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Setting the right mix—Analyzing outside directors' pay mix in public family firms

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ABSTRACT

Outside directors' pay mix determines if and to which extent a firm's designated monitor is incentivized by means of performance related (PR) pay. Owning families of public firms, still having substantial influence on the compensation process, need to balance the family's genuine interest against PR pay and non-family stakeholders' contrasting preferences in setting the right mix. At first, family and non-family firms show no difference regarding the adoption of PR pay. However, among PR pay adopters, we find family firms to devote greater shares to this pay component, thus sacrificing part of their socioemotional wealth in order to meet stakeholders' demand. A differentiation between different types of family firms reveals that especially true family firms, i.e. firms managed or owned by at least two family members, account for this particular behavior.

Introduction

Agency theory is concerned with problems stemming from the separation of ownership and control (Berle & Means, 1932). In the classical setting, agency conflicts occur because information asymmetries exist between shareholders and their managers, who have diverging goals (Jensen & Meckling, 1976; Eisenhardt, 1989). Public family firms, often characterized by a dominant family shareholder, are said to be less exposed to this type of agency problem; however, they are often troubled by agency conflicts among shareholders (Claessens, Djankov, Fan, & Lang, 2002; Morck & Yeung, 2003; Shleifer & Vishny, 1986; Villalonga & Amit, 2006). While it is unclear which agency conflict prevails in family firms, scholars agree that a firm's outside directors are an effective remedy for both types of conflict (Chrisman, Chua, & Litz, 2004; Fama & Jensen, 1983; Jensen & Meckling, 1976; Villalonga & Amit, 2006). In this regard, outside directors' primary task is to advocate for shareholders' rights and claims by diligently monitoring the firm's managers (Byrd & Hickman, 1992; Fama, 1980). Outside directors, who are hired to mitigate a firm's agency conflicts, can exacerbate these conflicts and create a new set of agency problems when they pursue different goals to those of the firm's shareholders. This scenario is likely due to the importance of non-economic goals for family firms (Chrisman et al., 2004; Gómez-Mejía, Hynes, Nunez-Nickel, & Moyano-Fuentes, 2007; Kumar & Sivaramakrishnan, 2008). This circumstance raises the difficult question: how can we align outside directors' conduct with shareholders' interests? As it is difficult to monitor outside directors, scholars frequently rely on incentive compensation and especially the use of performance-related (PR) pay (Kumar & Sivaramakrishnan, 2008; Morck, Shleifer, & Vishny, 1988). The family, either a dominant or powerful shareholder, is likely to have substantial discretion in setting outside directors' pay mix and to be able to determine the pay mix according to their preferences, which may include a focus on non-economic and long-term goals. These kinds of goals generally contradict the adoption of PR-pay (Chrisman, Chua, Pearson, & Barnett, 2012; Claessens et al., 2002; Gerhart & Milkovich, 1990). However, as public family firms are dependent on the capital market, they might also consider non-family stakeholders' potentially diverging preferences (e.g.,

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adoption of common business practices, focus on economic goals, short-term orientation) regarding the right pay mix. Thus, public family firms have to balance family shareholder preferences with those of non-family shareholders and other stakeholders to set the right mix of outside director compensation.

The extant literature includes few studies analyzing outside directors' pay mix (e.g., Andreas, Rapp, & Wolff, 2012; Ertugrul & Hegde, 2008; Fich & Shivdasani, 2005; Vafeas, 1999), and studies on the same issue in family firms are nonexistent to the best of our knowledge. This absence is remarkable given the public debates. Moreover, academics have observed, "in the last years an increasing momentum to understand director compensation as a firm-specific governance instrument to produce effective monitoring structures in the best interest of the company" (, p. 73). When we look at the literature on the determinants of pay mix in family firms, we find a similar picture: occasional studies mostly focusing on CEO pay mix (e.g., Block, 2011; Chrisman, Sharma, & Taggar, 2007; Gómez-Mejía, Larraza-Kintana, & Makri, 2003; McConaughy, 2000).

Building on existing findings, we combine classical agency theory with the more recently introduced perspective of socio-emotional wealth (SEW) to shed light on the determinants of outside directors' pay mix in public family firms and familial influence on that decision. Specifically, we investigate the tension between pressures of SEW to avoid adopting PR pay and external pressures imposed on the firm to adopt such practices. Based on the heterogeneity debate around family firms (e.g., Chua, Chrisman, Steier, & Rau, 2012), we discuss how different types of firms solve this dilemma. First, we assess differences between family and non-family firms and subsequently break down the group of family firms into lone-founder family firms (LFF) and true family firms (TFF). At first, our results reveal, contrary to our expectations, that there is no fundamental difference between family and non-family firms with regard to their likelihood to adopt PR pay for outside directors. In line with prior research (Gómez-Mejía et al., 2003), we interpret this result as evidence of two counterbalancing tendencies: on one hand, a family's genuine desire to avoid PR pay, in line with their wealth-preserving, risk-averse attitude, and on the other hand, their propensity to include PR pay to incentivize a more risk-taking attitude and thus to meet shareholders' demands. However, we find that among PR pay adopters, family firms in general and TFF in particular grant higher shares of PR pay than other firms, although this decision is contrary to their genuine interests. We suggest that these family firms are willing to accept a partial loss of their SEW (by granting higher shares of PR pay) to ensure the support from non-family stakeholders they need because it allows the family to maintain control and continue their pursuit of SEW.

Our paper contributes to the family business and compensation literature in several ways. First, we are the first study to investigate the pay mix of outside directors in family firms, thus extending the knowledge about family influence on a specific type of compensation contract design. Second, we contribute to a theory of the family firm (Chrisman, Chua, & Sharma, 2005) by expanding the knowledge around the pursuit of SEW. Specifically, we reveal that not all dimensions of a family's SEW can be pursued and maximized at all times. Instead, as the pursuit of one dimension might have an adverse effect on other dimensions, we find that family firms are willing to sacrifice part of their SEW to ensure permanent pursuit of the family's SEW. Third, we provide an empirical data point on outside directors' pay mix in German public family firms and thus providing a basis of comparison for future empirical studies in other countries. This is important as the legal system could affect compensation policies (Bryan, Nash, & Patel, 2010) and research seems to suggest that there could be a convergence in compensation policies across countries (Chizema, 2010)[1]. Fourth, we provide theoretically derived insights for practitioners with regard to the public perception and potential effects of PR pay adoption and the share of compensation dedicated to this type of pay. Last, we contribute to the debate on family firm heterogeneity (e.g., Chua et al., 2012) by distinguishing between two types of family firms: LFF and TFF.

Theoretical background

Outside directors are a powerful mechanism of a firm's corporate governance (Byrd & Hickman, 1992). On one hand, they monitor executives and offer advice on strategic decisions. On the other hand, they are endowed with the legal authority to decide on executives' nomination, compensation and potential dismissal (Agarwal, 1981; Byrd & Hickman, 1992; Fama & Jensen, 1983; Weisbach, 1988). Especially for two-tier governance systems, like for example in Germany, outside directors are in contrast to a firm's executives not entrusted with management. This distinction from a firm's CEO and management provides outside directors with a degree of independence, enabling them to fulfill their duties without being influenced by the reciprocal dependencies of the managers stemming from their day-to-day business interactions. Thus, outside directors are a vital part of a firm's checks and balances, established to mitigate its agency problems.

Two types of agency problems are of importance to our study: owner–manager and owner–owner agency problems. Stemming from the separation of ownership and management, the first evolves between a manager (agent) and an owner (principal) who delegates some of the firm's tasks to the former (Berle & Means, 1932; Jensen & Meckling, 1976). If the manager's goals are not congruent with those of the owner and information asymmetries between these parties exist, the manager's conduct is likely to undermine the owner's interests. The second type of agency problem arises from a conflict between different owners, especially between a dominant shareholder and other minority shareholders. When these parties do not share the same goals, existing information asymmetries and a controlling position often enable the dominant shareholder to pursue his goals and to extract private benefits at the expense of the minority shareholders (Shleifer & Vishny, 1997; Villalonga & Amit, 2006). While the owner–manager agency problem can be mitigated by monitoring managers or grant incentive compensation to them, the owner–owner agency problem can only be countered by monitoring the firm's management, which acts according to the dominant shareholder's interests. This task is usually carried out by the firm's outside directors (Cascino, Pugliese, Mussolino, & Sansone, 2010; Chrisman, Kellermanns, Chan, & Liano, 2010; Eisenhardt, 1989; Fama & Jensen, 1983; Jensen & Meckling, 1976).

[1] There are two fundamentally different systems how outside directors are embedded into a firm's corporate governance: a one-tier system and a two-tier system. The one-tier system combines inside and outside directors and their respective tasks under a single board. The one-tier system is applied in the US, the UK and many other important economies around the world. In contrast, the two-tier system requires two separate boards, the supervisory board, consisting of outside directors, and the management board, consisting of inside directors. In the two-tier system, the concurrent membership in both boards is legally prohibited. Beyond Germany, the two-tier system has been adopted in a variety of countries such as the Netherlands, Denmark and other central European countries. Conducting a systematic comparison of both systems, Jungmann (2006) concludes that directors are entrusted with a similar set of responsibilities and that both systems, despite existing weaknesses, resemble each other in terms of efficiency. In the same vein, Elston and Goldberg (2003) report that observed conflicts in both systems are quite the same. Due to this high degree of resemblance between the two systems, a systematic distinction seems not to be required in this paper.