



Where Experts Get It Wrong: Independence vs. Leadership in Corporate Governance

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INTRODUCTION

Over the last few decades, researchers have taken a thorough and critical look at corporate governance from various perspectives. They have studied how legal, social, and market forces influence the control mechanisms that a company adopts to prevent or discourage self-interested behavior by management. They have examined the structure and operations of the board of directors. They have explored processes of governance systems, including strategy development and oversight, risk management, CEO succession planning, performance measurement, executive compensation, the external audit, and the consideration of mergers and acquisitions to determine the relation of each to governance quality and firm outcomes. The result is a vast research literature across many different disciplines that chronicles the association between corporate governance choices and the likelihood of future success or failure.¹

For the most part, the findings of this research literature are modest. Many observed structural features of corporate governance have little or no relation to governance quality. For example, there is little systematic evidence that it benefits a company to have an independent chairman; maintain fully independent audit, compensation, or nominating and governance committees; restrict its audit firm from performing non-audit-related services; or grant shareholders an advisory vote on compensation. For other governance decisions—such as a decision to pay directors in cash or stock, or to award executives golden parachute severance payments—the research results are so mixed as to be effectively inconclusive. While there is evidence that governance processes are critical to success—such

as proper risk management or a workable CEO succession plan—it is the quality with which processes are designed and implemented rather than the mere presence of a program that determines whether they will be successful.

The lack of concrete evidence suggests that the current focus in corporate governance might be misdirected. Instead of debating *features* of corporate governance, more attention should be paid to *contextual issues*—a company's leadership, culture, and specific situation. While these are more difficult to measure, they are also likely to have a far greater impact on governance quality than one-size-fits-all structural requirements. To illustrate this, consider an issue that is hotly debated and often misunderstood: the debate whether to combine or separate the chairman and CEO roles.

INDEPENDENCE AND GOVERNANCE

In January 2013, the Connecticut Retirement Plans and Trust Funds (CRPTF) sponsored a proposal for inclusion on the Walt Disney Company annual proxy that would require the company to separate the chairman and CEO roles. The proposal was intended to reverse a decision made the previous year to grant CEO Robert Iger the additional title of chairman.

The issue of whether or not to allow a dual chairman/CEO is a contentious one in corporate governance and has been a particularly contentious issue at Disney. In 2004, the company stripped then Chairman and CEO Michael Eisner of his chairman title after significant backlash from shareholders who objected to Eisner's management of the company in recent years.² In 2006, Iger replaced Eisner as CEO, and the company continued the

practice of maintaining an independent chairman of the board. In 2012, following six very successful years at the helm, Disney awarded Iger the joint chairman/CEO title, a position he is to retain until his planned retirement in 2015.

By contesting this decision, shareholders highlighted the potential conflicts that can arise when a managerial role is combined with a monitoring role. In its proxy proposal, the CRPTF explained that:

*We believe that the role of the Chief Executive Officer and management is to run the business of the company and the role of the board of directors is to oversee management. We believe given these different roles and responsibilities, leadership of the board should be separated from leadership of management.*³

Others agreed with this position. New York City comptroller John Liu stated that “the Walt Disney Company needs a board chair who is independent of the company to best oversee management.”⁴ Proxy advisory firm Glass Lewis wrote that “we ultimately believe vesting a single person with both executive and board leadership concentrates too much oversight in a single person and inhibits the independent oversight intended to be provided by the board on behalf of shareholders.”⁵ Jack Ehnes, CEO of the California State Teachers’ Retirement System, agreed: “This is just a fundamental principle of corporate governance. Obviously, common sense is that there should be separation between the chairman of the board and CEO.”⁶

Disney shareholders on the whole, however, did not agree. When it came to a vote, the measure was defeated by a margin of 65 percent to 35 percent.⁷

What is interesting about this controversy is not the particular outcome at Disney but that such a controversy should arise over a matter that has been extensively studied and rigorously demonstrated to have no material impact on governance quality. For example, Baliga, Moyer, and Rao (1996) examine companies that announce a separation (or combination) of the chairman and CEO roles. They find no abnormal positive (or negative) stock price reaction to these announcements. They also find no material impact on future operating performance.

They conclude that although a combined chairman/CEO “may increase potential for managerial abuse, [it] does not appear to lead to tangible manifestations of that abuse.”⁸ Similarly, Boyd (1995) provides a meta-analysis of several papers on chairman/CEO duality and finds no statistically significant relationship between the independence status of the chairman and operating performance.⁹

The reason for this is simple: context matters. While the separation of the chairman and CEO roles might be advantageous in some settings, it can be inefficient in others. Because of this, the positive and negative results of individual companies cancel each other out, and researchers are unable to discern a material impact on average.

LEADERSHIP AND GOVERNANCE

A more instructive approach to deciding whether to separate or combine the chairman and CEO roles is to consider the specific individuals involved. This requires evaluating the strength of their character, the quality of their leadership, and the likelihood that they require additional monitoring. Although such an exercise is vastly more difficult than applying a single solution across all companies, there is some empirical evidence that it is worth the effort.

For example, a growing body of research demonstrates that the personality of a CEO is related to an organization’s long-term success or failure. These studies generally find that *conscientiousness*—the characteristic of being organized, systematic, efficient, practical, and steady in work—is positively associated with career success. They also tend to show that *neuroticism*—the characteristic of being moody, temperamental, envious, fretful, and emotionally unstable—is negatively associated with career success.¹⁰ In addition, there is some evidence that the personality traits of *extraversion*—the characteristic of being talkative, sociable, bold, assertive, and confident—and *agreeableness*—the characteristic of being warm, helpful, cooperative, and trustful—positively predict the ability of a manager to motivate subordinates to exceed expectations.¹¹

Furthermore, studies find that *narcissism*—the characteristic of being selfish, proud, and vain—can have a positive or negative impact on a corporation, depending on the individual. For example,

in a seminal essay, Maccoby (2000) describes two types of narcissists: productive narcissists and unproductive narcissists. Productive narcissists are those who

are gifted and creative strategists who see the big picture and find meaning in the risky challenge of changing the world and leaving behind a legacy.... Productive narcissists are not only risk takers willing to get the job done but also charmers who can convert masses with their rhetoric.

By contrast, unproductive narcissists are those who allow distrust of others and their own inflated sense of self to undermine their abilities:

[N]arcissism can turn unproductive when, lacking self-knowledge and restraining anchors, narcissists become unrealistic dreamers. They nurture grand schemes and harbor the illusion that only circumstances or enemies block their success. This tendency toward grandiosity and distrust is the Achilles' heel of narcissists. Because of it, even brilliant narcissists can come under suspicion for self-involvement, and—in extreme cases—paranoia.

Maccoby concludes that, while a narcissistic leader can bring transformational change to an organization through compelling vision and an ability to attract followers, their personality makes them susceptible to certain pitfalls. These include the tendencies to be sensitive to criticism and to demonstrate a lack of empathy, excessive competitiveness, and a dislike of mentoring and developing others.¹²

Consistent with this portrait, the research literature finds mixed effects of narcissism in corporate leaders. For example, Chatterjee and Hambrick (2007) find that narcissistic leaders tend to produce extreme outcomes in corporate performance, although in aggregate their results are no better than industry averages. They conclude that “narcissistic CEOs favor bold actions that attract attention, resulting in big wins or big losses.”¹³ Research also finds that narcissistic leaders tend to overpay for acquisitions. For example, Hayward and Hambrick (1997) find an association between narcissism and the size of the premium ultimately paid for a target company. They find that the greater the narcissism

and acquisition premium, the more shareholders tend to suffer through future losses.¹⁴ Finally, there is some evidence that narcissism is associated with financial misreporting and a tendency to inflate financial results.¹⁵ Together, these studies suggest that narcissistic leaders tend to favor bold action that can lead to above average outcomes but that in doing so they might demonstrate a disregard for standards, a tendency toward excessive risk taking, and potentially a reduction in honesty. From a governance perspective, this suggests that companies with narcissistic CEOs might benefit from heightened oversight by the board of directors, internal and external auditors, and other governance participants.

To this end, it might be that a separation of the chairman and CEO titles was a reasonable governance structure with Michael Eisner as the CEO of Disney but is an unnecessary division now that Robert Iger is CEO. While the press described Eisner as “brilliant, domineering, and combative,” it describes Iger as “invariably modest,” exhibiting “drive, good judgment, and grace under fire.”¹⁶ These personality types might justify different oversight systems.

WHY THIS MATTERS

1. Governance experts pay considerable attention to the structural features of a company's governance system (e.g., how many directors are independent in terms of New York Stock Exchange listing requirements). In many cases, this leads to a one-size-fits-all approach to governance, such as an insistence that companies *always* separate the chairman and CEO roles. Why isn't more attention paid to contextual considerations before deciding on an appropriate governance structure (see Exhibit 1)?
2. Researchers have developed a rigorous empirical record on a vast number of governance issues, including board structure, executive compensation, shareholder rights, and auditor requirements. Why don't governance experts base their recommendations on these results, rather than on subjective opinion? Wouldn't this help to avoid unnecessary controversy (such as the controversy at Disney) by grounding the dialogue

on facts?

3. The nascent research on CEO personality suggests that leadership quality is likely to have an important bearing on governance quality. To this end, certain CEO personality types are more likely to be associated with governance problems. How can corporate stakeholders take this information into account to design more effective governance systems? ■

¹ For a detailed review, see: David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New York, NY: FT Press, 2011).

² Shareholders were upset over the combination of poor financial results, leadership changes including the decision to hire and then fire Michael Ovitz as president, and excessive compensation and severance packages.

³ The Walt Disney Company, form DEF-14A (Jan. 18, 2013).

⁴ "Proxy Advisers Urge Split of Chair, CEO Roles at Disney," *Reuters* (Feb. 26, 2013).

⁵ *Ibid.*

⁶ Interview with Jack Ehnes, "CALSTRS vs. Disney's Iger," CNBC (Feb. 22, 2013).

⁷ Ben Fritz, "Disney Shareholders Defeat Governance Proposals," *The Wall Street Journal* (Mar. 6, 2013).

⁸ B. Ram Baliga, R. Charles Moyer, and Ramesh S. Rao, "CEO Duality and Firm Performance: What's the Fuss?" *Strategic Management Journal* (1996).

⁹ Brian K. Boyd, "CEO Duality and Firm Performance: A Contingency Model," *Strategic Management Journal* (1995).

¹⁰ Timothy A. Judge, Chad A. Higgins, Carl J. Thoresen, and Murray Barrick, "The Big Five Personality Traits, General Mental Ability, and Career Success Across the Life Span," *Personnel Psychology* (1999); and Murray R. Barrick, and Michael K. Mount, "The Big Five Personality Dimensions and Job Performance: A Meta-Analysis," *Personnel Psychology* (1991).

¹¹ Timothy A Judge and Joyce E. Bono, "Five-Factor Model of Personality and Transformational Leadership," *Journal of Applied Psychology* (2000).

¹² Michael Maccoby, "Narcissistic Leaders: The Incredible Pros, the Inevitable Cons," *Harvard Business Review* (Jan.-Feb. 2000).

¹³ Arijit Chatterjee and Donald C. Hambrick, "It's All About Me: Narcissistic Chief Executive Officers and Their Effects on Corporate Performance," *Administrative Science Quarterly* (2007).

¹⁴ Matthew L.A. Hayward and Donald C. Hambrick, "Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris," *Administrative Science Quarterly* (1997).

¹⁵ Jeffrey Hales, Jessen L. Hobson, and Robert J. Resutsek, "The Dark Side of Socially Mediated Rewards: How Narcissism and Social Status Affect Managerial Reporting," working paper (Mar. 2012). Available at: <http://ssrn.com/abstract=2021889>.

¹⁶ Marc Gunther, "Is Bob Iger Ready for His Close-Up," *Fortune* (Apr. 4, 2005).

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EXHIBIT 1 — SITUATIONAL CONSIDERATIONS FOR AN INDEPENDENT CHAIRMAN

Having an independent chairman includes several potential benefits:

- It leads to clearer separation of responsibility between the board and management.
- It eliminates conflicts in the areas of CEO performance evaluation, executive compensation, long-term succession planning, and the recruitment of independent directors.
- It gives clear authority to one director to speak to shareholders, management, and the public on behalf of the board.
- It gives the CEO time to focus completely on the strategy, operations, and culture of the company.

Advocates of an independent chairman believe that it is particularly important in these situations:

- The company has a new CEO, particularly an insider who has been promoted and therefore has no previous experience as CEO.
- Company performance has declined and significant changes to the company's strategy, operations, or culture are needed that require management's complete attention while the board considers whether a change in leadership or sale of the company is necessary.
- The company has received an unsolicited takeover bid, which management might not be able to evaluate independently without considerations for their own job status.

However, having an independent chairman can also cause several potential disadvantages:

- It can be an artificial separation, particularly when the company already has an effective chairman/CEO in place.
- It can make recruiting a new CEO difficult when that individual currently holds both titles or expects to be offered both titles.
- It can create duplication of leadership and internal confusion.
- It can lead to inefficient decision making because leadership is shared.
- It can create new costs to decision making because specialized information might not easily transfer from the CEO to the chairman (the "information gap").
- It can create a second layer of monitoring costs because the new chairman also poses a potential agency problem.

Source: David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New York, NY: FT Press, 2011).