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Employee Benefit Plan Review

U.S. District Court for the Northern District of Texas Upholds New ERISA Rules on Environmental, Social and Governance Investing

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A federal district judge in the U.S. District Court for the Northern District of Texas has upheld the U.S. Department of Labor's new ERISA regulations on environmental, social and governance (ESG) investing.

The case, *State of Utah v. Walsh*,[1] had been brought by 26 state attorneys general and private plaintiffs who alleged that the new rules, which took effect on February 1, 2023 (New Rules), violated the Employee Retirement Income Security Act of 1974 (ERISA) and were arbitrary and capricious under the Administrative Procedures Act (APA).

The decision by Judge Matthew J. Kacsmaryk, an appointee of former President Trump, upholds the Labor Department's interpretations under ERISA that plan fiduciaries may consider ESG factors when evaluating the risk-weighted returns of investment options, but should not give extra weight to ESG factors in choosing investments. The decision thus affirms the Labor Department's long-standing focus on risk-weighted financial returns as the touchstone for compliance with ERISA fiduciary duties.

Background

The New Rules[2] made two changes to the rules under ERISA pertaining to a fiduciary's consideration of ESG factors in making plan investments.

First, the New Rules eliminated language in rules adopted in 2020 that required fiduciaries to base investment decisions "only on pecuniary factors."[3] In place of the pecuniary/non-pecuniary distinction, the New Rules provide that the choice of an investment "must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis. . . . Risk and return factors may include the economic effects of climate change and other environmental, social or governance factors on the particular investment or investment course of action."[4]

Second, the New Rules permit fiduciaries to consider collateral benefits (such as ESG factors) as a tiebreaker if competing investments "equally serve the financial interests of the plan over the appropriate time horizon,"[5] rather than requiring that the competing investments be economically indistinguishable as under the rule promulgated in 2020.

The primary concern by plaintiffs in *Walsh* was that the New Rules promoted ESG investing at the literal expense of retirement plan beneficiaries by allowing fiduciaries to choose an investment based on "collateral benefits," rather than requiring fiduciaries to act "with the sole motive of promoting the financial interests of plan participants and their beneficiaries" under ERISA Section 404(a)(1)(A).[6]

Plaintiffs also alleged that the New Rules were arbitrary and capricious under the APA because, among other things, the Labor Department ignored relevant considerations and failed to consider alternatives.[7]

The Court's Decision

The court analyzed the New Rules under the *Chevron* framework applicable to administrative rulemaking and held that the New Rules were consistent with ERISA and a reasonable exercise of the Labor Department's rulemaking authority. The court's primary reasoning for upholding the New Rules was that they are supported by the Labor Department's prior rulemakings.[8] The New Rules "change little in substance" with respect to a fiduciary's duties.

The court declared that, under the prior rules:

> [A]n ESG factor could be worth consideration if it "is expected to have a material effect on the risk/return of an investment." 85 Fed. Reg. 72884. Similarly the [New Rules] state that risk and return factors may include ESG factors under some circumstances, but those factors must still reflect "a reasonable assessment of its impact on risk-return."[9]

The court held likewise that there was "little meaningful daylight" between the old and new tiebreaker provisions: "[w]here the 2020 Rule explained that collateral factors may be considered when a fiduciary is 'unable to distinguish' between two investment options based on financial factors alone, the 2022 Rule allows the same when the two options 'equally serve the financial interests of the plan.'"[10] The "little meaningful daylight" between the rules was of particular import to the court's decision, because plaintiffs had "approvingly" held out the 2020 rules as properly reflecting "ERISA's focus on *financial* benefits."[11]

The court also held that the Labor Department's rulemaking was not arbitrary and capricious. The court found that the Department of Labor had adequately explained the reasons for its rule changes (including the purported chilling effect that the 2020 rules had on fiduciaries' consideration of pertinent information when making investments).[12] The DOL also had fulfilled its duties to "consider the alternative of issuing sub-regulatory guidance instead of amending the regulation itself."[13]

Conclusion

The *Walsh* opinion does not itself turn over any new ground on interpretation of ERISA or the New Rules. But the fact that a conservative federal judge upheld the Biden Labor Department's rulemaking on a hot-button issue (though the opinion is still subject to appeal) suggests that the New Rules may stay in their current form for the foreseeable future. The opinion makes clear that, after stripping away the rhetoric, the New Rules are merely a continuation of longstanding Labor Department policy.

As the Labor Department said, "the final rule makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating a thumb on the scale in *favor* of ESG factors."[14]

Fiduciaries, in other words, should evaluate ESG factors just like any other potential factor in their risk-return analysis. ✪

Notes

1. State of Utah v. Walsh, Case No. 2:23-cv-00016-Z (2023).
2. Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73822 (Dec. 1, 2022) (amending 29 C.F.R. Part 2550).
3. See 85 Fed. Reg. 72884.
4. 29 CFR § 2550.404a-1(b)(1)(4).
5. 29 CFR § 2550.404a-1(c)(2).
6. State of Utah v. Walsh, Case No. 2:23-cv-00016-Z (N.D.Tex. 2023), DE-1, at ¶¶135-137.
7. Id. at ¶¶150-173.
8. State of Utah v. Walsh, Case No. 2:23-cv-00016-Z (N.D.Tex. 2023), DE-109, at 6.
9. Id. at 9, citing 29 C.F.R. §2550.404a-1(b)(4).
10. Id. at 7.
11. Id.; see also id. at 11 ("Plaintiffs again fail to distinguish the [New Rules] from the 2020 Rule.").
12. Id. at 11.
13. Id. at 13.
14. 87 Fed. Reg. 73831 (italics original).

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