

# THE IMPACT OF FAMILY REPRESENTATION ON CEO COMPENSATION

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## ABSTRACT

Understanding the nature of family representation in public firms has been an important topic for entrepreneurship research. Because CEO compensation is a key tool that boards use to align the interests of shareholders and managers, researchers have taken steps toward understanding how family representation affects CEO compensation. Prior research has painted family-member CEOs as stewards who accept lower compensation. Based on agency theory, we describe a different scenario wherein family representatives engage in strategic control that reduces family-member CEOs' compensation. Thus, family-member CEOs accept lower compensation only when additional family-members are represented in management or on the board. In comparison to CEOs at non-family firms, we find that family-member CEO compensation is 13 lower when multiple family members are involved, but 56 percent higher when the CEO is the lone family-member.

Family control is the dominant ownership structure across the globe, and family firms account for a significant portion of all publicly traded firms. In the United States, for example, one third of *Fortune* 500 firms are at least partially controlled by a single family who maintains substantial ownership in the firm (Anderson & Reeb, 2003). To better understand the role of family influence among large, publicly traded corporations, there has been considerable research interest geared toward understanding the differences between publically traded family and non-family firms (e.g., Anderson & Reeb, 2003; Dyer & Whetten, 2006).

Although research surrounding family firms has revealed important differences between family and non-family public firms (e.g., Dyer & Whetten, 2006), the topic of CEO compensation has received comparatively less attention. Understanding how family representation influences CEO compensation among public firms is important because CEOs are key resource allocators and decisions makers, and compensation is a key way that boards of non-family firms motivate CEOs to make decisions in shareholders' interests (Jensen & Murphy, 1990). It is questionable whether CEO compensation serves the same role in firms with family representation as it does in non-family firms because families are already heavily invested in the

firm through ownership and labor (cf. Chrisman, Chua, & Litz, 2004). Thus, knowledge that we gain about how family representation affects CEO compensation is likely to be useful for helping to understand CEO motivation and, consequently, firm behavior. Our focus is on family-member representation in management positions or on the board rather than ownership because active participation more likely places family members where they can directly influence important policy decisions (e.g., Dyer & Whetten, 2006).

Recognizing the implications of CEO compensation, Gomez-Mejia, Larraza-Kintana, and Makri (2003) took an important step toward understanding the effect of family representation on CEO compensation in publicly traded firms. Focusing on a sample of family firms with multiple family members involved, they found that family-member CEOs earn less total compensation than non-family CEOs. They explained that family-member CEOs do not need compensation that follows external market trends because their family ties make them less likely to exit the firm to pursue other career opportunities. In essence, family-member CEOs are less disposed to leaving and are willing to receive less compensation in exchange for the additional job security and the socio-emotional benefits that family involvement provides.

Gomez-Mejia *et al.*'s (2003) work takes a valuable step toward understanding how family influence affects CEO compensation, but their contribution also highlights two questions that appear important to address in order to extend our knowledge in this area. Specifically, what we do not yet know is (1) whether CEO compensation in family firms differs in situations where one versus multiple family members are represented, and (2) whether family-member CEOs' compensation differs from CEOs in non-family firms.

The first question – whether CEO compensation differs between family-member CEOs at firms with one versus multiple family-member representatives – has important theoretical implications. Wherein agency theory assumes that managers act in their own self interest

(Eisenhardt, 1989), stewardship theory contends that some managers will make sacrifices in the interest of the organization (Davis, Schoorman, & Donaldson, 1997). Gomez-Mejia *et al.* (2003) used agency theory as the grounding theoretical framework for their paper, but their findings led them to argue that family influence leads family-member CEOs to act like stewards in that they willingly accept lower pay in exchange for greater job security and socio-emotional wealth. We also use agency theory but offer an alternative possibility – i.e., that family-member CEOs would take more compensation if they could, but that other family representatives monitor their actions and put downward pressure on compensation. Thus, a lingering question is whether CEO compensation changes when family representation involves a lone-family-member CEO versus a CEO where multiple family-members are represented.

The second question – whether family-member CEOs' compensation differs from CEOs in non-family firms – is important because without having non-family firms as a reference point, we can not know the reasons behind compensation differences between family- and non-family CEOs among family firms. Gomez-Mejia *et al.*'s (2003) theory that family CEOs require less compensation implicitly assumes that the non-family CEOs in the family firms they studied are similar to CEOs in non-family firms. Without studying non-family firms as a reference point, however, we can not rule out the alternative explanation, which is that the difference between family and non-family CEOs in family firms is caused by non-family CEOs requiring more pay to compensate them for the risk that family dynamics could undermine their decisions and jeopardize their careers (cf. Gomez-Mejia, Nunez-Nickel, & Gutierrez, 2001; Sharma, Chrisman, & Chua, 1997). Under this alternative scenario, family CEOs are similar to CEOs in non-family firms, and it is the non-family CEO working in family firms whose compensation is different. Thus, including non-family firms as a reference point is key to understanding differences between family and non-family CEOs among family firms.

In order to help close the gap between what we know and what we need to know about family representation on CEO compensation, our study compares CEO compensation at non-family public firms with family-member CEO compensation at two types of public family firms – i.e., lone-family-member CEO firms versus those with multiple family-member representation. Theoretically, we build upon the concept of mutual monitoring (Fama & Jensen, 1983) to suggest that family representatives perform a strategic control function that places important limitations on family-member CEO pay, and that without this monitoring, lone-family-member CEOs will garner even more compensation than they would in non-family firms.

Our paper offers empirical and theoretical contributions. Empirically, we learn that family-member CEOs of firms with multiple family representatives earn less than CEOs at non-family firms, and that compensation for non-family CEOs in family firms is similar to CEOs at non-family firms. This is consistent with Gomez-Mejia *et al.*'s (2003) theory that family CEOs take less compensation, and rules against the alternative that compensation differences among CEOs at family firms are due to demands by non-family CEOs for a risk premium in order to work in a family firm. We also learn, however, that lone-family-member CEOs earn more than CEOs at non-family firms. Our theoretical contribution is to extend research on mutual monitoring from agency theory into the family firm context by emphasizing that family representation beyond the CEO provides an important source of CEO monitoring in family firms.

## **FAMILY REPRESENTATION AND CEO COMPENSATION**

Agency theory provides a theoretical basis for understanding the potential impact of family representation in public firms (Villalonga & Amit, 2006). An agency problem potentially exists whenever decision authority is delegated to managers who will not bear the full consequences of their decisions (Jensen & Meckling, 1976). In public firms where ownership is widely held, the central agency problem of concern has been the divergence of interests between

owner-shareholders and their board of directors – i.e., the principals – and their CEO-agents (Fama & Jensen, 1983). Agency theory suggests that agents will not act in the principals' best interests unless their behavior is closely monitored or they are offered incentives to do so (Eisenhardt, 1989). Given that the CEO's job is complex and that board members typically do not have the time or information to fully evaluate key decisions, it is difficult to decipher whether the CEO's decisions might increase personal gain at the expense of shareholders or whether the decisions are geared to improve performance in ways that increase shareholders' wealth (Eisenhardt, 1989). The solution is to offer CEOs enough cash compensation to keep them from seeking employment elsewhere (Fama, 1980), combined with very high levels of stock-based incentive compensation that encourages them to make decisions in line with shareholders' long-term interests (Jensen & Murphy, 1990).

The agency problem is different, however, for family-influenced firms (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). Participation in management by members of an influential family creates less separation between owners and managers than among widely-held non-family firms. Consequently, the agency problem is, in part, between the influential family and other shareholders. In such cases, shareholders need assurance that the family will not divert resources through perquisite taking, special dividends, or by engaging in low-risk strategies that preserve family wealth but under-invest the firm's resources (Anderson & Reeb, 2004; Villalonga & Amit, 2006). Families might also engage in strategies that do not maximize shareholder value for emotional reasons, such as producing in a local community when outsourcing is less costly, upholding the founder's strategic focus when conditions warrant change, or limiting focus to areas that accent the family's visibility (Astrachan & Jaskiewicz, 2008).

The shift in agency problems from concerns between shareholders and management (i.e., principal-agent) to potential issues between the family and other shareholders (i.e., principal-

principal) provides a foundation for understanding the impact of family representation in public firms (Villalonga & Amit, 2006). Given that the CEO is a central resource allocator and decision maker, and that a key way boards influence CEOs to make pro-shareholder decisions among non-family firms is through CEO compensation (Sanders, 2001; Jensen & Murphy, 1990), compensation is likely one factor that is affected by family influence.

Recognizing this, Gomez-Mejia *et al.* (2003) investigated CEO compensation in family firms with multiple family members involved, and found that family-member CEOs earn less total compensation than non-family CEOs working in family firms. They offer three inter-related reasons. First, family-firm CEOs, as stewards of the company and leaders of the family, will enjoy greater job security than non-family CEOs. Given agency theory's assumption that agents are generally risk averse, family-member CEOs should be willing to trade pay in order to enjoy greater job security. Second, family-member CEOs receive emotional benefits from their family ties and satisfaction that the larger family is supported and enriched by the firm. Thus, they will view their role as pro-organization stewards rather than in purely economic terms – as pay for services rendered – as is expected of non-family CEOs (Davis, *et al.*, 1997; Gomez-Mejia *et al.*, 2001). Finally, because of family ties, family-member CEOs are unlikely to leave for greater pay elsewhere, which makes it unnecessary to pay family CEOs market rates for their services.

Although Gomez-Mejia (2003) ground their work in agency theory, all three of the reasons that they offer require some self-restraint by family-member CEOs in that they must accept earning less than non-family CEOs. Thus, this reasoning suggests that family-member CEOs adopt the pro-organizational orientation described by stewardship theory (Davis *et al.*, 1997), which asserts that not all agents act only in their own self interest and that CEO commitment to and identification with their firm means that they will make pro-organizational decisions without being induced to do so via compensation (Davis *et al.*, 1997).

Without such stewardship orientations, agency theory anticipates that family-CEOs will seek as much compensation as possible because, as the principal-principal problem dictates, they would enjoy the full benefits of greater compensation but only bear costs in proportion to their ownership shares (Villalonga & Amit, 2006; Young *et al.*, 2008). One factor that might increase understanding of the extent to which family-member CEOs adopt stewardship orientations is the number of family-member representatives. If family-member CEOs view themselves as stewards who accept lower compensation in light of the other benefits that they receive, then it should not matter how many family-members are represented in management or on the board. Based on agency theory, however, we suggest that one reason family-member CEOs accept lower pay than non-family CEOs in firms with multiple family representatives is because their compensation is monitored by the other family members. Consequently, we assert that family-member CEO compensation will increase when there are no other family representatives involved.

### **FAMILY REPRESENTATION AS STRATEGIC CONTROL**

In most publicly traded firms, CEO compensation has three primary components – guaranteed salary, cash bonus, and stock options (Tosi, Werner, Katz, & Gomez-Mejia, 2000). According to agency theory, a well designed compensation plan incentivizes CEOs to increase their loyalty to the firm and direct their efforts toward strategies that will maximize shareholder value (Devers, Cannella, Reilly, & Yoder, 2007). Because managers are often involved in setting the targets used in bonus programs and because the targets involve benchmarks that can be manipulated – such as firm size via mergers or acquisitions – salary and bonus are typically lumped together as cash compensation (e.g., Combs & Skill, 2003).

If family-member CEOs view themselves as stewards of the family and of the firm, then they should willingly give up compensation in exchange for greater job security, socio-economic wealth, and in recognition that they do not need to earn market rates (Gomez-Mejia *et al.*, 2003).

In addition, they should continue to view themselves as stewards even if they are the only active family member. In support of this rationale, CEO founders of private and newly public firms take less compensation, which suggests that founders often adopt stewardship roles (He, 2008; Wasserman, 2006). However, support for this rationale fades as firms grow and attract greater outside investment (Wasserman, 2006), which suggests that founder CEOs – who are commonly the lone family-member – might give up their stewardship orientation and use their influence to garner increased compensation once their firm becomes a large public company.

One important factor that constrains the ability of CEOs in non-family public firms to misdirect resources is called mutual monitoring (Rediker & Seth, 1995). Fama and Jensen (1983) observed that other members of the top management team (TMT) want the firm to perform well because it reflects favorably on them in the managerial labor market and increases their chances of winning a coveted CEO position. If the CEO is misdirecting resources or simply engaging in unwise strategies, then other managers have an incentive to either exit to preserve their reputations or work to reverse course, perhaps by challenging the CEO directly (Semadeni, Cannella, Fraser, & Lee, 2008). Having more mutual monitoring in the form of TMT-board members, for example, leads to greater investments in research and development (Baysinger, Kosnik, & Turk, 1991) and faster CEO turnover when performance declines (Ocasio, 1994). Also, mutual monitoring appears to substitute for other forms of CEO monitoring, such as the presence of outside directors (Rediker & Seth, 1995). As a consequence, CEOs in widely-held firms are less likely to amass power and become entrenched in their position when there are other powerful managers who can challenge CEO actions (Ocasio, 1994).

Mutual monitoring is one source of what Baysinger and Hoskisson (1990) call strategic control. Strategic control occurs when powerful stakeholders invest time and energy to fully understand proposed strategic actions and how they might affect the firm. Strategic control takes

so much time and energy, however, that external independent board members prefer financial controls wherein CEO compensation is tied to outcomes that can be easily assessed. This is one reason that independent boards use more stock options (Conyon & Peck, 1998).

We suggest that multiple family members furnish the same level of strategic control in family-influenced firms as mutual monitoring by other TMT members does in non-family public firms. Family member motivation is different because family members are less likely to leave and therefore less interested in the impact that CEO actions might have on their reputation in the managerial labor market. Instead, as major shareholders and representatives of the larger family, family representatives possess incentives to invest their time and energy to fully understand the CEO's proposed initiatives and to make sure that they are in the long-term interest of the family.

Thus, one reason why family-member CEOs might accept lower compensation is because other members of the family perform strategic control over CEO actions. The presence of powerful parties who have the incentive and the capacity to engage in strategic control places downward pressure on CEO compensation (Hartzell & Sparks, 2003; Core, Holthausen, & Larcker, 1999). For example, compensation is lower when institutional investors are engaged (Gomez-Mejia, Tosi, & Hinkin, 1987). Monitoring also reduces the CEO's discretion, which reduces the complexity of the CEO's job and thus lowers the need for high compensation (Finkelstein & Boyd, 1998). Further, because a family-member CEO's compensation is unlikely to enrich other family members, other family members are likely to argue that – for the reasons expressed by Gomez-Mejia *et al.* (2003) – family-member CEOs should receive relatively less compensation than they might receive at comparable non-family firms. Thus, we expect that:

**Hypothesis 1a:** Family-member CEOs in multi-family-member firms receive less cash compensation than CEOs of non-family firms.

In regard to the other major source of CEO compensation, stock options, there is an additional reason that family-member CEOs might receive less in multi-family-member firms –

options increase the family's risk exposure (Sanders, 2001). In widely-held non-family firms, agency theory suggests that a key mechanism for aligning managers' and shareholders' interests is through stock options (Jensen & Murphy, 1990). Stock options are used because they are tax advantaged vis-à-vis stock grants or other forms of incentive compensation (Yermack, 1995). Also, stock options carry no down-side risks for managers. Managers gain nothing if the firm's share price falls below the options' strike price and stays there until the options expire, but unlike other shareholders, managers do not lose wealth that they once had. Because managers have much to gain and nothing to lose, this feature of stock options encourages managers to take risks geared towards improving firm performance (Sanders & Hambrick, 2008). Without such incentives, however, managers in widely-held public firms are more risk averse than shareholders because their labor is undiversified (Devers *et al.*, 2007). Thus, by increasing risk taking incentives, stock options help align managers' objectives with shareholders' interests.

For influential families, however, incentivizing the CEO to take greater risks might not be in the family's best interests because families tend to keep large portions of their wealth in the firm, and thus have a strong preference for wealth preservation strategies (Gomez-Mejia *et al.*, 2007). In addition, offering stock options to family CEOs gives them an opportunity to increase their personal ownership relative to other family members. Thus, from the viewpoint of other family representatives, options potentially increase the family-member CEO's ownership and encourage more risk taking than the family's large undiversified ownership stake might warrant (cf. Sanders, 2001). Consequently, we would expect other family representatives to limit the value of family-member CEO stock options in multi-family member firms. Stated formally:

**Hypothesis 1b:** Family-member CEOs in multi-family-member firms receive less stock option compensation than CEOs of non-family firms.

If Gomez-Mejia *et al.* (2003) are correct in that family-member CEOs adopt stewardship orientations and willingly give up compensation in exchange for greater job security, socio-

economic wealth, and in recognition that they do not need to earn market rates, then it should not matter whether the CEO is the only family representative. However, if family-member CEOs in firms with multiple family representatives accept lower compensation due to strategic control by other family representatives, then they might drop their stewardship orientation when they are the lone-family member and instead use their influence to garner increased compensation.

As the only family-member involved in their firm's management or board, lone-family-member CEOs are not subject to strategic monitoring by other family members. Agency theory suggests that when agents have the opportunity to direct resources toward their own benefit at the expense of shareholders, they will do so (Jensen & Meckling, 1976). Family-member CEOs, as principal shareholders, have an incentive to use their influence to increase their personal compensation because they receive all of the benefits from greater compensation, but pay only the proportional fraction of the cost associated with their ownership stake (Young *et al.*, 2008).

In addition, relative to CEOs at non-family public firms, they are more likely to possess direct ownership power, influential relationships, and longer tenure – all of which have been associated with greater CEO compensation (Devers *et al.*, 2007). Thus, lone family-member CEOs have, according to agency theory, the incentive to use their influence to increase compensation, and existing evidence suggests that CEOs with similar sources of power do indeed garner higher wages. Accordingly, we predict that:

**Hypothesis 2a:** Lone-family-member CEOs receive more cash compensation than CEOs of non-family firms.

Research on relationships among CEO power and compensation has focused primarily on cash compensation, at least in part, because agency theory anticipates that powerful CEOs will use their power to seek guaranteed rewards – not rewards that force their interests into alignment with shareholders (Devers *et al.*, 2007). Holding ownership effects constant, however, lone-family-member CEOs might embrace stock options. In essence, while the CEO might prefer all

compensation in cash, they will also want stock options because options have the potential to increase their personal wealth, and, by holding the stock garnered through options, further increase their ownership and control of the firm. While options can encourage risk-taking beyond what a family-member CEO with undiversified labor and wealth might want (Sanders, 2001; Schulze, Lubatkin, Dino, & Buchholtz, 2001), families will often take great risks to maintain control (Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007). Thus, if the CEO's personal ownership stake is not high enough to deflect most challenges to their control, he or she might be willing to take risks for the purpose of increasing ownership.

It also seems likely that boards might agree to a lone-family-CEO's request for more stock options. Given that external independent directors are not involved enough to engage in strategic control, and without other family-members involved to perform strategic monitoring, the remaining board members are likely to turn to financial controls (Baysinger & Hoskisson, 1990). Financial controls, such as stock options, reward managers for acting in shareholders' interests and thereby relieve the board of the need to evaluate the merits of each strategic decision (Baysinger & Hoskisson, 1990). Consequently, it seems likely that lone-family-member CEOs have an incentive to request stock options while boards view them as an appropriate substitute for strategic control. Thus, we expect that:

**Hypothesis 2b:** Lone-family-member CEOs receive more stock option compensation than CEOs of non-family firms.

## METHODS

To contrast CEO compensation among lone- and multi-family-representation firms with non-family firms, we sampled a panel of *S&P 500* firms for the years 2002 through 2005. We started in 2002 to avoid effects due to changes wrought by the Sarbanes-Oxley Act. Panel data helps temper the influence of uneven options allocations (O'Connor, Priem, Coombs, & Giley, 2006), and four years is sufficient to capture these fluctuations (e.g., Gomez-Mejia *et al.*, 2003).

The *S&P 500* has been a popular sample frame for examining the effects of family influence among public firms (e.g., Anderson & Reeb, 2003). An initial list was developed from the 2002 *S&P 500*. Accounting, market, and ownership data are from COMPUSTAT, CRSP, and RiskMetrics/Thompson-Reuters, respectively, and data on CEOs and boards are from EXECUCOMP. Information about family influence was gathered by examining company histories on websites and SEC filings. Many firms did not have public records for all years due to mergers and some instances of public firms going private. Consequently, our final sample contained 389, 383, 381, and 389 firms for 2002, 2003, 2004, and 2005, respectively. We include non-family firms as a reference point for understanding how differences among family firms compare to the larger population of public firms

### **Dependent Variables**

Following Gomez- Mejia *et al.* (2003) and others (e.g., Combs & Skill, 2003), *cash compensation* is the sum of guaranteed cash and cash performance bonus earned by the CEO in that year. The Black-Scholes formula was used to calculate *stock options* (e.g., Certo, Daily, Canella, & Dalton, 2003; O'Connor *et al.*, 2006). It provides an estimated value of stock options that has been widely used and validated in previous literature (O'Connor *et al.*, 2006) and accounts for historical firm stock price volatility (Certo *et al.*, 2003). Some studies have used the number of options granted multiplied by 25 percent of the exercise price, which is a highly correlated proxy for the Black-Scholes estimate (e.g., Gomez-Mejia *et al.*, 2003; Finkelstein & Boyd, 1998). Given that the data for the Black-Scholes estimate are now available, we used that rather than its proxy.

### **Independent Variables**

To identify family representatives, we searched Hoover's ([www.hoovers.com](http://www.hoovers.com)), individual company websites, and annual reports. This list was then used to identify whether the firm's

CEO was a family member and whether the CEO was the only family member involved. *Lone-family-member CEOs* are those where the CEO is the only family-member who is active in management or on the board of directors. *Multi-family-member CEOs* have one or more family members serving in management or the board in addition to the CEO. We grouped CEOs by family-member representation rather than investigating a linear interaction between being a family CEO and the number of family representatives. We did this because our theory predicts a qualitative change in compensation with a second family representative that is not linear with respect to additional family members.

**Control Variables.** Devers *et al.*'s (2007) review identified four categories of factors that impact CEO compensation: (1) firm performance, (2) job context factors, (3) corporate governance, and (4) CEO human capital. We identified control variables from each category in an effort to control for the full range of factors that influence compensation.

To capture multiple dimensions of firm performance, we include *ROA* to control for the effects of accounting returns and *shareholder returns* to control for market-based performance. Given the impact of industry membership on ROA (McGahan & Porter, 1997), we calculated the industry-adjusted ROA by deducting the two-digit industry mean ROA from each firm's ROA. Shareholder returns were measured as the change in stock price over the year plus dividends paid divided by the starting stock price. These were similarly adjusted by subtracting the total returns from the value-weighted stock index for that year.

Performance has an inverse relationship with *risk* (Wiseman & Bromiley, 1996). We control for risk because CEO pay-performance sensitivity decreases as risk increases (e.g., Aggarwal & Samwick, 1999). We measured systematic risk using beta from the capital asset pricing model (Merton, 1973). The slope of the firm's monthly returns regressed on monthly value weighted returns for the year is the firm's beta and our measure of risk.

The second category of factors that impact CEO compensation, job context, is important because it determines the complexity of the CEO's job (Devers *et al.*, 2007). The most important job context predictor of CEO compensation is *firm size* (Tosi *et al.*, 2000). We measure size using total sales (e.g., Combs & Skill, 2003). Given that the challenges confronting CEOs change with life-cycle stage (Miller, 1991), and that young firms are more likely to have first-generation family-members whose impact is different from second or third generation family-members (Villalonga & Amit, 2006), we control for *organizational age* measured in years. Family firms are over-represented in some industries (Westhead & Crowling, 1999), making CEO compensation potentially susceptible to industry patterns. Consistent with prior compensation research (e.g., Anderson & Reeb, 2004), we use a series of 2-digit SIC code indicator variables to control for industry. Finally, because we use panel data and job demands fluctuate with the economy, we include a series of indicator variables for *year*.

For the third set of factors, corporate governance, we include control variables for the three most frequently studied aspects of corporate governance – board independence, CEO duality, and institutional investors (Dalton, Daily, Ellstrand, & Johnson, 1998) – plus two pertinent aspects of family-influence – percentage of ownership and family representation on the compensation committee. *Board independence* was measured using the proportion of directors that are not family members, employees, or affiliated through supply or other key business relationships (e.g., Combs & Skill, 2003). *Duality* was measured with an indicator variable depicting whether the CEO also served as the board chair (Dalton *et al.*, 1998). Institutional investors put downward pressure on cash compensation but encourage incentive pay (Hartzell & Starks, 2003). We therefore controlled for *institutional ownership* using the sum of the holdings of each non-family institutional investor as a proportion of total common stock outstanding.

Our theory involves the presence of multiple family representatives on family-member CEO compensation, so it is important to control for other ways that the family might influence governance. Family participation on the compensation committee is one way that the family might have undue influence on compensation, so we included *family on compensation committee* as an indicator variable depicting whether a family-member was on this committee. We also controlled for the proportion of *family ownership*. This is an important control because ownership is an important source of family influence (Anderson & Reeb, 2003).

For the final set of factors that impact CEO compensation (i.e., Devers *et al.*, 2007), we controlled for three aspects of CEOs' human capital. Tenure impacts compensation as CEOs gain both experience and power over the course of their tenure (Hill & Phan, 1991). *CEO Tenure* was measured as the amount of time in years that the CEO has been with the firm. *CEO Ownership* similarly affects CEO motivation and firm performance (Coles, McWilliams, & Sen, 2001), especially for family firms (Anderson & Reeb, 2003). CEO ownership was measured as the percentage of total shares owned by the CEO. Finally, family managers come from a limited pool of managerial talent, so the presence of a non-family CEO suggests that the firm has drawn CEO talent from a much wider pool of human capital (cf. Gomez-Mejia *et al.*, 2003). Thus, we included an indicator variable depicting *non-family CEO in family firm*.

## RESULTS

Table 1 displays the descriptive statistics and correlations among study variables. Based on the results of the Hausman test, the hypothesis tests reported in Table 2 are from cross-sectional time series regressions with random-effects models and generalized least square estimators. One-tailed tests are statistically correct when hypotheses are theory-driven and directional (Jones, 1952). Thus, one-tailed tests were used for hypothesis tests while all other (non-directional) significance levels are based on two-tailed tests.

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The significant control variables are largely consistent with prior theory and evidence. The first set of controls deal with performance and risk, and, consistent with prior evidence, CEOs are rewarded for performance (Tosi *et al.*, 2000). Cash compensation reflects shareholder returns ( $\beta = .09; p < .001$ ), and ROA ( $\beta = .05; p < .01$ ); the latter is also weakly related to stock options ( $\beta = .06; p < .10$ ).

Among job context controls, firm size is related to cash ( $\beta = .22; p < .001$ ) and stock options ( $\beta = .09; p < .05$ ) as expected (Tosi *et al.*, 2000). We found weak evidence that older firms pay more in cash ( $\beta = .09; p < .10$ ), but also that young firms use more stock options ( $\beta = -.14; p < .01$ ). This likely reflects older firms' ability to use cash and the popularity of stock options among high tech firms (Hellmann & Puri, 2002). Finally, several of the 52 industry indicator variables are significant showing that compensation is influenced by industry norms.

Several corporate governance variables also show significant effects. Board independence was negatively related to stock options ( $\beta = -.09; p < .01$ ), which is puzzling given prior findings that independent boards increase pay sensitivity (Conyon & Peck, 1998). Perhaps our more recent data reflects trends after the 2002 passage of the Sarbanes-Oxley Act. Regarding duality, dual CEO-Chairs use their position to garner more cash ( $\beta = .05; p < .05$ ) and stock options ( $\beta = .07; p < .05$ ) as predicted by agency theory (e.g., Dalton *et al.*, 1998). Consistent with our theory, having a family member on the compensation committee puts downward pressure on cash compensation ( $\beta = -.06; p < .05$ ). Finally, we were surprised that whereas family ownership is in the expected direction, it is not significant for cash or stock options. This result is consistent, however, with our view that it is the physical presence of family member representation that facilitates strategic control.

The final category of control variables involves human capital. Reflecting their experience and power, long tenure positively impacts cash ( $\beta = .12; p < .001$ ). CEO ownership has a negative impact on options ( $\beta = -.22; p < .001$ ), which is consistent with prior research suggesting that ownership is a substitute for other forms of incentive compensation (Mehran, 1995). Finally, we found no evidence that cash or stock options differ between non-family CEOs in family versus non-family firms. Although null results need to be interpreted with caution, these non-significant findings are important because they suggest that the difference between family and non-family CEOs that Gomez-Mejia *et al.* (2003) found in a sample of multi-family-member firms was caused by lower-than-average pay among family CEOs and not from non-family CEOs in family firms requiring higher-than-average pay as premium for working in a family firm. It also implies that the strategic controls that family members exert on family-member CEOs does not extend to non-family-member CEOs.

Hypothesis 1a predicted that family-member CEOs in multi-family-member firms receive less cash compensation than CEOs of non-family firms; it is supported ( $\beta = -.09; p < .05$ ). Hypothesis 1b, which predicted that family-member CEOs in multi-family-member firms receive less stock option compensation than CEOs of non-family firms, is not supported ( $\beta = -.02; ns$ ).

Hypothesis 2a predicted that lone-family-member CEOs receive more cash compensation than CEOs of non-family firms. This hypothesis is supported ( $\beta = .09; p < .05$ ). Hypothesis 2b predicted that lone-family-member CEOs also receive more stock option compensation than CEOs of non-family firms; this hypothesis is also supported ( $\beta = .13; p < .05$ ). Overall, three of our four hypotheses were supported, suggesting that differences in CEO pay can be partially attributed to how family is represented among large, public firms.

## ***Post Hoc Analysis***

We ran several *post hoc* robustness tests to insure the integrity of our results. First, we sought to make sure our results are not due to the presence of founders. Founders are evenly divided (i.e., 49-51 percent respectively) among lone- and multi-family-member CEOs, but 68 percent of lone-family-member CEOs are founders, which is suggestive of potential founder effects. When an indicator variable for founder is added, however, it is never significant. Its impact on the hypothesis tests was to reduce the supported hypotheses to  $p < .10$ . Thus, founders influence the results, but are not a dominant factor.

Next, we sought to make sure that our results are robust with respect to different elements of family and CEO ownership. We first subtracted family CEOs' ownership from overall family ownership and re-ran the regressions. This new family ownership variable was not significant and its only impact on findings was to reduce the effect for lone-family member CEOs to  $p < .10$  in the cash model. We then added the interaction between CEO ownership and family firm to make sure that CEO ownership effects (a control variable) are not due to family CEOs' ownership. The variable isolating CEO ownership in family firms was not significant in the cash models and had no effect on the hypothesis tests. It was not significant and had no effect on the hypothesis tests in the stock options model either, but it did reduce the negative effect of CEO ownership so that it was no longer significant. This suggests that some of the negative impact of CEO ownership on CEO stock options is from high ownership among family CEOs.

Finally, we compared our results to an alternative empirical specification. We added a CEO family member indicator variable and the number of family member representatives as main effects, as well as their product, or interaction. The main effects are significant and in the predicted direction for both dependent variables. The interactions are not significant, however,

which is likely because this empirical specification treats the addition of a second family member the same as the addition of other family members, which is counter to our theory.

## DISCUSSION

We leveraged agency theory to explain the effect of family representation on CEO compensation. Specifically, we build on Gomez-Mejia *et al.* (2003) by investigating whether the seemingly steward-like compensation package among family-member CEOs that they identified extends to situations when there are no other family members involved in management or on the board. Broadly speaking, our findings suggest that family-member CEOs only accept a compensation package that reflects pro-organizational stewardship orientations in the presence of other family representatives. Our theoretical position is that this is because family representatives engage in strategic control wherein they monitor family-member CEOs' actions and influence the compensation package that is adopted.

Regarding multi-family-member CEOs, we find that they earn less cash (and total) compensation than CEOs at non-family firms. This result is consistent with Gomez-Mejia *et al.* (2003) in that they too found that family CEOs in multi-family-member firms receive lower compensation than non-family CEOs in such firms. Without using non-family firms as a reference point, however, there was no way to know whether CEO compensation in family firms differed for the reasons specified by Gomez-Mejia *et al.* (2003). They theorized that family-member CEOs received less-than-average compensation, but it seems possible that non-family CEOs at family firms might demand more-than-average compensation to reward them for the risk of working in a family firm. Because we show that multi-family-member CEOs receive less than CEOs at non-family firms, our findings support Gomez-Mejia *et al.*'s (2003) position that the difference between family and non-family CEO compensation at family firms occurs because family CEOs accept less. The non-significant coefficient for non-family CEOs in family firms

also suggests that Gomez-Mejia *et al.*'s (2003) findings depict lower-than-average pay to family CEOs rather than higher-than-average pay to non-family CEOs in family firms. The latter appear no different than their counterparts in non-family firms.

Our result regarding lone-family-member CEOs shows that when there are no other family representatives in management or on the board, the family-member CEO is not willing to accept a compensation package that reflects a stewardship orientation. Rather than allowing their compensation to be adjusted downward in recognition of non-economic benefits, lone-family member CEOs earn more cash and stock options than CEOs at non-family firms.

There is evidence that the key performance advantage for family firms is due to founders' influence (Miller, Le Breton-Miller, Lester, & Cannella, 2007). Although only about half of the founders in our sample are lone-family representatives, it raises the possibility that one reason lone-family-member CEOs garner more compensation is simply because it is a reward for better performance (Combs & Skill, 2003). Given, however, that firm performance explains only a small portion of CEO compensation (Tosi *et al.*, 2000) and that we control for both accounting and market performance in our analysis, it seems likely that multiple family representation also matters. Drawing on agency theory, we believe that the reason is because these family representatives perform a strategic control function that reduces the CEO's compensation directly by monitoring the compensation process, and indirectly by reducing the CEO's discretion. Less discretion translates into less job complexity and lower CEO pay (Finkelstein & Boyd, 1998).

### **Implications for Family Firm Research**

Our research adds to existing knowledge concerning the effects of family influence among public firms by further investigating one important factor – i.e., CEO compensation – that is affected by family representation. Specifically, prior research had shown that in firms with

multiple family representatives, family-member CEOs earned less than non-family CEOs. We extend research in this area by developing theory that challenges the characterization of family CEOs as pro-organizational stewards (e.g., Braun & Sharma, 2007). In support of our theorizing, our results show that absent family representation as a source of strategic control, family-member CEOs earn more compensation than CEOs of public non-family firms.

As shown in Table 3, the effects that we identified appear managerially meaningful. On average, lone-family-member CEOs earn \$628,972 more in cash and \$3,051,147 more in stock options than CEOs at non-family firms, and family-member CEOs with multiple family representatives earn \$463,627 less cash than CEOs at non-family firms. Among family-firms, lone-family-member CEOs earn \$1,092,599 more cash and \$3,438,551 more in stock options than family-member CEOs with additional family representatives.

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Insert Table 3 about here  
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Given that the indicator variable depicting non-family CEOs in family firms was not significant, the strategic controls that family representatives exert over family-member CEOs might not extend to non-family-member CEOs. One reason could be that there is a market for CEO talent and family firms must pay at least the going rate to keep talented non-family CEOs (Ezzamel & Watson, 1998). Further, for the reasons Gomez-Mejia *et al.* (2003) describe – i.e., greater job security, more socio-economic wealth, and less external market value – other family representatives might feel that family member CEOs *deserve* less pay than someone hired externally. The question of whether the family representatives' strategic control function extends to non-family members has important theoretical implications because using non-family CEOs in public family firms introduces an agent into the principal-principal agency problem. Our speculation is that, with respect to compensation, introducing a non-family agent makes the

family firm look like a non-family firm wrestling with traditional principal-agent problems. This notion is based on a non-significant result, however, and does not address broader questions beyond compensation about what happens to principal-principal agency costs when principals hire an agent. These broader questions appear to be fruitful avenues for future inquiry.

We found that multi-family-member CEOs make less cash compensation, but we did not find evidence that they earn less in stock options. Gomez-Mejia *et al.* (2003) only investigated the impact of family influence on total compensation. Thus, it appears that the effect that Gomez-Mejia *et al.* (2003) report is due mostly to the cash component of CEO compensation. We expected that options would increase the family's perceived risk exposure so much that family representatives would reduce options. Although non-significant results should be interpreted with caution, it seems likely that many decisions are still too difficult for family representatives to evaluate fully, and thus they still find value in CEO incentives.

Finally, because family business research is sensitive to how family influence is defined (Westhead & Cowling, 1999), our work has study design implications. Chua, Chrisman, & Sharma (1999) reviewed the many definitions that family business researchers have used to identify family influence, and proposed that the essence of a family firm involves a desire by the family to "shape and pursue the vision of the business...in a manner that is potentially sustainable across generations..." (p. 25). It seems less likely that lone-family-member CEOs seek to sustain their influence across generations as most CEOs with this designation are either founders or the only second-generation family-member to become involved. Accordingly, many studies have focused only on firms where family ownership is high *and* multiple family members are involved (e.g., Chrisman *et al.*, 2004). Yet, if the purpose of family business research is to understand how the family component impacts firms (Chua *et al.*, 1999), then our study suggests that firms with lone-family-member CEOs need to be considered; their impact is indeed distinct.

We agree that it makes sense to build a body of knowledge around the unique features of firms with multiple family representatives, but it should also be useful to study lone-family members and compare what we learn about each type of representation.

### **Implications for CEO Compensation Research**

Our results have implications for the broader literature focused on explaining executive compensation. This literature has done much to explain cash compensation for CEOs, producing models that predict close to seventy percent of the variance (Combs & Skill, 2003). Much of the compensation variation among firms can be attributed to firm size (Tosi *et al.*, 2000), but performance and other characteristics of the CEO's job, such as its information processing demands (Henderson & Fredrickson, 1996) and CEO discretion (Finkelstein & Boyd, 1998) matter too. Characteristics of the CEO, such as their power over the compensation process and individual human capital, impact compensation (Combs & Skill, 2003). We also know that when ownership is less dispersed and large institutional investors are available to monitor CEO actions, cash compensation is less (Gomez-Mejia *et al.*, 1987), and that the market for CEO talent also influences CEO compensation (Ezzamel & Watson, 1998). The results of this study show that the amount of family representation is another factor that affects cash compensation.

Relative to cash compensation, much less is known about factors that affect the amount of stock option compensation offered. Most firms offer much less stock option compensation than agency theory might predict (Jensen & Murphy, 1990), but we know little about what factors go into the decision to grant options and how many options to grant. Our study shows that the influence of lone-family-member CEOs is one factor that increases the size of stock option grants. Our theory and evidence suggest that lone-family-member CEOs are not monitored closely, which is consistent with evidence that stock option repricing decisions are influenced by managerial power (Pollock, Fisher, & Wade, 2002).

The high amount of compensation paid to lone-family-members might help to explain why stock prices rise upon the departure of founders (e.g., Jensen & Zimmerman, 1985). Founders and other lone-family-member CEO's are central figures in helping their firms grow and prosper (Miller *et al.*, 2007), but evidence suggests that over time many executives who stay in the same job often become "stale in the saddle" (Miller, 1991; p. 34). One reason is that the competitive environment that made them successful changes and executives are unable to adapt (Miller, 1991), but hubris might also play a role (Hayward & Hambrick, 1997). As is the case with non-family CEOs, the same power that gives lone-family member CEOs the ability to increase their compensation probably also allows them to stay in their jobs past their point of effectiveness (Combs & Skill, 2003). Perhaps the strategic control that multiple family representatives provide helps prevent ineffective family-member CEOs from staying too long.

### **Limitations and Future Research Opportunities**

Our theory suggests that the reason CEO compensation declines significantly when there are other family representatives involved is because they engage in strategic monitoring that reduces family-member CEOs' discretion and keeps compensation low, but there is much in this process that remains hidden from view and thus presents opportunities for future research. It is possible, for example, that rather than family representatives who rationally evaluate strategic decisions and CEO compensation, lower pay from multiple family representation might be due to intra-family rivalry wherein one family faction is trying to restrict another's power (e.g., Sharma, *et al.*, 1997). Thus, additional efforts to understand how family dynamics interact with corporate governance in large family firms appears warranted. Indeed, we did not separate family managers from family board members. Perhaps this or other role distinctions might help researchers capture underlying family dynamics.

We also did not investigate any factors that might systematically moderate our main findings. Gomez-Mejia *et al* (2003), for example, found that institutional investors limit the amount of stock options family-member CEOs receive. Our results suggest that one possibility worthy of attention might be to investigate whether such effects only exist when multiple family representatives facilitate institutional investors' efforts, and to investigate how successful lone-family-member CEOs are at resisting such limits. More broadly, investigating how family representation moderates other important relationships in family business research appears to be a fruitful avenue for future inquiry.

### **CONCLUSION**

We extend Gomez-Mejia *et al.* (2003) by investigating the effects of different types of family representation on CEO compensation among public firms. Our results reveal that relative to CEOs at non-family firms, family-member CEOs of family firms with multiple family representatives receive lower compensation. When the family-member CEO is the only family-member involved, however, compensation increases relative to CEOs at non-family firms. Our theory is that the additional family representatives engage in strategic control by evaluating CEO decision-making and monitoring the compensation process. The results imply that both forms of family representation matter because they help explain ways that families influence important outcomes.

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**TABLE 1**  
**Means, Standard Deviations, and Correlations<sup>a</sup>**

Variables	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	
1 Cash Compensation <sup>b</sup>	2.58	1.93																	
2 Stock Options <sup>b</sup>	4.13	6.60	.13***																
3 ROA	0.04	0.07	.12***	.03															
4 Shareholder Returns	0.13	0.51	.08**	-.06 <sup>†</sup>	.13***														
5 Risk	1.14	.97	-.15***	.05 <sup>†</sup>	-.18***	.00													
6 Firm Size <sup>c</sup>	1.48	2.60	.27***	.08**	.02	-.03	-.09***												
7 Organizational Age	77.83	47.02	.18***	-.14***	-.01	.05 <sup>†</sup>	-.19***	.14***											
8 Board Independence	72.54	14.93	.13***	-.06*	.01	.09***	-.01	.03	.22***										
9 Duality	0.74	0.40	.06*	.03	.00	.00	-.08**	.03	.14***	.11***									
10 Institutional Ownership	69.42	14.15	-.03	.00	.11***	.07**	.06**	-.18***	-.20***	.09***	.00								
11 Family on Compensation Committee	0.01	0.07	-.04	-.03	.05 <sup>†</sup>	-.01	-.05 <sup>†</sup>	-.04	-.02	-.06*	-.03	-.03							
12 Family Ownership	3.16	15.45	-.07**	-.02	.00	-.01	.00	-.06*	-.13***	-.17***	-.04 <sup>†</sup>	-.03	.04						
13 CEO Tenure <sup>d</sup>	7.28	6.64	.07**	.01	.06*	-.02	-.04	-.03	-.06*	-.13***	.13***	.05*	.10***	.17***					
14 CEO Ownership	0.66	2.65	-.05 <sup>†</sup>	-.06*	-.01	-.01	.00	-.05*	-.12***	-.21***	.02	-.05*	.09***	.27***	.42***				
15 Non-Family CEO in Family Firm	0.19	0.39	-.04 <sup>†</sup>	.06*	.11***	.01	.01	-.01	-.10***	-.18***	-.18***	-.03	.04 <sup>†</sup>	.08***	-.11***	-.07**			
15 Multi-Family-Member	0.23	0.77	-.10***	-.05*	-.02	.00	-.03	.00	-.17***	-.29***	-.09***	-.05 <sup>†</sup>	.26***	.16***	.25***	.21***	-.14***		
16 Lone-Family-Member	0.07	0.26	.01	.09***	-.06**	-.03	.14***	-.04 <sup>†</sup>	-.20***	-.06*	-.02	-.01	-.02	.26***	.21***	.34***	-.14***	-.08***	

<sup>a</sup> N varies from 1526 to 1656, pairwise deletion. <sup>†</sup>  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$

<sup>b</sup> in millions.

<sup>c</sup> in billions.

<sup>d</sup> in years.

**TABLE 2**  
**Results of Random-Effects GLS Models for Family Representation on Compensation<sup>a</sup>**

Variables	Controls		Main Effects	
	Cash Compensation	Stock Options	Cash Compensation	Stock Options
ROA	.05**	.06 <sup>†</sup>	.05**	.06*
Shareholder Returns	.09***	-.02	.09***	-.02
Risk	-.03	.02	-.03 <sup>†</sup>	.02
Firm Size	.22***	.09*	.22***	.09*
Organizational Age	.09 <sup>†</sup>	-.15**	.09 <sup>†</sup>	-.14**
Board Independence	.03	-.08*	.02	-.08*
Duality	.05*	.07*	.05*	.07*
Institutional Ownership	.04 <sup>†</sup>	.01	.04	.01
Family on Compensation Comm.	-.07*	.01	-.06 <sup>†</sup>	.02
Family Ownership	-.04	-.01	-.04	-.03
CEO Tenure	.12***	.03	.12***	.02
CEO Ownership	-.05	-.21***	-.05 <sup>†</sup>	-.22***
Non-Family CEO in Fam. Firm	.00	.03	.00	.04
Industry Indicator Variables	Yes***	Yes*	Yes***	Yes*
Year Indicator Variables	Yes**	Yes**	Yes**	Yes**
Multi-Family-Member CEO			-.09*	-.02
Lone-Family-Member CEO			.09*	.13**
<i>n</i> , firm years	1444	1439	1444	1439
<i>n</i> , firms	379	379	379	379
Observations/firm	3.81	3.80	3.81	3.80
Wald $\chi^2$	322.86***	109.50***	334.61***	118.13***
$R^2$ -within	.14	.06	.13	.06
$R^2$ -between	.32	.12	.34	.14
$R^2$ -overall	.28	.10	.29	.11

<sup>a</sup> Standardized coefficients. Directional hypothesis tests are one-tailed; all others two-tailed.

<sup>†</sup> =  $p < .10$ ; \* =  $p < .05$ ; \*\* =  $p < .01$ ; \*\*\* =  $p < .001$ .

**Table 3**  
**Predicted Values for Compensation**

<b>Independent Variables</b>	<b>Cash</b>	<b>Stock Options</b>	<b>Total Compensation</b>
Lone-family-member CEOs	\$3,211,797	\$6,987,723	\$10,199,520
Multi-family-member CEOs	\$2,119,198	\$3,549,172	\$5,668,370
CEOs at non-family firms	\$2,582,825	\$3,936,576	\$6,519,401