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Family firm heterogeneity and CEO compensation in Continental Europe

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ABSTRACT

CEO compensation in family firms is affected by certain corporate governance characteristics, such as the generational stage of the firm (founder or descendant-controlled firms), the level of family involvement on the board of directors (lone or multiple family members sitting on the board) and the family status of the CEO (family or professional CEO).

In this paper, we argue that moderating effects arise among these dimensions of heterogeneity. The results show that in firms owned by descendants, the presence of multiple family members is beneficial in lowering family CEO compensation, while the opposite is true in the presence of the founder. Moreover, within founder and descendant firms, the number of family representatives on the board exerts a strong influence on the compensation of family CEOs, whereas it does not affect the compensation of professional CEOs. The results also show that in certain family clusters, CEO compensation is higher than in nonfamily firms, thereby emphasizing that when comparing CEO compensation in family and nonfamily firms, it is important to consider the intersections among the heterogeneity dimensions of the governance of family firms.

The findings of the paper contribute to the literature on the governance of family firms by showing that certain family firm types are more effective than others in keeping CEO compensation under control.

1. Introduction

The extensive literature on family business has emphasized that family firms are heterogeneous entities (Chua, Chrisman, Steier, & Rau, 2012; Nordqvist, Sharma, & Chirico, 2014), characterized by different goals (Chrisman, Chua, Pearson, & Barnett, 2012), governance sources (Carney, 2005) and resources (Habbershon, Williams, & MacMillan, 2003) that ultimately affect their behaviors and performance. CEO compensation is one of the areas in which the effects of heterogeneity are particularly evident. Three dimensions of heterogeneity mostly affect CEO compensation: 1) the generational stage of the firm, namely, whether the founder is still alive and active in the firm, or control has passed into the hands of descendants (Jaskiewicz, Block, Combs, & Miller, 2015; Miller, Block, & Jaskiewicz, 2010); 2) the number of family representatives involved in the firm (Combs, Penney, Crook, & Short, 2010); and 3) the family status of the CEO, i.e., whether the CEO is a member of the family or not (Croci et al., 2012; Gomez-Mejia, Larraza-Kintana, & Makri, 2003; McConaughy, 2000).

However, extant research on CEO compensation has analyzed each heterogeneity dimension individually, without considering the intersections among these dimensions. This approach seems to have two main limitations. First, the dichotomous representation arising when heterogeneity dimensions are individually considered is far from the complexity of family firms' reality. Second and

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more importantly, measuring the effect on CEO pay of a single dimension of heterogeneity implies averaging out the effects exerted by the other dimensions. The lack of a multi-dimensional approach seems to be a notable research gap because any moderation effect is substantially neglected, which appears to be at odds with the relevance that family business research recognizes to moderators and mediators in explaining family firms' behavior and performance (Chua et al., 2012).

In this paper, we aim at filling this gap by performing a thorough and systematic analysis of CEO pay characteristics among the eight family clusters arising from the combination of the heterogeneity dimensions described above. Building on the interplay of agency theory (Jensen & Meckling, 1976) with stewardship theory (Davis, Schoorman, & Donaldson, 1997), we argue that the degree of stewardship attitude of both the owner and the CEO affects the characteristics of the CEO's compensation package and its exposure to the governance of family firms.

In more detail, we raise two novel arguments in the debate over CEO compensation in family firms. First, we argue that the effect exerted by the number of family representatives on CEO pay characteristics is contingent on the generational stage of the firm. As owners of the firm, founders and descendants show different degrees of stewardship orientation and attitudes, with the former mainly focused on firm performance and the latter more inclined toward socio-emotional aims (Jaskiewicz et al., 2015). We develop a research model in which the number of family representatives involved in the firm – a variable that impacts family firms' performance and behavior (Jaskiewicz & Klein, 2007; Lansberg, 1999; Le Breton-Miller & Miller, 2009; Miller, Le Breton-Miller, & Lester, 2007) – has the opposite effect on CEO compensation, depending on whether the family firm is owned by the founder or by descendants.

Second, we claim that the effects of the governance characteristics of the firm on the compensation contract depend on the family status of the CEO. Family firms are more likely to hire a professional CEO when specific or advanced managerial skills are required (Burkart, Panunzi, & Shleifer, 2003; Lin & Hu, 2007); on the other hand, the self-restraint of the family CEO is influenced by emotional ties and kinship relationships, according to the type of family control (Lubatkin, Schulze, Ling, & Dino, 2005). Therefore, we argue that the effectiveness of the firm's governance mainly influences the family CEO compensation, while the professional CEO contract would be relatively unaffected, due to the limited bargaining power of the family in the need of acquiring external competences and skills.

The empirical research was conducted using a sample of Continental European firms in the 1998–2010 period. Compared to Anglo-Saxon countries, corporate ownership in Continental Europe is characterized by a higher percentage of families in control (La Porta, López-de-Silanes, & Shleifer, 1999), large recourse to control-enhancing devices, and lower investor protection (Franks, Mayer, Volpin, & Wagner, 2012; La Porta, López-de-Silanes, Shleifer, & Vishny, 2000). The European institutional context is therefore the ideal setting for analyzing how different corporate governance characteristics within family firms affect CEO pay (Conyon & Schwalbach, 2000).

Our empirical results can be summarized as follows. First, the presence of multiple family representatives is associated with opposite effects on CEO compensation, depending on the generational stage of the firm. Second, the number of family representatives significantly affects family CEO compensation but not professional CEO compensation. Third, family CEO compensation is lower than professional CEO compensation only in some family clusters. Fourth, CEO compensation in family firms may be even higher than in nonfamily firms.

Our findings make several contributions to previous related literature. In particular, while Combs et al. (2010) emphasized the reciprocal monitoring associated with the presence of multiple family representatives and its effect of lowering family CEO compensation, we show that this result only holds in descendant firms but not in founder firms, in which the effect is reversed. Second, our findings show that the common view that family CEOs are paid less than professional CEOs (Gomez-Mejia et al., 2003; McConaughy, 2000) only holds in the presence of more effective governance structures that emphasize the bright side of family management (Lubatkin et al., 2005). Finally, these results challenge the longstanding view that, due to the attenuation of the principal-agent problem (Jensen & Meckling, 1976; Shleifer & Vishny, 1997), CEO pay in family firms is lower and less incentive based than in nonfamily firms.

The remainder of the paper is structured as follows: Section 2 discusses the literature and develops hypotheses, Section 3 describes the sample and methodology, Section 4 presents the results of the empirical tests, Section 5 discusses the robustness of the results, and Section 6 concludes.

2. Literature review and hypothesis development

In large public companies, CEO compensation is mainly conceived as a remedy to *Agency Problem I* (Jensen & Meckling, 1976; Villalonga & Amit, 2006) arising from the divergent interests of dispersed shareholders and the management of the company (Berle & Means, 1932; Eisenhardt, 1989). However, a different perspective also suggests that CEOs might exercise their power over the board of directors to extract excessive pay. Thus, CEO compensation would not only be a remedy to the agency problem, but it could also be a means to expropriate shareholders (Bebchuk, Fried, & Walker, 2002; Kole, 1997).

In family firms, *Agency Problem I* is attenuated by a higsh ownership concentration in the hands of an individual or a family, creating the incentives for the owner to closely monitor the CEO's actions (Anderson & Bizjak, 2003; Burkart et al. 1997; Shleifer & Vishny, 1986). Nonetheless, family firms are exposed to family "altruism" (Chrisman, Chua, & Litz, 2004; Schulze, Lubatkin, Dino, & Buchholtz, 2001), which appears in the form of benefits granted to family members that they would not otherwise receive, such as perquisites and privileges (Gersick, Davis, Hampton, & Lansberg, 1997; Ward, 2011). Moreover, *Agency Problem II* (Villalonga & Amit, 2006) can arise since the family has the opportunity to use its position to extract private benefits at the expense of minority shareholders (Claessens, Djankov, & Lang, 2000; La Porta et al., 1999; Morck & Yeung, 2003; Morck, Wolfenzon, & Yeung, 2005).

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