Where was the Canary in the Boardroom?

Why ExxonMobil's Proxy Contest Loss is a Wakeup Call for all Boards

Over the past five years, the largest institutional investors have been increasingly vocal and specific about their expectations of boards and directors regarding board composition and ESG. Despite this, they have rarely acted on those concerns when it comes to director voting. However, the ExxonMobil proxy fight may be a sign things have changed. Twenty twenty-one will go down as the year that large institutional investors aligned their voting with market communications and voted out three sitting board members at ExxonMobil. The world's largest shareholders have now demonstrated that they are willing to act and that they expect executives to take action on ESG and climate change. Importantly, this is a lesson that board composition matters and director skills need to align with a company's strategy.

At the end of May, the US proxy season reached its apex and the long-awaited contest between ExxonMobil and Engine No. 1 came to a vote. Engine No. 1, an activist hedge fund with just .02% ownership in the company, argued throughout the contest that there were shortcomings in oil and gas experience on ExxonMobil's board, slow strategic transitioning to a low carbon economy, and historic underperformance and overleverage relative to peers. The fund proffered four board director candidates to ExxonMobil investors, three of whom were ultimately elected to the 12-member board—and as a result, three sitting board members were ousted.

While this specific vote surprised many people, the increasing focus on ESG should not.

As we do at the close of each year, Russell Reynolds Associates interviewed over 40 global institutional and activist investors, pension fund managers, proxy advisors and other corporate governance professionals in late 2020 to identify the governance trends most relevant to boards. Atop our 2021 list was *Climate Change Risk*, and not far below it *Return of Activism*. In each of the prior three years, ESG topics consistently made their way onto the list. However, this was the first year climate took the top spot. Many savvy governance observers were paying close attention to how Exxon's top three investors—Vanguard, BlackRock, and State Street, in that order—voted. The Big Three, which own roughly twenty percent of the S&P 500's outstanding shares, had made significant climate commitments over the past several years. The key question for many was whether these commitments would translate into votes. In the end, BlackRock supported three dissident candidates and Vanguard and State Street each supported two.

The ExxonMobil contest was the result of the *Climate Change Risk and Return of Activism* trends intersecting and more than a decade of underperformance against their peers. We expect these trends to continue, and advise boards to consider the following key learnings and recommendations:

1. **Boards must be proactive in assessing board skills and risk generally.** In the Exxon contest, it is important to note, Engine No. 1 was not looking to add "ESG expertise" to the Exxon board. The first pillar of their campaign to restore value creation stated: "Board Composition—four new independent directors with successful track records in energy." What the Exxon contest underscored was that relevant operational industry expertise is essential to an investor's board quality calculus. Boards must consistently ensure their composition aligns with relevant industry risks and strategic opportunities. As one of the world's largest investors said to Russell Reynolds: "We always ask, is this board fit for purpose in terms of assessing risk and providing the oversight of the execution of the strategy?" Three of the four nominees had oil and gas experience—Engine No. 1's chief argument for soliciting change at the top. As one of the largest investors noted to us, "ultimately, this was a board composition issue" and the board could have solved for the "G" in ESG prior to the proxy contest, thus taking away the dissident's most compelling claim. Moreover, Exxon's sluggish transition to a low carbon economy was evident via public disclosure relative to peer O&G companies like Eni, Total, BP, and Shell. These "E" concerns are no longer simply niche, activist concerns—they are materially important to many investors when assessing whether the board is equipped to oversee management.
2. **Proactively building sustainable, quality relationships with key investors (and other stakeholders, as well) is critical to ensuring the board is maintaining their license to operate.** Exxon has historically maintained a weak board engagement posture with investors (as noted in BlackRock's 2020 XOM Vote Bulletin). It is essential that independent board leadership is engaged with investors on a consistent basis. In addition to strong investor relationships, companies need to understand the perspective of and build relationships with other key stakeholders. In challenging times, trust is at a premium. Independent board relationships built on consistent dialogue over time will instill confidence with stakeholders that credible activist concerns will, in fact, be addressed. As another of the largest institutional investors noted to Russell Reynolds, "the best activism defense is really knowing your shareholders."
3. **In the right circumstances, David can in fact bring down Goliath.** With just .02% share ownership, Engine No. 1 was able to garner both institutional and, equally important in this context, retail shareholder support. We believe this contest serves as a wakeup call to all boards that, regardless of size or industry, it is possible your board is also vulnerable to board composition and material ESG issues relative to peers. As one of the large institutional investors noted to us "Early shareholder proposals focused on the "E" and "S" of ESG disclosure and there has been a lot of progress around those disclosures. What we are now looking for is the actual oversight of what the company is doing." We recommend boards review their ESG activities and disclosure to ensure that the actual work of strategic sustainability initiatives and associated progress are being effectively communicated. In addition to a general activist review, boards should include a review centered on director vulnerabilities. (For more on this, see *Board and Director Assessments That Matter*.) Additionally, boards need to regularly educate themselves about the range topics under the ESG rubric and evolving investor expectations.

Companies can approach ESG from a range of perspectives and goals. Some companies are embracing ESG as an element of risk management. Others are embracing it because they view it as the right thing to do in a multi-stakeholder environment and they believe it will support long-term, sustainable value creation. Regardless of their motivation, this is a moment in time when boards need to step back and enhance their activist and ESG approaches. A year ago, we would have been hard pressed to believe that a nascent hedge fund could win three board seats at a Global Fortune 15 company. This vote should push every board leader to ensure these topics are under regular review with their nominating and governance committee.

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