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The dynamic relationship between CEO duality and firm performance: The moderating role of board independence

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ABSTRACT

For a panel of U.S. firms, we employ system GMM to estimate a dynamic model of the relationship between firm performance and governance characteristics including board leadership structure. Our results provide convincing evidence that a joint leadership structure, i.e., CEO duality has statistically significant negative impacts on firm performance. We also document that this effect is positively moderated by board independence. The results are robust across a number of sensitivity tests. The findings are consistent with arguments advanced by both agency theorists and some management scholars that though duality might reduce firm performance through managerial entrenchment, it can provide benefits to the firm in the presence of board vigilance.

1. Introduction

CEO duality and its impact on firm performance represents one of the most contentious issues in both academia and business (Dalton, Hitt, Certo, & Dalton, 2007; Finkelstein, Hambrick, & Cannella, 2009). In recent years, especially since the passage of the Sarbanes-Oxley Act of 2002, agency arguments and empirical evidence on the negative performance impact of duality (Fama & Jensen, 1983; Jensen, 1993) have led to calls for abolishing the combined leadership structure. Activist shareholders of various firms (e.g., News Corp, JP Morgan Chase, and Goldman Sachs) have campaigned against CEO duality by initiating proposals requiring its outright prohibition. Conversely, some firms (e.g., Chevron Corporation 2012) have provided arguments to support the value-enhancing attribute of the unity of leadership that duality engenders. Thus, determining whether CEO duality ultimately enhances firm performance is an increasingly important question for corporations, business practitioners and academics.

Two primary theoretical perspectives dominate the research on duality's performance effects. Agency theory argues that duality increases the power the CEO has over the board, hindering the independence between the board and management that is necessary to check managerial entrenchment (Jensen & Meckling, 1979; Fama & Jensen, 1983), resulting in negative performance effects (Jensen, 1993). In contrast, management and organizational scholars, relying on stewardship theory (Donaldson & Davis, 1991) and resource dependence theory (Pfeffer & Salancik, 1978), argue that duality promotes more focused and flexible leadership which facilitates organizational effectiveness in a potentially dynamic business environment (Finkelstein & D'Aveni, 1994; Dahya, Lonie, & Power, 1996).

The empirical literature investigating duality's impact on firm performance yields mixed results. Evidence from the 31 studies reviewed in Dalton, Daily, Ellstrand, and Johnson (1998) is inconclusive, ranging from positive to negative to statistically insignificant relationships (e.g., Daily & Dalton, 1994; Faleye, 2007). Because a board's choice of leadership structure might be endogenous (Faleye, 2007; Hermalin & Weisbach, 1998; Raheja, 2005), the ambiguous results on the relationship between duality and firm performance are often deemed a consequence of endogeneity problems (Harrison, Torres, & Kukalis, 1988; Adams, Almeida, & Ferreira, 2005) that make it difficult to identify a causal relationship between the two. Recent research (Iyengar & Zampelli, 2009) investigates this possibility and documents that studies which treat CEO duality as exogenous do not suffer from selection bias. Consistent with this, Linck, Netter, and Yang (2008) also find that performance does not appear to drive CEO duality. In contrast, Wintoki, Linck, and Netter (2012) provide evidence that CEO duality may be a function of past values of firm performance and hence not strictly exogenous.

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This paper assesses the performance effect of CEO duality within a dynamic framework, accounting for the possible linkages between current governance characteristics and other firm specific variables and past levels of firm performance. Specifically, we employ System GMM to estimate a dynamic model of firm operating performance.

We also extend the literature by examining under what other governance characteristics might the benefits of a joint leadership structure outweigh its costs (Finkelstein & D'Aveni, 1994; Harrison et al., 1988). Specifically, since board leadership structure exists within the context of other governance arrangements such as board composition, we investigate the performance effects of the interaction between duality and other elements of board structure/composition, with particular emphasis on board independence, drawing on theoretical arguments that integrate agency and resource-dependence theories (Desender, Aguilera, Crespi, & Garcia-Cestona, 2013; Hillman & Dalziel, 2003).

Our results provide evidence that duality has a statistically significant negative impact on firm performance that is positively and significantly moderated by board independence. This suggests that outside board members serve as effective monitors, limiting managerial opportunism and playing a disciplinary role while exploiting the benefits of decisive leadership associated with a joint board leadership structure. These results provide support for arguments that the performance impact of duality is contingent on board independence (Davidson, Jiraporn, Kim, & Nemec, 2004; Finkelstein & D'Aveni, 1994) and that the efficacy of corporate governance mechanisms depends on the interdependencies among them (Aguilera, Filatotchev, Gospel, & Jackson, 2008).

The remainder of the paper is organized as follows. Section 2 provides the theoretical background and hypotheses on the relationship between duality/board independence and firm performance. The econometric model of firm performance and the System GMM estimator is outlined and discussed in Section 3. Section 4 describes the sample design, data, and measurement of the dependent and explanatory variables. Estimation results are also presented and discussed in this section. Section 5 presents the results of a number of robustness tests. The implications and limitations of the study, and some concluding remarks are offered in Section 6.

2. Theory and hypotheses

Two main competing theories dominate the discussion of the relationship between CEO duality and firm performance. As the primary theoretical framework that emphasizes the monitoring role of boards, agency theory argues that boards should be independent from management to limit managerial entrenchment and opportunism (Jensen & Meckling, 1976). By breaching this independence, a dual board leadership structure is likely to have a negative impact on performance since it attenuates the board's potential to monitor management effectively (Jensen, 1993).

In contrast, a number of organizational and management theorists argue that CEO duality can enhance firm performance. Stewardship theory (Barney, 1990; Donaldson & Davis, 1991) argues that shareholder interests take priority with a joint leadership structure. In contrast to the implicit assumption of agency theory that CEOs are inherently opportunistic, stewardship theory contends that non-financial factors such as intrinsic satisfaction from achievement, recognition, respect and reputation will motivate CEOs to enhance firm value by using the unity of command to manage the firm's resources as good stewards. This view of managerial motivation is also consistent with an extension of resource dependence theory. Pfeffer and Salancik (1978) emphasize that the increased discretion afforded by dual leadership enhances the CEO's ability to more quickly react and respond in a dynamic business environment, and to secure resources critical to the firm's success. Taken together, the stewardship and resource dependence theories predict a positive relationship between CEO duality and firm performance.

Some theoretical studies that have modeled the determinants of board structure suggest that some board characteristics are dynamic. For example, Hermalin and Weisbach (1998) argue that a CEO's bargaining power derives from superior ability, suggesting that past performance, as a proxy of ability, can determine the elements of board structure implying clearly that there is a dynamic element in the determination of leadership structure. Wintoki et al. (2012) further argue and document that the dynamic element emanates from two sources: past performance and other firm characteristics that affect firm performance. Moreover, empirical papers such as Brickley et al. (1997) support the notion that CEO duality is often the reward for good corporate performance. Also, consistent with the bargaining hypothesis of Hermalin and Weisbach, various studies (e.g., Adams et al., 2005) document the positive association between duality and bargaining power. In particular, the turnover study by Harrison et al. (1988) shows that strong firm performance leads to greater CEO power resulting in duality while poor performance results in two individuals holding both titles.

Though Adams, Hermalin, and Weisbach (2010) suggest that the notion that past performance affects leadership structure does not necessarily imply that duality will improve or even affect performance, we argue that an understanding of duality's performance effects is incomplete and potentially flawed without explicitly incorporating the dynamics of leadership choice. An important implication of this view is that static models yield biased and inconsistent estimates, and raise serious concerns regarding statistical inference. While the dynamic model does not solve all endogeneity problems, it improves inference beyond pooled OLS and traditional fixed-effects estimation. Consequently, we present the following competing alternative hypotheses regarding the effect of CEO duality on firm performance:

H1a. (Agency theory): The dynamic relationship between CEO duality and firm performance is negative.

H1b. (Stewardship/resource dependence theory): The dynamic relationship between CEO duality and firm performance is positive.

These two alternative hypotheses are consistent with the "input–output" approach used in most of the research on the relationship between board characteristics and firm performance "whereby board composition or board structure (input) are linked directly to firm performance (output)" (Macus, 2008, p. 99). This approach has been criticized for neglecting "the processes that occur in the board as boards monitor management's activities, determine the strategic course of the firm, or secure important tangible or intangible external resources for the firm" (Macus, 2008, p. 101). It has also been indicted as one of the culprits in the mixed results reported in the empirical literature on the performance impacts of board characteristics (Daily & Dalton, 2003). Moreover, Macus (2008) offers a strong argument that board interactions are the building blocks of board processes, important to board effectiveness and ultimately firm performance.

We also draw on theoretical arguments that integrate agency and stewardship/resource dependence theories (Hillman & Dalziel, 2003; Desender et al., 2013). These management scholars posit that the board's impact on firm performance depends on both the incentives and the abilities (or power) of board members, and the choices a firm faces regarding the costs and benefits of different board structures. Specifically, efficiency and contingency arguments (Faleye, 2007) suggest that board independence accentuates the benefits of duality and mitigates its costs, resulting in a profitable balance between strong leadership and effective monitoring. Although information acquisition and processing costs are likely to be higher for more independent boards, extant literature (e.g., Armstrong, Core, & Guay, 2014) documents that firm transparency improves with increases in board independence, thus reducing information costs within the firm. Some studies also suggest that board independence improves the quality of accounting information. Others argue that in order to attract independent directors,