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Board Composition: Balancing Family Influence in S&P 500 Firms

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We examine the mechanisms used to limit expropriation of firm wealth by large shareholders among S&P 500 firms with founding-family ownership. Consistent with agency theory, we find that the most valuable public firms are those in which independent directors balance family board representation. In contrast, in firms with continued founding-family ownership and relatively few independent directors, firm performance is significantly worse than in non-family firms. We also find that a moderate family board presence provides substantial benefits to the firm. Additional tests suggest that families often seek to minimize the presence of independent directors, while outside shareholders seek independent director representation. These findings highlight the importance of independent directors in mitigating conflicts between shareholder groups and imply that the interests of minority investors are best protected when, through independent directors, they have power relative to family shareholders. We argue that expanding the discussion beyond manager-shareholder conflicts to include conflicts between shareholder groups provides a richer setting in which to explore corporate governance and the balance of power in U.S. firms.●

Large shareholders often wield substantial control and influence over firm matters, and agency theory suggests they have powerful incentives to consume the firm's resources since they bear only a fraction of the total cost. Faccio, Lang, and Young (2001) found that without vigilant oversight, large shareholders such as founding families are prone to exploit minority shareholders' portion of the firm's wealth Several empirical studies have documented that family shareholders in public firms extract private rents through special dividends, excessive compensations schemes, and with related-party transactions (e.g., DeAngelo and DeAngelo, 2000) Recent accounts in the popular press indicate that even in regimes with relatively strong legal safeguards, the security of minority investors' interests cannot be taken for granted For instance, Adelphia Communications' largest shareholder, the founding Rigas family, reportedly diverted firm assets to their private use without substantive interference from the board or other shareholder groups (Pulliam and Frank, 2004) Many other major U S firms, such as Rite Aid, U-Haul, and Wang Laboratories have experienced problems relating to purported rogue activities or looting by the founding family (Kenney, 1992).

Yet family ownership appears to be quite common in U.S. firms across a broad range of industries (Gomez-Mejia, Larraza-Kintana, and Makri, 2003; Schulze, Lubatkin, and Dino, 2003). La Porta, Lopez-de-Silanes, and Shleifer (1999) indicated that among mid-size firms, only one-half have widely dispersed ownership structures, while Colli (2003) suggested that perhaps as many as 90 percent of all businesses in the U.S. may be family controlled. Research on large public firms indicates that founding families have substantial stakes in roughly one-third of the largest U.S. companies and, in these firms, control nearly 20 percent of all board seats (e g , Shleifer and Vishny, 1986). Anderson and Reeb (2003a) argued that this continued founding-family ownership can be

advantageous because the family has the incentive and power to monitor managers, thereby minimizing the free-rider problem found in firms with more widely dispersed ownership structures. They found that among S&P 500 companies, many family firms have better accounting- and market-based performance than non-family firms, which is consistent with the notion that family ownership potentially reduces managerial opportunism. Recognizing the monitoring benefits of family ownership, Burkart, Panunzi, and Shleifer (2003) suggested that a key element in the desirability of family ownership is the ability to limit the family's expropriation of wealth from minority shareholders. The prevalence of founding-family shareholdings and the family's incentives to extract private benefits raises the question of who or what, if anything, keeps the family from expropriating minority shareholders' wealth.

The property rights literature suggests that minority investors are only protected when they have power relative to controlling shareholders and are able to limit large shareholders' expropriation of the firm's wealth (Grossman and Hart, 1986; Hart and Moore, 1990). But prior research indicates that several conventional corporate governance mechanisms used in mitigating agency conflicts between managers and shareholders are less effective in dealing with conflicts between shareholder groups. Gomez-Mejia, Larraza-Kintana, and Makri (2003), Shivdasani (1993), and Kole (1997) found that the takeover market, institutional investors, and incentive compensation are potentially less prevalent governance mechanisms in family firms than in non-family firms. Westphal (1998) indicated that boards of directors can have an especially important role in promoting firm performance when alternative governance mechanisms are weak, as they are in family firms.

Firms with founding-family ownership arguably provide one of the most distinct examples of conflicts over the distribution of the firm's wealth that can occur between powerful, large shareholders and atomistic shareholders. Westphal and Zajac (1995) suggested that in firms with dispersed ownership, board structure depends on the balance of power between the chief executive officer (CEO) and the board. In family firms, however, the salient conflict arguably occurs from families' potential expropriation of firm resources to their private benefit, suggesting that small shareholders have concerns with moderating family influence and power. Consequently, rather than concentrating on the board's role in alleviating agency problems between managers and shareholders, we examine the board's possible role in mitigating conflicts between opposing shareholder groups. To test the notion that boards of directors balance competing shareholder interests, we investigate the relation between firm performance and board independence in the presence of founding-family ownership.

Studies on the effectiveness of boards of directors frequently focus on their composition (Fama and Jensen, 1983; Baysinger and Hoskisson, 1990), classifying directors as either insiders (firm employees) or outsiders (non-employees). Outside directors are often further divided into those

with existing or potential business ties to the firm (affiliates) and those members (independents) whose only tie to the firm is their directorship (Daily et al., 1998; Coles and Hesterly, 2000). Using an agency theory framework, we theorize that the influence of independent directors may represent an important line of defense that minority shareholders can employ in protecting themselves against opportunism by large shareholders.

Implicitly, our analysis assumes that founding-family shareholders are important stakeholders whose interests may not always align or overlap with outside shareholders. When the divergence between family- and outside-shareholder interests becomes large and costly, independent directors can intervene to protect the interests of all shareholders. Anderson and Reeb (2003a, 2003b) found that U.S. firms with founding-family ownership perform better, on average, than non-family firms, indicating that the benefits of family influence often outweigh its costs. Consequently, family representation on the board potentially provides advantages to the overall board and the firm. But family power that goes unchecked or unbalanced by independent directors arguably increases the likelihood of opportunistic behavior by the family. Effective board structure in firms with family ownership would require a balance between family directors' interests and independent directors' objectivity. The implication is that some family influence provides benefits to minority shareholders, but too much influence creates the potential for moral hazard conflicts between the family and outside shareholders.

Although agency theory can be used to explain the relation between founding families and boards of directors, stewardship theory provides an alternative explanation. Specifically, founding-family members may identify closely with the firm and view the firm's health as an extension of their own well-being (Gomez-Mejia, Larraza-Kintana, and Makri, 2003; Davis, Schoorman, and Donaldson, 1997). Acting as stewards, families may place outside directors (affiliates and independents) on the board to provide industry-specific expertise, objective advice, or generally act as advocates for corporate health and viability. Consequently, a relation potentially exists between the board's independence and firm performance because of the counsel and advice that outside directors offer, as opposed to their monitoring and control activities. We attempt to disentangle these competing theories—agency and stewardship—by examining the influence of affiliated directors (the other type of outside director) and by examining the manner in which independent directors gain their board seats amongst family and non-family firms in the Standard and Poor's 500 (we excluded banks and utilities). For this study, family firm refers to publicly traded firms in which the founding family continues to have an ownership stake or maintain board seats. Anderson and Reeb (2003a, 2003b) suggested that founding families use this influence to oversee and limit managerial opportunism. We examine why and how this improved performance occurs and consider the board's role in conflicts among shareholder groups in family firms.

SHAREHOLDER CONFLICTS: BOARD CONTROL AND COLLABORATION

Founding families constitute an important and distinctive class of large shareholders. In the Fortune 500 and S&P 500, families are present in nearly one-third of all firms (Shleifer and Vishny, 1986; Anderson and Reeb, 2003a). Unlike other large shareholders, family investors usually maintain their ownership stakes for several generations, have a majority of their wealth invested in a single firm, and often serve as senior executives in the firm (Mackie, 2001). Founding families typically have sufficient power to ensure that the firm pursues the family's interests, but these interests are not necessarily the same as those of the firm or other shareholders (Allen and Panian, 1982). Founding families may engage in self-dealing by reducing firm risk, directly expropriating wealth from managers, employees, or other investors, engaging in non-profit maximizing objectives, or generally representing their interests over those of the firm's other stakeholders (Schulze et al., 2001; Faccio, Lang, and Young, 2001; Anderson, Mansi, and Reeb, 2003; Schulze, Lubatkin, and Dino, 2003; Gomez-Mejia, Larraza-Kintana, and Makri, 2003), suggesting conflicts over the distribution of wealth with the firm's other equity claimants.

A large volume of scholarly literature indicates that these dominant shareholders often pursue their private interests to the detriment of outside shareholders. Demsetz and Lehn (1985) suggested that families influence the firm's policies to meet their interests, thereby drawing limited resources from profitable investments. DeAngelo and DeAngelo (2000) documented how families' penchant for extraordinary dividends leads to lower capital spending and reduced investments in capital equipment. Barth, Gulbrandsen, and Schone (2003) found that family firms are less productive than non-family firms, while Ellington and Deane (1996) indicated that family firms are less innovative and less likely to adopt total quality management. Similarly, Chandler (1990) reported that family firms underinvest in emerging technologies and devote insufficient resources to research and development. Burkart, Panunzi, and Shleifer (2003) argued that family management, especially by descendants, is associated with poor decision making. Gomez-Mejia, Nunez-Nickel, and Gutierrez (2001) found that family ownership is associated with greater managerial entrenchment. Schulze et al. (2001) discussed how favoritism towards heirs and siblings can lead to family perquisites such as favored employment and promotions, leading to resentment by non-family managers. Burkart, Gromb, and Panunzi (1997) suggested that families acting on their own behalf can adversely affect employees' productivity and redistribute rents from employees to the family. Morck, Strangeland, and Yeung (2000) concluded that these actions by family shareholders generate excessive costs that lead to lower returns in family firms relative to non-family firms.

Similarly, families can seek to maximize firm performance but yet still create severe conflicts over the distribution of wealth among the varying shareholder groups. Families' large ownership stakes, for instance, provide ample economic incentives to increase the firm's profits (Anderson and Reeb, 2003a). In

the distribution of these profits, however, families may retain a disproportionately large share and thereby expropriate outside shareholders' earnings. Consistent with this idea, Ditmar, Mahrt-Smith, and Servaes (2003) found that powerful insiders hold excessive cash within the firm, potentially allowing the family to freely exploit these resources to their private benefit (DeAngelo and DeAngelo, 2000). Likewise, Faccio, Lang, and Young (2001) reported that family ownership results in greater transactions with other companies owned by the family, permitting the expropriation of minority shareholder wealth.

Recent accounts in the popular press concerning specific stories of founding-family expropriation also indicate the potential for families to engage in opportunistic behavior. The founding families of Ford Motor and Times-Mirror have received considerable attention because of activities that enriched the family at the expense of minority investors In addition, members of the founding family of Adelphia Communications recently came under criminal indictment for their alleged misuse of the firm's resources (Pulliam and Frank, 2004). In summary, founding families are in exceptional control positions to pursue their interests, indicating the potential for conflicts over the distribution of wealth between opposing shareholder groups.

Role of the Board in Balancing Competing Shareholder Interests

Grossman and Hart (1986) and Hart and Moore (1990) described residual control as the right to decide the manner in which a firm's resources are to be used except to the extent that particular usages have been specified by contract. From this perspective, large shareholders often have effective control of the firm and can use this control to make decisions to create private benefits at the expense of minority shareholders. Agency theory suggests that outside shareholders as such are only protected when they have the power to limit large shareholders' opportunism or their diversion of corporate resources. In firms with widely dispersed ownership, several power bases exist for outside shareholders to protect themselves against self-dealing insiders In family firms, however, many well-recognized corporate governance devices are less prevalent than in non-family firms Barclay and Holderness (1989), for example, observed that the presence of large shareholders deters bidding by outside agents, suggesting that the market for corporate control is less effective in constraining families' actions. Kole (1997) reported that executives in family firms, relative to those in non-family firms, earn significantly less incentive-based compensation. Gomez-Mejia, Larraza-Kintana, and Makri (2003) documented that family-member chief executive officers (CEOs) receive even less incentive compensation than outside CEOs in family firms. Shivdasani (1993) suggested that unaffiliated-blockholder ownership is substantially lower in family firms than in non-family firms, again indicating a lack of strong external agents to discipline and control families' actions.

Because of the relative lack of some governance mechanisms in family firms, outside shareholders potentially rely on boards of directors to monitor and control families' opportunism. Consistent with this proposition, Westphal (1999) found that board structure plays a large role in firms' performance when the level of CEO incentive alignment is low. Prior research has generally hypothesized that the board's effectiveness depends on directors being independent from senior managers. Independent directors contribute expertise and objectivity that ostensibly minimize managerial entrenchment and expropriation (Dalton et al., 1998). Bacon (1985) argued that independent directors provide candor in evaluating firm projects, in acquiring other firms, or in assessing intra- and interfirm business relationships. Winter (1977) posited that only independent directors can ask insiders the really difficult questions about firm activities.

In family firms, independent directors remain one of the primary lines of defense that outside shareholders can employ in protecting their rights against the influence and power of large, controlling shareholders. To enhance firm performance, independent directors potentially prevent families from directly expropriating firms' resources via excessive compensation, special dividends, or unwarranted perquisites. Independent directors can also impose structural constraints on the family by limiting their participation in important board subcommittees such as the audit committee, investment committee, nominating committee, and compensation committee. Perhaps one of the largest impacts that independent directors make in protecting outside shareholders from self-dealing families occurs when the board prevents an unqualified or incompetent family member from assuming the CEO post (Shleifer and Vishny, 1997). Given this, independent directors can play an influential role in standing up to family opportunism and protecting the rights of all shareholders, not just those of the dominant shareholder. In family firms there should be fewer conflicts between family shareholders and outside shareholders over the distribution of wealth as the fraction of independent directors on the board increases. More specifically, if independent monitors act to alleviate conflicts between family shareholders and outside shareholders, then we expect to observe a positive relation between firm performance and board independence in family firms:

Hypothesis 1 (H1): The greater the fraction of independent directors in public firms with founding-family ownership, the better the performance of the firm.

Family Interests and Independent Directors' Objectivity

Our prior hypothesis relies on an agency theoretic argument that greater numbers of independent directors limit and restrain family opportunism. Yet Anderson and Reeb (2003a) posited that family ownership in publicly traded corporations mitigates managerial opportunism and lengthens the firm's investment horizon, suggesting that family members, in pursuing their interests, add value to the board and the firm. Effective board structure in family firms may thus require a prudent balance between the objectivity of independent directors and the interests of family-directors.

On the one hand, calling for greater levels of board indepen-dence may prompt unproductive political activity by insiders or families that counteracts the objectivity of the independent directors and also reduces cooperative interaction between families and directors (Westphal, 1998, 1999). Independent directors may also lack much of the firm-specific expertise of insiders and family members, resulting in poor strategic deci-sions (Finkelstein and Hambrick, 1996). On the other hand, consistent with our agency argument, family-dominated boards potentially grant a disproportionate voice to the family in the firm's decision making, thereby increasing the likeli-hood that the family will expropriate the firm's wealth. Recent press reports support this proposition. One of the chief issues for minority shareholders at News Corporation, for instance, is the potential for nepotism in the selection of the next CEO (i.e., another Murdoch family member). Eisen-ger (2002) observed that the concern is that the board cannot stand up to the Murdoch clan, suggesting the importance of well-qualified independent directors. Likewise, the domi-nance of the Rigas family on the board of Adelphia Communi-cations (five of nine board seats) has been linked to the fami-ly's alleged private consumption of firm resources (Pulliam and Frank, 2004).

The previous discussion emphasizes that an effective board in family firms potentially includes both independent directors and family directors. Excessive family representation on the board relative to independent directors increases the likeli-hood of the family expropriating wealth. Too little family rep-resentation relative to independent directors potentially reduces managerial monitoring and hinders the board's effec-tiveness. Thus, family board representation moderated by the influence of independent directors can provide benefits to the firm. Family board representation that goes unchecked, however, increases conflicts between family shareholders and outside shareholders over the distribution of firm wealth. Specifically, we theorize a curvilinear relation (an inverted U shape) between the ratio of family directors to independent directors and firm performance. At low levels of family repre-sentation (relative to independent directors), we anticipate a positive effect on firm performance. As family representation continues to increase (relative to independent directors), however, we expect to observe a negative effect on firm performance.

Hypothesis 2a (H2a): At low levels of family board representation relative to independent directors, the higher the ratio of family direc-tors to independent directors, the better the performance of the firm.

Hypothesis 2b (H2b): At high levels of family board representation relative to independent directors, the higher the ratio of family direc-tors to independent directors, the poorer the performance of the firm.

Stewardship Theory and Dominant Shareholders

Although families can manage and manipulate the firm to their private benefit, the pervasiveness, size, and long-stand-ing patterns of their ownership potentially offer a different

perspective on families' motives. Davıs, Schoorman, and Donaldson (1997), for instance, theorized that families may identify closely with the firm and act as stewards of corporate value. In this sıtuation, the board's composıtıon may depend more on the ability of the directors to provide expert advice and counsel rather than oversight and control of the family's activity (Pfeffer and Salancık, 1978; Westphal, 1999). Families, acting as stewards, may therefore constıtute boards to assist in decision-making processes, collaborate in defıning corporate strategy, offer ımproved access to ınformatıon and capital, and generally to promote corporate welfare (Gomez-Mejia and Wiseman, 1997; Westphal, 1999). Such stewardship potentially offers an alternative explanatıon for observıng a relation between board independence and fırm performance as outlined under our first hypothesıs. To provide insıghts into which of these competing theorıes—agency or stewardshıp—better explains the role of boards ın family firms, we examine the role of outside dırectors ın the ınterplay of family influence and board structure.

Affiliate Directors

Prior studies have classified board members into two broad groups: insiders and outsiders (Hermalin and Weısbach, 2003). Insiders are directors who are firm employees, retıred employees, or family members of the fırm's employees The remaining directors, outsiders, can be further subdıvıded into affiliate and independent directors. Affiliate directors are non-employee board members with exıstıng or potentıal busıness ties to the firm (Daily et al., 1998). An agency perspective suggests that affilıate directors, ın seeking to protect or enhance their business relationshıp with the fırm, are less objective and less effective monıtors of the famıly than ınde-pendent directors. Affiliate directors are thus more likely to facilitate the family's expropriatıon of the fırm's resources to the famıly's private benefıt, implying poorer fırm performance (Brickley, Coles, and Terry, 1994). Daily et al. (1998) suggested that affiliate directors often have conflicts of ınterests due to their current and expected future business relationshıp with the firm, thereby impairing their ability to monitor and discipline. Carcello and Neal (2003) reported that affiliate directors are associated with greater pressure on the firm's auditors to issue positive reports even when the auditor has concerns about the firm's operations. Similarly, Kleın (1998) indicated that directors with business ties are less objective than independent directors and facilitate entrenchment. Final-ly, Byrd et al. (2004) found that affiliate directors are associat-ed with greater firm failure, while independent directors are associated with increased firm survival. Agency theory thus suggests that affilıate directors tend to side with those who control the firm, contribute little to corporate monitorıng, and provide few impediments to the family's exploitation of firm resources.

Stewardship theory provides a different perspectıve on the role that affiliate directors play in family firms. Families, act-ing as stewards of firm value, may not differentiate dırectors based on their affiliation with or independence from the fami-ly. Rather, to promote corporate health and firm performance, families place outside directors on the board for the dıstinct

skills and perspective that outsiders bring to the firm. Directors classified as affiliates often have skills in knowledge-based fields such as law, finance, accounting, and consulting, suggesting that families seek these directors for their value-adding advice and counsel. If this is so, stewardship theory suggests that affiliate directors and independent directors have similarly positive effects on firm performance.

Agency theory and stewardship theory both indicate that external directors (affiliates and independents) can influence firm performance. Both theories suggest that independent directors have a positive effect on firm performance: in agency theory, independent directors monitor and control insiders and/or the family; in stewardship theory, independent directors provide valuable outside advice and counsel to the firm. Consequently, the role—monitor or advisor—that independent directors play in firms with large, controlling shareholders is somewhat difficult to understand. Focusing on affiliates, the other type of external directors, however, provides an approach that helps to differentiate between the monitoring (agency) and counseling (stewardship) role of outside directors.

Agency theory indicates that affiliate directors are less effective monitors than independent directors, while stewardship theory indicates that affiliate directors are placed on the board to provide alternative perspectives and expertise similar to independent directors Thus, stewardship and agency theories provide different perspectives on the role that affiliate directors play on the board and in the firm. Agency theory predicts a negative effect of affiliate directors on firm performance. Stewardship theory suggests that affiliate directors have an effect on firm performance similar to that observed for independent directors. This leads to the following competing hypotheses, derived from agency and stewardship theory, respectively:

Hypothesis 3a (H3a): The greater the fraction of affiliated directors on the board in public firms with founding-family ownership, the poorer the performance of the firm

Hypothesis 3b (H3b): The greater the fraction of affiliated directors on the board in public firms with founding-family ownership, the better the performance of the firm

Independent Director Influence: Monitoring or Commitment

The family's large equity stake provides wealth that often supports multiple generations of family members, many of whom do not work at the firm (Anderson, Mansi, and Reeb, 2003) Family members clearly have strong incentives to run the firm efficiently (Demsetz and Lehn, 1985) and may choose board members for their distinct skill sets or decision-making qualities, rather than their independence (or lack thereof) from the family. For many large companies, the responsibility of developing a slate of directors for election by the firm's shareholders is delegated to a subcommittee of the board of directors, the nominating committee. This board subcommittee plays an important role because it must find directors and structure boards that provide effective decision

making, leadership, and oversight. Founding families can play an important role in determining the overall structure of the board by exerting their influence through the firm's nominating committee.

An agency perspective suggests that families seeking to exploit the firm's resources to their private benefit are unlikely to assemble boards that limit and mitigate their control of the firm, indicating a negative relation between family presence on the nominating committee and board independence. Thus agency theory indicates that family influence on the nominating committee would be used to maximize the family's discretion and control of firm resources and, at the same time, limit independent director representation

Alternatively, stewardship theory suggests that families differentiate directors based on their expertise and experience, indicating that families seek independent directors to serve on the board for their counsel and advice. As such, from a stewardship perspective, we expect to observe a positive relation between family presence on the nominating committee and the fraction of independent directors serving on the full board. Agency and stewardship theory therefore yield competing predictions on board composition when family members serve on the firm's nominating committee. The agency theory and stewardship theory hypotheses are, respectively:

Hypothesis 4a (H4a): The presence of founding-family members on the firm's nominating committee is negatively associated with the fraction of independent directors on the board

Hypothesis 4b (H4b): The presence of founding-family members on the firm's nominating committee is positively associated with the fraction of independent directors on the board

METHOD

Data

For our sample, we used the 1992 Standard & Poor's 500 firms for the period 1992 to 1999. Banks and public utilities were excluded (97 firms) because government regulations potentially affect large shareholder ownership or influence and because it is difficult to calculate market-based performance measures for banks. Firm-specific accounting variables were drawn from the COMPUSTAT Industrial Files. We manually collected data from corporate proxy statements on board structure and characteristics, CEO attributes, equity ownership structure, and founding-family attributes for 403 non-utility/non-banking firms, providing 2,686 firm-year observations. Founding-families hold stakes in 141 of these firms (262 without), with the average family holding 17.9 percent of the firm's equity and occupying nearly 20 percent of the board seats.

Dependent Variables

We developed a proxy for Tobin's Q as our primary measure of firm performance. Tobin's Q is a common market-based measure of firm performance. The appeal of this measure is that it incorporates current operations, potential growth

opportunities, and future operating performance. We estimated Tobin's Q as the market value of total assets divided by the replacement costs of assets Market values and replacement costs were estimated following Yermack (1996). Although Tobin's Q provides a measure of performance similar to other studies, prior research has found little evidence that board structure influences firm performance. To assess the robustness of our results, we also used an alternative measure of firm performance, Stern Stewart's economic value added (EVA), in our empirical analysis and found similar results to those reported in the tables. The results of the EVA analysis are available from the authors upon request

Independent Variables

We used a three-tier categorization of board members: independent, affiliated, and insiders. Directors employed by the firm, retired from the firm, or who are immediate family members are insiders Affiliate directors are directors with potential or existing business relationships with the firm but are not full-time employees Consultants, lawyers, financiers, and investment bankers are examples of affiliate directors. Independent directors are individuals whose only business relationship to the firm is their directorship Our primary measure of independent director influence is the number of independent directors divided by total board size (fraction of independent directors)

We designated family firms analogous to Anderson and Reeb (2003a). Specifically, we used the fractional equity ownership of the founding family and/or the presence of family members serving on the board of directors. While the fractional equity holdings of family members provides a measure of control similar to that of other ownership studies, differences in ownership levels may not represent the influence that the founding family plays in the firm To address this issue, we created a binary variable that equals 1 when the family is present in the firm and 0 otherwise A list of the firms classified as family and non-family firms is available from the authors. We also used alternative approaches to measure family ownership and control in our empirical analysis and found similar results.

We developed two additional variables to assess the family's influence relative to that of independent directors Our first measure is the ratio of board seats held by family members to board seats held by independent directors. For family firms, the average of the ratio is 0 58, suggesting that for each family director, two independent directors serve on the board. In the multivariate analysis, we used spline or piecewise linear regressions to better understand the relation between family directors and independent directors, which necessitates breaking the ratio of family to independent directors into three groups These groups are as follows: the Ratio of family to independent directors 0 0 to 0.50, the Ratio of family to independent directors 0.501 to 1.00, and the Ratio of family to independent directors over 1 01.

The second measure of family influence is a binary variable that equals 1 when family board control exceeds independent director control and 0 otherwise Family representation

on the board exceeds independent director representation for 16.8 percent of the family firms in our sample.

Control Variables

We introduced several control variables into our analysis to account for industry and firm characteristics and to minimize concerns about heterogeneity and endogeneity Carland et al. (1984) suggested that family firms may prefer to remain small so that the family can more easily maintain control of the firm. We measured firm size as the natural log of total assets. We created a proxy for the investment opportunity set by using research and development expenses divided by fixed assets. We measured firm risk as the standard deviation of stock returns for the previous 60 months. Accounting profitability was measured as the return on assets calculated as earnings before interest, taxes, depreciation, and amortization divided by total assets We measured firm age as the natural log of the number of years since the firm's inception

Bhagat and Jefferies (2002) suggested that concerns about causality can be diminished by incorporating into the model other governance devices that potentially influence corporate decision making and firm performance Other large shareholders such as mutual or pension funds may play a significant role in monitoring and disciplining managers, and the family's voice and influence in the firm may be substantially smaller in the presence of these institutional investors. From corporate proxy statements, we identified all institutional investors—entities whose only relation to the firm was their equity holdings—and their fractional equity holdings. We also included the equity holdings of officers and directors (minus family ownership) to capture the incentive effects of other insiders' ownership.

Finally, we included a CEO compensation measure in the analysis because CEO influence and incentives may influence the manner in which large shareholders interact with the firm. Gomez-Mejia, Larraza-Kintana, and Makri (2003) reported that the compensation structure significantly differs between family CEOs and non-family CEOs. We measured the portion of pay CEOs receive in equity-based forms as the dollar value of equity-based pay (new options) divided by the sum (in dollars) of new options, salary, and annual bonus. Options were valued using the Black-Scholes model. Compensation data came from S&P's EXECUCOMP Database.

Analysis

We used a two-way fixed-effects model (panel data) for our regression analysis; the fixed effects are dummy variables for each year of the sample and for each 2-digit standard industrial classification (SIC) code. We controlled for serial correlation and heteroskedasticity using both fixed effects and the Huber/White/sandwich variance estimator. We also considered alternative statistical techniques to control for disturbances in the error term. These techniques included pooled, time-series average regressions and Fama-MacBeth regressions. Finally, we considered both firm-level fixed effects and two-stage least squares regressions to control for unobserved heterogeneity and endogeneity.

RESULTS

Summary Statistics

Table 1 presents two panels of descriptive information for our sample of firms. Panel A provides means, medians, and standard deviations and shows difference of means tests between family and non-family firms. The total sample consists of 2,686 firm-year observations, of which 32.6 percent (876) are family firms and the remaining observations are non-family firms. We find large differences in board composition between family and non-family firms. Specifically, independent directors hold a majority of seats in non-family firms (61.2 percent) but hold under one-half the seats in family firms (43.9 percent). Family members (included as part of the insider group in the percentages reported), moreover, hold nearly 20 percent of all board seats in family firms. Board size is statistically indistinguishable between family and non-family firms. We also find that family firms, on average, exhibit better performance than non-family firms (Tobin's Q: 1.581 versus 1.315). Traditional governance devices such as institutional investor ownership and CEOs' equity-based pay are significantly less prevalent in family firms than in non-family firms. Institutional investors own 8.3 percent of the shares in family firms and 11.7 percent in non-family firms, and CEOs'

Table 1

Descriptive Data

Panel A: Summary Statistics for the Full Sample

Variable	All Firms			Family Firms	Non-Family Firms	t-statistics
	Mean	Median	S. D.			
1 R&D/Fixed assets (%)	9 46	1 53	23 12	2 08	2 13	0 13
2 Long-term debt/total assets (%)	19 05	17 55	13 70	18 33	19 40	0 78
3 Return volatility	0 28	0 26	0 09	0 28	0 28	0 57
4 Total assets ($000,000)	13,262	4,288	33,114	9,038	15,306	4 66***
5 Firm age (years)	84 83	85 00	37 60	75 91	89 15	3 03***
6 Tobin's Q	1 411	1 171	0 888	1 581	1 315	3 28***
7 Return on assets $_{t-1}$	14 73	13 78	10 30	15 62	14 30	1 53
8 Family ownership	5 97	0 00	13 92	18 11	0 00	—
9 Off & dir ownership (less family)	1 41	0 72	2 86	1 33	1 45	0 51
10 Institutional investors (%)	10 58	7 35	11 43	8 26	11 70	3 93***
11 Board independence	55 51	57 14	18 21	43 86	61 16	10 97***
12 Inside directors	27 99	25 00	14 57	39 36	22 51	13 52***
13 Affiliated directors	16 50	14 29	12 65	16 78	16 49	0 24
14 Family directors	7 13	0 00	11 50	20 09	0 00	19 41***
15 Board size	11 44	11 00	2 70	11 46	11 43	0 11
16 CEO equity-based pay (%)	36 20	36 30	26 69	28 57	39 89	6 71***
17 Number of observations	2686	2686	2686	876	1810	—

Panel B: Correlation Data

	Family firm	Board indep.	Tobin's Q	Officers & directors	Inst. investors	Ln (total) assets
Board independence (%)	− 446					
Tobin's Q	146	− 075				
Off & dir ownership (less family)	− 019	− 153	005			
Institutional investors	− 141	054	− 224	− 010		
Ln (total assets)	− 221	204	− 186	− 092	− 170	
Ln (firm age)	− 149	271	− 137	− 088	− 139	286

• $p \leq$ 10, •• $p \leq$ 05, ••• $p \leq$ 01

equity-based pay makes up nearly 11.5 percent less of total compensation in family firms than in non-family firms.

Panel B shows a simple correlation matrix for the variables. Founding-family ownership exhibits a negative relation to board independence and institutional investor ownership, potentially indicating a lack of strong external monitors and discipline agents to oversee the family. To control for firm size and other firm- and industry-specific attributes, we used a multivariate framework to examine whether independent monitors act to mitigate conflicts among different shareholders.

Multivariate Results

In our first regression, we examined the influence of founding-family ownership and board independence (as stand-alone variables) on firm performance. Consistent with earlier empirical research and as shown in table 2, we find a positive and significant relation between founding-family ownership and firm performance. Column 1 of table 2 shows that firm performance is about 10 percent better in family firms than in

Table 2

Firm Performance, Board Independence, and Founding-family Ownership*

Variable	Tobin's Q				Adj. Tobin's Q
	All firms	Family firms	Non-family firms	All firms	All firms
Intercept	2 482•••	3 979•••	2 075•••	2 782•••	0 798•••
	(6 65)	(10 05)	(8 69)	(14 43)	(3 42)
Board independence	0 102	0 450•••	−0 188•	−0 118	−0 194
	(0 65)	(3 15)	(1 86)	(1 22)	(1 23)
Family firm	0 142•••	—	—	−0 180••	−0 152
	(2 32)			(2 08)	(1 15)
Board independence * Family firm	—	—	—	0 598•••	0 504••
				(3 63)	(2 00)
Institutional investors	−1 176•••	−1 733•••	−0 631•••	−1 021•••	−0 679•••
	(6 33)	(7 63)	(5 29)	(9 74)	(3 53)
Officer and director ownership	1 271	−1 425•	2 373••	0 866	0 242
	(0 86)	(1 79)	(2.01)	(1 18)	(0 37)
CEO equity-based pay	0 195•••	0 366•••	0 106•	0 184•••	0 206•
	(2 63)	(3 83)	(1 80)	(3 62)	(1 72)
Ln (firm age)	−0 110•	−0 315•••	−0 009	−0 105•••	−0 085•••
	(1 87)	(3 90)	(0 25)	(3 31)	(2 53)
Long-term debt/total assets	−1 055•••	−0 674•••	−1 186•••	−0 932•••	−0 559•••
	(4 61)	(3 33)	(7 94)	(7 68)	(3 82)
R&D/fixed assets	0 620•••	0 283	0 740•••	0 594•••	0 162•
	(4 37)	(1 23)	(4 84)	(6 21)	(1 80)
Ln (total assets)	−0 092•••	−0 146•••	−0 064•••	−0 100•••	−0 036•••
	(3.28)	(5 59)	(3 79)	(7 15)	(2 38)
Return volatility	−1 015•••	−1 217•••	−1 032•••	−1 048•••	−0 621•••
	(3 39)	(3 04)	(4 84)	(5 92)	(2 51)
ROA	3 122•••	2 830•••	2 865•••	2 843•••	1 369•••
	(9 10)	(5 27)	(12 10)	(12 38)	(6 47)
Time-period dummies	—	—	—	—	—
2-Digit SIC dummies	—	—	—	—	—
Firm-level dummies	—	—	—	—	—
Adjusted R^2	0 482	0 463	0 528	0 484	0 182
Observations	2686	2686	2686	2686	2686

• $p \leq 10$, •• $p \leq 05$, ••• $p \leq .01$
* Results for the time-period and 2-digit SIC dummies and for the firm-level dummies in the adjusted Tobin's Q are repressed but are included in the regression. The t-statistics are corrected for heteroskedasticity using the Huber/White/sandwich estimator of variance

non-family firms. We calculated this percent differential between firms with family ownership and those without family ownership as follows: (coefficient estimate divided by the average Tobin's Q for the sample) = 0.142/1.411 = 10.1 percent. Also consistent with prior research investigating the role of boards, column 1 shows that across our entire sample of S&P 500 firms (family and non-family firms), no significant relation exists between board independence and firm performance.

Hypothesis 1 predicted that the greater the fraction of independent directors in family firms, the better the performance of the firm. The results in column 2 of table 2 support this hypothesis. Board independence bears a significant and positive relation to performance in firms with founding-family ownership. Economically, the coefficient estimate on board independence indicates that Tobin's Q is about 16 percent higher for family firms with greater board independence (75 percent independent) than in family firms with insider-dominated boards (25 percent independent directors). We calculate this percent differential between independent and inside boards as follows· (coefficient estimate * (75 − .25))/(Average Tobin's Q for the sample) = [(0.450*(.75 − .25))/1.411] = 0.1595.

To assess our H1 test results, we ran an equivalent regression for non-family firms. Column 3 of table 2 shows the results of the analysis and, consistent with prior studies, indicates that at conventional significance levels, board independence exhibits no relation to performance in non-family firms. In column 4, we again merged the family and non-family subsets into a single sample and introduced an interaction term between family firms and board independence to capture the marginal influence of board independence in family firms relative to non-family firms. Two results stand out. First, the interaction term between family firms and independent director influence is positive and significant; suggesting a significant valuation premium for family firms that have greater board independence relative to non-family firms or family firms with insider-dominated boards. We conducted an F-test to examine the joint probability that [Independent director influence + (Family firm * Independent director influence)] = 0 0. We rejected the null hypothesis ($F = 4.02$, $p = .04$) and concluded that independent director influence, on average, is associated with greater shareholder value in family firms. Second, the coefficient estimate on the stand-alone family-firm variable is negative and significant, indicating that without the presence of independent directors, firm performance is significantly worse than in non-family firms. F-tests indicate, however, that the family-firm variables (Family firm + Independent director influence * Family firm) are jointly different from zero ($F = 6 27$, $p = .01$) and suggest that family firms, on average, are more valuable than non-family firms. Overall, our results indicate that there are performance premiums in family firms with greater degrees of board independence relative to non-family firms or family firms with insider-stacked boards.

Next, we considered a firm-level fixed-effect regression, because unobserved heterogeneity among family firms may

influence the results. For instance, differences in family ownership stakes, degrees of control, or generational variations may lead to large differences among family firms. Consequently, we estimated a fixed-effects model with dummy variables for each firm. Because we could not include industry fixed effects, firm fixed effects, and time fixed effects all in the same regression, we computed an industry-adjusted Tobin's Q as our dependent variable for this test. The results of this analysis are reported in column 5 of table 2. Consistent with our earlier results, the interaction term between family firms and board independence is positive and significant, indicating better family-firm performance as board independence increases. The results from the analysis thus support H1: greater board independence in firms with founding-family ownership leads to better firm performance.

Family Power: Family and Independent Directors

The prior analysis concentrated on the role that independent directors play in moderating family influence and improving firm performance. Family members, however, routinely hold board seats to represent and promote family interests, and hypotheses 2a and 2b predicted that effective board structure in family firms requires a balance of family directors and independent directors. On the one hand, excessive family board representation increases the family's ability to extract private rents from the firm. During the mid-1990s, for instance, the Gottwald family of Ethyl Corporation held 25 percent of board seats while independent directors held just 17 percent. The family's influence in such a situation potentially outweighs outside directors' influence in board matters, suggesting that the family is free to pursue its interests without substantive interference from the board. On the other hand, too little family representation potentially hinders managerial oversight. Overall, we theorized a curvilinear relation (an inverted U shape) between the ratio of family directors to independent directors and firm performance. To test H2a and H2b, we used a specification similar to the one we used before but replaced independent director influence with variables that measured the relative influence of family directors to independent directors. The first measure breaks the ratio of family directors to independent directors into three distinct categories: from 0.0 to 0.50, from 0.501 to 1.00, and above 1.01. The second measure is a binary variable that equals one when family directors exceed independent directors, and zero otherwise.

The results of a spline regression using the ratio of family directors to independent directors (broken into three categories) are shown in column 1 of table 3. At low levels of family board representation relative to independent director representation, increases in the presence of family directors exhibit a positive relation to firm performance. But after the ratio of family board representation to independent director representation exceeds 0.50 (one family director to two independent directors), firm performance deteriorates. At higher levels of family representation relative to independent directors (beyond one to one), firm performance deteriorates even further, suggesting that providing too much voice to the family creates conflicts with the interests of outside sharehold-
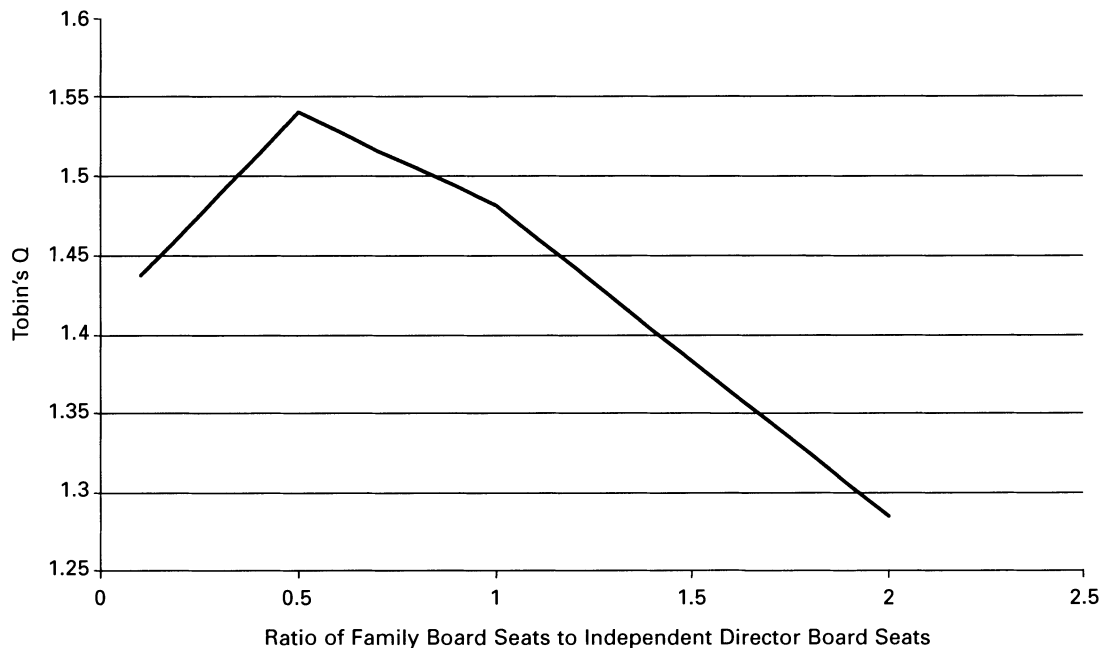
Table 3

Independent Director Characteristics and Family Power*

Variable	Tobin's Q	
Intercept	2 756•••	4 185•••
	(14 38)	(10 78)
Ratio of family directors to independent directors from 0 00 to 0 50	0 259•••	—
	(2 54)	
Ratio of family directors to independent directors from 0 51 to 1 00	-0 377••	—
	(2 20)	
Ratio of family directors to independent directors over 1 00	-0 078••	—
	(2 05)	
Family directors exceed independent directors	—	-0 202•••
		(2 99)
Institutional investors	-1 124•••	-1 772•••
	(10 58)	(7 79)
Officer and director ownership (less family)	0 823	-1 448•
	(1 10)	(1 73)
CEO equity-based pay	0 178•••	0 383•••
	(3 51)	(3 99)
Ln (firm age)	-0 010•••	-0 284•••
	(3 10)	(3 56)
Long-term debt/total assets	-0 915•••	-0 655•••
	(7 51)	(3 29)
R&D/fixed assets	0 656•••	0 323
	(6 29)	(1 49)
Ln (total assets)	-0 106•••	-0 160•••
	(7 40)	(6 09)
Return volatility	-0 985•••	-1 197•••
	(5 43)	(3 00)
ROA	2 782•••	2 778•••
	(12 04)	(5 28)
Time-period dummies	—	—
2-Digit SIC dummies	—	—
Adjusted R^2	0 461	0 462
Observations	2686	876

• $p \le$ 10, •• $p \le$ 05, ••• $p \le$ 01
* Results for the time-period and 2-digit SIC dummies are repressed but are included in the regression The t-statistics are corrected for heteroskedasticity using the Huber/White/sandwich estimator of variance

ers. Figure 1 presents a graphical depiction of the spline regression and shows that at low levels of family influence relative to independent directors, performance improves, while at higher levels of family representation relative to independent directors, firm performance declines.

The results of the regression using a binary variable that equals 1 when family directors outnumber independent directors are shown in column 2 of table 3 and again provide evidence consistent with the notion that too much family voice increases the likelihood of expropriation Economically, evaluating the binary variable in column 2, we find that firm performance is about 12.8 percent lower when family control of the board exceeds independent director control (relative to independent directors holding more board seats than family members) We calculated this as the coefficient estimate on the binary variable divided by the average Tobin's Q for the family-firm subsample [(-0 202/1 581) * 100% = 12.78 percent] Overall, our results support H2a and H2b and indicate that limited levels of family involvement provide benefits to the firm, but providing too much voice to the family creates costs that hinder firm performance

Figure 1. Performance and relative board representation of family and independent directors.

Ratio of Family Board Seats to Independent Director Board Seats

An Alternative Explanation: Stewardship Theory

The results in tables 2 and 3 are generally consistent with an agency theoretic approach in understanding the interplay between founding-family influence and board structure. Specifically, independent directors act to prevent the family's misappropriation of the firm's resources, resulting in better firm performance. According to stewardship theory, the observed relation could simply reflect families themselves placing independent directors on the board to act as advocates of the firm's health and corporate viability, again suggesting a positive relation between board independence and firm performance.

Affiliate Directors

The literature on board of director structure often divides outside directors into independent directors and affiliate directors. Agency arguments and stewardship arguments offer similar predictions on the role of independent directors in relation to firm performance but provide differing predictions on the influence of affiliate directors with respect to firm performance. Specifically, H3a predicted that the greater the influence of affiliate directors in family firms, the poorer the performance of the firm (agency). H3b alternatively predicted that the greater the influence of affiliate directors in family firms, the better the performance of the firm (stewardship).

The findings in table 4 support the agency prediction (H3a). Column 1 of table 4 indicates that as affiliate directors assume increasingly greater portions of total board seats, the performance of family firms deteriorates. To assess this result, we also examined the influence of affiliate directors in non-family firms. The results of this regression (column 2 of table 4) yield an insignificant relation between affiliate director influence and firm performance. In column 3, we merged

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Table 4

Distinguishing between Agency and Stewardship Explanations: Affiliate Directors*

Variable	Family firms	Tobin's Q Non-family firms	All firms
Intercept	4 084•••	2 345•••	2 782•••
	(11 29)	(10 90)	(15 75)
Affiliate director	–0 408•	–0 083	–0 068
	(2 20)	(0 72)	(0 61)
Family firm	—	—	0 143•••
			(3 09)
Affiliate director * Family firm	—	—	–0 312
			(1 50)
Institutional investors	–1 565•••	–0 690•••	–0 993•••
	(7 29)	(6 14)	(10 12)
Officer and director ownership (less family)	–1 441•	0 358	–0 037
	(1 82)	(0 50)	(0 68)
CEO equity-based pay	0 424•••	0 111••	0 223•••
	(4 68)	(2 02)	(4 74)
Ln (firm age)	–0 296•••	–0 033	–0 109•••
	(4 12)	(0 97)	(3 74)
Long-term debt/total assets	–0 422•••	–1 044•••	–0 759•••
	(2 43)	(7 54)	(7 01)
R&D/fixed assets	0 420•••	0 726•••	0 627•••
	(2 36)	(4 92)	(6 76)
Ln (total assets)	–0 123•••	–0 090•••	–0 101•••
	(5 23)	(5 92)	(8 08)
Return volatility	–1 788•••	–1 086•••	–1 192•••
	(5 04)	(5 18)	(7 11)
ROA	2 439•••	2 622•••	2 546•••
	(4 79)	(11 69)	(11 83)
Time-period dummies	—	—	—
2-Digit SIC dummies	—	—	—
Adjusted R²	0 445	0 528	0 484
Observations	2686	2686	2686

• $p \leq$ 10, •• $p \leq$ 05, ••• $p \leq$ 01
* Results for the time-period and 2-digit SIC dummies are repressed but are included in the regression The t-statistics are corrected for heteroskedasticity using the Huber/White/sandwich estimator of variance

the family and non-family subsets into a single sample and introduced an interaction term between family firms and affiliate director influence. The results, while marginal, again indicate that affiliate directors exhibit a negative effect on family-firm performance, suggesting that these directors do not act as stewards Rather, the results indicate that families may place affiliate directors on the board to facilitate the family's expropriation of the firm's resources.

Independent Directors: Monitoring or Collaboration

Our final competing hypotheses focused on an important board subcommittee, the nominating committee, to assess which theory—agency or stewardship—best explains the interplay of family influence and boards' structure. H4a, from agency theory, predicted that the greater the influence of founding families on the firm's nominating committee, the lower the independence of the board. H4b, based on stewardship theory, predicted that the greater the influence of founding families on the firm's nominating committee, the greater the fraction of independent directors on the full board. Information on nominating committees was garnered from corporate proxy statement for 230 firms in our sample, yielding 1,011 firm-year observations. There were nominating

committees in 138 firms (60 percent) of the subsample; for the remaining 92 firms, the full board assumed the responsibility of the nominating committee. The average committee size was 2.67 (median of 3.0) directors, with independent directors holding 65.3 percent of the seats and insider directors holding 17.4 percent. For family firms, family members held 19.1 percent of the nominating committee seats.

The findings in column 1 of table 5 support the agency argument with respect to the interaction of family influence and board structure. Column 1 presents OLS regression results examining whether the fraction of independent directors serving on the full board of directors is a function of family members serving on the nominating committee. For the dependent variable, we used the ratio of the number of independent directors to total board size. We designated family influence on the nominating committee with a binary variable that equaled 1 when a family member served on the committee and 0 otherwise. In addition, the analysis included other governance mechanisms to minimize endogeneity concerns. The regression results indicate a negative and significant relation between the fraction of independent directors on the board and family members serving on the nominating committee. Specifically, board independence is estimated to be

Table 5

Distinguishing between Agency and Stewardship Explanations: Nominating Committees*

| Variable | Fraction of Independent Directors | | |
	Firms with nominating committees		All firms
Intercept	0 276	0 359$^\bullet$	0 153
	(1 49)	(1 66)	(1 48)
Family presence on nominating committee	−0 095$^{\bullet\bullet\bullet}$	—	—
	(2 96)		
Instrument for family presence on nominating committee	—	−0 306$^{\bullet\bullet\bullet}$	—
		(3 07)	
Institutional investors	−0 059	−0 117	0 117$^{\bullet\bullet}$
	(0 49)	(0 76)	(1 98)
Officer and director ownership (less family)	−0 155	0 146	−0 608$^{\bullet\bullet\bullet}$
	(1 59)	(0 74)	(3 24)
CEO equity-based pay	0 043	0 016	0 089$^{\bullet\bullet\bullet}$
	(1 46)	(0 49)	(4 28)
Ln (firm age)	0 101$^{\bullet\bullet\bullet}$	0 099$^{\bullet\bullet\bullet}$	0 066$^{\bullet\bullet\bullet}$
	(3 18)	(2 76)	(3 49)
Long-term debt/total assets	−0 183	−0 242$^\bullet$	0 064
	(1 46)	(1 88)	(1 08)
R&D/fixed assets	0 093	0 044	0 031
	(0 60)	(0 29)	(1 02)
Ln (total assets)	0 007	0 004	0 015$^\bullet$
	(0 77)	(0 29)	(1 80)
Return volatility	0 125	0 037	−0 177$^{\bullet\bullet}$
	(0 74)	(0 22)	(1 96)
ROA	−0 001	−0 001	−0 002$^{\bullet\bullet}$
	(0 63)	(0 63)	(2 10)
Time-period dummies	—	—	—
2-Digit SIC dummies	—	—	—
Adjusted R^2	0 417	0 283	0 232
Observations	578	578	2686

$^\bullet$ $p \leq$ 10, $^{\bullet\bullet}$ $p \leq$ 05, $^{\bullet\bullet\bullet}$ $p \leq$ 01.
* Results for the time-period and 2-digit SIC dummies are repressed but are included in the regression. The t-statistics are corrected for heteroskedasticity using the Huber/White/sandwich estimator of variance.

9.5 percent lower if family members are involved in the selection of directors (relative to family members not participating in the nominating committee process). In regression results not shown, we estimated whether family firms are more (or less) likely to have a nominating committee. These results indicate that family firms are no more or less likely to have a nominating committee than a non-family firm.

A limitation to our nominating committee analysis is the assumption that family involvement in the selection of directors is exogenous. From a practical standpoint, when establishing board subcommittees, currently sitting independent directors may attempt to prohibit family members from serving on the nominating committee. The family's power to select new directors may thus emerge endogenously from negotiations with the entire board of directors (Westphal and Zajac, 1995; Zajac and Westphal, 1996; Hermalin and Weisbach, 2003). Ideally, we would like to know how directors receive appointments to the board, but a search of company press releases and proxy statements indicates that most companies simply state that an individual has been nominated for election and offers little insight into how the proposed director received the nomination. Consequently, to control for possible endogenous effects, we used a two-stage model in which family presence on the nominating committee was replaced with a predicted value. We estimated a first-stage logit model of the likelihood of family involvement on the nominating committee as a function of firm size, prior-period performance, presence of a family CEO, fractional equity holdings of the family, board size, and the fractional equity holdings of institutional investors.

The results of the two-stage framework are shown in table 5, column 2, and again support the agency argument in H4a for the interplay between family influence and boards' structure. The variable for family presence on the nominating committee has the same sign and significance, suggesting that family members prefer to limit independent director presence on the board. Thus, the basic finding that family involvement on the nominating committee is likely to lead to lower levels of board independence appears to hold when family presence (on the committee) is treated as an endogenous variable.

Because stewardship theory suggests that families seek qualified and competent outside directors (independents and affiliates) for their advice and counsel, a potential concern arises that our results in table 4 are driven by families seeking affiliate directors rather than independent directors for their boards. To investigate this possibility, we conducted two additional tests. First, we repeated the regression in column 1 of table 4 and included the fraction of affiliate directors serving on the board as an additional control variable. Second, we repeated the analysis in table 4 using the ratio of external directors (independents plus affiliates) as the dependent variable. Both tests allow us to isolate the influence of family preferences for independent directors, while controlling for the presence of affiliate directors. Consistent with the results in table 4, we found in both tests (results available from the authors upon request) that family presence on the nominating committee exhibits a negative relation to board

independence, suggesting that our primary results are robust to concerns that families seek affiliate directors to serve on the board.

To further explore this issue, we considered whether institutional investors seek to have independent directors on the board. Anecdotal evidence suggests that while some investors are quite active in developing corporate governance mechanisms (e.g., CALPERS), many others are much less involved. Yet it seems plausible that other large institutional investors would seek to have independent directors on the board to counteract family influence (Gomez-Mejia, Larraza-Kintana, and Makri, 2003). Column 3 of table 5 reports the results of regressing board independence on institutional investor ownership and our control variables. The coefficient estimate on institutional ownership is positive and significant at the 5-percent level. Overall, our results indicate that institutional investor ownership is positively associated with greater board independence, suggesting that independent directors are placed on the board to protect the interests of minority shareholders.

Robustness of Model Specification

We examined the endogenous nature of board structure using a simultaneous equation approach. We developed a proxy for board independence by modeling it as a function of other variables that potentially capture the key corporate attributes that influence the board of directors' structure. We modeled board independence as a function of firm age, officer and director ownership (minus family ownership), institutional investors, firm size, prior period performance, growth opportunities, and industry affiliation. Replicating the analysis with the two-stage framework, we found the same sign and significance for independent director influence as in the previous analysis.

To test the sensitivity of our results, we eliminated observations denoted as outliers and/or influential observations using the R-Student statistic and the DFFITS statistic. These tests examine a sample to determine if any observations have a dramatic effect on the fitted least-squares function. The results are similar to those reported in the tables and did not change substantively when truncated for outliers at the largest 1-percent, 3-percent, and 5-percent levels at each tail of the distribution for each variable in the model.

In addition, we considered alternative techniques for handling non-spherical disturbances. While our primary specifications were based on two-way fixed effects models and used the Huber/White/sandwich variance estimator, we repeated the analysis using both pooled time-series (mean) regressions and Fama-MacBeth regressions. We found similar inferences using either approach.

Another potential interpretation of our findings is that family ownership is a proxy for non-linear independent director influence because boards in family firms, on average, have fewer independent directors than those in non-family firms. In other words, family ownership may be irrelevant and greater board independence may matter when there are only a few inde-

pendent directors on the board. We used spline regressions with three to five breakpoints to explore this explanation in non-family firms. The results of this analysis provided no evidence of better performance as board independence increases when less than 70 percent of the board members were independent, regardless of the specification used In general, we tended to find the opposite: that performance appeared to be negatively related to board independence when there were low levels of independent directors, suggesting that family ownership is not a proxy for non-linear board effects.

Finally, we performed the analysis using an alternative measure of family presence, the family's fractional ownership of the firm's outstanding equity This information comes from the firm's proxy statements and, again, we found results similar to those reported in the tables. Overall, the results suggest a significant and positive relation between the influence of independent directors and firm performance in family firms.

DISCUSSION

Our findings provide a new perspective on the role that independent directors play in corporate governance. Rather than examining the board's role in controlling the manager-shareholder agency problem, we took a different perspective and asked whether boards play a role in mitigating conflicts between shareholder groups with diverging interests, specifically, whether independent directors temper agency problems between founding-family owners and outside shareholders The results were generally consistent with the hypothesis that independent directors minimize conflicts between shareholder groups with diverging interests In particular, in firms with founding-family ownership, there was a positive relation between firm performance and board independence, suggesting that there are performance premiums for family firms with greater levels of board independence relative to non-family firms or family firms with insider-dominated boards. We also investigated the relation between board independence and performance for firms without family ownership, and the results were consistent with earlier research suggesting that there is no significant relation between board independence and firm performance (Finkelstein and Hambrick, 1996). Only when delineating the sample based on the presence of founding families did we find evidence of a positive relation between board independence and firm performance, implying that independent directors potentially play an influential role in moderating the family's power and alleviating conflicts among shareholder groups. Also consistent with prior research, we documented that family firms, on average, perform better than non-family firms (Anderson and Reeb, 2003a) This result, however, appears to be primarily driven by family firms with greater degrees of board independence relative to family firms with few independent directors.

We also asked whether the relative power bases of family shareholders and independent directors are important in minimizing expropriation by the family. The results of our analysis generally indicated greater agency problems when family

power remains unchecked by the moderating influence of independent directors. More specifically, in firms with family ownership, we found that when family control of the board exceeded independent director control, the firm's performance was significantly poorer; when family control was less than independent directors', performance was better.

Although consistent with an agency theory perspective, our primary result of a positive relation between board independence and firm performance could also potentially be explained by stewardship theory, with families acting to protect and promote corporate welfare. To differentiate between agency- and stewardship-theory-based explanations of our results, we examined another group of outside directors, affiliate directors. Our empirical analysis indicated a significant and negative relation between the presence of affiliate directors and family-firm performance. These results are inconsistent with the stewardship explanation on the role of outside directors but are consistent with the agency hypothesis.

To gain further insights into whether agency or stewardship best explains the interplay between board structure and family influence, we explored how independent directors gain their board seats. From a stewardship perspective, families place independent directors on the board for their expert advice and counsel. Alternatively, agency theory indicates that family members on the nominating committee prefer to avoid independent director representation on the board. The results of our analysis indicated a negative relation between family member presence on the nominating committee and independent director (and external director) representation on the full board. Additional tests indicated a positive relation between the presence of institutional holdings and independent director representation on the full board. We interpreted these results to suggest that families themselves do not necessarily seek to place independent directors on the firm's board. Instead, it implies that outside shareholders call for independent directors on the board to minimize founding-family opportunism. This evidence is also consistent with the view that institutional investors perform an important role in moderating agency problems in family firms (Tosi et al., 1999; Gomez-Mejia, Larraza-Kintana, and Makri, 2003).

Overall, the results of the analysis of affiliate directors and the nominating committees provide evidence consistent with an agency explanation on the interaction between founding-family influence and board structure. Specifically, independent board members act to mitigate opportunistic behavior by large, controlling shareholders. We cannot completely eliminate the possibility, however, that some families seek the guidance and counsel of independent and affiliate directors to promote the firm's performance and corporate health.

To assess possible concerns about reverse causality, we also performed a two-stage least squares analysis and a lagged variable analysis. Consistent with our earlier results, we confirmed that board independence exhibited a positive relation to performance in firms with family ownership, suggesting that independent directors are important in alleviating con-

flicts between opposing shareholder groups. In addition, because family firms may vary more than non-family firms to the extent that some families act as stewards of firm value, our results could partially be explained by unobserved heterogeneity. To further investigate this possibility, we estimated a firm-level fixed-effects model and again observed that independent directors were performance enhancing in family firms, suggesting that minority investors benefit from governance devices that limit opportunistic family behavior.

Beyond providing new insights into the role of boards of directors, this study extended our understanding on founding-family ownership and influence in publicly traded firms. Anderson and Reeb (2003a) documented that founding-family firms, on average, are associated with greater accounting- and market-based performance. Our study advanced this line of research and addressed the question of what internal forces are at work to create these greater profits and what checks and balances limit family expropriation of the firm's resources. The analysis suggested that the superior performance of family firms found in Anderson and Reeb was driven largely by family firms with greater board independence. In contrast, family firms with relatively few independent directors performed significantly worse than the average non-family firm in the sample. Our results indicate that founding-family ownership, balanced and tempered with independent directors, appears to be a particularly effective organizational structure.

Our work also has important implications for research on the impact of board structure on firm performance. While prior studies focused on the board's role in monitoring and/or collaborating with managers, our findings suggest that the board also has a substantial role in mitigating conflicts of interest amongst shareholders. Prior studies have found little empirical evidence to support the hypothesis that board independence leads to greater firm performance (Westphal, 1999). In contrast, we observed that firm performance increased with increasing board independence for publicly traded firms with founding family influence, which provides compelling evidence that board composition and monitoring have an impact on firm performance in the presence of diverging shareholder interests.

Our analysis also contributes to the literature on the effective governance of dominant shareholders. Faccio, Lang, and Young (2001) found that the potential for family expropriation in East Asian firms (markets with restricted corporate transparency and limited legal safeguards for shareholders) was highest when family members' control exceeded their ownership rights. In contrast, in U.S. firms, we found one of the principal concerns with family expropriation is the relative influence of family and independent directors on the board. This finding is consistent with the property rights literature, suggesting that outside investors are only protected when they have the ability to limit the opportunism of large shareholders. Our results thus highlight the importance of appropriate governance mechanisms in the presence of large shareholders, even in countries with relatively strong legal safeguards.

Future Research Directions

Although this study focused on the role of independent directors in monitoring family opportunism, future research could examine other potential mechanisms to mitigate such conflicts among these shareholders. For instance, one might investigate whether the structure of family holdings or the absolute size of the family (number of family members) influences the family's behavior and incentives to expropriate firm wealth. Similarly, an interesting question arises as to whether family members rely on other families (external to their own) to provide important insights and advice on managing and controlling the firm. Additional studies could also examine family control of important board committees and the effect that committee control has on firm performance. Likewise, an interesting question arises concerning the importance of the board's relation to family members in privately owned firms in which some family members' interests conflict with the interests of other family members. The general findings from our study suggest that future research could consider the board's role in mitigating conflicts among other shareholders beyond those of founding families and minority investors.

Limitations and Implications

Although this study advanced our understanding of the board's role in balancing competing shareholder interests, it does have limitations. First, we focused on relatively large, publicly traded firms (S&P 500), suggesting that our results may not extend to smaller firms. Smaller firms tend to have less public scrutiny than larger firms, indicating that independent directors potentially play an even larger role in minimizing agency conflicts. Alternatively, in smaller firms, the family is perhaps more likely to identify with the firm, suggesting less need for directors to monitor. Second, our findings suggest that independent directors create value by limiting family opportunism, yet stewardship theory provides an alternative explanation for some of the observed results. As noted above, we performed several tests to distinguish between these competing ideas. Still, we cannot rule out the notion that some families have less desire to expropriate minority shareholders' wealth and thereby place more independent directors on the board. Finally, our analysis focused solely on the formal independence of the board and ignored the social and psychological factors that may affect relations between the family and directors. For instance, we did not examine issues such as demographics, social networks, age, or educational similarities between family members and independent directors on the board.

Our findings are relevant in light of the new regulations recently adopted by the governing bodies of the major U.S. stock exchanges and the Securities and Exchange Commission (SEC). Due to recent concerns about and allegations of corporate malfeasance, officials at the New York Stock Exchange, the National Association of Security Dealers, and the SEC adopted regulations that govern the structure of boards of directors. Member-listed firms are required to have boards comprised of a majority of independent directors. The

Sarbanes-Oxley Act passed by the U.S. Congress in 2001 also imposes legal constraints on boards by requiring that independent directors hold a majority of board seats. Our results indicate that, at least in firms with large concentrated shareholders, independent directors act as a powerful mechanism in mitigating family opportunism. To the extent that new policies may interfere with a well-balanced equilibrium between family and outside shareholders, however, the regulations may produce unintended consequences, such as disturbing the balance of power between inside and outside shareholders or providing an inequitable voice to large shareholders.

In aggregate, the results of this study indicate that independent directors are an important influence in alleviating moral hazard conflicts in firms with powerful, concentrated family shareholders. Our analysis suggests that the ability of outsiders to monitor family activity is one of the salient issues in assessing the vulnerability of minority shareholders to family opportunism. More specifically, our results indicate that the previously documented superior performance of firms with family ownership (relative to firms without family ownership) occurs when independent directors temper and moderate family influence. In contrast, those family firms with the fewest independent directors perform significantly worse than non-family firms in the S&P 500. Thus, considering the board's role in mitigating conflicts of interests between opposing shareholder groups, rather than minimizing agency conflicts between managers and shareholders, provides a new perspective on the relative importance of board independence. Our findings suggest that founding families monitor the firm, while independent directors monitor the family.

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