


Should The CEO Also Be Chairman Of The Board?

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Abstract

For some time, practitioners and academics have been trying to determine whether it is better for a company's shareholders to allow the CEO of the company to also be Chairman of the Board (a unitary leadership structure) or whether another person (an independent director) should hold the board Chair position (a dual leadership structure). Not surprisingly, most executives believe one person should hold both positions while academics hold mixed views on the subject. The empirical results presented in this study suggest that a dual leadership structure is superior for most firms because it allows the board to better control the opportunistic behavior of the firm's managers. Specifically, as agency theory predicts, dual leadership firms pay lower compensation to their CEOs, have lower selling, general, and administrative expenses, use more debt in their capital structures, pay out more of their free cash flows to investors, and are more profitable than unitary leadership firms. Each of these results indicates less opportunistic behavior by the managers of dual leadership firms.

Introduction

 ver the last 20 years or so finance, accounting, and management practitioners and academics have been trying to determine if it is better for a firm to have different people holding the Chairman of the Board and Chief Executive Officer (CEO) positions (a dual leadership structure) or whether one person should hold both positions (a unitary leadership structure). Agency theorists argue that a dual leadership structure is preferable because a Chair/CEO may keep the board from performing one of its most important functions, monitoring the senior managers of the firm. A unitary leadership structure could allow the Chair/CEO and other senior managers to engage in behavior that was detrimental to the interests of the firm's shareholders. Others have argued that having a unitary leadership structure is preferable because it actually contributes to the effective functioning of the board. They believe that making the CEO the Chairman of the Board promotes better communication and information flow between management and the board and results in better decision making by the board. In this paper, I will discuss the relevant leadership structure theories and review some empirical tests performed by myself (Fosberg (1999, 2003), Fosberg and Mulnix (2001) and Fosberg and Rosenberg (2003)) and other authors that seek to determine which leadership structure is superior.

Leadership Structure Theories

The theory that a dual leadership structure is superior was first put forth by Fama and Jensen (1983). Fama and Jensen note that one of the most important functions of a board of directors is to monitor the senior management of the firm to make certain they are acting in ways that are consistent with the interests of the owners of the firm (shareholders). However, because of the authority they possess, senior managers are in a position to use the assets of the firm to pursue their own interests even though those actions harm the interests of the firm's shareholders (lower shareholder wealth). This type of activity by managers is called opportunistic behavior. Examples of opportunistic behavior by managers include drawing excessive compensation, consuming an excessive amount of perks, shirking their responsibilities, etc. It is the responsibility of the board of directors to make certain that managers do not engage in any type of opportunistic behavior. To be effective in this pursuit, the board must not be under the control of the CEO (or other managers of the firm). Making the CEO the board Chair puts the CEO in a position to gain

effective control of the board and subvert the monitoring functioning of the board. This is likely to occur because the Chair controls or heavily influences the nomination of people to fill board vacancies and the appointment of directors to board committees, sets board meeting agendas, and controls the flow of information to board members. If the CEO/Chair uses this power to pack the board with people who will not effectively monitor the firm's managers or limits the flow of information to the board, managers will be free to engage in a wide range of opportunistic behavior. As a consequence, shareholder wealth (the value of the firm's common stock) will decline. To prevent this from occurring, the Chair must be an independent director. An independent director is someone who is not a current or former manager of the company and has no business relationships with the firm. I will call this the agency problem theory of leadership structure.

Those holding the contrary opinion, including Anderson and Anthony (1986) and Vancil (1987), believe that a unitary leadership structure is superior because it provides for a better flow of information to the board of directors. Proponents of this theory argue that for the board to function properly it is vital that the board be supplied with timely and accurate information about the operations of the firm. They argue that the requisite information flow to the board can be most effectively accomplished when the CEO is also the Chairman of the Board because the CEO has the most detailed knowledge about the operations of the firm. The CEO/Chair can then bring to the board's attention the issues and information that directors need to consider. Thus, allowing the CEO to also be the Chair will put in charge of the board the person best able to supply the board with the timely and accurate information the board needs to perform effectively. Having someone else serve as Chair would result in a reduced flow of information to the board and compromise board decision making. This theory implies that the monitoring problems created by allowing one person to be both Chair and CEO are relatively small in comparison to the benefits of enhanced information flow to the board. I will call this the information flow theory. In the following sections, I summarize the results of a number of studies, conducted by myself and several coauthors and reported in other papers, that empirically test the above theories.

Sample Selection

The sample of firms used in these studies was taken from the *Business Week* executive compensation studies. Each year *Business Week* reports the annual compensation and the titles held by the two highest paid executives of approximately 350 of the largest U.S. corporations. For each year from 1990 through 1996, I constructed a sample of firms matched by leadership structure and firm size. To be included in the sample for a given year a matched pair of firms had to be found which met the following criteria:¹ 1) a firm with a dual leadership structure and a similar firm with a unitary leadership structure had to be found. A unitary leadership firm was considered similar if it was in the same *Business Week* industry grouping and of approximately the same size (measured by sales) as the dual leadership firm and 2) each firm must have the same leadership structure and the same CEO for the sample year and the previous year. This procedure yielded a sample of 178 firms, half with a dual leadership structure and half with a unitary leadership structure.² Summary statistics for selected variables from the sample firms are presented in Table 1. As expected, the sample firms are quite large, with mean annual sales of \$4.612 billion. On average, the sample firms are also profitable, with mean a ROE (return on equity) of 17.3%. The CEOs of the sample firms received average total compensation of \$2.603 million in the sample year.

Empirical Analysis

In the empirical analysis, I test to see if there is any evidence that managers of unitary leadership firms engage in more opportunistic behavior than managers of dual leadership firms, as predicted by the agency problem theory. To test this involves trying to measure the costs associated with the opportunistic behavior of managers (agency costs). In that regard, I looked first at CEO compensation. One of the ways that a CEO can benefit themselves at the expense of the firm's shareholders is to draw excessive compensation. Generally, a CEO should receive compensation approximately equal to that being paid to CEOs of comparable firms. If a CEO/Chair is able to control the board, he can request and is likely to receive, more than the going rate of compensation for his services. Consequently, if the agency problem theory is correct, CEOs of unitary leadership firms should receive more compensation than CEOs of comparable dual leadership firms. Compensation paid to the CEOs of unitary and

dual leadership firms and the results of all other empirical tests are contained in Table 2. Looking first at Salary + Bonus, unitary leadership CEOs received, on average, \$1.405 million in salary and bonus as compared to \$1.163 million for dual leadership CEOs. Unitary leadership CEOs also receive, on average, \$828,000 more in Long-term Compensation than dual leadership CEOs. Long-term Compensation is the sum of retirement benefits, incentive plan compensation, and gains from the exercise of stock options. In total, unitary leadership CEOs received, on average, \$1.070 million (51.7%) per year more in compensation than dual leadership CEOs. This compensation difference could be justified if the CEO/Chair's activities as board Chair merited that much additional compensation. However, receiving an extra \$1 million in compensation for serving as Board Chair seems excessive.

Table 1: Summary Statistics for Selected Variables

	<u>Mean</u>	<u>Std. Dev.</u>
Sales (\$m)	4.612	3.286
ROE	.173	.082
Total Comp. (\$m)	2.603	2.797
SGA/Sales	.219	.110
Debt/Equity Ratio	.494	.664

m = million

Next, a broader measure of agency costs, a firm's selling, general, and administrative expense to sales ratio (SGA/Sales), is used to test for opportunistic behavior. Besides drawing excessive compensation, opportunistic behavior can take a number of other forms including excessive perk consumption, shirking of responsibilities, packing the company payroll with friends and relatives, etc. Examples of excessive perk consumption include

having multiple country club memberships when one would suffice, using corporate planes for travel when commercial airlines could be used more cheaply, having a more expensive than necessary company car, and billing the company for personal expenses unrelated to their professional duties. An example of shirking would be failing to exert the effort necessary to keep company expenses under control. The costs associated with these types of activities are likely to show up in the firm's selling, general, and administrative expense (SGA) account. To further control for size differences among the sample firms, SGA expense is divided by each company's sales. Unitary leadership firms have a mean SGA/Sales ratio of .236 versus .202 for dual leadership firms. The higher SGA/Sales ratio for unitary leadership firms means that, on average, unitary leadership firms incur approximately \$157 million more per year in SGA expense than similar dual leadership firms. This was calculated by multiplying average sales of the sample firms (\$4.612 billion) by the difference in mean SGA/Sales ratios (.034).

Several authors have noted that managers have large proportions of their personal wealth invested in their firm's common stock and in firm-specific human capital. Because their personal wealth is so heavily invested in their employers, these managers will lose a large part of their personal wealth if their employer goes bankrupt. Risk-averse managers may seek to mitigate this bankruptcy risk by using less than the optimal amount of debt in their firm's capital structure. The agency problem theory predicts that firms with a unitary leadership structure should engage in more of this type of opportunistic behavior. To test this theory, the debt to equity ratio (Debt/Equity) was calculated for each of the sample firms. Consistent with agency theory predictions, unitary leadership firms have a lower debt to equity ratio (.438) than dual leadership firms (.551).

Another agency problem that a dual leadership structure might help in solving is the free cash flow problem described by Jensen (1986). Free cash flow is money left over after all the firm's positive NPV (net present value) projects have been financed. Jensen argues that this free cash flow should be paid out to the firm's security holders. This could be accomplished by either disbursing the free cash flow as dividends to preferred and common stockholders and/or increasing the amount of debt in the firm's capital structure and paying the free cash flow out as interest on that debt. Although it is clearly not in the interest of the firm's shareholders, managers may invest some of the firm's free cash flow in negative NPV projects that increase firm size in order to obtain the personal benefits of enhanced compensation and prestige that managers of larger firms typically enjoy. If this opportunistic behavior occurs, unitary leadership firms should pay out less of their firm's free cash flows to security holders. The proportion of free cash flow disbursement is calculated as interest expense plus dividend payments divided by earnings before depreciation, interest, and taxes (Cash Disbursement). As theorized, dual leadership firms pay out a greater proportion of their free cash flow to security holders (.293) than unitary leadership firms (.239).

Table 2: Comparison of Unitary and Dual Leadership Firms

	<u>Unitary</u>	<u>Dual</u>	<u>Difference</u>
Salary + Bonus (\$m)	1.405	1.163	.242
Long-term Comp. (\$m)	1.733	.905	.828
Total Comp. (\$m)	3.138	2.068	1.070
SGA/Sales Ratio	.236	.202	.034
Debt/Equity Ratio	.438	.551	-.113
Cash Disbursement	.239	.293	.054
ROE	.170	.176	-.006

m = million

Lastly, I seek to determine if there is any difference in overall profitability between unitary and dual leadership firms. The measure of profitability employed is ROE (net income/common stockholder's equity). Perusing Table 2 reveals that the average ROE of unitary leadership firms is .170 (17.0%) as compared to .176 (17.6%) for dual leadership firms. The greater profitability of dual leadership firms is consistent with agency problem theory predictions. Empirical tests performed by

other authors have found either that dual leadership firms are more profitable than unitary leadership firms (Rechner and Dalton (1991)) or there is no difference in profitability between the two type of firms (Brickley, Coles, and Jarrell (1997)).

Conclusion

For some time, practitioners and academics have been trying to determine whether it is better for a company's shareholders to allow the CEO of the company to also be Chairman of the Board or whether another person (an independent director) should hold the board Chair position. Not surprisingly, most executives believe one person should hold both positions while academics hold mixed views of the subject. The empirical results presented in this study suggest that a dual leadership structure is superior for most firms because it allows the board to better control the opportunistic behavior of the firm's managers. Specifically, unitary leadership firms are shown to incur significantly higher CEO compensation expense and selling, general, and administrative expense, use less debt in their capital structures, pay out a smaller proportion of their free cash flows, and are less profitable than dual leadership firms. Each of these results indicates greater opportunistic behavior by the managers of unitary leadership firms.

Endnotes

1. Firms in the banking industry were not included in this study.
2. Complete data was not available for all 178 firms, consequently, some empirical tests involve less than the full sample of firms.

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