ESG RELATED LITIGATION – PAST HISTORY AND CURRENT ISSUES

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Overview

The leading hot topic in pension plan management, both public and private, is the emergence of disputes concerning environmental, social, and governance considerations in plan investments.

What is ESG?[1] It is an institutional investment standard which focuses decision-making on issues beyond standard investment metrics. These approaches may involve active proxy voting, company engagement and public policy work. ESG may alternatively be an active strategy and can be the consequence of a traditional investment strategy.

In earlier years, ESG was referred to as social investing. The question is whether an institutional investor can "do well" (achieve the desired investment return at an acceptable rate of risk) while also "doing good" (achieving a result deemed to have a positive societal goal). These general purposes seek to incorporate these issues into the investment decision-making process as a means to enhance returns and reduce risk.

Mission related investing is a more focused type of ESG and is closely aligned with the mission of the organization. For example, one large church pension plan will not invest in stocks relating to gambling, firearms, alcohol, or private prisons. Church plans have even greater flexibility as they are not regulated by either by state law or ERISA.[2] The decision to invest or refrain from investing in certain industries is deemed a matter of faith and is exempt from judicial

[1] https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp#:~:text (last visited 10/21/2023)
[2] 26 U.S.C. § 414e; https://www.irs.gov/pub/irs-tege/epchd403.pdf

or legislative interference under the First Amendment of the U.S. Constitution and comparable state constitutional provisions respecting freedom of religion.[3]

Another facet of ESG is sustainable investing. This philosophy is generally focused on investments in companies addressing issues relating to conservation of natural resources, such as energy, air, water and reducing risk associated with climate change.

Billions of dollars of public and private pension money have been placed into economically targeted investments (ETI's) which are designed to create jobs, boost local economies, or create affordable housing. The Labor Department began issuing responsible investing guidance for ERISA plans as early as 1994.[4] Fund trustees were reminded that loyalty to the plan, diversification, and prudence were the primary investment determinants. Responsible investing was criticized for failure to provide a solid economic return to the pension fund. Later research has not shown a compelling economic difference. Focus has shifted from negative screening (limiting the opportunity set) to positive screening, yielding a more balanced approach of integrating the ESG principles into the overall investment decision-making process.

In 2022, the Department of Labor issued guidelines for private pension fiduciaries that favored the use of ESG Principles.[5] The DOL rules marked a departure from guidance issued in 2020 which limited investment consideration solely to "pecuniary" concerns.[6] After the adoption of the 2022 rules, Congress adopted a resolution urging the White House to repeal the most recent

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[3] Sanzone v. Mercy Health, 499 F.Supp.3d 627 (E.D. Missouri 2020)
[4] 59 FR 38860 (7/29/1994)
[5] https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights
[6] 85 FR 72859 (11/13/2020)

guidance. President Biden vetoed the Congressional resolution to repeal the DOL's pro-ESG rule on March 23rd. [7]

More recently, a federal court upheld those DOL rules against a constitutional challenge. Twenty-six state attorneys general and two private parties challenged the 2022 Investment Duties Rule issued by the Department of Labor for ERISA plans. For 30 years, the rule did not forbid consideration of non-financial investment factors where the risks and rewards were substantially equal. The 2020 Rule altered this practice by expressly prohibiting the use of non-pecuniary factors unless the fiduciary was unable to distinguish investments on pecuniary factors alone and added special reporting requirements. The 2022 Rule eliminated the pecuniary/non-pecuniary analysis and reinstated the prior rule which permitted the use of ESG factors when investments would otherwise equally serve the best interest of the retirement plan and its participants. In a surprising decision, the U.S. District Court in the Northern District of Texas found that the Rule's allowance of ESG considerations was reasonable because in the over-all analysis, the ESG sensitive investments were required to perform on the same basis as all other investments in terms of risk and expected return.[8]

ESG had previously been approved in the context of a political decision by the plan sponsor rather than a highest and best rate of return investment.[9] The Maryland high court held that requiring South African divestment did not impair the pension contract or subvert the purposes of the System when the plan sponsor adopting the requirement was willing to bear any economic consequences of the political decision. Similarly, the West Virginia Supreme Court of Appeals

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[7] https://www.reuters.com/business/sustainable-business/biden-vetoes-resolution-block-labor-dept-rule-esg-investing-2023-03-20/

[8] *State of Utah v. Walsh*, 2023 WL 6205926 (N.D. Tex. 9/21/23)

[9] *Board of Trustees v. City of Baltimore*, 562 A.2d 720 (Md. 1989).

found that a legislatively mandated investment did not impair the constitutional rights of members in their pension. The West Virginia Legislature passed a bill directing the state investment board to invest $150 million of the state retirement fund assets in the jail authority for ongoing construction and renovation projects. The investment was for five years and had a guaranteed investment return equal to the fixed income portfolio of the system, but not less than 5%. The pension board refused to transfer the $150 million based on its belief that it impaired the rights of members to their constitutionally guaranteed pension benefit. The appeals court disagreed holding that as long as the state continued to pay the benefits of members that the contractual right to a pension was not impaired. The court held that the contract right was not in the assets, but rather as to the "promised pay." The court held it was also constitutional to direct the pension board's power to invest.[10]

A number of states have passed laws restricting investment by public retirement plans on the basis of international geopolitics as well as industry protection.[11] Most recently, in response to efforts to boycott Israel, a number of states adopted anti-BDS (Boycott-Divest-Sanction) statutes.[12] A First Amendment challenge to anti-BDS laws was recently rejected on the basis that participants in a defined benefit retirement plan have no direct legal interest in the underlying assets.[13] A beneficiary of two Texas state retirement systems filed suit claiming that a Texas law requiring

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[10] *State Regional Jail and Correctional Facility Authority v. West Virginia Investment Management Board*, 508 S.E.2d 130 (W.Va. 1998).

[11] For example, North Dakota Century Code 21-10; Idaho Stat. 67-2345; Tex. Gov't Code Ch. 809; Ok. Stat. 74-12002. See generally, https://corpgov.law.harvard.edu/2023/03/11/esg-battlegrounds-how-the-states-are-shaping-the-regulatory-landscape-in-the-u-s/ (last visited 10/21/2023)

[12] https://en.wikipedia.org/wiki/Anti-BDS_laws#:~:text=Most%20anti-BDS%20laws%20have,to%20avoid%20entities%20boycotting%20Israel. (last visited 10/22/2023)

[13] *Abdullah v. Paxton*, 2022 WL 127204 (W.D. Tex. 2022), *aff'd* 65 F.4th 204 (5th Cir. 2023)

divestment of any company boycotting the State of Israel violated his First Amendment and Due Process rights under the U.S. Constitution. A federal district court dismissed the case for lack of standing because the member's defined benefits were unaffected by the statute. On review, the U.S. Court of Appeals affirmed. The court found that the plaintiff lacked any actual injury as the member's defined benefits under the retirement systems were not dependent on specific investments. Therefore, any divestment, to the extent it caused a loss to the plans, would be borne by the state and would not result in a loss of benefits. On the Free Speech claim, the court found that the divestment statute did not interfere with the member's right to speak. His contention that the divestment statute limited free speech of the pension fund was without merit because he could not claim a loss of a third party's rights. The U.S. Supreme Court denied review in October 2023.[14]

This is not the first instance of foreign policy playing a role in pension investing since the 1989 Baltimore decision (see footnote 9). Geopolitics has been a feature of pension divestment for more than 15 years. For example, in 2007, the Illinois Legislature adopted the Illinois Act to End Atrocities and Terrorism in Sudan. The act attempted to impose various restrictions on the investment of public pension funds in Sudan-connected entities and on the deposit of state funds in financial institutions whose customers have certain links with Sudan. Among other things, the Act amended the Illinois Pension Code to prohibit the fiduciary of any pension fund established under the Code from investing in any entity unless the company managing the fund's assets certified that the fund managing company has not loaned to, invested in, or otherwise transferred

[14] *Abdullah v. Paxton,* ____S.Ct.___, 2023 WL 6378509 (10/2/23). Perhaps ironically, state, and local retirement systems hold more than $3.5B in Israel bonds and tens of millions more have been purchased by pension plans since October 7. 2023. (https://israelbonds.com) (last visited 11/25/2023)

any of the retirement system or pension fund's assets to a forbidden entity any time after the effective date of the Act. Several Illinois municipal pension funds and beneficiaries challenged the constitutionality of the statute in a suit brought under 42 USC 1983 against the state treasurer and attorney general. The plaintiffs argued that the Act is preempted by federal law governing relations with Sudan, interferes with the federal government's ability to conduct foreign affairs, violates the Constitution's Foreign Commerce Clause, and is preempted by the National Bank Act. The court recognized that the Illinois legislature acted with laudable motives. The Federal District Court for the Northern District of Illinois held that the Illinois act violated various federal constitutional provisions precluding the states from "taking actions that interfere with the federal government's authority over foreign affairs and commerce with foreign countries." The District Court enjoined the state from enforcing the act.[15] Later that year Congress authorized states to enact such laws. In the years which followed, a number of states outlawed investment with countries (Syria, Iran, North Korea) deemed hostile to the United States. Since the outbreak of the most recent hostilities in the Middle East, additional Iran sanctions particularly targeting Chinese companies invested in Iran, were adopted in a special session of the Florida Legislature[16].

The state legislative activity has not universally been anti-ESG. The California legislature mandated that the two state funded retirement systems, the California Public Employees Retirement System (CalPERS) and the California Teachers Retirement System (CalSTRS) divest of ownership in thermal coal (coal used to power electrical plants). While the statute created a

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[15] *National Foreign Trade Council v. Alexi Giannoulias,* 523 F.Supp.2d 731 (N.D. Ill. 2007).
[16] HB 5C, amending Section 215.473, Fla. Stat. (2023)

fail-safe for fiduciary concerns the message was clear.[17] Vermont considered divestment of all fossil fuels but did not adopt the statute.[18]

Florida adopted a particularly complex anti-ESG bill in 2023. Creating a new Florida Statues, Section 112.662, the bill prohibited consideration of any investment other than on a "pecuniary" basis, which employs language from the 2020 version of the DOL guidelines. The bill also adopted a requirement that all proxies be voted utilizing the same guidelines. Such laws have posed a challenge to investment managers who employ ESG concepts at the core of their investment strategies. This may have the effect of forcing managers to choose between creating parallel investment policies or deciding not to bring their products to markets with anti-ESG laws.

Current Litigation

A former American Airlines pilot filed suit in the U.S. District Court for the District of Texas claiming that the airline's pension trustees (for both the pilots' 401(k) plan and the general employees' 401(k) plan) violated their fiduciary duty by including ESG themed funds in their investment line-up which prioritized ESG goals over investment return.[19] The suit also claims that some funds which invest based solely on pecuniary factors used their proxy power to support ESG objectives. The airline responded that no such funds exist within its investment alternatives for plan participants and further, the plaintiff never invested in any of the options whose investment objectives he challenges. As such, the airline contends he lacks standing to bring the case.

Under the American Airline plans, an employee may choose from a family of mutual funds selected and monitored by the plan fiduciaries. In the alternative, an employee may open a self-directed brokerage account that enables the employee to choose from thousands of mutual funds,

[17] Cal. Gov't Code § 7513.75
[18] Vt. Senate Bill 42 (2023)
[19] *Spence v. American Airlines*, Case No. 4:23-cv-00552 (N.D. Tex. 2023)

exchange-traded funds, and individual stocks, at the employee's own risk. The challenged funds were available on the platform outside of the selections by the fiduciaries. The complaint was amended to add an additional count challenging the programs he did invest it claiming their performance was sub-par and that ESG favorable proxy voting practices were employed. Among the challenged funds is a BlackRock index fund. As the Plaintiff had not invested in any of the funds outside of the trustee curated selections, his broader complaint has also been challenged for lack of standing. The motion to dismiss was recently denied and the case will proceed. At the same time, on November 21st, the Plaintiffs filed a motion for class certification seeking to include all plan participants from June 1, 2017, through the date of judgment.

New York City's divestment of fossil fuels led to a suit filed in May.[20] The plaintiffs, who are participants in the various city retirement plans, contend that divestment has caused damage to the plans. In addition to the named employees, the suit is also supported Americans for Fair Treatment, an Oklahoma based conservative nonprofit organization that helps public workers opt out of unions. In August, the Boards of Trustees moved to the dismiss the case based on lack of standing. The motion argues that because the because the pensions are defined benefit plans, the plaintiffs' fixed retirement benefit will not be changed by good or bad investment decision making. The funds cite to the 2020 decision of the United States Supreme Court in *Thole v. U.S. Bank N.A.*[21] dismissing an ERISA claim for the same reason.

At the other end of the spectrum, a retired Oklahoma public employee sued the state treasurer to halt enforcement of the Energy Discrimination Elimination Act[22] which effectively

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[20] *Wong v. NYCERS*, Index No. 652297/2023(N.Y. Sup. Ct. May 11, 2023)
[21] 140 S.Ct. 1615 (2020)
[22] 74 Okl.St.Ann. §12001, et. seq.

bars business with investment firms taking ESG considerations into their decision making. The complaint alleges that divestment by the Oklahoma retirement system will have a $10M negative impact and is contrary to the state constitutional provision requiring retirement plans to be operated for the exclusive benefit of the members and beneficiaries.[23] More than 50% of the retirement fund is managed by BlackRock, one of the scrutinized companies. The suit also alleges that the law violates the retirees' First Amendment rights and is unconstitutionally vague.[24] The Act does have a fiduciary exception and the act does not apply to indirect holdings in actively or passively managed funds or to private equity.[25] Citing that provision, the Board of Trustees of the state retirement system declined to divest of certain holdings. This has led to an escalating battle between the state attorney general, who is a trustees of the pension fund, and the remainder of the board. The Oklahoma law has also reportedly had adverse impacts on local governments resulting in delayed bond projects or payment of higher interest.

In 2020, and as amended in 2023, the Montana Legislature adopted the Montana State Energy Policy Act[26] which forbids the State and its agents from considering the impacts of greenhouse gas emissions or climate change in their environmental reviews for the express purpose of perpetuating a fossil fuel-based energy system. Shortly after adoption of the 2020 act, a group of sixteen Montana youths filed suit challenging the constitutionality of the acts.[27] Specifically,

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[23] *Kennan v. State*, et. al., CV-2023-2762 (Dist. Ct. Okla. County 11/20/2023)

[24] While the 5th Circuit in *Abdullah* held that a member could not assert the pension board's free speech rights, a 2022 decision of the U.S. Supreme Court held that similar boards do have cognizable rights of free speech. In *Houston Community College System v. Wilson,* 142 S.Ct. 1253 (2022) a university board of trustees was held to have First Amendment rights when it censured one of its members.

[25] 74 Okl.St.Ann. §12003

[26] Mont. Code Ann. § 90-4-1001, as amended by Mont. Code Ann. §75-1-201(2)(a)

[27] *Held v. State of Montana*, *et al*, Cause No. CDV-2020-307 (1st Judicial Dist. Court 2023)

the Youth Plaintiffs alleged that the laws violated provisions of the state constitution protecting the rights of youths[28] and guaranteeing a healthy environment for current and future generations[29].

The Attorney General of Montana sought to derail the litigation by asking the state supreme court to take control of the litigation, but a unanimous Montana Supreme Court rejected the request. It called the Attorney General's claim of public emergency as a "manufactured" emergency and "disingenuous at best."

While the case was pending, multiple legislative maneuvers were made to change the law at issue and resulted in the 2023 provisions of HB 170, repealing Mont. Code. Ann. § 90-4-1001 and substituting, through HB 971, the provisions of Mont. Code. Ann. § 75-1-201(2)(a) which prohibited the consideration of greenhouse gas emissions and climate change in environmental reviews.

Following a lengthy trial which included multiple experts and tens of thousands of pages of exhibits, the District Court (state trial court) issued a 103-page order upholding the claims of the Youth Plaintiffs in their entirety. The trial court struck down provisions of the limitations as contrary to the constitution of the state and held that the plaintiffs proved the elements of damage to themselves and the environment. The entry of a final judgment is pending and will assuredly lead to an appeal of the case to the Montana Supreme Court.

This case is significant for two reasons. First, it puts express constitutional provisions relating to quality of life, which have been deemed fundamental to individual citizens, in direct conflict with the legislature's interest in protecting the fossil fuel industry. Second, this is the first

[28] Art. II, Sections 3,4, 15 and 17, Montana Constitution
[29] Art. IX, Sections 1 and 3, Montana Constitution

suit to target environmental regulators acting under statutes which are presumptively valid until a court holds otherwise. The appeal warrants close monitoring.

While these cases remain pending either at early stages of pleading or on appeal, it is unclear what impact the decision in *State of Utah v. Walsh* (see footnote 8), upholding the 2022 DOL rules will have on these cases.

It is clear, however, that politicization of fiduciary investment practices remain unsettled for the near future. For example, Nebraska[30] and Louisiana[31] have bills pending that empower consumers and the Attorney General to sue over consideration of ESG principles by the plan fiduciaries in both investment and proxy decisions. In addition, it extends to proxy voting advisors who recommend shareholder initiatives opposed by management or even external "consumer" interests.

Litigation Trends and Observations

There have been some commonalties observed in the current ESG related cases. The trends are worth exploring together with the expected defenses:

1. For providers defined benefit plans, the case law has been generally unchanged. Benefits are not dependent on assets. This means members of plans have no injury. Plans that base benefits in part on returns, such as surplus benefit arrangements, may be subject to claims for the same reasons as defined contribution plan providers.
2. For providers of defined contribution plans, there is substantial litigation alleging excessive fees and poor performance. Courts are increasingly critical of copy-cat cases

[30] LB 743
[31] SB 5; HB 902

which parrot general allegations of failure of fiduciary duty but lack specific analysis. Courts are also increasingly less interested in claims of excessive fees.

3. Standing, or a specific legal interest, is the most common defense. General allegations without an allegation of actual injury have fared poorly in recent court decisions.
4. Fiduciaries who are legislatively mandated to follow statutory restrictions find themselves with a dilemma. Failure to abide by statutory limitations exposes the fiduciary to litigation risk from the state seeking to enforce a legislative mandate.
5. Abiding by legislative mandates which are clearly injurious to the plan and risk an increase in employer contributions places the fiduciary at risk from participating employers. This "Catch 22" may require the fiduciary to seek declaratory relief from the courts as to its duty and where its immunities (like sovereign immunity or discretionary immunity) may be found.
6. The *Held* case in Montana shows that de-carbonization is largely a regulatory issue which should be managed by the regulators. Using institutional investment trusts as a proxy for regulatory legislation will have the same practical effect as a tax. If fiduciaries find that fossil fuel investments are poor business decisions, then the market will offer alternatives. However, de-carbonization through divestment, without regard to its impact on the investment trust assures lower returns which are directly passed on to the taxpayer through higher employer contributions. As noted above, this is no different than imposing a tax to specifically fund shortfalls created by divestment.
7. The liability for trustees is very real. The trustees, administrator and general counsel of the San Diego City Employees Retirement System were indicted in both state and federal court simply based on their approval of an actuarial valuation that enabled a

union-city collective bargaining agreement in 1996. The indictments, issued in 2005, were bitterly litigated for 5 years, finally ending when the California Supreme Court dismissed the case in 2010. The federal charges were dismissed shortly thereafter. During that time, most of the defendants (trustees and staff) were forced into personal bankruptcy due to the high cost of legal fees in two separate judicial systems at the same time and several resulted in divorces as a result of the strain on their families.

8. The only certainty is that uncertainty will continue for the near future and legal fees will increase. The best path for any investment fiduciary is to follow the prudent investor rules articulated in 14A V.S.A. § § 901-902 and VPIC's statutory mandate in 3 V.S.A. § 523.

Analysis of S 42 (4/10 House Draft)

The April 10th draft of S.42, while addressing some of the concerns previously raised still remains problematic. The goal of a cleaner environment is not the issue. "Doing well" (successful investment results) is not antithetical to "doing good." However, doing well must be a prudent investor's overarching goal, and doing good being an aspirational by-product.

The legislative regime and the governmental purpose behind the establishment of VPIC is to focus trust investments on achieving the highest and best return with a reasonable degree of risk and assigning that task to an apolitical, professional body. Directing VPIC to make investment decisions based on a timetable without regard to the financial needs of the retirement systems to pay benefits as and when they arise is contrary to the basic rules of fiduciary prudence. S.42 creates exceptions for fiduciary considerations, but the inclusion of deadlines

invites, rather than discourages litigation. It also artificially limits future investment opportunities which will be reflected in increased actuarial costs.

A prudent fiduciary VPIC has sought investment in private markets which avoid the volatility of public markets and ask as a buffer against public market uncertainty. Steady investment growth with reasonable risk avoidance is the fiduciary's primary goal. Engagement with the fossil fuel industry will not be possible at the same time divestment is occurring. There is little incentive for a corporation to respond to your concerns as a shareholder when your goal is not to be a shareholder. By telling the companies you are required to "leave the table" in a time certain, it encourages corporate foot-dragging.

A prudent fiduciary recognizes his or her ability to move the market in response to ESG or other related concerns. Vermont's relatively small size as an institutional investor makes it easier for asset managers to simply decline to do business, as some have already done in state's with anti-ESG statutes. Fiduciary management does not lend itself to arbitrary legislative direction, no matter how well-intentioned it may be. VIPC's focus must remain solely and exclusively on what is in the best interest of the retirement systems whose assets it has been entrusted with.

Sections 3 and 4 of the bill are confusing and contradictory. Section 3 provides for maximum damages and indemnification. Section 4 says there is no private right of action against an individual. There should be no right of action at all. The $2,000,000 cap invites rather than discourages litigation. It suggests that someone could claim to be damages even if they have no connection to the retirement systems at all. If no person can be sued as provided in Section 4, then what is there to indemnify? The language in the current draft would allow expensive litigation against VPIC (and possibly its contractual advisors) by someone who disagrees with

VPIC's fiduciary decision making. That undermines the independence of the Commission and its staff, which is directly contradictory to the purpose for the agency's creation. Even if no individual can be sued, there appears to be nothing to prevent a participating employer whose contributions are increased as a result of divestment from filing suit against VPIC. This has occurred in other jurisdictions. See, e.g., *New Orleans Firefighters' Pension and Relief Fund v. City of New Orleans*, 157 So.3d 581 (La. 2015) (City authorized to sue Board of Trustees for breach of fiduciary duty as a result of poor investment decisions increasing city contribution).

There should be no cause of action that can be brought against a governmental agency for its discretionary decision making. There should be no liability for damages of any kind. Members and beneficiaries have a defined benefit which is the constitutional responsibility of the taxpayers to ensure payment of retirement annuities in full and on time. The "public" suffers no injury because a broad and unrestricted investment program is the greatest assurance of their costs being stable.

In summary, S.42 is designed to fix a problem which does not exist. The current provisions of prudent investor laws are deigned to assure that VPIC will maintain its exclusive duty of loyalty to the participants of the retirement systems. Nothing prohibits them from considering achievement of ESG (inclusive of fossil fuel) goals when it does not adversely affect their ability to prudently maximize returns. By imposing the divestment mandate, the Assembly is telling the fiduciary not to put the best interests of the pensioners first. That is in direct contravention to the prudent investor laws. Can VIPC do good while doing well? Yes, but the ultimate decision making cannot be taken from VPIC without doing harm to its exclusive benefit obligations.