The Hedge Fund Activism of Engine No. 1

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I. INTRODUCTION

On the eightieth anniversary of the attack on Pearl Harbor, December 7, 2021, Engine No. 1 stormed into the world of shareholder activism with its letter[1] announcing to the board of directors of ExxonMobil that it was ready to engage the board in a proxy contest. Engine No. 1's activism was considered extremely successful. Despite having only $40 million worth of ExxonMobil common stock in hand and no specific recommendations to enhance shareholder value or move the company into profitable low carbon emissions, Engine No. 1 was still able to convince enough ExxonMobil shareholders to elect three of its four nominees to the board.[2]

One would think such success would inspire Engine No. 1 and other hedge funds to try to use the same type of activism at other publicly traded fossil fuel companies. Yet, that has not happened and I don't anticipate that it will. My new paper, "The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil,"[3] explains why that is so. It finds that Engine No. 1's activism was seriously flawed from both a theoretical and empirical perspective. It was not able to provide ExxonMobil's management with specific recommendations on how it could enhance shareholder value, reduce its carbon emissions, or profitably transition from a global leader in oil and gas production to a global leader in the production of clean energy. In sum, its success was an illusion.

Moreover, Engine No. 1 may have created a "deadly distraction"[4] in the global fight against climate change. The only apparent positive result of this

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[1] *See* Letter from Engine No. 1 LLC to Board of Directors, Exxon Mobil Corp. (Dec. 7, 2020), https://perma.cc/J45Z-LBLK.

[2] Exxon Mobil Corp., Current Report (Form 8-K/A) (June 2, 2021), https://perma.cc/478M-HRV7.

[3] Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE, art. 3, 2021.

[4] Tariq Fancy, *BlackRock Hired Me to Make Sustainable Investing Mainstream. Now I Realize It's a Deadly Distraction from the Climate-Change Threat*, The Globe and Mail (March 25, 2021),

activism, at least from the perspective of Engine No. 1, is that the entity got a huge marketing boost in its efforts to raise funding for its newly formed exchanged traded funds (ETFs).[5]

II. THE FOUNDATION FOR A THEORY OF HEDGE FUND ACTIVISM

The foundation of my understanding of hedge fund activism is derived from Henry Manne's "Mergers and the Market for Corporate Control."[6] In his pathbreaking article, Manne theorized that "the control of corporations may constitute a valuable asset" if the acquirer takes control with the expectation of correcting managerial inefficiencies.[7]

In the market for corporate control, an important process by which managerial inefficiencies can be corrected is through a hostile takeover. The lead actor in a hostile takeover, the hostile bidder, assuming it is well informed about the target company and seeking to correct managerial inefficiencies, may act as a *corrective mechanism* in corporate governance. A *corrective mechanism* is defined as a stakeholder, including shareholders, or potential stakeholders "of a public company, other than the current board of directors or executive management, which may have, from time to time, superior decision-making skills in the making of major corporate decisions."[8]

Unfortunately, while a vibrant hostile takeover market did exist in the United States during the sixties, seventies, and eighties, this has not been the case for many years. Without a vibrant hostile takeover market, the US stock markets no longer have access to a valuable corrective mechanism. Fortunately, the U.S. stock markets reacted to the loss of the hostile bidder by encouraging the rise of another corrective mechanism—the hedge fund activist.

III. A THEORY OF HEDGE FUND ACTIVISM

Like the hostile bidder, the hedge fund activist seeks ways to correct managerial inefficiencies in a public company. However, while sharing many of the same goals, the activist seeks to bring about change within a public company *without trying to gain control*.

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https://www.theglobeandmail.com/amp/business/commentary/article-sustainable-investing-is-a-deadly-distractionfrom-actually-averting/.

5 Engine No. 1, *Exchange Traded Funds* (accessed Mar. 5, 2022), https://perma.cc/9EDZ-WVAB.

6 Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

7 *Id.* at 112.

8 Bernard S. Sharfman, *The Tension Between Hedge Fund Activism and Corporate Law*, 12 J.L. ECON. & POL.'Y 251, 258 (2016) (alteration in original).

Hedge fund activism typically begins with the activist accumulating a significant amount of a public company's stock, usually around 5 percent to 10 percent of the shares outstanding. A large position is necessary in order for the hedge fund to earn a large enough return on the expected increase in the stock price to cover the costs of its activism—becoming informed about the target company, creating specific recommendations to correct managerial inefficiencies, and carrying out its activism. It also helps in enhancing its voting power, giving it a better chance of eventually getting its way at the target company.

The hedge fund activist believes that if management adopts its recommended strategies then the value of the company's common stock would significantly increase and the company's performance would improve, allowing the activist hedge fund's investors to potentially earn sizable returns. Moreover, based on the large amount of investment in makes in the target company, the hedge fund activist has a strong incentive to make sure its specific recommendations will actually be value enhancing.

Therefore, given the potential for a hedge fund activist to act as a *corrective mechanism* in a similar manner to the hostile bidder, we can extend Manne's theory of the market for corporate control to one that applies to hedge fund activism: In the context of public companies, hedge fund activism may constitute a valuable asset in and of itself if the goal of such activism is to enhance managerial efficiency.[9]

Numerous empirical studies[10] demonstrate that this type of *traditional* hedge fund activism increases the wealth of shareholders and improves the performance of the public companies it targets. These studies support the arguments that hedge fund activism "is a valuable asset in and of itself" and has the overall effect of being a *corrective mechanism* in the governance of public companies.[11]

IV. THE ANALYSIS OF ENGINE NO. 1'S ACTIVISM

Despite having only a de minimis amount of ExxonMobil common stock in hand and no specific recommendations to enhance shareholder value or move the company into profitable low carbon emissions, Engine No. 1 was still able to convince enough ExxonMobil shareholders to elect three of its four nominees to ExxonMobil's board of directors. This was an astonishing accomplishment given that the lack of specific recommendations was a clear signal to ExxonMobil shareholders that Engine No. 1 was not informed about the operations and strategies

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[9] Bernard S. Sharfman, *A Theory of Shareholder Activism and Its Place in Corporate Law*, 82 TENN. L. REV. 791, 804 (2015).

[10] For an overview of these studies, see Alon Brav et al., *Governance by Persuasion: Hedge Fund Activism and the Market for Corporate Influence* (Eur. Corp. Governance Inst., Finance Working Paper No. 797/2021, 2021), https://perma.cc/2DCR-Q58M.

[11] Sharfman, *supra* note 9 at 791.

of ExxonMobil and what was necessary to make it a more successful company. How was Engine No. 1 able to accomplish this utilizing a very *non-traditional* form of hedge fund activism?

Engine No. 1 succeeded because it was able to garner the votes cast by the "Big 3" investment advisers to index funds: BlackRock, Vanguard, and State Street Global Advisors. The Big Three had delegated voting authority for approximately 21% of ExxonMobil's voting stock.[12] However, that percentage was most likely a significant understatement of their actual voting power, given that institutional investors are much more likely to vote their shares than retail investors.[13] Moreover, ExxonMobil had a large percentage of retail investors directly holding stock in the company, 47%.[14]

To garner the Big Three's support, Engine No. 1 cleverly appealed to their desire to be perceived as investment advisers who are making a difference in helping to mitigate climate change, an important issue for millennials.[15] So, the Big Three were arguably in a bind. They were under a lot of pressure to support Engine No. 1's efforts or else they would be perceived as not walking the talk on climate change, especially BlackRock since it had taken the leadership role in espousing the use of shareholder voting and engagement for purposes of dealing with climate change.[16] Based on their voting, it appears that the need to market to millennials won out over

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12 Exxon Mobil Corp., Proxy Statement at 35 (March 16, 2021), https://corporate.exxonmobil.com/-/media/Global/Files/investor-relations/annual-meeting-materials/proxy-materials/2021-Proxy-Statement.pdf.

13 Alon Brav, Matthew D. Cain & Jonathan Zytnick, *Retail Shareholder Participation in the Proxy Process: Monitoring, Engagement, and Voting*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov. 19, 2019), https://corpgov.law.harvard.edu/2019/11/19/retail-shareholder-participation/ [https://perma.cc/6K25-ST8H] ("On the decision whether to cast a ballot, we find that retail shareholders cast 32% of their shares, on average, which is significantly lower than the 80% rate of participation by the entire shareholder base.").

14 *Exxon Mobil Corporation,* YAHOO! FINANCE, (accessed July 24, 2021), https://finance.yahoo.com/quote/XOM/holders?p=XOM. According to ExxonMobil's voting summary, 72% of outstanding shares were voted at the annual meeting. *See* Exxon Mobil Corp., Current Report (Form 8-K/A) (June 21, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/34088/000003408821000037/xom-20210526.htm.

15 Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, NY TIMES (June 9, 2021), ("The hedge fund reminded Vanguard, BlackRock and State Street that its campaign was in line with their own publicly stated goals to see the carbon emissions of the companies in their portfolios fall sharply over the next 30 years."), https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html.

16 Larry Fink's 2021 Letter to CEO's, BlackRock ("There is no company whose business model won't be profoundly affected by the transition to a net zero economy"), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

the need to actually implement value enhancing change at ExxonMobil, the primary objective of traditional hedge fund activism. BlackRock ended up supporting three Engine No. 1 director nominees,[17] while Vanguard and State Street Global Investors each supported two.[18]

V. CONCLUSION

Engine No. 1's activism did not serve as a corrective mechanism at ExxonMobil. Instead, its activism resulted in ExxonMobil needlessly spending significant resources on defending its director nominees and thereby distracting the company from engaging in its current strategy of focusing on the production of oil and gas, a strategy that Engine No. 1, as an uninformed shareholder, could not adequately disprove as being the correct one. Yes, ExxonMobil's current strategy may result in the company stranding oil and gas assets or the company eventually losing its independent existence if the road to decarbonization speeds up, but until proven otherwise, perhaps by an informed hedge fund, this strategy cannot be discounted as the one that will maximize the present value of its cash flows.

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17 BlackRock, *Vote Bulletin: Exxon Mobil Corporation* at 3–4 (May 26, 2021), https://www.blackrock.com/corporate/literature/press-release/blk-vote-bulletin-exxon-may-2021.pdf.

18 Richard J. Grossman & Neil P. Stronski, *What the Exxon Mobil Shareholder Votes Mean*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (June 16, 2021), https://www.skadden.com/insights/publications/2021/06/the-informed-board/what-the-exxon-mobil-shareholder-votes-mean.