

2 Theoretical Foundation

The paramount goal of this dissertation is to analyze the impact of family influence on aspects of outside director compensation. In order to achieve this goal and to create a common understanding of the topic, I provide a brief overview of basic terms and theories that build the theoretical foundation for my analyses. Section 2.1 covers the intriguing and challenging question how academia defines a "family firm" and highlights differences within this specific group of firms. Relevant characteristics with regard to outside directors are described in section 2.2. Finally, I introduce theories that help explain the idiosyncratic behavior of family firms (section 2.3).

2.1 Family Firms

2.1.1 Definition of a Family Firm

Family firms are prevalent around the world (La Porta et al, 1999). Although most people would instantly agree with this statement, thinking of small, privately owned firms from the neighborhood, the same also holds true for publicly traded family firms across all industries (Burkard et al., 2003; Villalonga & Amit, 2006; Anderson et al., 2003). Recent studies convey that at least one third of US Fortune 500 and S&P 500 companies are controlled by their founding families (Gómez-Mejía, Larraza-Kintana, & Makri, 2003; Anderson & Reeb, 2003). In the same vein, Claessens et al. (2000) observed family firms to account for more than two thirds of Asian companies, while Faccio & Lang (2000) find the owning family to play a crucial role in almost every second listed firm in Western Europe. Although these shares depend on the respective definitions applied in each study, commonly including a measurement of the family's influence through either management positions or shareholdings, they emphasize family firms' importance for all economies around the world (Chua et al., 1999; Gómez-Mejía et al., 2011; La Porta et al., 1999).

Despite, or specifically because of their frequent appearance, scholars have been struggling with the agreement on a common and uniform definition ever since the early beginning of family firm research (e.g., Chrisman et al., 2005). In order to understand the particular challenges in finding such a definition, the reader needs to keep in mind that the overarching goal of a family firm definition is the differentiation from non-family firms as this particular distinctiveness builds the foundation and eventually the *raison d'être* for the whole field of family business research (Chua et al., 1999). Without such distinctiveness, no

specific family business research would be necessary, let alone valuable. Moreover, family firm definitions can be distinguished between theoretical definitions that are used in theoretical research and operational definitions that are applied in the context of empirical research.

Following Chrisman et al. (2005), two streams have developed with regard to theoretical definitions: the *components-of-involvement* approach and the *essence* approach. The former approach requires the involvement of a family through management or ownership as sufficient condition for a firm to be defined as a family firm. The latter, however, postulates that only a specific behavior resulting from family involvement creates certain distinctiveness (i.e., the essence) that distinguishes family from non-family firms, thus justifying a firm to be classified as family firm. The differentiation between the two approaches emanates from the observation that firms although exhibiting the same degree of family involvement behave differently. Thus, scholars following the *essence* approach concluded that only a family's intentions to influence the business e.g. in its strategic orientation (Donnelly, 1964; Davis & Tagiuri, 1985) or a family's intentions to perpetuate the business over generations (Handler, 1990; Litz, 1995; Zellweger, Kellermanns, Chrisman, & Chua, 2011), among others, will lead to a family firm specific behavior. In this context, a family's involvement represents only the necessary condition whereas the resulting family specific behavior represents the sufficient condition in order to be defined as family firm (Chrisman et al., 2005). Although criticized for not being able to determine a family firm's distinct behavior in a tangible manner, the *essence* approach contributes its share to theoretical family business research by broadening the theoretical foundation as to what distinguishes family and non-family firms (Hack, 2009; Chua et al., 1999).

The connection between theoretical and operational definitions is reciprocal. On the one hand, a theoretical definition lays the groundwork for any operational definition that reflects the translation of theory driven characteristics in observable and measureable criteria that are used in conjunction with empirical research. On the other hand, the operational definition is required in order to apply, test and reassess the theoretical definition (Chua et al., 1999; Gómez-Mejía et al., 2011). Looking at existing operational definitions, one can find a broad range of definitions trying to capture a family's involvement. These definitions can include a family's involvement in ownership (e.g., equity share) and/or management (e.g., number of family managers) as well as a family's control (e.g., voting rights). In addition,

some definitions such as the F-PEC scale³ are complemented by proxies that aim to account for soft factors such as a family's experience (e.g., number of generations involved; family managers' tenure) or its culture, i.e., the extent to which family values are integrated in the business (Klein, Astrachan, & Smyrniotis, 2005a). As can be read from the many different operational definitions⁴, scholars agree that a uniform definition would not be desirable given the stark differences in research settings. Gómez-Mejía et al. (2011; p. 659, 660) conclude, while taking stock of recent developments in the family business research, that "every operational definition is context specific rather than generalizable" and "researchers must therefore defend their choice of measures depending on the sample." Following this notion, I define a family firm⁵ as any firm in which: (1) a family member holds a substantial voting stock of at least 5%, (e.g., Allen & Panian, 1982; Claessens et al., 2000; Gómez-Mejía et al., 2003); and (2) at least one family member is part of the firm's TMT as an executive or outside director (e.g., Allen & Panian, 1982; Anderson & Reeb, 2003). In this context, I define a family member as being either the founder of the firm or a relative by blood or marriage (Villalonga & Amit, 2006). This definition accounts for the fact that all firms in the sample used in this dissertation are publicly traded firms and characterized by a dispersed ownership structure. In such an environment, a family ownership of 5% can be regarded substantial while the same threshold would not be appropriate for an investigation of privately held firms (Hambrick & Finkelstein, 1995; Werner, Tosi, & Gómez-Mejía, 2005). The fact that I require involvement of a family member as substantial owner *and* as part of the firm's TMT reflects the aspiration to integrate the ideas of both, the *components-of-involvement* approach and the *essence* approach in my operational definition⁶.

³ The F-PEC scale is an operational definition that is composed of the three subscales Family-Power, Experience, and Culture (Astrachan, Klein, & Smyrniotis, 2002).

⁴ For an overview of family firm definitions used in family firm research throughout the last five decades, see: Chua et al. (1999) and Miller, Le Breton-Miller, Lester, & Canella (2007).

⁵ I use the term "family firm" as overarching term comprising a multitude of synonyms used in the literature such as family business, family-owned firm, family-managed firm, or family-controlled firm, among others.

⁶ Especially the involvement of the family as owner *and* manager indicates a high level of commitment from the family that creates the described "essence" in conjunction with the family business. In contrast, a family, whose members own a substantial part of the firm's equity but do not actively engage in the firm's business as part of the TMT, is likely to act like a sheer investor. A family, whose members are still part of the firm's TMT but who already sold its equity stake, is likely to perceive the firm as a mere provider of employment.

2.1.2 Heterogeneity of Family Firms

At the very beginning of family business research scholars devoted their efforts mainly on analyzing the distinctiveness of family firms. Theories and definitions were used in order to elaborate and explain differences in comparison with non-family firms. Along with the steady evolution of family business research and the increasing variety of family firm definitions that have been used in the literature, however, scholars' focus slowly shifted toward emerging differences among the group of family firms. The evolving *heterogeneity debate* on family firms quickly gained momentum and there is broad consensus today that family firms are a rather heterogeneous group (e.g., Sharma, Chrisman, & Chua, 1997; Melin & Nordqvist, 2007; Gómez-Mejía et al., 2007; Chua et al., 2012). Such a development is not new to academia and could also be observed in adjacent areas such as entrepreneurship research where a preliminary distinction between entrepreneurs and non-entrepreneurs gave way to more fine-grained analyses as the field advanced (Wiklund, 2006)⁷.

It is not surprising that family firms vary widely not only in terms of basic characteristics such as size, age, or industry but especially regarding their goal sets, their corporate governance and their resources (Chrisman et al., 2012a; Carney, 2005; Habbershon et al., 2003; Chua et al., 2012). These differences result in distinct behaviors among family firms causing inconsistent or even contrary results (e.g., Miller et al., 2007; Stewart & Hitt, 2012). A prominent example of such inconsistent results represents an attempt of Miller et al. (2007) to replicate the results of prior studies by Anderson & Reeb (2003) and Villalonga & Amit (2006) who investigated firm performance differences between family and non-family firms among Fortune 500 and S&P 500 companies, respectively. At first, Miller et al. (2007) were able to confirm the results corroborating that family firms exhibit superior firm performance. After further distinguishing between different types of family firms, however, they found that the superior firm performance could only be attributed to a specific group in which the founder is the only family member involved in the business.

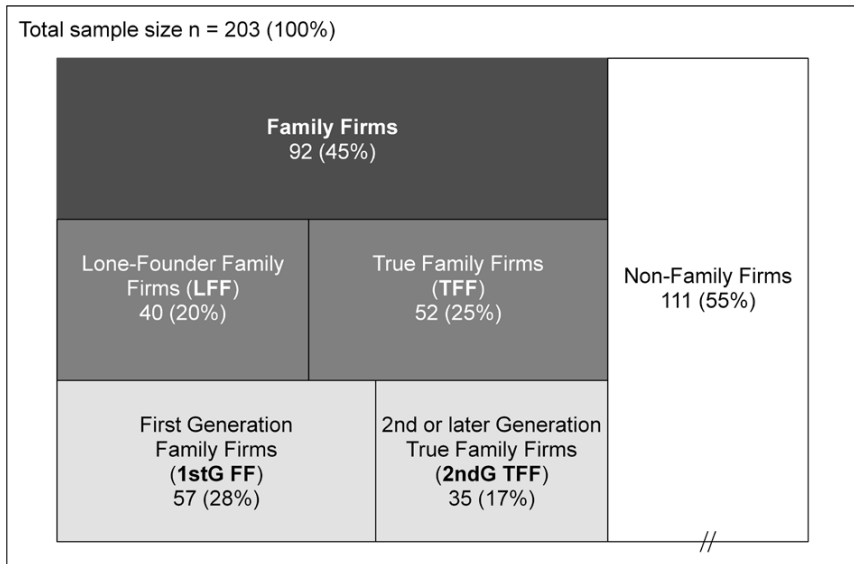
Researchers should adopt two interrelated consequences from these results: Firstly, family firm definitions that merely distinguish family firm non-family firms should be used

⁷ Wiklund (2006) reports that a simplistic distinction between entrepreneurs and non-entrepreneurs failed to become widely accepted among scholars, as a clear definition of either group could never be established. As a result, the field advanced as more fine-grained analyses were conducted using more specific distinctive features such as entrepreneurial orientation (firm level) or entrepreneurial experience (individual level).

with caution, as different types of family firms are likely to exhibit distinct behaviors. These distinct behaviors might easily be overestimated or even overlooked if contrary effects cancel each other out. Secondly, scholars should make use of theories that are capable of explaining why different types of family firms behave in a different manner. This argument also follows a call in the family business literature (e.g. Chrisman et al., 2007b) regarding the creation of a theory of the family firm that is able to (1) explain differences among family firms and in comparison with non-family firms (2) guide empirical research (Chua et al., 2012). In the same vein, scholars recently postulated that moderator and mediator analyses should be used in order to also accommodate statistical methods to the more fine-grained set of analyses that is required to further advance the field of family business research (e.g., Chrisman et al., 2012a)⁸.

Following these requests, I distinguish between different types of family firms and apply this differentiation in each of the three empirical investigations besides the general family firm definition. This multi-level approach allows me to (1) reveal general tendencies that apply for the whole group of family firms; (2) reveal specific tendencies that are only attributable to a specific type of family firms and; (3) consequently to detect and emphasize contrary tendencies that could be overlooked or misinterpreted under a broader definition. Figure 2-1 illustrates the different types of family firms used in this dissertation and their respective share in the sample. A more detailed description of the sample and the family firm subsample is provided in sections 3.2 and 3.3, respectively.

⁸ The use of moderator analyses represents a vital part of this dissertation's statistical methods whose details are explained in section 3.4.

Figure 2-1: Different Types of Family Firms

As illustrated in Figure 2-1, I further divide the group of family firms into smaller subgroups in order to achieve results that are more fine-grained in addition to the comparison between family and non-family firms. Therefore, I split the family firm subsample into either LFF and TFF or into first generation family firms (1stG FF) and second or later generation true family firms (2ndG TFF). Both splits have been used in prior research and proven to provide distinctive traits that are worth exploring⁹ (Miller et al., 2007; Bammens et al., 2008). As the group of 92 family firms is completely partitioned into different types of family firms, the family firm definition described in section 2.1.1 also applies to any of the family firm subgroups. That means each type of family firm is characterized by the involvement of a family member in the firm's TMT and as substantial owner (voting stock $\geq 5\%$). The

⁹ On the one hand, a differentiation between LFF and TFF allows to set a specific focus on the role of the founder and his particularly strong influence as the sole family member on the family business (Miller et al., 2007). Considering the involvement of different numbers of generations in the family business, on the other hand, permits to investigate effects such as an increased risk of family conflicts and potentially conflicting business agendas evolving from such a multiple generation involvement (Kellermanns & Eddleston, 2004; Bammens, Voordeckers, & Van Gils, 2008).

following criteria have to be fulfilled in addition to the family firm definition, in order to be classified as a specific type of family firm as illustrated above:

Lone-Founder Family Firms (LFF). The founder is the only family member. No other family member is involved in the business as part of the firm's TMT or as substantial owner. I also classify a firm a LFF, if it was founded by a group of founders on the premise that the founders are not related.

True Family Firms (TFF). If more than one family member is involved in the family business as part of the firm's TMT and as substantial owner, I classify it a TFF. In this connection, it is of no importance whether the two family members are involved at the same time or consecutively. That means, for example, a family firm involving father and son at the same time and a family firm in which the grandson is involved long after the grandfather retired are both treated as TFF.

The second independent fragmentation of family firms is based on the number of generations from a family that are or have been involved in the family business. As before, the requirements are in addition to the family firm definition described in section 2.1.1.

First Generation Family Firms (1stG FF). Only family members from the first generation, i.e., from the founder's generation are involved in the family business. Consequently, by definition all LFF are also 1stG FF.

Second or later Generation True Family Firms (2ndG TFF). If family members from the second or a later generation, i.e., descendants of the founder are involved as part of the firm's TMT and as substantial owner, I classify it a 2ndG TFF. Again, the classification does not depend on whether the two generations are involved contemporaneously or consecutively.

Despite being comparatively new to the family business research, the distinction between different types of family firms has already revealed some intriguing findings creating a promising outlook. It is remarkable that many of the findings emanating from analyses that include a further distinction between different types of family firms put existing findings into perspective. That means, these newer findings partly limit the generalizability of older findings that use only one broad family firm definition by emphasizing the specific conditions under which the results hold true. Gómez-Mejía et al. (2003), investigating differences in CEO compensation between family and non-family CEOs in family firms, found that family CEOs receive less compensation than CEOs that are not part of the family. Limiting the generalizability of this finding, Combs, Penney, Crook, and Short (2010) revealed that this

only proves true if other family members than the CEO are involved in the family firm. In a similar vein, Block (2012) found that family firms exhibit lower R&D spending than non-family firms, however, if the founder is the only family member, the author found the opposite to be true as these firms exhibit higher R&D spending.

These and other interesting findings inspired me to adopt a differentiation between different types of family firms beyond the general comparison between family and non-family firms. Thus, my empirical investigations presented in chapters 4, 5, and 6, all commence with a comparison between family and non-family firms and then continue with a further differentiation between different types of family firms.

2.2 Outside Directors

This section presents the fundamentals regarding outside directors. Who are these directors? What are their main functions? What are they paid for? These questions are answered in the following section trying to lend a face to the technocratic term *outside director*. I adopt a German perspective in this section as I analyze a dataset of German firms. Particularities with regard to Germany's legal setting are described in section 2.2.2. Here, I briefly examine regulations that play a leading role as to how outside directors are embedded in a firm's corporate governance, what needs to be considered with regard to board constitution and how best practices in corporate governance influence a firm's decision making concerning different aspects of outside director compensation.

2.2.1 Tasks and Compensation

Outside directors are non-executives and members of a firm's supervisory board¹⁰. The general meeting appoints a firm's outside directors for a four year term of office and also assigns the group's chairman and deputy¹¹. Outside directors must be distinguished from a

¹⁰ The term *Outside Director* is borrowed from the Anglo-Saxon literature where it is used to refer to members of the board (directors) who are not part (outside) of a firm's executive management. I adopt this definition and refer to any member of a firm's supervisory board who is not part of the firm's executive management as *Outside Director*. This also applies to employee representatives whose board membership is regulated by German codetermination law. Further details on German codetermination are provided in section 2.2.2.2.

¹¹ See §§ 101, 102, 107 German corporation law (Aktiengesetz). German codetermination law requires under certain circumstances the appointment of employee representatives on a firm's supervisory board. Employee

firm's inside directors, i.e., its executives, who serve on the management board which is responsible for the firm's day-to-day business and is headed by the firm's CEO. Together, both groups of directors constitute a firm's TMT. Outside directors' main function is the protection of shareholders' interests and their endorsement towards the firm's management board (Byrd & Hickman, 1992). In order to attend to this duty, outside directors monitor a firm's management and, thus, ensure the adherence of managements' activities to shareholders' interests¹². In addition, outside directors are equipped with the legal authority to appoint and dismiss a firm's inside directors and to determine their compensation¹³ (Fama & Jensen, 1983; Byrd & Hickman, 1992; Agrawal & Knoeber, 2001). They can provide strategic advice, access to tactical resources, or steer corporate governance processes (Byrd & Hickman, 1992; Fama 1980; Fama & Jensen 1983). To fulfill their duties, outside directors are regularly informed by a firm's management board and convene for supervisory board meetings several times a year¹⁴. To facilitate their work and to increase efficacy, German corporation law recommends the establishment of individual committees for outside directors that are concerned with the diligent elaboration of specific topics such as nomination, audit, or compensation¹⁵.

Over the course of the last years, requirements towards outside directors have been steadily increasing. New requirements were discussed and even codified into law, influenced by big corporation scandals at the beginning of the millennium (e.g., Enron, Worldcom, Mobilcom) and substantially driven by public debates about good corporate governance and sustainable firm growth¹⁶. In 2009, a new law called *Appropriateness of Management Board Remuneration Act* (Gesetz zur Angemessenheit der Vorstandsvergütung, VorstAG) came into effect requiring members of the supervisory board to ensure that a firm's executive compensation is set appropriately in connection with the executives' individual

representatives are elected by a firm's employees. Further details on German codetermination are provided in section 2.2.2.2.

¹² See § 111 German corporation law (Aktiengesetz).

¹³ See §§ 84, 87 German corporation law (Aktiengesetz).

¹⁴ For publicly traded companies German corporation law (§ 110 Aktiengesetz) requires the members of the supervisory board to convene at least four times per year.

¹⁵ See § 107 German corporation law (Aktiengesetz).

¹⁶ For example, German corporation law (§ 100 Aktiengesetz) requires at least one outside director to have expertise in the fields of accounting or auditing for all firms that fall under §264d of the Commercial Code (i.e., capital market oriented firms) from 2009 onwards.

responsibilities and skills and in connection with the firm's performance. Particularly, the new law requires that executives' compensation may not exceed common ranges without specific reason and deems outside directors personally liable for setting inappropriate executive compensation¹⁷.

Outside directors' own compensation is determined by a firm's general meeting¹⁸. It decides on their pay level (i.e., the level of their compensation) and pay mix (i.e., the composition of fixed and variable pay components). Thus, through the possibility of exerting targeted influence at the general meeting a connection between shareholders' interests and outside directors' compensation is ensured. Outside directors' compensation generally consists of fixed and variable payments. The annual retainer is a fixed amount that is granted for the fulfillment of outside directors' regular duties and usually represents the majority of their total compensation. Variable payments can be further divided into performance related and non-performance related pay components. The former payment is tied to the achievement of a pre-defined outcome which generally is a financial performance indicator such as earnings per share or dividends paid. If these indicators reach a certain threshold within a stipulated period, the performance-related pay is granted. Non-performance related payments are variable in nature but do not depend on a specific outcome as they are paid for supplementary tasks and responsibilities such as committee membership or being chairman of the supervisory board.

Considering outside directors rights and obligations, they represent a vital part of a firm's corporate governance, especially with regard to their internal monitoring function (Harford 2003; Byrd & Hickman, 1992). This and the fact that requirements towards outside directors are steadily increasing, emphasize the importance of a sophisticated compensation system for outside directors. Establishing such an appropriate compensation system to incentivize outside directors in the right way becomes a crucial matter for any kind of firm. Despite a firm's extensive discretion regarding the design of its corporate governance, many countries have established national statutes that build the framework for corporate activities. The following section briefly explains these legal specifics.

¹⁷ See § 116 German corporation law (Aktiengesetz).

¹⁸ German corporation law (Aktiengesetz §§113, 179) also permits the determination of outside directors' compensation via a firm's bylaw. In order to change a firm's bylaw, a qualified majority (here: a two-thirds majority) of the shareholders' capital present or represented at the general meeting is required.

Outside Director Compensation in German Public Family
Firms

An Empirical Analysis

Engel, P.

2015, XVIII, 181 p. 11 illus., Softcover

ISBN: 978-3-658-07315-2