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CEO duality and firm performance: The moderating roles of other executives and blockholding outside directors

Jianguan Tang

Faculty of Business Administration, Memorial University of Newfoundland, St. John's, NL, A1B 3X5, Canada

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ABSTRACT

This study examines how the effect of CEO duality on firm performance is affected by two internal governance forces – namely other executives in the top management team and blockholding outside directors. Results based on a longitudinal dataset from the U.S. computer industry were consistent with my hypotheses. Specifically, I found that the effect of CEO duality was negative when the CEO had dominant power relative to other executives and when the board had a blockholding outside director, but was nonsignificant otherwise. This study enriches our understanding of the effect of CEO duality, and helps reinforce the call for the nonduality structure as the default choice and put the burden of proof on those who wish to justify otherwise on special grounds.

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1. Introduction

CEO duality occurs when the CEO also occupies the chair position of the board of directors (Rechner & Dalton, 1991). The effect of CEO duality on firm performance has been extensively debated in academia as well as in the business community (Dalton, Hitt, Certo, & Dalton, 2007). From an agency perspective (Fama, 1980), CEO duality involves an inherent role conflict for the CEO-chair and enhances the power of the CEO relative to the board, thereby compromising the board's functions of monitoring and disciplining the CEO. Unsurprisingly, many researchers and practitioners (e.g., investors and policy makers) have long called for the separation of the CEO and chair positions (i.e., the nonduality structure), along with other measures to enhance board effectiveness (summarized in Finkelstein, Hambrick, & Cannella, 2009). However, from a stewardship theory perspective (Davis, Schoorman, & Donaldson, 1997), researchers have also long recognized the benefits of CEO duality, especially enhancing the unity of command at the top (Dalton et al., 2007; Finkelstein & D'Aveni, 1994).

Notwithstanding the extensive research on the relationship between CEO duality and firm performance, overall there is no empirical evidence of a substantial, systematic relationship (Dalton, Daily, Ellstrand, & Johnson, 1998; Dalton & Dalton, 2011; Dalton

et al., 2007; Heracleous, 2008). While it could be due to the relationship being quite distal (Finkelstein et al., 2009), such lack of empirical evidence, coupled with the conceptual ambivalence, has naturally prompted researchers to take a contingency approach. As no governance arrangement is costless (or flawless), the overall effect of an arrangement has to be assessed for its costs and benefits in relation to feasible alternatives (Williamson, 1996). In essence, the two aforementioned perspectives on CEO duality focus on its costs (i.e., agency problems) and benefits (i.e., unity of command) respectively. Ultimately, the overall effect of CEO duality depends on the balance between its costs and benefits, a balance that might depend on such factors as the CEO, the top management team (TMT), the board, the organization, and the environment.

Following a contingency approach, prior research has examined several contextual factors that might affect the benefits of CEO duality and thus moderate its effect on firm performance. For example, it has been suggested that the benefits of CEO duality (especially, unity of command) might be especially salient in complex and less munificent environments (Boyd, 1995), in transitional economies (Peng, Zhang, & Li, 2007), and in turnaround situations (Mueller & Barker, 1997). In such contexts, the benefits of CEO duality might outweigh its inherent agency costs and, as a result, CEO duality might have a positive effect on firm performance. However, prior research has largely ignored internal governance forces as moderators that may affect the agency costs of

E-mail address: jytang@mun.ca.

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CEO duality and thus moderate its effect on firm performance.

In this study I examine two such forces – namely other executives in the TMT and blockholding outside directors – which interact regularly with and perhaps most directly influence the CEO. To the extent that a force reduces (or exacerbates) a chair-CEO's agency problems, it will make the effect of CEO duality less (or more) negative. I argue that other executives, with sufficient power, might effectively monitor the chair-CEO (as well as the non-chair CEO) and thus reduce his or her agency problems, whereas blockholding outside directors tend to collude with rather than monitor and discipline the chair-CEO and thus exacerbate his or her agency problems. Thus, I hypothesize that the effect of CEO duality will be more negative when the CEO has dominant power relative to other executives and when the board has a blockholding outside director. I found support for these hypotheses based on a longitudinal dataset from the U.S. computer industry. More specifically, I found that the effect of CEO duality was negative when the CEO had dominant power relative to other executives and when the board had a blockholding outside director, but nonsignificant otherwise.

This study makes several key contributions. By examining two internal governance forces that affect the CEO's agency problems and thus interact with CEO duality to affect firm performance, it enriches our understanding of the effect of CEO duality. It also affirms and extends the applicability of agency theory to research on CEO duality, which has often been unwarrantedly questioned based on studies that do not consider such moderating forces. Moreover, it helps reinforce the call for the nonduality structure as the default choice by debunking the contingency approach as a critical intellectual basis for resisting the recall.

2. Theory and hypotheses

2.1. CEO duality: costs and benefits

The separation of ownership and control characterizes most large firms in modern economies, in which CEOs do not substantially own the firms and thus may pursue their self-interests at the expense of shareholders (Fama, 1980). The board has emerged as a key governance arrangement limiting the CEO's agency problems. In addition to aligning the CEO's interests with the shareholders' via incentive schemes, the board also oversees the decision process (e.g., via decision ratification and monitoring) and, as a final resort, might dismiss an underperforming CEO (Fama & Jensen, 1983).

The effectiveness of the board fulfilling its monitoring and disciplining functions depends on CEO power relative to the board (Finkelstein et al., 2009). Power is essentially “a property of social relationship, not an attribute of the actor” (Pettigrew, 1973, p. 26); it is a relational rather than an individual level construct such as personality and behaviors (Greve & Mitsuhashi, 2007; Tang, Crossan, & Rowe, 2011). Thus, CEO power relative to the board should be distinguished from CEO power relative to other executives in the TMT, the latter of which is a key construct in this study and will be further discussed later. In essence, the board's monitoring and disciplining functions are achieved by limiting CEO power relative to the board.

CEO duality, by enhancing CEO power relative to the board, compromises the board's monitoring and disciplining functions. First, as the chair is responsible for setting the board agenda and moderating board discussion (Carter & Lorsch, 2004; Gillies & Leblanc, 2005), the chair-CEO may control the board agenda and information flow so as to create norms in which questioning management effectiveness is deemed inappropriate (Mace, 1971; McNulty & Pettigrew, 1999). Second, as an independent chair serves as a focal point through which other directors raise and communicate their concerns regarding the CEO, the lack of such a

chair makes it difficult for other directors to do so (Roberts, McNulty, & Stiles, 2005).¹

By compromising the board's monitoring and disciplining functions, CEO duality may also compromise the quality of the firm's strategic decisions. First, in areas with conflicts of interests between the CEO and the shareholders – for example, employment contracts (Williamson, 1985), the adoption of anti-takeover defenses (Mallette & Fowler, 1992), and different temporal orientations and risk attitudes (Baysinger & Hoskisson, 1990; Fama, 1980) – under the duality structure the CEO is more apt to make decisions aligned with his or her self-interest but deviant from the shareholders' interest. Second, even in areas without conflict of interests where it is certainly in the CEO's broad interest to make high-quality strategic decisions (Hendry, 2005; Lane, Cannella, & Lubatkin, 1998), under the duality structure the CEO is more likely to make poor or extreme decisions. Note that extreme decisions, though not necessarily poor, are usually more likely to result in big losses than big wins (Sanders & Hambrick, 2007). From a behavioral perspective, the CEO's decision is affected not only by rational calculation but also by behavioral and political factors (Cyert & March 1992; Eisenhardt & Zbaracki, 1992). When facing less pressure from the board, the CEO is more likely to shirk (Eisenhardt, 1989) and engage in distracting activities that are enjoyed by or in the private interests of the CEO (Malmendier & Tate, 2009). As a result, the CEO might not make sufficient efforts to make the best possible strategic decisions for the firm. Moreover, under the duality structure the CEO's decisions are less likely to be rigorously scrutinized in the boardroom (Tang et al., 2011); as a result, poor or extreme decisions are more likely to remain unchallenged. It has been suggested that such CEOs are associated with more variable firm performance (Adams, Almeida, & Ferreira, 2005) and, on average, poor firm performance (Bebchuk, Cremers, & Peyer, 2011; Tang et al., 2011).

Whereas agency theory highlights the costs of CEO duality, a stewardship theory perspective (Davis et al., 1997) suggests that CEO duality has potential benefits, especially enhancing the unity of command at the top by clearing the confusion about who – the CEO or chair – is in charge (Dalton et al., 2007; Finkelstein & D'Aveni, 1994). The unity of command helps establish clear lines of authority and responsibility within the firm and thus has substantive and symbolic values (Barnard, 1938; Pfeffer, 1981). It enhances the power of the CEO and thereby enables fast, decisive decisions (Finkelstein & D'Aveni, 1994). It helps create an enabling and empowering structure which encourages the CEO to act pro-organizationally as a steward (Davis et al., 1997; Donaldson & Davis, 1991). It also helps project an image of strong CEO leadership, which may help the firm gain the confidence, support and resources from both internal and external stakeholders (Pfeffer & Salancik, 1978).

It is difficult to dispute either the costs or the benefits of CEO duality. They are indeed the two sides of the same coin; the benefits of CEO duality are possible only when the accompanying agency costs incur. Thus, the overall effect of CEO duality depends on the balance between its costs and benefits, a balance that may be situation dependent (Elsayed, 2010). Under the situations where the

¹ It should be noted that these concerns might, to some degree, be mitigated by having a lead independent director, an arrangement that has become widespread since the Sarbanes-Oxley (SOX) legislation of 2002 in the U.S. (Penbera, 2009). However, there lack well-established norms governing the role of lead director, which has been viewed by many as merely symbolic (Felton, Berryman, & Stephenson, 2004). The extent to which a lead director can actually mitigate the concerns of CEO duality remains unclear (Coombes & Wong, 2004; Dalton et al., 2007) and is a question warranting careful studies but beyond the scope of this study. It is clear, though, that a CEO has more power over the board when the CEO is the chair, whether there is a lead director or not, than when the CEO is not the chair.

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