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401(k) Plan Fiduciaries Breached ERISA's Duty of Loyalty By Allowing ESG Interests To Influence Management Of The Plan

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Last week, Judge Reed O'Connor of the U.S. District Court for the Northern District of Texas, issued the first-of-its-kind ruling on the merits pertaining to environmental, social, and corporate governance ("ESG") investing in ERISA-covered retirement plans. In his 70-page Opinion, Judge O'Connor concluded that the plan fiduciaries of American Airlines' (the "Plan Sponsor's") 401(k) plans breached their duty of loyalty, but not their duty of prudence, by allowing their corporate ESG interests, as well as the plan investment manager's ESG interests, to influence management of the plans. The case is *Spence v. American Airlines, Inc.*, No. 4:23-cv-552 (N.D. Tex. Jan. 10, 2025).

There have been numerous media reports on the Opinion which, as one may expect, have reached a wide array of views about its implications. On the one hand, some have viewed the Opinion as being limited to the specific facts of the case. On the other hand, some have viewed the Opinion as having far reaching consequences because (i) its undertone suggests it is yet another attack on the controversial practice of ESG investing, and (ii) it seeks to upend the common practice of plan fiduciaries delegating authority for proxy voting to investment managers.

Plan sponsors and fiduciaries will want to monitor developments in this action, including how Judge O'Connor addresses the issue of damages and what is likely to become a hotly contested appeal to the Fifth Circuit. In addition, a watchful eye should be kept on another case in this District recently remanded by the Fifth Circuit, where another judge is being asked to consider a legal challenge to ERISA's ESG investing-related regulations.

Background

Bryan Spence, a participant in one of the Plan Sponsor's two 401(k) plans, sued the plans' fiduciaries under ERISA, alleging that they breached their fiduciary duties of prudence and loyalty by mismanaging certain funds in the plans' investment menus that were managed by firms that pursued non-financial and non-pecuniary ESG policy goals through proxy voting and shareholder activism. Spence contended that such mismanagement harmed the financial interests of the plans' participants and beneficiaries by pursuing ESG policy goals rather than exclusively financial returns.

The Court's Opinion

After considering the evidence presented at trial, the court concluded that the plans' fiduciaries did not breach their fiduciary duty of prudence, but that they did breach their duty of loyalty.

The court concluded that Spence did not prove that the plans' fiduciaries acted imprudently because their process was consistent with, and in some ways better than, prevailing industry standards. While the court criticized the plans' fiduciaries for failing to probe the investment manager's ESG strategy, it concluded that the plans' fiduciaries maintained a "robust process" for monitoring, selecting, and retaining investment managers, which included the following:

- The plans' fiduciaries held quarterly meetings, which included reporting from internal and external experts responsible for evaluating the plans' investment managers;
- The plans' fiduciaries hired a well-qualified, independent investment advisor through a competitive bidding process;
- The plans' fiduciaries relied on in-house investment professionals to supplement the third-party advisor's analysis, "another layer of review that few large-plan fiduciaries replicate"; and
- The plans' fiduciaries met industry standards regarding delegation and oversight of the plans' investment manager's proxy voting guidelines and practices.

Notably, the court lamented that "the 'incestuous' nature of the retirement industry" means that fiduciaries could escape liability for imprudence by following the prevailing practices of fiduciaries who set the industry standard, even where, in its view, those practices have shortcomings. The court concluded, however, that an act of Congress would be required "to avoid future unconscionable results like those here."

The court next concluded that the plans' fiduciaries violated their duty of loyalty "by doing nothing" to ensure that the plans' investment manager acted in the best financial interests of the plans. In the court's view, the following facts, taken together, proved that the plans' fiduciaries failed to act with an "eye single" toward the plans and their participants and beneficiaries:

- The investment manager was one of the Plan Sponsor's largest shareholders and held more than $400 million of the Plan Sponsor's debt;
- A member of the plans' fiduciary committee was responsible for the Plan Sponsor's relationship with the investment manager, and the record included emails among fiduciaries referencing the importance to the Plan Sponsor of its relationship with the investment manager;
- As a large consumer of fossil fuels, the Plan Sponsor had a corporate reason to be concerned about the investment manager's ESG focus, which impermissibly clouded the fiduciaries' judgment; and
- The plans' fiduciaries allowed the Plan Sponsor's corporate commitment to ESG goals to influence their oversight and management of the plans; in other words, they failed to maintain the necessary divide between their corporate interests and the investment manager's use of plan assets in the pursuit of ESG policy goals with little fiduciary oversight.

The court found that the evidentiary combination of the (i) Plan Sponsor's corporate commitment to ESG, (ii) endorsement of ESG policy goals by the plans' fiduciaries, (iii) influence of, and conflicts of interests related to, the plans' investment manager that had emphasized ESG, plus the (iv) lack of separation between the defendants' corporate and fiduciary roles, together established a convincing picture that the defendants had breached their duty of loyalty under ERISA. Whether that disloyalty was in service of the investment manager's objectives or the Plan Sponsor's own corporate goals, or both, did not matter. According to the court, the defendants did not act solely in the interests of the plans' participants and beneficiaries and thus breached their fiduciary duty of loyalty to the plans.

The court ordered the parties to submit cross-supplemental briefing within three weeks on the question of whether the plans suffered any losses and other outstanding issues.

Proskauer's Perspective

Only time will tell whether the Opinion is limited to its facts or, as some believe, will have broad consequences for the retirement plan industry. Regardless, the court's decision is notable for several reasons.

To begin with, the premise of the court's analysis was that the investment manager's ESG focus was non-pecuniary. Consistent with the Department of Labor's most recent ESG-related guidance (described here), the court acknowledged that ESG factors could be relevant to a pecuniary risk-and-return analysis where there is a "sole focus on [the] ESG factor's economic relevance." For example,the court explained that an investment manager would not be permitted to decide to divest from a company because the company lacks diversity in its leadership, but could consider the lack of leadership diversity if the investment manager believes, based on sound analysis, that it materially risks financial harm to shareholders.

The court drew consequential conclusions based on what it characterized as significant holdings by the investment manager of the Plan Sponsor's equity and debt. The case illustrates the importance of maintaining clear separation between company considerations and plan fiduciaries' deliberations. Because many large investment managers have significant holdings in major companies, the court's analysis opens the door for increased scrutiny of whether an investment manager's holdings might cloud fiduciaries' judgment. In fact, it could be argued that the very same conduct the court found was consistent with industry norms and established that the plan fiduciaries acted prudently also established that the plan fiduciaries acted disloyally.

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