



Outside CEOs, board control and the financing policy of small privately held family firms



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ABSTRACT

We investigate how the presence of an outside CEO is related to the financing policy of privately held family firms, taking into account the degree of family control via the board of directors. For a sample of 367 Belgian firms we find that family firms with an outside CEO have a lower leverage, although they take more entrepreneurial risk. The negative relation between the presence of an outside CEO and leverage is more pronounced for long-term debt than for short-term debt. Family control via the board of directors reduces the effect of an outside CEO on entrepreneurial risk and leverage.

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1. Introduction

A significant percentage of privately held family firms are managed by an outside CEO. While family owners are generally reluctant to delegate responsibility to outsiders (Kets de Vries, 1993), they may by necessity employ outside CEOs when new managerial skills are required (Gedajlovic, Lubatkin, & Schulze, 2004) or when other intra-family succession problems occur (De Massis, Chua, & Chrisman, 2008; Chua, Chrisman, & Bergiel, 2009). Transferring the management to an outside CEO is a critical event in the lifecycle of a family firm and a dominant concern for family business leaders (Chua, Chrisman, & Sharma, 2003) as the separation of ownership and management could lead to agency conflicts between the family owners and the outside CEO.

In this study, we investigate how the presence of an outside CEO compared to the presence of an inside family CEO, is related to the financing policy of privately held family firms, taking into account family control via the board of directors. Surprisingly, this question has so far largely been ignored by the literature. A few studies (Anderson and Reeb, 2003; Amore, Minichilli, & Corbetta, 2011) have investigated the impact of an outside CEO on the debt policy of large listed family firms, but they do not consider small privately held family firms, which are the predominant form of family firm around the world and which are the focus of our study. We investigate the effect of an outside CEO on the debt policy of 367

small privately held family firms in Belgium. Belgium provides an appealing research setting to investigate privately held family firms because these firms play a crucial role in the Belgian economy and all limited liability companies must publish annual financial statements. Moreover limited liability companies with more than two shareholders are legally required to install a board of directors with at least three members. This allows us to combine financial data from a public database with corporate governance data collected by survey.

First, we expect that family firms will take more entrepreneurial risk if they have an outside CEO, which will reduce debt levels. Family owners want to keep control over the firm to protect their *socio-emotional wealth*, that is, the utilities family owners derive from the noneconomic aspects of the business (Gomez-Mejia, Cruz, Berrone, & De Castro, 2011). As a result, they will have a low appetite for risk (Schulze & Kellermans, 2015) and will be reluctant to issue new equity that dilutes their ownership of the firm. Family firms with an outside CEO will often have reached a stage in which family ownership is dispersed over extended family members (Schulze, Lubatkin, & Dino, 2003). At this stage, the socio-emotional wealth of family owners will be smaller and they will be less concerned about keeping control over the firm (Berrone, Cruz, & Gomez-Mejia, 2012; Cennamo, Berrone, Cruz, & Gomez-Mejia, 2012). They will therefore be more tolerant towards entrepreneurial risk taking and the issuance of new equity (Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007). The outside CEOs themselves are likely to have goals and preferences that diverge from those of the family owners, and may induce them to take more risk than family CEOs (Jensen & Meckling, 1976). We hypothesize that the family firm offsets the

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higher entrepreneurial risk taken when there is an outside CEO with lower financial risk, that is, by reducing leverage. The higher entrepreneurial risk of family firms with an outside CEO will also make it more difficult for the firm to get bank loans. We therefore expect that family firms will use less debt financing when the CEO is an outsider.

Second, we predict that the debt level of family firms with an outside CEO will depend on the extent of family control via the board of directors. Outside CEOs will not always get the same leeway from family shareholders. They are less likely to allow the outside CEO to pursue risky strategies that reduce leverage when the family's socio-emotional wealth is high. The board of directors plays a central role in setting the strategy and controlling the management of family firms (for example, [Bammens, Voordeckers, & Van Gils, 2011](#); [Wilson, Wright, & Scholes, 2013](#)). Board control will reflect the extent to which the family owners want to protect their socio-emotional wealth. If the family owners have a strong desire to preserve their socio-emotional wealth, the board of directors may be a tool to reduce risks that might lead to a loss in socio-emotional wealth ([Schulze & Kellermans, 2015](#)). This leads us to expect that the relation between the presence of an outside CEO and leverage will be moderated by family control via the board of directors. We use a direct measure of board control based on survey data reflecting a board's actual involvement in monitoring and control, rather than the traditional proxies based on board characteristics as is typically done in the literature.

Finally, we also distinguish between long-term debt and short-term debt. We hypothesize that the negative effect of an outside CEO on debt will be stronger for long-term debt than for short-term debt because the agency cost of debt is larger for long-term debt than for short-term debt ([Heyman, Deloof, & Ooghe, 2008](#)). The availability and the cost of short-term debt is less sensitive to the risk taking behavior of the outside CEO, as loan contract terms must be renegotiated more frequently ([Ortiz-Molina & Penas, 2008](#)).

All the hypotheses are confirmed by our empirical analysis, which includes a battery of robustness tests. We find that family firms take more entrepreneurial risk but have lower leverage when they have an outside CEO; the negative relation between the presence of an outside CEO and leverage is reduced when board control is stronger and is stronger for long-term debt than for short-term debt.

Our study contributes to the literature on family business in two important ways. To the best of our knowledge, ours is the first study to analyze how an outside CEO is related to the financing policy of small privately held family firms, distinguishing between long-term debt and short-term debt. Prior literature on the role of outside CEOs in family firms have investigated how their presence affects the financial performance ([Cucculelli & Micucci, 2008](#)), entrepreneurial risk ([Huybrechts, Voordeckers, & Lybaert, 2013](#)) and cash policy ([Steijvers & Niskanen, 2013](#)) of private family firms. However, no previous work has considered the effect that an outside CEO has on debt policy. Prior debt policy studies have investigated firm-level determinants of the debt policy of family firms (for example, [Coleman & Carsky, 1999](#); [López-Gracia & Sánchez-Andújar, 2007](#)), compared the debt policies of private family firms and nonfamily firms (for example, [Coleman & Carsky, 1999](#); [Gallo, Tàpies, & Cappuyns, 2004](#); [Blanco-Mazagatos, De Quevedo-Puente, & Castrillo, 2007](#)), and analyzed the influence of owner-manager characteristics and preferences ([Romano, Tanewski, & Smyrniotis, 2001](#); [Koropp, Grichnik, & Kellermans, 2013](#)), but do not consider the role of outside CEOs. [Mishra and McConaughy \(1999\)](#), and [Amore et al. \(2011\)](#) do take into account the difference between family CEOs and outside CEOs, but they investigate large listed family firms which are very

different from the firms in our sample, that is, small privately held family firms.¹

Second, we show that family influence via the board of directors matters when the family firm has an outside CEO. This finding is based on a *direct* measure of board control rather than on indirect proxies reflecting board composition. Governance scholars stress the need for research on board variations in terms of what boards actually do ([Bammens et al., 2011](#); [Kammerlander, Sieger, Voordeckers, & Zellweger, 2015](#); [Zattoni, Gnan, & Huse, 2015](#)). We respond to this call by examining how the involvement of the family firm's board in control moderates the impact of an outside CEO on leverage. Despite claims in the family business literature that small family firms rely more on informal governance mechanisms and have only a ceremonial board, we provide empirical evidence that the board of directors is an influential governance mechanism in the presence of an outside CEO ([Blumentritt, Keyt, & Astrachan, 2007](#); [Hall & Nordqvist, 2008](#); [Nordqvist, Sharma, & Chirico, 2014](#); [Kammerlander et al., 2015](#)). Our findings also indicate that board composition variables, which are typically used in the family business literature, do not fully capture the board's influence on small family firm processes and outcomes. Information about a board's involvement in monitoring and control should be included in the research design if one wants to understand board effectiveness with respect to firm outcome variables.

This paper proceeds as follows. First, we review the literature and formulate our hypotheses. Next, we discuss the research sample and variables and we present the descriptive statistics and results. The last section summarizes the findings and concludes.

2. Hypotheses

2.1. The presence of an outside CEO and leverage

Our starting point is the observation that family firms with an outside CEO take more entrepreneurial risk than those with a family CEO ([Huybrechts et al., 2013](#)). This may happen for two reasons. First, family firms will often appoint an outside CEO when they have reached a stage in which the family owners have become more tolerant towards risk-taking ([Gomez-Mejia et al., 2007](#); [Schulze et al., 2003](#)). Second, the outside CEOs themselves are likely to have personal objectives that diverge more from those of family owners than the objectives of family CEOs ([Barton & Matthews, 1989](#); [Chaganti, Decarolis, & Deeds, 1995](#); [LeCornu, McMahon, Forsaith, & Stanger, 1996](#); [Romano, Tanewski, & Smyrniotis, 2001](#)).

Outside CEOs will often be appointed when the firm's ownership is dispersed over extended family members, who are little or not involved in the firm's management. The family owner's socio-emotional wealth is likely to be lower and they are likely to be less concerned about keeping control over the firm ([Gomez-Mejia et al., 2007](#); [Schulze et al., 2003](#)). According to [Schulze et al. \(2003\)](#), in family firms where the daily management of the firm is delegated to an outside CEO, family owners are less "overinvested" in the firm and they have risk preferences that are similar to those of institutional investors. As a result, family owners are more tolerant towards pursuing promising projects with uncertain returns which might reduce socio-emotional wealth, resulting in more entrepreneurial risk-taking. Since they care less about

¹ [Anderson and Reeb \(2003\)](#) consider only family firms included in the S&P 500 Industrial index. [Amore et al. \(2011\)](#) also include private firms in their sample (they do not mention how many) but these firms are much larger than the firms in our sample. The average total assets in their sample is € 129 mio while it is €17 mio in our sample.

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