CEO Duality: Economic and Socio-Psychological Determinants

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The relationship between firm performance outcomes and a board leadership structure where the chief executive officer also occupies the function of the chairman of the board (i.e., CEO duality) is a much researched but inconclusive issue. This paper suggests that this line of research needs to look beyond this direct relationship and that related studies will gain explanatory power if they incorporate the mechanisms and processes that determine a board's leadership structure. It is argued that economic as well as socio-psychological determinants not only explain the occurrence of CEO duality but also influence its relationship to firm performance outcomes.

INTRODUCTION

One of the most controversial, emotional, and inconclusive debated issues in corporate governance in the U.S. is whether the chief executive officer (CEO) should also serve as the chairman of the board of directors (BOD). The popular business press views CEO duality (i.e., the same individual acting as the chairman of the BOD and the CEO simultaneously, which is also referred to as combined leadership) as a serious corporate governance problem and attributes many of the recent corporate governance scandals and the declining corporate performance of major U.S. corporations to this very practice (Wilson, 2008, July 16). Institutional investors and shareholders have diverging views concerning CEO duality and vote at times in favor of this practice (Caroll, 2013, October 14) and sometimes against it (La Monica, 2004, March 4). Some corporate governance observers argue that CEO and chairman roles should be mandated by law to be separate (Sora & Natale, 2004). They may find support in a recent survey by Russell Reynolds Associates (2006) that shows that 60 % of board members of U.S. companies are advocating the separation of the chairman and the CEO role. However, stock exchanges (e.g., NYSE, AMEX, NASDAQ), the SEC, and the Sarbanes-Oxley Act of 2002 do not mandate a separation of CEO and chairman roles (Green, 2005). The reality is that in approximately 70 % of all U.S. companies the CEO is also the chairman of the board (Chhaochharia & Grinstein, 2007).

Academic research in this area has mainly focused on the link between board leadership structure (i.e., separation or combination of CEO and chairman roles) and a wide range of accounting and market related firm performance outcomes. The literature in this stream of research is characterized by largely inconclusive findings and has failed to consistently link board leadership structure to firm performance outcomes (Daily, Dalton, & Canella, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Rhoades, Rechner, & Sundaramurthy, 2001).

This paper takes the position that CEO duality per se is not the determinant factor of corporate performance and it argues that before attempting to link board leadership structure to firm performance a deeper understanding of the determinants of board leadership structure is warranted. This position addresses the shortcoming in the literature that the largest part of BOD research has focused on how boards may influence firm performance, but neglected to examine and to theorize about how they get to be the way they are.

Only recently, research has recognized the lack of knowledge regarding the forces that drive the formation (Rehbein, 2008), the structure and the organization (Lehn, Patro, & Zhao, 2005), and the composition (Boone, Field, Karpoff, & Raheja, 2007; Markarian & Parbonetti, 2007) of a board. Apparent is also the lack of theoretical work that models the determinants of board leadership structure (Kang & Zardkoohi, 2005; Linck, Netter, & Yang, 2008). This lack of theoretical work and the increased attention that this phenomenon receives in the corporate world are taken as a sign for the need of in-depth understanding of the determinants of CEO duality.

Drawing on research in agency theory and psychology this paper posits that economic determinants (i.e., governance and environmental dimensions that affect the intensity of agency conflicts) as well as socio-psychological determinants (i.e., social exchange reciprocity, social comparison) shape a firm's board leadership structure. This paper argues that agency theory (Fama & Jensen, 1983; Jensen & Meckling, 1976), as the dominant theory in corporate governance in the U.S, is a valid but somewhat under-contextualized theory in BOD research. In addressing Eisenhardt's (1989) concern that agency theory "… ignores a good bit of the complexity of organizations" (p. 71) this paper proposes that additional socio-psychological theories and perspectives are needed to capture the complexity of the boardroom and to open up the "black box" (Jensen & Meckling, 1976, p. 306) that this theory contains.

In brief, it is argued here that an examination of the underlying economic and social and psychological determinants of CEO duality will contribute to a better understanding of the firm performance effects of CEO duality.

The remainder of the paper is organized as follows. Section 2 offers a review of the literature on CEO duality and summarizes the theoretical arguments for and against the practice. Section 3 addresses economic determinants of CEO duality and approaches the issue from a cost and benefit perspective. Section 4 concerns board-specific socio-psychological processes that may lead to CEO duality and attempts to enrich the somewhat under-contextualized view of economic agency theory. Section 5 closes with conclusion, limitations, and suggestions for future research.

CEO DUALITY: DEFINING THE DOMAIN

Corporate charters and security market listing standards require that shareholders elect a BOD. In fact, having a board is one of the legal requirements for incorporation. According to the Business Roundtable, an association of CEOs of leading U.S. corporations, the BOD has the following duties and functions: (1) select, regularly evaluate, and, if necessary, replace the CEO, determine management compensation, and review succession planning; (2) review and, where appropriate, approve the financial objectives, major strategies, and plans of the corporation; (3) provide advice and counsel to top management; (4) select and recommend to shareholders an appropriate slate of candidates for the board of directors, and evaluate board processes and performance; (5) review the adequacy of systems to comply with all applicable laws/regulations; (6) assure adequate and transparent financial reporting and disclosures; and (7) manage the corporation's overall risk profile (The Business Roundtable, 2005). This list represents generally accepted and desired duties and functions of the BOD and other groups like the American Law Institute (www.ali.org), the Council of Institutional Investors (www.cii.org), or the National Association of Corporate Directors (www.nacdonline.org) have developed similar lists.

Now, the dilemma that arises through CEO duality becomes apparent. When the chairman of the BOD is also the CEO, the BOD makes management accountable to an institution led by management. This may imply that, in some instances, the CEO will find himself or herself in a position of evaluating his or her own performance. However, the viewpoints regarding the directionality of the impact of CEO duality on firm performance diverge sharply.

The Business Roundtable (2005) points out that "Most American corporations have been well served by a structure in which the CEO also serves as the chairman of the board" (p. 15). The opposite perspective stresses that CEO duality violates the "good governance principle" of separation of decision-management (i.e., initiation and implementation of decisions) from decision-control (i.e., ratification and monitoring decisions) and causes agency problems and, ultimately, poor performance (Chhaochharia & Laeven, 2008; Fama & Jensen, 1983; Monks & Minow, 2004; Morrison, 2004).

These two contrasting positions also reflect the theoretical assumptions and perspectives based upon which academic research has approached the issue of CEO duality. The theoretical support for the first position is grounded in stewardship theory and resource dependence theory. Agency theory is the theoretical lens for arguments in favor of the latter view.

Main Theoretical Perspectives in Board Leadership Structure Research

Proponents of CEO duality are drawing their arguments by and large from organizational theory grounded in sociology and psychology. Stewardship theory (Davis, Schoorman, & Donaldson, 1997; Donaldson & Davis, 1991) argues that CEO duality establishes strong and clear-cut leadership. The unity of command at the top of the organization empowers the CEO with more discretion and authority, which, in turn, facilitates better and faster decision making. Stewardship theorists argue that the separation of chairman and CEO roles would create rivalry between the chairman and the CEO, conflicts between management and the board, and confusion due to the existence of two corporate spokespersons. The CEO in this theory is "… far from being an opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets" (Donaldson & Davis, 1991, p. 51). In this perspective, the organizational structure that supports the CEO in achieving high firm performance outcomes is CEO duality.

Resource dependence theory (Pfeffer & Salancik, 1978) is consistent with stewardship theory regarding the assumptions of managerial motivation. Pfeffer and Salancik (1978) state that "… when an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it" (p. 163). This theory provides a theoretical foundation for BOD members' resource roles. Proponents of this theory view the BOD as a boundary spanning mechanism between the organization and its environment that manages external dependencies and reduces environmental uncertainty. Depending on the environmental context, the characteristics of an efficient BOD will vary. Resource dependence theory argues that CEO duality can improve responsiveness to external events, facilitate accountability of decision making, and reduce the dependency between the organization and external contingencies. Thus, proponents of this theory would argue that, in certain contexts, CEO duality improves firm performance.

Opponents of CEO duality are traditionally building their arguments on agency theory (Jensen & Meckling, 1976) that is rooted in finance and economics. Agency theory assumes that CEOs (i.e., agents), because of their firm specific knowledge and expertise, can gain an advantage over firm owners (i.e., principals) who are not involved in the operations of the firm and who cannot effectively control CEOs. CEOs may be able to pursue actions to maximize their own interests at the expense of owners and to minimize their personal risk. Proponents of agency theory assume that the CEO is largely self-interested and generally unwilling to sacrifice personal interests for the interests of others. In this theory, corporations respond to potential agency problems by delegating decision management to the CEO, and decision control to an independent BOD that is charged with the task of minimizing the potential of abuses of this delegation. Fama and Jensen (1983) point out that, the BOD, as an internal control and monitoring mechanism, is only an effective device for decision control if it limits the decision discretion of the CEO. It is important to recognize here that total decision control, which would render the delegation of decision management to a CEO obsolete, cannot be the goal of the BOD. Based upon the outlined arguments, agency theorists would propose that CEO duality weakens the decision control function of the BOD, and negatively affects firm performance.

In the U.S. context, agency theory is by far the dominant theory in BOD and governance research (Chhaochharia & Laeven, 2008; Daily, Dalton, & Canella, 2003; Daily, Dalton, & Rajagopalan, 2003; Morrison, 2004). Agency theory also dominates the corporate governance practice and most mechanisms and regulations of "good corporate governance" (e.g., independent nominating, compensation, and audit board committees) are conceptualized to deter or to attenuate the potential effects of self-interested CEOs (Gompers, Ishi, & Metrick, 2003). Calls for the separation of the roles of BOD chairman and CEO and recent recommendations to require a BOD that is chaired by the CEO to install a lead independent director come directly from agency theory and intend to promote the independence of the BOD, to increase transparency of decision making, and to protect shareholder interests (Dalton & Dalton, 2005).

At the heart of the question concerning the appropriate theoretical perspective and consequently the preferable board leadership structure is the view that one adopts concerning human and managerial motivations. In the U.S. national business system, in its cultural and institutional context, agency theoretical assumptions of human and managerial motivation seem to guide practical and theoretical considerations regarding the definition of what constitutes “good corporate governance”. Agency theory is therefore a valid perspective in examining CEO duality, but theoretical progress in this area of research will depend on a better understanding of the determinants of CEO duality and the related inner working of the BOD.

The State of CEO Duality Research

Considering the prevailing definition of corporate governance in the U.S. where ”Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer & Vishny, 1997, p. 737), it may be a natural tendency of researchers to focus on the direct link between BOD leadership structure and firm performance outcomes, including financial performance. Numerous studies to date have focused on this link and have built upon the theories outlined above. The results have been inconclusive and mixed at best. A recent meta-analysis (31 studies; n=12,915) has found no systematic relationship between board leadership structure and accounting or market-based firm performance outcomes (Dalton et al., 1998). Bosner (2007) has reviewed seventeen publications that examined the impact of board leadership structure on firm performance outcomes that have been published since Dalton et al.’s (1998) meta-analysis. He as well has found no consistent support for a direct link between board leadership structure and firm performance.

Attempting to proof a direct relationship between board leadership structure and firm performance outcomes can be problematic for at least two reasons. First, isolating the direct effects of CEO duality on firm performance is hampered by an abundance of intervening factors as the impact of CEO duality is contingent upon a wide variety of contexts and situations. Second, the implicit assumption in research that improving firm performance is the primary goal of a certain leadership structure is questionable. For example, other primary goals could be related to reforming audit procedures or CEO pay to build reputation of a firm.

In a similar tenor, Pettigrew (1992), in his work on managerial elites and upper echelons, criticizes the focus of governance research on the direct relationship between board structure and firm performance. He points out that research needs to incorporate “… the processes and mechanisms which presumably link the inputs to the outputs” (Pettigrew, 1992, p. 171). It is argued in this paper that these processes and mechanisms that link a board leadership structure to firm performance outcomes are rooted in the economic and socio-psychological determinants of board leadership structure.

In summary, current research on the relationship between CEO duality and firm performance is characterized by an abundance of inconclusive studies that attempt to prove a direct relationship, and a lack of studies that attempt to explain the determinants of a board leadership structure and their related effects on firm performance.

The subsequent sections of the paper will focus on economic determinants and socio-psychological determinants of CEO duality. Both types of determinants will elicit mechanisms and processes that may lead not only to the occurrence of CEO duality in a firm but also affect its relationship to firm performance.

ECONOMIC DETERMINANTS OF CEO DUALITY

As stated above, approximately 70 % of U.S. companies are combining the roles of board chairman and CEO. In applying an economic logic, the prevalence of CEO duality in U.S. companies can be explained by arguing that for most firms, the costs of separating the two roles is larger than the benefits of combining the two roles. This logic is based upon the assumption that a BOD evolves efficiently and that firms select value-maximizing governance attributes that ensure “good governance” in that the interests of the CEO are aligned with shareholder interests. This would imply that, CEO duality, despite its criticism, can be an efficient governance attribute. A step towards an economic explanation of CEO duality is provided by Brickley, Coles, and Jarrell (1997) and Dahya and Travlos (2000), who discuss potential costs and benefits associated with the separation and the combination of board chairman and CEO roles. The benefits and costs of separating CEO and BOD chairman roles are summarized below:

The benefits of separating the CEO and BOD chairman roles are well articulated by Fama and Jensen (1983) who argue that in corporations that are characterized by a separation of ownership and control, the created agency costs of designing, implementing, and maintaining incentive and control systems are reduced by arrangements that separate decision making (i.e., by the CEO) from decision control (i.e., by the BOD).

The costs of separating the CEO role and the BOD chairman role consist of new agency costs, information costs, costs related to the succession process of the CEO, and other costs. New agency costs arise in the context of a need to “monitor the monitor” and are related to the delegation of decision making power to the chairman. Information costs arise in the process of transferring complex and critical firm-specific information between the CEO and the chairman. Costs related to the succession process of CEOs arise as in many successions the CEO/chairman first passes on the CEO title to his or her successor, while retaining the chairman title, and after the new CEO has proven himself as a capable successor he or she gets awarded with the chairman title. A separation of CEO and chairman would eliminate this incentive. Other costs could be incurred through extra compensation for the chairman, potential rivalry between chairman and CEO (Roberts & Stiles, 1999), and possible confusion among firm insiders and outsiders about who is really in charge.

The outlined costs and benefits do not support any arguments concerning the superiority of any single board leadership structure over the other. Theoretically, it is not clear which leadership structure is best since both, non-duality and duality, can impose costs and benefits on a firm. The recent white paper on corporate governance principles by the Business Roundtable (2005) supports this argument by pointing out that “… no one structure is right for every corporation …“ (p. 13) and “… the board should make that decision [whether the CEO also should serve as chairman of the board] in light of the corporation’s facts and circumstances …” (p. 15).

These “facts and circumstances” are addressed in the subsequent paragraphs as contingency factors concerning a firm’s economic choice of a board leadership structure. The economic determinants of CEO duality will be discussed first in the context of a firm’s corporate governance structure and second in the context of a firm’s organizational environment.

An important contingency factor that reflects a firm’s “facts and circumstances” pertains to the characteristics of the firm’s bundle of internal governance mechanisms. Board leadership structure is an important attribute of a critical internal corporate governance mechanism. Link et al. (2008) argue that internal governance mechanisms are determined within a firm’s broader system of corporate governance. The occurrence and the consequent impact of CEO duality on firm performance may therefore depend on the strength of other corporate governance mechanisms. The agency literature is supportive of this perspective and recognizes that the BOD is only one of several mechanisms that can mitigate agency conflicts within the firm. In an important paper for corporate governance research, Rediker & Seth (1995) have theorized that trade-offs and substitution effects exist between internal corporate governance mechanisms. Based upon their arguments, CEO duality as a governance mechanism does not operate independently and the internal governance environment of a firm can be viewed as a contingency affecting the prevalence of CEO duality and its relationship to performance.

Rediker & Seth (1995) also point out that firms have some flexibility in designing economically efficient and value-maximizing combinations of governance mechanisms to achieve an alignment of manager and shareholder interests. This lends support to the argument that CEO duality although it may increases the potential for managerial abuse, does not automatically lead to an abuse. CEO duality is not per se a "bad" corporate governance characteristic since several internal governance mechanisms (e.g., board independence, board diversity, board size, blockholder ownership and institutional investors, managerial ownership, executive compensation) can theoretically impose constraints on the CEO, and can affect the extent of costs and benefits of agency conflicts and consequently influence the decision of firms whether it is cost-effective to combine or to separate the two roles.

External governance mechanisms including the takeover market, competition in product markets, and the external managerial labor market, represent high costs to principals that make internal governance mechanisms more accepted (Rediker & Seth, 1995). However, it can be expected that external control mechanisms as well influence the economic choice of a BOD leadership structure. For example, consider a CEO who is highly concerned about his or her reputation among shareholders. In recognizing and in relying on the theoretical power of an efficient market for executive personnel, a firm may choose to combine CEO and chairman roles. CEO duality in this context may be a cost efficient solution because shareholder value destroying self-serving behaviors by the CEO would be punished by the external managerial labor market with negative effects for his or her reputation that he or she would certainly wish to avoid. Consequently, there may be a reduced need for additional control and monitoring and thus a reduced need for splitting the CEO and chairman roles. A similar argument could be made for the theoretical power of the takeover market that potentially reduces the CEO's human capital value as well.

Bosner's (2007) and Dalton et al.'s (1998) studies show the tendency in the CEO duality literature to focus on single mechanism for corporate control without giving consideration to a firm's bundle of internal governance mechanisms and its external governance environment. These internal and external governance mechanisms may not only represent determining factors of CEO duality, but may as well influence the link to firm performance outcomes. Considering the arguments presented above, the failure to address these determining factors may have led to the mixed and inconclusive results in current research on CEO duality effects.

A second important contingency factor is a firm's organizational environment, containing the operational and the industry specific environment. The economic logic proposed above can also in this context provide an explanation of a firm's choice of leadership structure. Arguing that firms select governance structures that are economically efficient and value-maximizing, firms will match the board leadership structure to a variety of factors that are specific and unique to its operational environment. In fact, Lehn et al. (2005), Baker and Gompers (2003), and Boone et al. (2007) show that operational characteristics (e.g., size, age, debt, diversification) can explain board composition in terms of board size and outside directors on the board. It can be expected that operational characteristics not only shape a board's composition but influence a board's leadership structure as well.

The economic logic would support the argument that CEO duality would be adopted in firms under certain conditions in their industry specific environment where the costs of combining the two roles would outweigh the benefits of separating the two roles. In a study that examined board leadership structure in the context of a firm's dimensions of environmental uncertainty, Boyd (1995) argues that CEO duality, during periods of high turbulence, allows a faster and more focused corporate response to changing events and improves firm performance. In this context, the benefits of the combination of CEO and board chairman roles may outweigh any potential agency costs. It can be expected that a firm's specific industry environment partly determines whether it is cost efficient for a firm to combine or to separate the chairman and the CEO role.

This discussion of economic determinants has implications for current BOD research that addresses effects of CEO duality on firm performance outcomes. The arguments presented above stress the point that the optimal board leadership structure reflects firm-specific characteristics and differs from firm to firm depending upon a firm's corporate governance structure and organizational environment. At one point in time, in a certain situation and under certain circumstances, CEO duality will be the economically optimal leadership structure, at a different point in time, in a different situation and under different circumstances the separation of CEO and BOD chairman roles will be the optimal structure. In this sense, an economic perspective on determining factors of CEO duality helps to understand not only the economic factors that influence the leadership structure of a BOD but also that governance variables that address the agency problem stand in relationship with other governance mechanisms and environmental contingencies. Therefore, a focus on CEO duality in isolation of its linkages to other governance mechanisms and environmental contingencies may fall short in reasonably explaining its implications on corporate performance.

This discussion also has implications for corporate governance legislation and current attempts to reform BOD leadership structures. The arguments presented above stand in strong opposition to calls for mandated legislation to outlaw CEO duality and populist sentiments in the business press that the "imperial CEO" (Green, 2004, p. 19) is harming corporate performance and that universal "good governance principles" solve related problems across a range of different companies. Based upon the economic explanation of CEO duality presented above, companies may chose their own combination of governance control mechanisms in the context of internal and external circumstances to restrict potential negative influences on firm performance outcomes. Consequently, it may even be argued that mandated changes in BOD leadership structure are detrimental to firm performance since they disrupt a company's economically chosen governance structure. It can be argued here that overly simplistic "good governance prescriptions" are likely to result in unintended and adverse effects.

A cost and benefit analysis of CEO duality, based upon agency assumptions is a useful theoretical perspective to view the determinants of CEO duality. An economic perspective is indeed very helpful to conceptualize and to explain the determinants of CEO duality as one mechanism that is embedded in the context of a company's broader system of corporate governance and organizational environment. It is argued here that a firm's board leadership structure adapts to promote firm profitability, and that boards tend to be structured efficiently. In this perspective the firm as well as the BOD is largely treated as a "black box" in that economically rational and optimal decisions regarding its leadership structure are being made. While the economic perspective treats the BOD as one mechanism embedded in a firm's corporate governance system and organizational environment, it is also plausible to argue that within the BOD, as a group of people, socio-psychological dynamics also influence its leadership structure. Socio-psychological processes are a fundamental and inevitable part in any group setting. Therefore, an alternative way to think about CEO duality is to consider how the interactions between CEO and directors influence a board's leadership structure. The following section of the paper will draw on socio-psychological arguments to offer a more process oriented and socio-psychologically based perspective on CEO duality and will seek to open the "black box" that an economic explanation of CEO duality contains. This perspective, however, is not suggested to replace the arguments presented above. In recognition that CEO duality may not be explained by economic arguments alone, the subsequent section is used to enrich the presented economic perspective based upon agency-theoretical assumptions and to add to this more detail on the socio-psychological dynamics that shape a board's leadership structure.

SOCIO-PSYCHOLOGICAL DETERMINANTS OF CEO DUALITY

Some authors have proposed that the BOD, rather than serving shareholders' interests, can be captured by the CEO and that he or she may use and abuse it to serve his or her own interests (Monks & Minow, 2004; Westphal & Zajac, 1995). The CEO in these authors' view is often portrayed as the "imperial CEO" characterized as the hegemonic manager, who with his or her power controls the board, serves as its chairman and acquiesces it into a passive, "rubber-stamping" role. However, the CEO might not only consciously but also subconsciously exert influence over the board. In economic based agency theory the standard argument suggests that the CEO as the self-interested agent is constantly looking for ways to draw personal gains from his position and that directors will do everything in their power to serve the interests of the shareholders and to restrict the self-interested behavior of the CEO. In explaining the executive wage setting process, Bebchuk and Fried (2003) and O'Reilly and Main (2007) show that there are no good reasons to believe that directors will actually behave this way. These authors point out several reasons why it should not be automatically presumed that board directors seek to maximize shareholder value. Just as the CEO may be driven by his or her self-interest, directors may as well be driven by their personal interests and directors' interests may be more closely aligned with the interests of the CEO rather than with the interests of shareholders. The two executive compensation studies cited above show that directors may collude with managers in order to get reelected and to keep their seats on the BOD, that directors may adopt a generous attitude towards the CEO in the hope of receiving higher pay themselves, that directors may be generous to the CEO because of friendship, and that directors may feel an obligation to please the CEO with a generous compensation package as he or she is seen partly responsible for their appointment to the BOD.

Thus rather than the CEO consciously influencing the BOD or using it to serve his or her own interest, it may be that the directors are simply trying to please the CEO with modifying certain institutional arrangements. This argument points out the possibility that several social and psychological processes may be operating in a BOD that potentially determine its leadership structure. It can be expected that the governance attribute CEO duality is shaped by socio-psychological processes. This perspective challenges the economic assumption that the primary goal of the governance attribute CEO duality is to maximize firm financial performance and that the directors of a BOD devotedly serve shareholders' interests. This perspective has not been addressed in depth in the studies to date which may have contributed to the inconclusive and mixed research findings reported in Dalton et al.'s (1998) meta-analysis and Bosner's (2007) narrative literature analysis.

Drawing on theory in social psychology, the following sections posit that social exchange reciprocity theory and social influence theory provide two valuable perspectives on viewing the fundamental underlying social and psychological processes that shape the interactions between CEO and board in ways that affect the leadership structure of a board. Social exchange reciprocity and social influence are so essential and fundamental to group dynamics that they can be expected to influence the leadership structure and its consequent effects on firm performance (O'Reilly & Main, 2007; Westphal & Zajac, 1995).

Social Exchange Reciprocity Theory

Monks and Minow (2004) report that in 95 percent of large U.S. companies, candidates for a vacant director position in a BOD are recommended to the BOD by a nominating committee. They further cite a Korn/Ferry study that finds that the nominating committee receives the names for vacancies from the CEO and that these vacancies are also being filled based upon his or her recommendation in 80 percent of the cases. The CEO therefore is highly involved in the process of selecting board members. From the perspective of social exchange reciprocity theory (Elster, 1989; Kunz & Woolcott, 1976), reciprocity, as a norm (i.e., a social expectation about how people ought to behave in a given social context), dictates that an obligation is generated, when one party benefits another. O'Reilly and Main (2007) study the power of reciprocity by examining why it is that whenever there are highly paid CEOs, there are highly paid directors. Indeed, Sethi and Somanathan (2003) argue that "Reciprocity is a pervasive and economically significant phenomenon in human interaction" (p. 1). The key to understanding the concept is that reciprocity occurs when an individual is responding to actions even if no material gain is anticipated. The appointment as a director to a board comes certainly with certain financial as well as social status related benefits. A newly selected board director can be expected to feel some reciprocal obligation towards the CEO as he or she is perceived to be partly or even solely responsible for the director's appointment to the BOD. Additionally, O'Reilly and Main (2007) argue that within group settings, where transaction costs are high, the group interaction continues over time, personal interactions occur frequently, and the group itself is small and homogeneous, reciprocity as a social psychological phenomenon is more likely to occur. These characteristics reflect very well the nature of a BOD and it is therefore expected that social exchange reciprocity influences the shape of the leadership structure of a board.

Social exchange reciprocity constitutes a fundamental part in the social relations between CEOs and directors and it can be argued that the determining factors of CEO duality are deeply embedded in social exchange reciprocity processes. For example, in a negative sense, when directors are offering the CEO the chairman title in the succession process, this act may actually have less to do with the CEO's actual performance but rather with norms of reciprocity on the part of the directors. In spinning this cycle forward, reciprocity in the light of poor CEO or poor firm performance can also lead directors to holding back and suppressing bad news, to misreporting and grooming of data, or to self-protective justifications for poor performance in order to please the CEO (Abrahamson & Park, 1994). In a more positive sense, feelings of reciprocity may not only lead to the occurrence of CEO duality in a firm, but may as well strengthen the director's personal and social relations with the CEO that may cause the director to not only to act as an engaged monitor and evaluator of the CEO but also as an expert, ally, and adviser to the CEO.

From the point of the economic perspective advocated above, reciprocity may impose an additional agency cost because it weakens the independence of the BOD. However, if the role of the director is not solely conceptualized as a monitor or evaluator of the CEO, but also as a sympathetic ally, adviser, or expert, social exchange reciprocity may as well constitute a benefit that can potentially improve firm performance.

Social Comparison Theory

Social comparison is another important group process through which CEO and directors, consciously or subconsciously, influence a board's leadership structure. O'Reilly and Main (2007), demonstrate the power of social comparison and find that directors, when confronted with the question of what constitutes reasonable executive compensation, tend to base their answer on what they themselves and others of their peers in comparable positions earn. In their paper, O'Reilly and Main (2007) observe that social influence occurs when the group signals, tacitly or also explicitly, what attitudes and actions are appropriate and acceptable and which ones are not. This observation reflects Festinger's (1954) arguments in his seminal work on social comparison. In his theory, which is an important theory in the development of modern management thought (A. G. Bedeian, lecture, 2007), he finds that people look to others to determine and to evaluate what attitudes, opinions, desires and actions are appropriate, and that groups may exert pressures on individuals to conform to group norms and goals. Interestingly, a review of the literature shows that Festinger's (1954) social comparison theory seems to be ignored in board leadership research. Because of its prevalence and fundamental essence to group processes it can be expected that social comparison processes have implications for the shape of a board's leadership structure.

For example, Westphal and Zajac (1997) found that a CEO who serves as the chairman of the BOD in his or her company is more likely to favor CEO duality in another company where he or she serves as a director on the board. More relevant, in terms of social comparison theory, they also report that the greater the proportion of CEOs on the BOD of another company, who serve as chairman of the BOD in their companies, the higher the prevalence of CEO duality in that company. On the one hand, this could imply that the CEO of a company, who is confronted with a BOD composed of CEOs who themselves are also chairmen of the BODs in their companies, may be pushed involuntary into CEO duality, because through a process of social comparison this BOD leadership structure appears to be the appropriate structure for the directors of the board and is consequently forced upon the CEO. On the other hand, processes of social comparison may lead a CEO to appoint directors to a board who themselves are CEOs and chairmen of the boards in their companies. As reported above, in many U.S. companies the CEO is highly involved in the process of selecting new board members and he or she may consciously or subconsciously prefer to appoint directors to the board that are similar to himself or herself. This, in turn, may lead to a sympathetic BOD that views the relationship between CEO and BOD through the very eyes of the CEO. It can be expected that social comparison, related to a variety of demographic dimensions besides the CEO's duality status, consciously or subconsciously, can shape a firm's BOD leadership structure.

From an economic perspective, these processes can impose costs as well as benefits on a firm. In a negative sense, processes of social comparison can lead to a BOD leadership structure that is not appropriate for a firm's specific governance structure, and organizational and environmental contingencies. In a positive sense, these same processes can also lead to a BOD leadership structure backed by directors who provide advice, expertise, or counsel to the CEO which, in turn, can improve overall board functioning and the link to firm performance.

Socio-Psychological Processes and Power

Corporate governance research is concerned with power relationships and its main theoretical perspective, agency theory, by its conceptual nature is a theory about power. Power, in board research, is commonly defined as the ability of the CEO or the directors to exert their will and to achieve their goals (Pettigrew & McNulty, 1998). Shen (2003) summarizes how managerial power and power relationships tend to be operationalized in BOD research. He states that the power balance in the relationship between CEO and directors is mostly conceptualized with regard to demographic or structural sources of power that the CEO holds such as expertise, tenure, prestige and social status, owning stock etc. The processes described above suggest that socio-psychological processes are as important to consider in research as are structural or demographic sources of power. It may be that structural and demographic sources of power may not be used as such by the players that possess them. It is important to recognize that subtle and subconscious socio-psychological processes may influence the relationship between CEO and directors and that these processes can confound theorized links between structural or demographical sources of power and firm performance outcome variables.

CONCLUSION AND FUTURE RESEARCH

CEO duality has complex roots and the value of applying an economic as well as a socio-psychological lens to explain this phenomenon lies in eliciting this very complexity. While this paper proposes that economic agency theory is a useful perspective in pointing out the importance of the board in monitoring and controlling the CEO, it also acknowledges that socio-psychological processes are a natural part of the boardroom and need to be incorporated into research on board leadership structure. The economic perspective suggests that the role of the board is to act as a monitor and evaluator of the CEO and his performance. The socio-psychological theories presented here supplement this view and demonstrate that CEO duality determined by processes of social exchange reciprocity and social comparison may impose additional agency costs by making a board less independent, but also have the potential to offer benefits if the board is able to help the CEO to be more successful. It is argued here that the processes and mechanisms that link a certain board leadership structure to firm performance outcomes are rooted in the processes and mechanisms that determine this very board leadership structure. The neglect of these mechanisms and processes that shape a board's leadership structure is found to be a weakness in current research.

The integration of the processes and mechanisms that shape a board leadership structure as moderators between CEO duality and firm performance outcomes may improve the explanatory power of related studies. Although Dalton et al. (1998), a long time ago, have argued that the inconclusiveness in research regarding the relationship between CEO duality and firm performance may be attributed to the limited range of moderating variables, the studies that were reviewed for this paper and that have been published after Dalton et al.'s (1998) meta-analysis limit the character of moderating variables by and large to the firm's external environment (i.e., complexity, dynamism, and resource scarcity). As shown in this paper, there are other important processes and mechanisms that warrant consideration as moderators.

While most of the processes and mechanisms related to the economic determinants described in this paper are unproblematic to operationalize, more thought and effort is needed to meaningfully operationalize the socio-psychological determinants. In the case of social exchange reciprocity, important variables could include, for example, the presence of the CEO on the nominating committee or the comparatively financial and social benefits of directors' board membership. These factors are expected to cause feelings of reciprocal obligation to the CEO. In the case of social comparison, key variables would be related to a broad range of demographic dimensions, such as educational background or employment position. Nevertheless, whether the socio-psychological processes outlined here will positively or negatively affect board functioning will depend on the quality of the relationship between CEO and directors. Researching and observing these actual relationships would require gaining access to boardrooms. Although it may be difficult for a number of reasons to get actual access, these difficulties are not insurmountable and recent studies demonstrate several creative and non-traditional routes to obtaining actual access and more insight into boardrooms (Leblanc & Schwartz, 2007; Lockhart, 2006; Zona & Zattoni, 2007).

Different approaches regarding the explanation of CEO duality and related firm performance effects are certainly possible. For example, it could well be argued that CEO duality and the way in which the power balance is held between the CEO and the directors is strongly related to history and culture (Cadbury, 2002). Future research may examine this and related issues by conducting comparative studies on an international level.

It is hoped that the arguments presented in this paper will direct research towards a better understanding and an appreciation of the roots of CEO duality. This paper seeks to promote the understanding that CEO duality is more than a binary coded variable and that research will gain explanatory power if it integrates the determinants of CEO duality.

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