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The cost of CEO duality: Evidence from French leadership compensation

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ABSTRACT

This paper aims to provide a detailed analysis of the relationship between board leadership structures and executive compensation. According to agency theory, the combined position of CEO and Chairperson of the Board (COB) entails greater compensation for the CEO in order to reduce conflicts of interest. In the literature, combined board structure is generally considered to generate additional costs for companies. However, the choice of two separate structures implies the payment of incentive compensation for the COB in addition to that defined for the CEO. This paper investigates the financial cost of duality when compensation packages are set for both leaders. Our results suggest that although combined board structure is associated with higher incentive compensation for the CEO, the overall compensation cost to the company is no higher when the chairperson's compensation is considered.

1. Introduction

Separating the positions of Chairperson of the Board (COB) and Chief Executive Officer (CEO) is seen as an essential key to ensuring good corporate governance. Agency theory argues that combining the functions of decision and control reduces the board's ability to effectively monitor the decisions and actions of the CEO, thus giving the latter more latitude to satisfy his own interests rather than those of shareholders (Fama & Jensen, 1983; Jensen, 1993). According to managerial power theory, CEOs holding the chairperson title may use their increased power for rent extraction, thus obtaining higher compensation at the expense of shareholders (Bebchuk & Fried, 2004). Alternatively, optimal contracting theory argues that the incentive compensation of a CEO holding the position of chairperson is likely to increase in order to mitigate the reduced effectiveness of direct monitoring (Jensen & Murphy, 1990; Murphy, 1999). Overall, although a combined chair position may have benefits such as improving the decision-making process and the ability to exchange information (Adams & Ferreira, 2007; Finkelstein & D'Aveni, 1994), this leadership structure may entail greater bonding costs for the firms, mainly due to the higher compensation that can be accorded to CEO-Chairpersons.

The aim of this paper is to shed new light on the relationship between board structure and executive compensation by considering the role of the chairperson, and specifically his/her own compensation contract. Separate leadership requires a compensation contract for the chairperson, in addition to that defined for the CEO. Specifically, the separation of ownership and control in firms can generate conflicts of interest between the chairperson and the shareholders, which can result in incentive compensation packages being set for the chairperson. It is therefore crucial to consider compensation paid to the chairperson when analyzing the impact of the choice of board structure on executive compensation. According to Brickley, Coles, and Jarrell (1997), the decision to separate the titles should be analyzed in terms of costs and benefits. In this light, additional compensation awarded to the chairperson in a separate structure is likely to result in additional costs for firms. Our study argues that although the cost of CEO compensation may be lower in firms with separate titles, the cumulative cost of leadership in these firms is equivalent to the cost associated with CEO compensation in dual firms, if not higher. The main objective of this paper is to analyze how far the choice of board structure impacts the total compensation of leadership, whether single or joint.

This study uses a sample of French public firms from 2005 to 2011 to address two main empirical questions. Firstly, how does

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duality affect French CEO compensation? In line with previous empirical literature, we investigate whether the choice of a combined structure, and the consequent lack of effective monitoring by a chairperson, entails higher CEO compensation levels. We particularly seek to pinpoint how the choice of board structure affects the design of CEO compensation packages and how this choice shapes the relationship between CEO compensation and firm performance. As the CEOs of firms with separate titles might be more effectively monitored by the board, we examine whether incentive pay contracts are used as complements or alternatively as substitutes. Secondly, how does duality affect French leadership compensation? We consider the total compensation costs for CEO and COB leadership, and investigate whether a separate board structure is still an additional cost to the company when COB compensation is included. By addressing this issue, we identify the determinants of COB compensation.

This study makes several new contributions to the literature. First, this paper sheds new light on the relationship between duality and executive compensation and on the predictions of optimal contracting and managerial power theories. Previous US-based empirical studies show diverging results on this issue and do not provide a definitive conclusion about the validity of these two theories (e.g. Capezio, Shields, & O'Donnell, 2011; Cordeiro & Veliyath, 2003; Cyert, Kang, & Kumar, 2002; Dey, Engel, & Liu, 2011). The recent meta-analysis from Van Essen, Otten, and Carberry (2015) suggests that managerial power does have a significant influence over the pay-setting process, but that optimal contracting arrangements may also exist. The present paper assesses the validity of these theories within the French context.

Second, this paper is a valuable addition to recent cross-national governance research. Several studies have highlighted the “undercontextualized” nature of agency theory, and the necessity to explain the diversity of corporate governance arrangements across different institutional contexts (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Aguilera & Jackson, 2003; Desender, Aguilera, Crespi, & Garcia-Cestona, 2013; Schiehll & Martins, 2016; Van Essen, Engelen, & Carney, 2013). These studies suggest that the effectiveness of governance prescriptions may be contingent on a variety of legal and institutional factors. Van Essen et al. (2013) specifically document that the positive effects of CEO duality depend on individual country factors such as the rule of law and investor rights (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). Besides, the governance mechanisms interact at both the firm-level and the country-level, and corporate governance can be viewed as the result of interrelated country- and firm-level factors (Aguilera et al., 2008; Schiehll & Martins, 2016).

The present study builds on these arguments to examine complementarities and substitutions among firm-level governance mechanisms such as board composition and incentive compensation, within the French context. The majority of literature on CEO compensation and board structure to date has been conducted in the Anglo-American context. This environment is characterized by dispersed ownership where board composition and contractual incentives are key governance mechanisms (Aguilera & Jackson, 2003; Fernandes, Ferreira, Matos, & Murphy, 2013). This study provides the opportunity to examine an environment where listed firms typically have large shareholders and a high proportion of family-based ownership (Belot, Ginglinger, Slovina and Sushka, 2014). Since large shareholders are likely to exercise more direct monitoring of managers, a concentrated ownership environment should entail less necessity for incentive compensation and a reduced monitoring role of the board. CEO compensation in France is indeed significantly lower and less equity-based than in the US. Nevertheless, compensation levels in France have increased considerably in recent years, as well as the relative proportion of incentive compensation (Goyer & Jung, 2011). Additionally, as large shareholders have both the power and incentives to discipline CEOs, they may encourage performance-based compensation. While ownership concentration is likely to limit agency conflicts between managers and shareholders, it is also a potential source of conflicts between large and small shareholders, and blockholders can use their discretion to extract private benefit (Schleifer and Vishny, 1997). In a context of weak minority shareholder protection, as observed in the French context (La Porta et al., 2000), the board is likely to play an important monitoring role to protect minority shareholders. In this case the choice of board structure remains a key issue.

The French institutional setting provides an interesting framework for the study of duality, as companies can freely choose to unify or split CEO and COB positions within a unitary board (as in the US model) or a two-tier board (as in the German model). This leadership structure model provides a stimulating context in which the relationship between CEO duality and compensation can be examined.

Lastly, this study provides greater insight into the ongoing debate surrounding the costs and benefits of implementing good corporate governance mechanisms in different countries (Aguilera et al., 2008; Doidge, Karolyi, & Stulz, 2007), and specifically the costs and benefits of separating roles (Brickley et al., 1997). The paper adds to the literature by providing a close examination of how CEO duality impacts leadership compensation within a novel framework that addresses COB compensation. This contribution seems significant given the scarcity of literature on the role - and more particularly the compensation - of the COB (Roberts, 2002). Nevertheless, the leadership provided by the joint CEO – COB positions is a key issue for companies that have chosen a separate board structure. As the leader of the board, the chairperson plays a pivotal role in the company (Karabadse & Karabadse, 2007; Roberts, 2002; Waelchli & Zeller, 2013). A COB can make an effective and positive contribution to the strategic direction and corporate success of companies. He/she has a central role in determining the effectiveness of a board and its contribution to the quality of executive decision making. The COB receives compensation to hold this key position. Our study provides insights into the financial cost of separating titles when COB compensation is taken into account.

2. Board structure and leadership compensation: The French context

2.1. Board structure in France

French companies have the opportunity to choose freely between three board structures. The first type, introduced by French law in 1966, is a two-tier board structure. This two-tier system consists of a supervisory board of non-executive directors and a separate management board of executive managers. The CEO runs the management board and the COB chairs the supervisory board; their respective roles and responsibilities are clearly separated. The management board conducts the day-to-day management and corporate activities of the firm, while the supervisory board supervises the management board and the monitoring of managerial activities. The chairperson sets the agenda for board meetings, leads discussions among non-executive directors and coordinates their activities. He/she plays a key role in ensuring that managerial decisions are in line with the overall strategic guidelines of the company, and in encouraging effective corporate governance practices.

The second type of structure is a traditional single-tier board structure, where the board of directors is typically chaired by one