STRIVE

August 23, 2023

Robert E. Jordan
Chief Executive Officer

Gary C. Kelly
Chairman of the Board

Southwest Airlines
2702 Love Field Drive
Dallas, Texas 75235

Via email, FedEx, and Strive.com

RE: Strive Asset Management Engagement with Southwest Airlines

Dear Messrs. Jordan & Kelly,

We write on behalf of Strive Asset Management's clients who are Southwest Airlines shareholders.

Since its founding 56 years ago, Southwest has been a leader in the airline industry, delivering superior value for its customers and shareholders alike. More recently, however, Southwest has faltered on both fronts. Nonetheless, Southwest's executives have continued to enjoy outsized bonuses and compensation packages that are untethered to the company's performance, mainly in the name of promoting environmental, social, and governance (ESG) objectives instead. As fiduciaries for our clients, we are gravely concerned about these practices, and the harm they are causing the company.

Southwest Pays Executives To Prioritize ESG Goals

Strive is concerned that Southwest's compensation policies incentivize its executives to pursue environmental and social goals, allowing leadership to line its own pockets at the expense of company shareholders and customers.

As disclosed in its most recent proxy statement, Southwest pays its leadership team through a mix of base salary, bonuses and incentive pay.[1] The incentive pay is substantial, as it can represent over $1 million of the CEO's pay, and several hundred thousand dollars for other members of senior management. Notably, 20% of executive incentive plan pay is tied to what the company calls its "major initiatives." In 2022, these initiatives included three categories: recovery response, network improvements, and ESG initiatives, which included diversity, equity and inclusion and sustainability.[2]

[1] See Southwest Airlines Co., *Form DEF 14A* (filed April 6, 2023), EDGAR, https://www.sec.gov/Archives/edgar/data/92380/000119312523093040/d361430ddef14a.htm.
[2] Southwest Airlines Co., *Form DEF 14A*, p. 37.

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As you know, the company fell far short of its targets in the first two categories in 2022. In December, Southwest cancelled over 16,000 flights, stranding tens of thousands of customers over the busy holiday season and costing the company more than $1 billion.[3] The company publicly apologized, acknowledging that it "didn't have enough winter operations resiliency" and blaming antiquated and inadequate crew scheduling software that the pilots' union had been urging the company to fix for years.[4] Southwest's Chief Operating Officer was later called to testify before Congress over the cancellations,[5] furthering the bad press and highlighting the company's failures.

Given the meltdown, it is no surprise that the compensation committee "considered the December 2022 operational disruption and determined that the Company performed below target-level expectations in the category of recovery response and performed much below target-level expectations in the category of network improvement."[6]

But instead of being forced to forgo his bonus as a result of these shortcomings, Southwest's CEO received record compensation. All told, Southwest's CEO received over $5.3 million, including over $900,000 in combined cash bonuses and incentive pay. The press did not miss this misalignment. "Southwest CEO's pay doubled to $5.3M—despite holiday travel meltdown," read one headline.[7] "Southwest CEO's compensation soars despite December debacle," read another.[8]

How could this be? One reason was because Southwest's compensation committee allowed executives to keep a significant portion of their bonuses because Southwest had exceeded its ESG targets for the year. "With respect to ESG initiatives, including DEI and sustainability, the Committee determined that the Company performed above target-level expectations," the company wrote.[9] In other words, company executives were able to largely offset their pay reductions resulting from the billion-dollar loss they caused the company by promising to hire more minority pilots[10] and replace 10% of their jet fuel with sustainable fuel by 2030[11] (despite the fact that sustainable fuel is up to eight times more

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[3] David Koenig, "'We Messed Up': Southwest COO Apologies in Senate Hearing About Holiday Travel Meltdown," *NBC DFW*, February 9, 2023, https://www.nbcdfw.com/news/business/we-messed-up-southwest-coo-apologizes-in-senate-hearing-about-holiday-travel-meltdown/3190725/.

[4] Koenig, "'We Messed Up.'"

[5] Leslie Josephs, "Southwest executive tells Senate 'we messed up' in holiday travel chaos," *CNBC*, February 9, 2023, https://www.cnbc.com/2023/02/09/southwest-senate-hearing-holiday-meltdown.html.

[6] Southwest Airlines Co., *Form DEF 14A*, p. 37.

[7] Ariel Zilber, "Southwest CEO's pay doubled to $5.3M — despite holiday travel meltdown," *New York Post*, April 7, 2023, https://nypost.com/2023/04/07/southwest-ceo-bob-jordans-pay-doubled-to-5-3m/.

[8] "Southwest CEO's compensation soars despite December debacle," *Associated Press*, April 6, 2023, https://apnews.com/article/southwest-airlines-ceo-pay-1bba0683cbdfa9e779fc4f12078f2931.

[9] Southwest Airlines Co., *Form DEF 14A*, p. 37.

[10] Jason Whitely, "Southwest Airlines partners with Texas HBCU to recruit future Black pilots," *WFAA*, May 31, 2022 (updated June 1, 2022), https://www.wfaa.com/article/news/local/southwest-airlines-partners-with-texas-southern-university-in-houston-to-recruit-future-black-pilots/287-6417a75a-6ddf-4dc0-8720-01fbec9e3613.

[11] "Sustainable Aviation Fuels," Southwest Airlines, https://www.southwest.com/citizenship/planet/sustainable-aviation-fuels/, accessed August 4, 2023.

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expensive[12]). And of course, there is no easier way to cut the company's carbon footprint than to ground thousands of flights, and so executives' ability to exceed these sustainability targets amid the shut down was likely a foregone conclusion regardless of these additional initiatives.

Paying Executives Based On ESG Metrics Hurts Shareholders

Southwest's executive pay policies distort incentives, hurting both Southwest as a company and its shareholders.

A litany of studies show that tying executive pay to ESG goals does not improve a company's financial performance. For example, a recent Stanford study examined 4,400 public companies in 21 countries to determine whether ESG-linked pay packages contributed to financial growth.[13] They did not: The study concluded that "the adoption of ESG Pay is not positively associated with better financial performance. If anything, the results point in the opposite direction."[14]

Another study from Sweden similarly found a generally negative correlation between ESG-linked pay and financial performance. The authors there sought to determine whether ESG-based executive compensation helped or hurt financial outcomes. The results were telling: even after the researchers excluded companies with CEOs that the researchers believed were less able to handle the competing demands of maximizing financial value and pursuing ESG goals, companies with ESG-linked executive compensation packages generally performed more poorly in financial terms than companies that did not incorporate ESG into executive pay, although the correlation was not statistically significant.[15] "We show that ESG targets compete with financial targets," the authors explain. For that reason, "ESG targets are not consistent with shareholders' wealth."

Nevertheless, the authors support ESG-linked compensation anyway because they believe "shareholders demand ESG in addition to wealth." The authors' argument on this point, however, is based on faulty reasoning. In particular, the authors reason that because ESG goals come at the expense of shareholder wealth, and because companies are pursuing ESG anyway, it *must* be the case that they are doing so because shareholders are demanding it.[16] That argument is specious. To the contrary, the ESG movement has been largely driven by self-interested asset managers hoping to attract new, socially-minded customers to higher-fee ESG funds at the expense of the majority of their investors who believe

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[12] "Clearing the runway for sustainable aviation fuels," *Airlines*, June 14, 2022, https://airlines.iata.org/2022/06/14/sponsored-clearing-runway-sustainable-aviation-fuels.
[13] Patrick J. Kiger, "Does it pay to link executive compensation to ESG goals?", *Stanford Institute for Economic Policy Research*, July 19, 2023, https://siepr.stanford.edu/news/does-it-pay-link-executive-compensation-esg-goals.
[14] Shira Cohen, Igor Kadach, Gaizka Ormazabal, and Stefan Reichelstein, "Executive Compensation Tied to ESG Performance: International Evidence," *Journal of Accounting Research* 61, no. 3 (June 2023): 805-853, https://doi.org/10.1111/1475-679X.12481.
[15] Swarnodeep Homroy, Taylan Mavruk, and Van Diem Nguyen, forthcoming, "ESG-Linked Compensation, CEO Skills, and Shareholder Welfare," *The Review of Corporate Finance Studies*, https://doi.org/10.1093/rcfs/cfad012.
[16] *See id.*at § 5 ("Since ESG and financial targets are competing, boards set ESG targets for CEOs more likely to succeed in these contracts. It suggests that ESG production doesn't directly lead to shareholders' wealth; hence, shareholders demand ESG in addition to wealth.").

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in shareholder primacy; this is not a movement that has been driven or demanded by owners of capital themselves.[17] Indeed, the authors themselves purport to support their argument that shareholders demand ESG by citing a PwC study showing the exact opposite: “a recent PwC survey among investors, 41% (42%) supported (opposed) ESG targets in executive compensation, even if they are inconsistent with financial returns.” Even by the authors’ own account, more investors *oppose* ESG-linked compensation than *support* it. And that gap has surely only widened since the PwC study in 2022.[18] Whereas at the time of the PwC study, 86% of investors believed pursuing ESG goals helped financial value,[19] that number has plummeted to just 31% today. Thus, there is strong reason to believe that shareholders are no longer willing to sacrifice financial return for ESG goals, if they ever were.[20]

A third study, conducted by Professors Lucian Bebchuk and Roberto Tallarita of Harvard Law School, reached a similarly critical result.[21] Professors Bebchuk and Tallarita examined executive compensation packages in 97 U.S. companies in the S&P 100 and concluded that “in almost all cases in which S&P 100 companies use ESG metrics, it is difficult, if not impossible, for outside observers to assess whether these metrics provide valuable incentives or merely line CEO’s pockets with performance insensitive pay.” As a result, “[e]ncouraging and expanding the use of ESG-based compensation . . . gives self-interested executives a powerful tool to increase their payoffs without creating any significant incentives to deliver value to either stakeholders or shareholders.”[22] Accordingly, the authors warn, “[t]he current use of ESG metrics . . . likely serves the interests of executives,” instead of shareholders.

Southwest’s policy represents the exact kind of opaque, “performance insensitive” pay Professors Bebchuk and Tallarita caution against. Notably, the other components of Southwest’s incentive pay are tethered to transparent, quantifiable, value-enhancing goals. For example, 45% of incentive pay is tied to the company’s earnings: If Southwest earns less than $1.5 billion in 2022, he gets no additional pay; at $2 billion, the executive gets 50% of his award; if Southwest earns $2.5 billion, he gets the full amount. On-time performance is another metric: If Southwest flights are on time less than 75% of the time, he receives no award; if they are on time at least 77.5% of the time, the executive gets half of his award; at 80% on-time performance, he gets the full award.

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[17] *See, e.g.*, Jed Rubenfeld & William P. Barr, “ESG Can’t Square With Fiduciary Duty,” *The Wall Street Journal*, Sept. 6, 2022, https://www.wsj.com/articles/esg-cant-square-with-fiduciary-duty-blackrock-vanguard-state-stree-the-big-three-violations-china-conflict-of-interest-investors-11662496552; Justin Danhof, “As Energy Interests Clash, Corporate America’s Green Dream Is Stuck Between BlackRock and a Hard Place,” *The Federalist*, Oct. 13, 2022, https://thefederalist.com/2022/10/13/as-energy-interests-clash-corporate-americas-green-dream-is-stuck-between-blackrock-and-a-hard-place/.
[18] Lydia Saad, “ESG Not Making Waves With American Public,” *Gallup News*, May 22, 2023, https://news.gallup.com/poll/506171/esg-not-making-waves-american-public.aspx.
[19] “Paying for good for all,” Pwc, accessed Aug. 10, 2023, https://www.pwc.com/payingforgoodforall.
[20] Tim Quinson, “ESG Strategy Receives Tough Feedback in Latest Bloomberg Survey,” *Bloomberg*, Aug. 3, 2023, https://www.bloomberg.com/news/articles/2023-08-03/esg-strategy-receives-tough-feedback-in-latest-bloomberg-survey?in_source=embedded-checkout-banner.
[21] Lucian A. Bebchuk and Roberto Tallarita, “The Perils and Questionable Promise of ESG-Based Compensation,” *Journal of Corporation Law* 48, no. 1 (2022): 37-75, https://dx.doi.org/10.2139/ssrn.4048003.
[22] Lucian Bebchuk and Roberto Tallarita, “The Perils and Questionable Promise of ESG-Based Compensation,” *Harvard Law School Forum on Corporate Governance* (blog), March 9, 2022, https://corpgov.law.harvard.edu/2022/03/09/the-perils-and-questionable-promise-of-esg-based-compensation/.

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The “ESG initiatives” category is different. Rather than utilizing any set, verifiable goals, Southwest’s “2022 Management Incentive Scorecard” simply states that the determination is “subjective.” Such a description is woefully insufficient for shareholders to be able to meaningfully understand what conduct Southwest’s compensation committee is incentivizing and how its executives are being paid. For a company whose slogan boasts about “transparency,” shareholders deserve more.
Given this research, as well as Southwest’s faltering performance during the holiday season, it is no surprise that Southwest’s stock has significantly underperformed its peers. As of July 26, the company’s stock price is down nearly 10% since its 2022 peak in late November, just prior to its December debacle.[23] In contrast, the stock prices of the other four largest U.S. airlines—American Airlines, Delta, United and Alaska—are all up over the same timeframe. Some significantly so: Both Delta and United, for example, have seen their stock prices rise over 20%, and American is up about 10%.[24] In light of the sector’s growth, Southwest’s fumbles have no doubt impacted shareholders.

Southwest Owes Its Fiduciary Duties To Its Shareholders, Not ESG Proponents

As a Texas corporation, Southwest’s board of directors “owe[s] a fiduciary duty to the corporation in their directorial actions, and this duty includes the dedication of their uncorrupted judgement for the sole benefit of the corporation”[25]—not outside stakeholders. More specifically, Texas courts have repeatedly declared that it is “corporate directors’ and officers’ duty to maximize corporate returns and [the] value of [the] corporation’s shares.”[26]

Despite these legal requirements, Southwest has abandoned its shareholder primacy obligations, and has instead embraced stakeholder capitalism, which is the theory that companies exist not just to serve shareholders, but employees, suppliers, the environment, and the communities in which they operate. This shift is evident not just from the company’s DEI reports[27] and ESG press releases,[28] but also from its

[23] “Stock Quote & Chart,” Southwest Airlines, accessed July 26, 2023, https://www.southwestairlinesinvestorrelations.com/stock-information/stock-quote-and-chart.
[24] “Airlines: Industry Performance,” TradingView, accessed July 26, 2023, https://www.tradingview.com/markets/stocks-usa/sectorandindustry-industry/airlines/.
[25] International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963) (quoted in Ritchie v. Rupe, 443 S.W.3d 856, 868 (Tex. 2014)).
[26] *Ritchie*, 368 S.W.2d; see also *Holloway*, 368 S.W.2d at 577 (“It is self-evident that it [i]s the duty of [corporate directors] to exert all efforts in behalf of [the] corporation to the end that the sale of its stock would net . . . the greatest possible return.”); Hughes v. Houston Northwest Medical Center, Inc., 680 S.W.2d 838, 843 (Tex. App. 1984) (“Corporate officers and directors owe the corporation and its shareholders a duty to act only in their best interest.”).
[27] See Southwest Airlines, *2022 Southwest Airlines Diversity, Equity, & Inclusion Report* (Dallas, TX: Southwest Airlines, 2023), https://www.southwest.com/assets/pdfs/communications/one-reports/2022-DEI-Report-Final.pdf.
[28] Southwest Airlines, “Southwest Airlines Showcases its Heart for Corporate Citizens with Release of Annual Reports,” press release, May 3, 2023, http://investors.southwest.com/news-and-events/news-releases/2023/05-03-2023-190032142; Southwest Airlines, “Southwest Airlines Continues Companywide Commitment Toward Diversity, Equity, and Inclusion,” press release, September 21, 2021, https://swamedia.com/releases/release-

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partnerships and stated commitments. In particular, Southwest's website touts the company's partnership with the World Economic Forum,[29] an organization "founded on the stakeholder theory, which asserts that an organization is accountable to all parts of society."[30] In addition to stakeholder theory, the WEF also promotes transhumanism, depopulation, equity and social emotional learning.[31] The company's website also includes a press release on its ESG efforts in which Southwest's CEO is quoted as saying Southwest is "focused on being a responsible global citizen" and committed to "act[ing] as a force for good in the business world" by establishing DEI goals, committing to achieving carbon neutrality, and reporting on its corporate social responsibility efforts.[32] Notably absent from this press release is any mention of Southwest's shareholders, much less how these extracurricular pursuits are intended to deliver long-term financial results.

There's no doubt that Southwest has been under tremendous pressure to adopt a stakeholder capitalism model in recent years, and that much of this pressure has come from its purported "shareholders." But the "shareholders" who have called for the pursuit of these non-financial goals are not the actual capital owners of your company.

The three largest asset management firms in the world—BlackRock, Vanguard and State Street—constitute three of Southwest's four largest shareholders.[33] And the Big Three have been vocal proponents of stakeholder capitalism, often imposing those views directly on Southwest. BlackRock has no doubt been the loudest of the group, imploring the companies in which it invests to engage in "conscientious capitalism"[34] and meet BlackRock's expectations in setting climate targets and increasing board diversity.[35] Vanguard and State Street have similarly foisted environmental and diversity mandates on the companies in which they invest.[36] All three have sanctioned the use of ESG-based

66d1c9ae7fd4aa2df09a33d5866e239b-southwest-airlines-continues-companywide-commitment-toward-diversity-equity-and-inclusion; Southwest Airlines, "Southwest Airlines Chairman And CEO Gary Kelly Recognized With Lifetime Achievement Award for Corporate Social Responsibility," press release, October 26, 2021, http://investors.southwest.com/news-and-events/news-releases/2021/10-26-2021-203032384.

[29] "Environmental Sustainability Initiatives," Southwest Airlines, https://www.southwest.com/citizenship/planet/, accessed August 4, 2023.

[30] "Our Mission," World Economic Forum, https://www.weforum.org/about/world-economic-forum, accessed August 4, 2023.

[31] Ethan Peck, "The Grand Conspirator: Klaus Schwab," *Human Events*, September 29, 2022, https://humanevents.com/2022/09/29/the-grand-conspirator-klaus-schwab.

[32] Southwest Airlines, "Lifetime Achievement Award."

[33] "Southwest Airlines Co. (LUV) Stock Major Holders," Yahoo Finance, https://finance.yahoo.com/quote/LUV/holders/, accessed August 4, 2023.

[34] John Frank, "Larry Fink 'ashamed' to be part of ESG political debate," *Axios*, June 25, 2023, https://www.axios.com/2023/06/26/larry-fink-ashamed-esg-weaponized-desantis.

[35] BlackRock, *BlackRock Investment Stewardship: Proxy Voting Guidelines for U.S. Securities* (New York, NY: BlackRock, January 2023), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

[36] "BlackRock, Vanguard and State Street Update Corporate Governance and ESG Policies and Priorities for 2022," Gibson, Dunn & Crutcher, January 25, 2022, https://www.gibsondunn.com/blackrock-vanguard-and-state-street-update-corporate-governance-and-esg-policies-and-priorities-for-2022/.

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executive compensation packages to meet these goals,[37] and as a result, studies show that companies with large institutional ownership, like Southwest, are much more likely to adopt ESG-linked pay packages than companies that do not.[38] Given the Big Three's devotion to ESG, it is not surprising that all three voted in favor of Southwest's ESG-linked executive compensation packages this year.[39]

But the Big Three are not the actual owners of Southwest, their *clients* are: the everyday citizens who invest in BlackRock, State Street and Vanguard funds. These investors depend on Southwest to fulfill their fiduciary duties to maximize the company's long-term value to fund their retirements, purchase homes, and pay for their children's education. **Southwest's recent pursuit of stakeholder capitalism—particularly via its ESG-linked executive compensation packages—cannot be reconciled with the fiduciary duties it owes to its shareholders.**

Speaking on behalf of the many actual owners of Southwest represented by the signatory of this letter, we respectfully urge the company to:

- Eliminate any ESG-related metrics from its executive compensation plans, and
- Commit to making all business decisions through the lens of maximizing long-term financial value for shareholders, without regard for extraneous social or environmental goals.

We look forward to engaging with you on these issues.

With best regards,

Justin Danhof
Head of Corporate Governance, Strive Asset Management

[37] Lee Anne Hagel, Hannah Orowitz, Donald Cassidy, "BlackRock Updates 2022 Proxy Voting Guidelines and Stewardship Expectations and Publishes Annual Letter to CEOs," Georgeson, https://www.georgeson.com/us/insights/esg/blackrock-updates-2022, accessed August 4, 2022.
[38] Cohen, Kadach, Ormazabal, and Reichelstein, "Executive Compensation Tied to ESG Performance," pp. 807, 828.
[39] Insightia Data (2023).

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