Independent Chairmen Are Smart Investments

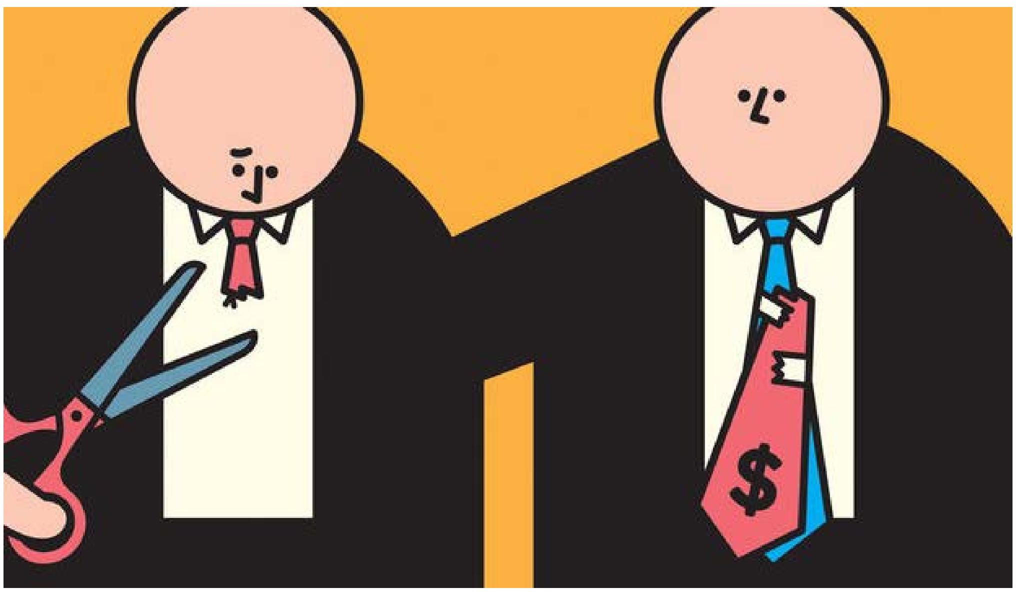

Illustration by Rami Niemi

By Nell Minow | Jul 17, 2012 6:30 PM ET

We don't let students grade their own exams, but we let CEOs chair their own boards.

At 281 of the S&P 500 companies, the chairman is the current chief executive officer. At 38 of the 500, the chairman is a former executive or has some other connection to the CEO or company. And at 72 others, the chairman is listed as an independent outside director, yet a closer look too often reveals relationships that squeezed through loopholes in the "independence" definition set by the stock exchanges, including connections through non-profit groups. The result is a level of independence that meets the letter of the law yet isn't enough to ensure arms-length oversight, especially when most CEOs decide who sits on the board.

In the U.K., by contrast, almost every board has an independent, outside chairman. This is a revolutionary change considering that, as recently as the 1980s, most British boards were primarily made up of insiders. Robert Boothby, a former Conservative member of Parliament, described in a speech what board service was like in that era: "No effort of any kind is called for. You go to a meeting once a month, in a car supplied by the company. You look grave and sage, on two occasions say 'I agree,' say 'I don't think so' once, and if all goes well you get 500 pounds a year." He added, "If you have five of them, it is total heaven, like having a permanent hot bath."

Company Scandals

In the early 1990s, Adrian Cadbury, the former chairman of Cadbury Schweppes, led a committee that proposed reforms to improve governance and reassure the investor community after a series of high-profile scandals among British companies. One of the recommendations called for independent outside chairmen. Within a decade, most U.K. companies had adopted the recommendation due to pressure from regulators and investors.

Separating the chairman and CEO roles has never been widely accepted in the U.S., where CEOs like to pile up titles and don't like answering to someone else. Chief Executive magazine reported in June that 63 percent of CEOs said in a survey that they would recommend a combined role for their replacements, despite the concerns of shareholder groups. The Council of Institutional Investors, for example, calls dual roles "a fundamental conflict of interest."

Over the past decade, the idea of an independent "lead director" has become a popular compromise. Of the S&P 500 boards, 284 have a director with that title. Generally, lead directors act as an ombudsman for the outside directors. They also preside over executive-session meetings (those held without management present) that are required by post-Enron reforms. But a lead director isn't the same as an independent chairman, who sets the agenda and committee assignments and presides over the meetings.

Some companies, in times of stress or management transition, have divided the jobs only to reverse themselves later, as both Walt Disney Co. and General Motors Co. did. In 2004, Michael Dell, the founder of computer-maker Dell Inc., decided to give up the CEO job and stay on as chairman; three years later, he changed his mind and again holds both titles.

More recently, Chesapeake Energy Corp. appointed an independent chairman when the oil-and-gas company became the target of shareholder anger over a series of governance failings, including excessive pay and revelations that the CEO was running a secret hedge fund. The appointment of former ConocoPhillips Chairman Archie Dunham as Chesapeake's chairman was intended to reassure investors.

Should it? A number of academic studies have tried to determine if shareholders benefit when the roles are split, and the results have been inconclusive. That isn't because splitting the jobs is unimportant; it's because we have an imperfect test for determining when the positions are in fact split.

No Oversight

A CEO at a company where the chairman and chief executive jobs were divided once told me off the record that the reason for the separate chairman was that the former CEO had refused to relinquish his position unless he could keep the chairman title. Because he didn't oversee the agenda or preside over meetings, no one was really monitoring management.

In one unusual case, a runner-up for the CEO position was enticed to stay on by being named chairman, a full-time job. When the CEO left, the chairman became the new CEO and retained the chairman title as well. The company never split the two again, and was ultimately sold. This month, Duke Energy Corp. made headlines when it split the two titles in a merger, but hours later ushered the new CEO out the door with a $44 million departure package, handing the CEO title to the chairman.

My company, GMI Ratings, has a new study of 180 large North American corporations. Most previous studies compared companies that combined the CEO and chairman positions with those that split the roles, finding little or no difference in shareholder returns. But GMI found that CEOs who wear both hats are more expensive than their CEO-only counterparts. They are also associated with significant indicators of risk.

Executives with both titles received a median total compensation of $16 million, versus $11 million paid by companies where the CEO and chairman were separate. Companies with independent outside chairmen were less risky in several categories, including problems with Securities and Exchange Commission filings.

Companies that combined the top two roles were also 86 percent more likely to register as "aggressive" in our assessment of their financial reporting. They showed a greater risk of defaulting on debts, laying off employees, selling assets or restructuring, or taking other steps to deal with a weakened financial condition.

'Hot Bath'

Boards have unquestionably become more independent than the "hot bath" days. The massive legislative changes imposed by the 2002 Sarbanes-Oxley Act and the Dodd-Frank financial reform law of 2010 -- following the sobering failures of the Enron-WorldCom era and the bailouts of Wall Street banks and the auto industry -- have made board members aware of the need to be more involved. "The board's job is to act in case of emergency," a director told me in the 1980s. "The board's job is to prevent an emergency," I said.

Splitting the two titles, of course, is no guarantee. At Barclays Plc, the independent chairman, the CEO and other top executives all resigned over the Libor rate-fixing scandal (with the chairman returning only to lead the search for a new CEO). Still, genuinely independent oversight is impossible when the chief executive is also the one who sets the board's agenda, makes committee assignments, and determines the quantity, quality and timing of information provided to directors. In pure return-on-investment terms, an independent outside chairman is a solid buy.

(Nell Minow, the co-founder and director of GMI Ratings, which evaluates governance risk at public companies, co-authored the textbook, "Corporate Governance," now in its fifth edition. This is the first of three articles on corporate governance issues. The opinions expressed are her own.)

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3 COMMENTS QUEUE

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SHOWING 3 COMMENTS ON INDEPENDENT CHAIRMEN ARE SMART INVESTMENTS

James McRitchie 2 months ago

Tracy - You're obviously CEO material. Having an independent chair seems a minimal requirement. "Independence," as defined by the NYSE isn't a very strict standard. Too often, lead directors are just window-dressing. The findings by GMI Ratings are important and will be used by many shareowner activists to bolster support for the needed transition to split these two critical positions.

I don't know anyone who thinks CEOs should have no input (wink to Tracy). However, when it comes to boards, an independent chair should set the agenda.

Like Reply

Tracy E. Houston 2 months ago

The Art of Constructive Challenge

THE SINGLE MOST IMPORTANT SKILL you
can sharpen as a board member in today's world is the ability to ask questions.
I wrote, The
Art of Constructive Challenge to be a comprehensive,
easy-to-follow guide to powerful asking skills.

Tracy Houston

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Brian Cheung 2 months ago

well i do believe students should have some say on what grade their exams should get.

2 Likes Like Reply

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