Entrepreneur & Innovation Exchange
Published online at FamilyBusiness.org on November 09 2022

Does the Family Matter? Improving Executive Compensation Practices in Family Firms

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KEYWORDS: Family business dynamics, Executive Compensation, Help with a family business, Running a family business tips, family business conflict.

The salaries of top executives can be a hot topic and a source of family business conflict and stress – at family businesses and non-family firms. How can family business leaders decide what's fair? We looked at what research has found about this topic and discovered that it doesn't answer some key questions about executive compensation in family firms. Along with reviewing this research, our conversations with family executives and advisors revealed that families need to talk about pay well before it causes a problem.

At family firms, the executives may be family members from one generation or multiple generations, or a top management team that draws some (or all) of its members from outside the family. Family firm leaders must think about not only how much to pay these managers, but also whether all should receive equal pay, whether merit plays a role in salary level, and how non-family executives should be compensated. Academic research has tried to address some of these questions, but much more is needed.

In this article, we summarize some of the previous research, discuss the role family dynamics can play, and conclude with tips for family firm leaders to consider in putting together an executive compensation plan.

What Research Tells Us, and Doesn't Tell Us

To better understand what research has found about executive compensation at family businesses, we reviewed more than 70 articles published in academic journals (Michiels, Botero & Kidwell, 2022). We saw that much of our current understanding about executive compensation in family business is based on studies of large, publicly listed firms, and compares family firms to non-family firms. These studies rarely considered the family's role in developing a top management compensation system.

Yet, as the issues noted above show, the *family* plays a central role in strategic decisions such as executive pay. So does the "family system," or the interplay of the family's established hierarchy, rules, values and rituals. Because past research has not considered how complicated families and family systems are, the research findings, related recommendations and "best practices" may not apply to the majority of firms worldwide: privately-held family businesses. Our research aims to offer family owners, managers, boards, management teams, and their advisors more specific and tailored advice on executive compensation.

Two key questions must be considered to further help decision makers within the family business:

- How do family firms of various sizes and in various industries design and implement executive compensation systems?
- How do family dynamics influence the design of executive compensation systems?

A broader focus on executive compensation can provide additional insights into how different family businesses make decisions about compensating family and non-family executives, and how the family system affects that process - and its consequences. This can be useful for advisors and family business leaders, while creating a stronger connection between research and practice.

How Family Firms & Non-Family Firms Pay Differently

The research findings give mixed messages about annual pay levels, structure of the compensation packages, and how pay can differ even among executives of the same top management team. Some studies support the longstanding view that CEO pay in family firms is lower than in non-family firms (e.g., De Cesari, Gonenc, & Ozkan, 2016; Pooser, Wang, & Barrese, 2017; Tinaikar, 2014; Yarram & Adapa, 2020) whereas others find that family ownership leads to higher executive pay levels (e.g., Basu, et al., 2007; Bhabra & Hossain, 2018; Cheng, Lin, & Wei, 2015). One complicating factor is that “total compensation” can encompass different things at different firms: pay, stock options, benefits, dividend income, long-term or short-term incentives, etc. This often prevents us from comparing results and drawing conclusions.

Some researchers have looked at compensation differences between family and non-family executives at family firms. Again, results are mixed. Some results confirm that family executives use their power to pay themselves too much and tap other benefits, thus exploiting the firm and its outside shareholders (e.g. Cai, et al., 2013; Cheong & Kim, 2019; Jong & Ho, 2019; Kim & Han, 2018). But other studies have found that family executives want to maximize firm value, which makes them unlikely to act against the interests of the firm. These executives often have lower compensation levels and less incentive-based compensation (Gomez-Mejia et al., 2003; McConaughy, 2000).

Incentive Pay as a Recruiting Tool

Most studies agree that family businesses use incentive contracts less than non-family firms (Baek & Fazio, 2015; Memili, et al., 2013; Speckbacher & Wentges, 2012) and have lower levels of incentive pay (Baek & Fazio, 2015; Bhabra & Hossain, 2018; Mazur & Wu, 2016; McConaughy, 2000; Tsao, Lin, & Chen, 2015). Few studies have investigated the differences of pay structures between family and non-family executives in family businesses. Studies by Chrisman et al. (2007) and Michiels et al. (2013) confirm that privately held family businesses do use incentive compensation for their family executives, but others indicate that family businesses tend to provide higher levels of performance-related incentive pay to non-family executives than to family executives (Cui et al., 2018; McConaughy, 2000; Kim & Han, 2018; Cheng et al., 2015). Because family firms are more likely to keep stock ownership within the family, they use cash incentives to recruit, retain and motivate non-family executives (Carlson et al., 2006). Also, because family executives are care deeply about non-economic (socioemotional) wealth preservation (Cui et al. 2018), they might require less incentive pay than non-family executives. One study (Gomez-Mejia and colleagues, 2019) found that a CEO’s ties to the family influenced his/her response to incentive compensation. However, in terms of what drives incentive compensation, research has largely failed to acknowledge the role of the family system, with the notable exception of Yu and colleagues (2019), who investigated the impact of kinship ties.

Other research findings have looked at pay “dispersion,” or how pay varies throughout the top management team. Some researchers found that family ownership increases the likelihood that the CEO is not the highest paid manager (Sharma & Huang, 2014). Others have found that executive pay is more equal as younger generations take over (Jaskiewicz, et al., 2017). Research shows that big differences in executive pay can have different outcomes for family than for non-family firms. In particular, Ensley and colleagues (2007) found that these differences can provoke strongly negative behaviors, especially among top managers at family firms, where group dynamics are more complicated. They also find that a close relationship between family members makes these teams more vulnerable to the negative impact of pay dispersion.

A Neglected Element: The Impact of the Family

While family firms in general are different from non-family firms, family firms also differ greatly from one another. Family science theories can help family business leaders understand the family system’s role in executive compensation decisions (Michiels, et al. 2022). For example, family dynamics can influence attitudes about top management compensation. Heredity, birth intervals, and personality differences in families can all influence a child’s personality development (Paulhus, Trapnell, & Chen, 1999; Sulloway, 1996). In addition, parenting style (authoritarian, authoritative and permissive) affects children differently (Baumrind, 1971) in terms of self-reliance, control, contentment, and trust. All of these factors can affect how the compensation system is designed or perceived as next generation top managers come into the family firm.

Other researchers (Yu, et al., 2019) have explored kinship theory, which looks at how family ties influence

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the design of executive compensation systems. These ties can negatively affect family firm executive compensation and performance (Miller, et al. 2007; Cheng et al. 2015). Strong ties might encourage family firm leaders to engage in such activities as negative nepotism (hiring and promoting family members regardless of merit). Strong ties can also blur lines between family and non-family matters; and encourage the pursuit of non-economic goals at the expense of economic ones (O'Brien, et al, 2018). A study by Yu and colleagues found that family firms with distant ties were more likely than tighter families to appoint a non-family CEO and to pay non-family executives lower salaries. In a study of employee theft in family firms, O'Brien and colleagues (2018) proposed that genetically related family members are more likely to misuse company resources because they know that other family members are more indulgent towards them. These studies show that kinship ties across family firms can affect executive pay plans. Closely connected family members may feel more entitled to preferential treatment and more altruistic towards other close relatives, influencing who fills the executive roles and how much they are paid.

What Families and Advisors Told Us

Challenged by the ambiguous findings from our literature review, we began a series of interviews with family firm leaders and advisors (Kidwell et al 2022) to see how they design and implement executive compensation plans. We saw that conflict and communication within and across generations can drive the discussion or result from it. Unfortunately, many families don't talk much about executive compensation until conflict arises, so having an open process involving all affected family members is crucial. Both the family's life cycle (Duvall, 1988) and its changing standards of behavior, e.g., communication norms (Ritchie & Fitzpatrick, 1990) have potential impact on major decisions such as how to compensate key leaders. In-family patterns of agreement and disagreement influence how well families communicate with one another through everyday conversations. And when generations don't talk openly with each other, it can create problems, as one second generation family firm leader shared:

"It's leading to difficulty and conflict right this second, because if my mom and I had defined roles, clearly defined compensation, or even had an exit strategy, which we never did have an exit strategy, we probably wouldn't be right now in this conflict that we're in."

Second, family dynamics and relationships are extremely important elements in decisions and outcomes about executive compensation. One advisor told us that:

"Seniority in the family is a major factor. Who you are, and where you are in the family, can play a major role. If there's animosity within, like between brothers and sisters, there's going to be a desire to lower someone's salary or argue someone's pay because they don't do as much - whether they do or don't do enough. Even after our assessments, they may still feel like the person doesn't do enough…. And, I would say the 'mother or father effect' tends to play a lot where the mother and father want to take care of their kids and they tend to give more than they should be giving because the kids demand a certain lifestyle and don't always want to work towards it."

Key Questions and Takeaways for Family Business Leaders and Advisors

Based on what the interviews have told us thus far, family firm executives should be asking themselves these questions regarding executive compensation:

- Does your family have an executive compensation policy or compensation expectations for family members? Why?
- If the family has a policy, are these compensations policies explicit (i.e., written) and shared with family members.
- How were these policies established? How are they communicated? How effective is this process?
- How are the compensation policies connected to individual performance?
- What is fair compensation for family executives versus what they could earn on the open market?
- If you want to start developing a compensation plan for executives in your family firm, consider the following:
- What is the goal of your compensation policy? Is it to facilitate decision-making, is it to[RK3] differentiate the different levels of performance, is it to prevent conflict?
- Is the policy reflective of the family's culture?

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- Who will have a say in determining the compensation policies?

These are some key takeaways from our research:

- The dynamics of the family system play an important role in decisions about executive compensation in family firm.
- Family business owners should ensure that discussions about compensation policies or practices be open with family members. This way, differences in perceptions could be negotiated.
- Establish an executive compensation policy for bringing in new family member leadership before the next generation seeks to take the reins.
- Executive compensation is not often discussed before there is a conflict that triggers this conversation. If a family business wants to be proactive about this topic, they should consider having discussions about this topic before a conflict emerges between family members.

Conclusion

As the family firm grows and passes from the involvement of just one generation to the involvement of multiple generations, the need for a more formal and transparent system of executive compensation is crucial. Failure to establish how family member executives and non-family executives are paid or otherwise compensated, and failure to communicate these policies to all concerned, can lead to conflict that could damage the firm and the family relationships. Research only tells us so much at this point, and families need to encourage additional conversations that consider the impact of the family system in a wide variety of family firm circumstances to establish best practices and contingencies regarding the pay of top managers. The results of those conversations should be shared with a wide audience of family firm leaders and advisors.

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