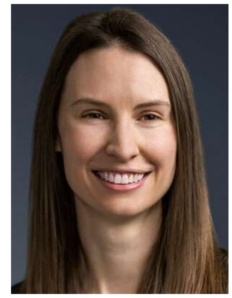
American Airlines ESG Ruling Could Alter ERISA Landscape

By **Brantley Webb, Ankur Mandhania and Kaushik Goswami** (July 22, 2024)



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On the eve of the Employee Retirement Income Security Act's 50th birthday this fall, a fast-moving case in Texas threatens to dramatically expand plan sponsor liability under the federal statute.

On June 20, Judge Reed O'Connor in the U.S. District Court for the Northern District of Texas denied a motion for summary judgment filed by American Airlines and its retirement plan employee benefits committee in Spence v. American Airlines Inc.

American Airlines had sought to put an end to a class action in which the plaintiff is contending that the defendants breached their fiduciary duties under ERISA by failing to monitor or take action to stop alleged environmental, social and governance activism by asset managers who provide investment funds in their 401(k) plan.

The trial began four days after the court denied summary judgment.

The bench trial — in which the plaintiff seeks millions of dollars in damages — has now concluded, and a decision is imminent.

Even if American Airlines prevails at trial, under the far-reaching summary judgment decision, plan sponsors may need to dedicate additional resources to evaluating proxy votes by the managers of the investment funds in their plans.

Depending on the outcome at the trial, plan sponsors also may be vulnerable to future challenges for not foreseeing even short-term dips in stock prices, which the plaintiffs may claim are traceable in some way to shareholder vote outcomes.

Background

American Airlines offers a 401(k) plan to its employees with four different tiers of investment options: target date funds, passively managed index funds, actively managed funds and a self-directed brokerage window.

BlackRock Inc. serves as the investment manager for almost all of the funds in Tier 2 — index funds — none of which are ESG funds.

The plaintiff does not challenge the performance of any of these investment funds by claiming they underperformed a benchmark, but instead claims that their investment managers engage in ancillary ESG-related activities, like proxy voting in favor of climate-focused shareholder proposals.[1]

By not monitoring or attempting to shut down those ESG-related proxy votes, the plaintiff argues, American Airlines breached its duties of prudence — and, when combined with American Airlines' own corporate policy in favor of ESG, loyalty — to participants who invest in those managers' funds.

One important assumption underlying the court's summary judgment opinion is that pro-ESG proxy vote outcomes necessarily harm investment returns. Thus, the plaintiff contends, prudent fiduciaries would not offer funds whose managers support such proposals.

The court had previously denied the defendants' motion to dismiss. Shortly thereafter, American Airlines moved for summary judgment, arguing that its process for selecting and monitoring investment managers is prudent, in line with comparable plans, and has resulted in financial benefits to plan participants.

Specifically, American Airlines pointed to: (1) its use of a reputable outside consultant; (2) the plan's well-performing index funds; and (3) contractual commitments it secured from the plan's investment managers that they would "pursue investors' financial interests when voting the [plan's] proxies."[2]

Summary Judgment Opinion

On June 20, the court denied American Airlines' motion for summary judgment. The court accepted the plaintiff's premises that ESG agendas are incompatible with the financial interests of retirement plan participants and that, by voting for pro-ESG proposals — in particular, one at Exxon Mobil Corp. — the plan's investment managers "covertly convert[ed] the Plan's core index portfolios to ESG funds."[3]
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With that in mind, the court found genuine issues of material fact regarding: (1) whether American Airlines failed to sufficiently monitor the proxy voting of the plan's investment managers; (2) whether, after learning about ESG-related proxy voting by the plan's investment managers, American Airlines took sufficient steps to force those investment managers to vote differently; and (3) whether the court should use "benchmarks and industry norms" to evaluate the plaintiff's claims.

The court also reserved for trial the question of whether American Airlines' companywide commitment to ESG caused its retirement plan fiduciaries to be disloyal to plan participants. Finally, the court found that because BlackRock owns some 5% of American Airlines' stock, and the two companies have other financial dealings, American Airlines may have been further deterred from "confront[ing] BlackRock about ESG proxy voting or other activism."[4]

Takeaways

Duty of Prudence

The plaintiff's case may dramatically increase the responsibilities of plan fiduciaries. Under his theory of ERISA liability, retirement plan fiduciaries would need to: (1) monitor all shareholder proposals and resulting proxy votes made by the managers of the investment funds offered in their plans; (2) determine which shareholder proposals are likely to negatively affect stock price (even temporarily); and (3) lobby the plan's investment managers to vote against those proposals.

The defendants have pointed out many problems with this theory, including that it is nearly impossible for plan sponsors to analyze the myriad shareholder proposals introduced at each company whose stock is held by their plan's investment funds.

As the defendants pointed out, for a large plan with multiple funds, this may include tens of thousands of shareholder proposals each year.[5] Analyzing even a fraction of those proposals would consume a disproportionate amount of plan resources, raising the costs to administer the plan and proportionately reducing plan participant account balances.

But there is a more fundamental problem with the plaintiff's theory. Even if plan sponsors could analyze the multitude of shareholder proposals each year, they cannot reliably predict the effects of shareholder vote outcomes on stock price.

Stock prices are notoriously hard to predict. Price fluctuations do not — as the plaintiff appears to assume — simply depend on whether a vote outcome is likely to increase or decrease corporate profits. Accurate prediction of short-term movements in stock price depends on an understanding of market expectations. In other words, if the vote is as the market was already expecting, the stock price may not move at all.

Trying to predict short-term event-based price impacts is a very different exercise than evaluating the expected returns of investment funds — something fiduciaries routinely do — where performance is measured based on benchmarks. In the case of proxy vote price impacts, the benchmark is missing.

It would be the market's expectations — but that is exceedingly hard to observe before the fact. Indeed, if American Airlines could accurately predict the price impacts of shareholder proposals, it would probably get out of the business of commercial aviation and into the business of investing.[6]

Ultimately, to win at trial, the plaintiff must prove: (1) that the proxy vote on the particular Exxon shareholder proposal caused a dip in stock price; (2) that it was possible for American Airlines to predict that price impact in advance; and (3) that American Airlines could have taken action to change the outcome of BlackRock's vote.

Whether the plaintiff ultimately wins or not, the court's summary judgment opinion provides some guidance to plan sponsors navigating these issues. For example, the court relies heavily on a "lack of evidence" that proxy voting was ever formally considered or discussed by plan fiduciaries before the plaintiff's lawsuit was filed.[7]

The court also noted that other (state) retirement plan fiduciaries took at least some action when they learned about ESG-related proxy voting.[8]

Loss

At summary judgment, American Airlines argued that the plaintiff lacked evidence of any reduction in plan-participant balances at the time the complaint was filed in 2023; even if the plaintiff was correct that there was a temporary dip in Exxon's stock price back in 2021, the market had subsequently corrected itself.

More generally, an unexpected proxy vote outcome may cause a temporary dip in stock price, but may lead to an overall net increase in stock price because it creates value for the company in the long term. Indeed, economists often study longer time periods precisely to strip out short-term price fluctuations.

Similarly, in evaluating shareholder proposals, investors often focus on longer-term value. Rejecting these arguments, the court held that the plaintiff could carry his burden simply by pointing to a drop in investment returns "at a point in the life of the Plan."[9]

That holding is remarkable — it suggests that an ERISA plaintiff can demonstrate loss based on a temporary drop in the value of an investment. In other words, the plaintiffs will be able to avoid summary judgment unless the plan sponsor can show that the challenged investment fund went up in value throughout the entire relevant period.

Curiously, the court holds — in a footnote — that the defenses to such loss theories that are available in securities cases may not "be applicable in an ERISA breach-of-fiduciary duty context."[10] Read broadly, that holding would work a tremendous change in ERISA law, forcing plan sponsors to become guarantors that the funds placed on a plan lineup will never go down.

That said, there are reasons to doubt the court intended to sweep so broadly.

First, the opinion assumes, but does not yet decide, whether the plaintiff's expert's analysis is admissible under the federal rules."[11] The defendants argue that the plaintiff's expert misapplied his methodology in ways that stacked the deck toward finding a price dip — including by adopting a 50% threshold for statistical significance, instead of the usual 5%.[12]

Second, while most courts hold that temporary reductions in market value are insufficient to establish loss under ERISA, here, the court holds the opposite in part based on the plaintiff's theory that the plan sponsor was acting disloyally.[13]

Duty of Loyalty

The court made clear at summary judgment that corporate ESG commitments do not, alone, establish disloyalty. There must be evidence that the company "allowed their corporate goals to influence their fiduciary obligations."[14] However, the evidence the court found sufficient was a conversation endorsing ESG objectives between the company's director of sustainability and a plan fiduciary.

As part of its reasoning, the court assumed that ESG goals are incompatible with the financial interests of plan participants. This all imposes a very light standard for the plaintiffs at summary judgment, and suggests that plan fiduciaries should be careful to separate their corporate and fiduciary roles at all times.

But it is the court's ruling on BlackRock's influence over American Airlines that may be the most significant aspect of its decision. The court found that BlackRock's 5% ownership stake in, and other financial relationships with, American Airlines could lead a reasonable fact finder to conclude that American Airlines had an ulterior motive to "further the interests of BlackRock."[15]

BlackRock — like other large investment managers — owns shares of stock in many of the nation's largest corporations. The court's determination that this creates a "circular" relationship, and potential conflict of interest for retirement plan fiduciaries, is a conclusion that could pose tricky ERISA questions.

For example, can a plan sponsor select funds from an investment manager who owns a substantial share of the company's stock? If the fiduciary genuinely believes that the investment manager's products are superior, is it obligated to pick a second-best option merely to avoid the appearance of a conflict of interest?

Conclusion

Should the plaintiff prevail, it could foretell a dramatic expansion in ERISA liability. Not only would plan fiduciaries be responsible for selecting and monitoring prudent investments, they may also be obligated to micromanage the proxy votes of the plan's investment managers, or try to do so.

However, the court may not adopt such a sweeping approach. For example, it might hold that plan sponsors should simply have a process to monitor proxy voting by plan investment managers to issue spot votes that are out of line with the managers' own proxy voting policies.

Plan sponsors might also be able to rely on proxy voting services to avoid liability — although a widespread reliance by ERISA plans on such firms would likely further consolidate the influence of a handful of proxy advice firms on corporate decision-making.[16]

What should plan sponsors take away at this point? At this time, this is only one district court opinion without precedential impact. Nonetheless, plan sponsors could consider implementing a mechanism for evaluating their investment managers' proxy voting process.

This could include reviewing the investment managers' proxy voting policies and requiring manager certifications that they voted their proxies in accordance with policy. Plan fiduciaries should also take steps to distinguish between the actions they take in their fiduciary capacity versus those taken when acting in a nonfiduciary, corporate capacity.

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[1] Publicly traded US companies hold annual meetings in which shareholders are eligible to vote on a slate of proposals. Because votes are usually submitted by fund managers rather than beneficial owners, these votes are known as "proxy votes."

[2] Defendants' Mot. for Summary Judgment, at 1.

[3] Summary Judgment Op. at 3. Plaintiff offered evidence at summary judgment that certain ESG-labeled funds underperformed, but did not offer evidence that all ESG goals at the corporate level necessarily harm investment returns.

[4] Summary Judgment Op. at 31.

[5] Defendants' Proposed Findings of Fact and Conclusions of Law, at ¶ 106.

[6] Even if a plan sponsor could accurately predict the immediate price impacts of particular shareholder proposals, it is unclear how they would then satisfy their fiduciary obligations. In its summary judgment opinion, the court notes that investment managers have scaled back "ESG activism after facing an onslaught of pressure" at the state-level. Summary Judgment Op. at 38. Less clear is whether lobbying by a single (or even multiple) plan

sponsors would cause investment managers to alter their proxy vote decisions.

[7] Summary Judgment Op. at 18.

[8] Summary Judgment Op. at 26 n.111.

[9] Summary Judgment Op. at 36.

[10] Summary Judgment Op. at 36 n.142.

[11] Summary Judgment Op. at 35 n.136.

[12] Defendants' Mot. to Exclude in part Expert Testimony of J.B. Heaton.

[13] Summary Judgment Op. at 36-37.

[14] Summary Judgment Op. at 30.

[15] Summary Judgment Op. at 32.

[16] See, e.g., https://www.law360.com/articles/1852106/attachments/0 at 3.