Simpson Thacher

Memorandum

Texas District Court Finds ESG Elements of American Airlines' 401(k) Plans Violate ERISA Fiduciary Duties

January 13, 2025

On January 10, 2025, the U.S. District Court for the Northern District of Texas issued its decision in a class action lawsuit against American Airlines and its employee benefits committee (together, "Defendants"), holding that Defendants breached their fiduciary duty of loyalty under the Employee Retirement Income Security Act of 1974 ("ERISA")[1] by hiring and retaining a third-party investment manager that ostensibly exercised shareholder rights on behalf of two American Airlines 401(k) plans (the "Plans") based on non-pecuniary environmental, social and governance ("ESG") factors because such manager was a large shareholder in American and pursued certain ESG factors that aligned with American's broader corporate policy on ESG.[2] The Court deferred ruling on questions of losses and remedies, including whether an injunction is warranted and if damages are appropriate, and requested further supplemental briefings from the parties on these questions by January 31.

Background and Decision

The class of plaintiff employees argued that Defendants breached their ERISA fiduciary duties of loyalty and prudence by mismanaging the Plans when selecting this investment manager on behalf of the Plans alleging that the manager's vocal public commitments to ESG-related goals, and actions taken to pursue those goals (including proxy voting) were harmful to the financial interests of retirement plan beneficiaries.

District Court Judge Reed O'Connor stated in the decision that Defendants "cross-pollinat[ed]" their corporate and fiduciary interests by failing to separate their corporate interests and their relationship with [the investment manager], including corporate commitments to ESG goals and a desire to comply with [the investment manager]'s ESG-related preferences[3], from their responsibility to act 'solely in the interest of the participants and beneficiaries' and for the 'exclusive purpose' of providing benefits," as ERISA's duty of loyalty requires.[4] In his analysis, Judge O'Connor cited the investment manager's role as a significant (over 5%) shareholder of American's stock, its public commitment to ESG goals and American's own corporate ESG commitments, including evidence and testimony provided demonstrating the interplay of these factors in American's pursuit of ESG-related goals

[1] Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq.

[2] Findings of Fact & Conclusions of Law, *Spence v. Am. Airlines, Inc.* (N.D. Tex. Jan. 10, 2025) (4:23-cv-00552-O), available here.

[3] *Id.* at 55.

[4] *Id.* at 66 (internal citations omitted).

and investments, stating that American's "incestuous relationship with [the investment manager] and its own corporate goals disloyally influenced administration of the [401(k)] Plan[s]."

The Court held that Defendants did not breach the duty of prudence because their actions in monitoring the 401(k) plans at issue were appropriately aligned with prevailing industry standards. However, in holding so, Judge O'Connor noted that although this conclusion is "is the result [of] a faithful application of what the law demands," it is "problematic," and encouraged the legislature to amend ERISA "to avoid future unconscionable results like those here."[5]

American has not yet stated whether it will appeal the decision.

Key Takeaways

This case presents the following takeaways for ERISA plan sponsors and fiduciaries:

- *ESG issues present a variety of different types of concerns for ERISA plan fiduciaries*. This decision is a sobering reminder that risk to ERISA plan fiduciaries arising out of ESG is not limited to the selection of investments, and that there could also be risk from the incorporation of ESG factors when voting proxies and exercising other shareholder rights on behalf of an ERISA plan. Thus, the exercise of these rights on behalf of a plan, and oversight of that process, should be carefully evaluated in the context of ERISA's fiduciary duties and applicable DOL regulations.[6]
- *The hiring and retention of plan service providers on behalf of an ERISA plan is an ERISA fiduciary function*. If a plan sponsor is publicly-traded and included in many indices, there may be material mitigation of ERISA liability risk by appointing an independent fiduciary with responsibility for the hiring and monitoring of the plan's investment managers.
- *Employers may continue to have corporate policies on ESG—but proceed with care*. The decision, which points to employees' mixed motives and involvement in the company's corporate ESG programs and goals, emphasizes the fact that plan fiduciaries should be mindful to solely focus on complying with the plan's investment policy statement and other governing materials, all of which are subject to ERISA's fiduciary duty requirements.
- *Duty of Prudence, while not found to be violated here, remains a key concern*. The Plans' fiduciaries were generally found to have prudently managed the Plans, particularly in their appointment of, and reliance on,

[5] *Id.* at 54.

[6] The DOL has issued regulations designed to guide ERISA fiduciaries in their exercise of shareholder rights in a manner that accords with ERISA's stringent fiduciary duties. *Cf. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 FR 73822 (currently in effect, as promulgated by the Biden Administration) *and Fiduciary Duties Regarding Proxy Voting and Shareholder Rights*, 85 FR 81658 (Dec. 16, 2020) (as promulgated under the first Trump Administration, later superseded by the aforementioned rulemaking under the Biden Administration). We believe the incoming Trump Administration will seek to codify an ERISA standard for ESG and proxy voting related thereto through legislation of a Republican-controlled Congress and/or seek to reverse various rulemakings issued under the Biden Administration, including, but not limited to, the aforementioned regulation related to an ERISA fiduciary's requirements with respect to shareholder rights.

established outside advisers and consultants with respect to their monitoring investment managers' performance. The use of consultants willing to act as "3(21)" advisers to a plan fiduciary can be a useful tool in establishing sound plan governance and mitigating risk to the plan fiduciary.

- *The fact pattern in the case may feel familiar to many public companies*. In finding an "impermissible cross-pollination of interests and influence on management of the Plan,"[7] Judge O'Connor points to facts that may apply to a broad range of plan sponsors: (1) a relationship with a retirement plan investment manager that itself (a) endorses (or endorsed) a sustainability-focused view of asset management, including having a record of proxy votes supporting certain ESG-related efforts, and (b) owns a substantial percentage of the plan sponsor's publicly-traded stock and/or debt; and (2) the existence of corporate ESG-related goals or programs that may broadly align with the views of the investment manager, which (3) those overseeing the retirement plan may have endorsed as part of a corporate or investment relations strategy. The decision states that it is this combination of factors, plus the failure to review, monitor and evaluate the investment manager's ESG-related positions, which "reveals Defendants' disloyalty."[8]
- *The fate of the DOL's pending ERISA "tie-breaker" rule is likely to be determined later this year*. The same Circuit Court in this case is slated to hear another argument relating to the intersection of ESG factors with retirement plans. In July 2024, the 5th Circuit (which includes the Northern District of Texas) remanded a suit led by 26 states against the Department of Labor, challenging the legality of its "tie-breaker" rule.[9] The tie-breaker rule, adopted under the Biden Administration, generally allows ERISA fiduciaries to consider climate change and other ESG-related factors when considering investment opportunities and those under consideration "equally serve the financial interests of the plan over the appropriate time horizon." The rule had overturned a prior rule disallowing such considerations that had been adopted by the first Trump Administration.

  The Northern District of Texas is now set to reconsider the suit in light of the Supreme Court's *Loper Bright* decision.[10] However, given next week's change of presidential administration, including a new Secretary of Labor nominee, the Department of Labor is unlikely to continue to defend its 401(k) tie-breaker rule.

ERISA plan fiduciaries should closely monitor how the incoming Trump Administration will shape policy with respect to sound plan governance requirements related to ESG investments and the exercise of shareholder rights related thereto. At a minimum, plan fiduciaries should continue to have a prudent process in evaluating plan investment options and seek to identify and mitigate potential conflicts of interest, if any, when hiring and monitoring plan service providers. Members of a plan committee should remain cognizant that their duties under ERISA to the plan participants and beneficiaries are separate and apart from broader company policies and goals.

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[7] Findings of Fact & Conclusions of Law, *supra* note 2, at 55.

[8] *Id*. at 68.

[9] Non-Dispositive Published Opinion, *Utah v. Su* (5th Cir. July 26, 2024) (No. 23-11097).

[10] *Utah v. Su*, 2:23-cv-016-Z (N.D. Tex.).

Such delineation between corporate policies and plan investment guidelines should be unambiguous and well documented.

More broadly and for companies and investment managers outside of the ERISA plan fiduciary context, the decision poses possible implications beyond 401(k) plans. Judge O'Connor's decision includes a lengthy discussion of what is, and is not, "ESG investing," calling on many of the principles underlying anti-ESG investing statutes that prohibit investment decisions based on non-pecuniary factors. The decision draws distinctions between making investment decisions based on an ESG factor due to the belief that a company has a responsibility to improve society, and decisions based on the same underlying factor because the manager believes it will reasonably reduce material risk. This distinction could be relevant to a variety of plan sponsors as well as to asset managers more broadly as they consider defenses to ESG-related decisions. The Court states, "Simply describing an ESG consideration as a material financial consideration is not enough. There must be a sound basis for characterizing something as a financial benefit."

The decision also points to a continuing and accelerating trend away from public ESG-related commitments and involvement in multi-stakeholder initiatives. The opinion discusses the involvement of American's retirement plan asset manager in various climate-related multi-stakeholder initiatives, including Climate Action 100+, as evidence of the firm's pursuit of ESG-related aims that are not appropriately grounded in pecuniary returns. As noted in the opinion, the investment manager subsequently departed from Climate Action 100+, marking a clear trend among financial institutions. The investment manager has also subsequently departed the Net Zero Asset Managers (NZAM) initiative, following which NZAM announced the suspension of its activities.[11] In recent weeks, three U.S. banks being investigated by Texas Attorney General Ken Paxton under the state's anti-boycott law, SB 13,[12] for alleged "boycotting" of the fossil fuel industry departed the Net-Zero Banking Alliance (NZBA), a UN-affiliated multistakeholder initiative promoting the achievement net-zero greenhouse gas (GHG) emissions within finance activities. Following the departure, the Texas AG closed his investigation of these institutions.[13]

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[11] *Update from the Net Zero Asset Managers initiative*, NET ZERO ASSET MANAGERS INITIATIVE (Jan. 13, 2025), available here.

[12] Under SB 13, Texas governmental entities must divest from financial institutions found to be boycotting the fossil fuel entities. For additional information on this and other U.S. state-level anti-ESG developments, see our ESG Battlegrounds alert, updated monthly.

[13] Press Release, Office of the Attorney General of Texas, *Following Attorney General Ken Paxton's Urging, All U.S. Based Major Banks Withdraw from Anti-Oil and Gas Net-Zero Banking Alliance* (Jan. 7, 2025), available here.

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