



Independence of the Chairman and Board Composition: Firm Choices and Shareholder Value

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This paper examines the role of leadership structure and board composition in the context of poison pill adoptions. We distinguish, for the first time, independent, separated leadership structures from non-independent, separated leadership structures. Our results suggest that there is an important interaction effect between board composition and the independence of the board Chairman, and that while there is a critical monitoring role for outside directors, inside directors also provide a critical informational role in board decision-making. © 2000 Elsevier Science Inc. All rights reserved.

The common governance practice of U.S. corporations of combining the positions of Chief executive officer (CEO) and Chairman of the board (Chairman) is a topic that has received a great deal of attention from academics, shareholder activists, and the business press. Since the duties of the Chairman typically include taking the lead in hiring/firing, evaluating and compensating top management, some suggest that it would be difficult for a CEO who is also Chairman to perform these duties in an objective manner. Consistent with this sentiment, some observers expect the number of firms that require separation between these two positions to rise dramatically in this decade (Fuchsberg, 1993; Lublin, 1992). Such alarm about conferring both the CEO and Chairman roles on one person clearly involves concerns about boards of directors. More specifically, those who oppose such leadership structures question whether boards are able or willing to effectively monitor management, particularly in the case when the CEO is also Chairman (Lublin, 1992).

Notwithstanding the purported problems associated with a leadership structure that does not separate the Chairman and CEO positions, the practice of

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combining the titles is common in the U.S. Various estimates of the incidence of this combination leadership structure range from 70 to 80 percent (e.g., Berg & Smith, 1978; Rechner & Dalton, 1991). In addition, the empirical work examining the role of leadership structure in firm governance has produced results that are generally mixed. In a recent meta-analytic review of the empirical work in this area, Dalton, Daily, Ellstrand, and Johnson (1998: 272) note that, “. . . neither the joint, nor separate, board leadership structure has been strongly supported as enhancing firm financial performance.” These authors also comment on the literature regarding the impact of board composition on financial performance. They characterize this stream of research as an area where the evidence has been inconsistent in demonstrating a clear relationship between the composition of the board and superior financial performance of the firm.

Recent studies suggest possible reasons for the lack of conclusive findings surrounding leadership structure and firm performance. The first involves the interaction of board leadership structure and board composition. In particular, we examine the use of outside board members as a governance mechanism which can be used to mitigate the difficulties associated with a leadership structure where the roles of Chairman and CEO are combined in one person. Our view, consistent with the evidence provided by Finkelstein and D’Aveni (1994) on vigilant boards, is that outsiders can provide a critical, independent perspective necessary for effectively monitoring managerial behavior. However, we also examine the role of insiders on the board interacting with leadership structure. Insiders serving on the board can provide an important source of information in making decisions about the effectiveness of firm managers, in particular when the Chairman is an outsider.

A second reason for the lack of conclusive findings involves the classification of leadership structure. In a recent discussion of the research in this area, Harris and Helfat (1998: 904) propose a closer examination of board leadership structure, beyond the generally accepted classifications of CEO duality. Previous studies have dichotomized leadership structure into two categories: (1) firms where the CEO and Chairman positions are combined in one person; and (2) firms where separate people occupy the offices. The intent of this dichotomy is to serve as a proxy for how much independence the Chairman possesses. Those who hold both positions are thought to lack independence while those who serve only as Chairman are seen as exercising greater independence. We argue, however, that this dichotomy is inadequate to capture the independence of the Chairman. We propose a third category of leadership structure in order to examine the independence of the Chairman and CEO, in particular, when two individuals occupy these roles. Our view is that two individuals occupying these roles does not necessarily imply that these individuals are independent, objective actors. Some separated leadership structures are led by chairmen who may not be truly independent of the firm’s management because they may have previously served as a manager of the firm or have other close ties to the current management team. Consequently, these chairmen may identify more closely with the interests of the firm’s management than those of the shareholders. As John Smale, former non-executive Chairman of General Motors, asserts, “A retired CEO should be considered an inside director

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