SANGRA MOLLER LLP
Barristers & Solicitors

LEGAL CURRENCY
A Client Communication

ESG Activism: Observations on the Exxon Mobil Proxy Fight

On May 26, 2021, Engine No. 1 LLC ("**Engine No. 1**"), a small hedge fund founded in December 2020 with only USD$250 million in assets, successfully elected two nominees to the board of directors (the "**Board**") of Exxon Mobil Corporation ("**Exxon**") at its annual meeting of shareholders. At the meeting, Engine No. 1 nominated four individuals to Exxon's Board. Of the four, Engine No. 1 succeeded in electing two nominees with support from large institutional shareholders, including BlackRock, Inc. ("**BlackRock**"), The Vanguard Group, Inc. ("**Vanguard**") and State Street Corporation ("**State Street**"). At the time of this article, the preliminary voting results for a third Engine No. 1 nominee were still too close to call.

The dissent marked the first successful proxy contest at a major oil company centered on issues of climate change. Engine No. 1's success is particularly noteworthy due to its relatively minor 0.02% stake in Exxon. The hedge fund gained support from institutional investors, including from Exxon's three largest shareholders, BlackRock, Vanguard and State Street, which together held approximately 20% of Exxon's voting shares. This is an early indication of the increasing influence that environmental considerations have on the voting decisions of institutional investors. Activist funds do not need to acquire a significant stake to enact change in a company if they can garner the support of these investors.

I. Background

Exxon is one of the world's largest greenhouse gas producers. Engine No.1 claimed that while its competitors in the oil and gas industry have begun to transition into more sustainable energy, Exxon has continued to increase capital expenditure in fossil fuel projects.

Engine No. 1 claimed that its director nominees brought "the successful and transformative energy experience that the [Board] is missing". The goal is to "gradually but purposefully reposition [the] company to succeed in a decarbonizing world … [while] maintaining current profitability".

Engine No. 1 cited Exxon's reluctance to diversify as both a climate and valuation issue for long-term investors. It views the transition to sustainable energy as an opportunity for major oil companies to utilize their size, influence and expertise to create significant long-term value while reducing systemic business risks.

II. Support of Institutional Investors

BlackRock and Vanguard both point to Exxon's failure to transition to sustainable energy, and its overall lack of addressing environmental, social and corporate governance ("**ESG**") issues as their rationale for supporting Engine No. 1's dissident director nominees. In voting for two dissident nominees, State Street noted that such nominees would "oversee an energy transition strategy, underpinned by an appropriate capital allocation approach."

BlackRock

In its 2021 Investment Stewardship Vote Bulletin regarding the Exxon vote, BlackRock explains that its "prevailing view [is] that the risks of climate change and the transition to a lower carbon economy present material regulatory, reputational, and legal risks to companies that may significantly impair their financial position and ability to remain competitive going forward". BlackRock believes that "climate risk carries financial impacts that will reverberate across all industries and global markets, affecting economic stability and long-term financial returns," and that "those companies that proactively consider their operational footprint in the context of a low carbon transition will be better positioned".

In BlackRock's view, Exxon's energy transition has fallen short of what is necessary to ensure its financial resilience in a low carbon economy. Specifically, BlackRock is "concerned about Exxon's strategic direction and the anticipated impact on its long-term financial performance and competitiveness".

BlackRock supported three of the four directors nominated by Engine No. 1 because they "bring the fresh perspectives and relevant transformative energy experience to the Board that will help the company position itself competitively in addressing the risks and opportunities presented by the energy transition".

Vanguard

In its 2021 Investment Stewardship Insights regarding the Exxon vote, Vanguard outlines its expectation that its portfolio companies and their boards be cognizant of climate-related material risks. This includes "an expectation of appropriate risk oversight, mitigation strategies and practices, and effective disclosure to the market of how the board oversees climate-related strategy and risk management". In its view, a highly engaged board will ensure that climate related risks and opportunities are included in both short- and long-term planning.

Vanguard expects boards to be "climate competent", and for boards to "reflect the necessary skill set to independently oversee a company's risk and strategy related to the energy transition, and to be effectively composed in such a way that independent directors can challenge management on areas related to climate strategy and climate risk mitigation in both the short and longer term". Where boards lack these competencies, the company must conduct "a thorough search to identify qualified directors".

Vanguard recognized that a "pressing need exists for Exxon to better align its climate strategy with (1) target setting in line with global peers and (2) its public policy efforts related to climate risks". In supporting the two successful directors nominated by Engine No. 1, Vanguard considered both the best interest of long-term shareholders and Exxon's ability to succeed through the energy transition.

Key Takeaways from BlackRock and Vanguard

The Exxon proxy contest is an early signal to boards that ESG factors will play into future proxy voting decisions by institutional investors. Both Vanguard and BlackRock have taken the position that climate risks are investment risks, which directly affect long-term shareholder value.

To retain the support of institutional investors, management should consider creating transparent policies and action plans, which address the environmental risks inherent in its business model. Such plans must consider current realities as well as anticipate longer-term environmental trends. These considerations should be factored into the company's overarching business plans and risk assessments. Companies should not ignore the shifting social sentiment towards more environmentally and socially sustainable business practices. By proactively factoring ESG issues into the company's operations, management will be better poised to both mitigate these risks and retain the support of its shareholders.

III. Voting Guidelines

Proxy advisory firms have increasingly incorporated ESG factors into their yearly voting guidelines. Additionally, some institutional investors also have their own guidelines that include ESG metrics.

Proxy Advisory Firms

The two largest proxy advisory firms, Institutional Shareholder Services, Inc. ("**ISS**") and Glass, Lewis & Co., LLC ("**Glass Lewis**"), have added more stringent ESG considerations into their 2021 voting guideline policies.

The existing ISS policy has been to vote against directors due to material failures of governance, stewardship or risk oversight. In its 2021 voting guidelines, ISS has added "environmental and social issues, including climate change" to its examples of failed risk oversight.

Glass Lewis has also expanded its guidelines for oversight of environmental and social risk factors. It released a 2021 policy specific to ESG initiatives to provide for support of increased diversity reporting, the codification of its approach to management-sponsored ESG resolutions, and a stricter approach to climate change. Specifically, Glass Lewis believes all companies in every industry should address climate change and it will no longer consider the company's industry when reviewing climate-reporting resolutions. Glass Lewis will generally recommend in favor of shareholder resolutions requesting that companies provide enhanced disclosure on climate-related issues.

BlackRock and Vanguard

In its 2021 proxy voting guidelines, BlackRock states, "when a company's reporting is inadequate, investors, including BlackRock, will increasingly conclude that the company is not adequately managing risk". This may result in BlackRock voting against management director nominees. BlackRock may also support shareholder proposals that ask companies for additional climate disclosure aligned with its expectations.

Vanguard's 2021 proxy voting policy has also been updated to include climate-related considerations when evaluating disclosure-oriented proposals. Vanguard is now likely to support proposals that "request disclosure on how climate change risks are incorporated into strategy and capital allocation decisions, ask for an assessment of climate impact and/or request feasibility analysis". Additionally, Vanguard will generally vote against directors that have failed to "effectively identify, monitor, and ensure management of material risks … [including] environmental and social risks".

Insights from the Voting Guidelines

Both BlackRock and Vanguard cited Exxon's failure to disclose and address ESG-related risks as their rationale for supporting the Engine No. 1 director nominees. This is consistent with the updated voting guidelines released by ISS, Glass Lewis, BlackRock and Vanguard. The proxy voting guidelines make clear that the support for Engine No. 1 against Exxon was not a one-off event. It directly aligned with their voting philosophies.

IV. Notable Recent ESG Activism

On the same day as Exxon's annual meeting of shareholders, the shareholders of Chevron Corporation ("**Chevron**") voted on two climate-related shareholder proposals led by Follow This, a Netherlands-based shareholder activist group. A proposal to cut Chevron's Scope 3 emissions passed with 61% of the shareholder vote. A second proposal, which would have required Chevron to report on the affects of a 2050 net zero scenario on its business, also nearly passed with 48% of the votes. Management opposed both of the shareholder proposals.

The Chevron proposals comes only weeks after Follow This successfully led another climate-related shareholder proposal at ConocoPhillips. Follow This has filed climate-related resolutions aimed at 7 major oil companies in 2021 alone.

These shareholder proposals provide an alternative means for disgruntled shareholders to affect change that management is unwilling to implement. However, management should try to avoid the need for these proposals. Shareholder proposals, such as increased ESG disclosure or decreased emissions, can be expensive to implement.

The activists lack insider knowledge and may propose unnecessarily stringent or impossible to achieve standards. Further, the approval of management-opposed proposals can hurt investor confidence in the management team. Management would fare better by proactively implementing their own ESG proposals in-line with industry standards and the guidance given by proxy advisory firms and their institutional investors. If management fails to do so, the success that Follow This has had in 2021 shows that shareholders have real power which they can use to circumvent management and take matters into their own hands.

V. Summary

The Exxon proxy contest shows that shareholders are willing and able to vote against electing directors that refuse to address their concerns. It is also an early signal of the increasing influence that ESG factors will have on proxy voting decisions by institutional investors.

Suite 1000 Cathedral Place, 925 West Georgia Street, Vancouver, B.C. V6C 3L2
Telephone: (604) 662-8808 • Facsimile: (604) 669-8803