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The Stakes Are High: The Importance of Implementing an Effective Stakeholder Engagement Strategy

Companies today face increasing pressure from stakeholder groups to become more transparent and involved in addressing various economic, environmental, governance and social issues. Due to the changing corporate environment, not only are companies expected to maximize long-term shareholder value and ensure high standards for employees, suppliers and the communities in which they operate, but they are also expected to be responsive to other stakeholder concerns, sometimes even those unrelated to their business. Moreover, today's increasingly interconnected society has provided those groups with the ability to more easily collaborate and to monitor, scrutinize and publicize corporate actions. As a result, it is important for companies to adopt and implement a strategy to effectively engage with their stakeholders. Such a strategy may, in turn, generate increased profits for companies and result in creating long-term shareholder value, for example, by way of attracting new customers, increasing customer loyalty and motivating employees.

This corporate governance update discusses certain topics that highlight the need for a stakeholder engagement strategy and presents considerations to facilitate boardroom and C-suite discussions to help execute a cohesive and effective engagement strategy.

Why Implement a Stakeholder Engagement Strategy?

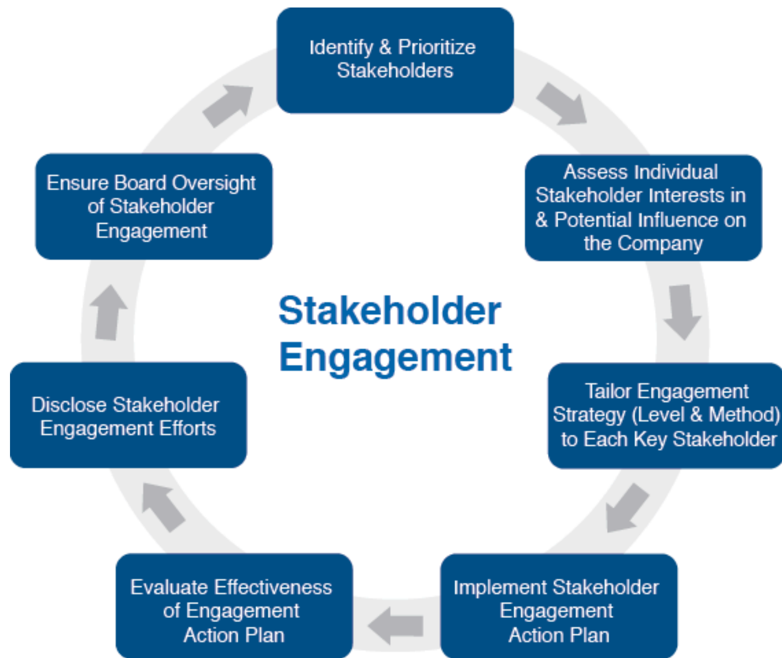
Background. Corporate stakeholder engagement is the process by which a company involves those groups who directly or indirectly affect and/or may be affected by a company's actions, products or services. In addition to shareholders, stakeholders often include employees (retired, current and future), customers, suppliers, creditors, communities, governmental officials (e.g., public authorities, policymakers and regulators), nongovernmental organizations (e.g., labor unions and faith-based organizations) and the environment. Stakeholders inherently have an interest in the company and may directly experience benefits, losses or harm as a result of corporate actions. Stakeholders' interests and concerns, however, are often diverse and at times conflict with each other. Yet corporate success frequently depends on maintaining positive relationships with all of these groups.

> A McKinsey & Company survey found that 67% of executives from profitable companies, versus 28% of executives from less profitable companies, reported that they are very effective at understanding the priorities and objectives of stakeholders.[1]

Further, it is becoming more widely accepted by management and boards of directors as well as certain investors that addressing the interests of key stakeholders and delivering value to society at large are not necessarily at odds with the goal of maximizing long-term shareholder value; on the contrary, they may be essential to achieving that goal.[2] Nevertheless, many companies do not appear to be making effective stakeholder engagement a priority, as they tend to focus primarily on shareholder issues and concerns. The benefits of an effective stakeholder engagement strategy, however, may be numerous and could include:

- increasing corporate profits (and, in turn, shareholder returns)
- reducing production costs and/or organizational expenses
- retaining current and attracting new customers
- generating greater customer loyalty
- motivating employees (retired, current and future)
- enhancing relationships with governmental officials and legislators
- increasing organizational effectiveness
- enhancing communications among key constituents, including with respect to compliance and ethics issues
- staving off shareholder activism
- enhancing corporate opportunities by better understanding emerging issues that may affect the company
- increasing community confidence
- promoting innovation
- anticipating potential problems
- reducing the risk of regulatory proceedings or litigation
- reducing adverse reputation risk
- satisfying investment criteria for certain institutional investors
- staying at the forefront of emerging best corporate governance practices

An effective stakeholder engagement strategy requires ongoing evaluation, implementation, reporting and oversight, and includes the following key components:



The importance of implementing an effective stakeholder engagement strategy is further highlighted by the following topics.

Managing Reputation Risk. A company's reputation is an essential asset. A highly regarded reputation can contribute to a company's bottom line by attracting new customers, creating brand loyalty among current customers, recruiting and retaining top performing employees, and generating trust and confidence among suppliers and government officials. In today's socially interconnected world, however, a mismanaged corporate reputation has the potential to adversely affect a company's revenue and stock price, result in the loss of customers or brand value, or trigger a regulatory investigation. A key component of successful reputation risk management, therefore, is implementing and maintaining an effective stakeholder engagement strategy that includes, for example, monitoring and surveying employees', customers' and suppliers' perception of the company and engaging shareholders on issues such as executive compensation and corporate governance.

> On average, more than 25% of an S&P 500 company's market value is directly attributed to its reputation.[3]

> 87% of surveyed executives rate reputation risk as more important or much more important than other strategic risks their companies are facing.[4]

Preventing Fraud & Incentivizing Internal Whistleblowing. Approximately two-thirds of companies in the U.S. are affected by fraud, losing an estimated 1.2% of revenue each year to such activity.[5] Costs associated with investigation and remediation of the fraudulent acts and resulting indirect costs, such as reputational damage, may also be significant. Therefore, it is critical for companies to have an effective compliance and ethics program and to communicate that program to applicable stakeholders. Further, the financial incentives provided by certain governmental whistleblower programs can be substantial, which makes it crucial for companies to have an effective whistleblower program so that stakeholders (including current and former employees and suppliers) understand how to utilize internal processes and are incentivized to report suspected unethical or unlawful conduct internally rather than first turning to regulators. The Securities and Exchange Commission ("SEC") Whistleblower Program, for example, permits a (natural) person (e.g., customer, supplier or creditor) to be eligible for a whistleblower award and does not require that a whistleblower be an employee of the company.[6]

Effective stakeholder engagement, therefore, should include company training with and the dissemination of compliance and ethics educational materials to relevant stakeholders, beyond employees. Regularly educating stakeholders on the processes behind reporting suspected wrongdoing in accordance with a company's

compliance and ethics programs, which should include a whistleblower hotline, may prove beneficial to the company and potentially result in reduced fraudulent activity and increased corporate profits.

Staving Off Shareholder Activism. Shareholder activists are increasingly engaged in pressuring companies to address their and other stakeholders' concerns relating to certain environmental and social ("E&S") issues. Activist campaigns are often costly for a company, consuming time, labor and financial resources necessary to respond to the campaign, and may also contribute to management distraction, business disruption and damage to reputation and relationships with various stakeholders.

Top 5 E&S Proposal Topics in 2015[7]

- environmental/sustainability
- political activity
- human rights
- employment/discrimination
- board diversity

It is predicted that E&S shareholder proposals, which currently represent 52% of all proposal submissions (compared to 46% in 2014 and 39% in 2013), will set new records in the 2015 proxy season.[8] Many of the same E&S proposal themes from 2014 (e.g., disclosure of political contribution and lobbying activities, and proposals promoting board diversity and employee sexual orientation anti-bias policies) and several new ones have emerged this proxy season. The largest number of 2015 E&S proposals concern climate change, carbon asset risk and greenhouse gas emissions.[9] Several new topics this proxy season involve human rights and equal employment issues, including political nondiscrimination in the workplace, fair employment, migrant workers, gender pay inequality and low employee wages versus top executives' pay.[10] A stakeholder engagement strategy that effectively addresses stakeholder concerns relating to E&S issues may stave off shareholder activism, thus allowing the company to allocate valuable resources elsewhere.

Understanding Sustainability Concerns. Stakeholders are increasingly concerned about sustainability issues confronting companies. In recent years, as noted above, shareholder activists have made sustainability a frequent shareholder proposal topic. Certain stakeholders consistently urge companies to address sustainability-related issues, including those pertaining to air and water quality, emissions, carbon footprint and eco-friendly consumption, and companies must consider the impact these issues could have on their long-term corporate strategy. Consequently, companies that have an effective stakeholder engagement strategy are more likely to understand the sustainability concerns of their key stakeholders and take steps toward addressing those concerns. In addition, various institutional investors specifically seek to invest in companies with comprehensive and transparent sustainability practices.[11]

Attracting Institutional Investors. The primary objective of a company should be to maximize long-term shareholder value. Focusing solely on maximizing shareholder wealth at the expense of those who create corporate value (including customers, employees, creditors, suppliers, communities and the environment in which the company operates), however, is not sustainable.[12] To that end, institutional investors are increasingly looking to invest in companies that effectively manage their stakeholder relationships. BlackRock, for example, has stated that part of its risk-management investment strategy is to invest in companies that (among other factors) build trust with long-term shareholders and other stakeholders, which strategy has resulted in more consistent returns on its investments over time.[13] Similarly, the Florida State Board of Administration notes that to optimize shareholder returns over time, a company should endeavor to ensure the long-term viability of its business by effectively managing its relationship with stakeholders.[14]

Mitigating Ramifications of Required Disclosures. SEC rules requiring certain company disclosures generate interest among various stakeholders, thus making effective engagement ever more important. For example, in August 2012, the SEC adopted rules requiring companies to disclose their use of conflict minerals (including tantalum, tin, gold and tungsten) if those minerals are "necessary to the functionality or production of a product" manufactured by those companies.[15] These rules, which at times have opened companies to stakeholder backlash, are intended to raise public awareness about the origins of companies' conflict minerals and promote the exercise of due diligence on conflict mineral supply chains. The SEC notes that this disclosure requirement, in part, is to allow stakeholders to form their own views on the reasonableness of the company's efforts with respect to conflict minerals and advocate for difference processes if the stakeholders believe it necessary.[16]

Further, in response to the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, certain forthcoming executive compensation-related SEC final rulemaking is also expected to generate interest among stakeholders. In September 2013, the SEC proposed the "CEO pay ratio" rule[17] and more recently, in April 2015, the "pay versus performance" rule.[18] The potential ramifications of the CEO pay ratio and pay versus performance disclosures, if such rules are adopted, may impact stakeholder relationships, as these disclosures could affect employee morale (should the disclosures expose significant income inequality or

disparity between company TSR and executive pay) or become a public relations issue, as it is uncertain how stakeholders will use and respond to this information. An effective stakeholder engagement strategy (including proactively discussing and receiving feedback from stakeholders on these topics prior to making such disclosures), therefore, is critical to mitigate the possible adverse responses to certain required disclosures.

Addressing Political & Social Issues. One study revealed that 80% of U.S. adults believe that companies should take action to address important issues facing society.[19] Actions (or sometimes inaction) and stances taken by companies in response to political and social issues may generate certain impassioned responses from various stakeholders. Prior to taking action or adopting a stance on such issues, it is critical that companies are aware of their key stakeholders' positions as part of a company's risk-benefit analysis of whether to publicly support or oppose an issue.[20] Engaging with and clearly conveying to stakeholders a company's position on select political issues may prove advantageous and benefit the company, such as by boosting employee morale and community support for the company.

Political and social actions taken by a company may have significant implications on corporate reputation and relationships with certain stakeholders.

Recognizing Stakeholder/Constituency Statutes. A majority of states have adopted corporate law provisions, often referred to as stakeholder or constituency statutes, that explicitly provide company directors (and, in some cases, officers as well) with the authority, beyond traditional case law and the business judgment rule, to consider the interests of stakeholders other than shareholders when exercising their corporate decision-making authority.[21] A typical stakeholder statute permits (but does not mandate) directors to consider with respect to any board action, the interests and effects upon stakeholders other than shareholders (including employees, suppliers, customers, creditors and communities), both long- and short-term interests of the company, and any other factor the directors consider pertinent.

Additional Considerations for Companies

Although there is no one-size-fits-all approach to stakeholder engagement, companies may consider the following to help facilitate the implementation of an effective stakeholder engagement strategy:

- **Adopt & Disclose a Stakeholder Engagement Policy.** A robust stakeholder engagement strategy is essential for companies to be able to understand and respond to stakeholder concerns that merit dialogue. A stakeholder engagement policy can be a vital part of this strategy by providing a structured approach to engagement. It also provides the opportunity to formalize and communicate that approach to enhance the engagement process. Further, a stakeholder engagement policy posted on the company's corporate governance website provides transparency while establishing the parameters within which a company will engage with its stakeholders. Elements of a stakeholder engagement policy, which should be more encompassing than those in a company's policy required by the New York Stock Exchange ("NYSE") relating to communications with shareholders and other interested parties,[22] may include:
  - the objectives and scope of the policy
  - identification of primary stakeholders
  - identification of different levels and methods of engagement
  - delegation of engagement responsibilities (e.g., who/which department will implement and be assigned day-to-day duties)
  - how engagement will be evaluated and reported
  - board/board committee oversight of company engagement activities
- **Review & Update (as Necessary) Other Corporate Policies.** Certain existing company policies (e.g., a Shareholder and Other Interested Parties Communications Policy, a Charitable Contributions Policy and a Whistleblower Policy) likely address, in part, stakeholder engagement-related issues and/or activities. Companies should review these policies to confirm that they are aligned with and accurately reflect the company's corporate strategy, stakeholder engagement policy and best practices.
- **Establish Regular & Systematic Forms of Dialogue.** Companies should consider establishing regular and systematic forms of dialogue with their key stakeholders to gauge, among other items, stakeholder perspectives, ideas, expectations and concerns with respect to corporate strategy, operations and governance. Such dialogue may be established by way of periodic town hall meetings, surveys, conferences, forums, workshops, newsletters, road shows and third-party moderated interviews. Stakeholder engagement needs to be managed and characterized by clear strategy, objectives and allocation of responsibility. Further,

stakeholder engagement, once initiated, should be ongoing, as stakeholder needs and concerns, as well as their contributions to the company, evolve over time. During the engagement process, however, companies should continue to be mindful (1) not to disclose confidential corporate information (e.g., trade secrets) and (2) of the general prohibition under Regulation FD regarding communicating material nonpublic information.

- **Ensure Board Oversight.** Stakeholder engagement is an important component of corporate accountability. Accordingly, board members should receive the information necessary for them to adequately oversee the company's stakeholder engagement. To better understand current stakeholder concerns, for example, a board should be regularly briefed by management on the status of company and key stakeholder relationships and activities. Boards (or a committee thereof) may also consider convening stakeholder forums and periodically inviting key stakeholder representatives to present at board (or committee) meetings. In addition, the board (or a committee thereof) may include certain environmental, social and governance ("ESG") metrics in the management evaluation process and/or the performance-based compensation formula.

- **Disclose ESG Performance & Stakeholder Engagement Efforts.** *The Corporate Social Responsibility/Sustainability Report* – The corporate social responsibility ("CSR") or sustainability report provides a company with an opportunity to communicate its ESG performance to the company's stakeholders and to discuss (within the confines of a single document) certain company successes and challenges on a wide array of ESG topics, including corporate governance, environmental issues, employee and supplier diversity initiatives, and community investments and partnerships. The CSR report is also a medium for transparency (which often improves a company's reputation with stakeholders) and may be used as an effective tool as part of an ongoing stakeholder engagement strategy. The report may also deter shareholder activists from submitting ESG-related shareholder proposals or pursuing or threatening litigation. In addition, the CSR report provides existing and potential investors with ESG-related information to assist in analyzing investment decisions. The CSR report should be broadly disseminated so that stakeholders are aware of the company's ESG performance and stakeholder engagement efforts.[23]

  Other Disclosure Mediums – Other means of disclosure, which may be utilized as an extension of stakeholder engagement efforts, include various regulatory filings, such as a company's proxy statement or Form 10-K. Although it is not currently common practice for companies to voluntarily make "stakeholder engagement" disclosures,[24] companies are increasingly disclosing engagement with shareholders.[25] As "shareholder engagement" disclosure becomes more prevalent, companies may experience pressure to expand such disclosure to include other stakeholders. Regardless of the disclosure medium, it is essential that a company finds the medium that is best suited to effectively disclose its stakeholder engagement efforts. Moreover, companies should monitor whether their stakeholder engagement disclosure practices are aligned with peer companies and the industry in which they operate (as outliers may become the target of shareholder activist campaigns or unwanted negative publicity).

- **Evaluate Risk.** As with every corporate action, a company should identify and evaluate the risks (e.g., economic, organizational and reputation) involved with engaging stakeholders. Prior to engaging a stakeholder, a company should evaluate, among other factors as necessary, the risks associated with (1) engagement, (2) not engaging and (3) engaging unsuccessfully.

- **Review Stakeholder/Constituency Statute.** Companies should confirm whether their state of incorporation has a stakeholder/constituency statute and, if so, ensure that board members are aware of the statute. Such statutes permit directors to consider interests other than shareholder interests (often in the form of a list of constituency groups) in exercising corporate decision making authority.

How Chapman Can Help

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1 *Beyond Corporate Social Responsibility: Integrated External Engagement*, McKinsey & Company, John Browne and Robin Nuttall (March 2013).

2 See *Capitalism for the Long Term*, Harvard Business Review, Dominic Barton (March 2011). See also *21st Century Engagement, Investor Strategies for Incorporating ESG Considerations into Corporate Interactions*, BlackRock, Inc. and Ceres, Inc. (May 28, 2015).

3 *The Impact of Reputation on Market Value*, World Economics, Simon Cole (July–September 2012).

4 *2014 Global Survey on Reputation Risk*, Deloitte (October 2014).

5 *2013/2014 Global Fraud Report, Who's Got Something to Hide?*, Kroll (October 2013).

6 Under the SEC Whistleblower Program, eligible whistleblowers may potentially recover a reward equal to 10%–30% of the amount of any monetary sanctions collected that exceed $1 million in actions brought by the SEC and related actions brought by other regulatory and law enforcement authorities. The SEC has received a high volume of hotline calls since its Whistleblower Program became effective in 2011, with 3,620 calls received in fiscal 2014 (up from 3,238 in fiscal 2013). Of the individuals receiving whistleblower awards, nearly 60% have been persons other than current or former company employees. *U.S. Securities and Exchange Commission: 2014 Annual Report to Congress on the Dodd-Frank Whistleblower Program*, SEC (November 17, 2014). As of April 30, 2015, the SEC Whistleblower Program had awarded nearly $50 million to 17 whistleblowers. *The SEC as the Whistleblower's Advocate*, SEC Chair Mary Jo White (April 30, 2015).

7 *2015 Proxy Season Preview*, The Advisor, Shirley Westcott (April 2015).

8 *2015 Shareholder Proposal Landscape*, EY Center for Board Matters (April 2015).

9 *2015 Proxy Season Preview*, Shirley Westcott, *supra* note 7.

10 *Id*.

11 According to one report, as of year-end 2013, more than one out of every six dollars under professional investment management in the U.S. (or more than $6.57 trillion) was invested according to sustainable, responsible and impact investing strategies (an increase of 76% since 2012). *2014 Report on U.S. Sustainable, Responsible and Impact Investing Trends*, The Forum for Sustainable and Responsible Investment (2014).

12 See *Wealth Transfer Versus Wealth Creation*, The Conference Board Governance Center Blog, Donna Dabney (August 7, 2014).

13 *2013 Corporate Governance & Responsible Investment Report: Taking The Long View*, BlackRock, Inc. (2014).

14 *Florida SBA 2015 Corporate Governance & Proxy Voting Guidelines*, Florida State Board of Administration (2015).

15 *Conflict Minerals*, SEC Release No. 34-67716 (August 22, 2012).

16 *Id*. Notably, the SEC uses the term "stakeholders" and not solely "shareholders" with respect to certain provisions of the Conflict Minerals final rule.

17 The "CEO pay ratio" rule, if adopted, will require public companies to calculate and disclose in certain SEC filings (1) the median annual total compensation of all employees of the company, excluding the chief executive officer (the "CEO"), (2) the annual total compensation of the company's CEO and (3) the ratio of those two figures. *Pay Ratio Disclosure*, SEC Release Nos. 33-9452 and 34-70443 (September 18, 2013).

18 The "pay versus performance" rule, if adopted, mandates that a public company disclose in its proxy or information statement, among other information, (1) the compensation "actually paid" to the CEO, (2) the average compensation "actually paid" to other named executive officers, (3) cumulative total shareholder return ("TSR") of the company and its peer group and (4) the relationship between executive compensation "actually paid" and company TSR, and company TSR and peer group TSR. *Pay Versus Performance*, SEC Release No. 34-74835 (April 29, 2015).

19 *Business & Politics: Do They Mix? 2014 Annual Study*, Global Strategy Group (October 2014).

20 For example, earlier this year, several state legislatures enacted "Religious Freedom Restoration Act" laws (proponents maintained that the laws are meant to protect free exercise of religion, while opponents argued that the laws provide businesses with the right to discriminate). A number of companies took a position on the legislation and, depending on that position, generated positive (or negative) stakeholder reactions. In many of those cases, however, executives at these companies clearly articulated the company's position on the legislation to pertinent stakeholders and in doing so, received certain stakeholder support for those positions.

21 It has been reported that 41 states have enacted some form of stakeholder (or constituency) statute, including Alabama, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Dakota, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia,

Washington, Wisconsin and Wyoming. Notably, Delaware has not enacted such a statute. *Lessons Learned from the Capitulation of the Constituency Statute*, 4 ELON L. REV. 209, Nathan E. Standley (2012).

22 NYSE Listed Company Manual, Section 303A.03, Executive Sessions (providing that a listed company must disclose a method for all interested parties, not just shareholders, to communicate directly with the presiding independent director or with independent directors as a group).

23 See *Companies Increase ESG Scores, but Get Less Credit*, COMPLIANCE WEEK, Jaclyn Jaeger (October 23, 2012).

24 A review of proxy statements filed by S&P 500 companies in 2015 revealed that very few companies (approximately 10) voluntarily disclosed information specifically relating to "stakeholder engagement." When made, such voluntary disclosure typically discussed the frequency and specific activities in which the company engaged with stakeholders, including shareholders, during the previous year.

25 In 2014, 50% of surveyed S&P 500 companies provided proxy statement disclosure of their engagement efforts with shareholders, including identifying the participants taking part in the engagement, the topics discussed and the subsequent actions taken. *Let's Talk: Governance, 2014 Proxy Season Review*, EY Center for Board Matters (July 2014).

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