Copycat behavior in CSR incentive contracts: The role of board interlocks

Over the last years, more and more firms are introducing CSR performance targets in executive compensation contracts in order to tie executive bonuses to social and environmental measures (i.e. "CSR contracting"). In general, nonfinancial performance measures can be predictive of long-term value creation, therefore inclusion might improve the effectiveness and efficiency of incentive contracts (Feltham and Xie 1994; Ittner et al. 1997; Flammer, Hong and Minor 2019). This has led industry leaders and top corporate climate actors such as Google, Apple, Bank of America and HP to start incorporating sustainability metrics in executive compensation contracts (Greenbiz 2015). This adoption of CSR targets by influential players increases pressure on other companies to engage in CSR contracting. Effectively implementing non-financial targets is, however, a complex matter and poses a large challenge to companies. Moreover, the concept of CSR contracting is relatively new, implying that boards generally have limited experience in setting these targets. It is especially in this type of context, characterized by high complexity and uncertainty, that board members might be prone to imitate what other companies are doing. Our study thus extends prior research by documenting the diffusion of CSR contracting practices through direct imitation and the consequences of such imitation for firm performance. The CSR setting where various measures can be used allows us to examine if copying of exact measures occurs through interlocks.

Prior research on the choice and inclusion of performance measures in incentive schemes usually refers to economic determinants, such firm size (Carter, Ittner and Zechman 2009), performance (Bettis, Bizjak, Coles and Kalpathy 2010), growth opportunities (Ittner, Lambert and Larcker 2003), organizational strategy (Ittner, Larcker and Rajan 1997), but also noise in accounting measures (Lambert and Larcker 1987). In contrast, much less attention has been devoted to the social dynamics which influence board decision-making regarding CEO incentive schemes (Gallani 2016). This study fills this gap by investigating the role of interfirm imitation in the diffusion of CSR performance targets in executive contracting. We distinguish between imitation of practices through compensation committee interlocks and CEO interlocks and document differential effects of both imitation channels in terms of subsequent firm performance and CEO compensation.

An important question is to which extent copycat behavior in CEO incentive contracting is effective in improving shareholder value and (non-)financial firm performance. If firms copy their tied-to firms' CSR performance measures without effectively aligning these measures with the corporate strategy nor integrating them into the compensation contract, adoption might not necessarily result into improved performance or long-term value creation. On the other hand, if the firm carefully imbeds CSR performance measures into the firm's long-term business strategy, such targets might be highly effective in creating value. In this study, we delve deeper into the performance consequences of CSR contracting imitation and investigate whether the consequences of adoption differ depending on the channel through which the practice enters the firm. That is, we differentiate between CSR targets adopted through compensation committee interlocks versus targets adopted through CEO interlocks. Whereas compensation committee members have strong incentives to develop compensation contracts exhibiting an optimal fit with the company's long-term objectives, the CEO may tend to favor practices from tied-to firms in line with his own interest. In this case, copied CSR incentive contracts may not necessarily benefit company performance, but rather CEO incentive pay.

The empirical evidence provided in this study is based on a large sample of U.S. listed companies included in the Incentive Lab database of ISS for the period 2006–2015. In our tests, we first assess whether firms copy from their tied-to counterparts when adopting CSR performance measures, differentiating between the CEO and compensation committee members, and find empirical evidence of imitation through both channels. In the second part, we link this to the question whether CSR contracting is effective. Our results support our expectations, namely: (1) imitation via compensation committee members is efficient, as in these firms both financial and nonfinancial performance improves, providing evidence that CSR contracting is effective; (2) if imitation via the CEO occurs, the incentive mechanism is distorted, resulting in no improvements or even worse performance. At the same time incentive compensation increases, showing that CSR contracting under these circumstances is rather symbolic and thus less efficient. In addition we find that imitation behavior from other board members (not being the CEO or not being a compensation member) does not improve but also does not hamper firm performance.

Our paper makes several contributions to the literature. First, while the literature on board interlocks has documented imitation practices in a variety of settings, the differential effects of *who* creates the interlock tie between the firms remains underexplored (Shropshire 2010). In the management literature, authors are starting to investigate the differential role of the CEO versus board connections in shaping the firm's decisions (e.g. Zhu and Chen 2015; Oh and Barker III, 2018). However, in the context of executive pay decisions, the role of the CEO is controversial. With this study, we provide evidence that even in the context of CEO pay design, ties created by the CEO are influential but at the same time detrimental for firm performance. In doing so, we are one of the first studies to empirically provide evidence of direct CEO interference in his own compensation design. Moreover, in this study we also show that imitation of practices through CEO and board interlocks may have different effects on firm (non)financial performance as the incentives of both parties are likely to be very different. This finding contributes to the literature on interorganizational imitation as we are the first ones to document different outcomes depending on the type of board interlock though which imitation happens.

Second, we contribute to the literature of imitation. In contexts where experiences with non-financial targets is limited, we document strong imitation behavior. That is, connected directors at corporate boards directly imitate the same measures that their tied firm is using. While imitation studies suggest that such practice might be efficient (Lieberman and Asaba 2006), we show that the channel through which it happens is crucial. When the interlock is created via CEO, imitation behavior somehow is used in a self-serving manner where the CEO uses imitation as a way to get legitimacy for getting better contract terms without improving firm performance. Only when compensation members use imitation through their interlocks, imitation somehow seem to be efficient in that both financial and non-financial performance is improved and thus firms seem to learn from "best practices" at other firms. Importantly, imitation via other members in the board does not hamper nor improve firm performance.

Finally, our study also contributes to the literature on the effectiveness of CSR performance measures. With the increasing prevalence of CSR contracting, more and more studies question whether such performance measures are effective, and report inconclusive results (Flammer et al. 2019; Bachmann et al. 2020; Maas 2018; Berrone and Gomez-Mejia 2009; and Kolk and Perego 2014). The results of this study reconcile prior conflicting findings by indicating that the conditions under which CSR contracting is initiated determine to some extent its effectiveness. Importantly, policy makers should be aware that such imitation can be efficient, only when it happens via members of the compensation committee. That is, imitation can be a valuable strategy when people with "knowledge" on compensation contracts engage in it. Counterproductive effects of imitation do arise, when CEOs use imitation as a strategy.

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