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How American Airlines ESG Case Could Alter ERISA Liability

By **Brantley Webb, Ankur Mandhania and Kaushik Goswami** (April 3, 2024, 5:21 PM EDT)

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In recent years, environmental, social and governance, or ESG, has transformed from a relatively obscure acronym to a hot-button political issue. One way this controversy has manifested is through state legislation restricting the use of ESG factors in the management of state investments, including state-funded retirement and pension plans.

Beyond this, efforts to scrutinize ESG activities have spread to the private sector, including corporate policies and the management of private employer-sponsored retirement plans governed by the Employee Retirement Income Security Act.

Litigants have argued that the use of ESG factors in the management of ERISA plans violates the law's requirement that fiduciaries act in the best interest of a retirement plan's participants.

Counterbalancing those arguments are the popularity of ESG investment options with plan participants as well as economic theory regarding the importance of considering all types of financial risks and opportunities in evaluating investment options, including those that involve environmental, social or governance elements.

The vigorous debate reiterates the importance of thoughtful process by fiduciaries in evaluating investment options under ERISA.

Against this backdrop, a recent case — Spence v. American Airlines Inc. — threatens to upend ERISA's well-established legal framework for fiduciary liability in the name of curtailing ESG-related activities.

On Feb. 21, U.S. District Judge Reed O'Connor in the U.S. District Court for the Northern District of Texas denied a motion to dismiss an ERISA plaintiff's complaint challenging American Airlines' selection and retention of multiple investment funds in its retirement plan.[1]

The plaintiff alleged that American Airlines violated its fiduciary duties by knowingly offering non-ESG funds that are managed by investment managers who pursue allegedly nonfinancial ESG goals more broadly, such as through proxy voting.

The plaintiff offered no allegations that such practices caused the specific investment funds offered by defendants to underperform relative to benchmarks or peer funds. If adopted broadly, the court's ruling could have far-reaching consequences for plan sponsors.

Shortly after the court denied defendants' motion to dismiss, defendants moved for summary judgment, arguing that its procedures for selecting and monitoring investment managers are prudent, in line with comparable plans, and have resulted in benefits to plan participants.[2]

The plaintiff recently filed a brief in opposition asserting the novel theory that American Airlines should have not only monitored its investment managers' ancillary ESG activities, but also ensured that those managers engaged only in activity that maximizes financial benefits to American Airlines' plan participants.[3]

The Allegations

American Airlines offers a 401(k) plan to its employees with four tiers: target date funds, index funds, actively managed funds and a self-directed brokerage window. The first two tiers include funds that are either managed by BlackRock Inc. or invest in funds that are managed by BlackRock.

The plaintiff does not contend that any fund in the first three tiers uses ESG factors in selecting investments. Instead, the plaintiff claims that the investment managers of certain of those funds engage in ancillary ESG-related activities like proxy voting in favor of carbon-neutral shareholder proposals.

That alone, the plaintiff argues, makes it a breach of American Airlines' duties of prudence — and, when combined with American Airlines' own corporate policy in favor of ESG efforts, loyalty — to permit participants to invest in those managers' funds.

The plaintiff alleges that an investment manager's broader pursuit of ESG goals is necessarily incompatible with maximizing financial benefits to investors, such that a prudent fiduciary would not have offered funds from such a manager.

And, although the plaintiff also alleges generally that funds that select investments based on ESG criteria tend to underperform their peers and benchmarks, the plaintiff does not allege that the specific funds in American Airlines' plan underperformed peers or benchmarks.

American Airlines' Motion to Dismiss

The court held that the plaintiff pled viable claims for breach of the duties of prudence and loyalty. On the duty of prudence, the court concluded that the plaintiff stated a plausible claim that American Airlines acted imprudently by selecting and retaining funds managed by entities that engaged in ESG-related activities.

The court concluded that because ERISA is directed at fiduciary process, the plaintiff's allegation that American Airlines had failed to consider investment manager ESG-related activity was enough to state a claim for breach of the duty of prudence.

The court pointed to allegations that BlackRock's vote for ESG-related measures at certain oil companies caused those companies' stocks to temporarily drop as sufficient to establish that ESG conduct is something that American Airlines should have considered.

As for American Airlines' argument that the plaintiff had not shown underperformance of any funds in the plan relative to any peer or benchmark, the dourt concluded that the U.S. Court of Appeals for the Fifth Circuit has not imposed a requirement that ERISA plaintiffs point to a "meaningful benchmark" when pleading a violation of the duty of prudence.[4] Thus, this claim was adequately pled.

The court also concluded that the plaintiff had adequately pled breach of the duty of loyalty. Here, the plaintiff alleged that American Airlines was motivated by its own nonpecuniary interest in promoting ESG initiatives, and that this motive caused it to select investment managers — and their funds — for reasons other than maximizing financial benefits for plan participants.

To support that theory, the plaintiff claimed that American Airlines has a company-wide pro-ESG policy, as exemplified by actions it has taken in a nonfiduciary role, e.g., exploring sustainable aviation fuel.

The court rejected American Airlines' argument that these actions were taken while wearing a "corporate hat" and thus irrelevant to its fiduciary conduct, explaining that "whether the company-wide ESG policy motivated Defendants' choice to invest Plan funds with ESG-oriented investment managers is a fact question that is not appropriate to resolve at this stage."[5]

As such, the court found the plaintiff's claim for breach of the duty of loyalty adequately pled as well.

Summary Judgment

While defendants' motion to dismiss was pending, the case proceeded to discovery. On Feb. 26, the defendants **moved** for summary judgment. They argue that the evidence shows the plans' fiduciaries engaged in a prudent process that was in line with peer plans and resulted in benefits to plan participants in the form of lower fees.

They further argue that the plaintiff's theory has shifted multiple times, and that his current theory — that American Airlines should have insisted its investment managers refrain from ESG-related activity — is not pled anywhere in the complaint.

In his opposition filed on March 18, the plaintiff argues that defendants failed to act prudently because they failed to monitor and stop plan investment managers from pursuing proxy votes that caused temporary dips in the share prices of certain stocks included in plan index funds.

Specifically, the plaintiff's expert concluded that one particular proxy vote — joined by multiple plan investment managers — caused a temporary dip in the share price of several energy stocks.

This, the plaintiff argues, created a loss to the plans. Notably, the plaintiff's expert also conceded that the share price quickly recovered and that the dip would have affected all comparable index funds similarly.[6]

The plaintiff further argues in his opposition that trial is warranted on his breach of loyalty claim because the evidence shows that American Airlines' corporate ESG initiatives made it more willing to allow its retirement plan investment managers to pursue ESG objectives.

Takeaways

Motion to Dismiss

The court's analysis in its opinion denying the motion to dismiss, if taken to its logical limits, could result in a massive increase in fiduciary liability.

The court's duty of prudence analysis suggests that a plaintiff can sustain a breach claim — and proceed to costly discovery — merely by pointing to some activity of an investment manager not directly related to maximizing financial benefits, and that a plan sponsor erred by not considering that activity when selecting the manager's funds.[7]

The court did not find it dispositive that the plaintiff had not alleged any connection between the investment manager's ESG-related activity and the performance of the specific funds retained by defendants. While the opinion deals directly with the pursuit of ESG goals, the logic could extend beyond those programs.

For example, some investment managers offer so-called faith-aligned products, which are designed not to invest in corporations whose products conflict with certain religious beliefs. The opinion's reasoning suggests it could be imprudent for the fiduciary of a plan covered by ERISA to offer such a product to plan participants.

Under the opinion, a plan sponsor's investment selection and monitoring process could be imprudent if it does not ask about some activity of a fund manager that a plaintiff later claims resulted in lower investment returns.

But plan fiduciaries cannot continuously ask about every ancillary action of an investment manager — or predict, in advance, which such activities may diminish returns — leaving the door open to a future plaintiff claiming that the one that just happened not to be asked about renders the entire process imprudent.

Similar issues abound with the opinion's analysis of the duty of loyalty. If a corporation's nonfiduciary goals and values can be used to portray its fiduciary decisions as disloyal, then it is easy to construct a narrative about a given plan sponsor valuing some nonpecuniary characteristic in a way that renders them disloyal.

For example, a plan sponsor who donates to a local sports team might be accused of disloyalty for hiring an investment manager who sponsors the same team, on the theory that it was motivated more by the company's desire to help the local squad win a championship than retiree benefits.

Fortunately, the opinion's sweep is more limited than that suggests. The opinion itself recognizes that courts in other circuits require a "meaningful benchmark" before deeming a fund imprudent.[8]

In those circuits, plaintiffs who want to plead a breach of the duty of prudence will be required to allege evidence that other comparable funds — whose managers did not engage in ESG-related activities — outperformed the challenged funds. Allegations that ESG funds underperform generally will not be enough.

Those arguments, at least in most courts, remain important safeguards against far-fetched claims for violation of the duty of prudence, or derivative duty-of-loyalty claims such as the one pled here. Additionally, the plaintiff abandoned his claim related to the ESG funds offered through the plan's

brokerage window.

A ruling that plan sponsors must satisfy the same fiduciary requirements for investment options provided in a brokerage window compared with a plan's regular investment options would have been a significant departure from U.S. Department of Labor guidance and practitioner understanding of brokerage windows.

Summary Judgment

More expansive is the plaintiff's theory of breach on summary judgment. He argues that the defendants should have "done something to ensure that the Plans' investment managers were not pursuing ESG objectives to the financial detriment of the plan."[9]

But ERISA does not require plan sponsors, as part of the investment selection and monitoring process, to insist or ensure that investment managers conform all of their activities to the exclusive pursuit of maximizing financial benefits.[10]

Even if everyone always agreed on what that means, plan sponsors and fiduciaries have neither the bargaining power nor the 360-degree vantage point necessary for such an undertaking.

Even attempting to do so would require plan fiduciaries to shift some of their focus from the actual investment funds in the plan to monitoring the ancillary day-to-day activities of the fund providers.

Even farther reaching is the plaintiff's theory of loss. Assuming that a plaintiff could prove that a dip in stock price is traceable to a particular action of a specific investment manager, holding plan sponsors strictly liable for such losses upends ERISA's loss framework. Any number of proxy votes, including those having nothing to do with ESG, may be alleged to influence stock price.

The plaintiff's theory would require fiduciaries to monitor every proxy vote and predict, in advance, which voting positions may negatively affect stock price — irrespective of any economic rationale offered by the investment manager.

Depending on how the court rules on the motion for summary judgment, this case may, in practice, end up reiterating the different legal standard to clear a motion to dismiss compared to a motion for summary judgment.

For example, the judge's order on the motion to dismiss allowed the case to move forward, on that basis that risk-adjusted returns against comparable funds would be better resolved on a complete record.

If American Airlines' motion for summary judgment succeeds, this could indicate that future litigants should carefully consider which arguments are best suited for each stage of legal proceedings.

Alternatively, it could suggest that raising an argument that is unsuccessful at the motion to dismiss stage could set up the argument to ultimately be successful at a later stage, such as a motion for summary judgment.

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[1] Spence v. American Airlines, Inc., et al., No. 23-cv-552, 2024 WL 733640 (N.D. Tex. Feb. 21, 2024).

[2] Spence v. American Airlines, Inc., et al., No. 23-cv-552, ECF No. 100 (Feb. 26, 2024).

[3] Spence v. American Airlines, Inc., et al., No. 23-cv-552, ECF No. 110 (Feb. 26, 2024).

[4] Spence v. American Airlines, Inc., et al., No. 23-cv-552, 2024 WL 733640, at *4 (N.D. Tex. Feb. 21, 2024).

[5] Spence v. American Airlines, Inc., et al., No. 23-cv-552, 2024 WL 733640, at *5 (N.D. Tex. Feb. 21, 2024).

[6] Spence v. American Airlines, Inc., et al., No. 23-cv-552, ECF No. 100, at 17-18 (Feb. 26, 2024).

[7] Spence v. American Airlines, Inc., et al., No. 23-cv-552, 2024 WL 733640, at *4 (N.D. Tex. Feb. 21, 2024).

[8] Spence v. American Airlines, Inc., et al., No. 23-cv-552, 2024 WL 733640, at *4 (N.D. Tex. Feb. 21, 2024).

[9] Spence v. American Airlines, Inc., et al., No. 23-cv-552, ECF No. 110, at 19 (Feb. 26, 2024).

[10] See Spence v. American Airlines, Inc., et al., No. 23-cv-552, ECF No. 110, at 28 (Feb. 26, 2024).