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Texas and Maine Approaches to Fossil Fuel Divestment a Cautionary Tale for Investment Managers

State and local governmental plans, which are excluded from ERISA, are subject to idiosyncratic legal requirements, including specific investment restrictions. These plans are also not immune to the political winds blowing in that state. Nowhere is this more apparent than recent developments out of the States of Texas and Maine with respect to fossil fuel divestment. Investment managers of any governmental plan, especially those that take environmental, social and governance (ESG) factors into account, should pay close attention to these developments. Private equity and other fund managers, for the reasons stated below, should also take note.

Texas

On June 14, 2021, Texas Governor Greg Abbott signed into law SB 13. This new law, which goes into effect on September 1, 2021, generally prohibits state governmental entities, including the Employees

Retirement System of Texas and the Teacher Retirement System of Texas, from directly or indirectly holding the securities of a publicly-traded financial services, banking or investment company that "boycotts" companies that (i) explore, produce, utilize, transport, sell or manufacture fossil fuel-based energy and (ii) do not "commit or pledge to meet environmental standards beyond applicable federal and state law…." The concept of "boycott" is not limited to divestment; rather, it picks up activity that is designed to inflict economic harm on the energy company. The exercise of certain shareholder rights could possibly amount to a "boycott" of a company.

The law also generally prohibits governmental entities from contracting with a service provider unless the contract provides a written verification from the service provider that it does not boycott energy companies and will not boycott energy companies during the term of the contract. This applies to contracts entered into on or after September 1, 2021.

Fiduciaries of these Texas governmental plans remain subject to countervailing fiduciary duties under Texas law, including the Texas Constitution. The new law crucially allows for breathing space between these core fiduciary duties and the state's interest in protecting significant portions of its economy.

The law provides that these governmental entities are not required to divest from any holdings in "actively or passively managed investment funds or private equity funds." However, the governmental entities are required to submit letters to the managers of these funds requesting that they remove from the portfolio financial companies that the state comptroller has designated as boycotting energy companies. The Texas governmental entities will alternatively request that the managers "create a similar actively or passively managed fund with indirect holdings devoid of listed financial companies." Investment managers should be on the lookout for these letters starting this coming Fall.

Maine

Meanwhile, in Maine, the House of Representatives recently passed a bill that calls for the divestment of fossil fuel companies by the Maine Public Employees Retirement System (Maine PERS) and other permanent state funds by 2026. As with Texas, the law is sensitive to the overriding fiduciary duties that apply to the management of these assets. An official for Maine PERS recently testified that, "[p]ermanently striking broad portions of the financial market is incompatible with earning optimal returns for member retirements, will not change corporate behavior, and may not advance the social goals sought because investments are rarely one dimensional."

Takeaways

Governmental plans invested in separate accounts or commingled funds managed by an investment manager have always posed risks to that manager, as these plans are subject to their own fiduciary duties and investment restrictions. Though the state laws applicable to governmental plans may contain ERISA-like language, we caution investment managers from relying on ERISA or DOL guidance as a failsafe way to manage governmental plan assets. As evidenced from the disparate approaches the States of Texas and Maine have taken, investment managers should pay close attention to the specific rules applicable to these plans to avoid running afoul of state law. With the calls for fossil fuel divestment growing louder in some quarters, and as other ESG issues come to the fore, careful due diligence on the part of investment managers is essential.

Please contact George Michael Gerstein to discuss these matters or other due diligence issues related to governmental plans.

For more information, please contact:

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