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District Court Ruling Opens the Door for Challenges Against Companies with ESG Initiatives

A Texas district court's recent denial of a motion to dismiss a case challenging an airline's hiring of investment managers that pursued environmental, social, and governance ("ESG") investment goals is a signal that more plan sponsors that have ESG initiatives could be targeted with similar lawsuits. While this case is still in the preliminary stages, a final ruling could have significant impacts on companies and investment managers adopting ESG policies.

Background

In June 2023, a pilot employed by a major airline filed a class action complaint in the U.S. District Court for the Northern District of Texas against the airline on behalf of participants and beneficiaries of the airline's 401(k) plan. The lawsuit alleges that, in its capacity as plan sponsor, the airline breached its ERISA fiduciary duties by selecting, including, and retaining funds whose managers pursued ESG objectives instead of focusing exclusively on maximizing financial benefits for the plan's participants. In general, ERISA requires a plan fiduciary to act solely in the interest of participants and to act prudently; a fiduciary must also monitor the activities of the plan's investment managers.

The plaintiff alleged that when the airline hired the plan's investment managers, it knew that they pursued non-financial ESG policy goals – such as investments that support combatting climate change – through what the plaintiff called "shareholder activism." As a result, according to the plaintiff, the airline failed to properly investigate and monitor the fund managers' "activism," allegedly costing participants millions of dollars in lost earnings because of the focus on socio-political outcomes rather than the exclusive prioritization of financial returns. The plaintiff pointed to several specific actions taken by plan's investment managers (who are not defendants in the lawsuit themselves) that allegedly showed "ESG activism" was more important than participants' investment returns, such as one manager reportedly voting against management at companies over climate-related concerns.

Denial of Motion to Dismiss

In a February 21, 2024 ruling, the North District of Texas denied the airline's motion to dismiss the case, finding that the plaintiff's complaint contained sufficient facts to survive at this stage. To survive a motion to dismiss, a plaintiff is not required to present detailed factual allegations, but they must plead enough facts to state a claim to relief that is plausible on its face. The court concluded that the airline's failure to properly consider certain information about ESG investments that it knew or should have known – such as their "known poor performance" compared to non-ESG investments – gives rise to a plausible inference that the company's conduct resulted in a violation of its fiduciary duties, which is all that is needed to survive a motion to dismiss. One example the court cited to support its ruling is the plaintiff's allegation that the plan's investment managers cast proxy votes that caused stocks in major oil companies to fall, thereby reducing participants' returns on those particular investments.

Implications of Ruling

While this case still has far to go before a final ruling, many plans and investment managers have expressed concern that it lowers the threshold for a claim to survive a motion to dismiss, which could mean that more plan sponsors and managers who have similar cases brought against them in the future might have to spend significant resources on defending themselves against a lawsuit. Another concern for plans is that this case appears to be one of the first lawsuits targeting the private sector on the issue of ESG investing, a topic which has garnered nationwide attention in recent years.

In addition, because the lawsuit targets several of the country's largest investment managers, a final decision in the case could have a major impact on the investment strategies of managers that are collectively responsible for trillions of dollars in retirement savings. For plans and investment managers that have adopted ESG policies – which is becoming more and more common – this case is one to watch.

IRS Warns Against Using FSA, HRA and HSA funds to Pay Nutrition, Wellness and General Health Expenses

Sounding a familiar refrain, the IRS on March 7 issued an alert to taxpayers and health FSA and HRA administrators reminding them that personal expenses for general health and wellness are not considered medical expenses and thus cannot be paid from these accounts. HSAs can be used to pay non-medical expenses, but the distribution will be treated as taxable income and may be subject to an additional excise tax.

Background

The IRS said it issued the alert "because some companies are misrepresenting the circumstances under which food and wellness expenses can be paid or reimbursed under FSAs and other health spending plans."

In general, health FSAs and HRAs may only reimburse medical care expenses incurred by the accountholder, their spouse or dependents. HSAs are slightly different because they technically can be used for anything, but only reimbursements for medical care expenses are excludible from taxable income.

Subject to certain special rules, what is and is not a medical care expense for these purposes is defined by Code section 231(d). Under that rule, medical care expenses generally include amounts paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease." Significantly, this definition does not include expenses incurred for an individual's general health or wellbeing.

IRS Alert

The impetus for this alert, according to the IRS, is that:

> Some companies mistakenly claim that notes from doctors based merely on self-reported health information can convert non-medical food, wellness and exercise expenses into medical expenses, but this documentation actually doesn't. Such a note would not establish that an otherwise personal expense satisfies the requirement that it be related to a targeted diagnosis-specific activity or treatment; these types of personal expenses do not qualify as medical expenses.

To illustrate the issue, the IRS alert provides the following example:

> A diabetic, in his attempts to control his blood sugar, decides to eat foods that are lower in carbohydrates. He sees an advertisement from a company stating that he can use pre-tax dollars from his FSA to purchase healthy food if he contacts that company. He contacts the company, who tells him that for a fee, the company will provide him with a 'doctor's note' that he can submit to his FSA to be reimbursed for the cost of food purchased in his attempt to eat healthier. However, when he submits the expense with the 'doctor's note', the claim is denied because food is not a medical expense and plan administrators are wary of claims that could invalidate their plans.

The last part of the example is significant because, as noted, health FSAs and HRAs may not allow reimbursements for non-medical expenses. If they do, they will lose their status as "qualified" plans – meaning that all participants will be taxed on all distributions, regardless of whether they are for medical care expenses or something else.

IRS Announces Continuation of Pre-Examination Pilot Program

The Internal Revenue Service ("IRS") announced that it would be starting the second phase of its Pre-Examination Retirement Plan Compliance Program pilot, under which the agency notifies retirement plan sponsors ahead of time that they have been selected for an upcoming examination. Plan sponsors then have the opportunity to review their plans and correct certain errors, reducing the chance that an error will be discovered by the IRS during its examination.

Overview

On February 7, 2024, the IRS published an announcement in its Employee Plans Newsletter publicizing the continuation of the Pre-Examination Retirement Plan Compliance Program pilot. The pilot program, which was first launched by the IRS in June 2022, is intended to reduce the amount of time spent on plan examinations and encourage plans to self-correct errors.

Under the program, retirement plan sponsors are notified in a letter that their plan was selected for an upcoming examination by the IRS, which the agency conducts to ensure plans are compliant with their plan terms and applicable law. Following the letter, plan sponsors are given a 90-day window to review their plan documents and operations for possible compliance failures. If the plan sponsor discovers an error that is eligible to be corrected under the IRS's Employee Plans Compliance Resolution System ("EPCRS") Self-Correction Program ("SCP"), then it can self-correct the error prior to examination within the 90-day window. The EPCRS allows retirement plans to correct certain types of errors, such as the failure to follow the plan terms, issues with participant loans, and certain problems with the plan document (e.g., the failure to keep the document current to reflect new changes in the law).

For a plan that discovers mistakes that cannot be self-corrected, they can request a closing agreement, which is an agreement between the IRS and a taxpayer addressing a specific issue or tax liability, typically requiring the taxpayer to pay a penalty. In this case, the pilot program uses the fee structure associated with the EPCRS's Voluntary Correction Program ("VCP") to determine the penalty amount the plan will pay. The VCP's fee structure is much less costly than the fee structure typically used in closing agreements.

After reviewing the plan sponsor's documentation, the IRS will determine whether the sponsor has appropriately self-corrected any mistakes. Then, the IRS will issue a closing letter or conduct either a limited or full-scope examination. If a plan sponsor does not respond within the 90-day window, the IRS moves forward with scheduling an examination as usual.

Benefits of Program & Looking Forward

Once a plan is under examination by the IRS, plans cannot use the VCP, and the SCP is available only in very limited circumstances. The pre-examination program gives plan sponsors an opportunity to catch errors prior to undergoing an examination, which could reduce the cost of corrections.

The IRS reported in its February 7th announcement that during the first phase of the program, 100 pre-exam compliance letters were mailed to plan sponsors, with a 72% response rate. The IRS's announcement indicates that at the end of the pilot, the agency will evaluate the effectiveness of the pilot and decide whether the program will continue.

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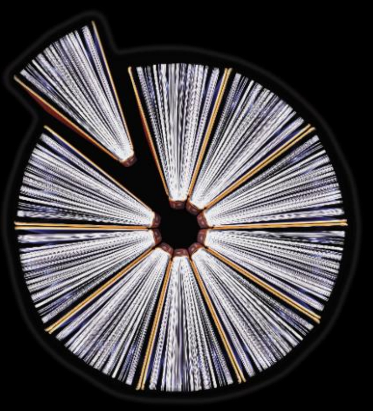

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