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What ESG Investing Ruling Means For Fiduciaries

By **Richard Shea, Jason Levy and Jack Lund** (October 20, 2023, 3:50 PM EDT)

Richard Shea

In a surprise decision on Sept. 21, the U.S. District Court for the Northern District of Texas issued a ruling upholding the Biden administration U.S. Department of Labor's environmental, social and governance investing rule for Employee Retirement Income Security Act plans.

This is a welcome decision for retirement plan fiduciaries who have been buffeted by partisan noise and misinformation about whether they can consider ESG factors in ERISA investment management decisions.

Jason Levy

The decision clearly articulates the governing standard from the ERISA statute as interpreted by the U.S. Supreme Court: ESG factors may be considered for the sole purpose of maximizing risk-adjusted financial returns for plan participants and beneficiaries.

While, consistent with the governing law, the decision is clear that ERISA fiduciaries cannot consider ESG factors to further nonfinancial policy goals, it also drives a nail in the coffin of an argument that ESG factors are per se incompatible with risk-return investing.

Jack Lund

Background

On Nov. 22, 2022, the DOL released the Biden rule. It replaced and made modifications to parts of the Trump administration DOL ESG investing rule for ERISA plans.

In so doing, the DOL noted that the purpose of this new rule was, in part, to address "the chilling effect and other potential negative consequences caused by the [Trump rule] with respect to the consideration of climate change and other [ESG] factors."

The Biden rule, and the Trump rule that preceded it, both fell within a familiar pattern of prior ESG regulations and guidance.

Going back at least 30 years, there has been a ping-ponging between administrations. The media has tended to portray Republican regulations and guidance as restricting the ability of ERISA plans to make ESG investments, and to portray Democratic regulations and guidance as making it easier to make ESG investments.

Although that discussion highlights the atmospherics of the issue, the actual legal impact of these

regulations and guidance has, on balance, been quite small.

Ultimately, the binding rule governing ERISA fiduciary investment management decisions comes from ERISA itself, as interpreted by the Supreme Court.

Both are clear that fiduciary investment management decisions should be made for the exclusive purpose of maximizing financial returns on a risk-adjusted basis in order to provide the benefits due under the plan and to defray the reasonable costs of administering the plan.

The Biden rule, like the final version of the Trump rule, falls within this framework. It provides that consideration of ESG factors may be appropriate when reasonably determined to be relevant to a risk-return analysis — but generally not for a collateral purpose of achieving nonfinancial goals.

Both the Trump and the Biden rules contain a narrow exception to this prohibition to permit consideration of nonfinancial collateral benefits, including nonfinancial ESG benefits, to break a tie between potential investment choices. This exception applies only in rare circumstances and, in our experience, is seldom used in practice.

Misperceiving the Biden rule as favoring or requiring the consideration of ESG factors, the U.S. Congress used a process established by the Congressional Review Act to formally disapprove of and overturn that rule.

Then, issuing a statement mischaracterizing the Trump rule as foreclosing the consideration of ESG factors, President Joe Biden used his first veto to override the misbegotten congressional action.

It is against this confused legal background that plaintiffs in Texas, in Utah v. Walsh, and the U.S. District Court for the Eastern District of Wisconsin, in Braun v. Walsh in February, filed suits to overturn the Biden rule and replace it with the Trump rule.

Both suits charged that the Biden rule violated ERISA by impermissibly encouraging ERISA fiduciaries to select ESG investments for collateral or nonfinancial purposes.

Texas Decision

In an opinion cutting through much of the partisan noise, the Northern District of Texas upheld the Biden rule, focusing on a nonpartisan technical legal analysis of the ERISA statute and related case law, and the actual language of the Trump and Biden rules.

The Texas court concluded that the Biden rule changed little of substance from the Trump rule and prior guidance.

Determining that the Supreme Court's 2014 decision in Fifth Third BankCorp v. Dudenhoeffer controlled the issue, the district court judge held that, when making investment decisions, ERISA plan fiduciaries have the freedom to consider ESG factors — along with any other relevant financial factors — for the sole purpose of maximizing risk-adjusted financial returns.

The ruling made clear that where a fiduciary reasonably determines that an investment strategy will maximize risk-adjusted returns, a fiduciary "may pursue the strategy, whether pro-ESG, anti-ESG, or entirely unrelated to ESG."

This neutral standard requires that the assets of ERISA-governed retirement plans be invested to maximize the financial benefits of retirement plan participants and their beneficiaries — and not according to the political preferences of the plan fiduciaries.

This general legal standard has applied since at least 1974, when ERISA was passed into law, and, historically, it has not been controversial or partisan.

Between the Trump rule, the Biden rule and the Texas decision, it should now be clear that this legal standard applies with as much force with respect to ESG investment as to any other investment strategy.

This consensus should blunt the rhetorical and partisan claims that ESG factors are never (or always) relevant to financial decisions made by the fiduciaries of retirement plans.

Takeaways for Retirement Plan Fiduciaries

While an appeal in this case or a different result in the Wisconsin case, which is still pending, are always possible, the persuasive authority created by the Texas court's clear opinion should not be understated — particularly given the fact that the Northern District of Texas has not been shy about enjoining federal administrative action with which it has disagreed.

Still, while the Texas district court ruling provides welcome clarity for ERISA plans, ESG investing issues are likely to remain an area of focus for ERISA-covered retirement plans over at least the intermediate term.

For example, in June, a proposed class action was filed alleging fiduciary breaches in the selection of a number of ESG funds offered in two of American Airlines Group Inc.'s 401(k) plans. This was the first case challenging the selection of ESG funds in 401(k) plans.

The complaint itself appears to take for granted the notion that ESG investment is per se incompatible with ERISA — rather than articulating a theory as to why individual ESG funds available to participants in the American Airlines plans were selected without fidelity to the requirement that the funds in question maximize risk-adjusted returns.

In light of the Texas district court ruling, this blunderbuss argument seems even less likely to survive scrutiny.

Nonetheless, investment decisions are highly fact-intensive, and decisions to make ESG investments or offer — or not offer — ESG funds in plan investment lineups should continue to be supported by the kind of rigorous analytical process that supports any other investment decision.

ERISA fiduciaries might also consider documenting, in their investment policy statements, how investment managers may, or may not, analyze ESG financial factors with respect to different investment strategies.

Finally, there is likely to be significant turbulence ahead for non-ERISA plans, as fiduciaries of those plans contend with state laws and pending bills that would limit the fiduciaries' ability to select investment products that maximize financial returns because of the products' perceived relationship to ESG factors,

either pro or contra.

Perhaps state governments will ultimately come to adopt — or readopt — the bipartisan national standards articulated in the recent Texas court decision, but, until then, politically charged pro- and anti-ESG state bills seem likely to proliferate.

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