor in Period 1. We first consider the case in which the family knows the ability of its offspring but is uncertain about the ability of the outside agent prior to his or her recruitment in Period 1 (the agent's ability is revealed with certainty only in Period 2). We then examine the case in which, in Period 1, the family knows the ability of both the offspring and the agent, and in which the agent also possesses idiosyncratic knowledge of and/or industry-specific assets relevant to the family busi-

FIGURE 1
Model of Family Business Succession



ness. This is possible if the agent has been working for the family business, or in an industry related to the family business, for some years.

When the Outside Agent Engaged in Period 1 Turns Out to Be of High Ability

If an outside agent is engaged in Period 1, the family faces a cost in replacing the agent in

Period 2. This is because, as the incumbent agent, the individual has an advantage in idiosyncratic knowledge over outside agents. Hence, if the agent turns out to be of high ability, as long as he or she demands a premium no more than the additional benefit that he or she can generate for the business, compared to a replacement, the family will rationally accept the agent's demand. This premium increases

with the agent's bargaining power and represents the appropriation risk to the family that is limited only by the cost the family faces in replacing the agent.

Proposition 1: An incumbent agent of known high ability can demand a premium in compensation by exploiting both his or her advantage in idiosyncratic knowledge of the family business over outside agents and the risk in replacing the agent with an outside agent of uncertain ability.

Proposition 1 is consistent with observations made by several authors that an agent's power over pay is a direct manifestation of his or her social and human capital (Barkema & Pennings, 1998; Finkelstein & Hambrick, 1989) and that, although an agent with such idiosyncratic knowledge could increase business profit, he or she would also demand a premium over the competitive market rate (Harris & Helfat, 1997).

The essence of Proposition 1 remains unchanged, regardless of the risk preference of the players—in particular, that of the family business. Specifically, if the family is risk seeking (or averse), the additional benefit that the incumbent agent can generate for the business as compared to an outside agent with uncertain ability and no idiosyncratic knowledge is valued lower (or higher) but remains positive. This is because with an increased (or decreased) appetite for risk, the option of an unknown outsider is now less (or more) unattractive. Hence, although the family's valuation of the difference in benefits (which constitutes the premium that the incumbent agent can command) may change, depending on its risk preference, the difference and, hence, the incumbent agent's premium exist nonetheless.

When the Outside Agent Engaged in Period 1 Turns Out to Be of Low Ability

In this case, the family will still accept the continued service of the incumbent agent, rather than seek a replacement, if the agent's idiosyncratic knowledge is important to the performance of the firm. The incumbent agent, though of known low ability, may even be able to command a premium over the competitive market rate, since the ability of a new replacement is uncertain. However, if idiosyncratic knowledge

is not important to firm performance, the family is better off engaging another agent, with the upside potential of getting someone of high ability, rather than being stuck with an incumbent of known low ability. Hence, as long as idiosyncratic knowledge is crucial to firm performance and the ability of a replacement is uncertain, there is an appropriation risk, even if the agent is of known low ability.

Proposition 2: An incumbent agent of known low ability may secure his or her appointment because of his or her advantage in idiosyncratic knowledge of the family business over outside agents, and the agent may even command a premium in compensation.

Proposition 2 identifies one reason why there are instances in which nonfamily members hold key executive positions in family businesses, even though they may not be highly able or have the "right" qualifications (Weidenbaum, 1996; Zaudtke & Ammerman, 1997). These nonfamily members have risen through the rank and file over the years and, hence, have acquired substantial idiosyncratic knowledge of the family business that is important to firm performance.

When the Agent Engaged in Period 1 Is of Known Ability

We first note that the family will not knowingly engage an agent of known low ability and with little idiosyncratic knowledge. This is because the family will strictly prefer to appoint a low-ability offspring over such an agent, as long as the agent is more opportunistic than the offspring.

Suppose the agent considered is of known ability and has idiosyncratic knowledge that is family business specific (having been employed by the family business for some time) and/or industry specific. An agent of known high ability and who has idiosyncratic knowledge may command a premium over the competitive market rate when engaged. Subsequently, after being appointed, the agent can demand an even higher premium as his or her idiosyncratic knowledge further increases. For such an agent, an appropriation risk will similarly arise because of his or her advantages in idiosyncratic

knowledge and certainty in ability over outside agents.

Even if the agent is of known low ability, there is still an appropriation risk in engaging him or her, as long as the agent has idiosyncratic knowledge that is important to firm performance and there is uncertainty in the ability of a replacement.

The same argument for the presence of appropriation risk holds with an agent of known high ability but who lacks idiosyncratic knowledge. Hence, Propositions 1 and 2 remain unchanged when the agent is of known high and low ability, respectively.

The Agency Paradox Faced by the Family

The profitability of the family business improves when the family engages an agent of known high ability. However, a more able agent also will demand a higher premium in compensation over the competitive market rate in Period 2. Thus, the family will face a paradox in engaging an agent as head of its business.

Proposition 3: The family faces an agency paradox in engaging an agent to head its business; both profitability and appropriation risk increase with the agent's ability.

Proposition 3 implies that the family benefits only partially from an agent's idiosyncratic knowledge and/or ability, and the extent of this benefit depends on the family's bargaining power vis-à-vis the agent's. In the extreme case where the family has little power, the agent appropriates almost all gains derived from his or her idiosyncratic knowledge and/or ability. However, profitability may suffer if the business is handed to a low-ability agent. The agency paradox in engaging agents of known high ability and the risk to profitability in engaging outside agents of uncertain ability are therefore legitimate reasons why families are reluctant to appoint agents to key executive positions. This is especially so when idiosyncratic knowledge is crucial to business success (Rosenzweig & Wolpin, 1985), since appropriation risk increases with business idiosyncrasy.

SUCCESSION STRATEGY

We now examine how different abilities and idiosyncratic knowledge between the agent and

the offspring affect the family's choice of a successor. The family's payoff over the two periods is always greater if a high-ability offspring is appointed than if an outside agent of uncertain ability is employed. Obviously, in such a case, the family appoints the high-ability offspring.

Intuitively, we expect the family to engage an agent when the offspring is of low ability. However, faced with the agency paradox (Proposition 3), the family may be better off appointing the offspring, even over an agent of known high ability, if firm performance is highly dependent on the idiosyncratic knowledge of the head of the business.

Proposition 4a: The family strictly prefers to appoint a high-ability offspring to head the family business, regardless of the agent's ability.

Proposition 4b: The family prefers to appoint a low-ability offspring to head the family business, even over an agent of known high ability, if and only if idiosyncratic knowledge is crucial to business performance.

As Proposition 4b implies, families may still prefer to hand over their businesses to low-ability offspring if idiosyncratic knowledge is important to performance. Initially, profitability will suffer, but in the long run, if the business is highly idiosyncratic, profitability will be recovered as the offspring gains idiosyncratic knowledge of the business. Furthermore, there is no appropriation risk in future periods with the engagement of offspring. Proposition 4 is thus consistent with Pollack's (1985) views that the transaction costs arising from the incentive and monitoring advantages of family firms and family members' idiosyncratic knowledge of local conditions could explain why family and nonfamily labor might be imperfect substitutes.

Because family businesses are idiosyncratic to a high degree (Nooteboom, 1993b; Pollak, 1985), families are more likely to appoint their offspring as successors. Therefore, Proposition 4 provides an economic rationale, as opposed to any altruistic reasons, for why families often hand over leadership of their businesses to their offspring, even if those offspring are less competent than outside professionals (Weidenbaum, 1996). By doing so, families preempt the appropriation risk in engaging agents. Although

the reluctance of family businesses to engage outside talents might make them susceptible to having limited networks that could add significant value to their businesses, the recruitment of such talent would also present the families with the agency paradox.

Proposition 4 also implies that families prefer to appoint agents as successors under two scenarios. The first scenario is stated in Corollary 1.

Corollary 1: Families prefer to hand over their businesses to agents if their businesses are low in idiosyncrasy and their offspring are low in ability.

The second scenario is when the family business is highly idiosyncratic but the offspring is so poorly qualified that handing over the business to the offspring is clearly detrimental to the business's profitability and long-term survival. Under such a scenario, the family faces a *succession dilemma*: the appropriation risk is high if the business is handed over to an agent, whereas the survival of the business is threatened if it is handed over to a poorly qualified offspring.

Corollary 2: Families face a succession dilemma if their businesses are highly idiosyncratic but their offspring are poorly qualified.

With the succession dilemma, business survival requires that an agent be appointed as the successor. However, Proposition 4 states that a sufficiently qualified offspring, if available, should be appointed to take over the business. Hence, it follows that a family could resolve its dilemma by following the seat-warmer strategy—that is, appointing an agent temporarily and replacing that agent once a suitably qualified offspring is available.

Corollary 3: Faced with the succession dilemma, families could resolve the dilemma by following the seat-warmer strategy.

An agent engaged as a seat warmer may demand a premium in compensation if the individual knows that he or she may be replaced when a suitably qualified offspring is available. The agent may indeed be paid a premium if he or she is of known high ability. Otherwise, if the agent's ability is uncertain, he or she will be paid the competitive market rate in a competi-

tive labor market. However, after being engaged, as Propositions 1 and 2 imply, regardless of whether the agent's ability is uncertain or known prior to being appointed, he or she can demand an increase in compensation for continued employment as he or she acquires idiosyncratic knowledge of the business, thereby presenting an appropriation risk to the family. To resolve this, the family could replace the seat warmer with an offspring, once a sufficiently qualified offspring was available.

DISCUSSION AND CONCLUSION

Our analysis shows that if a family business is highly idiosyncratic, the family will prefer to appoint its offspring to head its business, even though the offspring may be less competent than nonfamily managers. The exception to this is when the offspring is so poorly qualified that the survival of the business will be jeopardized with such an appointment, in which case the family might follow a seat-warmer strategy, as Zaudtke and Ammerman (1997) suggest. A family will appoint nonfamily managers to take over the business when its offspring's competency is low and its business is low in idiosyncrasy. Therefore, we propose that the likelihood the successor to a family business will be an offspring will increase with business idiosyncrasy and that business idiosyncrasy will interact with the competency of both the offspring and agent to affect successor choice.

Because many family businesses are highly idiosyncratic, it is not surprising that most successors will be the families' offspring, as our analysis suggests. When families do not have suitably qualified offspring, other than adopting the seat-warmer strategy, they may keep the business within the family by handing it over to an agent who is absorbed into the family as a son-in-law, provided that this arrangement is mutually acceptable to the family and the agent. These sons-in-law need not be superior in ability or idiosyncratic knowledge over all other agents, although families may seek for such sons-in-law. Instead, they need only be sufficiently able to ensure the survival of the business. This is because, once absorbed into the family, the son-in-law is a "close family member" (like an offspring) to whom the family prefers to hand over its business, even though he may be less capable than other agents.

For example, many Chinese and Korean families who are unable to produce capable sons and unwilling to hand over their businesses to daughters (Kuratko, 1993) have handed over their businesses to their sons-in-law. Some have even forced their sons-in-law to take their family names (Weidenbaum, 1996). Also, it is not uncommon for a Japanese family who does not have any capable sons to hand over its business to a *mukoyoshi* (Numazaki, 2000: 165). The *mukoyoshi* (son-in-law), also called the male bride (Hamabata, 1990: 36), assumes his in-laws' surname and will usually move into his in-laws' dwellings, effectively being absorbed into the family. Such practices, Bhappu (2000) argues, could explain why, unlike Chinese family businesses that typically have spanned only one or two generations, Japanese businesses have thrived through several generations (Kondo, 1990).

Families also reduce the appropriation risk of engaging nonfamily managers by handing over their businesses only to long-serving employees who have proven their trustworthiness. Furthermore, since idiosyncratic knowledge tends to be individual specific in family businesses, institutionalization of such knowledge is another way to reduce appropriation risk. This can be achieved through proper documentation of firm-specific assets, standardization of tasks, and/or setup of systems to regularly rotate staff to serve in the various operations and departments of the firm "so that all employees, particularly those who have the potential to replace the CEO, have the opportunity to gain expertise over time" (Neubauer & Lank, 1998: 150). Through institutionalization, idiosyncratic knowledge becomes firm (rather than individual) specific, thus precluding the exclusive concentration of such knowledge in any particular individual and reducing the appropriation risk. In this regard, more established and bigger family firms, with more plentiful resources, are better positioned to institutionalize their idiosyncratic knowledge so as to reduce the appropriation risk in engaging agents. *Therefore, we propose that the larger the family firm, the greater the likelihood that outside agents will be appointed.*

Like studies on incentive contracting that are based on principal-agent theory (e.g., Dewatripont & Maskin, 1995; Holden, 1999; Olsen, 1996), our study, based on TCE, is also founded on the incompleteness of contracts and the hazards of

opportunism in engaging agents. However, the *ex post* cost identified in our paper arises from agents' idiosyncratic knowledge, rather than from their private information on their own productivity, as in incentive-contracting studies based on the principal-agent approach. Our study thus suggests that even if moral hazard behaviors due to the private information of agents can be minimized through appropriate incentive and/or monitoring mechanisms, firms may still be faced with appropriation risk owing to specific human capital, which requires the formulation of different mechanisms to manage.

Similar to Grossman and Hart (1986) and Hart and Moore (1994), we focus on the implications of the holdup theory to a firm, when it cannot costlessly replace an agent because specific assets are involved in the relationship. However, we note that, depending on the specificity of the assets that an agent has acquired while in the employ of a family business, the agent may face a holdup problem that puts him or her at a disadvantage in securing another job. If the acquired assets are specific to the family business, the agent will be disadvantaged, because such specific assets are less transferable to other firms. However, if the agent's acquired assets are industry specific and transferable to other firms, his or her marketability in the job market will be improved.

In conclusion, we suggest here that observations of the appointment of family members as successors to family firms are not necessarily evidence of nepotism. Rather, this could be a rational response by families to the appropriation risk and the agency paradox that they encounter in engaging agents as heads of their businesses, given that family businesses are highly idiosyncratic in general.

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