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Corporate Social Responsibility

In her regular column on corporate governance issues, Holly Gregory explores corporate social responsibility issues that are likely to gain attention in the 2014 proxy season and provides guidance for boards on their oversight of corporate social responsibility strategies.

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Holly counsels clients on the full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

The power and influence of companies in relation to government power, as well as public concerns about the responsible use of corporate power, continue to increase pressures on companies to satisfy not only legal obligations, but also evolving societal expectations about what it means to be a responsible corporate citizen. To respond effectively to these pressures while satisfying the interests of shareholders, consumers, creditors, suppliers and employees, many US companies have increased their level of attention to corporate social responsibility (CSR) issues in analyzing the risks that they face relating to existing and future operations and strategies.

Proponents have long asserted that a company benefits from a CSR strategy that is grounded in core values and ethical principles, is designed to support economic growth and addresses the environmental and social impacts of business decisions. CSR issues are coming into sharper focus in boardrooms as customers, employees and shareholders emphasize the importance of high standards of ethics and respect for human rights, environmental protection, sustainability, and diversity and inclusion in the global marketplace.

As a result, boards and senior management have greater clarity about the relation of CSR to customer loyalty, employee retention and the ability to attract certain investors. By focusing attention on corporate values, ethical conduct and compliance with the policies that a company adopts to promote its values and ethics (as well as legal and regulatory requirements), CSR programs also help to reinforce internal controls and reduce risk.

Against this background, this article:

- Provides an overview of various definitions of CSR.
- Explores the debate on the role of the corporation in society.
- Examines recent shareholder proposals on CSR issues.
- Reviews company practices regarding CSR disclosure and reporting.

CSR DEFINED

The phrase "corporate social responsibility" or "CSR" is associated with various definitions. For example:

- The World Business Council for Sustainable Development broadly defines CSR as "the continuing commitment by business to contribute to economic development while improving the quality of life of the workforce and their families as well as of the community and society at large."
- The European Commission more narrowly defines CSR as "the responsibility of enterprises for their impacts on society."

CSR is the subject of both voluntary corporate action and legal and regulatory mandates relating to:

- Environmental concerns, including environmental protection and the impact on the ecological balance of climate change, hazardous waste and nuclear energy.
- Societal interests, including human rights, diversity, a living wage and economic disparity, and consumer protection.

Under some definitions corporate governance concerns are also included, recognizing the important interests of shareholders and employees and the role that governance plays in:

- Relations with employees.
- Executive compensation.
- Anti-corruption efforts.
- Compliance with laws and regulations.
- Corporate ethics.
- Corporate decisions that impact CSR issues.

SHAREHOLDER PROFIT VERSUS SOCIETAL INTERESTS

The debate over the role of the corporation in society and more specifically the responsibility for corporate stewardship of the environment and social justice is long-running. Economist Milton Friedman gained attention in the 1970s with his assertion that the only responsibility of business is the generation of profits and shareholder value.

However, the law provides for more flexibility. The American Law Institute's *Principles of Corporate Governance and Structure: Analysis and Recommendations* (ALI Principles) summarizes, in general terms, the principles of corporate governance statutory and case law. Section 2.01(b) of the ALI Principles provides that:

> "Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
>
> (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
>
> (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
>
> (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes."

While the language of the ALI Principles is permissive, it is now fairly well accepted that corporate decisions are not made in a vacuum devoid of social and environmental context.

> Boards and corporate managers must assess what CSR issues are important for corporate action from a strategic and values perspective, without being unduly reactive.

Given the very broad variety of potential CSR issues, pressure is often brought by groups with a focus on a particular interest. Boards and corporate managers must assess what CSR issues are important for corporate action from a strategic and values perspective, without being unduly reactive. In doing so, they must often grapple with the issue of whether the company's CSR efforts should focus on broad environmental and social issues or only on areas where company operations have a direct impact.

Environmental and social activists, and many leading companies, take the broader view that as a member of society the company needs to take a fuller and longer-term approach, recognizing that through commerce companies play a key role in our broader economic, political and social well-being. At the same time, there continues to be legitimate debate about the extent to which corporate assets should be devoted to issues beyond addressing the direct impacts of the company's

Conservative Push-back

The National Center for Public Policy Research has raised concerns about whether companies are adequately assessing the extent to which environmental policies may have a negative business impact and is pressing for greater disclosure about the extent to which companies support groups with environmental and sustainability agendas.

Efforts in 2014 have included a highly unsuccessful shareholder proposal at Apple Inc., seeking disclosure of the company's membership in and payments made to trade associations and organizations that educate members about sustainability practices, assist members in developing sustainability practices, encourage or require members to engage in sustainability practices or undertake sustainability actions. The proposal asked that the report be presented to the audit or other relevant oversight committee of the board and be posted on the company's website.

In its supporting statement, the proponent asserted:

> "Some trade associations and business organizations have expanded beyond the promotion of traditional business goals and are lobbying business executives to pursue objectives with primarily social benefits. This may affect Company profitability and shareholder value. The Company's involvement and acquiescence in these endeavors lacks transparency, and publicly-available information about the Company's trade association memberships and related activities is minimal. An annual report to shareholders will help protect shareholder value."

The proposal failed to achieve 3% of the votes. Therefore, the proponent will not be able to resubmit a substantially similar proposal for a period of three years.

decisions. Where each company comes out in this balance is a matter for board consideration based not only on values and strategy, but also on asset allocation decisions.

Search Corporate Social Responsibility and the Supply Chain for information on approaches companies can take to address CSR issues in their supply chains.

SHAREHOLDER PROPOSALS

According to Institutional Shareholder Services Inc. (ISS), shareholders have filed a record number of proposals on CSR issues for the 2014 proxy season. As in the past two years, the most prevalent proposals are those seeking disclosure regarding political contributions and lobbying activity. However, the number of proposals relating to sustainability and environmental concerns, most notably regarding climate change, is growing and may soon overtake political contributions and lobbying proposals. Support for shareholder proposals on CSR issues averaged 21.7% in 2013.

CORPORATE POLITICAL ACTIVITY AND LOBBYING

With SEC rulemaking on disclosure of political spending removed from the SEC's list of 2014 priorities, shareholders and interest groups are expected to continue to seek company-by-company adoption of voluntary standards for disclosing political contributions.

As of early March 2014, ISS had tracked 123 proposals related to political contributions and lobbying. Chief proponents include the American Federation of State, County & Municipal Employees (AFSCME), and Walden Asset Management. In addition, a number of proposals have been filed by shareholders participating in the Center for Political Accountability's organized campaign.

Increasingly, concerns about political activity and lobbying efforts are linked to other CSR issues. For example, Walden Asset Management has stated that it will focus attention on fossil fuel companies' public advocacy and lobbying, both individually and through trade associations.

SUSTAINABILITY AND THE ENVIRONMENT

Sustainability, which broadly defined encompasses efforts to protect the environment so that the company and future generations have the natural resources they need, has been a particular focus of shareholders over the last decade. This interest in sustainability shows no signs of abating. As of early March 2014, ISS had tracked 111 environmental proposals, an increase of 10% over 2013. More may be on the way.

Ceres, a nonprofit group focused on climate change, announced in March 2014 that shareholders were planning to propose 142 resolutions during the 2014 proxy season on climate-related issues, including:

- Greenhouse gas reductions.
- Energy efficiency.
- Deforestation.
- Hydraulic fracturing (fracking).
- Water use.

While the resolutions are varied, many seek greater disclosure by companies of the risks to the business associated with greenhouse gas emissions and the use and production of fossil fuels. The Ceres campaign involves 35 institutional investors, including public pension funds from California, Connecticut and New York. It focuses on oil and gas companies and electric utilities, but also targets retailers and manufacturers.

While these resolutions have in the past tended not to receive majority support, they typically are supported by about one-third of the votes and can help position the proponent for engagement and negotiation with the targeted company.

HUMAN RIGHTS

Shareholders continue to express concerns about human rights issues in companies with global operations. As of early 2014, the number of shareholder proposals related to human rights had already outpaced the number filed in 2013. The most prominent proposals seek disclosure of a "human rights risk assessment." This is consistent with a general focus on the adoption of comprehensive, transparent, and verifiable human rights policies and systems related to the company's direct operations and supply chains.

Key issues include worker safety concerns and, for some industries (largely the transportation and hotel industries), concerns about policies designed to prevent and detect human trafficking and sexual exploitation. In the food industry, attention from shareholders can be expected on ingredient labeling, product traceability, food safety monitoring and the encouragement of healthy eating.

ANIMAL WELFARE

Animal welfare issues receive attention from special interest shareholders on an industry specific basis, but the number of proposals continues to decline. As of early March 2014, only 13 proposals had been filed, down from 16 in 2013 and 29 in 2010. These proposals do not tend to obtain significant support from other shareholders, but have resulted in engagement and negotiated withdrawals. Pharmaceutical and food companies are frequently the targets.

Typically, these shareholder proposals seek cessation of and reporting on animal testing and changes to and reporting on the conditions under which livestock is raised. Over the last several years, the Humane Society of the US has used proposals with some success in pressing for change in the conditions under which chickens and pigs are raised.

EQUAL EMPLOYMENT AND BOARD DIVERSITY

Shareholders continue to seek corporate policies designed to explicitly prohibit discrimination based on sexual orientation and gender identity, although the number of proposals on these topics fell in 2013. Related proposals seek enhanced disclosure of workplace diversity data.

Board diversity is likely to gain more attention in the 2014 proxy season through shareholder proposals and also vote-no campaigns directed at members of nominating and governance committees where board diversity is below average. Efforts to add language to nominating and governance committee charters that expressly calls for racial and gender diversity can be expected.

PAY INEQUALITY

Executive compensation in relation to worker compensation remains an issue of concern for some shareholders. After a decline in the number of proposals over the last several years, there is more activity this year. In addition, retailers and fast food restaurant chains may be the focus of negative vote campaigns in 2014 on both say on pay and on the election of directors who serve on the compensation committee.

CSR REPORTING

A common feature of many shareholder proposals on CSR issues is a call for greater transparency about corporate policies and actions regarding a particular issue, whether political and lobbying activity, sustainability, safety, health or child labor issues. Boards and corporate managers need to balance transparency with concerns about protecting strategic information and the time and cost of enhanced disclosure. That said, the pressure to provide more meaningful disclosure on CSR issues, including the link between CSR and financial performance, is likely to increase.

According to KPMG:

> "More and more investors accept that environmental and social megaforces put company value at stake. As their understanding grows, they will expect companies to be transparent about the risks they face, what the financial impacts of those risks could be and what the company is doing to mitigate them. Our research suggests that many companies still have a long way to go on that front."
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> (*Press Release, KPMG, Corporate responsibility risk not sufficiently tied to remuneration, says KPMG (Dec. 9, 2013)*.)

Boards and corporate managers need to balance transparency with concerns about protecting strategic information and the time and cost of enhanced disclosure.

CSR: Questions for Boards

Boards should consider the following questions in discussing CSR strategies and policies with management:

- **CSR strategy.** What is the company's CSR strategy and how does it relate to corporate strategy generally? What is the business case for the CSR strategy?
- **Risk management.** How does the company's CSR strategy relate to risk management? What are the most significant CSR issues and risks associated with corporate strategy and operations?
- **Leadership commitment.** How does the CEO exhibit leadership commitment to CSR issues that are important to the company? Does the CEO drive CSR sensitivity within the company through regular internal communications?
- **Management responsibility.** Who is the corporate manager with responsibility for the company's CSR program (including stakeholder engagement) and reporting? How often does that manager report to the board (or relevant board committee)?
- **CSR reporting.** How does CSR responsibility and reporting relate to responsibility for risk management and compliance? Is the company appropriately positioned to assess and manage CSR risk?
- **Peer comparison.** Is the company lagging, following or leading industry and peer standards on CSR, including voluntary codes and standards?
- **Incentives and training.** How does the company encourage and incentivize appropriate consideration of CSR issues in decision-making, and how does it measure success? Is there a link to compensation? What types of training programs are in place? How else does the company assure that executives and other employees are mindful of the potential CSR impact of decisions?
- **Stakeholder engagement.** How does the company engage with key stakeholders on CSR issues? What issues have stakeholders raised in the past three years? How are those issues changing over time?
- **Board expectations and oversight.** Has the board clearly defined its expectations about the company's approach to CSR, as well as the board's role in oversight? Is appropriate oversight supported by regular information flow to the board? Do committee structures and charters support the company's CSR approach?
- **Monitoring third parties.** How does the company ensure that it understands and monitors the CSR approach and commitment of its suppliers and other business partners?

The *KPMG Survey of Corporate Responsibility Reporting 2013* (available at *kpmg.com*), indicates that reporting on corporate social responsibility initiatives has become a mainstream practice at the world's largest companies. For example:

- Of the 4,100 companies surveyed in 2013, 71% report on corporate social responsibility issues, an increase of 7% over 2011 rates.
- Among the world's largest 250 companies, the reporting rate is 93%, which is relatively the same as it was in 2011.

However, only 5% of companies report on how environmental and social risks could impact their financial results. Further, only 10% of companies report a link between CSR and executive compensation.

In considering how to approach pressures for greater CSR-related reporting, boards and corporate managers should be mindful of the growing trend for shareholders to view environmental and other CSR issues as interconnected with corporate values and corporate performance.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.