Strong Relationships with Stakeholders Can Prevent Crises and Lessen Their Financial Impact

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Note: Sinziana Dorobantu is an Assistant Professor in the Department of Management and Organizations of the Stern School of Business at New York University. The note below synthetizes the findings presented in an academic article entitled "Not All Sparks Light a Fire: Stakeholder and Shareholder Reactions to Critical Events in Contested Markets," co-authored with Witold Henisz from University of Pennsylvania and Lite Nartey form University of South Caroline. The article is forthcoming in *Administrative Science Quarterly*. Prior to its publication in the journal, the full text is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2844466

Why is it the case that apparently isolated events (e.g., a court decision or a negative report from an environmental organization) sometimes escalate into crises while other times they go almost unnoticed? In new research to be published in the *Administrative Science Quarterly* and entitled "Not All Sparks Light a Fire: Stakeholder and Shareholder Reactions to Critical Events in Contested Markets," we argue that variations in stakeholders' perceptions of an organization and in their reactions to the initial event explain why, in some instances, negative news spark a social movement opposing the organization escalating into a bigger crisis, while in others they pass almost unnoticed. We analyzed a dataset of more than 51,000 media-reported events describing the interactions between 2,293 diverse stakeholders (including local communities, government representatives, NGOs, suppliers, etc.) and 19 publicly-traded gold mining firms operating 26 mines around the world, to find that:

- *Stakeholders defend or mobilize against the organization, depending on what they thought about it before the incident.* Following a negative event, a stakeholder who held positive prior beliefs (or perceptions) about the organization is likely to take a public stand in support of it and question the validity of accusations raised against it. Conversely, a stakeholder who held negative prior beliefs about the organization is likely to mobilize in protest against the organization following the initial event. Thus, at the firm-level, small variations in the distribution of stakeholders' prior beliefs explain why, in some instances, negative news pass almost unnoticed, while in others they are followed by cascades of negative stakeholder reactions leading to full-blown reputational crises.
- *Stakeholders influence each other by revealing what they think about the organization through public statements and actions.* In addition to his or her own prior beliefs about the firm, a stakeholder's reaction is also influenced by other stakeholders' reactions following the initial event. As a result, the very first reactions after the event – after the "spark" – play a very important role as well. Immediate positive reactions from stakeholders willing to speak out to defend the organization (for instance, an NGO defending the firm by talking about a partnership they developed or a mayor defending the firm by highlighting the positive impact it had on the community) make a crisis less likely. If, on the contrary, the first reactions are reinforcing opposition to the firm (for instance, a protest in the local community), a crisis becomes more likely. In addition, high-status or high-visibility stakeholders (e.g., famous actors, politicians, big NGOs) have greater influence on the mobilization of other stakeholders.

- *Shareholders respond similarly to other stakeholders, and their reactions are best captured by changes in the stock price.* Shareholders are also stakeholders of the firm, and respond in a similar way to the initial event and to other stakeholders' reactions that follow it. Shareholders' reactions are best captured by variations in a firm's stock price. Our analysis of cumulative abnormal returns following 161 events targeting the firms in our sample highlights that stakeholder's reactions are influenced both by information about a firm's stakeholder relations *before* the event and by publicly reported stakeholder statements and actions *following* the event.

Key takeaways from our research

First, our research highlights the benefits that companies can derive from engaging their stakeholders in a strategic and systematic way. The best way to manage a crisis is by not having one at all. The easiest way to manage a social movement campaigning against the organization is by not giving stakeholders a reason to mobile in the first place. Our research shows that companies that also think about their stakeholders when they strategize about their business operations can effectively prevent stakeholder mobilization that escalates into reputational crises. To this end, the same process used for managing employees, suppliers and customers should be applied to managing stakeholders more broadly defined, including local communities, NGOs and activists, mayors and local councils, governments and regulatory agencies.

Second, our research demonstrates that publicly available information (through the news or social media) facilitates the mobilization of a social movement by enabling unconnected stakeholders to synchronize their reactions without having to coordinate explicitly. The making of a crisis in an era of increased transparency does not require explicit coordination; those involved can use publicly available information to gauge the extent of likely opposition against the firm and to synchronize (without coordinating) their reactions. The "spark" of the initial event can be a court decision that triggers a protest in the local community, a negative press statement from a minister, and the mobilization of environmental activists. These different stakeholders did not coordinate explicitly (though calls or emails) to form a social movement against the firm. They reacted independently of each other, responding to the initial event and to other stakeholders' reactions. But uncoordinated negative reactions reach investors and the public as a chorus of negative voices resembling a broad campaign opposing the firm and have significant impact on the stock price. This suggests that managers and their teams should not wait for signs of coordinated social campaigns because explicit coordination is not required to have an event escalate into a larger crisis consuming the firm.

The third takeaway from our research is that in a world of increased transparency and information availability, even the most isolated, arguably small issue can escalate into a larger crises if a range of stakeholders want to raise their own concerns and reinforce their opposition towards the firm. The best way to protect the value created by an organization is by building meaningful stakeholder relations. Our research shows that the companies that take their stakeholders' concerns seriously are the companies that do not experience a cascade of negative headlines. For these companies, sparks don't light fires; instead, when something happens, their stakeholders defend them, or at the very least, they give the firm the benefit of the doubt to address the issues at hand. Most likely, these companies' managers will address the concerns seriously and collaboratively, and use these moments as opportunities to make their organizations more responsible and sustainable.