M&G Investments

M&G Insights

CEO to Chair: A smart move or poor governance?

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In South Africa these days we are becoming accustomed to seeing instances of a former CEO of a company moving to assume the Chairman's position. Shareholders, in our view, may have voted in favour of such moves as a way of erring on the side of caution, as they are not always well positioned to understand whether the justifications are indeed valid. However, this does not mean it is generally considered to meet high standards of governance – in fact, good governance standards require that a Chairman be truly independent of the company and its Board, offering an outsider's perspective on management decisions. Here we share our views on what is a serious debate for asset managers actively engaged in assessing the standards of governance in an investee company: is it ever appropriate for a company's CEO to become Chairman? And if so, under what conditions? How does one regulate, balance or exit this type of scenario?.

The debate

On face value, the CEO's move to Chair could appear to offer a number of benefits. Institutional memory is quite key to many institutions whose success depends on strategy in numerous diverse and complex businesses, particularly where the new CEO might not be 'home grown'. It could also bring cultural continuity, while additionally allowing the company's previously successful track record to be "grandfathered" (we can assume the CEO would not be nominated to be Chair if they weren't successful). Finally, the new CEO could be mentored by the Chairman and guided by his stronger experience and extensive corporate knowledge.

The disadvantages of a former CEO becoming Chairman are perhaps less obvious, but significant, and are grounded in both theoretical considerations (with practical implications) and pragmatic reasoning.

If we look at the basics of corporate governance, the Board of Directors represents the shareholders and has oversight over the company executive, and the Chairman of the Board's role is expected to be independent. A former CEO working as a Chairman at their old entity may find it difficult to transition in mindset from a top executive role involved in detailed execution to an "independent" oversight function representing shareholders: risk management takes on quite a different dimension from strategic execution. The Chairman's role is one of guardianship and no longer in the detail of strategic accountability and execution. In fact, the roles are fundamentally different, and often the role of the Chair as mentor is over-emphasised, to the detriment of accountability. In practice, the tolerance for missteps can differ between an independent Chair and their CEO, creating a blurred space between mentor and mentee.

There are a number of other considerations, with two being the most common.

(i) **The drivers that set a company on its early growth path, under the former CEO's leadership, may not be its continuing drivers.**
We often see the CEO transfer to Chair in entities that have reached between 20 and 40 years old, having successfully grown under charismatic leadership. In their earlier stages, many companies are entrepreneurial and often high-risk takers. As the company matures, however, to be sustainable it must necessarily take on a more restrained culture. As such, a former CEO who achieved success under a high-risk entrepreneurial approach may prevent this cultural shift, and be closed to new strategies that differed from their own.

Additionally, in 'break through' companies, the initial cause of success may no longer be an advantage over time. Peers may have caught up, or strategies or technologies that sparked the group's expansion may have become outdated. Should the new CEO become too close to the former CEO as Chair, and adopt the latter's old ideas, the company is not likely to fare well in an environment that requires innovation and new strategy. We have seen evidence of this in our own markets, where Chairs have fixed offices amongst the executives.

Naturally the converse is equally true – the new CEO or existing CEO may be stymied from bringing fresh ideas by a Chair who cannot recognise that the environment that supported his success and strategy has shifted.

(ii) **Echo chambers are hard to fight**

Secondly, a CEO that has been grandfathered into the Chairman's role may be too similar to the previous Chair. Bringing in an outside Chair may bring fresh thinking from the industry. The Board must then challenge the new risks and strategy on its merits. Equally, should both the new Chair and the new CEO come from within the company after many years of experience, it will be more difficult for the Board to exercise oversight and institute necessary change, since neither the Chair nor the CEO easily welcome other methods of operation.

Why it happens: The occasional good reason

In our voting on these CEO-to-Chair cases, we have heard many justifications from the companies, some more reasonable than others. At M&G we take a pragmatic approach in our decision-making, depending on the circumstances.

For example, one prominent media company unfortunately experienced a death on its Board of Directors following its very rapid unbundling. The former CEO stepped in as Chairman following this event. Given the unique nature of the Board and the circumstances of the company and industry, following discussions with other shareholders and the Board, we agreed that having the prior CEO as Chair was a pragmatic interim measure. From April 2024 he will move into in a consulting role, so that his strong expertise and experience is not lost to the board and CEO, and the Board will have a new and truly independent Chairman. This is certainly not the only instance of succession planning going awry as a result of the health issues of senior Board members or executives.

Interim Chair?

Meanwhile, quite often companies propose appointing the former CEO as an interim Chair or a non-executive Board member during the time it takes to search for and appoint a permanent replacement. Subsequently, in some cases that "interim" appointment gets extended numerous times until the incumbent would have been in the position (as a supposed "independent") for many years – we have seen 12 and 15 years, for example. The company's justification for the extensions is almost always that there is a new(ish) board on average, so the former CEO's experience is too valuable to lose. In our view, however, this simply illustrates failed succession planning, and we would not be in favour of allowing these situations to continue.

No Chair good enough

Then we have more extreme cases where the search for the appropriate Chair has gone on for years. Shareholders are basically held hostage to the company's claims that a highly specific Chair is required. Ironically, this approach goes against the defined role of the Chairman, which is to Chair the Board, not necessarily to be the most experienced person in the industry. A good Chair will be able to ensure the right people are present, or presenting, at meetings. They manage the brightest and the best people in the company, and act as a valuable check function for risks and reasoning. They are not required to determine strategy on their own. If this is the expectation by the company, then there are likely to be questions around the culture of that company. If we examine the reason behind the years-long search more closely, it can be that the company is looking for another Chairman who is very similar to their current one, but because this Chair is also still playing a quasi-CEO role, a replacement will naturally be very hard to find.

Can Lead independent directors (LIDs) solve the matter?

In other cases where we question the independence of the Chairman, having a LID in place has also been provided as justification. In our view, this helps mitigate the situation only when three criteria are met:

- The LID's role must be true to its definition, and the candidate (and company) have a solid understanding of the role;
- The LID candidate must have sufficient experience and be backed by a sufficiently independent board; and finally
- The LID candidate must be independent from the company.

For us, to adhere to good governance, LIDs should be salves only in exceptional cases. Too often we encounter LIDs who are placed on the Board with little industry experience, which renders countering a Chair who is overstepping into an executive-type function very difficult.

In conclusion, In our view, a former CEO's presence on a Board can be invaluable for their experience. However, this does not mean that they must necessarily assume the role of Chairman, or of Non-Executive Director (NED), both of which are meant to offer independent counsel. To do so contravenes the basic rules of good governance. Rather, we would always prefer that they become a non-executive director not classified as independent, or much better yet, a consultant to the Board or the new CEO. For us, the move from CEO to Chair is a path that should be very seldom travelled, and not for any duration.

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