Harvard Law School Forum on Corporate Governance

Memo to Corporate Directors: Three Lessons from the Exxon-Mobil Activist Victory

Posted by Nell Minow, ValueEdge Advisors, on Sunday, May 30, 2021

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Editor's Note: Nell Minow is Vice Chair of ValueEdge Advisors. Related research from the Program on Corporate Governance includes **The Illusory Promise of Stakeholder Governance** by Lucian A. Bebchuk and Roberto Tallarita (discussed on the Forum **here**); **Companies Should Maximize Shareholder Welfare Not Market Value** by Oliver Hart and Luigi Zingales (discussed on the Forum **here**); and **Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee** by Max M. Schanzenbach and Robert H. Sitkoff (discussed on the Forum **here**).

Exxon-Mobil spent $35 million, added new directors, and made promises to do better, all in an effort to defeat the dissident slate nominated by activist fund Engine No. 1. It failed, and, at this writing, Exxon-Mobil has lost at least two seats on the board of directors and votes for two others were still being calculated. The challengers, who spent $30 million, making this the most expensive proxy fight ever, are really the little Engine that could; with only a tiny .002 percent of the stock, they were able to succeed by making an incontrovertible business case for change, helped, no doubt, by Exxon-Mobil's poor performance, with losses last year of $22 billion, its worst performance in forty years, and by nominating four highly qualified candidates. With the support of the major proxy advisory firms and institutional investors like BlackRock, CalPERS, and CalSTRS, Engine No. 1 candidates defeated those nominated by the board.

This David and Goliath victory reflects investor concerns about the viability of fossil fuel companies. But it also reflects broader investor frustration with inadequate oversight by boards of directors. The most important lesson for corporate boards and executives is that this is not a singular event; it is the beginning of a fundamental change in the way that investors push back on portfolio companies. From now on, activist investors do not have to be Carl Icahn-types with major stakes in order to succeed.

Three key lessons for all corporate executives and directors:

1. This is capitalism 101. Back when I was taking Corporations in law school, I remember the professor explaining that corporations, like the US government, were set up with a series of checks and balances, and one of them was the ability of investors to replace directors if they were unhappy with the direction of the company. That turned out to be more true in theory than in practice. The pretense of using the term "election" when insiders select the candidates, no one runs against them, and the company counts the votes is an increasing source of frustration for investors. So is the unconscionable disconnect between pay and performance, misaligning the connection between the incentives for CEOs and the creation of shareholder value.

The entire system of capitalism is based on a credible mechanism for minimizing agency costs. If investors have no recourse when they are not satisfied with an investment other than selling the stock when it is undervalued, the cost of capital will reflect additional risk. And when it becomes intolerable, a group like Engine No. 1 will recognize the potential for creating value by leveraging shareholder discontent to support meaningful change.

2. Past performance is no guarantee of future performance, as investment fund disclosures remind us. That applies to corporate strategy as well. Just because a particular business model has been successful in the past does not mean it does not have to be continually re-evaluated. The scientific consensus on climate change was established years ago. The political and consumer consensus has reached a tipping point. The Biden administration has already taken a strong, administration-wide position on improving ESG disclosure and environmental standards. Failure to adapt to the changing environment, in both literal and metaphorical senses of the word, can make a company go the way of the manufacturers of buggy whips.

3. Do not take your investors for granted. Index funds, pension funds, and other major institutional investors have majority or near-majority permanent holdings. Because they are not going anywhere, if they do not believe the board is providing adequate oversight it is more cost-effective to support activists than to liquidate the position. They may not be willing to mount a dissident campaign themselves but they will be happy to support one. Therefore, you have to make your case to the market every day.

Do not wait to reach out to them when you are in trouble. The best time to cultivate them is five years ago. The second best time is today. That $35 million Exxon-Mobil put into the proxy fight would have been much better spent communicating with investors and responding to their concerns. The same goes for the very expensive fossil fuel industry-funded efforts at the SEC and Department of Labor to push through rules making it more difficult for investors to get access to independent research, submit shareholder proposals, and vote proxies, reminiscent of the efforts of the US-based auto industry efforts to prevent safety and emission standards rather than use them as a starting point for improvement, opening the door to more fuel-efficient, lower-emission competition from Japan.

Instead of trying to kill the messenger, show that you understand the message. Exxon-Mobil further damaged its credibility by mischaracterizing Engine No. 1's position instead of responding on the merits. Of course, its credibility was already severely damaged by its poor financial performance and the way it lagged its competitors in transitioning to a more sustainable business model. That created an opportunity for activists that was as impossible to resist. Other investors found their message just as compelling.

I have spent more than thirty years studying corporate failure and the one constant indicator is responding to criticism with hostility instead of constructive engagement. Every board should make sure that does not happen with a committee that oversees investor communications and lead directors who are liaisons for addressing shareholder concerns. They should expect a lot more interest from shareholders in the quality of the board, with emphasis on independence that goes beyond resume disclosures. Wise boards will solicit suggestions from investors and make sure that all directors know that their obligation as fiduciaries is to shareholders, not executives, and that their actions make that message clear to shareholders as well. Engine No. 1 is the first of a new kind of activist; its success makes it clear it will not be the last.

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