Federal Court Rejects States' Challenge to DOL's ESG Investing Rule

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On September 21, 2023, a federal judge in Texas granted summary judgment in, and thus dismissed, a lawsuit filed by the Attorneys General of 25 states and other interested parties challenging a final rule issued by the U.S. Department of Labor (DOL) regarding the use of certain environmental, social and governance (ESG) considerations by fiduciaries in their investment decision-making.[1] The final rule (Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights (the 2022 Rule)) took effect on January 30, 2023.

Background

The key factor with respect to ESG investing in the context of the Employment Retirement Income Security Act of 1974 (ERISA) is the extent to which ESG factors may be considered by a fiduciary consistent with the fiduciary's duties of loyalty and prudence to plan participants and beneficiaries. Although, historically, the DOL has taken a more expansive or restrictive view of the issue based on the then current presidential administration, it has consistently posited that a fiduciary is not precluded from considering collateral or non-pecuniary benefits in the selection of competing investments that serve the plan's economic interests equally.

In 2020 the DOL issued regulations (the 2020 Rule) indicating that ESG factors may only be considered in a tiebreaker situation where fiduciaries are unable to distinguish between investments on the basis of pecuniary factors alone. The 2020 Rule also imposed a stringent documentation requirement where ESG factors were employed. In subsequent comments received by the DOL in response to the 2020 Rule, commentators expressed confusion over whether ESG factors could ever be considered financially material.

To address these concerns, the DOL issued the 2022 Rule clarifying that ERISA fiduciaries may take into account ESG factors that are relevant to an investment's expected risk-return, restating the ESG tiebreaker rule, but not to obtain collateral benefits. The 2022 Rule also eliminated special requirements concerning the selection of qualified designated investment alternatives (QDIAs), as well as the monitoring and recordkeeping requirements which previously had to be employed with respect to proxy voting.

A coalition of states[2] subsequently brought suit in January 2023 alleging that the 2022 Rule "undermines key protections for retirement savings of 152 million workers – approximately two-thirds of the U.S. adult population and totaling $12 trillion in assets – in the name of promoting ESG factors in investing, including the Biden Administration's stated desire to address climate change." The plaintiff's complaint further alleged that the 2022 Rule was both arbitrary and capricious and overstepped the statutory authority granted the DOL under ERISA.

Applicable Standard of Review

In analyzing whether the 2022 Rule violates ERISA, U.S. District Judge Matthew J. Kacsmaryk invoked the analytical framework outlined in *Chevron USA Inc. v. Nat. Res. Def Council, Inc.,* 467 U.S. 837 (1984), requiring courts to first analyze whether Congress has directly spoken to the question at issue and assuming that Congress has not addressed the issue or the statute is ambiguous, courts must second determine whether the agency's rule was either "manifestly contrary to statute" or "arbitrary and capricious" and must not disturb the agency's ruling unless so.

In applying this two-part framework, Judge Kacsmaryk determined that the DOL prevails at both steps. First, insofar as ERISA does not contemplate the possibility of two financially equivalent investment options, Congress has not spoken to the question at issue. Secondly, the reasonableness of the DOL's interpretation is supported by its prior rulemakings which posit that ESG factors may have a financially material impact on the value of an investment and failure to consider them, in certain circumstances, could constitute a violation of a fiduciary's duty of prudence.

The 2022 Rule is Consistent with ERISA

In its 2020 rulemaking, the DOL determined that collateral factors may be considered when a fiduciary is "unable to distinguish" between two financially equivalent investment options. The 2022 Rule reworked this tiebreaker test somewhat, allowing the use of ESG factors when fiduciaries are faced with two options that "equally serve" the plan's financial interests. Although the latter test is understood to be less burdensome than the former, Judge Kacsmaryk determined that this modification changes little between the two rules.

The court further observed that the DOL clarifies in its 2022 Rule, even where collateral benefits are considered in a tiebreaker situation, a fiduciary must not "accept expected reduced returns or greater risks to secure such additional benefits." 29 C.F.R. § 2550.404a-1(c)(2). Rather, the 2022 Rule "makes unambiguous that it is not establishing a mandate that ESG factors are relevant under every circumstance, nor is it creating an incentive for a fiduciary to put a thumb on the scale in favor of ESG factors." 87 Fed. Reg. at 73831.

Thus, after granting the DOL the deference it should be afforded under *Chevron*, Judge Kacsmaryk concluded that the 2022 Rule was not manifestly contrary to ERISA.

The 2022 Rule is Neither Arbitrary nor Capricious

In analyzing whether the 2022 Rule satisfies the "arbitrary and capricious" standard set forth under the Administrative Procedures Act (APA), Judge Kacsmaryk noted that the court should not substitute its own judgment for that of the agency. Nevertheless, the agency must have considered all important aspects of the problem, examined all relevant data and be able to "articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made."

In enacting the 2022 Rule the DOL explained that its prior position on ESG considerations, as set forth in its 2020 Rule, created confusion and had a "chilling effect" on fiduciaries' invocation of ESG factors, even when pertinent to their investment decision, as evidenced by the comments received by the DOL in response to the 2020 ruling. To allay these concerns, the DOL issued the 2022 Rule, clarifying that risk-return considerations can include ESG factors, but need not to where an ESG-focused investment is not in fact prudent.

The plaintiffs also raised a number of alternative arguments, similarly dispensed with by Judge Kacsmaryk, regarding the elimination of the prohibition on proxy voting rights to promote non-pecuniary goals (already required of fiduciaries), the removal of restrictions on qualified default investment alternatives (QDIAs) (most commentators felt the restrictions unnecessary), the elimination of the collateral benefit disclosure requirement (already required of fiduciaries) and whether the DOL could have accomplished its objectives through the issuance of sub-regulatory guidance as opposed to an amended regulation (sub-regulatory guidance would not have eliminated the "chilling effect" created by the 2020 Rule).

After considering all of these factors, the court held that the plaintiffs failed to establish an APA violation and, thus, ruled in favor of the DOL on summary judgment.

Implications of the Ruling

Although the DOL initially expressed skepticism over the venue and requested a change – which was rejected – Judge Kacsmaryk – a Trump-appointee – found in favor of the agency, noting that "while the Court is not unsympathetic to plaintiff's concerns over ESG investing trends, it need not condone ESG investing generally or ultimately agree with the Rule to reach this conclusion."

Meanwhile, a separate lawsuit challenging the 2022 Rule, filed by two individual plan participants in the U.S. District Court for the Eastern District of Wisconsin, Milwaukee Division, is still ongoing.

[1]*Utah v. Walsh,* N.D. Tex., No. 2:23-cv-00016, 9/21/23.

[2]The states participating in the suit were Utah, Texas, Virginia, Louisiana, Alabama, Alaska, Arkansas, Florida, Georgia, Indiana, Idaho, Iowa, Kansas, Kentucky, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Carolina, Tennessee, West Virginia, and Wyoming.