In Defense of the CEO Chair

Separating the roles of chief executive and chairman of the board may harm the very stakeholders advocates hope to protect.

by William T. Allen and William R. Berkley

Investors, researchers, and government officials seem gradually to be accepting the view that corporate governance best practices require the separation of the roles of board chairman and CEO. The January 2003 report of the Conference Board’s Commission on Public Trust and Private Enterprise recommended this structure, and the practice has become common in England. But is it really a good idea?

We doubt that such a separation would improve investors’ risk-adjusted returns. On the contrary, there is good reason to believe that the wide adoption of this “improvement” would risk imposing costs and delays on well-functioning businesses. More important, it would foster a risk-averse corporate bias that would injure the economic interests of diversified shareholders.

Those who invest in the large and liquid U.S. securities markets take advantage of the system’s ability to provide risk diversification at very low cost. The combination of liquid markets and cheap diversification is a great source of efficiency, but it also gives rise to an important problem. Investors with diversified holdings have little incentive to spend resources on monitoring management; it is easier simply to sell. In the absence of monitoring owners, managers may be inclined to advance their own interests. The risk that managers will do that is described by economists as an “agency cost.” The reduction of such costs, like the reduction of many types of costs, is generally a good thing. To some investors, scholars, and other commentators, corporate governance is chiefly a matter of structures and practices that will reduce the agency costs of management. Separating the chair and the CEO position appears, in the current environment, an effective way to do this.

But those who focus exclusively on steps designed to more effectively monitor and control management lose sight of a fundamental fact. Reducing the agency costs of management will not necessarily improve investors’ risk-adjusted returns. Of course, those of us interested in improved governance do well to keep in mind the undesirable side effects of powerful managers and passive owners and the importance of prudently reducing agency costs. But the central driver of a corporation’s efficiency is its management team. It is good management’s superior ability to identify and evaluate opportunities, place investments at risk, and manage the business that creates above-market returns.

The idea that separation of the CEO and chair positions will provide an advantage to investors is based on the mistaken belief that well-designed corporate governance is simply a system to reduce agency costs. But both the benefits and the costs of the separation must be considered.

What is the source of the gains that proponents expect? Gains must come from reducing the CEO’s power in situations when the chief executive faces a conflict of some sort. CEO compensation is the paradigm. But reforms now being implemented already offer reasonable steps to manage this conflict. A nonexecutive chair adds little or nothing to the gains to be realized from a fully independent compensation committee of the board.

A more intractable source of conflict arises when there is a long-term, gradual failure of...
the firm’s business plan. A board’s ability to act in such a circumstance may be one of its greatest potential sources of contribution. Often, those who have originated a strategy may become psychologically committed to it and may be biased. Of course, overcoming impediments and riding out a brief series of disappointments may be the key to long-term value creation. But a brief series of disappointments may be the beginning of a longer series of bigger disappointments. Distinguishing between the two situations involves judgment. Since management will be much better informed, it is natural that the board will initially defer to it. But at some point a board may be required to act. We suppose that a board with an independent chair would on average be quicker to act in this context. This, we think, is the most likely source of an efficiency gain from the proposal.

What, then, are the proposal’s costs? We identify three principal problems. First, the separation would reduce the authority of the CEO. Effective organizations lodge ultimate leadership and accountability in a single place. The CEO should always be constrained and accountable. But effective boards can create structures that enhance CEO accountability without diminishing the chief executive’s leadership role. Under the split system, the CEO’s power would be shared with a person who is less informed and whose principal concern would tend to be risk avoidance.

Second, splitting the roles of CEO and chair would inevitably introduce a complex new relationship into the center of the firm’s governance and even into its operations. Two centers of authority in a business would create the potential for organizational tension and instability. In times of even moderate stress, such a system would tend to default into dueling centers of authority. Even the threat of such conflict would produce a costly diversion of attention from more productive areas.

Third, adopting the nonexecutive chair would inevitably subvert the corporation’s commitment to the unitary board. With a nonexecutive chair, the principal governing powers of the organization would inevitably be shared by two directors. Others would be reduced to specialized roles. Such a step would reduce the status and perhaps the sense of responsibility of the remaining outside board members.

We understand why there is substantial support for the idea that a logical next step in governance reform is to separate these important roles. Putting an “outsider” at the head of the governing board is a plausible answer to a particular problem that we have painfully seen: the greedy or fraudulent CEO. But while this problem was closely related to all of the recent big-ticket failures, we do not think it is typical or even sufficiently widespread to justify the system-wide costs of the remedy being called for. The costs of this reform would be invisible, and they would be borne by all firms, were it universally adopted. Finally, other reforms that are in process will reduce the risk, going forward, that those inclined to deceive will be able to do so easily.

Institutional investors and those who purport to speak for investor interests should exercise caution in championing further changes in governance that may hinder management’s effectiveness in creating value. They should think carefully about the hidden costs as well as the benefits they imagine their reform may bring.

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